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Bank Capital Regulation by Enforcement: An Empirical Study

JULIE ANDERSEN HILL*

Improving commercial bank capital requirements has been a top priority on the regulatory agenda since the beginning of the 2008 financial crisis. Unfortunately, some of the information necessary to make informed decisions about capital regulation has been missing. Existing regulations establish numerical capital requirements. Regulators, however, have significant discretion to set higher capital requirements for individual banks. In considering necessary reforms, regulators often focus on specific numerical requirements but sometimes ignore enforcement efforts. Without clear information about capital enforcement, it is impossible to make informed judgments about the current capital regulation system.

This Article provides a more complete picture of capital enforcement. It reports an empirical study of all publicly available formal capital enforcement actions between 1993 and 2010. The data, compiled from 2350 enforcement actions, reveal four significant insights. First, the number of capital enforcement actions has dramatically increased during the current economic downturn. Second, an increasing number of banks are subject to individual capital requirements—requirements that are higher than the requirements specified in statutes and regulations. Third, the data suggest that enforcement rates are not consistent among bank regulators. In particular, the Federal Reserve is less likely than other regulators to bring serious capital enforcement actions and is less likely to increase capital requirements. Fourth, the data show a near-complete absence of capital enforcement actions issued to the largest banks.

The Article examines the proper role of this discretionary enforcement. It concludes that a capital regulation system that relies heavily on individual bank capital requirements is troublesome. This type of discretionary capital enforcement can be ineffective and costly. Moreover, the focus on individual bank conditions can blind regulators to macroeconomic problems. Instead, policymakers should work to create capital rules that are sufficient without significant discretionary capital increases.

* Assistant Professor of Law, University of Houston Law Center. I am grateful to Michael Hill for his editing and assistance with the study data. I am also grateful to Paul Andersen, John Buchman, Timothy Canova, Anna Gelpert, Erik Gerding, Lonny Hoffman, Joe Sanders, Spencer Simons, Jeffrey Schwartz, and David Zaring for their helpful comments on this Article. Earlier versions of the Article were presented at The George Washington University Law School's Center for Law, Economic, and Finance Junior Faculty Workshop, the Southeastern Association of Law Schools Annual Conference, Arizona State's Southwest/West Junior Faculty Conference, a University of Denver faculty workshop, a South Texas College of Law faculty workshop, and the University of Houston Law Center's colloquium series. The Article benefited greatly from the many comments I received from participants at these conferences and workshops.

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INTRODUCTION

Since the financial crisis began in 2008, the banking world has been in turmoil. More than 300 U.S. banks have failed.¹ Even more will likely fail in the future.² Amid this carnage rises a near-uniform call for regulatory reform; the only question is what reform is necessary. When a reporter asked Treasury Secretary Timothy Geithner about his priorities for reform he said, “The top three things to get done are capital, capital and capital.”³ Secretary Geithner is not alone in his view.⁴ Congress, through the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), has instructed bank regulators to establish new capital requirements for banks.⁵ Regulators, however, have not yet determined what their new capital rules will require.⁶ This Article informs the debate over capital requirements by providing a more complete picture of past capital regulation.

1. Robin Sidel, *Sterling Bancshares Puts Itself on Block*, WALL ST. J., Jan. 14, 2011, at C1. As used in this Article, the term “bank” refers to federally insured commercial banks and thrifts. It does not include credit unions, foreign banks, bank holding companies, financial holding companies, or investment banks.

2. See Joe Adler, *How Many to Fail; Do We Hear 1,000?*, AM. BANKER, Mar. 23, 2009, at 1; John R. Engen, *M&A in 2010: The Year of the No-Frill Deal*, BANK DIR., Jan. 1, 2010, at 38.

3. David Leonhardt, *Heading Off the Next Financial Crisis*, N.Y. TIMES MAG., Mar. 28, 2010, at 36.

4. See Cheyenne Hopkins, *Regulatory Revamp Newest Plank in Obama’s Platform*, AM. BANKER, Mar. 28, 2008, at 1 (noting President Barack Obama’s support for capital regulation reform).

5. 12 U.S.C.S. § 5371 (LexisNexis 2010). The new capital requirements cannot be lower than the existing bank capital requirements and must address “the risks that the activities of such institutions pose, not only to the institution . . . but to other public and private stakeholders in the event of adverse performance, disruption, or failure of the institution.” *Id.*

6. John Walsh, Acting Comptroller of the Currency, Remarks at the Exchequer Club (Jan. 19, 2011), available at <http://www.occ.treas.gov/news-issuances/speeches/2011/pub-speech-2011-5.pdf> (noting that “notice of proposed rulemaking to implement [new capital] standards is just getting underway and final rules lie well into the future”); *Oversight of Dodd-Frank Implementation: A Progress Report by the Regulators at the Half-Year Mark*:

Capital is the amount by which a bank's assets exceed its deposits and other liabilities.⁷ When a bank experiences a loss, the losses first reduce capital. Once capital is depleted, losses fall on depositors or the deposit insurer. Adequate bank capital protects depositors (or the deposit insurer) from losses.⁸

By law, banks must maintain specific ratios of capital to assets. Most simply, banks must maintain at least a 4% leverage ratio—the bank's capital divided by its assets must equal at least 4%.⁹ Although the existing regulatory framework sets numerical capital requirements, it leaves regulators significant discretion to increase capital requirements for individual banks.¹⁰ For example, a regulator can require a bank to maintain more capital if the bank is operating in an unsafe or unsound manner.¹¹ Regulators implement discretionary increases in capital requirements through capital enforcement actions.

In considering capital adequacy reforms, policymakers often focus on specific numerical requirements but sometimes ignore the structure of the regulatory system and the role discretionary enforcement plays.¹² Perhaps this is because little academic research has examined regulators' discretionary capital enforcement.¹³ How often do bank regulators bring capital enforcement actions? How often do regulators exercise their discretion to depart from the numerical capital requirements? How much capital do regulators require? Are different bank regulators consistent in their enforcement of capital standards? Do regulators treat large banks and small banks similarly? This Article provides a better understanding of the answers to these questions through an empirical analysis of capital enforcement actions.

After first offering an overview of existing bank capital statutes, regulations, and agency guidance,¹⁴ this Article reports an empirical study of all publicly reported formal bank capital enforcement actions issued between 1993 and 2010.¹⁵ By

Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs, 112th Cong. 47 (2011) (written testimony of Sheila C. Bair, Chairman, FDIC) (“[T]he banking agencies are . . . developing rules to implement Basel III proposals for raising the quality and quantity of regulatory capital . . .”). The new rules will be informed by Basel III, an international framework for regulating capital at internationally active banks. *See generally* BASEL COMM. ON BANKING SUPERVISION, *BASEL III: INTERNATIONAL FRAMEWORK FOR LIQUIDITY RISK MEASUREMENT, STANDARDS AND MONITORING* (2010), available at <http://www.bis.org/publ/bcbs188.pdf>. However, because Basel III focuses on internationally active banks, U.S. regulators retain significant autonomy in the development of capital regulation for the thousands of U.S. banks that are not internationally active. Walsh, *supra*.

7. George G. Kaufman, *Capital in Banking: Past, Present and Future*, 5 J. FIN. SERVICES RES. 385, 385 (1991).

8. RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* 252–53 (4th ed. 2009).

9. *See infra* Part I.A.

10. *See infra* Part I.B.

11. 12 U.S.C. § 1818(b)(1) (2006).

12. *See* Jean-Charles Rochet, *Rebalancing the Three Pillars of Basel II*, FRBNY ECON. POL'Y REV., Sept. 2004, at 7.

13. *See infra* Parts II.A and II.B (discussing existing academic studies of capital enforcement).

14. *See infra* Part I.

15. *See infra* Part II.

examining these 2350 formal capital enforcement actions, the study provides a clearer picture of regulatory capital enforcement. The data reveal four significant insights:

- First, there has been a sharp increase in the number of formal agency capital enforcement actions during the current economic downturn. More and more banks are subject to capital enforcement actions.
- Second, an increasing number of banks are subject to individual bank minimum capital requirements. Through discretionary capital increases implemented on a bank-by-bank basis, bank regulators are creating ad hoc capital requirements that are, in some cases, much higher than capital requirements published in regulations.
- Third, the data suggest that enforcement rates are not consistent among bank regulators. In particular, the Federal Reserve appears less likely than other regulators to bring formal, serious capital enforcement actions and less likely to impose individual bank minimum capital requirements.
- Fourth, the data show a near-complete absence of formal capital enforcement actions issued to the largest banks. During the study period, only 2 banks received capital enforcement actions when they were one of the 50 largest banks as measured by domestic deposits. None of the 25 largest banks received a formal capital enforcement action.

Given the significant and growing number of banks subject to discretionary capital enforcement, the Article next considers the proper role of enforcement as a tool for capital regulation.¹⁶ Bank regulators, like most administrative agencies, typically can choose to establish standards through rulemaking or through individual enforcement. Some maintain that discretionary capital enforcement is necessary to allow regulators to adjust to financial innovation and changing economic conditions. In their view, discretionary enforcement allows regulators to finely tune capital requirements to account for the individual and unique risk posed by each individual bank. This Article challenges this description of discretionary capital enforcement. It argues that discretionary enforcement is not an effective way to adjust capital to account for innovation, economic change, or even the financial condition of individual banks. Capital standards established through enforcement are costly and opaque. In addition, discretionary capital enforcement is unlikely to consider the macroeconomic consequences that might occur as a result of numerous enforcement actions. In other words, discretionary capital enforcement is not a panacea.

Of course, capital requirements established by rulemaking are also sometimes problematic. Capital regulations cannot account for all potential risk present at all banks. If regulations are simple enough to be understood and implemented, they

16. See *infra* Part III.

will likely be somewhat crude measures. Moreover, by making rules clear some banks might be motivated to skirt the rules. Our system of capital regulation must then depend on both requirements established by rule and requirements established by enforcement. Nevertheless, this Article concludes that, in some respects, reliance on capital enforcement has gone too far.¹⁷ This Article recommends more robust capital rules that limit regulators' need to set capital standards by enforcement.

I. BANK CAPITAL REQUIREMENTS

As previously explained, capital is the amount by which a bank's assets exceed its deposits and other liabilities.¹⁸ Capital acts as a cushion to protect depositors and other creditors of the bank from loss.¹⁹ In the event a bank loses money or fails, the losses are born first by the shareholders and then by the depositors.²⁰ Other things being equal, banks that hold more capital are less likely to become insolvent and inflict losses on depositors.²¹

While capital can stabilize a bank and insulate depositors, holding capital is not costless. First, the act of raising external capital investment can be expensive.²² Then, once a bank has raised capital by issuing stock, the stockholders expect a return on their investment. Banks can increase the expected return on equity by holding more liabilities relative to their capital—that is, by increasing their leverage.²³ However, increasing leverage increases the risk posed to depositors because the relative amount of capital has decreased.²⁴ Increasing leverage also makes a bank more prone to engage in risky behavior. When a bank has a small amount of capital and a large amount of liabilities, investors have little to lose if the bank fails but much to gain if the bank succeeds.²⁵

Because of the costs associated with holding capital, in the absence of regulation, banks might choose to hold less capital and subject depositors to significant risk. This is particularly true when the depositors are protected by government deposit insurance. Protected depositors have little incentive to monitor their banks' capital holdings and move their money from thinly capitalized banks.²⁶

17. See *infra* Part III.C.

18. Kaufman, *supra* note 7, at 385.

19. CARNELL, MACEY & MILLER, *supra* note 8, at 252–53.

20. *Id.*

21. *Id.*

22. See Robert Reilly & Aaron Rotkowsky, *The Discount for Lack of Marketability: Update on Current Studies and Analysis of Current Controversies*, 61 TAX LAW. 241, 265 (2007) (discussing the potential accounting, legal, administrative, and underwriting costs associated with raising external capital).

23. CARNELL, MACEY & MILLER, *supra* note 8, at 43–45; STEPHEN G. CECCHETTI, MONEY, BANKING, AND FINANCIAL MARKETS 102–03 (2d ed. 2006).

24. CARNELL, MACEY & MILLER, *supra* note 8, at 43–45; CECCHETTI, *supra* note 23, at 102–03.

25. CARNELL, MACEY & MILLER, *supra* note 8, at 282.

26. Patricia A. McCoy, *The Moral Hazard Implications of Deposit Insurance: Theory and Evidence*, in 5 CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW 417, 422 (Int'l Monetary Fund Legal Dep't ed., 2008).

Recognizing the possibility that banks might hold less than optimal capital, policymakers have long set bank capital requirements.²⁷ ..

In the United States, four federal bank regulators have administered modern capital requirements for commercial banks. Each bank is assigned a primary federal regulator. The Office of the Comptroller of the Currency (OCC) supervises banks with national charters.²⁸ The Board of Governors of the Federal Reserve (Federal Reserve) supervises state-chartered banks that have elected to be members of the Federal Reserve System.²⁹ The Federal Deposit Insurance Corporation (FDIC) serves as the primary federal regulator for state-chartered banks that are not members of the Federal Reserve System.³⁰ Finally, until recently the Office of Thrift Supervision (OTS) supervised federally insured savings banks and thrifts.³¹ However, the Dodd-Frank Act abolished the OTS.³² In the summer of 2011, the OCC began regulating federally chartered thrifts and the FDIC began regulating state-chartered thrifts.³³ Because this Article focuses on capital enforcement between 1993 and 2010, the OTS regulations and enforcement are considered alongside the other banking regulators.

The federal bank regulators enforce many of the same capital statutes and have largely similar capital regulations. Current capital regulations have two parts.³⁴ First, capital regulations set mechanically determined numerical capital requirements. Second, capital regulations give regulators enforcement tools and discretionary authority to adjust numerical capital requirements on a bank-by-bank basis.

A. Numerical Capital Requirements

Banking statutes and regulations require that all banks maintain capital equal to a certain percentage of their assets. Banking regulations specify four capital ratios: a leverage ratio, a tangible equity ratio, a tier 1 risk-based capital ratio, and a total

27. See generally Sandra L. Ryon, *History of Bank Capital Adequacy Analysis* (FDIC Working Paper No. 69-4, 1969) (discussing historical development of bank capital requirements in the United States).

28. *About the OCC*, OCC, <http://www.occ.treas.gov/aboutocc.htm>.

29. *BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTIONS* 59–60 (9th ed. 2005).

30. *Who is the FDIC?*, FDIC <http://www.fdic.gov/about/learn/symbol/WhoisTheFDIC.pdf>. The FDIC has backup regulatory authority for all other banks that are federally insured.

31. See *Functions and Responsibilities of the Director of the Office of Thrift Supervision*, 12 C.F.R. § 500.1 (2009).

32. 12 U.S.C.S. §§ 5401–52 (LexisNexis 2010).

33. *Id.* §§ 311–12.

34. The Basel Committee on Banking Supervision has identified three “pillars” of capital regulation: “minimum capital requirements, supervisory review, and market discipline.” *BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK 2* (2006) (comprehensive version), available at <http://www.bis.org/publ/bcbs128.pdf>. Discussion of the role of market discipline and public disclosures is beyond the scope of this Article.

risk-based capital ratio.³⁵ A small number of banks are also subject to capital requirements determined by models designed to account for operational and market risk.³⁶

The leverage ratio is the most straightforward of the capital ratios. It is calculated by dividing tier 1 capital (essentially common stock, noncumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries) by the bank's total assets.³⁷ The regulations' definition of the term "leverage ratio" deviates from the standard financial meaning of the term. In common parlance a leverage ratio is a debt-to-equity ratio,³⁸ but in banking law the leverage ratio compares equity capital to assets.

Generally, the higher a bank's leverage ratio, the safer the bank.³⁹ For example, suppose there are two banks with identical portfolios of assets worth \$100 million. The first bank has \$90 million in deposits and \$10 million in common stock. This gives the first bank a leverage ratio of 10%.⁴⁰ The second bank has \$95 million in deposits and \$5 million in common stock. The second bank has a leverage ratio of 5%.⁴¹ The first bank is safer than the second bank because it holds more capital (common stock) relative to its assets. Accordingly, it has a higher leverage ratio. This example assumes that both banks have identical asset portfolios. The first bank might not actually be safer if it held assets that were more risky than the second bank's assets. However, the leverage ratio makes no adjustment for the riskiness of a bank's assets.

The tangible-equity ratio is very similar to the leverage ratio. It is calculated by dividing tangible equity by adjusted total assets. Before calculating the ratio, the bank must deduct intangible assets (including goodwill⁴² and investments in some subsidiaries) from assets. This deduction correspondingly reduces capital. Tangible equity (common stock, noncumulative perpetual preferred stock, and cumulative perpetual preferred stock) is then divided by the adjusted assets.⁴³ The higher the tangible equity ratio, the safer the bank.

Next, regulations establish risk-based capital ratios. As their name suggests, they are designed to more explicitly adjust for the riskiness of assets.⁴⁴ To calculate

35. See *infra* notes 37–63 and accompanying text.

36. See *infra* notes 64–70 and accompanying text.

37. 12 C.F.R. § 325.2(m) (2011) (FDIC); 12 C.F.R. pt. 208, app. B (Federal Reserve); 12 C.F.R. §§ 3.6, 6.2(d) (OCC); 12 C.F.R. §§ 565.7, 567.5(a) (OTS).

38. See BLACK'S LAW DICTIONARY 926 (8th ed. 2004) (defining "leverage" as "[t]he ratio between a corporation's debt and its equity capital").

39. This is different from a debt-to-equity leverage ratio where a higher ratio would suggest more risk.

40. \$10 million tier 1 capital / \$100 million assets = 10% leverage ratio.

41. \$5 million tier 1 capital / \$100 million assets = 5% leverage ratio.

42. "Goodwill is an intangible asset that represents the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed." 12 C.F.R. pt. 208, app. A.

43. 12 C.F.R. § 325.2 (FDIC); 12 C.F.R. § 208.41 (Federal Reserve); 12 C.F.R. § 6.2(g) (OCC); 12 C.F.R. § 565.2(f) (OTS).

44. The risk-based capital ratios were adopted as part of the U.S. implementation of international capital guidelines developed by a group of banking regulators from major industrialized countries. See BASLE COMM. ON BANKING SUPERVISION, INTERNATIONAL

these ratios, assets are first sorted into four risk categories. Each category is assigned a percentage correlating with its riskiness: 0%, 20%, 50%, or 100%. For example, cash and U.S. government bonds are considered safe and fall in the 0% category. In contrast, outstanding credit card loans are considered comparatively risky and fall in the 100% category. First mortgages on residential property are classified in the 50% category.⁴⁵ Next, the risk-based capital ratios require that some items normally not included as assets on the balance sheet (for example, standby letters of credit and unused lines of credit) be included in the calculation. These off-balance sheet items are assigned credit-equivalent amounts. Then, like assets, they are sorted by the risk-weighted categories.⁴⁶ Once each asset and off-balance sheet item has been assigned a risk category, the amount of the item is multiplied by the appropriate risk-weight percentage. These numbers are then added to determine the total amount of risk-based assets. This becomes the denominator in the risk-based capital ratios.⁴⁷

The numerators of the risk-based capital ratios are measurements of capital. For regulatory purposes capital is divided into two categories: tier 1 (core) capital and tier 2 (supplementary) capital. Tier 1 capital includes common stock, noncumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries.⁴⁸ Once tier 1 capital has been determined, it can be divided by the risk-adjusted assets to determine the tier 1 risk-based capital ratio.⁴⁹ Capital not included in tier 1 is tier 2 capital. Tier 2 capital includes items such as long-term preferred stock, loan-loss reserves, hybrid capital instruments, and subordinated debt.⁵⁰ Total capital is calculated by adding tier 1 capital to tier 2 capital, subject to some limitations. Most importantly, tier 2 capital added cannot exceed tier 1 capital.⁵¹ Total capital is divided by the risk-adjusted assets to determine the total risk-based capital ratio.⁵²

To illustrate how the risk-based capital ratios account for the riskiness of assets, consider the example of two banks, each with \$100 million in assets, \$95 million in

CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (1988), available at <http://www.bis.org/publ/bcbs04a.pdf>.

45. 12 C.F.R. pt. 325, app. A (FDIC); 12 C.F.R. pt. 208, app. A (Federal Reserve); 12 C.F.R. pt. 3, app. A (OCC); 12 C.F.R. § 567.6(a)(1) (OTS). There are minor differences in the way regulators classify some items. See Joint Report: Differences in Accounting and Capital Standards Among the Federal Banking Agencies, 75 Fed. Reg. 47,900 (Aug. 9, 2010).

46. 12 C.F.R. pt. 325, app. A (FDIC); 12 C.F.R. pt. 208, app. A (Federal Reserve); 12 C.F.R. pt. 3, app. A (OCC); 12 C.F.R. § 567.6(a)(2) (OTS).

47. 12 C.F.R. pt. 325, app. A (FDIC); 12 C.F.R. pt. 208, app. A (Federal Reserve); 12 C.F.R. pt. 3, app. A (OCC); 12 C.F.R. § 567.6 (OTS).

48. 12 C.F.R. pt. 325, app. A § I.A (FDIC); 12 C.F.R. pt. 208, app. A § II (Federal Reserve); 12 C.F.R. pt. 3, app. A § 2(a) (OCC); 12 C.F.R. § 567.5 (OTS).

49. 12 C.F.R. § 325.2(w) (FDIC); 12 C.F.R. § 208.41(h) (Federal Reserve); 12 C.F.R. § 6.2(i) (OCC); 12 C.F.R. § 565.2(h) (OTS).

50. 12 C.F.R. pt. 325, app. A § I.A (FDIC); 12 C.F.R. pt. 208, app. A § II (Federal Reserve); 12 C.F.R. pt. 3, app. A § 2(a) (OCC); 12 C.F.R. § 567.5 (OTS).

51. 12 C.F.R. pt. 325, app. A § I.A (FDIC); 12 C.F.R. pt. 208, app. A § II.A.2 (Federal Reserve); 12 C.F.R. pt. 3, app. A § 2(c)(2)(i) (OCC); 12 C.F.R. § 567.5(c)(1) (OTS).

52. 12 C.F.R. § 325.2(y) (FDIC); 12 C.F.R. § 208.41(j) (Federal Reserve); 12 C.F.R. § 6.2(k) (OCC); 12 C.F.R. § 565.2(j) (OTS).

deposits, and \$5 million in common stock. The first bank's assets consist of \$50 million in cash and \$50 million in first mortgages on single-family homes. The second bank's assets consist of \$100 million in first mortgages on single-family homes. Common sense suggests that the bank with cash is less risky than the bank with only mortgages. The risk-based capital ratios account for this understanding. For the first bank, the cash would be classified in the 0% risk-weight category and the mortgages would be classified in the 50% category. Once the risk-weight categories are multiplied by the amount of assets in the category and added together, the bank would have \$25 million in risk-weighted assets⁵³ and a tier 1 risk-based capital ratio of 20%.⁵⁴ The mortgages in the second bank's portfolio would also be classified in the 50% risk-weight category, giving it risk-weighted assets of \$50 million.⁵⁵ The second bank's tier 1 risk-based capital ratio would be 10%.⁵⁶ Because neither bank has tier 2 capital, each bank's tier 1 risk-based capital ratio equals its total risk-based capital ratio. As expected, the first bank has a higher tier 1 risk-based capital ratio and a higher total risk-based capital ratio. This reflects the understanding that it is less risky to hold cash than mortgages.

