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BANK FAILURES, RISK MONITORING, AND THE MARKET FOR BANK CONTROL

Jonathan R. Macey*
and Geoffrey P. Miller**

INTRODUCTION

Not since the Great Depression has there been such concern in the popular press about the fundamental stability of the banking industry. This apparent decline in public confidence stems from the unprecedented increase in the incidence of bank failures during the past decade. From 1946 to 1984 the average failure rate for banks was a modest .07%, but from 1984 to 1987 this rate increased five-fold to .37%.1 Although this failure rate is still quite small compared with the failure rate for firms throughout the rest of the economy,2 the large stake that the federal government has in the financial stability of banks, and the widespread perception that healthy banks are especially important to the economy, suggest that concern about the increasing incidence of bank failures is warranted.3

The absolute number of bank failures is not particularly large. One hundred twenty banks failed in 1985,4 145 failed in 1986,5 and 184

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2. Id.

3. See Rosenberg & Given, Financially Troubled Banks: Private Solutions and Regulatory Alternatives, 104 Banking L.J. 284, 284 (1987) ("There are more banks in trouble at present in the United States than there have been since the Great Depression of the 1930s.").

4. Deposit Insurance Reform and Related Supervisory Issues: Hearings Before the
failed in 1987. With nearly 15,000 commercial banks in the country, unless there is some reason to be particularly concerned about banks as distinct from other business entities, it is at least arguable that the current rate of failure simply represents the healthy weeding out of weaker operations in the face of more stringent competition in the financial services industry. Indeed, the current level of bank failures pales in comparison to that of the Depression, when some 9,000 banks suspended operations. Even during the roaring 1920s more than 500 banks failed in an average year.

This Article considers some causes and consequences of the current rash of bank failures and proposes procedural reforms to deal with the problem in ways that will strengthen the economy as a whole. Part I argues that bank failures are a particular concern because the current system of banking regulation imposes the costs of bank failures on the general public. It is this regulatory system, rather than any notion that banking institutions are peculiarly deserving of protection, that justifies the special attention paid to bank failures.

Because any attempt to improve the procedures for dealing with the bank failure problem must be sensitive to the sources of the problem, Part II examines the reasons why we observe bank failures in an otherwise healthy economy. Fraud and self-dealing, insufficient asset diversification, and fluctuations in the business cycle all have contributed to the recent high incidence of bank failure.

Using these reasons as background, the remainder of the Article analyzes the role played by the legal system in coping with the problem of bank insolvency, and concludes that a number of banking laws and regulations actually increase the probability of bank failure.

Part III analyzes the procedures used by the Federal Deposit Insurance Corporation (FDIC) and other administrative agencies to administer failed banks and evaluates the costs and benefits of alternative regulatory schemes. This section concludes that the procedures most popular with the regulatory agencies destroy much of the incentive of depositors to monitor excessive risk taking by banks and thus make bank failures more likely by eliminating an important constraint on bank management.

Part IV describes the beneficial consequences that enhanced depositor monitoring would have on the banking system and identifies brokered deposits as an additional cause for the low level of depositor monitoring in the current system. Finally, Part V suggests that the inci-
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idence of bank failure in the economy could be decreased if the procedures governing the shift in control of a bank were amended. Such an amendment would enhance the market for corporate control of banks in order to expose bank management to monitoring by potential acquirers.

I. THE CONCERNS ABOUT BANK FAILURES

Contrary to popular belief, the failure of an insured depository institution does not reflect a failure of the banking system as a whole or even of the regulatory system that was constructed in the aftermath of the wave of bank failures stemming from the collapse of the stock market in 1929.8 As in other sectors of the economy, the failure of a financial institution indicates one of two things: either the firm has not responded to market forces with a satisfactory mix of price and product performance relative to its competitors in the industry or else the product the firm is offering is not in sufficient demand by consumers to justify its production in the first place. In either case termination of the firm's operations represents a net social gain. In a market economy, when an enterprise fails, the resources previously devoted to a firm will find other, more efficient uses.9 As a result, the existence of failing institutions may be a sign of health rather than a sign of malaise since it indicates either that innovation is driving obsolete firms out of the industry, or that competition is driving inefficient firms out of the market. These considerations suggest that in a developed market system bank failure is not necessarily problematic. If there is a legitimate social concern with bank failure, therefore, it must be because there is something different about banks that alters our customary reliance on the valuable economic role played by business failure. A number of bank-specific concerns have been suggested: the fear of bank runs; the loss of society's and depositors' wealth; and the costs of bank failure for the system

8. See Tussing, The Case For Bank Failure, 10 J.L. & Econ. 129, 143 (1967).
9. Indeed, there may well be a stronger case for allowing banks to fail. As financial intermediaries, banks directly affect the allocation of financial resources by other firms. As Professor Tussing notes a financial intermediary has the potential not only for misusing the labor, invested capital, and other factor inputs it uses directly, but also for distorting the use of resources by business generally. If it is desirable that an inefficient manufacturing establishment fail, so that the resources devoted to it can be made more useful to society, it is doubly desirable that an inefficient bank fail. Not only will the resources directly devoted to it find more useful outlets, but the increased efficiency in financial processes which results can mean that loans are made more nearly in accordance with social priorities, that local and regional economic growth are not retarded by underbanking, and that interregional financial flows are not impeded through the petrification of inept locational decisions.

Id. at 146.
of deposit insurance which itself is a response to perceived problems with bank failures.

A. The Fear of Bank Runs

Perhaps the most common argument against allowing banks to fail is that such failures cause bank runs which then lead to socially disruptive waves of failures. This argument assumes that failures of inefficiently managed banks impose negative external effects on sound banks. In other words, any bank failure is of concern since the failure of any one bank threatens harm to all banks. Proponents of this position observe that the distinctive feature of banks as financial intermediaries is that banks typically have a higher proportion of their liabilities in the form of demand or near-demand deposit accounts, while their assets are in relatively illiquid mortgages and commercial loans. As a result of this asymmetry in the maturity structure of assets and liabilities, no bank is able to pay off all depositors instantaneously. If all or even a large percentage of the depositors suddenly demanded withdrawal of their funds, the bank would face a severe crisis. It would be forced to sell assets in order to meet the unanticipated liquidity demands; if assets could not be liquidated quickly enough, the bank would have to close until it could obtain sufficient liquidity. Even more seriously, in the rush to obtain the necessary liquidity the bank would have to sell off assets at "fire sale" prices or call in profitable loans. The value of the bank as a whole would be reduced accordingly.

Normally, however, the balance sheet mismatch poses no problem. Banks rely on the law of large numbers for assurance that on any given day they will not be required to pay out more than a small fraction of their deposit accounts. The reserves of liquid and near-liquid assets that banks keep on hand are more than sufficient in normal circumstances to cover depositors' demands. That banks are technically unable to honor their promises to pay out all depositors "on demand" is ordinarily of no concern to anyone.

The mismatch between deposits and liabilities does become a problem, however, in the unusual situation of a bank run. Bank runs are essentially a collective-action problem among depositors. Depositors as a whole are much better off if large numbers of them do not

10. E.g., Garten, Banking on the Market: Relying on Depositors to Control Bank Risks, 4 Yale J. on Reg. 129, 160–63 (1986) (arguing that individual bank failures will lead to economically disruptive bank runs).

11. This disparity, of course, may benefit bank customers. See Diamond & Dybvig, Bank Runs, Deposit Insurance, and Liquidity, 91 J. Pol. Econ. 401, 402 (1983) (banking allows consumers to transform "illiquid assets into liquid liabilities" by pooling risk of withdrawal to enable banks to invest in higher-yielding illiquid assets); see also Jacklin & Bhattacharya, Distinguishing Panics and Information-Based Bank Runs: Welfare and Policy Implications, 96 J. Pol. Econ. 568 (1988) (examining the proposition that intermediary contracts transform highly illiquid asset payoff streams into more liquid securities products).
withdraw large sums simultaneously, since as noted above, sudden un-
anticipated withdrawals tend to reduce a bank's value—increasing the
probability that depositors will not be paid in full—and may force a
bank to close altogether. But if for any reason large unanticipated with-
drawals do begin at a bank, depositors as individuals will rationally con-
clude that they must do the same to avoid being left with nothing.
Thus, in a classic prisoner's dilemma, while depositors may collectively
be better off if they refrain from withdrawing their money from a bank
that is experiencing temporary liquidity problems, their inability to co-
ordinate their response to the problem will lead to a seemingly irra-
tional response—depositors will rush to be among the first to withdraw
their funds so that they can obtain their money before the bank's cash
reserves are drained. Thus a bank run begins.\(^1\)

Banks, therefore, are classically subject to runs whereas other fi-
nancial intermediaries are not. Proponents of the "panic" justification
for bank regulation suggest that if a run can occur on a single bank, it
can occur on the banking system as a whole. If depositors see deposi-
tors in another bank rushing to withdraw their funds, and especially if
they see the other bank closing its doors rather than paying out, they
might conclude that their own institution is vulnerable to the same sort
of experience. The prisoner's dilemma could extend to the system as a
whole, resulting in economic catastrophe for the nation. This theory
finds empirical support in the events of the Great Depression when a
form of nationwide bank panic did indeed occur, forcing the govern-
ment to declare a bank holiday and eventually institute reform meas-
ures that constitute the fundamental structure of the bank regulatory
system today.

Despite the surface plausibility of this theory, it is unlikely that a
generalized bank panic like that which occurred during the Depression
would occur today. First, improvements in financial markets now per-
mit banks much greater leeway to match the duration of their assets and
liabilities, substantially mitigating the asset-liability mismatch in banks' 
balance sheets. The development of a secondary mortgage market and
of mortgage-backed securities has allowed banks to reduce the average
maturities of their assets, and interest rate deregulation has given banks
the opportunity to attract longer-term liabilities through the sale of cer-
tificates of deposit. Banks are also earning a greater percentage of their
income through fee services rather than pure intermediation. These
marketplace developments, although driven by economic concerns
other than a desire to avoid bank runs, have partially mitigated many
banks' susceptibility to runs.

Second, the danger of pure "liquidity" runs—runs on economi-
cally solvent banks based on fears that the banks will be forced to sell

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12. For a useful exposition see Fischel, Rosenfield & Stillman, The Regulation of
off assets or close to meet liquidity demands—is substantially mitigated by the Federal Reserve Board's readiness to provide emergency liquidity assistance. If a run does develop on a healthy institution, the Federal Reserve Board can supply short-term cash through the "discount window" in order to allow the bank to pay depositors without the need to liquidate assets at below-market prices.

Third, the comprehensive system of federal deposit insurance greatly reduces the danger of bank runs of all sorts—even those based on a bank's actual financial condition. Depositors with accounts below $100,000 know their funds are backed, at least de facto, by the full faith and credit of the United States, so that weakness of their own bank, much less that of other institutions, is no special cause for concern. Deposit insurance, in the words of Milton Friedman and Anna Schwartz, "has succeeded in achieving what had been a major objective of banking reform for at least a century, namely the prevention of banking panics."

The efficacy of the present system at preventing systematic bank panic is attested to by the fact that the dramatic increase in bank failures in recent years has failed to bring about any significant loss of confidence in the banking system itself. The current absence of generalized panic does not conclusively establish that one will not oc-

14. See Tussing, supra note 8, at 144. Milton Friedman and Anna Schwartz argue that the most plausible cause of the wave of bank failures during the Depression was the unwillingness of the Federal Reserve at the time to provide sufficient liquidity to solvent institutions. See M. Friedman & A. Schwartz, A Monetary History of the United States, 1867-1960, at 355-59 (1963).
15. Deposit insurance thus serves a function not unlike federal bankruptcy law, a principal objective of which is to reduce collective-action problems outside the banking industry. See, e.g., H.R. Rep. No. 595, 95th Cong., 1st Sess. 220, reprinted in 1978 U.S. Code Cong. & Admin. News 5963, 6180 (the automatic stay of actions against a debtor in Chapter 11 prevents creditors "from acting unilaterally to gain an advantage over other creditors"); see also Jackson, Bankruptcy, Non-Bankruptcy Entitlements and the Creditors' Bargain, 91 Yale L.J. 857 (1982) (explaining bankruptcy by using "creditors' bargain" model).
16. It is unclear whether this continued depositor confidence stems from a belief that the FDIC and the FSLIC actually have the resources to satisfy depositor demand in the case that insolvency rates continue to grow at their current rate, or from a belief that their deposits are backed by the full faith and credit of the United States. See Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 901, 1987 U.S. Code Cong. & Admin. News (101 Stat.) 552, 657 (1987) (codified as amended in scattered sections of 2 U.S.C., 12 U.S.C., 15 U.S.C., & 31 U.S.C.) (declaring it to be the "Sense of Congress" that "deposits up to the statutorily prescribed amount in federally insured depository institutions are backed by the full faith and credit of the United States").
18. Where federal deposit insurance is lacking, however, more generalized bank runs are still possible, as evidenced by the minor panics that occurred during the early 1980s among state-chartered, non-federally insured thrifts in Maryland and Ohio. See generally Miller, The Future of the Dual Banking System, 53 Brookyn L. Rev. 1, 19 (1987) (describing disasters in state sponsored insurance funds in Maryland and Ohio).
cur in the future, but it does support the inference that a generalized panic is unlikely under present conditions. Disclosure of negative information about certain banks does not "spillover" to other banks causing general disruption because the market is able to distinguish the firm-specific financial problems that affect individual banks from the industry-wide problems that affect banks generally. Indeed, there is no evidence of any spillover effect from the recent abundance of bank failures, including such large failures as that of Continental Illinois.

B. Loss of Depositors' and Society's Stock of Wealth

A second argument for granting special regulatory treatment to insolvent banks (and for society's apparent low tolerance for bank failures) depends on the alleged lack of sophistication on the part of depositors coupled with the importance of demand and time deposits as a stock of wealth. According to this line of reasoning, the owners of bank deposits lack the expertise and sophistication to make informed decisions about which financial institutions can provide safe havens for their savings. Thus, it is said, the government should provide special regulatory protections to prevent the loss of wealth stemming from bank failure.

This argument, however, does not support special regulatory treatment for banks. First, the premise that depositors will be unsophisticated in their choice of a bank in which to place their savings is doubtful today. There is little reason to suppose that depositors are any less


The fact that the market value of similar banks does not decline when an individual bank fails is strong evidence of a lack of a spillover effect since it indicates that the bank failure has not even raised the cost of capital of the other banks. See Murphy, Disclosure of the Problem Bank Lists: A Test of the Impact, 10 J. Bank Res. 88, 92 (1979) (showing that disclosure of the fact that certain banks were in trouble did not affect market value of other banks).

20. G. Kaufman, Implications of Large Bank Problems and Insolvencies for the Banking System and Economic Policy 12 (Federal Reserve Bank of Chicago, Staff Memorandum No. 85-3, 1985) (Bank runs do not take the form of currency drains out of the system, but of "redeployment of deposits to other, presumably less risky banks of similar characteristics. A run on a bank no longer translates into a run on the banking system ". . . .").

21. Examples of time deposits are passbook savings accounts and certificates of deposit.

22. The argument that depositors have sufficient expertise and sophistication to make informed decisions about which financial institutions to entrust with their money presupposes that depositors can obtain sufficient information upon which to bring their expertise and sophistication to bear. It is clear that such information is readily available. As one commentator has observed, "information about the operations and financial condition of banks, particularly large institutions, already is surprisingly comprehensive, readily available, and, in the view of the professional analysts who use it, equal to or better than disclosure currently available about other industries." Garten, supra note 10, at 140 (citations omitted).
sophisticated in their choice of a bank in which to invest than in their other financial decisions, such as the choice of a mutual fund or individual retirement account. The vigorous price competition that broke out when deposit interest rates were deregulated suggests that consumers are quite sophisticated about their investment in financial institutions, at least as far as the return features of their investments are concerned. There is good reason to suppose that depositors would be equally sophisticated about the risks of their investments in banks.

Second, even if depositors are somehow unsophisticated, the danger of bank failure would not threaten society's stock of wealth. During the Depression, when 9,000 banks failed or suspended operations, depositor losses amounted to only $1.3 billion, a figure that pales in comparison to the $85 billion in losses borne by holders of common and preferred stock over the same period. Bank failures simply do not threaten to destroy society's stock of wealth, nor do they threaten to wipe out all of the savings of those depositors who place their money at banks that fail.

Furthermore, it is not at all obvious why a bank failure is any more disruptive to the economy than the failure of an industrial enterprise.

23. As with financial return, information about bank riskiness will be contained in the rates of interest that banks must pay to obtain funds from depositors who are willing to risk making deposits above the $100,000 insurance ceiling. See infra note 107 (demonstrating that interest rates increase with riskiness).

24. M. Friedman & A. Schwartz, supra note 14, at 351; Tussing, supra note 8, at 145.

25. While bank failures do not appear to threaten to destroy society's stock of wealth, those people who hold a disproportionate share of their wealth in the form of bank deposits will suffer disproportionately in the case of bank failure, just as those who hold a disproportionate share of their wealth in the stock market lose disproportionately when the stock market crashes.

But even a person with one hundred percent of her assets in a bank that fails will not lose all of her assets in the event of a bank failure. In the worst case, the assets of the bank will be liquidated, and the depositor will share pro rata with other creditors in the distribution of those assets. Historically, depositors have recovered a very high percentage of their assets in the event of failure. George Kaufman examined depositor losses from bank failures before the introduction of the FDIC (from 1865 through 1933) and found that 82 percent of the losses borne by failed banks came from liquidation of assets (62 percent) and from shareholders' equity (20 percent). This means that only 18 percent (a total of 2.2 billion out of total losses of 12.3 billion) were borne by depositors. Most important, depositors' losses were only .21 percent of total deposits. G. Kaufman, supra note 20, at 5.