While the capital ratios can help us gauge the riskiness of a bank, there is no clear point at which a bank becomes "risky." For this reason, rather than simply setting required capital ratios, regulations use a stepped approach to capital by classifying banks as well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized. The capital ratios required for each classification are listed in Figure 1.⁵⁷

53. $(0\% \text{ risk-weight category} * \$50 \text{ million cash}) + (50\% \text{ risk-weight category} * \$50 \text{ million mortgages}) = \$25 \text{ million risk-weighted assets.}$

54. $\$5 \text{ million tier 1 capital} / \$25 \text{ million risk-weighted assets} = 20\% \text{ tier 1 risk-based capital ratio.}$

55. $50\% \text{ risk-weight category} * \$100 \text{ million mortgages} = \$50 \text{ million risk-weighted assets.}$

56. $\$5 \text{ million tier 1 capital} / \$50 \text{ million risk-weighted assets} = 10\% \text{ tier 1 risk-based capital ratio.}$

57. The capital ratios for each classification are established by regulation. 12 C.F.R. §§ 325.3, 325.103 (FDIC); 12 C.F.R. § 208.43 (Federal Reserve); 12 C.F.R. § 6.4 (OCC); 12 C.F.R. § 565.4 (OTS). In order to be well capitalized or adequately capitalized, a bank must meet or exceed the required percentage for each ratio. A regulator can downgrade a bank to the next lower capital category if the bank is in an unsafe or unsound condition. 12 U.S.C. § 1831o(g) (2006).

In addition to the requirements listed in Figure 1, thrifts are required to maintain tangible capital (similar to tangible equity capital, but excluding noncumulative perpetual preferred stock) "equal to at least 1.5% of adjusted total assets." 12 C.F.R. § 567.9. This capital requirement "has effectively been eclipsed by the more stringent" capital requirements. OTS, EXAMINATION HANDBOOK § 120.3 (2009), available at http://www.ots.treas.gov/_files/422017.pdf.

Figure 1: Capital Classifications

Classification	Tangible Equity Capital Ratio	Leverage Ratio	Tier 1 Risk-Based Capital	Total Risk-Based Capital
Well Capitalized	--	≥5%	≥6%	≥10%
Adequately Capitalized	--	≥4% ⁵⁸	≥4%	≥8%
Undercapitalized	--	<4%	<4%	<8%
Significantly Undercapitalized	--	<3%	<3%	<6%
Critically Undercapitalized	<2%	--	--	--

A bank gains certain privileges, such as the ability to solicit brokered deposits, by maintaining capital sufficient to be classified as well capitalized.⁵⁹ All banks, however, must maintain capital sufficient to be classified as adequately capitalized. If a bank becomes undercapitalized, the bank must submit a capital restoration plan to its regulator explaining “the steps the [bank] will take to become adequately capitalized.”⁶⁰ The regulator evaluates the plan to determine whether it “is based on realistic assumptions, and is likely to succeed in restoring the [bank’s] capital” without increasing the bank’s risk.⁶¹ If a bank is significantly undercapitalized or fails to obtain approval of its capital plan, the regulator must take at least one of a variety of measures designed to prevent further declines in capital. In particular, the regulator can require the bank to sell enough stock to become adequately capitalized.⁶² If the bank becomes critically undercapitalized the regulator must, within ninety days, appoint a receiver or take other action to limit loss to the insurance fund.⁶³

Although all U.S. banks are required to comply with the leverage and risk-based capital requirements, larger banks face additional capital requirements. Banks with more than \$250 billion in total assets or with foreign exposures greater than \$10

58. A bank is adequately capitalized if it has a 3% leverage ratio and it “is not anticipating or experiencing significant growth and has well-diversified risk, including no undue interest rate risk exposure, excellent asset quality, high liquidity, good earnings and in general is considered a strong banking organization, rated composite 1 under the Uniform Financial Institutions Rating System.” 12 C.F.R. § 325.3(b)(1) (FDIC). If a bank does not have a 1 examination rating, it must maintain a 4% leverage ratio. *Id.* at §§ 208.43(b)(2), 325.3(b)(2), 565.4(b)(2). “In theory, a very healthy, well-run bank with the highest possible examination rating can qualify as adequately capitalized with only 3% capital. But the real rule remains 4%—not least because a bank with only 3% capital would have difficulty obtaining such a high examination rating.” CARNELL, MACEY & MILLER, *supra* note 8, at 257.

59. 12 U.S.C. § 1831f(a).

60. *Id.* § 1831o(e)(2).

61. *Id.* While a bank is undercapitalized, it may not increase its asset base or acquire new branches or lines of business without its regulator’s approval. *Id.* § 1831o(e)(3)–(4).

62. *Id.* § 1831o(f).

63. *Id.* § 1831o(h)(3).

billion are beginning to implement a more risk-sensitive approach for determining capital minimums.⁶⁴ This approach, developed by the Basel Committee on Banking Supervision, uses banks' internal ratings to assess credit risk. It also uses risk models developed by banks to account for operational risk ("the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events").⁶⁵ Only about ten of the largest banks are required to implement this internal rating and modeling approach.⁶⁶ Even these banks cannot maintain capital less than that required by the leverage ratio, tier 1 risk-based capital ratio, and total risk-based capital ratio.⁶⁷ Smaller banks, with the approval of their regulator, can elect to use this approach, but it is expected that most small banks will continue to rely solely on the traditional capital ratios.⁶⁸ In addition to credit-risk capital requirements, banks with large trading accounts are required to hold capital to protect against market risk.⁶⁹ The amount of capital required is typically determined using value-at-risk models developed largely by each bank. Only a small number of banks are currently subject to the market-risk capital requirements.⁷⁰ In sum, the leverage ratio, tier 1 risk-based capital ratio, and the

64. 12 C.F.R. pt. 325, app. D § 21 (FDIC); 12 C.F.R. pt. 208, app. F § 21 (Federal Reserve); 12 C.F.R. pt. 3, app. C § 21 (OCC); 12 C.F.R. pt. 567, app. C § 21 (OTS).

65. Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II, 72 Fed. Reg. 69,288, 69,293, 69,403 (Dec. 7, 2007) (codified at 12 C.F.R. pt. 3; 12 C.F.R. pts. 208, 225; 12 C.F.R. pt. 325; 12 C.F.R. pts. 559, 560, 563, 567); BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK (2004), available at <http://www.bis.org/publ/bcbs107.pdf>.

66. Mark Sobel, Deputy Assistant Sec'y, Dep't of Treasury, Remarks at Center for European Policy Studies (Apr. 28, 2010), available at 2010 WLNR 8734614 (discussing U.S. implementation of Basel II).

According to regulations, these banks had until April 1, 2011 to complete four consecutive quarters of a "parallel run" in which they calculated capital levels using models but continued to comply with the traditional risk-based capital ratios. See *id.* However, the financial crisis and other factors led some banks to begin their parallel run period late and miss this deadline. Victoria Tozer-Pennington, *Dodd-Frank Slows Down Full Implementation of Basel II*, FX WEEK (Nov. 25, 2010), <http://www.fxweek.com/fx-week/news/1900819/dodd-frank-slows-implementation-basel-ii>; see also Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II, 76 Fed. Reg. 37,620, 37,621 (June 28, 2011) (to be codified at 12 C.F.R. pt. 3; 12 C.F.R. pts. 208, 225; 12 C.F.R. pt. 325) (noting that "[t]o date, no U.S.-domiciled banking organization has entered a transitional floor period and all U.S.-domiciled banking organizations are required to compute their risk-based capital requirements using the general risk-based capital rules").

67. Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II, 76 Fed. Reg. at 37,626–29.

68. See Benton E. Gup, *Introduction to the Basel Capital Accords*, in THE NEW BASEL CAPITAL ACCORD I, 8 (Benton E. Gup ed., 2004).

69. The market risk capital requirements apply only to banks "whose trading activity . . . equals . . . 10% or more of total assets [or is] \$1 billion or more." 12 C.F.R. pt. 325, app. C (FDIC); 12 C.F.R. pt. 208, app. E (Federal Reserve); 12 C.F.R. pt. 3, app. B (OCC).

70. See GEN. ACCOUNTING OFFICE, RISK-BASED CAPITAL: REGULATORY AND INDUSTRY APPROACHES TO CAPITAL AND RISK 9 (1998) (stating that the market risk capital requirement "generally pertains only to the largest 15 to 20 U.S. banks with extensive trading activity");

total risk-based capital ratio are the primary capital requirements applied to all U.S. banks.

B. Discretionary Capital Requirements

Although at first inspection the statutory and regulatory rules with respect to bank capital seem rather clear-cut, bank regulators actually have significant discretion to set capital requirements on a bank-by-bank basis. According to statute, “[e]ach appropriate Federal banking agency [has] the authority to establish [a] minimum level of capital for a banking institution as the appropriate Federal banking agency, in its discretion, deems to be necessary or appropriate in light of the particular circumstances of the banking institution.”⁷¹ Regulations reiterate this discretionary authority. For example, regulations state that “the FDIC is not precluded from requiring an institution to maintain a higher capital level based on the institution’s particular risk profile.”⁷² In other words, each regulator has broad discretion to increase capital requirements on an individual bank basis.

Regulations also provide guidance about when regulators should require capital above the regulatory minimum. There are differences among the federal bank regulators in their regulatory text. According to FDIC regulations, increased capital is warranted when

the financial history or condition, managerial resources and/or the future earnings prospects of a bank are not adequate, or where a bank has sizable off-balance sheet or funding risks, significant risks from concentrations of credit or nontraditional activities, excessive interest rate risk exposure, or a significant volume of assets classified substandard, doubtful or loss or otherwise criticized.⁷³

The Federal Reserve states that higher requirements are justified when a bank is “contemplating significant expansion proposals” or when the bank has “inordinate

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, 345 n.543 (2002) (stating that the market risk capital requirement applies “to about twenty large banks”). Thrifts are not subject to market risk capital requirements. See James J. Croke, *What Banks Need to Know About New Developments in Asset-Backed Commercial Paper*, 121 BANKING L.J. 218, 284 n.9 (2004).

71. 12 U.S.C. § 3907(a)(2) (2006); see also 12 U.S.C. § 1464(s)(2) (2009) (stating that “[m]inimum capital levels may be determined by [the OTS] Director case-by-case”).

72. 12 C.F.R. § 325.3(a); see also 12 C.F.R. pt. 208, app. A (Federal Reserve) (noting that “the final supervisory judgment on a bank’s capital adequacy may differ significantly from conclusions that might be drawn solely from the level of its risk-based capital ratio”); 12 C.F.R. § 3.11 (OCC) (“The appropriate minimum capital ratios for an individual bank cannot be determined solely through the application of a rigid mathematical formula or wholly objective criteria. The decision is necessarily based in part on subjective judgment grounded in agency expertise.”); 12 C.F.R. § 567.3 (OTS) (“Minimum capital levels higher than the risk-based capital requirement, the leverage ratio requirement or the tangible capital requirement required under this part may be appropriate for individual savings associations.”).

73. 12 C.F.R. § 325.3(a).

levels of risk.”⁷⁴ The OCC notes that the “factors to be considered” in determining capital levels “will vary in each case.”⁷⁵ The OCC’s regulations state that it may be appropriate to consider the “overall condition, management strength, and future prospects of the bank.”⁷⁶ The OTS regulations list nine instances in which higher capital levels might be appropriate.⁷⁷ In determining the appropriate level, OTS regulations recommend that the regulator consider the bank’s “overall condition, management strength, and future prospects,” as well as the bank’s “liquidity” and “financial stability.”⁷⁸ While the regulatory language may be somewhat different, each regulator has significant discretion to adjust capital levels in a myriad of circumstances.

When a regulator determines that a bank warrants higher capital levels, the regulator can establish that higher standard through a formal or informal enforcement action. Regulators have significant discretion in choosing between formal enforcement actions and informal enforcement actions. Banking regulations are largely silent on how the regulator should decide which enforcement mechanism to use. Recognizing that some individual bank examiners might choose different enforcement approaches, each banking agency has developed internal policies designed to encourage consistent application of enforcement tools.⁷⁹

74. 12 C.F.R. pt. 208, app. A. Higher capital requirements might also be appropriate when the bank has significant interest rate risk, liquidity issues, poor earnings, portfolio risk, or risk from nontraditional activities. *See id.*

75. 12 C.F.R. § 3.11.

76. *Id.* § 3.11(c). It may also be appropriate to consider “[t]he bank’s liquidity, capital, risk asset and other ratios compared to the ratios of its peer group,” and “[t]he views of the bank’s directors and senior management.” *Id.* § 3.11(d), (e).

77. *Id.* § 567.3(b). Those circumstances include banks with high exposure to various risk, banks with “poor liquidity or cash flow,” and banks that are growing rapidly. *Id.*

78. *Id.* § 567.3(c). The regulation further recommends considering “[t]he policies and practices of the savings association’s directors, officers, and senior management as well as the internal control and internal audit systems.” *Id.*

79. *See* FDIC, DIVISION OF SUPERVISION AND CONSUMER PROTECTION, RISK MANAGEMENT MANUAL OF EXAMINATION POLICIES §§ 13.1, 14.1, 15.1 (2004) [hereinafter FDIC, RISK MANAGEMENT MANUAL], available at http://www.fdic.gov/regulations/safety/manual/manual_examinations_full.pdf; FDIC, DIVISION OF SUPERVISION AND CONSUMER PROTECTION, FORMAL AND INFORMAL ACTIONS PROCEDURES MANUAL (2005) [hereinafter FDIC, ACTIONS PROCEDURES MANUAL] (obtained through a Freedom of Information Act request; copy on file with author); FEDERAL RESERVE, COMMERCIAL BANK EXAMINATION MANUAL § 5040.1 (2011), available at http://www.federalreserve.gov/board_docs/supmanual/cbem/cbem.pdf; OCC, AN EXAMINER’S GUIDE TO PROBLEM BANK IDENTIFICATION, REHABILITATION, AND RESOLUTION 28, 92–108 (2001) [hereinafter OCC, EXAMINER’S GUIDE], available at http://www.occ.gov/publications/publications-by-type/other-publications-reports/prbbnk_gd.pdf; OCC, POLICIES & PROCEDURES MANUAL 5310-3 (2011) [hereinafter OCC, PPM 5310-3], available at <http://www.occ.gov/static/publications/ppm-5310-3.pdf>; OTS, EXAMINATION HANDBOOK § 080 (2011), available at <http://www.ots.treas.gov/files/422345.pdf>.

1. Formal Actions

An enforcement action is classified as a “formal” action if violation of that action can serve as the basis for further administrative penalties, such as civil money penalties, the removal of bank officers, or the termination of federal deposit insurance.⁸⁰ Formal actions are publicly available unless the regulator determines that publication “would be contrary to the public interest.”⁸¹

According to regulatory guidance, formal actions should be used when a bank “has significant problems, especially when there is a threat of harm to the [bank], depositors, or the public.”⁸² Formal actions are also used when informal actions have been ineffective.⁸³ Regulators can use several types of formal enforcement actions to enforce capital requirements: prompt corrective action directives, capital directives, cease-and-desist orders, and written agreements.

a. Prompt Corrective Action Directives

By statute, bank regulators must take “prompt corrective action to resolve the problems of insured depository institutions.”⁸⁴ As previously explained, bank regulators are required to take certain regulatory actions once a bank becomes undercapitalized, significantly undercapitalized, or critically undercapitalized as defined by regulation.⁸⁵ Regulators can also issue a prompt corrective action directive when a bank fails to meet previously established individual bank capital requirements.⁸⁶

While a bank is classified as undercapitalized, significantly undercapitalized, or critically undercapitalized, the regulator has authority to require the bank “to take any other action that the [regulator] determines will better carry out the purpose of [the prompt corrective action statute].”⁸⁷ Because the purpose of prompt corrective action is to “resolve the problems of insured depository institutions at the least possible long-term loss to the Deposit Insurance Fund,”⁸⁸ the regulator can require the bank to hold more than the regulatory minimum capital.

80. 12 U.S.C. § 1818(a)(2), (e), (i)(2) (2006).

81. *Id.* § 1818(u).

82. OTS, *supra* note 79, at § 080.6; *see also* OCC, EXAMINER’S GUIDE, *supra* note 79, at 30 (“Formal actions are appropriate when a bank has significant problems, especially when there is a threat of harm to the institution.”).

83. OCC, EXAMINER’S GUIDE, *supra* note 79, at 30 (stating that formal actions are used “when corrective action by the board is not forthcoming, or when informal actions are insufficient”).

84. 12 U.S.C. § 1831o(a)(2).

85. *See supra* notes 60–63 and accompanying text.

86. 12 U.S.C. § 1831o(b)(2)(G).

87. *Id.* § 1831o(f)(2)(J); *see also id.* § 1831o(e)(5) (“The appropriate Federal banking agency may, with respect to any undercapitalized insured depository institution, take actions . . . if the agency determines that those actions are necessary to carry out the purpose of this section.”).

88. *Id.* § 1831o(a)(1).

Regulators take discretionary action, including increasing capital requirements, against an undercapitalized bank by issuing a prompt corrective action directive. Before issuing a prompt corrective action directive, the regulator must typically provide the bank with notice and opportunity to comment on the proposed action.⁸⁹ However, no administrative hearing is required. Regulators can enforce prompt corrective action directives in federal district court.⁹⁰

By regulation, prompt corrective action directives are ordinarily reserved for banks that are classified as undercapitalized.⁹¹ Beyond that, OCC guidance suggests that prompt corrective action directives should be issued only in the most extreme circumstances—when the regulator anticipates that the bank will be closed in the future.⁹²

b. Capital Directives

Regulators need not wait until banks become undercapitalized to take formal enforcement actions. The International Lending Supervision Act allows regulators to issue a capital directive to any bank that “fails to maintain capital at or above” the level determined to be appropriate by the regulator.⁹³ The process for issuing a capital directive is similar to that for issuing a prompt corrective action directive. The regulator provides the bank notice and an opportunity to comment on the proposed directive. After the bank responds or the period for response expires, the regulator can issue the directive.⁹⁴ No hearing is required.⁹⁵ Banks cannot appeal a regulator’s decision to issue the capital directive in court.⁹⁶ However, regulators can enforce capital directives in court.⁹⁷

Agency guidance counsels that a capital directive is an appropriate enforcement measure when the regulator’s only concern is capital adequacy. According to the FDIC, “[a] directive is to be used solely to correct a capital deficiency and it is not

89. In urgent circumstances, the regulator can issue an immediately effective prompt corrective action directive. 12 C.F.R. §§ 325.105(b), 308.201 (2009) (FDIC); 12 C.F.R. §§ 208.45(b), 263.202(a)(2) (Federal Reserve); 12 C.F.R. § 6.21 (OCC); 12 C.F.R. § 565.7 (OTS).

90. 12 U.S.C. § 1818(i); 12 C.F.R. § 308.204(a) (FDIC); 12 C.F.R. § 263.205(a) (Federal Reserve); 12 C.F.R. § 6.25(a) (OCC); 12 C.F.R. § 565.10(a) (OTS).

91. See generally 12 U.S.C. § 1831o.

92. See OCC, PPM 5310-3, *supra* note 79, at 5 (noting that a prompt corrective action directive “can enhance the office’s use of resolution options later because failure to submit or implement a capital restoration plan required in [the] directive is a ground for receivership”).

93. 12 U.S.C. § 3907(b)(2)(A).

94. 12 C.F.R. § 325.6 (FDIC); 12 C.F.R. § 263.83 (Federal Reserve); 12 C.F.R. §§ 3.15-21 (OCC); 12 C.F.R. § 567.4 (OTS).

95. See *FDIC v. Bank of Coughatta*, 930 F.2d 1122, 1126 (5th Cir. 1991).

96. See *id.* at 1129; see also John C. Deal, *Banking Law is Not for Sissies: Judicial Review of Capital Directives*, 12 J.L. & COM. 185 (1993); Keith R. Fisher, Michael Roster, Karen Shaw Petrou, Wayne A. Abernathy & Charles Taylor, *Panel Discussion: “The Ideal Basel,”* 13 FORDHAM J. CORP. & FIN. L. 139, 175 (2008).

97. 12 U.S.C. §§ 1818(i)(1), 3907(b)(2)(B)(ii).

intended to address other weaknesses that may be present in a bank.”⁹⁸ The FDIC guidance further states that “in cases where it is possible to obtain a consent Cease and Desist Order that includes an appropriate capital provision, it is preferable to take [that] action instead of capital directive action.”⁹⁹ OTS guidance advises that a capital directive is appropriate when a bank has failed to respond to informal enforcement actions designed to increase capital.¹⁰⁰ The capital directive is rarely used.¹⁰¹

c. Cease-and-Desist Orders

Bank regulators more commonly increase capital requirements through cease-and-desist orders.¹⁰² Regulators have broad power to issue cease-and-desist orders to prevent any “unsafe or unsound [banking] practice.”¹⁰³ While the precise contours of unsafe or unsound practices are not well defined, operating with insufficient capital is an unsafe or unsound practice.¹⁰⁴ Regulators may also issue cease-and-desist orders if a bank violates a statute, regulation, or written agreement with the regulator.¹⁰⁵

If the unsafe or unsound condition “is likely to cause insolvency or significant dissipation of assets or earnings of the [bank], or is likely to weaken the condition of the [bank] or otherwise prejudice the interests of its depositors,” the regulator has authority to issue a temporary cease-and-desist order.¹⁰⁶ Temporary cease-and-desist orders are granted without the participation of the bank and are immediately effective.¹⁰⁷ The bank may challenge the issuance of the order in federal district court.¹⁰⁸

For unsafe or unsound practices that are less urgent, the regulator must provide the bank with notice concerning the practice.¹⁰⁹ The bank is entitled to a hearing before an administrative law judge to determine whether an unsafe or unsound condition exists.¹¹⁰ However, few banks avail themselves of this right. Realizing that the regulator has broad discretion, most banks waive the hearing and consent to

98. FDIC, RISK MANAGEMENT MANUAL, *supra* note 79, at § 15.1-11; *see also* OCC, PPM 5310-3, *supra* note 79, at 21.

99. FDIC, RISK MANAGEMENT MANUAL, *supra* note 79, at § 15.1-11.

100. *See* OTS, *supra* note 79, at §§ 80.8.

101. OCC, PPM 5310-3, *supra* note 79, at 21; LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES 581 (4th ed. 2011).

102. *See* Joseph T. Lynyak III, *The Failing Bank Scenario—An Explanation and Suggested Analysis for a Bank’s Board of Directors and Management*, 126 BANKING L.J. 771, 774 n.7 (2009).

103. 12 U.S.C. § 1818(b)(1) (2006).

104. *See id.* §§ 1467, 3907(b)(1); FDIC, ACTIONS PROCEDURES MANUAL, *supra* note 79, at § 4-4.

105. 12 U.S.C. § 1818(b)(1).

106. *Id.* § 1818(c)(1).

107. *Id.*

108. *Id.* § 1818(c)(2).

109. *Id.* § 1818(b)(1).

110. *See id.*

cease-and-desist orders rather than risk further aggravating their regulators.¹¹¹ Regulators sometimes label cease-and-desist orders issued by consent as “consent orders.”¹¹² Regulators can enforce the terms of cease-and-desist orders and consent orders in federal district court.¹¹³

In addition to directing a bank to refrain from unsafe or unsound actions, a cease-and-desist order can require the bank to “take affirmative action to correct the conditions.”¹¹⁴ The order may require the bank to hold capital in excess of the standard regulatory amounts. FDIC guidelines recommend that explicit capital requirements be included in the order:

If inadequate capital is evident, the amount of capital needed will be stated. This amount can be a ratio, e.g., Restore a ___% capital-to-asset ratio, or a dollar amount of new capital funds or a capital level, e.g., Increase capital and reserves to not less than ___ and maintain.¹¹⁵

Other regulators’ guidance documents do not address the issue of what remedial measures should be included in cease-and-desist orders issued to correct inadequate capital.

In general, regulators’ policies recommend using cease-and-desist orders in situations serious enough to warrant formal action, but when capital levels have not yet deteriorated to a level where a prompt corrective action directive may be used.¹¹⁶

d. Written Agreements

Regulators are also authorized to impose conditions on banks through written agreements.¹¹⁷ Formal written agreements, sometimes referred to as formal agreements or supervisory agreements, are very similar to cease-and-desist orders entered by consent. Like cease-and-desist orders, written agreements can “require affirmative corrective action to address any existing violations, management or

111. See James M. Rockett, *Confronting a Regulatory Crisis: A View from the Trenches During Troubled Times*, 126 BANKING L.J. 307, 312 (2009); see also FDIC, ACTIONS PROCEDURES MANUAL, *supra* note 79, at § 5-5 (“To eliminate the need for time-consuming administrative hearings, the FDIC attempts to obtain the respondent’s stipulation to a consent Order.”).

112. OCC, PPM 5310-3, *supra* note 79, at 18–19; Rockett, *supra* note 111, at 312.

113. 12 U.S.C. § 1818(i).

114. *Id.* § 1818(b)(1).

115. FDIC, RISK MANAGEMENT MANUAL, *supra* note 79, at § 15.1-4; see also FDIC, ACTIONS PROCEDURES MANUAL, *supra* note 79, at § 5-8 (“If the amount [of capital] requested is larger than the [regulatory] minimum capital requirements, the amount must be justified based on the institution’s condition.”).

116. See FDIC, RISK MANAGEMENT MANUAL, *supra* note 79, at §§ 15.1-1 to 15.1-14; FEDERAL RESERVE, *supra* note 79, § 5040.1, at 1–2; OCC, PPM 5310-3, *supra* note 79, at 18–21; OTS, *supra* note 79, at §§ 080.1–9.

117. See 12 U.S.C. §§ 1818(b)(1), 1818(e)(1)(A)(i)(IV), 1818(i)(2)(A)(iv), 1818(u)(1)(A); see also 12 C.F.R. § 325.2(z) (FDIC).

operational deficiencies, or other unsound practices,” including operating with insufficient capital.¹¹⁸

As with the other formal enforcement actions, a bank’s violation of a written agreement may subject the bank to administrative penalties such as fines or the removal of bank officers or directors.¹¹⁹ However, unlike other formal enforcement actions, written agreements cannot be directly enforced in court.¹²⁰ To enforce a written agreement, a regulator must first issue a cease-and-desist order and then enforce the cease-and-desist order in court.¹²¹

Because written agreements are not enforceable in court, regulatory guidance recommends that they be used for situations less serious than those warranting cease-and-desist orders. According to the FDIC, “the use of a written agreement should normally be reserved for a bank whose problems are limited essentially to a capital deficiency that has not been caused by the unsafe and unsound practices of its management.”¹²² Similarly, the Federal Reserve recommends written agreements “[w]hen circumstances warrant a less severe form of formal supervisory action.”¹²³ In spite of the fact that written agreements are not enforceable in court, OCC guidance acknowledges that “[t]he decision to utilize a Formal Agreement instead of a Consent Order is largely driven by negotiation strategy and the discretion of the delegated decision-making official.”¹²⁴

2. Informal Actions

In some instances, regulators may not need a formal action to persuade a bank to increase its capital. For example, a regulator might encourage a bank to increase its capital by telling the bank that it will receive a cease-and-desist order if it does not voluntarily comply. “Given the federal banking agencies’ tremendous power over insured banks . . . they have ample means of—and opportunities for—informally coercing [banks].”¹²⁵ All of the federal bank regulators acknowledge that they have

118. OTS, *supra* note 79, at §§ 080.7–8; *see also* FEDERAL RESERVE, *supra* note 79, § 5040.1, at 3 (“The provisions of a written agreement may relate to any of the problems found at the bank . . .”).

119. *See* 12 U.S.C. §§ 1818(b)(1), 1818(e)(1)(A)(i)(IV), 1818(i)(2), 1818(u)(1)(A); *see also* 12 C.F.R. § 325.2(z) (FDIC).

120. CARNELL, MACEY & MILLER, *supra* note 8, at 649; BROOME & MARKHAM, *supra* note 101, at 580–81.

121. *See* 12 U.S.C. §§ 1818(b), (i).

122. FDIC, RISK MANAGEMENT MANUAL, *supra* note 79, at § 15.1-11; *see also* CARNELL, MACEY & MILLER, *supra* note 8, at 649 (“[I]f the agency doubts that a written agreement will actually resolve the matter, it may decide to save time by commencing a cease-and-desist proceeding without attempting to secure a written agreement.”).

123. FEDERAL RESERVE, *supra* note 79, § 5040.1, at 3.

124. OCC, PPM 5310-3, *supra* note 79, at 19–20 (“Often the semantic title difference is significant to many boards of directors, who will agree to enter into a Formal Agreement where they would otherwise fight a Consent Order. However, in some cases, the OCC’s long-term strategy for the bank may require the use of a [Consent Order] rather than a Formal Agreement.”).

125. CARNELL, MACEY & MILLER, *supra* note 8, at 644; *see also* Jerry L. Mashaw, *Reinventing Government and Regulatory Reform: Studies in the Neglect and Abuse of*

informal regulatory powers outside the formal tools granted by banking statutes.¹²⁶ The FDIC notes that “the use of reason and moral suasion [are its] primary corrective tools.”¹²⁷

An informal supervisory action may be memorialized in writing, “when moral suasion will not, by itself, accomplish the [regulator’s] goal of correcting identified deficiencies in an institution’s operations.”¹²⁸ The writing may take the form of a board resolution, a commitment letter, a safety and soundness plan, or a memorandum of understanding (MOU).¹²⁹ The OCC even has an informal action aimed specifically at capital—the individual minimum capital ratio letter.¹³⁰ Regardless of how an informal action is styled, it is not enforceable in court. If a regulator determines that a bank has not sufficiently responded to informal action, it must take formal enforcement action before turning to the courts.¹³¹ Bank regulators do not publicly release informal enforcement actions.¹³² However, all regulators except the OTS release annual summary statistics concerning informal actions.¹³³ In addition, individual banks may determine that securities laws require public disclosure of their informal enforcement actions.¹³⁴

Regulatory guidance counsels that informal actions are appropriate when the problem is minor and the regulator believes that bank management is likely to resolve the issue.¹³⁵

Administrative Law, 57 U. PITT. L. REV. 405, 420–21 (1996) (noting that “banking regulatory agencies can probably be equally effective through threats of prosecution, even raised eyebrows,” as they can through formal regulation).

126. FDIC, RISK MANAGEMENT MANUAL, *supra* note 79, at § 15.1-1; FEDERAL RESERVE, *supra* note 79, § 5040.1, at 6; OCC, PPM 5310-3, *supra* note 79, at 4; OTS, *supra* note 79, at § 080.5.

127. FDIC, RISK MANAGEMENT MANUAL, *supra* note 79, at § 15.1-1.

128. FDIC, ACTIONS PROCEDURES MANUAL, *supra* note 79, at § 3-2.

129. FEDERAL RESERVE, *supra* note 79, § 5040.1, at 6; OCC, PPM 5310-3, *supra* note 79, at 18; OTS, *supra* note 79, at § 080.6; Rockett, *supra* note 111, at 311. FDIC guidance instructs its regulators to style informal supervisory actions as MOUs. FDIC, RISK MANAGEMENT MANUAL, *supra* note 79, at § 13.1-1.

130. *See Federal and State Enforcement of Financial Consumer and Investor Protection Laws: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 65–66 (2009) (written testimony of John C. Dugan, Comptroller of the Currency); OCC, ANN. REP. 41 (2009); OCC, ANN. REP. 35 (2008).

131. FDIC, RISK MANAGEMENT MANUAL, *supra* note 79, at § 13.1-1; FEDERAL RESERVE, *supra* note 79, § 5040.1, at 6; OCC, PPM 5310-3, *supra* note 79, at 18; OTS, *supra* note 79, at § 080.5.

132. FDIC, ACTIONS PROCEDURES MANUAL, *supra* note 79, at § 1-4.

133. *See* FDIC, ANN. REP. 26 (2009); FEDERAL RESERVE, 96 ANN. REP. 109 (2009); OCC, ANN. REP. 40 (2010).

134. FEDERAL RESERVE, *supra* note 79, § 5040.1, at 6.

135. FDIC, RISK MANAGEMENT MANUAL, *supra* note 79, at § 13.1-1 (stating that informal action “is a means of seeking informal corrective administrative action from [banks] considered to be of supervisory concern, but which have not deteriorated to the point where they warrant formal administrative action”); FEDERAL RESERVE, *supra* note 79, § 5040.1, at 6 (“Informal supervisory tools are used when circumstances warrant a less severe form of action”); OCC, PPM 5310-3, *supra* note 79, at 4 (“When a bank’s overall condition is sound, but it is necessary to obtain written commitments from a bank’s board of directors to ensure that identified problems and weaknesses will be corrected, the OCC may

II. CAPITAL ENFORCEMENT STUDIES

Because the current bank capital regulation system gives regulators significant discretion to implement individual bank capital requirements, it is impossible to get a complete understanding of capital requirements by simply reviewing statutes, regulations, and agency guidance. It is necessary to understand how regulators exercise their discretion.

Little has been done to empirically analyze how regulators enforce and apply capital requirements. A study by Joe Peek and Eric S. Rosengren at the Federal Reserve Bank of Boston examined formal enforcement actions in New England between 1989 and the third quarter of 1994.¹³⁶ A second study, conducted in 2005 by Harvard law professor Philip A. Wellons, reviewed prompt corrective action directives issued between 1993 and 2001.¹³⁷

After reviewing the Peek-Rosengren Study and the Wellons Study, this Part reports the results of a new empirical analysis of formal capital enforcement actions between 1993 and 2010. The new research reveals that during the current financial crisis, regulators have increasingly brought formal capital enforcement actions. Regulators are also increasingly using their agency discretion to set individual bank capital requirements. Finally, there is some evidence that regulatory enforcement efforts vary by regulator and size of the bank.

A. Peek-Rosengren Study

Joe Peek, an economics professor, and Eric S. Rosengren, an economist at the Federal Reserve Bank of Boston, were the first to empirically describe regulators' discretionary enforcement of capital adequacy standards in the United States.¹³⁸ The Peek-Rosengren Study was primarily concerned with the effect of formal enforcement actions on bank behavior. In particular, Dr. Peek and Dr. Rosengren studied whether formal enforcement actions decreased bank lending. To address this question, their study examined all formal enforcement actions issued to banks in New England between the first quarter of 1989 and third quarter of 1994.¹³⁹

use *informal* enforcement actions." (emphasis in original)); OTS, *supra* note 79, at § 080.5 ("When [a bank's] overall condition is sound, but it is necessary to obtain written commitments from [a bank's] board of directors or management to ensure that it will correct the identified problems and weaknesses, OTS may use informal enforcement actions.").

136. Joe Peek & Eric S. Rosengren, *Bank Regulatory Agreements in New England*, NEW ENG. ECON. REV., May/June 1995, at 15.

137. Philip A. Wellons, *Enforcement of Risk-Based Capital Rules*, in CAPITAL ADEQUACY BEYOND BASEL: BANKING, SECURITIES, AND INSURANCE 284 (Hal S. Scott ed., 2005).

138. Peek & Rosengren, *supra* note 136.

139. *Id.* at 17–18. For the purposes of the Peek-Rosengren Study, New England was defined as the First District of the Federal Reserve System (Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, and most of Connecticut). *Id.* at 18. Rather than focusing only on actions addressing capital, the Peek-Rosengren Study appears to have included all formal enforcement actions. *Id.* at 15.

Because the Peek-Rosengren Study included all formal enforcement actions (rather than just capital enforcement actions) and its time period only overlapped with the formal capital enforcement action study discussed in Part II.C for seven quarters, no attempt was

The Peek-Rosengren Study offered a number of insights about formal enforcement actions. First, it noted that the type of formal action issued often depended on the regulator instituting the action. "The Federal Deposit Insurance Corporation (FDIC) normally issue[d] cease and desist orders and the Office of the Comptroller of the Currency (OCC) generally sign[ed] formal agreements."¹⁴⁰ Second, the Peek-Rosengren Study found that the number of formal enforcement actions tended to track the "health of the banking sector."¹⁴¹ In particular, the number of formal enforcement actions closely paralleled the ratio of nonperforming loans to assets in the New England banking market. As nonperforming loans increased relative to assets, more formal enforcement actions were issued. Third, the Peek-Rosengren Study found that banks often received formal enforcement actions "before their leverage ratios fell below 5 percent."¹⁴² Fourth, the Peek-Rosengren Study found that "[s]maller institutions were more likely than larger institutions to receive their formal actions while their leverage ratios were still relatively high."¹⁴³ Fifth, the Peek-Rosengren Study captured the capital levels required by the formal actions.¹⁴⁴ It found that the most common leverage ratio requirement contained in actions was 6%.¹⁴⁵

After describing the formal enforcement actions issued, the Peek-Rosengren Study combined the data on formal enforcement actions with subsequent data about the financial conditions of banks receiving actions.¹⁴⁶ The Peek-Rosengren Study found that "[a]lmost 40 percent of all FDIC-insured banks with formal actions had declines in assets of more than 10 percent within one year."¹⁴⁷ The Peek-Rosengren Study further found that "loan shrinkage was even more dramatic, with nearly 60 percent [of banks receiving actions] having registered declines in excess of 10 percent and 20 percent registering declines in excess of 20 percent."¹⁴⁸

While the Peek-Rosengren Study was an important step toward understanding formal enforcement efforts, there is room for further empirical research in this area. By design, the Peek-Rosengren study focused only on formal enforcement actions implemented in New England; it can only be applied nationwide by inference. More importantly, the Peek-Rosengren Study focused primarily on a time period before the Federal Deposit Insurance Corporation Improvement Act was passed in 1991.¹⁴⁹ This Act and its accompanying regulations created the prompt corrective

made to reconcile the Peek-Rosengren data with the formal capital enforcement action study data.

140. *Id.* at 16.

141. *Id.* at 17.

142. *Id.* at 18.

143. *Id.* at 19.

144. *Id.* at 20.

145. *Id.* According to the Peek-Rosengren Study, 1 bank received a leverage ratio requirement less than 5%, 20 banks received a leverage ratio requirement between 5% and 6%, 98 banks received a leverage ratio requirement of 6%, 13 banks received a leverage ratio requirement between 6% and 7%, and 8 banks received a leverage ratio requirement of greater than 7%. *Id.*

146. *See id.* at 21.

147. *Id.*

148. *Id.*

149. *See* Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 305(b), 105 Stat. 2236, 2354-55 (1991); Prompt Corrective Action, 57 Fed. Reg.

action directive and implemented the tiered system of capital classifications that is now the bedrock of capital regulations.¹⁵⁰ These changes were not fully implemented until December 1992.¹⁵¹ As a consequence, the Peek-Rosengren Study provides data for only seven quarters of enforcement under a regulatory structure that closely matches the current system.

B. Wellons Study

Professor Philip A. Wellons was next to tackle capital adequacy enforcement.¹⁵² His study focused on FDIC, Federal Reserve, and OCC prompt corrective action directives issued between 1993 and 2001.¹⁵³ Using public data collected from the regulators' web pages, the Wellons Study found a total of 27 prompt corrective action directives—roughly 3 per year.¹⁵⁴ “Of these, the OCC was responsible for 12, the FDIC for 10, and the [Federal Reserve] only for five”¹⁵⁵

44,866 (Sept. 29, 1992) (codified at 12 C.F.R. pts. 6, 19, 208, 263, 308, 325, 565).

150. Michael S. Helfer & Mary Jane Wilson-Bilik, *FDICIA's Prompt Corrective Action Provisions Limit Discretion of Regulators*, 11 BANKING POL'Y REP., no. 7, 1992 at 5.

151. See *supra* Part I for a discussion of current capital regulations. Even prior to the Federal Deposit Insurance Corporation Improvement Act of 1991, federal regulators promulgated risk-based capital guidelines based on the Basel I international capital regulatory framework. These rules became effective on December 31, 1990. See *Capital Maintenance*, 54 Fed. Reg. 11,500 (Mar. 21, 1989) (codified at 12 C.F.R. pt. 325) (FDIC); *Risk-Based Capital Guidelines*, 54 Fed. Reg. 4168 (Jan. 27, 1989) (codified at 12 C.F.R. pt. 3) (OCC); *Capital* 54 Fed. Reg. 4186 (Jan. 27, 1989) (codified at 12 C.F.R. pts. 208, 225) (Federal Reserve); *Prompt Corrective Action*, 57 Fed. Reg. 44,866 (Sept. 29, 1992) (codified at 12 C.F.R. pts. 6, 19, 208, 263, 308, 325, 565). However, banks were allowed to meet lower numerical capital requirements until December 31, 1992. See, e.g., *Risk-Based Capital Guidelines*, 54 Fed. Reg. 4168 (Jan. 27, 1989) (codified at 12 C.F.R. pt. 3). Since 1992, there have been amendments to the capital regulations, but the bulk of the rules remain unchanged. See, e.g., *Risk Based Capital Requirement*, 62 Fed. Reg. 55,490 (Oct. 24, 1997) (adjusting the capital treatment of transfers of small business loans).

152. Wellons, *supra* note 137, at 285.

153. *Id.*

154. *Id.* at 286, 300, 323–24. The formal capital enforcement study summarized in Part II.C located 8 prompt corrective action directives during the 1993 to 2001 time frame that were not included in the Wellons Study. See *id.* at 323–24, app. 1; *In re First Charter Bank, NA*, Order No. OCC-93-383 (July 15, 1993) (Two prompt corrective action directives were issued to Charter Bank in 1993, but only 1 is included in the Wellons study.); *In re Fla. First Int'l Bank*, Order No. FR-93-047-PCA-SM (Sept. 30, 1993); *In re Commercial Bank & Trust Co.*, Order No. FDIC-93-235PCAS (Feb. 1, 1994); *In re Suburban Bank*, Order No. FDIC-93-226PCAS (Apr. 22, 1994); *In re Charter Bank, NA*, Order No. OCC-96-51 (Aug. 27, 1996); *In re OmniBank*, Order No. FR-98-002-PCA-SM (Jan. 26, 1998); *In re Provident Bank*, Order No. FDIC-93-82PCAS (Jan. 30, 1996); *In re Pac. Thrift & Loan Co.*, Order No. FDIC-98-96PCAS (Nov. 23, 1998). It is not readily apparent why the Wellons Study did not contain these directives. The directives may not have been available then.

In addition, the Wellons Study data does not completely match the formal capital enforcement study data due to a difference in the studies' methods for recording the date of directives. The Wellons Study recorded the date of the directive according to the order number of the directive. The formal capital enforcement action study recorded the date of the directive as the date the order was signed. For example, *In re Bank of San Pedro*, Order No.

The Wellons Study sought to explain why the number of prompt corrective action directives was so low.¹⁵⁶ Professor Wellons postulated that the low number could be partly attributed to the robust economic conditions that existed between 1993 and 2001.¹⁵⁷ However, he noted that the number of directives did not significantly increase between 1998 and 2001, even though the economy was deteriorating.¹⁵⁸ Professor Wellons also hypothesized that the low number of directives might be explained by effective supervision: “Perhaps the supervisors caught banks that were heading toward violations of the capital adequacy rules and turned around many of the bad performers.”¹⁵⁹ Professor Wellons ultimately discounted this hypothesis after reviewing case studies of failed banks that questioned regulators’ ability to identify and correct problems.¹⁶⁰

Although the Wellons Study was not designed to evaluate differences in enforcement strategies among the commercial bank regulators, it noted an interesting difference in the language of prompt corrective action directives issued by the FDIC and the Federal Reserve. When the Federal Reserve issued a prompt corrective action directive, the directive “simply require[d] the bank to return to acceptable legislated levels” of capital.¹⁶¹ In contrast, FDIC directives “specifie[d] the dollar amount of the Tier 1 capital increase, the Tier 1 target ratio (or step-ups over time), and the methods to be used to increase capital, which require[d] FDIC prior approval.”¹⁶² This suggests that FDIC directives required banks to maintain capital in excess of the numerical ratios specified by regulation. However, the Wellons Study did not record the amounts of capital required.

Lastly, the Wellons Study noted that no prompt corrective action directives were issued to major banks.¹⁶³ Although Professor Wellons clearly found the absence of actions involving large banks curious, he was unable to explain it. According to the Study, “[i]t is not clear if this happened because the large firms are well managed or because the capital rules do not apply to them as well.”¹⁶⁴

FDIC-93-161PCAS (Jan. 31, 1994), appears as a 1993 order in the Wellons Study and as a 1994 order in the formal capital enforcement action study.

Notwithstanding these minor differences in data, the formal capital enforcement action study is consistent with the Wellons Study results.

155. See *Wellons*, *supra* note 137, at 300. The Wellons Study also examined formal capital enforcement actions brought against investment banks by securities regulators. Because these finding are not relevant to this Article, they are not discussed herein.

156. See *id.* at 300–06.

157. *Id.* at 302–05.

158. *Id.* at 305.

159. *Id.* at 322.

160. *Id.* at 322–23.

161. *Id.* at 299.

162. *Id.* Another commentator during the 1990s suggested that regulators rarely used their discretion to set individual bank capital requirements. Stuart D. Root, *Three Cs of Bank Capital: Convergence, Conundrums and Contrariness*, 1994 COLUM. BUS. L. REV. 135, 151 (stating that “in each instance where there existed statutory authorization for regulators to make judgments based on the ‘particular circumstances’ of institutions, regulators eschewed that authority”).

163. See *Wellons*, *supra* note 137, at 300, 313 (“No big banks have been subject to [prompt corrective action].”).

164. *Id.* at 312.