It is also true, however, that the segment of the population with deposits of less than $100,000 is most likely to have a disproportionate share of its wealth in bank deposits. This is a strong argument for insuring small deposits, so that such people, who are less able to diversify their savings, will have some form of completely safe investment that still can be reinvested by intermediaries such as banks.

26. The willingness of the federal government to bail out a large industrial enterprise such as Chrysler suggests that the federal bailout of major banks may not be particularly anomalous. There are at least two responses to this. First, as argued earlier, insolvencies serve the valuable economic functions of weeding out poorly run firms,
When banks fail, depositors may lose their money if their deposits are not insured. When other firms fail, these same depositors lose their jobs, which of course amounts to much the same thing. Although it is sometimes argued that bank failures may disrupt the payments system, it is unlikely that anything short of a massive wave of failures would have any significant adverse effects on that system. Finally, under the current regulatory structure in which bank customers with deposits of $100,000 or less are insured by the FDIC, the argument that banks should not be allowed to fail because unsophisticated depositors will be harmed carries even less weight.

Upon closer inspection, the argument that insolvent banks must be kept open because of the critical role they play as financial intermediaries in investing the nation’s stock of wealth turns into an argument that capital is allocated to its highest valuing users, and ensuring that vigorous product-market competition will provide customers with high quality products at competitive prices. See supra notes 8–9 and accompanying text (discussing the positive role that business failures play in the economy). The positive role of insolvency implies that, from a policy perspective, government bailouts of failing firms are not usually desirable. Rather, the consequences of each bailout decision must be analyzed and justified independently.

Second, there are important differences among various types of bailouts. As argued in a subsequent section of this Article, it would be possible to protect (or “bail out”) small depositors of failed banks while still retaining the salient disciplinary features of insolvency. See infra notes 136–151 and accompanying text (discussing bank failure policies). In other words, the issue really is not whether banks should be allowed to fail, but rather which classes of claimants should be protected when insolvency occurs. Thus the bank failure situation differs dramatically from the Chrysler insolvency because there was an independent policy judgment made that Chrysler—as a large employer and a major defense contractor—should not be allowed to fail. By contrast, in the bank failure situation, nobody has yet argued that a particular bank should be kept open because it serves some unique social role in the national economy due to the fact that it was heavily involved in defense contracting. Indeed, the existence of the Federal Reserve Board, twelve powerful regional federal reserve banks, and 15,000 independent commercial banks, suggests that no individual bank has the same niche in the banking industry that Chrysler had in the automotive and defense industries. Thus the federal bailout of Chrysler does not serve as a useful precedential model for insolvent U.S. banks.

29. If regulatory agencies delay making payments to insured depositors, such depositors may suffer unnecessary losses. If such depositors are unable to make timely interest payments on secured obligations such as home mortgage payments, such losses may be quite large. But the importance of making prompt payouts to insured depositors of failed banks long has been recognized. See Preston, The Banking Act of 1935, 43 J. Pol. Econ. 743, 750 (1935).

When a bank fails and the FDIC liquidates the institution, insured depositors typically are paid off within forty-eight hours of the insolvency. Interview with officials from the Division of Bank Supervision, Failing Bank and Assistance Transactions Section, Office of the General Counsel of the FDIC, and Office of the Chairman of the FDIC (Dec. 8, 1986) [hereinafter Interview]. To its credit, the FDIC takes great pride in its ability to make payoffs to insured depositors quickly. Id. (emphasizing ability of FDIC to handle large bank failures without disruption in depositors’ access to funds).
argument in favor of permitting banks to fail. Clearly a bank that makes improvident investment decisions is more likely to fail than a bank that makes sound investment decisions. Barring the misappropriation of funds by management, the reason banks fail is that they loan money to people and companies who cannot pay it back. When banks make such bad investment decisions, the damage is felt not only by those who have invested in the bank, but throughout the entire economy, because of the opportunity cost of the bad investment decisions. Each dollar committed by a bank to an improvident borrower is a dollar that could have been invested in a socially desirable venture. Banks, as financial intermediaries, have the potential for a double impact on the efficient use of resources. Not only can they misuse such resources as labor and capital themselves, but they can distort the allocation of these resources to other end-users. Allowing failures, then, could actually improve the prospects for increasing society's stock of wealth.  

C. The Real Source of Concern: The Regulatory Costs of Bank Failures

The principal attribute that makes banks "special" is the asymmetry between assets and liabilities that exacerbates the collective-action problem facing depositors and leads to the threat of bank runs on healthy banks. In our economy the implementation of deposit insurance has addressed this problem. The administration of deposit insurance, however, poses a regulatory cost of its own—it gives the shareholders and the managers of insured banks incentives to engage in excessive risk taking because the people who stand to benefit if the risks pay off (bank shareholders) are able to allocate some of their losses to innocent third parties.

Thus, bank failure is of legitimate concern because the costs of bank failures fall on third parties. These third parties are the healthy banks whose contributions to the FDIC and Federal Savings and Loan Insurance Corporation (FSLIC) insurance funds pay off depositors of failed banks, and ultimately the federal taxpayers whose funds replenish the federal insurance funds when they are depleted.

A fundamental contribution of modern corporate finance has been to formalize the nature of the conflict within the modern, publicly held corporation between the interests of holders of fixed claims and the interests of shareholders who hold the residual claims on the firm's wealth. Among any particular set of asset allocation decisions, any investment strategy that increases risk will transfer wealth from the fixed claimants to the residual claimants. Indeed, shareholders—who influence corporate decisions through their voting power—can even enrich themselves at the expense of the fixed claimants by shifting assets to risky investments that drive down the total value of the firm. A simple
example illustrates how this can happen.\textsuperscript{31}

Suppose that a bank has total assets of $1,000, of which $500 represents liabilities to depositors and $500 represents shareholders' equity. The bank has the option of investment strategy \textit{A} that has an expected payoff of $1010 or investment strategy \textit{B} that has an expected payoff of only $960.

**INVESTMENT A:**

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If the bank selects investment strategy \textit{A}, there is a ten percent probability that the strategy will cause the firm to have a net worth of $500, an eighty percent probability that the investment will cause the firm to have a net worth of $1000, and a ten percent probability that the investment will cause the firm to have a net worth of $1600. Investment strategy \textit{A} poses no risk of loss to depositors. Even under the worst possible scenario, in which the bank receives a return of only

\textsuperscript{31} The example used here was adopted, with several alterations, from a similar example contained in Professor William A. Klein's now classic work, Business Organization and Finance: Legal and Economic Principles 223–24 (1980). We are grateful for his permission to tinker with his presentation.

The term "monetary return" in the text refers to the actual net return that the firm will receive under alternative contingencies in the future. So, for example, investment strategy \textit{A} has three possible outcomes. If the firm employs strategy \textit{A}, it will receive the present value of either $500, $1000, or $1600 at some point in the future. Which of these payoffs it receives depends on the outcome of certain contingencies. While the outcome of these contingencies is currently unknown, we can estimate the probabilities that they will occur. Under this hypothetical, there is a ten percent chance that the firm will receive a payoff of $500, an eighty percent chance that the firm will receive a payoff of $1000, and a ten percent chance that the firm will receive a payoff of $1600 (these probabilities of course sum to 100 percent). The "expected value" is calculated by multiplying the monetary return of a particular contingency by the probability that that return will be realized. A risk-neutral investor will value an investment that provides an expected return of $50 at $50.
$500, the depositors will be fully paid because their claim on the assets of the bank comes before that of the shareholders.

Alternatively, if the bank embarks on investment strategy B, there is a significant probability (forty percent) that the bank will fail. Obviously, the depositors prefer strategy A to strategy B; they are holders of fixed claims so they do not share in the greater potential “upside” payoff of strategy B, and they prefer the certain payoff that strategy A affords. From the depositors’ perspective, a decision to opt for investment strategy B means greater default risk and significantly lower net expected return ($300 as against $500 under strategy A). By contrast, this strategy holds the promise of a much greater return for the common shareholders, who, as residual claimants, reap the gain of investment B’s greater upside potential. Therefore, even though there is a greater probability that the shareholders will be wiped out entirely, the shareholders unambiguously will prefer strategy B.

The expected monetary value to shareholders under strategy B is $660 as opposed to $510 under strategy A. By employing strategy B, the shareholders receive an expected monetary gain of eighteen percent, which comes at the expense of the depositors. To make things worse, under the example posited above, the dominant strategy from the shareholders’ perspective diminishes the total value of the bank.

In the publicly held corporation, the problem of excessive risk taking is mitigated to a significant extent by two factors. First, various devices serve to protect fixed claimants against excessive risk taking. Corporate lenders typically insist on protection against actions by corporate managers that threaten their fixed claims. Second, risk taking is reduced to some extent because managers are not perfect agents of risk-preferring shareholders. Managers are fixed claimants to that portion of their compensation designated as salary. In addition, managerial incentives for risk taking are reduced since managers have invested their non-diversifiable human capital in their jobs. This capital would depreciate significantly in value if their firms were to fail.

The second risk-reducing factor—that managers tend to be more risk-averse than shareholders—is present for commercial banks as well.

32. The conflict between risk-averse fixed claimants (depositors) and risk-preferring residual claimants (shareholders) outlined above is not peculiar to banks. Designing mechanisms for resolving these sorts of conflicts (and conflicts between shareholders and managers) constitutes the core of the subject of corporate finance. Preferred stock, convertible bonds, and bond indentures can all be understood as market-driven mechanisms for controlling excessive risk taking by shareholders. See Smith & Warner, On Financial Contracting: An Analysis of Bond Covenants, 7 J. Fin. Econ. 117 (1979).

33. The restrictions on managerial behavior that lenders obtain from borrowers can be divided into four categories: restrictions on production or investment decisions, restrictions on dividend payments, restrictions on the obtaining of additional financing, and restrictions controlling the forms that the borrower’s repayment to creditors can take. See id. at 125–47.
as other corporations. What makes banks fundamentally different from other types of firms, however, is the lack of significant discipline from other fixed claimants. FDIC insurance removes any incentive that insured depositors have to control excessive risk taking because their funds are protected regardless of the outcomes of the investment strategies that the banks select. In a world without deposit insurance, depositors would demand that banks refrain from engaging in risky investment strategies or else would demand that they be compensated in the form of a higher interest rate for the extra risk. Thus, depositors of insured financial institutions cannot be expected to exert the same degree of restraints on excessive risk taking as other fixed claimants, and this enhances the degree of influence exerted by shareholders, whose preference is to assume high levels of risk.

Although deposit insurance generally achieves its purpose of preventing bank runs, it does so at the cost of providing incentives for excessive risk taking by banks. This excessive risk taking leads in turn to a greater risk of bank failure. Methods devised for dealing with the problem of bank failures must therefore be sensitive to the concern that the current structure of banking regulation creates incentives for excessive risk taking.

II. THE SOURCE OF BANK FAILURES

The bank regulatory system is not unaware of the problem of excessive risk taking created by deposit insurance; indeed, much federal banking regulation is designed with the express purpose of limiting bank risk. Minimum capital requirements, restrictions on banks’ investment banking activities, lending limits, and limitations on bank holding company activities are all justified on the ground that they reduce the incidence of bank failure by limiting the ability of banks to engage in risky ventures or by preventing them from becoming too highly leveraged. This complex structure of regulation is backed up by a system of bank inspection designed to detect and correct excessive risk taking before it places a bank in jeopardy.

34. Other fixed claimants, such as trade creditors, other banks that participate in the interbank federal-funds market, and holders of subordinated or senior debt securities, do not in general act as adequate substitutes for monitoring by uninsured depositors. This is because, with the exception of holders of subordinated or senior debt securities, these other claimants extend credit only on an extremely short-term basis. In addition, federally insured depository institutions simply do not have subordinated or senior debt securities in their capital structure.
37. Id. § 84 (1982).
With all of these restrictions in place, one may wonder where the weak points in banking regulation are located. A useful starting point for such an analysis is to define the optimal regulatory regime. The optimal regulatory mix would be designed so as to maximize the difference between (1) the social costs of bank failure in the absence of regulation, and (2) the sum of (a) the social costs of the bank failures that occur with regulation plus (b) the social costs of the regulation itself, in the form of reduced flexibility and efficiency of banking operations. As will be seen, certain regulatory policies may be open to question on this score.

Banking regulation—and FDIC policies concerning bank closures—should be sensitive to the causes of bank failure since the ultimate success of such policies will depend on whether they can reduce or eliminate the adverse incentives necessarily created by the implementation of deposit insurance and other bank safety regulations. Instead, bank regulations are designed to prevent bank failures. But even here, the regulations increase rather than reduce the likelihood of such failures. The remainder of this section examines the causes of bank failures in order that bank failure policies may be examined on their own terms. Analytically, bank failures can be divided into three categories: (1) those that result from fraud and self-dealing on the part of management; (2) those that result from insufficient asset diversification; and (3) those that result from severe cyclical variations in the business cycle.

A. Fraud and Self-Dealing

It has been estimated that fraud and self-dealing transactions are "apparent" in as many as one-third of today's bank failures. Such behavior, of course, is a possibility in any large firm since it is not possible or efficient for owners to monitor all employees at all times. These sorts of problems are particularly acute in financial institutions, however, because of the large portion of their assets held in highly liquid form. Nonetheless, there seems to be a higher incidence of fraud-related insolvencies in the banking industry than in other, similar forms of business such as insurance and investment banking.

The same regulatory structure that creates a problem of excessive risk taking by banks also leads to a reduction in the normal levels of monitoring within the firm and thus also may lead to a higher incidence


41. Probably due to obvious documentation problems, we have no empirical support for the proposition that there is a higher incidence of fraud-related problems in banks than in other institutions. It is clear, however, that the correlation of bank failure and fraud is high and that "[p]roblems of insider abuse or fraud were often related to lack of oversight and controls." Comptroller of the Currency, An Evaluation of the Factors Contributing to the Failure of National Banks 4 (1988).
of bank failures due to fraud. Not only does the protection afforded by the FDIC remove any incentive for insured depositors to control excessive risk taking, it also removes their incentive to monitor in order to reduce the incidence of fraud and self-dealing.

Shareholders have an incentive to monitor to prevent fraud and self-dealing in banks, but shareholder monitoring is notoriously ineffective in many cases because individual shareholders rarely have sufficient incentives to engage in monitoring due to collective-action problems. Outside the banking setting, fraud and self-dealing are monitored by fixed claimants and preferred shareholders through contractual devices, and by lenders' regular oversight of the affairs of their borrowers.

One might argue that FDIC insurance simply replaces one set of creditors—depositors—with another set of creditors—state and federal regulators. These other creditors might appear more financially sophisticated than rank and file depositors and thus in a better position to conduct the monitoring necessary to prevent bank fraud. This contention is supported by the authority that both federal and state regulators have to require periodic reports from banks and to conduct on-site inspections of bank premises.

The Federal Financial Institutions Examination Council was formed in 1979 to develop a standardized system for examining banks and measuring bank performance. The major innovation of the Examination Council has been the adoption of a uniform rating system (generally referred to by the acronym CAMEL) for evaluating banks.

42. Easterbrook, Two Agency-Cost Explanations of Dividends, 74 Am. Econ. Rev. 650, 653 (1984). Depositors face the same collective-action problems that burden shareholders when called upon to monitor fraud and self-dealing by bankers. The collective-action problems of fixed claimants such as depositors can be mitigated in a number of ways. First, rating agencies such as Moody's and Standard and Poor's provide continuous monitoring of management. Second, a credible promise by a bank to make frequent trips to the capital markets will ensure periodic monitoring of management by the investment banking community. Id. Third, indenture trustees, who represent the interests of an entire group of fixed claimants, provide still another layer of monitoring. Smith & Warner, supra note 32, at 148–52. Finally, holders of fixed claims can require that debtors solve their collective-action problem for them by mandating that financial reports be prepared by independent auditors.

These various mechanisms for solving the collective-action problems that face both shareholders and fixed claimants are likely to be more useful to fixed claimants than to shareholders because shareholders, as residual claimants, are not simply concerned with ensuring the return of a stated sum of principal and interest, but with the more amorphous problem of maximizing firm value. These independent agencies are unlikely to be as competent at determining whether a firm is engaging in profit maximizing ventures as they are in deciding whether the firm is acting in ways consistent with the more modest interests of the fixed claimants.

43. See 1 M. Malloy, supra note 39, at § 3.1.

44. The letters in the word “CAMEL” represent the following factors that regulatory agencies take into account when assessing bank risk: (C)apital adequacy, (A)set quality, (M)anagement ability, (E)arnings, and (L)iquidity. E. Symons & J. White, Banking Law: Teaching Materials 572–74 (2d ed. 1984).
Upon the discovery of a fraudulent banking practice—or indeed of a practice that regulators deem to be "unsafe or unsound"—the appropriate regulator may order the activity terminated.\textsuperscript{45} Courts have determined that the term "unsafe banking practice" may be liberally construed to give the relevant bank regulator discretion to correct perceived problems in their infancy.\textsuperscript{46} In addition to the normal cease and desist powers, bank regulators may direct bank managers, employees, and their agents to take specific, positive steps to correct any problems discovered during the examination process.\textsuperscript{47} Bank regulators also have the authority to remove officers and directors from their posts under appropriate circumstances,\textsuperscript{48} and the FDIC has the authority to revoke a bank's depositor insurance if necessary.\textsuperscript{49} Thus, the problem with the current system, which substitutes government regulators for private sector creditors as the primary monitors of bank activity, is not that the regulators lack the administrative authority to do an effective job.