While the Wellons Study was an important first look at enforcement under the new prompt corrective action statutes and regulations, Professor Wellons acknowledged that his Study was not comprehensive.¹⁶⁵ It did not include informal enforcement actions because they were not publicly available. It did not include a review of capital enforcement efforts through capital directive, cease-and-desist orders, or written agreements. And it did not include OTS enforcement actions.¹⁶⁶

C. Formal Capital Enforcement Action Study

Given the limitations of the Peek-Rosengren Study and the Wellons Study, a new analysis of bank capital enforcement actions is warranted. This Part summarizes a study of formal capital enforcement actions against commercial banks between 1993 and 2010. This study aims to build on the previous studies by including more recent data and by using a more robust data set that includes all available formal capital enforcement actions, including prompt corrective action directives.

After further explaining the design of the study, this Part presents the data and focuses on four questions:

- Has the rate of formal capital enforcement action issuances changed over time?
- Have individual bank capital requirements changed over time?
- Did different regulators bring formal capital enforcement actions and impose individual bank capital requirements at similar rates?
- Did the largest banks receive formal capital enforcement actions?

The data reveal an increasing number of formal capital enforcement actions, an increasing number of individual bank capital requirements, a disparity in rates of enforcement among regulators, and a near-complete absence of actions issued to the largest banks.

1. Study Design

To gain a better understanding of current bank capital enforcement efforts, the current study examined formal capital enforcement actions against U.S. banks between 1993 and 2010.¹⁶⁷ This time period includes every year since the current risk-based capital rules became fully effective.¹⁶⁸ In addition, this time period is sufficiently long to identify regulatory trends. It includes regulatory efforts during

165. *See id.* at 285 (noting that as the first study of its kind, it was meant to provide a general “lay of the land”).

166. *See id.* at 327 n.28.

167. The study does not include formal capital enforcement actions issued only to bank holding companies, foreign banks, or individuals.

168. *See supra* notes 149–51 and accompanying text.

various phases of the economic cycle¹⁶⁹ and spans Republican and Democratic presidencies.

The study focused on formal capital enforcement actions because, unlike informal actions, formal actions are publicly available. The FDIC, Federal Reserve, OCC, and OTS all maintain websites containing the full text of most of their formal enforcement actions.¹⁷⁰ In addition, formal enforcement actions for the FDIC, Federal Reserve, and OCC are available in Westlaw and LexisNexis databases.¹⁷¹ To ensure that the data set was complete, all sources were consulted.¹⁷²

Unlike the Wellons Study, which focused only on prompt corrective action directives, this study identified all publicly available formal actions that enforced bank capital regulations.¹⁷³ All public written agreements, cease-and-desist orders, capital directives, and prompt corrective action directives issued to banks between 1993 and 2010 were reviewed to determine whether they enforced capital regulations.

169. See *US Business Cycle Expansions and Contractions*, NAT'L BUREAU OF ECON. RES. (Sept. 20, 2010), <http://www.nber.org/cycles/cyclesmain.html>.

170. See *FDIC Enforcement Decisions and Orders*, FDIC, <http://www.fdic.gov/bank/individual/enforcement/begsrch.html> (last visited Aug. 19, 2011); *Search Enforcement Actions*, FEDERAL RESERVE <http://www.federalreserve.gov/boarddocs/enforcement/search.cfm> (last visited Aug. 19, 2011); *Enforcement Actions Search Tool*, OCC, <http://apps.occ.gov/EnforcementActions/> (last visited Aug. 19, 2011); *Enforcement Search*, OTS <http://www.ots.treas.gov/?p=EnforcementSearch> (last visited Aug. 19, 2011). Data collected from these websites was finalized on Aug. 19, 2011. Some orders, particularly Federal Reserve and OCC actions from early in the study time period, were missing.

171. In Westlaw the relevant databases are: Federal Finance & Banking, Federal Deposit Insurance Corporation (FDIC) Enforcement Decisions; Federal Finance & Banking, Federal Reserve Board Materials Combined; and Federal Finance & Banking, Office of the Comptroller of the Currency, Enforcement Actions. In LexisNexis the relevant databases are: FDIC Institution Letters and Enforcement Decisions; Federal Reserve Bulletin and Regulatory Service; and Office Comptroller Currency Enforcement Decisions. Neither Westlaw nor LexisNexis appear to maintain databases for OTS enforcement actions.

172. The study first reviewed all actions available on the bank regulators' websites. Because some actions were in nonsearchable, portable document format (.pdf), the actions were read rather than searched using key terms. In some instances, an action was listed on a regulator's website, but the text of the action was not included. These actions were then located using Westlaw or LexisNexis. If the action could not be located in these databases, a copy of the action was requested from the appropriate regulator through a Freedom of Information Act request. Once this process was complete, the relevant Westlaw and LexisNexis databases were searched using the key terms "capital or dividend." The final searches were conducted on August 19, 2011. These searches were designed to locate actions that may not have been included or listed on the regulators' websites. The results of the searches were crosschecked against the existing data and necessary additional actions were included.

173. The study did not review civil money penalties because it seemed unlikely that these orders would be used to require banks to maintain more capital. The study also did not review actions terminating deposit insurance, appointing a receiver, or closing a bank. These actions were excluded to allow the study to focus on operating banks.

Some judgments were required in determining which formal enforcement actions to designate as capital enforcement actions.¹⁷⁴ An action was designated as a capital enforcement action and was included in the study if the action contained any of the following: (1) a finding that the bank did not have adequate capital, (2) a requirement that the bank cease-and-desist from operating with inadequate capital, (3) a requirement that the bank increase or maintain capital levels, (4) a requirement that the bank develop a capital plan, or (5) a requirement that the bank suspend the payment of dividends without the approval of the regulator.¹⁷⁵ An action was not included as a capital enforcement action if it contained items that, if left unchecked, could lead to capital problems. For example, actions addressing classified assets or allowances for loan and lease losses were not included unless they contained one of the above items. In addition, an action was not included if it required only that the bank develop a business plan, even if capital was mentioned as one required element of the business plan.

For each formal capital enforcement action, the date, the docket number, and the title of the action were recorded.¹⁷⁶ For actions titled "cease-and-desist order," the order was reviewed to determine whether it was issued by consent or after an administrative hearing.

Each capital enforcement action was also reviewed to determine if the action set an individual bank minimum capital requirement in excess of the numerical regulatory standards. Again, some judgment was required. For the purposes of the study, a formal capital enforcement action was treated as having an individual bank minimum capital requirement if it required any capital ratio in excess of the ratios required to be classified as adequately capitalized¹⁷⁷ under the prompt corrective action statute.¹⁷⁸ If the action required the bank to gradually increase capital, then

174. Without developing a process to exclude unrelated actions, the study would have included a large number of actions unrelated to capital. For example, enforcement actions are commonly issued to enforce flood insurance requirements and the Bank Secrecy Act. Examining those actions would not have aided our understanding of capital enforcement.

175. Because the payment of dividends decreases a bank's capital ratio, regulatory action limiting a bank's payment of dividends is a capital enforcement action.

176. Amendments or modifications to existing actions were treated as independent actions.

177. Some believe that because banks gain regulatory benefits from being well capitalized, well capitalized (rather than adequately capitalized) is the de facto minimum capital standard. See R. ALTON GILBERT, NETWORKS FIN. INST., KEEP THE LEVERAGE RATIO FOR LARGE BANKS TO LIMIT THE COMPETITIVE EFFECTS OF IMPLEMENTING BASEL II CAPITAL REQUIREMENTS 7 (2006), available at http://www.networksfinancialinstitute.org/Lists/Publication%20Library/Attachments/10/2007-PB-08_VanHoose.pdf. Nevertheless, this study uses adequately capitalized as the minimum standard because doing so allows examination of individual bank minimum capital requirements that are set between the adequately capitalized and well capitalized levels. Using well capitalized as the minimum standard would have excluded these data, resulting in a less complete view of capital enforcement activity.

178. If an action required only a 4% leverage ratio, the action was not treated as containing an individual bank minimum capital requirement. Similarly, an action containing a minimum tier 1 risk-based capital ratio of 4% or a total risk-based capital ratio of 8% was not treated as containing an individual bank minimum capital requirement. See *supra* Figure

only the largest capital requirement was recorded in the data set.¹⁷⁹ If the action required that the bank become well capitalized, then the numerical requirements in Figure 1 for well-capitalized banks were included in the data set. An action was also classified as having an individual bank minimum capital requirement if it required the bank to raise or maintain a specific dollar amount of capital. In those cases, the dollar requirements were recorded.¹⁸⁰ Finally, a small number of actions contained what might be called contingent individual bank minimum capital requirements.¹⁸¹ These actions set individual bank minimum capital requirements only if certain conditions (other than the passage of time) occurred. These actions were not counted as containing an individual bank minimum capital requirement unless the action contained a separate capital requirement that was not contingent.¹⁸²

2. Formal Capital Enforcement Actions

First, the study allows us to evaluate whether the rate of formal capital enforcement actions or the type of formal capital enforcement actions has changed over time. Press reports detail an explosion of recent capital enforcement activity. According to reports, “[t]he pace of enforcement actions [in 2010 was] about double that of [2009].”¹⁸³ Some accuse bank regulators of adopting a “paper-for-

1 (showing the requirements for an adequately capitalized bank). No adjustments were made for tangible capital ratios because there were no formal capital enforcement actions containing tangible capital requirements of 2% or lower.

179. For example, one order provided:

As of the effective date of this ORDER, the Bank shall have and maintain its level of Tier 1 capital as a percentage of its total assets (“capital ratio”) at a minimum of 8.0%. As of March 31, 2009, the Bank shall have and maintain its capital ratio at a minimum of 8.5%. As of June 30, 2009, the Bank shall have and maintain its capital ratio at a minimum of 9.0%.

In re Geauga Savings Bank, Order No. FDIC-08-241b (Jan. 12, 2009). In that instance, a 9.0% leverage ratio requirement was recorded.

180. No attempt was made to determine whether the required dollar amounts would actually result in capital ratios greater than those required by regulation. However, it seems reasonable to count these actions as having individual bank capital requirements because the regulator would gain little benefit by issuing an action requiring a dollar amount of capital equal to or less than the required statutory amount.

181. For example, one written agreement provided:

If, on September 30, 1993, the Association’s assets as of that date which had been classified assets as of July 6, 1992, exceed 200% of tangible capital, then, by no later than October 31, 1993, the Association shall have received an external cash capital infusion in at least the amount of \$250,000 minus the amount of any external cash capital infusion(s) received since January 1, 1993.

In re Homestead Sav. Ass’n, Order No. OTS-SA-7488, 4 (Aug. 17, 1993); *see also In re* Syringa Bank, Order No. FDIC-10-314b, 3 (Aug. 19, 2010) (consent order).

182. No effort was made to determine whether the condition or conditions necessary to activate the contingent capital requirements ever occurred.

183. *Regulators Issuing Orders on Record Pace; Enforcement Actions Becoming ‘Ordinary,’* BANK SAFETY & SOUNDNESS ADVISOR, Sept. 6, 2010, at 4 [hereinafter *Regulators Issuing Orders on Record Pace*] (quoting Matthew Anderson, managing director of Foresight Analytics); *see also* Cheyenne Hopkins, *Agencies’ Orders to Banks Set Mark in*

all” strategy, meaning that most banks receive some kind of formal or informal enforcement action.¹⁸⁴ While not all enforcement actions involve matters related to capital, reports suggest that “[m]ost” do.¹⁸⁵ The formal capital enforcement action study provides a more precise measure of the changes in capital enforcement activity.

As illustrated in Figure 2, the formal capital enforcement action study shows a recent increase in formal capital enforcement activity. The number of actions issued tripled from 2007 to 2008 and tripled again from 2008 to 2009.¹⁸⁶ By 2010, the rate of increase slowed, but the number of capital enforcement actions was still rising.¹⁸⁷ In fact, 61% of the formal capital enforcement actions in the study (1442 of 2350) were issued between 2008 and 2010.¹⁸⁸

'10, AM. BANKER, Feb. 11, 2011, at 1; Cheyenne Hopkins, *Regulatory Actions Hit a Record Level in '09*, AM. BANKER, Mar. 10, 2010, at 1; Russ Wiles, *Words of Warning: Regulators More Aggressive About Enforcement Orders for Banks*, ARIZ. REPUBLIC, June 6, 2010, at D1; Rachel Witkowski, *More Banks Feel Sting of Actions by Agencies*, AM. BANKER, Aug. 13, 2010, at 1.

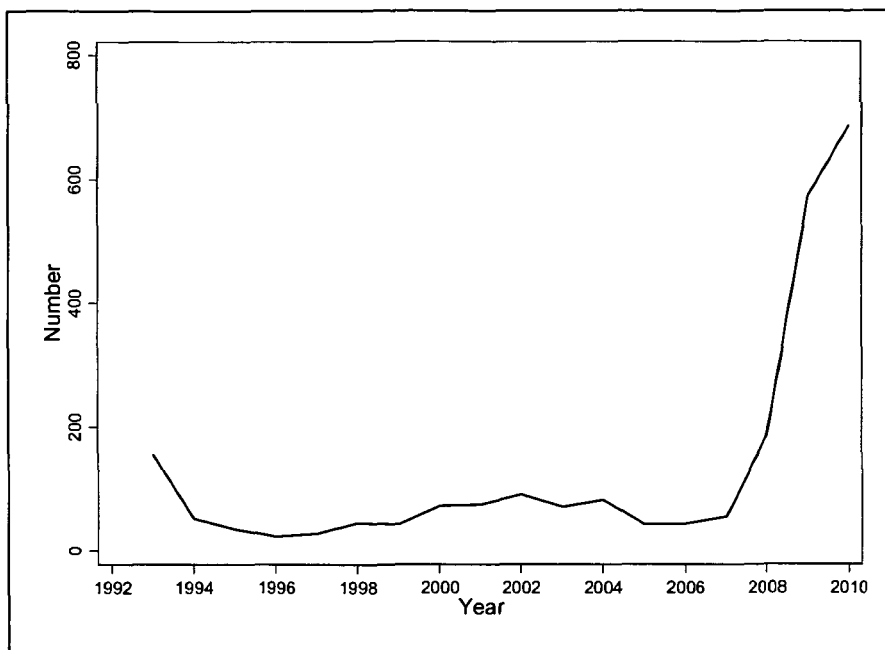
184. See *Regulators Issuing Orders on Record Pace*, *supra* note 183, at 3 (quoting bank attorney Jeffrey Gerrish).

185. *Id.*; see also Hopkins, *Regulatory Actions Hit a Record Level in '09*, *supra* note 183, at 1 (quoting Professor Cornelius Hurley as stating, “I would think the main driver for [enforcement actions] is capital deficiencies”); Wiles, *supra* note 183, at D1 (“The most vexing issue now for banks is the need to raise more capital, as happens when loan portfolios disintegrate.”).

186. There were 55 actions in 2007, 185 actions in 2008, and 571 actions in 2009.

187. In 2010, regulators issued 686 actions.

188. During the study time period, the number of banks has gradually decreased from a high of 13,221 in 1993 to a low of 7658 in 2010. See *Statistics on Depository Institutions*, FDIC, <http://www2.fdic.gov/sdi/> (last updated Aug. 16, 2011). Thus, the increase in the number of enforcement orders is not due to an increase in the number of regulated banks.

Figure 2: Formal Capital Enforcement Actions per Year (1993–2010)

This rise in the number of capital enforcement actions corresponds with the timing of the current financial crisis. The subprime mortgage market began deteriorating in 2006. By 2007, home foreclosures were at record highs.¹⁸⁹ The increased mortgage defaults led rating agencies to downgrade their ratings of mortgage-backed securities, causing problems for investment banks and commercial banks with heavy exposure to subprime mortgage securities.¹⁹⁰ However, the true extent of the financial crisis did not become apparent until 2008.¹⁹¹ By March 2008, investors were pulling money from Bear Stearns, a major investment bank.¹⁹² Just as Bear Stearns was on the brink of failure, the Federal Reserve provided bailout funds and brokered a deal for JPMorgan Chase to purchase Bear Stearns.¹⁹³ As it turned out, Bear Stearns was only the beginning. Before the dust settled, “the federal government took over the two largest players in

189. See Elizabeth Warren, *Making Credit Safer: The Case for Regulation*, HARV. MAG., May–June 2008, at 34, 35.

190. See Serena Ng & Ruth Simon, *Ratings Cuts by S&P, Moody’s Rattle Investors*, WALL ST. J., July 11, 2007, at A1.

191. See generally RICHARD A. POSNER, *A FAILURE OF CAPITALISM: THE CRISIS OF ’08 AND THE DESCENT INTO DEPRESSION* (2009); Douglas W. Arner, *The Global Credit Crisis of 2008: Causes and Consequences*, 43 INT’L LAW. 91 (2009).

192. See Landon Thomas, Jr., *Run on Big Wall St. Bank Spurs U.S.-Backed Rescue*, N.Y. TIMES, Mar. 15, 2008, at A1.

193. See Edmund L. Andrews, *In Sweeping Move, Fed Backs Buyout and Wall St. Loans*, N.Y. TIMES, Mar. 17, 2008, at A1; Landon Thomas, Jr. & Eric Dash, *Seeking Fast Deal, JPMorgan Quintuples Bear Stearns Bid*, N.Y. TIMES, Mar. 25, 2008, at C1.

the mortgage market, allowed a large investment bank to go bankrupt, bailed out one of the world's largest insurance companies, and steered a major financial institution through the largest bank failure in U.S. history."¹⁹⁴ As the financial crisis reached its full-blown stage, formal capital enforcement actions began to increase dramatically. In March 2008, the month of the Bear Stearns rescue, the number of formal capital enforcement actions reached double digits.¹⁹⁵ The number of formal capital enforcement actions reached double digits every month between March 2008 and December 2010. There is, however, good news. Most commentators believe that the worst of the financial crisis has passed.¹⁹⁶ This is consistent with the lower rate of growth in the number of formal capital enforcement actions between 2009 and 2010.¹⁹⁷

In addition to the high levels of enforcement activity during the final three years of the study, the data show a large number (154) of actions in 1993, the first year of the study. The 1993 actions reflect the remnants of an economic downturn and the savings and loan crisis that began about 1985.¹⁹⁸ The Peek-Rosengren Study suggests that if data had been collected for 1990 through 1992, those years would have seen even more formal capital enforcement activity than in 1993.¹⁹⁹ By 1994, the banking industry had seen several years of increased earnings, and few banks were undercapitalized.²⁰⁰ Correspondingly, the formal capital enforcement action study shows only 52 actions in 1994 and 35 actions in 1995.

The formal capital enforcement study's finding that formal capital enforcement actions fluctuate with the economic conditions is consistent with the conclusions in both the Peek-Rosengren Study and Wellons Study. Both previous studies concluded that enforcement actions increase during downturns in the banking industry and economy.²⁰¹

The total number of enforcement actions issued tells only part of the enforcement story. As explained in Part I.B.1, regulators can select from a variety

194. DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: LAW, EXPLANATION AND ANALYSIS 32 (2010) (citation omitted).

195. There were ten or fewer actions per month in 2005, 2006, and 2007.

196. See, e.g., THE FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 353-401 (2011) (describing the 2008 financial crisis and its lingering aftershocks); Joe Adler, *Loan Quality Improves as Fee Income, Revenue Dip*, AM. BANKER, Feb. 24, 2011, at 1 (noting that FDIC Chairman Sheila Bair called 2010 "a turnaround year").

197. See *supra* Figure 2. In fact, the OTS issued fewer formal capital enforcement actions in 2010 than it did in 2009. All other federal regulators increased the number of formal capital enforcement actions issued from 2009 to 2010.

198. See Barbara A. Rehm, *FDIC Cuts '94 Budget 5% as Workload Plunges*, AM. BANKER, Dec. 15, 1993, at 3; Barbara A. Rehm, "Prompt Action" Specter Fades; Upturn Made Plans for Early Intervention Irrelevant, AM. BANKER, Aug. 9, 1993, at 17 (stating that "record-breaking [bank] earnings [and] low interest rates" explained why the number of enforcement actions in 1993 was lower than in previous years).

199. See Peek & Rosengren, *supra* note 136, at 17.

200. See Barbara A. Rehm, *Prompt Corrective Action Used in Just 30% of Capital-Poor Banks*, AM. BANKER, Jan. 12, 1995, at 3.

201. See *supra* notes 141-42, 157-58, and accompanying text.

of formal enforcement tools. Which type of actions do regulators favor? The data show that banks consent to the vast majority of formal capital enforcement actions. Of the 2350 formal capital enforcement actions during the study time period, 203 were prompt corrective action directives, 11 were capital directives, and 3 were temporary cease-and-desist orders. In other words, regulators used actions that did not require a hearing or the consent of the bank about 9% of the time. Cease-and-desist orders issued after hearings were even rarer; only 8 occurred during the study period. The remaining 90% of formal capital enforcement actions, including written agreements, consent orders, and cease-and-desist orders, were entered by consent.²⁰²

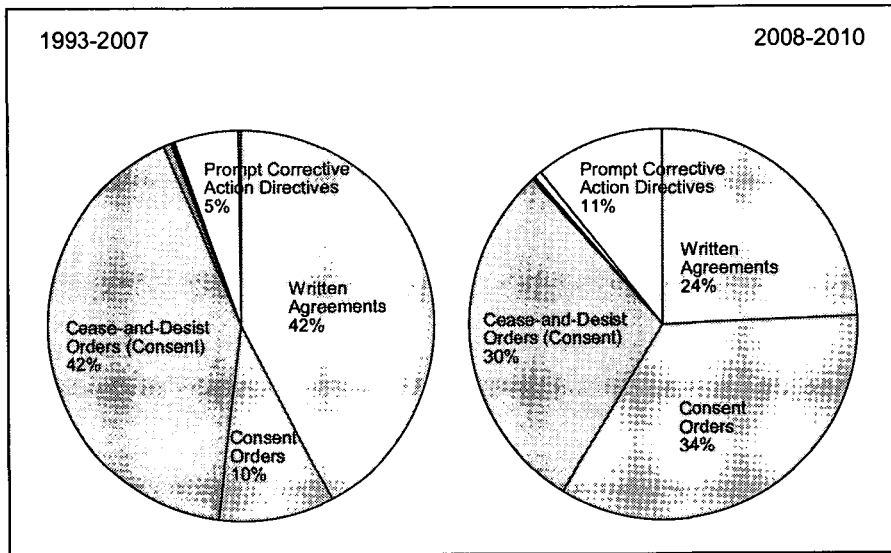
Regulators' decisions about the type of formal action to use might be influenced by the condition of the economy and the banking industry. In particular, prompt corrective action directives might increase during economic downturns as banks' capital is depleted. Under current regulations, regulators must issue a prompt corrective action directive when a bank's capital levels fall below the adequately capitalized level.²⁰³ The formal capital enforcement action study confirms that regulators have turned to more serious actions during the current financial crisis (See Figure 3). During the last three years of the study, the percentages of prompt corrective action directives, the most serious of enforcement actions, increased. At the same time, 2008 through 2010 had much lower percentages of written agreements (the least serious of formal actions)²⁰⁴ than the previous years. The data also show comparatively fewer cease-and-desist orders issued by consent and more consent orders. The difference in percentages of the latter two types of actions is likely due to the FDIC's decision in 2009 to begin labeling cease-and-desist orders entered with consent as consent orders.²⁰⁵

202. There were 736 written agreements, 583 consent orders, and 804 cease-and-desist orders issued by consent. In addition, 2 actions issued by the OCC were labeled as "Safety and Soundness Orders." See *In re* Fremont First Nat'l Bank, Order No. OCC-99-46 (Apr. 30, 1999); *In re* Merchs. Bank of Cal., N.A., Order No. OCC-98-91 (Dec. 22, 1998).