Nevertheless, replacing private-sector creditors with public-sector regulators as the first line of defense against bank fraud and self-dealing presents two problems.\textsuperscript{50} First, private-sector creditors have far greater incentives than public-sector regulators to monitor closely for fraud and self-dealing. Because the creditor's own money is on the line, they will monitor until the losses avoided from such monitoring equal the marginal cost of such activity. In addition, if a competitive market for bank services exists, those bankers who can develop mechanisms for providing depositors and creditors with credible assurances that they will refrain from fraudulent activities will thrive at the expense of their competitors.

The second reason there may be a social cost to displacing private-sector regulators is that, not surprisingly, the public sector simply has not manifested a willingness to bear the enormous costs of continuously monitoring the nation's 15,000 FDIC-insured depository institutions. Under current regulatory policies, "banking agencies ordinarily do not begin to focus extra attention on a bank" until a bank's CAMEL rating reaches three.\textsuperscript{51} For a bank to obtain such a rating it must be


\textsuperscript{46} See 1 M. Malloy, supra note 39, at § 1.3.3 (noting that "there has been surprisingly little reported litigation involving challenges to the FDIC's" power to terminate deposit insurance due to unsafe and unsound banking practices of the insured, and attributing the lack of litigation to the fact that "the FDIC's decisions in this regard have been viewed as committed to its discretion").


\textsuperscript{49} Id. § 1818(a).

\textsuperscript{50} See supra note 42; Macey & Garrett, supra note 19, at 225.

\textsuperscript{51} See E. Symons & J. White, supra note 44, at 574.
found to be "in significant non-compliance with laws and regulations" or have a financial condition that is sufficiently weak so as to make it so vulnerable to the onset of adverse business conditions that the bank might fail if "concerted action is not effective in correcting the areas of weakness."  

When a bank's problems are grounded in self-dealing, by the time regulators begin to focus "extra attention" on the institution, it may be too late. In theory, all banks are supposed to be examined once a year. However, the FDIC reports that due to staffing problems, the books of roughly half of the problem banks supervised by the FDIC have not been examined in more than a year. The FSLIC, which oversees much of the nation's thrift industry, has even more severe staffing problems. To make matters worse, the current spate of bank failures has placed such an enormous burden on bank examiners that federal "examiners are being overwhelmed by the workload . . . [and] are failing far behind in audits of banks with known problems . . . [and] may be failing to identify [apparently] healthy banks that are slipping into trouble."  

William M. Isaac, the former chairman of the FDIC, has observed that the shortage of bank examiners poses "an enormous risk to the banking system." Hiring more bank examiners would be costly, not only because of the sheer numbers involved, but also because of the high cost of training bank examiners and the need to compete with the relatively high salaries offered by the private-sector banks to trained bank examiners. In addition, hiring more examiners would solve only the numbers problem; it would not solve the problem of providing examiners with the same incentives facing private-sector creditors. By contrast, changing the regulatory system to give private parties incentives to monitor bank activity would not only decrease the current pressure on the bank examination system, but would have the added benefit of forcing those parties who enjoy the benefits of the additional monitoring—shareholders and creditors—to bear the costs.

B. Insufficient Asset Diversification

There is considerable support for the proposition that expanding the scope of permissible bank activities may reduce bank risk by enabling banks to diversify into investments with a low covariance to

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54. Id.  
55. Remarks of William Isaac, former Chairman of the FDIC, quoted in Washington Post, supra note 53, at D1, col. 5.  
traditional bank activities. Such activities will do well when traditional banking activities are suffering, thereby reducing the overall riskiness of banking. When a bank develops special expertise in evaluating the credit risks of a single industry like cattle, oil, or commercial real estate, the need to hedge against an economic downturn in this industry becomes particularly acute.

Two observations about the relationship between asset diversification and the specific problem of bank failures need to be made. First, the argument that the FDIC can monitor a restricted range of activities with greater effectiveness than a broader range of activities is highly suspect. However, even if the FDIC can monitor some bank activities better than others, then outside monitors should also be able to monitor some activities better than others. If this is the case, encouraging private-sector monitoring activity as a supplement to federal monitoring would produce a more efficient set of restrictions on banking activities than the ones that are the subject of so much current criticism. Private creditors such as depositors would negotiate for additional activity restrictions and be forced to pay for such restrictions in the form of foregone interest. By contrast, under the current system depositors have no reason to ask that banks restrict the scope of their activities.

A second and related reason why society will benefit if restrictions on the scope of acceptable banking activities are generated through private contracting is that Congress, unlike private creditors, is likely to restrict the scope of bank activities for reasons that are wholly unrelated to public interest concerns such as increasing bank safety. Some current bank activity restrictions can only be explained on the ground that they provide to some well-organized economic interest group regulatory protection from potential competition from other banks.

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57. See, e.g., Fischel, Rosenfield & Stillman, supra note 12, at 320–21 (explaining the benefits of diversification).
58. Because the focus of this Article is on the bank failure problem, asset diversification will not be discussed at length.
59. This argument is effectively attacked by Fischel, Rosenfield & Stillman, supra note 12, at 321–22. As these authors observe, the argument that regulators can monitor those activities and investments open to banks—loans to third world nations, for example—more cheaply than those from which banks are barred is simply not plausible. The reason banks sometimes are thought to be better able to monitor the prudence of commercial loans to oil drilling is because it is assumed that they somehow can observe the credit worthiness of the firm to whom a commercial loan is to be made independently of their evaluation of the merits of a particular venture such as oil drilling. It is not possible to do this, however, because the credit worthiness of any firm depends on the viability of the ventures it engages in. Therefore, a bank must be able to evaluate oil drilling before it can evaluate a loan to a firm engaging in oil drilling.
60. At the local level, branching restrictions seem particularly amenable to the charge that they are the product of interest-group pressure from the regulated industry. See Butler & Macey, The Myth of Competition in the Dual Banking System, (forthcoming 1988 Cornell L. Rev.). Similar inferences can be drawn as to restrictions on interstate banking. See Miller, Interstate Banking in the Court, 1985 Sup. Ct. Rev. 179, 208–09.
restrictions on certain bank underwriting activities are an especially poignant example.\(^{61}\) When the scope of permissible bank activities is restricted for reasons of economic protectionism, such restrictions increase the probability of bank failure by barring banks from profitable—and diversified—business ventures and forcing them to turn to activities that offer lower risk-adjusted rates of return.

C. Fluctuations in the Business Cycle

In their classic book on the monetary economics of the Great Depression, Milton Friedman and Anna Schwartz distinguish between bank-asset allocation decisions that are bad "ex ante" and those that are bad "ex post."\(^{62}\) Ex ante deterioration in the quality of a loan describes deterioration in the asset that takes place as a result of economic characteristics that were latent at the time the loan was made. Ex post deterioration refers to deterioration in asset quality attributable not to conditions observable at the time the loan was made, but to unforeseeable, systematic downturns in the business cycle. Friedman and Schwartz attribute the increases in the default rate during the Depression to ex post deterioration—"the loans and investments came to fruition and had to be repaid in the midst of a major depression"\(^{63}\)—rather than to poor ex ante decision-making by bankers.

Considerable evidence supports the proposition that bankers cannot protect themselves from ex post deterioration in asset quality as successfully as they can protect themselves from ex ante deterioration. Modern portfolio theory teaches that asset risk can be sorted into two categories, firm-specific risk and systematic risk.\(^{64}\) Only firm-specific risk can be avoided by diversifying one’s asset portfolio. Systematic or market risk describes those risk factors that affect the market as a whole and thus cannot be diversified away through prudent portfolio selection.\(^{65}\) An economic system that is vulnerable to severe systematic shocks “takes much of the power to control asset quality out of the hands of the banker.”\(^{66}\)

From a regulatory perspective, the danger of severe and unanticipated fluctuations in the business cycle does not pose any particular problems for banks as distinct from other firms. In addition, such fluctuations do not pose the same threat to bank solvency as they once did. As one commentator has observed, “[t]he moderation of the business

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\(^{62}\) M. Friedman & A. Schwartz, supra note 14, at 354–56.

\(^{63}\) Id. at 354.

\(^{64}\) See generally J. Lorie & M. Hamilton, The Stock Market: Theories and Evidence, chs. 10 & 12 (1973) (summarizing the attributes of firm-specific and systematic risk and describing the phenomenon of diversification).

\(^{65}\) See id. at 204–05, 275.

\(^{66}\) Tussing, supra note 8, at 136.
cycle that has appeared since World War II has put that power—and an associated responsibility—squarely and unmistakably in the banker's hands."

Another reason why fluctuations in the business cycle pose a lower risk to banks now than in previous years is that it has become much "easier . . . to acquire a substantial volume of essentially riskless assets, just as it is easier to attain a high degree of asset liquidity." The growing size of the federal deficit—funded by the sale of United States government debt obligations—has provided banks with a highly liquid investment alternative that is virtually free of default risk. Furthermore, the interest rate risk that at one time characterized bank balance sheets has now been substantially moderated by the use of various "gap management" techniques that allow a bank to match the average duration of its assets and liabilities. In sum, broad-based fluctuations in the economy are no longer significant sources of bank failure. Rather, the source "is almost certain to be an error in judgment on the part of the bank's management."

III. BANK FAILURE POLICIES: THE FDIC'S REGULATORY ALTERNATIVES

The remainder of this Article examines two bank regulatory schemes that greatly affect banks' incentives for risk taking and the level

67. Id. Recent downturns in certain industries, particularly oil, gas and real estate, have been blamed for a great many bank failures over the past decade. These problems, however, do not represent failures attributable to undiversifiable, systematic risk. Rather, these failures often represent a form of excessive risk taking by banks since prudent asset-selection strategy ordinarily would dictate a diversification of the bank's asset portfolio away from excessive concentration on particular industrial sectors. Note, however, that in some cases a bank's expertise may make it economically rational to concentrate on particular industrial sectors if the benefits of increased expected returns on investment outweigh the costs of reduced diversification. In such cases, though, the risk of nondiversification is latent at the time the loan is made.

68. Id. at 136.

69. "Interest rate risk" refers to the risk that banks incur due to the fact that their assets traditionally have been placed in relatively illiquid, long-term investments, while the bulk of their liabilities are due to creditors, such as depositors, on demand. This makes banks particularly vulnerable to rising interest rates caused by events such as inflation. If interest rates go up, the banks will not be able to earn more revenue on their outstanding loans but their cost of funds will go up because depositors will demand higher rates on their funds.

There are two approaches to "gap management" that can be used to mitigate the problem of interest-rate risk. The first involves the liability side of the bank's balance sheet, and the second involves the asset side. First, banks can limit the ability of creditors such as depositors to obtain their money on demand. Depositors may be willing to accept restrictions on their ability to withdraw money in exchange for a higher interest rate. Second, banks can purchase short-term assets that match the short-term nature of their liabilities. They can also "securitize their assets" and sell them for immediate cash. To securitize an asset is to bundle the asset with other income-producing assets and sell the income stream to investors in the form of a security.

70. Tussing, supra note 8, at 136.
of monitoring activity that banks receive. First, the Article assesses the settlement practices used by the FDIC when a bank is closed. This examination shows that current settlement policies may in some cases exacerbate the hazards of excessive risk taking and thus may occasionally contribute to the bank-failure problem. The following section examines the market for control of banks. The market for bank control has the potential to provide a substantial level of monitoring of bank management which could supplement current levels of monitoring by regulators. Unfortunately, current law and administrative policies regarding bank takeovers remove many of the incentives of outside bidders to provide this valuable monitoring function.

Strangely enough, although the FDIC administers the insurance fund for all insured banks, it lacks the power to close any bank or to petition a court for the appointment of a receiver of a failed bank. The power to close a national bank lies with the Comptroller of the Currency in the case of national banks and with the relevant state bank examiner in the case of state chartered banks. The FDIC generally becomes the receiver of a failed bank. This is the case as a matter of law for national banks and as a matter of custom for state chartered banks. Thus, when a bank fails, the FDIC typically acts in its corporate capacity as insurer and administrator of FDIC insured banks and also as receiver of the failed bank. In its corporate capacity the FDIC is obligated to protect insured deposits. In its capacity as receiver, the FDIC “must engage in the traditional activities of receiver” which involves marshalling the debtor bank’s assets on behalf of the creditors, controlling disbursements, and most importantly, determining the form of insolvency that will best protect the aggregate interests of bank creditors.

The FDIC has four basic regulatory options when confronted with a troubled bank. It may use open bank assistance to keep a troubled bank afloat. If the bank is closed, the FDIC may use the old-fashioned deposit-payout approach and actually liquidate the bank. In addition, the FDIC may invoke such recently developed alternatives as the modified-payoff approach or the purchase and assumption method of dealing with an insolvent financial institution.

71. E. Symons & J. White, supra note 44, at 600–01.
76. E. Symons & J. White, supra note 44, at 600.
A. Open Bank Assistance

Before a troubled bank has been formally declared insolvent, the FDIC may, under certain conditions, provide it with direct financial assistance in order to prevent it from failing. Prior to the amendment of 12 U.S.C. § 1823(c) in 1982, the FDIC was able to provide direct monetary assistance to an open bank only if the continued operation of the bank was "essential to provide adequate banking service in the community." After 1982, however, the FDIC's power to provide assistance to a troubled bank was expanded considerably in a wide variety of ways, so that it includes the abilities to purchase the bank's bad loans and buy its preferred stock or other securities, excluding common stock.

If the following conditions are met, the FDIC has the "sole discretion" to provide open bank assistance even if the continued operation of the bank is not essential to provide adequate banking services in its community. First, in all cases, the amount provided in the form of open bank assistance must be no greater than the amount that the FDIC would have to pay out if it liquidated the bank and reimbursed the insured depositors from the insurance fund. While this may appear to be a significant curb on the FDIC's discretion, in fact it is not. As Professor Kane has observed, the method of calculating the alternative methods of failure resolution in particular cases is "left to the discretion of the agency involved."

In addition to the cost test described above, the FDIC must determine that either (1) the bank applying for direct assistance is about to close or has already closed, or (2) severe financial conditions exist that threaten the stability of a significant number of insured banks or a smaller number of insured banks with significant financial resources, and that the potential financial repercussions from the insured institution's financial instability poses a risk to the FDIC as insurer.

Under the restrictive conditions that existed prior to 1982, the

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78. Id. § 1823(c)(1) (1982); id. § 1823(c)(4)(B) (FDIC may not buy common or voting stock).
79. Id § 1823(c).
80. Id. § 1823(c)(4)(A).
82. Id. at 46. It is not possible to evaluate the calculations of the FDIC in any systematic way because "the agencies [do not] report their methods for estimating the costs of alternative approaches in sufficient detail to let an external critic reproduce their alternative estimates.” Id.
84. Id. § 1823(c)(1)(B).
85. Id. § 1823(c)(1)(C).
FDIC utilized direct assistance only five times.\textsuperscript{86} One commentator, writing shortly after the legislative changes were implemented, opined that "it is doubtful whether use of the power will substantially increase in the future."\textsuperscript{87} This prognostication at first seemed to be correct; from 1983 until the end of 1986, only sixteen banks had received open bank assistance.\textsuperscript{88}

On December 2, 1986, however, the FDIC promulgated new guidelines for determining when troubled banks qualify for open bank assistance.\textsuperscript{89} These guidelines became necessary after the 1982 legislative changes because of the strong demand for such assistance by banks that consider it the most desirable form of resolving their economic difficulties. Banks' preference for direct assistance is unsurprising since it is the only avenue that provides shareholders of insolvent institutions with a chance to recover their initial investment.

There are indications that, under its new guidelines, the FDIC is making open bank assistance more readily available.\textsuperscript{90} In 1987, the FDIC provided open bank assistance to nineteen banks.\textsuperscript{91} The new guidelines contain four basic criteria for determining when a bank is eligible for open bank assistance. A bank's proposal for open bank assistance "should meet [these] guidelines except where there are compelling reasons to the contrary . . . ."\textsuperscript{92}

First, the cost to the FDIC of the bank's proposal must clearly be less than other available alternatives, as determined by looking at two factors. The FDIC will look at the amount by which the liabilities of the bank exceed the value of the bank's assets, and then at the amount of the deficit that would be borne by the FDIC in the event the depositors

\textsuperscript{86}. E. Symons & J. White, supra note 44, at 602.
\textsuperscript{87}. Id.
\textsuperscript{90}. The "FDIC Watch" of October 3, 1986, issued while the new legislation was being drafted, went so far as to suggest that bank regulators were preparing "to deal with a torrent of troubled banks through open bank assistance." Regulators Mull Proper Use of Open Bank Assistance, The FDIC Watch, Oct. 3, 1986, at H-4.
\textsuperscript{91}. FDIC, supra note 88, at 4.
\textsuperscript{92}. See FDIC Statement, supra note 89, at 44,122.
have to be repaid directly by the FDIC as in the case of an insolvency.\textsuperscript{93} This new guideline is unlikely to operate as a significant curb on the FDIC's statutory discretion to grant open bank assistance. In making the determination that open bank assistance is less costly than other alternatives, the FDIC will estimate "the value of the bank's assets based on available examination data and \textit{prior experience in collection of failed bank assets}."\textsuperscript{94} Clearly the FDIC has sufficient discretion under this rather vague criterion to employ direct-bank assistance under a variety of circumstances. In addition, when employing the cost calculation, the FDIC considers other factors such as the higher administrative costs of alternative insolvency schemes,\textsuperscript{95} all of which are sufficiently vague to provide the FDIC with a significant degree of discretion.

The second criterion for determining whether open bank assistance may be used is whether the proposal provides a "reasonable assurance of the future viability of the bank."\textsuperscript{96} This, in turn, will depend on whether the proposal for open bank assistance provides for "adequate managerial resources" and "sufficient tangible capitalization."\textsuperscript{97} It is generally expected that open bank assistance will result in the renegotiation or termination of management contracts.\textsuperscript{98} New compensation packages and termination agreements must meet with FDIC approval.\textsuperscript{99}

Third, FDIC assistance "must be accompanied by significant capital infusions from non-FDIC sources."\textsuperscript{100} The FDIC does require that the "financial effect on common shareholders and holders of material amounts of subordinated debt and/or preferred stock must approximate the effect which would have occurred had the assisted bank failed."\textsuperscript{101} But shareholders who cause their banks to apply to the FDIC for open bank assistance under the FDIC's new guidelines obviously believe they are better off under such an assistance plan than under an insolvency plan, or else they would not have filed an application for open bank assistance.\textsuperscript{102}

\textsuperscript{93} Id. at n.1.
\textsuperscript{94} Id. at 44,122 (emphasis added).
\textsuperscript{95} Id.
\textsuperscript{96} Id.
\textsuperscript{97} Id.
\textsuperscript{98} Id.
\textsuperscript{99} Id.
\textsuperscript{100} Id.
\textsuperscript{101} Id. at 44,123.
\textsuperscript{102} Thus, the requirement that open bank assistance "approximate" the effect of insolvency is not entirely credible, particularly in light of contemporaneous FDIC pronouncements such as the one by Douglas H. Jones, Deputy General Counsel for Open-Bank Regulation and Supervision, that "it doesn't always pay to wipe out shareholders . . . ." Open-Bank Assistance: Watershed Change in Regulation, The FDIC Watch, Oct. 10, 1986, at H-5. Shareholders and subordinated creditors, who recover nothing in a typical insolvency, clearly are better off if they can manage to obtain open bank assistance. Indeed, a number of banking lawyers have developed extensive expertise and
Fourth, the proposal for FDIC assistance must provide assurances that the FDIC's money will be used to benefit the bank and not be diverted to other purposes. 103 This requirement insures that banks receiving open bank assistance do not use the money to pay off favored creditors or to finance other actions that do not improve the bank's long-term chances of survival. The FDIC does allow open bank assistance to benefit the shareholders and other creditors of a troubled bank, 104 but will only permit such assistance "where compelling reasons require it, and then only when the holding company acts as a conduit for providing assistance to the bank." 105

It is difficult to gauge whether the benefits of open bank assistance outweigh the costs even when the evaluation is made on a case-by-case basis. It does seem clear that the FDIC's current method of calculating costs is flawed. Under the current method, the FDIC compares the costs of open bank assistance directly with such other regulatory alternatives as liquidating the bank. 106 The problem with this method of calculation is that it does not take into account error costs—the probability that the bank ultimately fails despite the FDIC cash infusion. When this happens, the ultimate costs to the FDIC of paying off shareholders must be layered onto the costs of the initial open bank assistance. While the insolvency costs may be mitigated to some extent by the earlier cash infusion, some significant costs are not overlapping. 107 Indeed, the history of the earlier cases of open bank assistance

reputational capital in handling petitions for open bank assistance. These lawyers' clients plainly are of the opinion that they have something to gain from keeping the institutions open with infusions of capital by the FDIC.

103. FDIC Statement, supra note 89, at 44,122.
105. FDIC Statement, supra note 89, at 44,123.
106. By law, no alternative may be used when selecting among the various strategies to be used in a bank failure unless that strategy is less costly than liquidation or the bank is essential to provide adequate banking services in the community. 12 U.S.C. § 1823(c)(4)(A) (1982). The FDIC bases its analysis of whether open bank assistance is less costly than the other regulatory alternative on two factors: (a) the amount by which the liabilities of the bank exceed the value of the bank's assets, and (b) the portion of this deficit which would be borne by the FDIC in the event of a payoff. The FDIC estimates the value of the bank's assets based on available examination data and prior experience in collecting failed bank assets. In applying its cost calculation, the FDIC considers the premium that may be received for a closed bank in a purchase and assumption transaction and the administrative cost of paying off depositors. The FDIC also may consider other factors such as interest on funds it advances and the cost of maintaining a liquidation operation.

FDIC Statement, supra note 89, at 44,122 n.1.
107. The administrative costs of paying off depositors and the cost of maintaining a liquidation operation are obvious examples of nonoverlapping costs. But perhaps more significant are the costs to the FDIC due to additional bad loans made between the date of an initial cash infusion and the date when the bank finally is closed or merged. Especially troubling are additional extensions of credit made to keep current borrowers temporarily afloat during this interim period, since they represent a paradigmatic case of
is not very encouraging. Only one of the first five banks to receive such assistance remains open under the same ownership.\textsuperscript{108}

Thus, once the FDIC reaches its initial calculation of the costs of using open bank assistance under its current methodology, it should then generate an estimate of the costs that the FDIC will incur if the open bank assistance program ultimately does not work, and then multiply this figure by the probability of such a failure occurring. This figure should then be added to the initial calculation of the costs of using open bank assistance to give a more accurate determination of the expected costs of using open bank assistance.\textsuperscript{109}

While the point is not entirely free from doubt, the relevant statute

\begin{quote}
"throwing good money after bad." A bank in trouble is also likely to offer higher-than-market interest rates on deposits in order to attract new capital to shore up its operations. Such measures may act as palliatives in the short term, but are likely to drive the bank even further under water over the long run. Indeed, as Stanley Silverberg, the FDIC's director of research has noted: "If a bank becomes insolvent but remains liquid and open, it is generally in the interest of managers and owners to gamble in an effort to recoup, especially if that can be done legally. If the bank rolls the dice and loses, the FDIC typically bears the loss." G. Kaufman, supra note 20, at 9.

A striking example of this phenomenon appears to have occurred in the case of two California FSLIC-insured savings and loan associations that failed in June, 1988. One of these institutions, the North America Savings and Loan Association, was paying an average deposit rate of 8.53\%, 145 basis points above the national average at the time. (A basis point is one one-hundredth of a percentage point.) The other S&L, American Diversified, paid an average deposit rate of 8.64\%, 156 basis points above the average.

Queue Forms for FSLIC's Biggest Payout, Am. Banker, June 7, 1988, at 1, col. 1, 22, col. 2. Both of these banks engaged in extremely high-risk loans. According to regulators, North America invested in high-risk real estate, while American Diversified had invested money in windmill farms and a plant that was supposed to generate electricity from cow manure. Id.

\textsuperscript{108}. FDIC, Federal Deposit Insurance Corporation: The First Fifty Years 95 (1984). The fact that the banks have not remained open under the same ownership indicates that the problems with the banks stemmed from the current bank management because management changes generally accompany ownership changes. The fact that the FDIC had to change the ownership after open bank assistance indicates that the banks did not perform well under the management that received the open bank assistance.

\textsuperscript{109}. To illustrate, suppose the FDIC determines that the cost of open bank assistance in a particular instance is $450,000 because the bank's insured liabilities exceed its net assets by that amount after the infusion of capital from private sources. Assume further that the cost (in present value terms) of the next best regulatory alternative will be $500,000. Under the current policy guidelines the bank is eligible for direct, pre-insolvency assistance from the FDIC. The problem with this methodology is that it presumes that there is probability of 1.0 that the open bank assistance program will be successful, that the bank will achieve long-run solvency and present no further drain on the FDIC's resources. It is extremely unlikely that this occurs every time open bank assistance is used. Thus, suppose there is a twenty percent probability that the bank's depositors eventually will need FDIC protection after the bank has been given open bank assistance. If this additional assistance will involve a cost (in present value terms) of $300,000, the cost of the open bank assistance program would be an additional $60,000 (300,000 \times .2), bringing the total to $510,000. Under the revised method of calculation, open bank assistance would not be permitted under the current guidelines.
may already require that the FDIC's cost determinations account for the probability of failure. Section 1823(c)(4)(A) requires that open bank assistance be used only when the cost of such assistance does not exceed "that amount which the Corporation determines to be reasonably necessary to save the cost of liquidating, including paying the insured accounts of, such insured bank." Congress clearly designed the statute to permit open bank assistance in order to preserve the corpus of the FDIC insurance fund. As such, it seems appropriate to look at the total expected cost of open bank assistance, including the probability of the assisted bank ultimately failing, when making the statutorily required cost calculation.

From a broader perspective, even when a troubled bank meets the stricter requirements of the modified cost test described above, it is not clear that open bank assistance serves the long-run interests of the FDIC or of the banking system as a whole. The increased use of open bank assistance contemplated by the FDIC in its recent policy guidelines greatly exacerbates the disincentive to monitor created by deposit insurance. Open bank assistance provides an effective government subsidy not only for insured depositors, but also for uninsured depositors and all other creditors. If these creditors expect open bank assistance to bail out the banks to whom they have loans outstanding, they lack any incentive to incur costs in monitoring such banks.

It might be argued that the effects of open bank assistance in reducing monitoring are mitigated by the inability of depositors and creditors to predict ex ante which banks will receive open bank assistance and their resulting need to continue to engage in some monitoring activities, albeit at a lower level, than if there were no prospect of such assistance. However, creditors and depositors are able to predict in general fashion which banks are more likely to qualify for open bank assistance and thus can direct their resources to those banks. Indeed, it is likely that large depositors expend significant resources in assessing the type of bailout regulators are likely to use. If the regulatory
scheme were improved, at least some of these resources would be allocated to monitoring the performance of bank management.

Two sorts of insured banks, the nation's very largest and the nation's very smallest, are much more likely to receive open bank assistance than all other banks. The smallest banks are likely to receive direct assistance because the FDIC no longer is required to determine that such assistance is the least costly way of handling the bank's financial problems if the bank "is essential to provide adequate banking services" in its community.\textsuperscript{112} And if a bank is "essential," the cash infusion does not even have to be less costly than alternative forms of insolvency for the FDIC to make use of it.\textsuperscript{113}

More important than the use of open bank assistance for small communities is the use of such assistance for the nation's very largest banks. The most dramatic—and controversial—open bank assistance plan was the 1984 bailout of Continental Illinois, which protected all of the bank's depositors and general creditors from loss, and even went so far as to protect the creditors of the parent bank holding company.\textsuperscript{114}

The FDIC decided to use open bank assistance to aid Continental because it was concerned that closing the bank would cause a ripple effect that would be particularly damaging to many of the nation's small banks.\textsuperscript{115} Thus, open bank assistance seemed appropriate since the situation was one in which "severe financial conditions exist which threaten the stability of a significant number of insured banks."\textsuperscript{116} While it is not clear that the failure of Continental would have caused a problem for other banks,\textsuperscript{117} the Continental bailout has important precedential implications, particularly because it appears to have been a success.\textsuperscript{118} Indeed, the FDIC recently rescued the huge First Repub-

\textsuperscript{112} The requirement that the FDIC determine that the continued operation of the bank is essential to the banking service of the community was eliminated in 1982. E. Symons & J. White, supra note 44, at 601.
\textsuperscript{115} Like all direct-assistance plans, the Continental rescue was designed to provide the bank with sufficient capital to enable it to regain its position as a viable lending institution. Toward this end, the FDIC bought $4.5 billion of troubled loans from Continental for $3.5 billion, as well as two issues of nonvoting preferred stock from the bank's holding company for $1 billion. Id. at 2. The FDIC is not permitted to acquire voting stock in a bank that it insures. 12 U.S.C. § 1823 (c)(4)(B) (1982).
\textsuperscript{116} See I. Sprague, Bailout: An Insider's Account of Bank Failures and Rescues 183 (1986).
\textsuperscript{118} See Note, The Modified Payoff of Failed Banks: A Settlement Practice To Inject Market Discipline Into the Commercial Banking System, 73 Va. L. Rev. 1349, 1362.
licBank Corp., a Dallas-based bank holding company, on terms closely resembling the Continental rescue.\textsuperscript{119}

While the FDIC generally attempts to merge failed banks with healthier banks in order to avoid direct payments from the insurance fund, when banks as large as Continental get into financial difficulty it is often difficult to find a merger partner with sufficient capital to effect a merger. This circumstance, coupled with the suggestion after the Continental bailout by the Comptroller of the Currency that the nation's eleven largest banks were too big to fail,\textsuperscript{120} sent a clear signal that open bank assistance would be used to protect all bank creditors whenever a very large bank experiences serious financial difficulty.

While this policy may save the FDIC money on a case-by-case basis, it not only reduces the incentives investors have for monitoring large banks, but it also undermines the incentives such depositors have for developing contractual and other provisions to ensure that banks control their level of risk taking ex ante. As such, the FDIC's open bank assistance policy, if ever utilized on a widespread basis, may ultimately result in a weaker banking system since it creates incentives for banks to engage in greater risk taking than they otherwise would.

Open bank assistance may also affect smaller and mid-sized banks because it will drive large depositors from those banks to larger banks where their funds are effectively guaranteed against loss by the FDIC's bank-closure policies.\textsuperscript{121} To compete for the funds of the larger, unin-

\textsuperscript{119} See Am. Banker, Mar. 18, 1988, at 1, col. 4. The FDIC lent $1 billion to a number of the holding company's subsidiary banks and guaranteed all of the banks' current and future depositors and creditors, including those not covered by deposit insurance. Id.


\textsuperscript{121} The observation that rational, uninsured depositors will remove their funds from small- and mid-sized banks to banks deemed "too large to fail" holds when the banks are offering depositors the same rate of return on their deposits.

Smaller banks are disadvantaged by the flight of large depositors because the need to attract additional insured deposits to replace the large depositors that are uninsured if they remain with the smaller banks raises their costs of capital. In addition, there are obvious economies of scale associated with administering depository accounts. The costs of administering a $1 million account are not one million times higher than the
sured depositors, smaller banks may be forced to offer higher interest rates to compensate depositors for the increased risk associated with banking at such institutions.122

B. Purchase and Assumption Transactions

Purchase and assumption (P&A) is the FDIC's strategy of choice when confronted with an insolvent bank.123 In a P&A transaction, the deposits of the failed bank are assumed by another bank, which also purchases some of the failed bank's assets.124 In the past, the FDIC acquired all of the bank's bad loans itself and sold only "acceptable assets" to the acquiring bank. This policy provided the acquiring bank with a clean bank relatively free of troubled loans. On occasion, however, the FDIC has required an acquiring institution to purchase all of the loans of the troubled bank, including the bad loans.125

1. The Standard Purchase and Assumption. — Current law appropriately gives the FDIC considerable flexibility to determine the structure, terms, and other details of a P&A transaction. When, for example, the value of the assets purchased by the sound bank are less than the value of the deposit liabilities assumed, the FDIC provides financial assistance in the amount of the difference.126 Similarly, the FDIC sometimes agrees to repurchase loans and other assets from acquiring banks if the assets are thought to be valuable, but then turn out to be nonperforming after a stated period of time.

As with open bank assistance plans, the FDIC, despite its considerable administrative discretion, is not authorized to execute a P&A trans-

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122. See Staff of Comm. on Banking, Finance and Urban Affairs, 99th Cong., 1st Sess., Continental Illinois National Bank: Report of an Inquiry into its Federal Supervision and Assistance 18 (Comm. Print 1985) ("over time large banks will be able to attract capital at lower cost than comparably sized nonbanking companies and smaller banks"); Macey & Garrett, supra note 19, at 234–35.

123. E.g., Gilbert, Recent Changes in Handling Bank Failures and Their Effects on the Banking Industry, Econ. Rev., The Fed. Reserve Bank of St. Louis, June/July 1985, at 22 ("The FDIC prefers to handle most bank failure cases through . . . (P&A) transactions"); see also Bennett, supra note 75, at 24–25 ("The P&A is preferred because it is less disruptive than the payoff approach and has apparent cost advantages.").


125. Caliguire & Thomson, FDIC Policies for Dealing with Failed and Troubled Institutions, Econ. Commentary, Fed. Reserve Bank of Cleveland, Oct. 1, 1987, at 2 n.4 ("Operating under the philosophy that loan collection is best accomplished locally, the FDIC has begun experimenting with leaving the delinquent loans in the failed-bank package.").

126. Gilbert, supra note 123, at 22.
action unless this alternative meets a statutory cost test.\textsuperscript{127} The FDIC must determine that the funds it provides in a P&A transaction will not be greater than the cost of liquidating the bank, except when the continued operation of the bank is essential to provide adequate banking services in the bank's community.\textsuperscript{128}

Thus, a P&A transaction is simply "a merger of a failing bank into a successful bank, with the successful bank paying a certain amount for the goodwill value of the failing bank."\textsuperscript{129} Despite the statutory language of the cost test, which implies that the test will be administered on a case-by-case basis, the observed behavior of the FDIC indicates that the agency has, as a matter of administrative policy, determined that bank failures should always be handled by P&A transactions when possible.\textsuperscript{130}

The FDIC finds P&A transactions to be superior to straight liquidation for several reasons. First, P&A often requires no immediate expenditure of funds from the FDIC insurance fund because the acquiring bank assumes the liabilities of insured depositors.\textsuperscript{131} In addition, regulators claim that P&A transactions are preferable to straight liquidations because they avoid the temporary disruption of banking services that typically accompany liquidations\textsuperscript{132} and preserve "going concern" value and good will.\textsuperscript{133} Finally, P&A transactions have the supposed advantage of providing protection for \textit{all} depositors, even those whose deposits exceed the FDIC's $100,000 limits.