203. See *supra* Figure 1 and accompanying text.

204. Written agreements are the least serious of the formal capital enforcement actions because, unlike the other actions, written agreements cannot be enforced in court. See *supra* notes 120–21 and accompanying text.

205. See Robert Barba, *FDIC Speaks More Softly, Retains Stick*, AM. BANKER, Nov. 16, 2009, at 1.

Figure 3: Formal Capital Enforcement Actions by Action Type

The finding that regulators seem to be migrating to more serious enforcement actions raises an important question: Have enforcement efforts increased during the current financial crisis, or have regulators just shifted their efforts from informal actions to formal actions? Like the Wellons Study, one of the limitations of this empirical analysis is that it includes only formal enforcement actions. Without data concerning informal capital enforcement actions, the picture of enforcement efforts is incomplete. A review of formal enforcement actions alone cannot determine whether overall enforcement efforts are increasing.

While individual informal enforcement actions are not available, some aggregate data for informal enforcement actions are available. These data suggest that informal capital enforcement actions likely mirror formal capital enforcement actions. The most helpful data are from the OCC. Unlike the other regulators, the OCC has a specific informal action aimed at capital enforcement—the individual minimum capital ratio letter. These letters impose capital requirements, but are not publicly released by the OCC and are not formal actions.²⁰⁶ According to its annual reports, the OCC did not issue any individual minimum capital ratio letters between fiscal years²⁰⁷ 2003 and 2007.²⁰⁸ In fiscal year 2008, the OCC issued 9 such letters.²⁰⁹ By fiscal year 2009, the number ballooned to 132.²¹⁰ Fiscal year 2010

206. See *supra* notes 130–32 and accompanying text.

207. The OCC's fiscal year ends on September 30. See OFFICE OF INSPECTOR GEN., DEP'T OF THE TREASURY, AUDIT REPORT: MANAGEMENT LETTER FOR THE AUDIT OF THE OFFICE OF THE COMPTROLLER OF THE CURRENCY'S FISCAL YEARS 2010 AND 2009 FINANCIAL STATEMENTS (2010).

208. OCC, ANN. REP. 21 (2007); OCC, ANN. REP. 15 (2006); OCC, ANN. REP. 21 (2005); OCC, ANN. REP. 15 (2004); OCC, ANN. REP. 16 (2003). Annual reports prior to 2003 do not contain summary data about enforcement actions.

209. OCC, ANN. REP. 35 (2008).

also saw a robust amount of informal capital enforcement with 126 individual minimum capital ratio letters.²¹¹ In other words, the OCC's informal capital enforcement increased at approximately the same time as its formal capital enforcement increased.²¹² Thus, it seems reasonable to conclude that regulators were increasing capital enforcement efforts, rather than just shifting from informal to formal enforcement.²¹³

In sum, the data show a dramatic increase in the number of formal capital enforcement actions between 2008 and 2010. At the same time, regulators shifted to more serious types of formal capital enforcement. These years of heightened enforcement correspond to an economic downturn and financial stress in the banking industry.

3. Discretionary Capital Requirements

The formal capital enforcement study also allows us to evaluate whether regulators' use of individual bank minimum capital requirements has changed over time. Many bankers believe that during the current financial crisis regulators have increasingly used discretionary enforcement actions to increase capital

210. OCC, ANN. REP. 41 (2009); see also *Examiner Hot Buttons: Reserves, Capital, Management Oversight*, BANK SAFETY & SOUNDNESS ADVISOR, Apr. 5, 2010, at 1 (discussing the OCC's increasing use of individual minimum capital ratio letters); T.J. Grasmick, *Today's Bank Regulatory Enforcement Landscape: Tough Disclosure Issues and Unintended Consequences*, BANKNEWS, Sept. 2009, at 14, 15 (same).

These data are consistent with press reports that generally indicate a rise in informal enforcement actions between 2008 and 2009. See Hopkins, *Regulatory Actions Hit a Record Level in '09*, *supra* note 183, at 1 (reporting 1099 informal actions in 2009). The *Wall Street Journal* similarly reported that the Federal Reserve and FDIC had issued more informal MOUs by August of 2009 than they had in all of 2008. See Damian Paletta & David Enrich, *Regulators Step Up Bank Actions*, WALL ST. J., Aug. 26, 2008, at C1. The article states that the FDIC had entered into 118 MOUs through August 15, 2008, compared with 175 in 2007. Neither article reported informal actions by the OTS. According to the *Wall Street Journal*, the OTS would not provide data on MOUs, but did acknowledge "a significant spike." *Id.*

211. OCC, ANN. REP. 40 (2010). Data for the FDIC and Federal Reserve show that their informal enforcement actions (of all types, including capital) rose in 2010. See Hopkins, *Agencies' Orders to Banks Set Mark in '10*, *supra* note 183, at 1 (noting that in 2010, the FDIC issued 890 informal actions and the Federal Reserve issued 639). In fact, the FDIC's total number of informal actions rose so dramatically between 2009 and 2010 that Gil Schwartz, a partner in Schwartz & Ballen LLP, concluded that "[t]he FDIC seems to have taken the approach of de-emphasizing its reliance on formal orders and increasing its reliance on informal memorandums of understanding." *Id.* If this is true, the formal capital enforcement action study may underreport enforcement in 2009 and 2010 more than it underreports enforcement in previous years.

212. The formal capital enforcement study shows that the OCC issued 14 formal capital enforcement actions in 2007, 69 in 2008, 114 in 2009, and 125 in 2010.

213. This conclusion is consistent with earlier research on informal and formal actions. Federal Reserve data from the 1990s found that changes in the number of informal enforcement actions roughly mirrored changes in the number of formal enforcement actions. See R. Alton Gilbert & Mark D. Vaughan, *Do Depositors Care About Enforcement Actions?*, 53 J. ECON. & BUS. 283, 287 (2001).

requirements.²¹⁴ Reports seem to agree that “[e]xaminers are increasingly demanding a 9% leverage ratio, 11% Tier 1 risk-based capital [ratio,] and 12% total [risk-based capital] for banks.”²¹⁵ On the other hand, regulators bristle at the charge that they are increasing capital requirements. According to Scott Polakoff, then-Acting Director of the Office of Thrift Supervision:

Regarding capital standards, I would like to dispel some inaccuracies receiving recent attention. The first is the notion that federal bank and thrift examiners are raising capital requirements for the financial institutions they regulate. This incorrect assertion has been circulated perhaps because the financial services industry generally is facing significant challenges and, at the OTS, this stress has resulted in a marked increase in formal enforcement orders related to safety-and-soundness. Under such actions, which include cease-and-desist orders, institutions are often required to maintain capital levels above the well-capitalized standard. Although these types of cases are increasing, they remain relatively few in number and the requirements are necessary to provide a counterbalance to the elevated risks confronting these institutions.²¹⁶

The formal capital enforcement action study examined both the number of actions containing individual bank capital requirements and the capital levels set by these actions.

First, how often did regulators require capital in excess of the statutory minimum? Of the 2350 formal capital enforcement actions during the study period, 1718 (73%) contained individual bank minimum capital requirements. As Figure 4 shows, the proportion of formal capital enforcement actions containing individual bank minimum capital requirements has remained fairly constant for the bulk of the study period. As the number of formal capital enforcement actions has increased,

214. See *Is 12 the New 10? Examiners Ask for More and More Capital, Orders Show*, BANK SAFETY & SOUNDNESS ADVISOR, July 19, 2010, at 1 [hereinafter *Is 12 the New 10?*] (reporting that Tom Youngblood, president of Park Cities Bank in Dallas, “expressed disbelief that examiners are demanding so much capital beyond the well-capitalized definitions”).

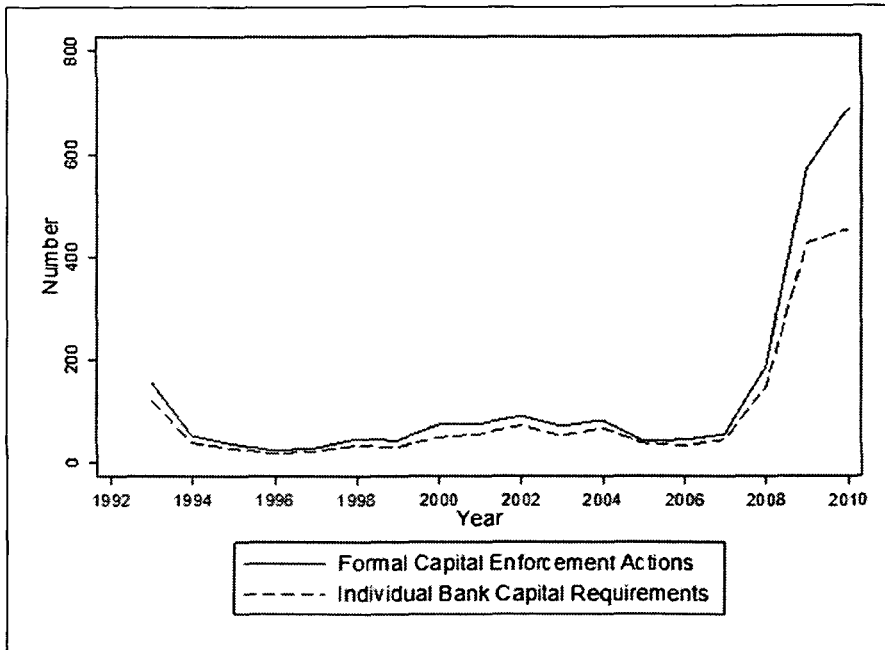
215. *What New Capital Ratios Would Mean for Banks*, BANK SAFETY & SOUNDNESS ADVISOR, July 26, 2010, at 1. See Steve Cocheo, *Squeeze Play*, A.B.A. BANKING J., Nov. 2010, at 26, 27 (stating that “bankers talk about [12%] as the new de facto [total risk-based capital] requirement”); *Is 12 the New 10?*, *supra* note 214, at 1 (“[Bank] examiners are seeking 9% to 10% Tier 1 leverage capital ratios”); Damian Paletta & David Enrich, *Banks Told: Lend More, Save More*, WALL ST. J., Dec. 26, 2008, at C1 (“‘At the moment, for many banks, eight[% tier 1 risk-based capital] is the new six and 12[% total risk-based capital] is the new 10,’ said Eugene A. Ludwig, former head of the Office of the Comptroller of the Currency, which oversees many U.S. banks.”); see also Rockett, *supra* note 111, at 316 (“In many instances otherwise well-capitalized institutions are being required to maintain capital levels far in excess of current ‘well-capitalized’ standards in recognition of the risk profile of an institution.”).

216. *Exploring the Balance Between Increased Credit Availability and Prudent Lending Standards: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 167 (2009) (written testimony of Scott M. Polakoff, Acting Director, Office of Thrift Supervision).

so has the number of individual bank minimum capital requirements. Thus, in the last three years, the number of banks subject to an individual bank minimum capital requirement has increased dramatically.

On the other hand, the 2010 data show one of the lowest percentages of actions containing an individual bank minimum capital requirement. In 2010, only 65.9% of formal capital enforcement actions (452 of 686) contained an individual bank minimum capital requirement.²¹⁷ By comparison, the percentage of actions containing individual bank minimum capital requirements was 78.9% in 2008 and 74.6% in 2009. It is not clear why the percentage of actions containing minimum bank capital requirements was lower in 2010.

Figure 4: Formal Capital Enforcement Actions and Individual Bank Minimum Capital Requirements (1993–2010)



Next, the formal capital enforcement study allows us to describe individual bank minimum capital requirements. When regulators did impose individual bank minimum capital requirements, how did they specify those requirements? The data show that regulators most often use the regulation-defined ratios. Of the regulatory capital ratios, the leverage ratio was the most popular: 1691 actions contained increased leverage ratios. The total risk-based capital ratio was next with 1066 actions, followed by the tier 1 risk-based ratio with 483 actions.²¹⁸ Two hundred

217. Only one other year had a lower percentage of enforcement actions that contained an individual bank minimum capital requirement. In 2000, 48 of the 73 enforcement actions (65.8%) contained an individual bank minimum capital requirement.

218. In addition, 8 actions contained tangible equity capital requirements. *See, e.g., In re*

eighty-three of the actions contained requirements for all three of the capital ratios. Regulators also occasionally chose to set individual bank minimum capital requirements by using dollar amounts rather than capital ratios. In some instances, the regulator required a bank to increase its capital by a specific dollar amount.²¹⁹ In other instances, the regulator specified a dollar amount of capital that the bank must maintain.²²⁰

How much capital do regulators require? When formal enforcement actions contained individual bank minimum capital requirements, they often required significantly more capital than the standard regulatory ratios. The mean leverage ratio in individual bank minimum capital requirements was 8%—double the 4% specified in regulations to be classified as adequately capitalized. It is also higher than the average leverage ratio of 6% found in the Peek-Rosengren Study.²²¹ One bank received a 28% leverage ratio—seven times the standard requirement.²²² This action is an outlier.²²³ However, during the study period, 23 banks received leverage ratios between 12% and 17%. As shown in Figure 5, the other average individual bank minimum capital requirements are also well above the standard regulatory requirements. The mean tier 1 risk-based capital ratio required was 9.2%—more than double the 4% required by regulation to be considered adequately capitalized. The mean total risk-based capital ratio was 11.5%—well above the regulatory 8%.²²⁴

Alaska First Bank & Trust, N.A., Order No. OCC-2006-15 (Feb. 2, 2006) (written agreement).

219. Fifty-four actions required the bank to increase tier 1 capital by a specific dollar amount. *See, e.g., In re W. Commercial Bank*, Order No. FDIC-10-575b (Aug. 20, 2010) (consent order) (requiring the bank to “increase its Tier 1 capital by not less than \$10 million”). Fifteen actions required the bank to increase total capital by a specific dollar amount. *See, e.g., In re Syringa Bank*, Order No. FDIC-10-314b (Aug. 19, 2010) (consent order) (requiring the bank to “increase capital by \$8.5 million”).

220. Thirteen actions specified a minimum dollar amount of tier 1 capital and 4 actions specified a minimum dollar amount of total capital. *See, e.g., In re Cmty. State Bank*, Order No. FDIC-10-494b (Sept. 9, 2010) (consent order) (requiring the bank to “[w]ithin 45 days after the effective date of this ORDER . . . achieve and maintain Tier 1 Capital of \$5,000,000 and no less than \$7,500,000 by December 29, 2010”).

221. *See Peek & Rosengren, supra* note 136, at 20.

222. *In re First Consumers Nat’l Bank*, Order No. OCC-2000-40 (May 15, 2002) (consent order).

223. The next highest individual bank minimum leverage ratio is 17%. *See In re Advanta Nat’l Bank*, Order No. OCC-2000-48 (May 31, 2000).

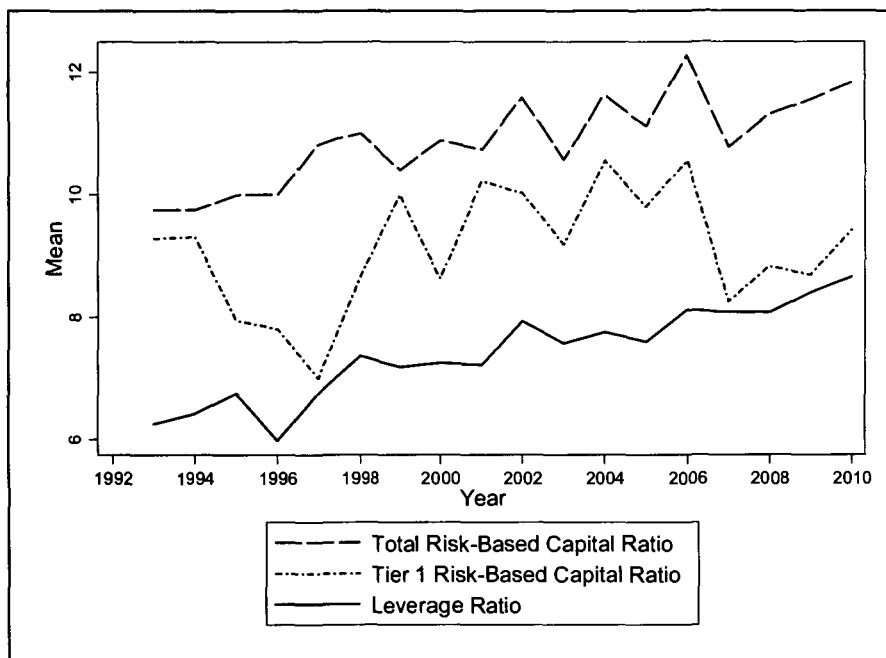
224. Even if the prompt corrective action statute’s “well capitalized” standard is viewed as the regulatory requirement, the capital requirements included in the formal capital enforcement actions are significantly higher.

Figure 5: Individual Bank Minimum Capital Requirements by Requirement Type (1993–2010)²²⁵

Capital Measure	Range	Mean	Median	Mode
Leverage Ratio	4.5%–28%	8.0%	8%	8%
Tier 1 Risk-Based Capital Ratio	6%–19%	9.2%	10%	6%
Total Risk-Based Capital Ratio	9%–18%	11.5%	12%	12%
Tangible Equity Capital Ratio	4%–10%	8.4%	8.7%	10%
Tier 1 Capital Increase	\$.05–\$300.00	\$11.61	\$2.00	\$.30, \$1.00
Total Capital Increase	\$.05–\$75.00	\$10.52	\$3.00	\$1.00
Minimum Amount Tier 1 Capital	\$.75–\$57.00	\$12.71	\$7.50	--
Minimum Amount Total Capital	\$2.00–\$37.61	\$16.20	\$12.59	--

Have regulators increased the capital ratios contained in individual bank minimum capital requirements over time? Figure 6 illustrates that, when considering the mean individual bank capital requirements, there is a gradual trend toward higher leverage and total risk-based capital ratios. The trend is most pronounced for leverage ratios. In 2010, the mean leverage ratio (8.65%) was higher than any other year during the study period. In contrast, the tier 1 risk-based capital requirement appears more volatile, and, in fact, has been lower in the last few years than earlier in the decade. The reasons for the varying trends is not readily apparent. However, it does not appear that the capital requirements in formal enforcement actions have increased dramatically during the current financial crisis.

225. Dollar amounts are in \$1,000,000s. Data are reported only for banks containing each specific capital requirement type. For example, the leverage ratio line contains summary data only for actions that included a leverage ratio requirement greater than 4%.

Figure 6: Mean Individual Bank Minimum Capital Requirements (1993–2010)

In conclusion, the study reveals that individual bank capital requirements are found in most formal capital enforcement actions. During the current economic downturn, the number of banks subject to individual bank capital requirements has spiked. This means that more banks than ever are subject to capital requirements that exceed the regulatory minimum. However, the leverage ratio and total risk-based capital requirements included in actions exhibit a more modest upward trend that does not appear to closely track economic conditions.

4. Enforcement Differences Among Regulators

Next, the formal capital enforcement action study allows us to evaluate whether regulators take similar approaches to discretionary capital enforcement. Congress has urged bank regulators to work together to standardize capital regulations.²²⁶ The purpose of uniform capital standards is to ensure that banks compete on a level playing field.²²⁷ However, there is little reason for uniform regulations if regulators do not apply the regulations in the same manner.²²⁸

226. See 12 U.S.C. §§ 1831n(c), 4803 (2006); 12 U.S.C.S § 5371 (LexisNexis 2010) (contemplating uniform bank capital standards).

227. S. REP. NO. 111-176, at 87 (2010) (“It is the view of the Committee that, as a matter of good public policy, banks . . . should not compete on the basis of differences in safety and soundness regulation.”).

228. See *supra* Part I.A for a discussion of the standard capital requirements.

When the capital amounts are determined through a discretionary process, it is possible that some bank regulators may be more lenient than others. This would give some banks a competitive advantage. For example, “if the [OCC] had a more lenient regulatory treatment of capital for national banks than the Federal Reserve Board or FDIC had for state banks, then the costs of operation for national banks would be reduced, thus giving them a competitive advantage over state banks.”²²⁹ More serious problems could occur if one regulator responded to an economic crisis by imposing higher individual capital requirements while another regulator left its capital requirements low. If the low capital requirement was too low, some banks would fail and the FDIC’s insurance fund could suffer significant losses.²³⁰ The FDIC might cover those losses by raising premiums for the remaining banks.²³¹ The healthier banks with higher capital requirements would pay twice: once to raise or maintain their capital at a sufficient level, and once to compensate for the lower capital requirement enjoyed by other banks.

Anecdotal evidence suggests that federal regulators have divergent views concerning appropriate amounts of capital. Perhaps the most public regulatory turf battle over capital requirements involved Washington Mutual Bank, a massive thrift seized by regulators in September 2008.²³² Before closing Washington Mutual, the bank’s primary federal regulator, the OTS, and its deposit insurer, the FDIC, spent months bickering about the financial condition of the bank. The FDIC was convinced the bank needed at least an additional \$5 billion in capital, but the OTS disagreed.²³³ Ultimately, the regulators agreed to close the bank after bank customers began withdrawing their deposits, creating a liquidity problem.²³⁴ However, the OTS and the FDIC still disagree about whether the bank had sufficient capital to survive but for the liquidity problem.²³⁵

229. Joseph Jude Norton, *Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities?*, 49 OHIO ST. L.J. 1299, 1355 (1989); see also Heath Price Tarbert, *Rethinking Capital Adequacy: The Basle Accord and the New Framework*, 56 BUS. LAW. 767, 778 (2001); Charles K. Whitehead, *What’s Your Sign?—International Norms, Signals, and Compliance*, 27 MICH. J. INT’L L. 695, 727 n.168 (2006).

230. See Richard Falk & Andrew Strauss, *On the Creation of a Global Peoples Assembly: Legitimacy and the Power of Popular Sovereignty*, 36 STAN. J. INT’L L. 191, 212 n.88 (2000) (“Minimally capitalized banks have a competitive advantage in loaning money but also have a heightened risk of failure.”).

231. This scenario is not far-fetched. During the current financial crisis, the FDIC has raised deposit insurance premiums to cover losses incurred by bank failures. See Paul Davis, Heather Landy, Katie Kuehner-Hebert et al., *Best in Banking, Year in Review*, AM. BANKER, Dec. 7, 2009, at 19A.