The FDIC's preference for P&A transactions over straight liquidations provides distinct advantages to two interested groups—medium-sized banks and large, uninsured depositors. P&A transactions benefit medium-sized banks because they remove the regulatory bias in favor of the nation's very largest banks that came in the wake of the bailout of the uninsured claimants on Continental Illinois. The protection of large uninsured depositors in that transaction provided an incentive for

\textsuperscript{128} Id.
\textsuperscript{129} E. Symons & J. White, supra note 44, at 620–21.
\textsuperscript{130} See Gilbert, supra note 123, at 22.
\textsuperscript{131} The FDIC generally will accept the highest bid for the P&A transaction if its net cost is lower than the estimated costs of a deposit payoff. These estimates are not very precise, and the FDIC has tended to use the P&A method except in situations in which:
1. there is virtually no interest by other banks in acquiring the failed bank, or
2. fraud or other circumstances, such as contingent liabilities, make it difficult to estimate losses . . .
\textsuperscript{132} Id.
\textsuperscript{133} E. Symons & J. White, supra note 44, at 602.
\textsuperscript{134} See Burgee, supra note 124, at 1153.
such depositors to shift their funds from mid-sized banks to the nation’s largest banks.\textsuperscript{134} The regulatory preference for P&A transactions, because it also provides protection for large depositors, effectively mitigates the migration of uninsured deposits to larger banks. As such, it is not surprising that, despite occasional cries of administrative bias in favor of the very largest banks in the wake of Continental Illinois, the empirical evidence shows that large depositors have not shifted their uninsured funds from medium-sized to large banks since that bailout.\textsuperscript{135}

Regardless of whether uninsured depositors keep their funds at large or small banks, the FDIC preference for P&A transactions has the additional effect of benefiting large depositors by providing them with low-risk repositories for their funds. It is not as clear, however, that P&A transactions provide the same benefits to the public. The FDIC’s preference for such transactions removes most of the incentive that large depositors have to provide market discipline for the risks assumed by a bank whose failure is expected to be handled by P&A. Thus, while P&A transactions provide benefits to the FDIC in the short run because they protect its cash position, the long-run results may take the form of increased bank failures due to excessive risk taking by banks.

2. The Modified Payout. — The FDIC’s preference for P&A transactions seems particularly odd in light of the availability of a variant on the straight payout, the so-called “modified payout,” which has many of the advantages of a straight P&A, but retains some of the elements of market discipline lacking in the current system.\textsuperscript{136} The FDIC developed the modified payout method of handling bank insolvency and announced it as a new procedure in 1983.\textsuperscript{137} When a modified payout is used, “the FDIC makes full payments to insured depositors and partial payments to [uninsured] depositors” based on the FDIC’s “estimate of the proceeds [of a] liquidation of the . . . failed bank. If recoveries on the assets . . . exceed th[is] initial estimate, the uninsured depositors receive additional payments.” If recoveries fall short of the estimate, “the FDIC absorbs the loss.”\textsuperscript{138}

\begin{itemize}
  \item [134.] See supra notes 120–22 and accompanying text.
  \item [135.] Gilbert, supra note 123, at 25.
  \item The share of large-denomination time deposits at the small banks did decline from almost 40 percent in the first week of May 1984 [following the announcement of the Continental bailout in mid-May of that year] to about 37 percent . . . . That change might reflect an initial response by depositors to the handling of the Continental Illinois situation by the FDIC . . . . Whatever the cause of that dip, it was more than reversed by October [1984], and the share of large time deposits at small banks continued to rise through May 1985.
  \item Id.
  \item [136.] Macey & Garrett, supra note 19, at 237.
  \item [137.] 1 General Accounting Office, Staff Study, Deposit Insurance: Analysis of Reform Proposals 33 (1986).
  \item [138.] Gilbert, supra note 123, at 22; see also Note, supra note 118, at 1378–81 (describing the modified payout approach).
\end{itemize}
Like a P&A transaction, a modified payout does not disrupt the insured depositor's activities because these bank liabilities are transferred to another bank. As with P&A, the FDIC arranges the merger of the failed bank with a healthy bank and provides cash to cover any shortfall between the value of the assets purchased and the value of the liabilities assumed by the healthy bank. The major difference between the two types of transactions is that the modified payout provides uninsured depositors with a significant incentive for monitoring the banks where their funds are held and for imposing discipline on excessive risk taking.

The FDIC used the modified-payout system in twenty-one bank failures between 1983 and 1985. On average, uninsured depositors received over forty percent of the balance of their accounts under these payouts. Unfortunately the modified-payout experiment was only used in the case of extremely small banks.

If the modified-payout method were used in all bank failures it would increase market discipline on the banking system without providing a regulatory advantage to larger banks. The modified-payout experiment, however, was undermined when regulators decided that the Continental Illinois crisis should not be handled by modified payout because the losses to uninsured depositors would have been too great. This decision reduced the credibility of the FDIC's statements concerning the universal applicability of modified payouts and led to the abandonment of the experimental program.

No credible reason has ever been given for why the modified-payout system was abandoned. The argument that modified payouts undermine the policy of equal treatment of large and small banks begs the question of why modified payouts cannot be used for large banks as well as smaller banks. Indeed, the decision to close the Penn Square Bank without providing protection for uninsured depositors indicates that an institution of substantial size can be permitted to close without...
devastating disruptions to the financial system. Nevertheless, it might be argued that the Penn Square and Continental Illinois situations must be distinguished because of the much larger percentage of uninsured deposits in Continental Illinois. This argument, however, is unpersuasive because the percentage of uninsured deposits in a bank such as Continental is likely to be far lower if the owners of these funds are faced with risk of loss. Indeed, the higher the percentage of uninsured deposits at a troubled bank, the more willing the FDIC should be to use a modified-payoff scheme since its exposure will be reduced by the amount of such deposits.

Furthermore, the use of a modified-payout plan for banks with large numbers of uninsured depositors will serve as a valuable signal to other large depositors that they should monitor the banks in which their uninsured deposits are held. It is possible that the heavy concentration of uninsured depositors in certain banks such as Continental reflects the decision by such depositors to engage the federal regulators in a game of chicken. Under this strategy, uninsured depositors may have gambled that they can achieve de facto deposit insurance by aggregating all of their large deposits in a small number of banks on the assumption that the FDIC will not dare effect an insolvency plan that imposes such large losses on them. The gamble appears to have paid off in the case of Continental, where the large percentage of uninsured deposits was cited as a prime reason for the bailout of all depositors.

In sum, the advantages in terms of increased market discipline of a...

147. Sprague has estimated that a startling 90 percent of Continental's deposits were uninsured. I. Sprague, supra note 115, at 184. By contrast, 52 percent of Penn Square's depositors were uninsured. FDIC, 1982 FDIC Ann. Rep. 32 (1983).
148. It may also be argued that a modified-payoff scheme will cause large depositors to split their deposits among many accounts of depository institutions each coming within the $100,000 deposit insurance ceiling. Deposit splitting of this kind would impose costs on the depositors—and on society—in the form of the increased transaction costs of maintaining numerous different accounts. Further, when deposits are split, the money is likely to flow—with or without the services of deposit makers—into banks offering the highest interest rates, which are likely to be among the more risky banks. In this respect, the incentive for deposit splitting that modified payouts would create might have the effect of marginally increasing bank risk. However, it is very likely that corporate depositors will continue to place uninsured money in banks they consider safe in order to achieve the economics of maintaining a single account, and in order to maintain good relations with a potential source of credit. Because substantial uninsured deposits can be expected to remain in the banking system even if modified deposit payout is adopted as the FDIC's preferred approach to bank failure, the value of market discipline can be expected to be at least partially effective under such a system even without new rules limiting deposit splitting. See infra notes 214–21 and accompanying text (discussing brokered deposits and deposit splitting).
modified-payout system appear to outweigh the disadvantages. The experiment should be started again. This time the FDIC should make it clear that it will consider modified payouts the method of choice in all bank failure cases, large and small, unless strong countervailing considerations indicate that one of the alternative approaches is preferable. Although the FDIC now has the administrative discretion to use modified payouts whenever it considers them the best regulatory alternative, the best way to employ modified payouts is for Congress to pass legislation requiring the FDIC to treat modified payouts as its method of choice unless it decides to liquidate the bank.\textsuperscript{150} Without such legislation, the FDIC is likely to experience intense political pressure to bail out large institutions with high levels of uninsured deposits.\textsuperscript{151} In addition, legislation requiring a preference for modified payoffs would send a clear signal to uninsured depositors that it is in their best interests to impose market discipline through contractual controls on excessive risk taking and through increased monitoring activity.

3. The Payout System and the Auction Theory. — While modified payout is clearly preferable to purchase and assumption as a method for coping with bank failure, these alternatives have a common feature that has the potential for imposing large regulatory costs on the FDIC. Whether the FDIC disposes of the assets and liabilities of a bank through a P&A transaction or a modified payoff, it conducts a sealed-bid first-price auction, usually within a few days after the closure of the failed bank.\textsuperscript{152} This auction procedure results in large wealth transfers from the FDIC to the firms bidding for failed banks.

It is clear from the economic literature on auction mechanisms that the procedures used for auctioning assets can have significant effects on the revenues received by the seller.\textsuperscript{153} Recent empirical studies of the FDIC's auction procedures indicate that these procedures may cause wealth transfers from the FDIC's insurance fund to the winning bidders of these auctions.\textsuperscript{154} The evidence also indicates that the auction procedures may result in a loss of real resources since the procedures may exclude some bidders who value the assets of the failed bank more than

\textsuperscript{150} See Note, supra note 118, at 1378–85 (advocating "[u]niversal application of a modified-payout approach," but noting that the limited tenure of FDIC officials tends to put greater emphasis on short-term concerns).

\textsuperscript{151} Witness for example the intense political pressure placed on regulators by Speaker of the House Jim Wright in an effort to prevent them from closing several Texas savings and loan institutions. N.Y. Times, June 22, 1987, § I, at 12, col. 5; N.Y. Times, Feb. 9, 1987, § IV, at 2, col. 1.


\textsuperscript{154} See James & Weir, supra note 152, at 1.
the winning bidder.\textsuperscript{155}

Auction procedures for failed banks are complex.\textsuperscript{156} To be invited to participate in an auction for a failed bank, a bidding bank must comply with the FDIC's capital requirements and with relevant state and federal laws governing bank acquisitions, be rated by regulators as a low risk bank, and operate within the appropriate geographical boundaries.\textsuperscript{157} The process by which the FDIC determines who is eligible to bid at the auctions it conducts is obscure. The Corporation "may solicit offers . . . as are practicable from any prospective purchasers or merger partners it determines, in its sole discretion, are both qualified and capable of acquiring the assets and liabilities of the closed bank or the bank in danger of closing."\textsuperscript{158} The haste with which such auctions are conducted requires the FDIC largely to rely on its own intuitions about which bidders might be interested. In addition, the FDIC prefers to keep the news about particular bank failures secret until it has worked out the details of the assistance plan. This preference for secrecy prevents interested bidders who are not contacted by the FDIC from coming forward on their own. Therefore, established banks are almost always the only entities to participate in FDIC managed sealed-bid auction and individual entrepreneurs who would enter the industry by bidding on an insolvent bank are systematically excluded.

Thus, the haste with which the FDIC conducts its auctions may prevent the assets of a failed bank from being allocated to their highest valued user since such people may not be notified of the auction.\textsuperscript{159} In a world without transaction costs or legal regulation, this failure would not matter from an efficiency perspective since the highest valuing user

\textsuperscript{155} Id. at 2.

\textsuperscript{156} It is possible under a narrow range of circumstances to conduct an auction for a bank that has not yet been declared insolvent. If regulators have not closed the bank to be sold, the bank's board of directors must specify in writing that the bank is in danger of closing and request in writing that the FDIC assist in the takeover. 12 U.S.C. § 1823(f)(3)(B) (1982). In addition, the state bank supervisor must be consulted and be given a reasonable opportunity to object to the FDIC's planned takeover, unless the FDIC obtains a unanimous vote of the bank’s board of directors.

\textsuperscript{157} See James & Weir, supra note 152, at 4.


\textsuperscript{159} This analysis of the costs of current FDIC auction procedures is confined to the costs of particular sales as compared to an idealized auction process. The current procedures might have advantages that offset these costs when viewed from a broader perspective. Current auction procedures are conducted with great speed, and while this forecloses the number of bidders who can participate, it has the offsetting benefit of ensuring that depositors are not left without banking services for extended periods of time. Nonetheless, it is difficult to imagine that the additional time necessary to attract the number of bidders required to improve the competition at auctions would cause losses to depositors of a magnitude great enough to offset the benefits of increasing the pool of bidders. And, in cases where the bank has not yet closed, the additional delay will not inconvenience depositors. In any event, the relevant consideration is whether the gains from the higher bids obtainable in the lengthier time period offset any losses depositors might suffer from a delay in obtaining their money.
could always emerge after the auction to purchase the asset from the winning bidder at the auction. However, in the real world of banking regulation, the costs of such later acquisitions are significantly increased because the costs of obtaining regulatory approval will be much higher and the ability of incumbent management to resist will have been restored.\footnote{160}

A recent empirical study by Professors James and Wier applied the economic models of auctions developed by French and McCormick to the auctions conducted by the FDIC in the failed-bank context.\footnote{161} The earlier work by French and McCormick showed that auctions which impose restrictions on bidder participation reduce the price that sellers receive for their assets at first-price sealed-bid auctions.\footnote{162} Furthermore, this will be true even when all of the bidders place the same value on the assets being sold.\footnote{163} Thus, even in those auctions that do not exclude the bidder who values the object most highly, when the assets of a failed bank are sold under current FDIC auction procedures, the FDIC may not receive the highest possible bid price for the assets due to the limitations it places on bidder participation. Indeed, there is strong evidence that the FDIC's auction procedures transfer wealth from the FDIC's insurance fund to the winning bidders.\footnote{164}

\footnote{160. See infra notes 267-325 and accompanying text.}
\footnote{161. James & Weir, supra note 152.}
\footnote{162. French & McCormick, supra note 153, at 418, 423-24.}
\footnote{163. Id.}
\footnote{164. Using standard event-study methodology, James & Weir, supra note 152, at 12 (citing Brown & Warner, Using Daily Stock Returns: The Case of Event Studies, 14 J. Fin. Econ. 3 (1985)). James and Weir compared the abnormal stock market returns of those banks that acquired other banks in FDIC auctions with the stock market returns of those banks that acquired other banks in normal market transactions, unaided by the FDIC. Id. at 9-11. They found that winners of FDIC auctions enjoyed mean abnormal returns of 2.36% for the two day period surrounding the auction. Id. at 13 (0.66% on day -1 and 1.70% on day 0). James and Weir were able to estimate this gain to winners of FDIC auctions with a high degree of statistical significance. Id. at 14. Their results represent significantly greater returns to winners of FDIC auctions than to purchasers who are unassisted by the FDIC. These figures are also significant for purposes of evaluating the costs of the FDIC auction procedures. The figures show that the average gain for winners of FDIC auctions to be about $6 million. Because the median gain to winners is only $2 million, it seems clear that some winners gain far more. Bidders should not expect to enjoy gains greater than the market average in a fully competitive bidding process. Thus, these gains to bidders represent losses to the FDIC from its use of the current auction process. Id.}

Another measure of the costs of the current auction process compares the abnormal returns to bidders with the number of bidders participating in the auction. French & McCormick, supra note 153, at 423-24. Here, James & Weir found a negative relation between the number of bidders and the gains to bidders. In other words, as the number of bidders declines, the gains to bidders goes up. James & Weir, supra note 152, at 15. They concluded that the data supports the hypothesis that FDIC auction procedures result in wealth transfers from the FDIC to winning bidders. Id. at 20. The conclusion that FDIC auction procedures are a costly means of disposing of failed banks' assets is further supported by the fact that these procedures limit the potential competition for
Another supposed benefit of the speed and secrecy associated with the current approach is that it avoids the negative external effects that a bank failure could have on other banks in the community. The argument is that even small delays suffered by some depositors in obtaining funds will cause depositors as a group to lose confidence in the banking system as a whole, and this will have a deleterious effect on the economy. However, this argument is without merit so long as the banking system continues to stand behind insured depositors' accounts and to provide adequate liquidity assistance. The public's confidence in banking derives from this government guarantee, not from any guarantees made by the purchasers of the bank's assets. Similarly, the argument that the delay harms depositors because it "can throw a wrench into the financing of their activities" is untenable. Except in unusual cases, delay limited to a few days is unlikely to impose serious inconvenience on depositors. In addition, lenders would no doubt be willing to extend credit to borrowers whose funds are temporarily tied up at an insolvent bank if the United States government guarantees the ultimate repayment of those funds.\textsuperscript{165}

Indeed, when insolvent banks are liquidated by the FDIC in its receivership capacity there is necessarily some delay while the records of insured deposit accounts are compiled and verified.\textsuperscript{166} The delay associated with the auction process in a P&A or modified payout is not significantly longer than the delay involved in a typical bank liquidation.\textsuperscript{167} In some cases the delay period may even be shorter.\textsuperscript{168}

For the same reasons, the benefits of the FDIC's policy of keeping bank auctions secret do not appear to be offset by the costs involved. So long as the funds of insured depositors are protected by the FDIC's insurance fund, the closure of these banks pending an auction is un-

the assets of failed banks as well as the actual competition for these assets. Id. at 18. This lack of potential competition may limit the returns to the FDIC on the assets it sells during failed bank auctions. Id.

\textsuperscript{165} Clearly, small depositors may find it more difficult to obtain access to funds during the interim period between failure and repayment than large depositors. The FDIC obviously should be sensitive to the needs of small, insured depositors in failed banks who need immediate access to funds to make home mortgage payments, tuition payments or other highly time-sensitive obligations. Indeed, the FDIC, like a private insurance company, should be liable for consequential damages flowing from failure to make timely payments to insured individuals.

\textsuperscript{166} According to FDIC officials, the delays generally stem from poor record keeping and account documentation at certain insolvent banks. Ironically, the inconvenience appears to fall disproportionately on small depositors because their records are often in the greatest state of disarray. Interview, supra note 29.

\textsuperscript{167} See infra notes 170-82 and accompanying text (describing bank liquidation procedures).

\textsuperscript{168} The delay period for an auction or modified payout is likely to be shorter in cases where poor record keeping causes a lengthy delay for the verification of insured deposit accounts. Liquidation may not occur until such records are compiled and verified, while mergers can take place beforehand, subject to later verification and settlement of accounts. See infra note 172 and accompanying text.
likely to cause widespread panic. Indeed, the FDIC's recent history of using P&A transactions instead of paying off depositors in a liquidation threatens to erode public confidence in the banking system because depositors do not have the opportunity to observe the FDIC making payments out of the insurance fund. When the public is able to observe such payments being made, they come to understand the nature of the deposit protection they enjoy and are unlikely to panic if the bank holding their deposits fails. Clearly at some point the costs to depositors of delaying the final disposition of the bank's assets and liabilities will come to equal or exceed the benefits in the form of higher auction returns. The FDIC's goal should be to try and establish the equilibrium that maximizes net returns. The available evidence suggests that the current system, which downplays the goal of maximizing auction returns and exalts the goal of depositor convenience, is inefficient. The FDIC should close insolvent banks and publicly announce that it is conducting an auction of the failed bank's assets and liabilities within the week following the closing. And, in order to maximize the returns to the FDIC from the bidding process, it should notify all eligible bidders and give them an opportunity to submit a bid.

C. The Deposit Payoff

The deposit payoff is the most straightforward way to handle a bank failure and the one that Congress envisioned would be used when it devised the federal deposit insurance scheme in 1935. It is akin to the straight liquidation that takes place in certain bankruptcy proceedings. When the FDIC as receiver elects to dispose of the assets of a failed bank by the deposit payoff method, it makes payments to each depositor up to the amount of the FDIC insurance limit as soon as the depositors submit proof of claims or otherwise satisfy the FDIC of their creditor status. Those depositors with accounts in excess of the insurance limit become general creditors of the failed bank for the amount that their deposits exceed the insurance limit.

As the FDIC sells the assets of the failed bank, the uninsured depositors receive payments on the uninsured portions of their deposits to the extent that funds become available to make such disbursements. The uninsured depositors share these funds pro rata with the FDIC which in its corporate capacity becomes a general creditor of the bank.

169. See Garten, supra note 10, at 148 n.111 (describing speedy payments made by the FDIC).

170. Indeed, the alternatives of open bank assistance and purchase and assumption of failed bank assets had not even been invented when FDIC insurance was made available.


172. 12 U.S.C. § 1821(f) (1982) (If the FDIC is "not satisfied as to the validity" of a depositor's claim, it may withhold payment until obtaining the "final determination of a court of competent jurisdiction.").
for the sums it previously has dispensed to insured depositors.173

Uninsured depositors historically have received an average of 99.5 percent of their losses after completion of liquidation.174 This level suggests that such depositors exert a significant degree of influence on banks and can protect themselves when their funds are genuinely at risk. It also indicates that market discipline will not impose oppressive costs on uninsured depositors. However, the recent trend away from the use of the deposit payoff method of dealing with bank failure in favor of options that protect uninsured depositors deprives the market of the beneficial effects of such monitoring.175

The high percentage of recovery by uninsured depositors makes the current hostility towards the deposit payoff option even more curious. The typical complaints are that (1) all depositors, particularly uninsured depositors, are inconvenienced because they must wait some period of time before receiving payment;176 (2) a deposit payoff “disrupts vital banking services”;177 and (3) a deposit payoff is disruptive to the overall economy since it requires that buildings be closed and bank employees be terminated.178

None of these complaints has merit. The inconvenience to depositors is ordinarily not severe, particularly in comparison to the inconvenience suffered by creditors in ordinary bankruptcy proceedings such as a reorganization or liquidation that can take years.179 Current policies ignore the regulatory benefits of causing depositors to suffer delays. The cost of such delays will cause depositors to monitor the banks where their funds are held. As such, it is entirely appropriate that uninsured depositors suffer greater losses in the form of the loss of use of their funds than insured depositors because uninsured depositors are in a much better position to monitor the performance of the bank.

As for the second point, vital banking services are not disrupted when an insured bank is liquidated because most communities have a plethora of banks. And, in those rare instances when the termination of services of the bank will cause a disruption of vital banking services, the FDIC has the authority to prop up the insolvent bank by direct investment even if this is not the least-cost method for handling the insol-

173. The FDIC is subrogated by force of law to the claims of the insured depositors whose claims it has paid. Id. § 1821(g).
175. See supra notes 125–35 and accompanying text (describing FDIC's preferred method of dealing with insolvent banks).
176. See, e.g., Note, supra note 118, at 1355–56 ("all depositors must wait some time to receive payments in a deposit payoff").
177. Id. at 1356.
178. Id.
179. Insured depositors typically are reimbursed out of the insurance fund within five to seven days when the FDIC liquidates a bank. Garten, supra note 10, at 148. The real cost to depositors comes in the form of lost post-failure interest. Id.
With approximately 15,000 banks in the United States, the argument that banks cannot be allowed to fail because each and every bank in the country delivers "vital banking services" is impossible to defend. In those rare communities where the banks' operations are essential to the community, the statute permits exceptions to be made, but this limited exception cannot support the current policy which seems to presume that all banks are essential.

The third argument against deposit payoff is that it involves bank closures and employee layoffs that disrupt the economy. However, P&A transactions often result in these same unhappy occurrences since the new management of the insolvent bank must, if the merger is to be successful, rid the bank of redundant employees and unprofitable operations. Furthermore, very few bank assets are firm-specific. As such, if there is a demand for the continued deployment of displaced bank employees and facilities in the banking industry, then other banking institutions will have an incentive to hire such employees and purchase such assets rather than have them go to waste or, worse, be purchased by a competitor. The argument also contains the erroneous presumption that bank failure policies should take into account values besides the twin goals of protecting depositors and guarding the integrity of the banking system. It should not. There is no reason for the FDIC's insurance fund to subsidize inefficient or redundant banking operations.

Finally, improving the market for corporate control of banks best assures that banking resources are allocated to their highest valuing users. Consequently, those who are concerned about the allocation of such resources should advocate restructuring the rules regulating takeovers in those markets rather than advocate abandoning the deposit payoff system.

IV. THE CURRENT REGULATORY STRUCTURE: THE EFFICACY OF MONITORING AND THE DESTRUCTIVE ROLE OF BROKERED DEPOSITS

A. Empirical Evidence

The above discussion of the benefits of depositor monitoring is based on an elementary application of marginal cost analysis. Uninsured depositors can be expected to monitor banks and impose constraints on bank risk taking until the costs of engaging in such activities equals the benefits. The benefits come in the form of a higher probability of repayment by the bank. The costs come in the form of the transaction costs involved in researching the solvency and future prospects of banks and, in some cases drafting restrictions on bank in-

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180. See supra notes 77-122 and accompanying text.
181. See infra note 252 and accompanying text (evidence indicates bank employees do not lose jobs after mergers).
182. See infra notes 226-66 and accompanying text.

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vestment policies and in developing reporting systems which can monitor the adherence to those agreements. If the FDIC does not protect depositors over the $100,000 ceiling, banks will have an incentive to devise ways to make credible promises such as posting bonds to assure depositors that their funds will be secure.\footnote{183}

Despite the simplicity of the point, the desirability of increased depositor monitoring deserves further exploration. First, the cost-benefit analysis described above must be altered in one significant respect. By breaking up large deposits into a number of smaller deposits, large depositors can avoid the monitoring costs described above.\footnote{184} Breaking up these deposits involves significant transaction costs, but recent technological developments and judicial decisions have made it increasingly easy to break up large deposits into smaller, insured bundles.\footnote{185} According to Professor Scott, about 90 percent of all bank assets are financed by deposits, of which 70 percent are insured.\footnote{186} A growing number of these insured deposits represents deposits of substantial size that have been placed in insured institutions through deposit brokers who take the large deposits, divide them into insurable sums, and place them with the banks offering the highest rates of return to depositors. This practice thus represents a threat to any plan that seeks to instill depositor discipline on bank risk taking.\footnote{187}

In addition to the problem of brokered deposits, it appears that the particular form such monitoring takes has important policy implications. If, as some have claimed, monitoring by large depositors merely manifests itself in the form of precipitous withdrawals of uninsured funds on the basis of unfounded rumors, then depositor discipline may be a net drag on the banking system.\footnote{188} It has been argued that the low cost of withdrawing funds means that depositors will not impose effective constraints on bank risk taking, but instead will use their informational advantage simply to withdraw funds in anticipation of an upcoming bank failure.\footnote{189}

\footnote{183. See Macey & Garrett, supra note 19, at 229–30, 238.  
184. See FAIC Sec. v. United States, 768 F.2d 352, 355 (D.C. Cir. 1985) (discussing "deposit splitting" among several different insured institutions by deposit brokers).  
185. Id. The Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. §§ 3501–3509 (1982), established the Depository Institutions Deregulation Committee to implement the elimination of interest rate ceilings on deposit accounts. This created an environment in which banks competed for deposit funds. In addition to eliminating interest rate ceilings, the committee permitted banks to pay fees to deposit brokers who obtained deposits for them. These changes, along with the increasing ease of electronic transfers of large sums of money, led to the rise of the deposit brokerage business.  
188. See Garten, supra note 10, at 153–57.  
189. Id. at 153–54.
This theory is unsupported empirically or theoretically. First, while it is true that it is not very costly for uninsured depositors to withdraw their funds, they must incur search costs in finding an alternative repository for these funds. Second, the theory presupposes a "race" among uninsured depositors to withdraw their money from a troubled bank in order to avoid having deposits in the bank when all the bank's liquid assets are gone. But the risk that a particular uninsured depositor will lose this race provides him with an incentive to engage in monitoring. Similarly, the threat of precipitous withdrawals provides bankers with an incentive to provide uninsured depositors with current information about the state of their bank—or to change the terms of their contractual agreements with borrowers—in order to prevent such withdrawals. As such, the threat of depositor withdrawal is more likely to have a beneficial rather than a harmful effect on depositors.

The argument that monitoring by uninsured depositors will take the form of bank runs also misses the point that bank runs are not spontaneous events that occur randomly. Rather, they occur to banks with badly managed loan portfolios or other excessive exposure to risk. In other words, the evidence strongly indicates that bank runs occur to banks that deserve such treatment by their depositors. Consequently, the widespread withdrawal of funds by depositors should be viewed as a healthy occurrence, not as a sign of market failure, because such runs demonstrate that depositors are monitoring the banks in which their deposits are kept.

There are two sources of empirical support for the proposition that uninsured depositors who face a genuine risk of loss provide a healthy, not a destructive, monitoring function on banks. First, if uninsured depositors are concerned about excessive risk taking, they will demand

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192. This is consistent with the argument that it is not costless for depositors to remove their funds from a bank, since the depositors must incur search costs in finding another bank. Macey & Garrett, supra note 19, at 230. In a world of zero search costs, it would be cheaper for uninsured depositors to shift their accounts upon hearing any rumors regarding the bank's solvency rather than attempting to verify the validity of the rumor, provided they can find another bank offering the same rate of return.
that bank shareholders bear a significant share of potential losses by capitalizing their banks with a high proportion of equity. Thus, if market discipline by depositors has been eroding, we should expect capital reserves to be declining. Recent research indicates that the current reliance on federal deposit insurance has resulted in a decrease of banks' capital cushions as well as of their loan-loss reserves. These changes are very likely to increase the risk of insolvency.

Kaufman's evidence is particularly significant because it indicates that the market discipline provided by depositors does not only manifest itself ex post through massive withdrawals but ex ante as well through the contracting process. Prior to the present era of de facto insurance, shareholders were induced to reduce risk by putting up a significant equity cushion of their own funds and by providing substantial loan-loss reserves to guard against unforeseen contingencies. The equity cushion and the loan-loss reserves represent credible precommitment promises made by shareholders to persuade risk-averse depositors to entrust their funds with the shareholders' bank.

The federal banking agencies have attempted to mimic this marketplace response by imposing capital adequacy requirements on depository institutions. As with other regulatory strategies designed to reduce risk taking, government-imposed capital adequacy rules are unlikely to be good substitutes for the equity cushion that would result from the interplay of market forces.

Another precommitment strategy that has been abandoned concerned the liability of bank shareholders for the debts incurred by their firm. In the standard corporate contract, shareholders of a firm are not


194. E.g., C. Henning, W. Pigott & R. Scott, Financial Markets and the Economy 71-72 (4th ed. 1984) (explaining how capital accounts relate to bank safety in that “safety is provided . . . by having enough capital that any probable losses on loans can be charged off against capital”).


196. See Macey & Garrett, supra note 19, at 221-22 (explaining why “even conscientious regulators with the best intentions are likely to produce regulations that provide a sub-optimal level of safety for the banking system as a whole”).

In addition, minimum capital requirements do not fall into that category of issues for which government regulation is advisable because a simple, uniform, and easily administrable rule can not be promulgated to cover all situations. Capitalization constantly changes as investors shift their funds among alternative investments. In addition, the capital structure of individual banks depends on such diverse things as the economic prospects of the bank, the competitive conditions within the community served by the bank, the risks inherent in the bank's assets, the amount of the bank's fixed asset investment, and the ability of investors to supply additional capital when needed. M. Malloy, supra note 39, at 441 (describing federal guidelines for initial capitalizations of banks).
exposed to liability in excess of their initial capital investment. In the past, however, shareholders of banks have agreed to face liability in excess of this initial investment, by agreeing to supply additional funds (up to an amount equal to the par value of their stock) if necessary to protect depositors and other creditors.\footnote{197}{P. Blumberg, The Law of Corporate Groups 47-49 (1987).}

Prior to the present era of de facto insurance for all bank depositors, this arrangement may have had certain desirable features from the perspective of both depositors and shareholders. Depositors benefited from the increased level of safety for their funds, and shareholders benefited because the banks in which they invested enjoyed a lower cost of capital as a result of their promise.\footnote{198}{Note, however, that double-liability rules face serious problems of enforceability if shareholders are widely dispersed.}

Under current market conditions, however, shareholders have no incentive to make such a guarantee to depositors; de facto deposit insurance provides depositors with the assurances they need. The problem is that the strong incentives that shareholders previously had to avoid excessive risk taking are no longer in place. Shareholders' risk of loss is lower, therefore we can expect them to take greater risks.

Other empirical evidence provides a second level of support for the proposition that uninsured depositors provide a healthy form of market discipline for banks. A recent study by Baer and Brewer\footnote{199}{Baer & Brewer, supra note 190.} suggests that holders of large denomination certificates of deposit (CDs) will demand higher rates of return on these certificates if the stock returns of the bank with whom they are placing their funds exhibits high volatility—a strong proxy for risk.\footnote{200}{Id. at 29.} Because higher rates on CDs reflect higher capital costs for shareholders, shareholders have an incentive to refrain from engaging in excessive risk taking in order to keep their cost of capital low. Or, put another way, if fixed claimants bear the risk of loss, in a competitive capital market they will pass these costs on to equity claimants by charging them higher rates of interest.\footnote{201}{For useful introductory materials on stock price volatility as a proxy for risk, see generally V. Brudney & M. Chirelstein, Cases and Materials on Corporate Finance 75-113 (3d ed. 1987).}

Thus, the studies concerning the rates on uninsured CDs are strong evidence that risk monitoring has healthy rather than deleterious effects on bank safety because they show that shareholders bear the costs of bank riskiness when there are uninsured depositors. Rational shareholders will force their banks to engage in safe practices in order to avoid the cost of riskiness, which comes in the form of high CD rates. High CD rates for risky banks are also strong evidence that depositors

\footnote{197}{P. Blumberg, The Law of Corporate Groups 47-49 (1987).}
\footnote{198}{Note, however, that double-liability rules face serious problems of enforceability if shareholders are widely dispersed.}
\footnote{199}{Baer & Brewer, supra note 190.}
\footnote{200}{Id. at 29.}
\footnote{201}{For useful introductory materials on stock price volatility as a proxy for risk, see generally V. Brudney & M. Chirelstein, Cases and Materials on Corporate Finance 75-113 (3d ed. 1987).}
\footnote{202}{See Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305, 334-37 (1976).}
engage in monitoring, because if they did not monitor, they would not know enough to demand higher CD rates.

Similarly, Baer and Brewer show that CD owners demand higher rates of return when the market value of a firm’s equity is low relative to the bank’s total assets.203 This too is evidence of market discipline at work because as the market value of a bank’s equity goes up in relation to the total value of its assets, uninsured depositors enjoy a greater cushion in the event of financial trouble. As in the case of share-price volatility, this evidence shows that shareholders pay a cost for engaging in risk taking when uninsured depositors face a risk of loss. As these costs go up, one must expect the incidence of risk taking to decline. These data support the proposition that uninsured depositors exert discipline throughout the period when their money is in the bank’s hands.