232. See Robin Sidel, David Enrich & Dan Fitzpatrick, *WaMu Is Seized, Sold Off to J.P. Morgan, In Largest Failure in U.S. Banking History*, WALL ST. J., Sept. 26, 2008, at A1 (discussing regulators’ closure of Washington Mutual).

233. Drew Desilver, *Infighting Distracted WaMu’s Regulators—Turf Battles One Agency Thwarted Another’s Access to Data—Or a Desk*, SEATTLE TIMES, Apr. 17, 2010, at A1.

234. Joe Adler, *FDIC’s ‘Big One’: Long Prelude Gave Way to a Sudden End*, AM. BANKER, Sept. 29, 2008, at 1.

235. Joe Adler, *‘Pitiful’ OTS Blamed for Wamu’s Fall*, AM. BANKER, Apr. 19, 2010, at 1 (reporting that the former OTS chairman stated that Washington Mutual’s failure “was a

Incidents like the Washington Mutual failure led many to conclude that the OTS was the most lenient of the federal bank regulators. For example, according to Professor Patricia McCoy, “[t]he OTS [was] the worst federal regulator on the block.”²³⁶ Professor McCoy accused the OTS of having “a culture of being . . . permissive and cozy with the thrifts it regulates.”²³⁷ Based in part on the widespread belief that the OTS was a lax regulator, Congress decided to eliminate the OTS and transfer its authority to other regulators.²³⁸ From this evidence, it would be reasonable to predict that federal regulators would issue formal capital enforcement actions and impose individual bank capital requirements at different rates. It would also be reasonable to predict that the OTS would have the lowest rates of formal capital enforcement actions and the lowest individual bank capital requirements.

The data from the formal capital enforcement action study reveal a somewhat different story. The data show that all regulators brought capital enforcement actions at roughly similar rates. Regulators, however, did differ in the type of formal capital enforcement action employed and the rate at which they issued individual bank minimum capital requirements. Surprisingly, the Federal Reserve was the least likely to impose the most serious enforcement actions and the least likely to impose individual bank minimum capital requirements.

Because each regulator supervises a different number of banks, comparisons of regulators must focus on the rate of enforcement actions per bank rather than simply the number of enforcement actions. Figure 7 shows the ratio of formal enforcement actions to the number of regulated banks for each regulator by year. The rates of formal order issuance are similar among all federal regulators. From 1993 through 2007, each regulator issued actions to less than 2% of its banks. Moreover, all regulators significantly increased their rates of enforcement between 2008 and 2010.

liquidity failure, not a capital failure”); Drew Desilver, *WaMu Hearings Depict Sinking Bank*, SEATTLE TIMES, Apr. 25, 2010, at C1 (stating that the FDIC believed Washington Mutual’s “mortgage losses were mounting, (credit) downgrades were occurring, and efforts to raise capital had been exhausted”).

236. Mary Kane, *Agency at Forefront of Mortgage Crisis Making a Comeback*, THE WASH. INDEP. (Jan. 9, 2009, 4:59 PM), <http://washingtonindependent.com/24782/insurance-firms-aim-for-tarp-money-less-oversight>; see also Kenneth W. Dam, *The Subprime Crisis and Financial Regulation: International and Comparative Perspectives*, 10 CHI. J. INT’L L. 581, 596 (2010) (“The OTS has a reputation for being a more pliable regulator.”); Richard Clough, *FirstFed’s Fault Lines: Some Former Executives Feel Regulators Short-Circuited Efforts to Save the Santa Monica Institution*, L.A. BUS. J., Mar. 29, 2010, at 22 (calling the OTS “a notoriously lenient regulator”); Brady Dennis, *Born in a Previous Crisis, OTS Faces Extinction*, WASH. POST, June 18, 2009, at A15 (“Over time, the OTS has become synonymous with ineffective and lax regulation, failing to rein in high-risk, destructive practices of some of the largest institutions it monitors.”).

237. Kane, *supra* note 236.

238. S. REP. NO. 111-176, at 26 (2010) (noting that “the thrift charter ‘created opportunities for private sector arbitrage’ of the regulatory system”); see also *supra* notes 32–33 and accompanying text.

Figure 7: Percent Formal Enforcement Actions to Number of Banks by Regulator and Year²³⁹

Year	FDIC	Federal Reserve	OCC	OTS
1993	0.96%	1.57%	1.64%	0.41%
1994	0.34%	1.03%	0.45%	0.12%
1995	0.23%	0.41%	0.26%	0.45%
1996	0.14%	0.19%	0.24%	0.35%
1997	0.14%	0.38%	0.40%	0.30%
1998	0.33%	0.60%	0.65%	0.16%
1999	0.26%	0.60%	0.85%	0.00%
2000	0.40%	0.89%	1.35%	0.82%
2001	0.43%	0.61%	1.43%	1.12%
2002	0.73%	0.82%	1.82%	0.29%
2003	0.54%	0.74%	1.49%	0.31%
2004	0.51%	0.86%	1.95%	0.86%
2005	0.17%	0.00%	1.36%	0.79%
2006	0.23%	0.44%	1.26%	0.46%
2007	0.52%	1.00%	0.81%	0.59%
2008	1.58%	2.05%	4.22%	1.94%
2009	5.92%	8.01%	7.40%	10.62%
2010	7.76%	11.60%	8.54%	10.33%

239. To create Figure 7, data from the formal capital enforcement study were compared with the data concerning the number of banks supervised by each regulator. The number of banks for each year was determined by searching the FDIC's Statistics on Depository Institutions. See *Statistics on Depository Institutions*, FDIC, <http://www2.fdic.gov/sdi/> (last updated Aug. 16, 2011). The number of banks was determined as of December 31 of the preceding year.

However, not all capital enforcement actions are created equal. Regulators have significant discretion to choose the type of formal enforcement action employed. Figure 8 illustrates that regulators differ in their use of the various types of capital enforcement actions. Two variations stand out. First, the Federal Reserve was substantially more likely to use written agreements—the least serious capital enforcement action.²⁴⁰ More than 75% of the Federal Reserve’s formal capital enforcement actions were written agreements.²⁴¹ In contrast, the FDIC only issued two written agreements during the entire study. Second, the data show that various regulators have different preferences regarding how they style formal capital enforcement actions. Because consent orders and consent cease-and-desist orders have the same legal consequences, a regulator’s choice of title may be governed primarily by the effect the regulator hopes to have on the public’s perception of the bank receiving the order. The OCC has adopted a bank-friendly approach.²⁴² Only one of its formal actions used the words “cease-and-desist” in the title.²⁴³ In November 2009, the FDIC announced that it would follow suit and label cease-and-desist orders entered with the consent of the bank as “consent orders.”²⁴⁴

240. Unlike other actions imposed by consent, written agreements cannot be enforced in court. *See supra* note 131 and accompanying text.

241. Similarly, 65% of the OCC’s formal enforcement actions were written agreements.

242. Banks typically prefer that formal actions be labeled as consent orders rather than cease-and-desist orders because they believe these titles are less likely to cause investors and depositors excess concern. *Cf. Rockett, supra* note 111, at 312 (noting that formal agreements “appear less threatening” than cease-and-desist orders).

243. Even that action softened the language by using the title “Consent Cease and Desist Order.” *In re Capitol Nat’l Bank*, Order No. OCC-2009-216 (Dec. 22, 2009).

244. The FDIC had previously been labeling the orders cease-and-desist orders. *See Barba, supra* note 205, at 1.

Figure 8: Formal Capital Enforcement Actions by Action Type and Regulator (1993–2010)

Action Type	FDIC	Federal Reserve	OCC	OTS	Total
Written Agreement	2	216	441	77	736
Consent Order	375	0	208	0	583
Cease-and-Desist Order (Consent)	649	23	1	131	804
Cease-and-Desist Order (Hearing)	7	1	0	0	8
Cease-and-Desist Order (Temporary)	3	0	0	0	3
Capital Directive	1	0	9	1	11
Prompt Corrective Action Directive	88	43	21	51	203
Other	0	0	2	0	2
Total	1125	283	682	260	2350

While banks care about the title of a particular enforcement action, they are even more sensitive to individual bank minimum capital requirements included in the action. Again the data suggest that the Federal Reserve may be the most lenient. The Federal Reserve was the least likely to include an individual bank minimum capital requirement in a formal capital enforcement action. Of the 283 formal capital enforcement actions the Federal Reserve issued, only 17 contained individual bank minimum capital requirements. As shown in Figure 9, all other regulators included individual bank capital requirements in well over half of their formal capital enforcement actions.²⁴⁵ This finding is consistent with Professor Wellons's general observation that the Federal Reserve only required that banks achieve the regulatory capital minimums, while the FDIC was likely to require specific increases in capital.²⁴⁶

245. The chi-square test of independence was statistically significant, indicating that the inclusion of individual bank minimum capital requirements was meaningfully different among regulators ($\chi^2(3, N = 2350) = 836.25, p < 0.001$, Cramér's $V = 0.60$).

246. See *supra* notes 161–62 and accompanying text.

Figure 9: Percentage of Formal Actions Containing Individual Bank Minimum Capital Requirements by Regulator (1993–2010)

Regulator	Individual Bank Minimum Capital Requirements	Formal Capital Enforcement Actions	Percentage
FDIC	998	1125	89%
Federal Reserve	17	283	6%
OCC	551	682	81%
OTS	152	260	58%

For actions containing individual bank minimum capital requirements, the mean leverage ratio and tier 1 risk-based capital ratio imposed varied depending on the regulator issuing the action (Figure 10).²⁴⁷ There was little difference among the means of the required total risk-based capital ratios.²⁴⁸ In general, the Federal Reserve and the OTS had the lowest average individual bank capital requirements.

247. One-way analysis of variance (ANOVA) tests suggest that the mean leverage ratios and tier 1 risk-based capital requirements imposed vary significantly among regulators (Leverage: $F(3, 1686) = 31.29, p < 0.001$; Tier 1 Risk-Based Capital: $F(3, 476) = 32.91, p < 0.001$). The ANOVA test, however, may not accurately analyze these data. The ANOVA test assumes that each group has an equal variance. This assumption was violated here. Bartlett's test for equal variances finds significant differences among the variances for both leverage and tier 1 risk-based capital requirements (Leverage: $\chi^2(3) = 67.50, p < 0.001$; Tier 1 Risk-Based Capital: $\chi^2(3) = 42.16, p < 0.001$). ANOVA also assumes that the number of observations per group is roughly equal. Here, however, the group sizes varied widely. The FDIC had 993 actions containing a leverage ratio, but the Federal Reserve had only 14. Similarly, the OCC had 292 actions containing a tier 1 risk-based capital ratio, but the Federal Reserve had only 4. For these reasons, ANOVA may indicate significance where none exists. See ALAN C. ACOCK, *A GENTLE INTRODUCTION TO STATA 189–90* (2d ed. 2008); ROBERT M. LAWLESS, JENNIFER K. ROBBENOLT & THOMAS S. ULEN, *EMPIRICAL METHODS IN LAW 285* (2010).

248. With respect to the total risk-based capital ratios, ANOVA does not show a significant difference in the means among regulators ($F(3, 1061) = .51, p = 0.68$). Again, however, not all of the assumptions of ANOVA are true. Bartlett's test for equal variances finds significant difference among the variances in total risk-based capital requirements ($\chi^2(3) = 20.16, p < 0.001$). The number of observations also varied widely. The FDIC had 599 actions with total risk-based capital requirements while the Federal Reserve had only 5.

Figure 10: Mean Individual Bank Minimum Capital Requirements by Regulator (1993–2010)

Regulator	Leverage Ratio	Tier 1 Risk-Based Capital Ratio	Total Risk-Based Capital Ratio
FDIC	8.21%	8.78%	11.53%
Federal Reserve	6.50%	6.50%	11.00%
OCC	7.79%	9.89%	11.58%
OTS	7.13%	6.28%	11.55%

In sum, when compared with the other federal bank regulators, the Federal Reserve was more likely to use written agreements—the least serious of the formal capital enforcement actions.²⁴⁹ The Federal Reserve was also the least likely to include an individual bank capital requirement. When the Federal Reserve did include an individual bank capital requirement, the requirement was, on average, lower than the requirements imposed by the FDIC and the OCC.

Although this suggests that the Federal Reserve was less likely to aggressively regulate bank capital, the analysis presented here does not account for the condition of each bank receiving a formal capital enforcement action. Without data about each bank's financial condition at the time it received an order, it is impossible to conclusively say the Federal Reserve is more lax. It is possible that the Federal Reserve's lower incidence of enforcement simply reflects the better financial condition of the banks it regulates.²⁵⁰ Another possible explanation is that the Federal Reserve, as the federal regulator for bank holding companies and financial holding companies, prefers to enforce capital requirements at the holding company level rather than the individual bank level.²⁵¹ It might also be that the Federal Reserve often elects to require banks to submit to increased capital requirements in the capital plans required by many formal enforcement actions.²⁵² Because the capital plans submitted are generally not publicly available, it is difficult to assess

249. Unlike other formal actions, written agreements cannot be enforced in court. See *supra* note 131 and accompanying text.

250. If it were found that the banks regulated by the Federal Reserve were more financially stable, that stability might be due to the quality of regulation, selection bias among banks who choose to be members of the Federal Reserve System, or other factors.

251. In 2009, the Federal Reserve issued more formal enforcement actions (of all types, including capital) to bank holding companies than to individual banks. William J. Brown, *Formal Enforcement Actions Issued Against Institutions—What Do Today's Numbers Say?*, SRC INSIGHTS (Fed. Reserve Bank of Phila.), Fourth Quarter 2009, at 9. However, when a Federal Reserve Bank of Philadelphia study summarized the requirements contained in the 2009 formal enforcement actions, it did not mention individual bank capital requirements. *Id.* Thus, it is likely that even the orders issued to holding companies do not contain specific capital requirements.

252. The author's informal discussions with bank regulators and attorneys suggest that this explanation is the most plausible.

enforcement efforts through capital plans. At any rate, the stark differences in capital enforcement strategies among regulators raise questions about the consistency of capital enforcement.

5. Enforcement and Large Banks

Lastly, the formal capital enforcement study allows us to see whether the largest banks received formal capital enforcement actions. Capital enforcement efforts at large banks are important. While there are about 8000 banks in the United States, the largest banks control a significant part of the banking industry. The 10 largest banks²⁵³ in the United States, as measured by domestic deposits, hold 42% of all domestic deposits.²⁵⁴ The 50 largest banks hold 63% of the domestic deposits.²⁵⁵

Press reports suggest that several of the largest banks have experienced capital stress during the study time period. In fall 2008, Washington Mutual (the sixth-largest bank as measured by domestic deposits²⁵⁶) failed.²⁵⁷ Wachovia (the third-largest bank as measured by domestic deposits²⁵⁸) was on the brink of failure until it was purchased by Wells Fargo.²⁵⁹ These events caused regulators to question whether the largest banks held enough capital.²⁶⁰ In hopes of quelling any capital concerns, Treasury summoned the chief executive officers of JP Morgan, Wells Fargo, Citigroup, Bank of America, State Street Corporation, and Bank of New York Mellon to its offices and convinced them to accept billions of dollars in capital from the federal government.²⁶¹ Thereafter, regulators spent three months scouring the books of the 19 largest bank holding companies conducting “stress tests” to determine whether these holding companies had enough capital to withstand the economic downturn.²⁶² As a result of the stress tests, regulators

253. As of June 30, 2010, the ten largest banks as measured by total domestic deposits were Bank of America, N.A.; Wells Fargo Bank, N.A.; JPMorgan Chase Bank, N.A.; Citibank, N.A.; PNC Bank, N.A.; U.S. Bank N.A.; TD Bank, N.A.; SunTrust Bank; Branch Banking and Trust Company; and Regions Bank. See *Summary of Deposits*, FDIC, <http://www2.fdic.gov/sod/> (linking to Summary Tables, which provides a table for the Top 50 Commercial Banks and Savings Institutions by Deposits) (June 30, 2010 report).

254. The 10 largest banks hold \$3.25 trillion of the \$7.75 trillion domestic deposits. *Id.*

255. The 50 largest banks hold \$4.89 trillion of the \$7.75 trillion domestic deposits. *Id.*

256. *Id.* (June 30, 2008 report).

257. Peter S. Goodman & Gretchen Morgenson, *Saying Yes to Anyone, WaMu Built Empire on Shaky Loans*, N.Y. TIMES, Dec. 28, 2008, at A1; Sidel et al., *supra* note 232, at A1.

258. *Summary of Deposits*, *supra* note 253 (June 30, 2008 report).

259. David Enrich & Dan Fitzpatrick, *Wachovia Chooses Wells Fargo, Spurns Citi*, WALL ST. J., Oct. 4, 2008, at A1.

260. Sudeep Reddy, *Bernanke Eases Bank-Nationalization Fears*, WALL ST. J., Feb. 25, 2009, at A2.

261. HENRY M. PAULSON, JR., ON THE BRINK: INSIDE THE RACE TO STOP THE COLLAPSE OF THE GLOBAL FINANCIAL SYSTEM 358–68 (2010) (describing the meetings that lead to the government’s initial capital investment in these banks). Treasury provided the capital investments through the Troubled Asset Relief Program created by Congress. See Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765.

262. BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE SUPERVISORY CAPITAL

announced that Bank of America, Wells Fargo, Citigroup, and others needed to raise even more capital.²⁶³ At least one of these banks would have failed but for the government's capital assistance.²⁶⁴ Given this apparently high level of capital stress at large banks, one might expect that the regulators would have issued formal capital enforcement actions and individual bank minimum capital requirements to these banks.

To determine whether the largest banks received formal capital enforcement actions during the study period, it was first necessary to identify the largest banks. The FDIC maintains lists of the largest 50 banks as measured by domestic deposits on June 30 of each year.²⁶⁵ These lists were crosschecked with the data from the formal capital enforcement study to determine whether any banks that appeared on the Top 50 lists received formal capital enforcement actions.

Only 2 banks received formal capital enforcement actions while they appeared on the FDIC's Top 50 list. Providian National Bank entered a written agreement with the OCC on November 21, 2001.²⁶⁶ The written agreement did not impose individual bank minimum capital requirements.²⁶⁷ That year, Providian National Bank was listed as the forty-eighth-largest bank as measured by domestic deposits.²⁶⁸ The second bank, Colonial Bank, consented to a cease-and-desist order issued by the FDIC on June 15, 2009.²⁶⁹ The order required that Colonial maintain an 8% leverage ratio and a 12% total risk-based capital ratio.²⁷⁰ On June 30, 2009, the FDIC listed Colonial Bank as the forty-seventh-largest bank as measured by domestic deposits.²⁷¹

The study did not find any formal capital enforcement actions for the largest of the large banks. There were no formal capital enforcement actions for Washington Mutual even though it failed. There were no formal capital enforcement actions for Wachovia even though it narrowly escaped failure. There were no formal capital enforcement actions for Bank of America, Wells Fargo Bank, or Citibank, even

ASSESSMENT PROGRAM: DESIGN AND IMPLEMENTATION (2009); David Wessel, *Capital: What Testing Banks Will Tell Us About Their Health*, WALL ST. J., May 7, 2009, at A2.

263. BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE SUPERVISORY CAPITAL ASSESSMENT PROGRAM: OVERVIEW OF RESULTS 9 (2009); Damian Paletta & Deborah Solomon, *More Banks Will Need Capital* WALL ST. J., May 5, 2009, at A1; Deborah Solomon, David Enrich & Damian Paletta, *Banks Need at Least \$65 Billion in Capital*, WALL ST. J., May 7, 2009, at A1.

264. See generally NEIL M. BAROFSKY, SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM, EXTRAORDINARY FINANCIAL ASSISTANCE PROVIDED TO CITIGROUP, INC. (2011) (describing Citigroup's financial condition and the government's effort to prevent its failure).

265. *Summary of Deposits*, supra note 253. The list for 1993, the first year for which formal capital enforcement action data were collected, was not available. Because there is a significant overlap on the Top 50 lists from year to year, it is likely that little is lost by the unavailability of the 1993 list.

266. *In re Providian Nat'l Bank*, Order No. OCC-2001-98 (Nov. 21, 2001).

267. *Id.*

268. *Summary of Deposits*, supra note 253 (June 30, 2001 report).

269. *In re Colonial Bank*, Order No. FDIC-09-125b (June 15, 2009).

270. *Id.*

271. *Summary of Deposits*, supra note 253 (June 30, 2009 report). In 2008, Colonial Bank was the forty-ninth-largest bank. *Id.* (June 30, 2008 report).

though their holding companies failed the regulators' stress tests and were instructed to raise capital.²⁷²

While the dearth of formal capital enforcement actions issued to large banks is surprising, it is, nevertheless, consistent with the findings of the Wellons Study. The Wellons Study found no prompt corrective action directives issued to large banks.²⁷³ Likewise, the formal capital enforcement action study found no prompt corrective action directives issued to large banks.

The reasons for the apparently low level of formal capital enforcement against the largest banks are not readily apparent. It may be that the largest banks were more likely to maintain adequate capital levels without prodding from their regulators. Because the formal capital enforcement action study did not capture financial data about the banks receiving actions, it is impossible to determine whether the banks receiving actions were the least healthy banks.

The Peek-Rosengren Study, however, does discount bank health as the primary explanation for the low level of formal capital enforcement actions issued to large banks. It compared the leverage ratios of banks receiving formal enforcement actions with the size of the banks.²⁷⁴ The Peek-Rosengren Study concluded that “[s]maller institutions were more likely than larger institutions to receive their formal actions while their leverage ratios were still relatively high.”²⁷⁵ Of course, a high leverage ratio is not necessarily indicative of less risk. It may be that large banks with low leverage ratios are safer than small banks with similar leverage ratios because large bank assets are more diversified.²⁷⁶ Indeed, data maintained by the FDIC for all insured institutions show that large banks, on average, operate with lower leverage ratios than smaller banks. For example, in the fourth quarter of 2010, banks with assets of more than \$10 billion on average maintained leverage ratios of 8.63%, while banks with assets of less than \$100 million on average maintained leverage ratios of 11.28%.²⁷⁷ The Peek-Rosengren Study, however, also compared the percentage of nonperforming loans receiving formal enforcement actions with bank size. It concluded that “small banks were more than twice as

272. Although the largest banks did not receive formal capital enforcement actions, they did receive formal actions for reasons other than capital. *See, e.g., In re Bank of America, N.A.*, Order No. OCC-2010-239 (Dec. 7, 2010) (written agreement concerning “the marketing and sale of . . . derivative financial products to municipalities and other non-profit organizations”); *In re Bank of America, N.A.*, Order No. OCC-2005-10 (Feb. 9, 2005) (written agreement concerning market timing and late trading); *In re Citibank, N.A.*, Order No. OCC-2003-77 (July 28, 2003) (written agreement concerning complex financial transactions with Enron).

273. *See supra* notes 163–64 and accompanying text.

274. *See Peek & Rosengren, supra* note 136, at 19.