Further evidence in support of the efficacy of uninsured depositors as continuing monitors comes from a study by Hannon and Hanweck which examined the rates of return on CDs of five different maturities.204 They found that the risk premiums on these CDs in the secondary market increases with the ratio of risky assets to total bank capital. In addition, Hannon and Hanweck found that CD risk premiums increase as uncertainty about bank returns on assets goes up.205 As one commentator has pointed out, “the implication [of the Hannon and Hanweck study] is that the market for large CDs helps to discipline bank risk-taking.”206 These results are consistent with earlier, more tentative results showing that interest rates on large, uninsured CDs increase as the amount of a bank’s risky assets increases relative to the bank’s capital.207

The available evidence also suggests that the market provides a very good early warning of bank problems. For example, a study by Pettway and Sinkey of six bank failures that occurred between 1973 and 1975 found that the market signalled problems with all of these banks an average of thirty-three weeks before regulatory agencies placed them on problem lists.208 Similarly, a study by Johnson and Weber in-

203. The ratio of market value of equity to total assets is called the market-to-asset ratio. Baer & Brewer, supra note 190, at 26–29. Baer and Brewer find that one standard deviation increase in the market-to-asset ratio causes CD rates to fall by 17 basis points. Id. at 31, table 4. A similar increase in CD rates follows a decline in a bank’s market-to-asset ratio. Id.

204. T. Hannan & G. Hanweck, supra note 190, at 2 (finding “strong evidence that the market for [large certificates of deposit] exacts a price for bank risk taking”).

205. See id. at 18.


208. Pettway & Sinkey, Establishing On-Site Bank Examination Priorities: An
dicates that the addition of a bank to a regulator’s problem bank list does not cause a significant market reaction, indicating that the market has already reacted to this information by the time the regulators act. Similarly, when the names of banks on the Comptroller of the Currency’s list of problem banks were leaked to the press there was no significant market reaction to the disclosure, indicating that the market already knew the regulator’s information. And a study by Shick and Sherman showed that stock prices of bank holding companies began to decline 15 months before regulators recognized that the subsidiary banks were experiencing financial trouble.

Furthermore, the risk of widespread withdrawal of funds by uninsured depositors may have the added beneficial effect of inducing regulators to hasten the closure of troubled banks, thus saving the FDIC insurance fund further strain. Widespread withdrawals provide regulators with early information that a bank is in difficulty. If a bank can be closed as soon as it is economically insolvent—when the present value of its assets net of liquidation costs equals the present market value of its liabilities—the loss to the insurance fund from the bank failure will be zero. When there is delay between the moment of economic insolvency and closure, insolvent institutions with nothing to lose have a strong incentive to take imprudent risks in an attempt to regain solvency. This strategy, while perfectly rational from the shareholder’s perspective, generally will increase the magnitude of the payout necessary by the FDIC because, in all likelihood, the strategy will succeed only in a small percentage of cases.

This evidence strongly supports the underpinnings of the theory articulated thus far. Uninsured depositors are a valuable source of market discipline for banks. When uninsured depositors face a realistic possibility of significant economic loss from a bank failure, they will cause banks to make credible precommitment promises to refrain from excessive risk-taking, and they will continue their supervision so long as their funds are on deposit with the bank.

B. Brokered Deposits

A significant impediment to controlling the moral hazard problem


211. Kaufman, supra note 20, at 10.

212. Id. at 9.

213. See id.

214. "Moral hazard" refers to the problem of an insured person’s having less incentive to reduce risk than an uninsured person simply because he is insured. R. Posner, Economic Analysis of Law 150 (3d ed. 1986). More formally, moral hazard re-
lem by improving private sector monitoring of FDIC insured banks comes from the recent growth of a new form of business enterprise, the deposit brokerage firm. Deposit brokers earn fees by bringing together individual depositors and arranging for the placement of their separate funds in whichever insured financial institutions currently offer the highest rates of return to depositors. 215

Brokered deposits pose problems for the banking system in several ways. First, they make it easier for the shareholders and other controlling persons of troubled banks to engage in excessive risk taking immediately before failure. Insured institutions on the brink of insolvency have an incentive to take imprudent risks in an attempt to regain solvency. 216 But, because troubled banks frequently face severe liquidity problems, they are unable to obtain the funds necessary to engage in the last minute risk-taking. Access to brokered deposits by such institutions provides them with a plentiful source of relatively inexpensive funds to fuel their last ditch ventures. Second, even under the current regulatory system, depositors with funds above the de jure insurance threshold have an incentive to engage in a minimal degree of monitoring because there is some uncertainty in the administration of the current regulatory scheme. It is always possible that the regulators will change their strategy and refuse to bail out uninsured depositors. There is also a remote possibility that the regulators will be unable to find a suitable merger partner for a failed bank at the last minute and may not be able to consummate a P&A transaction. If it is then decided that the bank is not essential to its community, the regulators may liquidate the bank through a cash payout, leaving uninsured depositors un-


Sometimes deposit brokers match banks with depositors and arrange for the depositors to deposit their money directly with the bank. FAIC Sec., 768 F.2d at 355. Other times the broker deposits the funds on behalf of the depositor. Id. In both cases the depositors enjoy the benefits of federal deposit insurance so long as their deposits with one lending institution do not exceed the $100,000 statutory limit. Id.

Some deposit brokers specialize in splitting funds from large investors into $100,000 increments that can be placed with insured banks in order to permit all of the investor's funds to qualify for federal deposit insurance. Id. Deposit brokers generally place funds with particular banks on behalf of several customers, and thus the amount placed by brokers with one institution typically exceeds $100,000. Id.

216. Shareholders will gamble here because they stand to lose nothing more than their initial investment if the bank still fails. If they do not act, that investment is certain to be lost.
protected. Even if the odds of such events taking place are small, they impose some risk on uninsured depositors, who in turn impose discipline on the banks with whom they have deposited their funds. But, as the transaction costs of splitting up these large deposits into insurable increments goes down, they will be split up and will destroy even this modicum of market discipline that exists under the current regulatory scheme.\textsuperscript{217} The FDIC and the Federal Home Loan Bank Board (FHLB) share the opinion that brokered deposits in failed financial institutions have exacerbated demands on the relevant federally sponsored bank insurance funds.\textsuperscript{218}

Finally, the emergence of brokered deposits puts subtle strains on the banking system by fueling the incentives that banks currently have to shift to even riskier ventures. Deposit brokers compete with each other for customers with funds to deposit by searching for those banks that offer the highest rates of return to depositors. Because of deposit insurance, these deposit brokers and their customers are unconcerned about the risks associated with the banks that hold these deposits. As such, the continued use of deposit brokers will cause a flight of funds to the banks that offer depositors the highest rates of return—the riskiest banks. Other banks, to attract funds, will have to match the high rates being offered by these risky banks. In order to cover the higher marginal costs of funds, these banks, in turn, will be forced to shift their assets to riskier ventures. Thus, the emergence of deposit brokers provides banks with an even stronger incentive to shift their funds to riskier ventures.

In an effort to deal with the problem of brokered deposits, the FDIC and the FHLB promulgated regulations that would aggregate all of the deposits placed at a single bank by a particular deposit broker—regardless of the beneficial owner of the funds—for the purpose of computing the FDIC insurance limit.\textsuperscript{219} In an opinion later affirmed by

\textsuperscript{217} Macey & Garrett, supra note 19, at 225.

\textsuperscript{218} See FAIC Sec., 768 F.2d at 355–56. The problem is that:

[b]anks or S & L’s bordering on insolvency can, by offering high interest rates, attract large sums in a very short period in an effort to stave off failure of the institution. Because the brokered accounts are federally insured . . . neither the brokers nor their customers adequately investigate the institution’s financial condition before depositing their funds. The result, when the bank or S & L is unable to stave off failure, is that the potential cost to the insuring agencies of making payment on the insured accounts is significantly increased due to the last-minute influx of brokered deposits.


\textsuperscript{219} FAIC Sec., 595 F. Supp. at 76. Thus, if ten people placed $20,000 each with a deposit broker, who in turn placed the money with one bank, the $100,000 insurance limit would be surpassed by $100,000 under the new regulations. In this situation only $100,000 of the depositors’ funds would be insured. See id. at 76. The regulations did not confront the interesting question of how the insurance would be apportioned among these various depositors in the event the bank failed. See id. at 77 n.4.
the U.S. Court of Appeals for the D.C. Circuit, a U.S. District Court in *FAIC Securities, Inc. v. United States* struck down the regulation as being in violation of the Banking Act of 1935. The court construed the Act to mean that beneficial owners of deposit accounts are entitled to insurance protection up to the statutory limit. The court therefore decided that the banking regulators lacked the administrative authority to deprive insurance protection to single depositors whose funds did not exceed the statutory limits.

In the wake of *FAIC Securities*, legislation granting the FDIC and the FHLB authority to impose constraints on brokered deposits is clearly appropriate. The present ability of deposit brokers to use modern technology to exploit the deposit insurance system greatly exacerbates the moral hazard problem facing troubled financial institutions. Indeed, the ability of deposit brokers to transform uninsured deposits into insured deposits will seriously reduce the effectiveness of the regulatory changes advocated above. The ability to convert large, uninsured deposits into smaller, insured deposits will provide large depositors with an even greater incentive to seek out the riskiest banks and place their money with those banks to enjoy the highest returns. In turn, safer banks, to compete for funds, will have to offer higher rates to depositors. And, to justify paying depositors these higher rates of return, these safer banks will be forced to invest in riskier projects.

**V. The Market for Bank Control**

Whatever one's view about the desirability of exposing large depositors to increased risk of loss in order to increase the level of monitoring that insured banks receive, it is clear that deposit insurance makes banks different from other business firms because a large class of claimants—depositors—are protected from the consequences of making bad capital allocation decisions by a pervasive insurance scheme for which they do not pay directly. This insurance scheme makes it impossible to apply the basic principles of corporate finance theory directly to federally insured depository institutions.

A basic tenet of the modern theory of corporate finance is that a business firm is a complex web of contractual relationships among shareholders, directors, officers, employees, creditors, and others. Each of these groups agrees to invest their capital (which may come in the form of both money and labor) in the firm in exchange for the prospect of a market rate of return on its investment. Those groups that bear greater risk must be compensated for this increased risk-bearing.

220. Id. at 77–79.
221. Id. at 78–79.
One of the most trenchant forms of risk that faces investors is the risk that the interests of managers, directors, and other employees of a public corporation will diverge sharply from those of the shareholders and other investors. Many of the contracts in the corporate sphere are designed to control non-optimal risk-taking and to align the interests of managers with those of the shareholders and other claimants. In the bank setting there is far less incentive to design such contracts because the federal government, through the federal deposit insurance scheme, has agreed to bear the risks associated with the most acute form of non-optimal performance—failure.

Unfortunately, it is not the federal deposit insurance system alone that leads to insufficient monitoring and hence to sub-optimal managerial performance. Federal banking regulation, by virtually forbidding hostile takeovers, removes an equally powerful market mechanism that exerts a corrective influence on managerial misbehavior—the market for bank control.

This section first reviews the mechanism by which the market for corporate control, particularly the tender offer, serves as a mechanism for monitoring the performance of errant management teams when this market process is not constrained by the types of regulations that currently pervade the world of banking. It is shown that the market for corporate control, if allowed to function properly, would serve to improve managerial performance by bank managers in the same way as would permitting large depositors to suffer losses from bank failures: by providing private parties with an economic incentive to monitor management. The complex system of regulation that governs the market for control of banks is then reviewed in order to show that these regulations significantly reduce the possibility that a bank can be acquired in a hostile takeover—regardless of how bad the performance of its incumbent management has been. Finally, we suggest ways that regulators can improve the operation of this market so as to provide an additional source of monitoring of banks by outsiders.

A. The Theory of the Market for Bank Control

In some respects, tender offers for firms provide an even more attractive prospect for improving managerial discipline than contracts between firms and shareholders or contracts between creditors and firms. Creditors and shareholders cannot provide the same level of monitoring as outside bidders because they are plagued by free rider problems that reduce their incentives to monitor. Specifically, those shareholders and creditors who engage in monitoring of their firm's management

224. See generally Smith & Warner, supra note 32, at 136–39 (how covenants are means whereby fixed claimants control risk taking by debtor firms).
bear all of the costs of such monitoring, while the benefits are dispersed among all creditors and shareholders according to the amount of their investments.\textsuperscript{226} Those who enjoy the benefits of monitoring without paying are free riders, and such free riding leads to a suboptimal level of monitoring.\textsuperscript{227}

Furthermore, as discussed above, while monitoring by creditors takes place throughout the duration of a creditor's relationship with the firm, ex ante monitoring is in many ways more socially desirable than ex post monitoring.\textsuperscript{228} Ex ante monitoring consists of drafting contracts and forging credible precommitment strategies that constrain managerial misbehavior.\textsuperscript{229} For banks, ex post monitoring by creditors comes in the form of bank runs and demands for risk premiums as compensation for excessive risk taking.\textsuperscript{230} Here, too, collective action problems take their toll as each creditor realizes that the optimal strategy is to be the first to withdraw his funds, thereby leading to the danger of premature deposit withdrawals.

Easterbrook and Fischel point out that the societal benefits from a robust market for corporate control far exceed the benefits to particular bidders and target firm shareholders because the monitoring by bidders "poses a continuous threat of takeover if performance lags."\textsuperscript{231} The consequence of this continuous threat is that "managers will . . . reduce agency costs in order to reduce the chance of takeover, and the process of reducing agency costs leads to higher prices for shares."\textsuperscript{232}

Weaker firms are particularly likely candidates for takeover, since they are likely to provide the greatest opportunity for arbitrage profits by superior management teams. Indeed, in an insight that is particularly relevant for banking law and policy, Professor Dewey observes that takeovers are "merely a civilized alternative to bankruptcy or the voluntary liquidation that transfers assets from falling to rising firms."\textsuperscript{233} Thus, when properly viewed as a substitute for bankruptcy, a robust market for bank control is seen as a sign of the vigor of competi-

\begin{itemize}
\item \textsuperscript{227} Id. at 710.
\item \textsuperscript{228} See Macey & Garrett, supra note 19, at 228–32, 238.
\item \textsuperscript{229} Id. at 229–30.
\item \textsuperscript{230} Id. at 230–31.
\item \textsuperscript{231} Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161, 1174 (1981).
\item \textsuperscript{232} Id.; see also Fischel, Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers, 57 Tex. L. Rev. 1, 9 (1978) (arguing threat of takeover gives managers incentive to remain efficient and to keep share prices high); Manne, Mergers and the Market for Corporate Control, 78 J. Pol. Econ. 110, 112–13 (1965) (discussing relationship between managerial efficiency, stock prices, and takeover motivation).
\end{itemize}
tion in a particular industry, rather than of its decline. Manne, in a seminal article, made a substantial extension of Dewey's earlier insights. He observed that takeovers are not only efficient when the failure of a firm is imminent, but also "before bankruptcy becomes imminent in order to avoid that eventuality." Manne goes on to point out that "if mergers were completely legal, we should anticipate relatively few actual bankruptcy proceedings in any industry which was not itself contracting. The function so wastefully performed by bankruptcies and liquidations would be economically performed by mergers at a much earlier stage of the firm's life." Manne's defense of the market for corporate control catalogues a host of advantages to the economy from a regulatory policy that encourages takeovers. A free market for corporate control would bring about more efficient management of firms, increased protection for non-controlling investors—stockholders, depositors, and other creditors—and a more efficient allocation of resources.

The arguments in support of a robust market for corporate control apply with even greater force to banks than they do for corporations generally. The monitoring function that the corporate control market provides for all firms is a supplement to the monitoring conducted by unsecured creditors in the non-FDIC insured public corporation. Because depositors have very little incentive to engage in monitoring under the current regulatory regime, which protects virtually all deposits, the need for a robust market for corporate control is even more acute in banking than in other sectors of the economy.

The observations of Dewey and Manne that the market for corporate control both serves as a substitute for bankruptcy and reduces the incidence of insolvency are particularly relevant for the banking industry. If creditors and shareholders make uninsured investments in a firm that becomes insolvent, they bear virtually all of the costs of the insolvency. But if an FDIC insured bank becomes insolvent, much of the costs are borne not by shareholders and uninsured creditors of the failed institution, but by the FDIC insurance fund. FDIC deposit insur-

234. Id. This does not mean that takeovers of banks will only occur when failure is imminent. Rather, takeovers are likely to take place whenever a firm is being run by inept or dishonest management, even if the firm happens to be profitable. See Haddock, Macey & McChesney, Property Rights in Assets and Resistance to Tender Offers, 73 Va. L. Rev. 701, 709 (1987). It stands to reason, however, that all else being equal, firms with inept or dishonest management are more likely to fail than firms with competent, honest management.

Takeovers also are likely to occur when a firm's assets could be redeployed to more valuable uses than the ones selected by incumbent management. Macey, State Anti-Takeover Legislation and the National Economy, 1988 Wis. L. Rev. 467, 469.

235. Manne, supra note 232, at 111.

236. Id. at 112.

237. See Easterbrook & Fischel, supra note 226, at 698; Haddock, Macey & McChesney, supra note 234, at 709.
ance and the FDIC bank failure policies cause bank insolvency to impose costs on the healthy banks whose premiums constitute the FDIC insurance fund. These externalities provide even stronger arguments than otherwise for facilitating a robust market for corporate control in order to reduce the incidence of bank failure.

The administrative costs of bankruptcy are an example of an insolvency-related expense that is borne, at least in part, by third parties in the case of bank insolvencies. These expenses, which vary greatly depending on a variety of factors, can be quite large.\textsuperscript{238} The expenses are borne by the claimants of the insolvent firm because they reduce the size of the asset pool which such claimants will share. The FDIC and other government agencies are in complete charge of the bank insolvency process, and these agencies incur significant costs in connection with this process. A robust market for bank control would cause the cost of transferring control of bank assets to fall on the parties who benefit from the transaction—the purchasers and sellers of the firm.