275. *Id.*

276. *See generally* Geoffrey P. Miller, *Legal Restrictions on Bank Consolidation: An Economic Analysis*, 77 IOWA L. REV. 1083 (1992) (arguing that geographic diversification of assets at large banks promotes safety and soundness).

277. *Quarterly Banking Profile Time Series Spreadsheet: Ratios by Asset Size Group*, FDIC, <http://www2.fdic.gov/qbp/timeseries/RatiosByAssetSizeGroup.xls> (last visited Aug. 19, 2011). The differences are less for other capital measures. In the fourth quarter of 2010, banks with assets of more than \$10 billion had an average tier 1 risk-based capital ratio of 12.23% compared with 12.71% for banks with assets of less than \$100 million. *Id.*

likely as large banks to receive their formal actions before their nonperforming loans reached 2 percent of assets.”²⁷⁸ In other words, regulators appeared more willing to issue actions to small banks when there was only some evidence of problem loans.

Recent regulator comments also discount the theory that large banks were healthier than small banks. In 2009 FDIC Chairman Sheila Bair stated that, “[o]ver the past 18 months, large banks, as a group, have posed much greater risks to the banking system than small banks have.”²⁷⁹ Regulators were nervous enough about the capital at the largest banks to conduct stress tests and provide government capital to some of the largest bank holding companies.²⁸⁰

It is, therefore, possible that regulators believed some of the largest banks should raise capital, but nevertheless chose not to use formal capital enforcement actions against those banks. Perhaps regulators worried that public capital enforcement actions against large banks would cause a widespread banking panic. Perhaps the large banks had more influence with regulators and were more successful in negotiating non-public enforcement actions.²⁸¹ Perhaps regulators believed that for large banks, capital is best set through risk modeling that may not translate well into formal capital enforcement actions.²⁸² Perhaps regulators believed that they had other more efficient or appropriate tools for regulating large banks, such as providing capital through the Troubled Asset Relief Program. Sorting out these and other possible explanations for the low number of formal capital enforcement actions aimed at large banks is beyond the scope of this study.

III. RULES OR DISCRETION

While the formal capital enforcement action study leaves some unanswered questions, one trend is clear: banks are increasingly subject to discretionary capital enforcement. In the current regulatory environment, a significant number of banks have capital requirements that are set by discretionary capital enforcement actions

278. Peek & Rosengren, *supra* note 136, at 18.

279. Binyamin Appelbaum, *Big Banks to Pay Larger Share of FDIC Levy—Fees to Replenish Fund Altered After Protest by Small Institutions*, WASH. POST, May 23, 2009, at A13.

280. *See supra* notes 261–65 and accompanying text.

281. *See generally* Joseph J. Norton, *A Perceived Trend in Modern International Financial Regulation: Increasing Reliance on a Public-Private Partnership*, 37 INT’L LAW. 43, 50–51 (2003) (“The safety and soundness of elite banks is enormously important to the banking authorities . . . perhaps to the detriment of other banking institutions and economic interests. The reality is that more influential elite banks, in all likelihood, exert greater influence upon banking authorities than the authorities exert upon them.”). According to the *Wall Street Journal*, Bank of America and Citibank did receive informal enforcement actions related to the financial condition of the banks from their regulators during the financial crisis. *See* Dan Fitzpatrick, *U.S. Regulators to BofA: Obey or Else*, WALL ST. J., July 16, 2009, at C1.

282. In conjunction with the stress tests conducted on the 19 largest bank holding companies, the Federal Reserve limited these banks’ ability to raise dividends. Dan Fitzpatrick, *Fed Poised to Ease Its Grip on Banks*, WALL ST. J., Mar. 18, 2011, at C1. This type of restriction is commonly seen in formal capital enforcement actions.

rather than by statute or regulation. Consequently, the time is ripe to re-examine the role of discretion in capital enforcement. Should capital be regulated by rule or by discretionary enforcement?

The rule versus discretionary enforcement choice is not unique to bank regulators.²⁸³ Legal scholarship has addressed the rule versus discretion question on a number of fronts. Should automobile safety be promoted through rules or discretionary recalls?²⁸⁴ “How much discretion should a trial judge have to design procedures for a given lawsuit?”²⁸⁵ Should the regulators control emissions from diesel engines by rule or by bringing suit against engine manufacturers?²⁸⁶ Should the securities markets be governed by specific requirements or broader principles that are enforced through discretionary prosecution?²⁸⁷

Still, little has been done to determine the proper role of discretion in bank capital regulation. This Part explores the traditional arguments for regulatory discretion in setting capital requirements. It then explains why, even assuming regulators are conscientious in assessing individual bank risk, the recent increase in individual bank capital requirements is problematic.

A. The Tradition of Discretion

The traditional justification for allowing regulators discretion to adjust individual bank capital requirements is that mechanically determined numerical capital requirements are insufficient to safeguard deposits in a dynamic and complex banking industry. Certainly the current leverage and risk-based capital ratios are only an approximation of the riskiness of an individual bank. Current regulations miscategorize some assets and ignore some off-balance-sheet items.²⁸⁸ These (and other) deficiencies may lead banks to attempt to game the capital requirements.²⁸⁹ However, revising the mechanical capital requirements to perfectly

283. 32 CHARLES ALAN WRIGHT & CHARLES H. KOCH, JR., *FEDERAL PRACTICE & PROCEDURE: JUDICIAL REVIEW OF ADMINISTRATIVE ACTION* § 8123 (2006) (“The choice between the individual decisionmaking of adjudication and the generalized, policy oriented decision of rulemaking is generally left to the agency.” (footnote omitted)).

284. See generally JERRY L. MASHAW & DAVID L. HARFST, *THE STRUGGLE FOR AUTO SAFETY* (1990); Jerry L. Mashaw & David L. Harfst, *Regulation and Legal Culture: The Case of Motor Vehicle Safety*, 4 *YALE J. ON REG.* 257 (1987).

285. Robert G. Bone, *Who Decides? A Critical Look at Procedural Discretion*, 28 *CARDOZO L. REV.* 1961, 1962 (2007).

286. Andrew P. Morriss, Bruce Yandle & Andrew Dorchak, *Choosing How to Regulate*, 29 *HARV. ENVTL. L. REV.* 179 (2005).

287. See ROBERTA S. KARMEL, *REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA* (1982); Jonathan R. Macey, *Wall Street in Turmoil: State-Federal Relations Post-Eliot Spitzer*, 70 *BROOK. L. REV.* 117, 128–30 (2004); James J. Park, *The Competing Paradigms of Securities Regulation*, 57 *DUKE L.J.* 625 (2007); Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 *YALE J. ON REG.* 149, 149 (1990).

288. See generally David Jones, *Emerging Problems with the Basel Capital Accord: Regulatory Capital Arbitrage and Related Issues*, 24 *J. BANKING & FIN.* 35 (2000).

289. See DANIEL K. TARULLO, *BANKING ON BASEL: THE FUTURE OF INTERNATIONAL FINANCIAL REGULATION* 80–82 (2008) (cataloguing various types of regulatory arbitrage

capture the riskiness of every bank is probably impossible. Even if perfect mechanical capital requirements could be developed, they would probably be unworkably complex and confusing.²⁹⁰

The realization that mechanical capital standards are imprecise leads some to conclude that mechanical numerical standards should not be codified. According to Treasury Secretary Timothy Geithner:

[T]he financial markets are dynamic, and it is imperative that regulatory capital requirements be able to adapt quickly to innovation and to changes in accounting standards and other regulations. Placing fixed, numerical capital requirements in statute will produce an ossified safety and soundness framework that is unable to evolve to keep pace with change and to prevent regulatory arbitrage.²⁹¹

Others take Secretary Geithner's argument even further, rejecting written "detailed mechanical formulas" in regulations as well as statutes.²⁹² For example, Professor Arturo Estrella favors an approach where bank regulators exercise significant supervisory judgment in setting capital requirements. Professor Estrella notes that "not only is the institution of banking an evolving response to economic conditions, but evolving economic conditions are in turn profoundly affected by the institution of banking."²⁹³ He worries that an "inflexible regulatory" system will require changes "with increasing frequency," and that such changes will not keep pace with the banking industry.²⁹⁴ Similarly, S. Raihan Zamil, the International Monetary Fund's Banking Policy and Supervision Advisor to Bank Indonesia, argues that discretionary determination of capital standards for individual banks is "particularly critical during an expansionary [economic] cycle, when a combination of relaxed loan origination standards and easy credit allows marginal borrowers to refinance—rather than to repay—their debt obligations, which leaves the impression of low default risk."²⁹⁵

For those who favor regulatory discretion, an increase in individual bank capital requirements is not troubling; it merely signals a change in circumstances that

possible under Basel I, but concluding that "there is very little empirical work that quantifies the practice"); Patricia A. McCoy, *Musings on the Seeming Inevitability of Global Convergence in Banking Law*, 7 CONN. INS. L.J. 433, 450–56 (2001).

290. Duncan E. Alford, *Basle Committee International Capital Adequacy Standards: Analysis and Implications for the Banking Industry*, 10 DICK. J. INT'L L. 189, 217 (1992).

291. Letter from Timothy F. Geithner, Secretary of the Treasury, to Keith Ellison, U.S. House of Representatives (Jan. 11, 2010), available at http://ellison.house.gov/images/stories/Documents/2010/01-11-10_Treasury_Letter.pdf. Secretary Geithner supports including numerical requirements in regulatory, as opposed to statutory, text. See Leonhardt, *supra* note 3, at 36 ("'We don't know where the next crisis is going to come from,' Geithner told me. . . . 'So we want to build a much bigger cushion into the system against . . . basic human limitations. I don't want a system that depends on clairvoyance or bravery.'").

292. Arturo Estrella, *Formulas or Supervision? Remarks on the Future of Regulatory Capital*, FRBNY ECON. POL'Y REV., Oct. 1998, at 191, 195.

293. *Id.* at 194.

294. *Id.* at 195.

295. S. Raihan Zamil, *Judgment Day*, FIN. & DEV., Sept. 2010, at 44, 46 (emphasis omitted).

regulators identify as risky and seek to correct. For example, regulators explain that “[h]istorically, enforcement actions increase as one would expect during periods of economic stress.”²⁹⁶ During the current economic downturn some banks undoubtedly experienced a decline in asset values²⁹⁷ and consequently a decline in capital ratios. If capital levels at troubled banks dropped dangerously low, it would be unsurprising for regulators to bring capital enforcement actions against those banks. If regulators expected more losses, they might impose individual bank minimum capital requirements.²⁹⁸

B. The Dangers of Discretion

Regulatory discretion, however, is far from perfect. The very nature of discretionary enforcement and individual bank capital requirements may exacerbate problems in the banking industry as a whole.

1. Regulatory Ability

Proponents of regulatory discretion likely put too much faith in regulators’ ability to fine-tune capital requirements to account for innovation, economic conditions, and individual bank concerns. This misplaced faith in regulatory discretion leads to inadequate statutory and regulatory capital requirements.

As an initial matter, it is not clear that regulators appropriately use their discretion to respond to innovation. The formal capital enforcement action study shows very low rates of capital enforcement actions between 1994 and 2007.²⁹⁹ This low capital enforcement action rate cannot be attributed to a lack of innovation in the banking industry. During the same time period, the use of private-label mortgage-backed securities exploded, a sizeable subprime mortgage market developed, and credit default swaps and collateralized debt obligations became common.³⁰⁰ Although regulators had the authority to adjust capital requirements for

296. Hopkins, *Regulatory Actions Hit a Record Level in '09*, *supra* note 183, at 1 (quoting Kevin Murkri, OCC spokesman).

297. The current financial crisis is attributable, at least partly, to decreasing real estate prices, increasing defaults on home mortgages, and declining values of mortgage-backed securities. *See generally* Douglas W. Arner, *The Global Credit Crisis of 2008: Causes and Consequences*, 43 INT’L LAW. 91 (2009). All of these items would negatively impact a bank’s balance sheet.

298. *See, e.g.*, *The Condition of Financial Institutions: Examining the Failure and Seizure of an American Bank: Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Servs.*, 111th Cong. 101 (2010) (written testimony of Jennifer Kelly, Senior Deputy Comptroller for Midsize and Community Bank Supervision, OCC) (“Regulators expect banks with significant credit concentrations or deteriorating asset quality to hold higher capital levels to compensate for their risk profile.”).

299. *See supra* Figure 2 and accompanying text.

300. *See* Eric Bruskin, Anthony B. Sanders & David Sykes, *The Nonagency Mortgage Market: Background and Overview*, in THE HANDBOOK OF NONAGENCY MORTGAGE-BACKED SECURITIES 5, 9–10 (Frank J. Fabozzi, Chuck Ramsey & Michael Marz eds., 2d ed. 2000); Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1019–23 (2007); Christopher L. Peterson, *Fannie Mae, Freddie Mac, and*

banks engaging in these risky activities, regulators rarely used it.³⁰¹ It appears that regulators failed to appreciate the risk and adjust capital requirements accordingly.³⁰²

It is also not clear that regulators appropriately use discretion to respond to economic conditions. Discretionary capital enforcement is prone to regulatory cycles. In other words, regulators are prone to underregulate during economic expansions and overregulate during (and immediately following) economic downturns.³⁰³ According to Professor Alan White, “[w]hen [economic conditions] are good . . . there’s a tendency to believe that they’ll just remain good, and regulation gets lax when it should get tough.”³⁰⁴ Professor White’s observation is consistent with the capital enforcement action study which shows few enforcement actions between 1993 and 2007, a period of economic expansion.³⁰⁵ Now that the economy is no longer expanding, some bankers believe that regulators, feeling political heat, are overreacting to the current economic downturn.³⁰⁶ While the formal capital enforcement action study cannot confirm this claim,³⁰⁷ it does not

the Home Mortgage Foreclosure Crisis, 10 LOY. J. PUB. INT. L. 149, 158–59 (2009); Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Speech at the Federal Reserve System’s Sixth Biennial Community Affairs Research Conference: Financial Innovation and Consumer Protection (Apr. 17, 2009), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20090417a.htm>.

301. See *supra* Figure 4 and accompanying text; see also Ezra Klein, *Don’t Trust the Regulators; Financial Reform Can’t Be Left to Those Who Failed Us Before*, NEWSWEEK, Apr. 12, 2010, at 20 (“‘The story the regulators want to tell,’ says Richard Carnell, a former assistant secretary of the Treasury for financial markets, ‘[is] that they just needed more tools. But they can set capital requirements now. They had ample tools, and they lacked the prescience and will to use them.’” (alteration in original)).

302. See Hopkins, *Regulatory Actions Hit a Record Level in ’09*, *supra* note 183, at 1 (quoting economist Chris Low as stating that “[t]he regulators were asleep for 10 years during the [economic] boom”); Leonhardt, *supra* note 3, at 36 (“When times were good over the previous decade, Fed officials—and not just Alan Greenspan—neglected to use the powers they did have.”).

303. A variety of articles discuss the phenomenon of regulatory cycles. See, e.g., John C. Coffee, Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 815–22 (2011); Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393, 423–24 (2006); Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77 (2003); David Zaring, *A Lack of Resolution*, 60 EMORY L.J. 97, 117–20 (2010).

304. Joe Adler, *In Reports on Failures, Regulators Also Fail: IGs Find Examiners Uncover Problems, But Don’t Fix Them*, AM. BANKER, Apr. 15, 2009, at 1.

305. See *supra* Figure 2.

306. Hopkins, *Regulatory Actions Hit a Record Level in ’09*, *supra* note 183, at 1 (“‘There is a consistent comment for regulators that the pendulum has swung too far,’ said Diane Casey-Landry, senior executive vice president and chief operating officer of the American Bankers Association. ‘No one is asking for easy supervision, but we need a balance. The pendulum has swung too far, and it’s inhibiting not only banks’ ability to lend, but to manage their business.’”).

307. Because the formal capital enforcement study did not consider data about the financial condition of the banks subject to enforcement actions, the study cannot tell whether regulators have increased their capital standards during the financial crisis. The study also does not attempt to determine the optimal bank capital requirements. Therefore, it is

negate it either. At a minimum, the study shows a procyclical increase in enforcement actions.³⁰⁸

Next, it is not appropriate to think of bank examiners as carefully adjusting each bank's capital requirements after considering each and every circumstance that might make that bank unique. To see why, consider the analogous situation of an insurance adjuster handling a claim after a multiple-car traffic accident.³⁰⁹ In deciding which party should pay for the accident, the adjuster might turn to tort law. Tort law, however, is complicated and nebulous. Professor H. Laurence Ross explained that instead of carefully studying the particular circumstances of each accident, insurance adjusters develop rules of thumb to process claims.³¹⁰ For example, adjusters adopt a rule that in rear-end collisions, the driver in the back car is liable.³¹¹ The rules of thumb are more easily administered and usually lead to the same result that a complete tort law analysis would achieve. Thus, the rules of thumb are an efficient way to process a myriad of claims. If, however, the case is extraordinarily large or particularly unique, adjusters may have to abandon the rules of thumb and return to the traditional tort law analysis.³¹²

Bank regulators, like insurance adjusters, are tasked with evaluating individual bank circumstances in light of a complicated and sometimes nebulous body of law.³¹³ They are guided by regulatory capital ratios and minimums, but they are empowered to take any action necessary to preserve "safety and soundness."³¹⁴ Because there is no regulatory formula for assessing safety and soundness, regulators develop rules of thumb to evaluate the capital adequacy of each bank. The internal regulatory policies memorialized in handbooks and manuals are rules of thumb; they do not have the legal effect of statutes or regulations.³¹⁵

In addition, regulators likely use rules of thumb that are not memorialized in publicly available material. The individual bank minimum capital requirements contained in the formal capital enforcement actions seem to hint that regulators employ non-public rules of thumb. Although regulators have virtually unbounded discretion in choosing how to express an individual bank minimum capital requirement, regulators most often include a leverage ratio—the most simple of the regulation-defined capital measurements.³¹⁶ Similarly, the different approaches to capital enforcement among regulators suggest that different regulators may have

impossible to determine whether current regulators are overzealous.

308. See *supra* Part II.C.2. Professor David Zaring found that regulators' decisions to close financial institutions follow a similar procyclical pattern. Zaring, *supra* note 303.

309. See H. LAURENCE ROSS, SETTLED OUT OF COURT: THE SOCIAL PROCESS OF INSURANCE CLAIMS ADJUSTMENTS 96–101 (1970).

310. *Id.* at 99.

311. *Id.* at 98–99.

312. See *id.* at 135.

313. Others have noted that "rules of thumb" appear in many areas. See, e.g., Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83 (2002); Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 24–27 (2003); Hillary A. Sale, *Judging Heuristics*, 35 U.C. DAVIS L. REV. 903 (2002).

314. See *supra* Part I.

315. See *supra* note 79 and accompanying text.

316. See *supra* notes 218–20 and accompanying text.

adopted different rules of thumb concerning capital adequacy.³¹⁷ Finally, the near absence of enforcement actions issued to the largest banks may indicate that regulators depart from rules of thumb when the safety and soundness of a very large bank is at issue.³¹⁸ Rules of thumb allow bank regulators to efficiently evaluate capital adequacy concerns at more than 7000 banks. But, as with capital regulations themselves, rules of thumb likely result in incorrect assessments in at least some cases.³¹⁹

This is not to suggest that bank regulators are lazy, daft, or corrupt. Rather, it is to suggest that predicting the long-term economic consequences of financial innovations is difficult business. Even the brightest regulators (especially those regulators focusing only on the financial condition of a single bank) may overlook potential problems. Then, when facing previous mistakes, they may overreact. Moreover, fine-tuning capital requirements for each of the more than 7000 U.S. banks is a daunting task. A system that expects regulators to use their discretion to instantly react to innovations and changes occurring at an individual-bank level expects too much.

Unrealistic expectations about discretionary enforcement are problematic not only because the discretionary regulation itself falls short, but also because the expectations divert attention from establishing sufficient statutory and regulatory standards. Congress has declined to put stringent capital requirements in banking statutes, instead relying on regulators to correct capital problems through administrative rulemaking. For example, the prompt corrective action statute, adopted in 1991, relies on bank regulators to establish minimum capital levels.³²⁰ Similarly, the Dodd-Frank Act delegates the duty of establishing capital requirements to bank regulators.³²¹ Unlike prior banking statutes, the Dodd-Frank Act does provide some guidance about the appropriate capital ratios; it specifies that new capital requirements must not be lower than previously established regulatory requirements.³²² However, the clear suggestion from Congress was that regulators should establish higher capital requirements—higher requirements that Congress itself was unwilling to establish.

In promulgating regulations, bank regulators show that they also rely on the false promises of discretionary enforcement. As explained in Part I, regulations

317. See *supra* Part II.C.4 (discussing the enforcement rates of different regulators).

318. See *supra* Part II.C.5 (discussing formal capital enforcement actions issued to the largest banks).

319. Cf. Mark Seidenfeld, *Why Agencies Act: A Reassessment of the Ossification Critique of Judicial Review*, 70 OHIO ST. L.J. 251, 260 n.22 (2009) (“In any case, regulators sometimes are not aware and have not evaluated the rules of thumb they use to optimize them for the decisions they face, and psychologists have demonstrated that individuals often use biased (i.e., non-optimal) rules of thumb.”).

320. See 12 U.S.C. § 1831o(b)(2)(G) (2006).

321. The Dodd-Frank Act requires the “Federal banking agencies [to] establish minimum leverage capital requirements on a consolidated basis for insured depository institutions.” 12 U.S.C.S. § 5371(b)(1) (LexisNexis 2010); see also 156 CONG. REC. S5891 (daily ed. July 15, 2010) (statement of Sen. Judd Gregg) (“It isn’t constructive for the Congress to set arbitrary capital rules. That should be left to the regulators.”).

322. 12 U.S.C.S. § 5371(b)(1).

provide numerical minimum capital ratios but leave regulators significant discretion to adjust capital requirements on an individual-bank basis. Statements from bank regulators show that they believe the minimum capital ratios established by regulation are insufficient. A recent report from the federal bank regulators to Congress states:

The federal banking agencies have substantially similar capital adequacy standards. These standards employ a common regulatory framework that establishes minimum leverage and risk-based capital ratios for all banking organizations (banks, bank holding companies, and savings associations). The agencies view the leverage and risk-based capital requirements as minimum standards, and *most institutions are expected to operate with capital levels well above the minimums*, particularly those institutions that are expanding or experiencing unusual or high levels of risk.³²³

Rather than adopt regulations that set generally applicable capital requirements, regulators seem to be relying on discretionary enforcement to ensure that most banks have capital well above the regulatory requirements. We are left with a regulatory structure that relies on discretion to establish capital requirements for many banks. Because numerical capital requirements are not established by statute and are set intentionally low by regulations, when discretion fails, capital regulation becomes ineffective. Instead, policymakers should recognize the shortcomings of regulatory discretion and develop statutes and regulations with conservative capital requirements.

2. Ambiguity and Cost

The second problem with discretionary capital enforcement is that it leads to ambiguous capital requirements that are costly for banks to implement. When capital requirements are established by statute or regulation, a bank can readily identify the amount of capital it should maintain to satisfy the law. When regulators set capital requirements through formal or informal capital enforcement actions, banks have a difficult time assessing the amount of capital their regulators might require. This can be costly not only for a bank receiving an enforcement action, but also for the economy as a whole.

Regulation by enforcement is generally thought to be more costly than regulation by rule.³²⁴ Regulators expend significant resources examining banks to determine the amount of capital required.³²⁵ Although most formal capital enforcement actions are entered by consent, they are still expensive. Such an action

323. Joint Report: Differences in Accounting and Capital Standards Among the Federal Banking Agencies, 75 Fed. Reg. 47,900, 47,901 (Aug. 9, 2010) (emphasis added).

324. See Edward Brunet, *Blending State and Federal Administrative Law*, 75 CORNELL L. REV. 366, 366 (1990) (book review) (noting that “adjudication is a comparatively costly mode of regulation”).

325. Although careful regulatory examinations would still be required with clear capital rules, the effort spent by regulators might be more efficiently directed with clear rules.

can cost a “\$100 million community bank . . . between \$750,000 and \$1 million in additional expenses, including hiring outside consultants, regulatory counsel and increased FDIC insurance premiums.”³²⁶ In addition, banks faced with higher capital requirements bear the costs of raising additional capital or shrinking asset portfolios.³²⁷ Raising capital after receiving a formal capital enforcement action can be particularly difficult.³²⁸ Some investors may worry that future losses could lead to enforcement actions, additional capital issuances, or even bank closure.³²⁹ Other investors might prefer to delay investment until a bank has failed, hoping to get a better deal from the FDIC.³³⁰

Discretionary capital enforcement also leads to ambiguous rules.³³¹ As the number of banks subject to capital enforcement actions increases, ambiguity increases. Some bankers complain that current capital requirements are indecipherable. According to one observer:

Ask a bank CEO which capital standards his regulators care most about, and what minimum levels they’re insisting on, and he’ll look as if you’d ask him to count to 100 in Mandarin. He won’t have a clue. But you can’t blame the poor guy. These days, banks don’t know what capital standards they’re supposed to be operating under. Yes, regulators have published official numbers. But in the wake of the financial crisis, they’re also whispering new, much higher, “guidance” that they’re “encouraging” bankers to follow. What’s a banker supposed to do?³³²

326. *What an Enforcement Order Will Cost Your Bank*, BANK SAFETY & SOUNDNESS ADVISOR, Nov. 22, 2010, at 1. For larger banks, enforcement actions are probably even more costly. *See id.* at 5 (noting that a \$348.6 million community bank spent between \$1 million and \$2 million on a cease-and-desist order).

327. *See* Cocheo, *supra* note 215, at 27, 32.

328. *See* Cheyenne Hopkins, *Regulators Order an Ohio Thrift, Parent to Improve*, AM. BANKER, Aug. 14, 2008, at 3 (“[I]n the current [poor economic] environment, [cease-and-desist] orders could make it more difficult for . . . thrift[s]” to raise capital.).

329. *See* Steve Cocheo, *Stack That Capital: Period of Turmoil Has Banks Looking for Capital Where and How They Can Find It*, A.B.A. BANKING J., Sept. 2008, at 26.

330. During 2008 and 2009, the FDIC often entered loss-sharing agreements with the purchasers of failed institutions. *See* Damian Paletta, *Raft of Deals for Failed Banks Puts U.S. on Hook for Billions*, WALL ST. J., Aug. 31, 2009, at A1. These agreements often provided investors a better deal than they could have negotiated before the bank failed. *See* Brian Olasov, *Help Salvageable Banks*, AM. BANKER, May 25, 2010, at 8 (“[I]nvestors prefer to negotiate over the carcass of an institution post-failure.”).

331. *See* Lars Noah, *Administrative Arm-Twisting in the Shadow of Congressional Delegations of Authority*, 1997 WIS. L. REV. 873, 936 (“Undue reliance on individualized bargaining undermines consistency and invites the standardless (and largely unaccountable) exercise of agency discretion.”) (citations omitted).

332. Tom Brown, *Confusion Reigns About Banks’ Minimum Capital Requirements*, SEEKING ALPHA (Nov. 17, 2009), <http://seekingalpha.com/article/173735-confusion-reigns-about-banks-minimum-capital-requirements> (emphasis omitted).

Others have described individual bank capital requirements as “arbitrary,” “frustrating,” and “confusing.”³³³ Banks can glean some information by carefully reviewing formal capital enforcement actions. However, this time consuming process does not reveal any precise rules of thumb that regulators employ. Formal enforcement actions do not explain, for example, why regulators might choose to require a 12% leverage ratio instead of a 10% leverage ratio. Furthermore, past enforcement actions do not necessarily predict regulators’ future enforcement actions. Regulators might adjust their rules of thumb to account for changing conditions or newly discovered information. At best, a review of existing actions, like this Article, provides only a general picture of regulators’ past enforcement efforts.³³⁴

Uncertainty created by enforcement can lead to a misallocation of credit and capital. If banks have only a vague notion about the amount of capital their regulators might require, banks will have difficulty planning to meet those requirements.³³⁵ Particularly during an economic downturn (when banks fear increased capital enforcement actions), banks may respond to ambiguous capital requirements by holding more capital than necessary.³³⁶ In order to accommodate this capital hoarding, banks may restrict credit in an inefficient manner.³³⁷

333. Chris Serres, *Tough Times Prod Tougher Oversight of State Banks; Regulators Are Changing How They Define Healthy Institutions, Forcing Some Hard Adjustments*, STAR TRIB. (Minneapolis), Aug. 1, 2009, at 01D (“We’ve read a few out-of-state (enforcement actions) that call for a 12 percent ratio We all as an industry have to play by the rules. But in the interim, it’s a little confusing.” (omission in original) (quoting Adam Dittrich, President and CEO, Americana Bank)); *Why Healthy Banks Need to Raise More Capital Than Ever*, BANK SAFETY & SOUNDNESS ADVISOR, July 19, 2010, at 1 (“[Tad Gage, executive vice president of Capital Insight Partners in Chicago] says the situation is frustrating for bankers. ‘What is the [capital] standard? There doesn’t seem to be one.’”); Brown, *supra* note 332 (“[R]egulators seem to be making up minimum capital ratio requirements, that vary from bank to bank, as they go along. It is a picture of total arbitrariness, the exact opposite of what smart regulation is supposed to be about.”); Stuart Dobson, *How to Fix the So Called Banking Crisis in the U.S.*, COM. NOTE BROKERS (June 28, 2010), <http://www.commercialnotebrokers.com/blog/how-to-fix-the-so-called-banking-crisis-in-the-u-s/>.

334. The problem is even more acute when regulators set capital requirements using informal, rather than formal, actions. Then banks must rely on communication with their regulator and gossip collected from bank peers and industry publications.

335. See Norton, *supra* note 229, at 1357. According to Professor Norton:

In the capital adequacy area . . . regulatory transparency is of particular importance. With the inherent definitional problems with bank capital, the assessment complexities involved with bank capital adequacy, and the confidentiality and subjectivity surrounding capital adequacy on the examination level, it is difficult, without open and uniform regulations, for all affected parties to be able to assess intelligently and prudently the impact of such supervisory practices.

Id.

336. See Justin Baer & Francesco Guerrera, *Regulators Tell Banks to Retain Their Funds*, FIN. TIMES (London), Mar. 10, 2010, at 1 (reporting that regulators urged banks to hold capital until the banks learned whether capital requirements would be increased); David Reilly, *Don’t Bank on Lenders Just Yet*, WALL ST. J., June 28, 2010, at C10 (“Until there is

It is difficult to determine whether the recent increase in discretionary capital enforcement has contributed to a misallocation of credit. There is evidence that banks have tightened lending standards and restricted the flow of credit during the current economic crisis.³³⁸ Some attribute the tight credit at least partly to capital enforcement actions.³³⁹ However, banks are probably also motivated by a general angst about their deteriorating loan portfolios and poor economic conditions.³⁴⁰ Untangling the precise credit impact of capital enforcement actions and individual bank minimum capital requirements would likely be difficult.

At any rate, a significant amount of discretionary capital enforcement activity is costly for banks and has the potential to confuse capital standards and misallocate

greater clarity on capital, banks are unlikely to return cash to shareholders and might remain wary of lending too aggressively.”). Because raising capital is costly, and can be even more costly during economic downturns, most banks would prefer to maintain capital levels rather than attempt to raise external capital when required by their regulators. *See id.*

337. *See* David Enrich, Robin Sidel & Deborah Solomon, *Fed Sees Up to \$599 Billion in Bank Losses*, WALL ST. J., May 8, 2009, at A1; Heather Scoffield, *Leaders Launch New Push in Face of Global Recession*, GLOBE & MAIL (Toronto), Nov. 10, 2008, at B1 (stating that “[i]f leaders can show financial institutions that they don’t plan to increase capital requirements during the downturn . . . then banks don’t have to hoard, and can start lending again”).

There is some debate among economists about whether a bank’s mix of debt and capital influences the bank’s lending decisions. Those who believe that capital has little effect on lending often root their view in the Modigliani-Miller theorem, which holds that in a perfect market, a company’s decision to use debt or equity financing will have no effect on the company’s profits. *See generally* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958) (establishing the Modigliani-Miller theorem); Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig & Paul Pfleiderer, *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive 2* (Rock Ctr. for Corp. Governance at Stanford Univ., Working Paper No. 86, 2011), available at <http://ssrn.com/abstract=1669704> (arguing that bank “equity requirements need not interfere with any of the socially valuable activities of banks, including lending”); Skander J. Van den Heuvel, *Does Bank Capital Matter For Monetary Transmission?*, 8 FRBNY ECON. POL’Y REV. 259, at 259 (2002) (noting that under the Modigliani-Miller theorem “the bank will always be able to find investors willing to finance any profitable lending opportunities, the level of bank capital is irrelevant to lending”). Many economists, however, reject the Modigliani-Miller assumption of perfect markets and conclude that higher capital requirements lead to less lending. Indeed the Peek-Rosengren Study found that banks that received formal capital enforcement actions trimmed their asset portfolios and reduced lending after receiving the action. Peek & Rosengren, *supra* note 136, at 21–23; *see also* Joe Peek & Eric Rosengren, *Bank Regulation and the Credit Crunch*, 19 J. BANKING & FIN. 679 (1995); Joe Peek & Eric S. Rosengren, *Crunching the Recovery: Bank Capital and the Role of Bank Credit*, in REAL ESTATE AND THE CREDIT CRUNCH, FED. RESERVE BANK OF BOS. CONFERENCE SERIES NO. 36, 151, at 151–71 (Lynn E. Browne & Eric S. Rosengren eds., 1992).

338. Michael R. Crittenden & Tom Barkley, *Regulators to Banks: Loan to Small Firms*, WALL ST. J., Feb. 6, 2010, at B4.

339. *See* Brown, *supra* note 332.

340. *See* Julie Andersen Hill, *Bailouts and Credit Cycles: Fannie, Freddie, and the Farm Credit System*, 2010 WIS. L. REV. 1, 6–9 (discussing lending and credit cycles).

credit. Meaningful capital standards set by statute or regulation would be less costly and more transparent.³⁴¹

3. Myopia

Finally, discretionary capital enforcement is dangerous because it encourages a regulatory myopia that focuses on the financial condition of individual banks.

Bank regulators have two primary responsibilities: (1) ensuring that the banking system as a whole operates efficiently, and (2) ensuring that individual banks are safe and sound. This is most clearly seen with the Federal Reserve, which administers monetary policy and acts as a central bank in addition to supervising some banks and bank holding companies.³⁴² While the other federal regulators are sometimes thought to focus more on the safety and soundness of individual banks, they also are often expected to consider the function of the banking system as a whole. For example, the mission of the FDIC is “to maintain stability and public confidence in the nation’s financial system by: insuring deposits, examining and supervising financial institutions for safety and soundness and consumer protection, and managing receiverships.”³⁴³

Often the responsibilities of overseeing individual and collective bank health are complimentary—that is, by keeping individual banks safe, regulators promote health in the entire banking system. Sometimes, however, there is tension between these two responsibilities.³⁴⁴ For example, during an economic downturn a regulator might reasonably require an individual bank to increase its capital ratios.³⁴⁵ After all, increased capital ratios will make that bank more able to bear loan losses. However, to achieve the higher capital ratio the bank might reduce lending.³⁴⁶ Taken alone this action is probably not significant. But if each regulator raises capital levels and each bank responds by restricting lending, the collective

341. Indeed, if regulators are using rules of thumb to evaluate capital levels, there seems to be little lost in informing banks of those rules of thumb.

342. See BROOME & MARKHAM, *supra* note 101, at 134–35, 156.

343. *FDIC Mission, Vision, and Values*, FDIC (May 4, 2009), <http://www.fdic.gov/about/mission/index.html>.

344. See Anna Gelpern, *Financial Crisis Containment*, 41 CONN. L. REV. 1051, 1075 (2009); Richard J. Herring, *The Known, the Unknown, and the Unknowable in Financial Policy: An Application to the Subprime Crisis*, 26 YALE J. ON REG. 391, 401–02 (2009); Saule Omarova & Adam Feibelman, *Risks, Rules, and Institutions: A Process for Reforming Financial Regulation*, 39 U. MEM. L. REV. 881, 883–84 (2009) (“In the wake of the current crisis, it is also now clearer that institution-level (that is, micro-prudential) regulation can be in tension with systemic stability.” (footnote omitted)); Heidi Mandanis Schooner, *Private Enforcement of Systemic Risk Regulation*, 43 CREIGHTON L. REV. 993, 996 (2010) (“The 2008 Financial Crisis, however, challenged the assumption that systemic risk could be addressed by attempting to protect the solvency of individual banks (what is now called a ‘micro-prudential’ approach to regulation).”).

345. See *supra* notes 297–98 and accompanying text.

346. See Joe Peek & Eric Rosengren, *The Capital Crunch: Neither a Borrower Nor a Lender Be*, 27 J. OF MONEY, CREDIT & BANKING 625, 625–26 (1995); *Is 12 the New 10?*, *supra* note 214, at 1. *But see supra* note 337 and accompanying text.

action might exacerbate economic downturns and destabilize the overall banking system.³⁴⁷

The trouble is that formal capital enforcement actions typically germinate during a bank examination. During the bank examination, a team of bank examiners makes a determination about whether the bank has sufficient capital and considers what remedial measures might be appropriate.³⁴⁸ Yet, these bank examiners, who are tasked with evaluating the capital levels of individual banks, have little incentive to consider the macroeconomic impact of their decisions. An examiner may be criticized if the bank he or she examined ultimately fails, but an individual examiner is unlikely to be blamed for the state of the economy or the banking system as a whole.

Regulators might note that field office examiners are generally not given authority to issue formal capital enforcement actions. According to the FDIC, “[a]ll FDIC formal enforcement actions are reviewed by a number of high-level FDIC officials both prior and subsequent to their initiation.”³⁴⁹ While review above the field-examiner level is certainly helpful, it likely does not ameliorate the problem. At the FDIC, the “high-level” official reviewing and approving a formal enforcement action is often a regional director or regional counsel.³⁵⁰ FDIC decision making proceeds to the Washington office of the regulator primarily when the regulated bank requests a hearing on the matter.³⁵¹ This means that, as a practical matter, regulatory officials with broad powers and responsibilities approve only a tiny fraction of formal capital enforcement actions.³⁵² Regulatory decisions about formal enforcement actions are made mostly by those whose principal task is ensuring individual bank safety and soundness.

Although the formal capital enforcement action study does not conclusively show that regulators have increased capital requirements through discretionary enforcement, it does raise concerns about regulatory myopia. The study shows a striking increase in the number of banks subject to individual bank minimum capital requirements. These requirements are implemented by examiners whose duty is to consider the health of individual banks.³⁵³ In contrast, legislative and

347. See generally Ben Bernanke & Mark Gertler, *Agency Costs, Net Worth, and Business Fluctuations*, 79 AM. ECON. REV. 14 (1989) (describing the “credit multiplier” effect).

348. See FDIC, ACTIONS PROCEDURES MANUAL, *supra* note 79, at 1-7 (“The FDIC’s first line of supervision is the field examiner staff. The . . . manuals of examination policy require examiners to describe any problems detected during examinations of financial institutions and to recommend appropriate corrective action.”); OCC, PPM 5310-3, *supra* note 79, at 11 (“Generally, the [Examiner in Charge] is responsible for initially recommending the use of an enforcement action to address problems and concerns identified in assigned banks.”).

349. Guidelines for Appeals of Material Supervisory Determinations, 73 Fed. Reg. 54,822, 54,824 (Sept. 23, 2008).

350. FDIC, ACTIONS PROCEDURES MANUAL, *supra* note 79, at 5-24 to 5-29, 6-12 to 6-15.

351. For example, Washington office approval is required if a bank requests a hearing on a cease-and-desist order or if a bank appeals the issuance of a prompt corrective action directive. *Id.*

352. See *supra* note 202 and accompanying text.

353. See *supra* Part I.B.1 (explaining the regulatory process for formal capital enforcement actions).

rulemaking processes force regulators to consider and publicly address how increased capital requirements could affect overall lending and economic recovery. Because rulemaking considers a wider variety of interests, it should be the preferred method of setting capital requirements.

C. Balancing Rules and Discretion

Given the problems associated with discretionary capital enforcement, it makes sense to consider the appropriate balance between capital regulation by rule and capital regulation by enforcement. Both types of regulation have appeal. Rules are clear, provide certainty, and can be crafted to consider macroeconomic concerns. On the other hand, enforcement has some capacity to identify and correct truly unique situations at individual banks. In addition, regulation by enforcement might discourage banks from deliberate attempts to skirt regulations established by rule. What then is the appropriate balance? Part III.B suggests that in some respects reliance on discretionary enforcement may have gone too far. As regulators adopt new capital rules, efforts should be taken to define by rule some items previously left for discretionary enforcement.

First, regulations should include real capital minimums. There is little sense in adopting minimum rules if every bank is required to maintain more than the minimum amount of capital all of the time.³⁵⁴ Unless the regulatory rules have some application, they do not provide clarity or certainty.

Second, to the extent regulators rely on rules of thumb to assess capital adequacy, these rules of thumb should be included in regulation or at least publicly disclosed to banks.³⁵⁵ Unless banks have a clear understanding of capital rules, they may hoard capital and restrict lending,³⁵⁶ or they may undercapitalize and force regulators to undertake expensive enforcement actions.³⁵⁷ Both scenarios make bank regulation unnecessarily costly. Moreover, if regulators disclose rules of thumb, banks and policymakers can more effectively identify differences in capital enforcement among regulators.

Third, regulations should be designed to adjust to changing economic conditions without relying on discretionary enforcement. Regulators have been nearly universal in their calls for countercyclical capital requirements—that is, capital requirements that are lower during economic downturns and higher during economic booms.³⁵⁸ While it might be tempting to rely on discretionary

354. See *supra* note 323 and accompanying text (discussing regulator statements that most banks should maintain capital in excess of regulatory capital ratios).

355. See *supra* Part III.B.1 (discussing regulators' use of rules of thumb).

356. See *supra* notes 335–37 and accompanying text.

357. See *supra* notes 324–26 and accompanying text.

358. *Modernizing Bank Supervision and Regulation—Part I: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 111th Cong. 64, 86 (2009) (statements of Sheila C. Bair, Chairman, FDIC and Scott M. Polakoff, Acting Dir., OTS); Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., *Financial Regulation and Supervision After the Crisis: The Role of the Federal Reserve*, Speech at the Federal Reserve Bank of Boston 54th Economic Conference (Oct. 23, 2009), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20091023a.htm>.

enforcement to adjust capital in light of economic conditions, the Dodd-Frank Act requires that regulators “seek to make the capital standards . . . countercyclical so that the amount of capital required to be maintained by an insured depository institution increases in times of economic expansion and decreases in times of economic contraction, consistent with the safety and soundness of the insured depository institution.”³⁵⁹ It is wise to put countercyclical requirements in regulations. Countercyclical capital requirements are meant to address macroeconomic concerns.³⁶⁰ They can help maintain lending during an economic downturn, even as banks experience losses. Bank examiners making decisions about individual bank health and imposing discretionary enforcement are not well positioned to consider or implement policies guided by macroeconomic concerns.³⁶¹ In drafting regulations, regulators should be mindful that the discretionary enforcement authority granted to examiners under their safety and soundness mandate is not allowed to overshadow countercyclical regulations.

Fourth, if regulators believe that capital at the largest banks should be regulated differently, then regulations should specify which banks will be treated differently. Regulations should also provide the different capital requirements for each class of banks. Again, this would allow banks to plan to meet capital requirements. Furthermore, it would deflect criticism leveled by some smaller banks that “regulatory practices . . . often seem to disadvantage [community banks] and favor much larger institutions or even non-banks”³⁶² for no apparent reason.

Of course, even with more comprehensive regulations, there will still be a role for capital enforcement. Banks should still receive formal capital enforcement actions when their capital levels drop below levels specified in regulations. Moreover, regulators should still retain the power to issue discretionary actions and impose individual bank minimum capital requirements. These actions, however, should be limited to the small number of extraordinarily unique banks. If regulations were properly crafted, it would be unnecessary for regulators to issue hundreds of actions containing individual bank minimum capital requirements per year.

CONCLUSION

Effective capital regulation relies on a mix of regulation by rule and regulation by enforcement. The formal capital enforcement action study presented in this

359. 12 U.S.C. § 3907(a)(1) (2010).

360. See generally COMM. OF EUR. BANKING SUPERVISORS, POSITION PAPER ON A COUNTERCYCLICAL CAPITAL BUFFER (2009); FIN. SERV. AUTH., THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 53–62 (2009); MARKUS BRUNNERMEIER, ANDREW CROCKET, CHARLES GOODHART ET AL., THE FUNDAMENTAL PRINCIPLES OF FINANCIAL REGULATION 29–38 (2009); Charles W. Calomiris, *Financial Innovation, Regulation, and Reform*, 29 CATO J. 65, 80–84 (2009).

361. See *supra* Part III.B.3.

362. *The Condition of Financial Institutions: Examining the Failure and Seizure of an American Bank: Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Servs.*, 111th Cong. 64 (2010) (written testimony of Jeff Austin III, Chairman-Elect, Texas Bankers Ass’n).

Article examines capital enforcement efforts as never before. It shows that an increasing number of banks are subject to capital enforcement actions. These actions often include individual bank minimum capital requirements that are significantly higher than the capital requirements established by regulations. The study suggests that different bank regulators may not have similar standards for selecting a type of action or imposing higher individual bank minimum capital requirements. Moreover, the study shows a near complete absence of capital enforcement actions issued to the largest banks.

Because discretionary capital enforcement actions now appear to be a significant part of capital regulation, policymakers should carefully address the proper role of discretion in setting capital requirements. In general, rulemaking should be favored over discretionary enforcement because rulemaking is less costly, more transparent, and more likely to consider macroeconomic concerns. Nevertheless, discretionary capital enforcement may still be necessary to effectively regulate banks that do not meet the regulatory requirements or to set capital requirements for banks that are truly unique.