This point becomes particularly clear when the tender offer process in the normal course of a firm’s business is compared with the P&A transaction.\textsuperscript{239} If possible, when an FDIC insured bank becomes insolvent, the regulators hurriedly arrange an auction for the failed bank’s assets. The speed and the necessarily restricted nature of the auction process imposes heavy costs on the FDIC. In fact, the P&A transaction is nothing other than a last ditch effort by regulators to create a robust market for bank control when a bank has already failed. If administrators permitted a more robust control market for banks that have not been officially declared insolvent, not only would they avoid the administrative costs of the P&A transactions, but the monitoring conducted by potential bidders would prompt incumbent management to perform better in order to avoid being displaced in a takeover.\textsuperscript{240} This in turn

\textsuperscript{238} Ang, Chua, & McConnell, The Administrative Costs of Corporate Bankruptcy, 37 J. Fin. 219, 224 (1982). Ang, Chua, and McConnell examined a randomly selected sample of eighty-six bankruptcy liquidation cases filed in the Western District of Oklahoma and found the ratio of administrative costs to total value of the firm to have a mean of 7.5\% and a median of 1.5\%. Id.; see also Altman, A Further Empirical Investigation of the Bankruptcy Cost Question, 39 J. Fin. 1067 (1984). Altman compared the bankruptcy liquidation costs of firms in the retail industry with the liquidation costs of industrial firms. He found the ratio of bankruptcy administrative expenses to the value of the firm to have a mean of 4.0\% for the retail firms and a mean of 9.8\% for the industrial group. Id. at 1074–75.

\textsuperscript{239} See supra notes 123–35 and accompanying text (describing P&A transactions).

\textsuperscript{240} While the administrative costs of purchase and assumption transactions are avoided when there is a merger or hostile takeover of a bank, there is still a danger that bank managers will use the resources of the bank to try to fight off unwanted tender offers. See Easterbrook & Fischel, supra note 231, at 1174–82 (arguing that the target managers should not be allowed to resist hostile takeover attempts since such attempts improve the quality of corporate governance and move corporate assets to their most highly valuing users). But the costs of such resistance are borne by bank shareholders,
would result in fewer bank failures overall. Of course, markets do not work perfectly. Even with a healthy market for bank control some (although fewer) banks will become insolvent. Transactions costs and information costs will make it inefficient for outsiders to search and bid for all undervalued or inefficiently managed banks. Even when the regulators declare a bank insolvent, however, a functioning market for bank control would facilitate disposing of the failed bank’s assets. If a market for bank control were allowed to develop, individuals and firms would develop specialized expertise in locating and evaluating poorly managed banks, just as they have in the market for corporate control generally. Such firms and individuals—often pejoratively described as “raiders”—would improve the operation of the auction market for the assets of banks that the regulators have declared insolvent and that the FDIC is attempting to sell in a P&A transaction. This too would reduce the costs of bank failure.

The empirical evidence overwhelmingly supports the theory of the market for corporate control presented here and also serves to quell the oft-heard complaints that takeovers are exploitative of target firms and that the gains from takeovers represent mere wealth transfers from one class of claimants to another. Indeed, there have been so many studies proving large gains to target firms from takeovers, that it is even difficult to catalogue the articles that review the various studies.

A famous review article by Jensen and Ruback looked at thirteen studies on the gains from tender offers that occurred between 1977 and 1981. The thirteen studies all showed that targets of successful tender offers and mergers earn significant, positive rates of return, ranging who must decide for themselves if the benefit from additional resistance, which comes in the form of higher premia for their stock, outweighs the cost, which comes in the form of a lower probability that an initial bid ever will be made for the target firm’s stock. Haddock, Macey & McChesney, supra note 234, at 720–26 (arguing that shareholders bear these costs). Thus the problem of excessive managerial resistance seems overstated. Id.

241. See Macey & McChesney, A Theoretical Analysis of Corporate Greenmail, 95 Yale L.J. 13, 28–29 (1985) (arguing that prospective tender offerors make investments in locating undervalued firms and are subject to “victimization by others who can free-ride on the information produced”).


from sixteen percent for mergers to thirty percent for tender offers. Jensen and Ruback conclude that the evidence supports the hypothesis that corporate acquisitions represent positive net-present-value projects. A recent study by several financial economists with experience at the Security and Exchange Commission's (SEC) Office of the Chief Economist estimates total premiums to target firm shareholders of over $54 billion dollars from 1981 to 1986.

The scientific evidence is completely at odds with the theory that target firms are exploited by takeovers; instead, the most recent evidence continues to support the hypothesis that target firms benefit from takeovers. The Office of the Chief Economist studied all of the successful tender offers that occurred between 1981 and 1984 and found that target firm shareholders of such takeovers enjoyed a 53.2% increase in the value of their shares, net of the market average. Thus, as a recent study by Jarrell, Brickley, and Netter points out, "the evidence reported thus far indicates substantial gains to target shareholders."

The empirical evidence also discredits the view that takeovers represent attempts by bidding firms to exploit target firms. Regardless

245. Id. at 47.
247. Id. at 52.
248. Id.
249. The Jensen and Ruback study shows that the returns to bidding firms is significantly smaller than the returns to targets, Jensen & Ruback, supra note 243 at 11-13, indicating that the sharing of gains between bidders and targets does not represent the systematic exploitation of targets by bidders. Jarrell, Brickley & Netter, supra note 243, at 53-54. Recent evidence concerning the gains to bidders in tender offers is presented in a 1987 study by Jarrell and Poulson. Jarrell & Poulson, The Returns to Acquiring Firms in Tender Offers: Evidence from Three Decades (1987) (unpublished manuscript) (on file at the Columbia Law Review). They show that while bidders do realize small gains, in recent years their share of these gains has been declining. Id.

The evidence supports alternative hypotheses for why bidders realize smaller gains than targets. The most plausible explanation is that the market for takeovers has become increasingly competitive over the years, and this rivalrous competition manifests itself in the emergence of a market that more closely resembles auctions than single-buyer/single-seller transactions. Jarrell, Brickley & Netter, supra note 243, at 54. Richard Roll presents an alternative explanation, called the "hubris hypothesis" which posits that takeovers represent empire building by the management teams of bidding firms. Roll, The Hubris Hypothesis of Corporate Takeovers, 59 J. Bus. 197 (1984). Another theory is that bidders do gain from taking over other firms, but that these gains may not be reflected in the current studies due to problems with the testing methodology. Macey, supra note 234. Specifically, present testing methodology only recognizes gains to bidders that occur within a relatively short period preceding an acquisition. Id. If the stock market is efficient, the gains to bidders from an acquisition may be anticipated well in advance of the acquisition itself and thus are not reflected by the current statistical technique. Id.; see also Malatesta, The Wealth Effect of Merger Activity and the Objective Functions of Merging Firms, 11 J. Fin. Econ. 154, 168 (1983) (offering empirical evidence).
of a bidder's motivations for launching a hostile takeover, so long as the target firm shareholders are not exploited by bidders, the imposition of regulatory constraints on the market for bank control cannot be justified. This is particularly true in light of the evidence that, while sure knowledge of the sources of takeover gains "still eludes us," several studies show that the acquisition of monopolistic market power is not a plausible explanation for takeovers.  

Recently, it has been argued that takeovers should be regulated or prohibited to the extent that they are a disruptive influence on local communities and on local workers who have made significant, non-recoverable firm specific investments in the firms being taken over. While this argument may have some merit when applied to the takeover of certain manufacturing operations such as steel, which require a substantial amount of local industrial support, the argument makes little sense when applied to banking. First, banks require little if any of the unique sorts of support from specialized suppliers that large industrial firms require. Second, according to banking industry officials involved in mergers, rank and file employees do not lose jobs when banks merge. And, even if employees were to lose jobs, bankers can easily transfer the accounting and analytical skills they have developed to other sorts of jobs, so there is little danger of loss of firm specific human capital.

A final question about the sources of takeover gains, of particular importance here, is the question whether takeovers simply represent a wealth transfer from fixed claimants—such as bondholders or depositors—to shareholders. If this occurs, then a robust market for bank control could prove more harmful than beneficial to depositors. For example, it could be argued that placing a bank's assets in the hands of a hostile acquirer will undesirably increase the bank's riskiness because the acquirer will need to take greater risks in order to justify the costs of the acquisition. Thus, it is important to examine the contention that the premiums paid by bidders represent a redistribution from fixed claimants to equity claimants.

It is implausible that such redistributions could take place over the

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252. Merged Banks See Cuts by Attrition, Not Layoffs, Am. Banker, March 30, 1988, at 1, 15 (industry consultants claim mergers cause layoffs, but banks themselves say that staff cuts only accomplished through attrition and transfer).

253. See supra notes 31–34 and accompanying text (illustrating how increases in risk redistributes wealth from fixed claimants to equity claimants).
long run. If a robust market for bank control were allowed to develop, rational fixed claimants would demand assurances that the essential attributes of the investment they are purchasing, particularly the risk-return trade-off, will not be altered by post-contractual behavior of the shareholders. As such, the fixed claimants would write contracts that constrain the ability of shareholders to increase the riskiness of the firm ex post, and shareholders would have incentives to provide credible assurances that they will not engage in post-contractual opportunistic behavior in order to attract investors at reasonable interest rates.

If the changes to bank-failure policy advocated in the previous section are not adopted, then there exists, at least in theory, the danger that takeovers of banks will occur solely for the purpose of transferring wealth from the FDIC to shareholders by making the resulting bank more risky. This danger exists because even large depositors will not exert a mitigating influence on shareholders' risk taking proclivities if such depositors can expect protection under current FDIC bank-failure policy. If, however, modifications to current bank-failure policies are implemented so that uninsured depositors face losing their deposits in the event of an insolvency, there is little danger of a bank's being taken over by people who only want to loot it or make it riskier, since large depositors, acting in their role as fixed claimants, can be expected to extract credible contractual assurances that prevent such problems from arising.

Consistent with this theory of the incentive structure facing fixed claimants, several studies indicate that the gains from acquisitions do not come at the expense of the holders of the fixed claims and senior securities of target firms. A 1977 study by Kim and McConnell shows that the abnormal returns to nonconvertible bondholders of bidding and target firms do not vary significantly from zero. More recent studies confirm these results, which strongly suggest that takeovers do not benefit shareholders at the expense of fixed claimants. These studies are particularly significant for our purposes because they indicate that the banks' fixed claimants, including

254. See supra notes 71-182 and accompanying text (discussing bank-failure policies of FDIC).
255. Contracts forbidding risky activities will constrain future as well as present management teams. In addition, Smith and Warner report that 39.1% of bond covenants contain provisions restricting certain merger activity, and 90.8% contain restrictions on the issuance of additional debt. Smith & Warner, supra note 32, at 123.
256. The studies are summarized in Jarrell, Brickley & Netter, supra note 243, at 51-52.
257. Kim & McConnell, Corporate Mergers and the Co-Insurance of Corporate Debt, 32 J. Fin. 349, 358, 362 (1977) (finding no statistically significant transfer of wealth from bondholders to shareholders).
depositors, the FDIC, and the FSLIC, need not be harmed by facilitating a more robust market for bank control.\footnote{259} A word of caution about drawing inferences from these studies for banking policy is in order. Takeovers cannot impose costs on the fixed claimants of target firms because such fixed claimants have strong incentives to design contractual provisions to protect themselves against such contingencies.\footnote{260} However, current bank failure policies, by providing protection for all fixed claimants of insolvent banks, removes those incentives.\footnote{261} As such, the proposal that bank-failure policies should avoid subsidizing fixed claimants,\footnote{262} particularly large depositors, must also be implemented in order to insure that the market for corporate control will function optimally.

A more difficult question is whether the current rules concerning bank takeovers should be retained even if present bank-failure policies are continued. Under the current regulatory system, banks can increase share value at the expense of the FDIC and the FSLIC by increasing the riskiness of their assets.\footnote{263} As such, under the current regulatory regime, banks that are not maximizing value for shareholders because they are maintaining a relatively safe portfolio of assets represent particularly attractive takeover targets because they can be acquired by a new management team which will increase share value by increasing the bank’s risk exposure. Thus, in order for the market for bank control to operate effectively, those banks subject to takeover should be required to maintain a capital structure that contains sufficient uninsured, unsecured debt—either in the form of large deposits that are uninsured either de jure or de facto, or in the form of debentures—to ensure that the new management is not going to increase share value at the expense of depositors.

\footnote{259} At first blush, it might seem unlikely that fixed claimants can protect themselves by contract from being oppressed by future acquirers whose identities are unknown to them at the time the contractual devices are put in place. But bond covenants restricting merger activities, the issuance of additional debt, and the firm’s disposition of assets restrain the actions of subsequent acquirers as well as incumbent management. See Smith & Warner, supra note 32, at 126–29.

In addition, the free rider problems that plague the monitoring activities of fixed claimants do not pose a particularly large problem here because these restrictions are imposed when the firm makes its initial offering of the securities containing the restrictions. The investment banking community, which underwrites these debt instruments, wants them to be marketable, and it is this community that solves the free rider problem by making sure that the bonds contain whatever restrictions are necessary to make the issue attractive in the secondary market. See Easterbrook, supra note 42, at 654 (when a firm issues securities “an investment banker or similar intermediary acting as a monitor for the collective interest” of investors will review the firm’s affairs on behalf of such investors).

\footnote{261} See supra notes 71–182 and accompanying text.
\footnote{262} Smith & Warner, supra note 32, at 128–29.
\footnote{263} See supra notes 31–34 and accompanying text (demonstrating effects of increased riskiness on share value).
share value simply by increasing risk.\textsuperscript{264} The current rules, which impede banks from taking over other banks, should be removed.

For non-bank corporations, a significant obstacle to a properly functioning market for corporate control is the strong incentive of target firm managers to oppose value-increasing hostile takeovers in order to preserve their jobs.\textsuperscript{265} Indeed, the less effective a particular management team has been, the greater its incentive to prevent a takeover.\textsuperscript{266}

\textbf{B. The Legal and Regulatory Constraints}

A number of state and federal laws constrain bank takeover activity for some firms and not others. State and federal laws require that both the acquired and the acquiring firms be commercial banks located within the same state or geographical region.\textsuperscript{267} Many states have additional laws that restrict expansion to particular political subdivisions or provide protection for the home offices of existing banks.\textsuperscript{268}

\textsuperscript{264} In other words, the only sensible way for the banking industry to garner the benefits of the market for corporate control without altering current bank failure policies is to declare that banks that are the subject of hostile takeovers will be allowed to fail and will be required to maintain a capital structure that ensures that market generated restrictions on excessive risk taking will be put in place.

\textsuperscript{265} Easterbrook & Fischel, Auctions and Sunk Costs in Tender Offers, 35 Stan. L. Rev. 1, 12 (1982); see also Haddock, Macey & McChesney, supra note 234, at 701–02 (describing job preservation as a reason for resistance of target managers).

\textsuperscript{266} Easterbrook & Fischel, supra note 231, at 1175.

\textsuperscript{267} The relevant federal statutes are 12 U.S.C. § 36(c) (1982) (restricting branching of national banks), and id. § 1842(d) (acquisition across state lines by bank holding company permitted only when state law expressly authorizes).

State laws restricting bank acquisition vary. Some states prohibit acquisitions by out-of-state firms. Other states permit acquisitions by out-of-state banks within a specified region. For example, Massachusetts permits an out-of-state bank holding company with its principal place of business in one of the other New England States . . . , which is not directly or indirectly controlled by another corporation with its principal place of business located outside of New England, may establish or acquire a Massachusetts-based bank or bank holding company, provided that the other New England State accords equivalent reciprocal privileges to Massachusetts banking organizations. Northeast Bancorporation, Inc. v. Board of Governors of the Fed. Reserve Sys., 472 U.S. 159, 164 (1985).

\textsuperscript{268} States may restrict the interstate banking activities of national banks doing business within their borders. Federal law prohibits interstate branching by national banks and limits their in-state branches to those permitted state banks by state law, 12 U.S.C. § 36(c) (1982), and prohibits bank holding companies from acquiring an out-of-state bank unless its state law expressly permits the acquisition, id. § 1842(d). As an example of such a state law, banks in Utah could branch only in certain cities, unincorporated areas of other counties, or where they took over an existing bank. See First Nat'l Bank v. Walker, 385 U.S. 252, 254 n.2 (1966). Utah has since repealed this restriction. Utah Code Ann. § 7-1-708 (1988). New York permits banks to branch statewide except in counties with less than 50,000 inhabitants where other banks have their headquarters. N.Y. Banking Law § 105 (McKinney 1988). Missouri prohibits banks from operating more than one place of business for the exercise of financial services. Mo. Ann. Stat. § 362.107 (Vernon 1988). Some states, such as Illinois, restrict branch bank-
These statutes ostensibly were enacted in the public interest to make banks safer and to prevent the banking industry from becoming overly concentrated. In fact, the statutes historically have served to cartelize the banking industry, restricting output and raising prices for consumers. But in a country with 15,000 banks, 20,000 credit unions and 4,000 savings and loan institutions, there is no support for the proposition that permitting bank mergers will cause the banking industry to become overly concentrated.

A strong argument can be made that the regulatory system which was once designed to benefit banks through cartelization gradually has been transformed into a system that imposes substantial costs on banks—and society generally through bank failures—because the system prevents banks from taking advantage of new technology and scale economies that permit substantial cost savings to firms capable of expanding. As a consequence, these statutes no longer enjoy even the partisan political support they once did and are “prime candidates for extinction.”

Until recently, bank holding companies could potentially expand into other states, even without the permission of the home state’s legislature, by establishing a “nonbank bank” in that state. As is now well known, a nonbank bank is a financial intermediary that does not fall under the technical definition of bank contained in the Bank Holding Company Act because it does not both take deposits payable to custom-


269. Butler & Macey, supra note 60.


271. See Scott, supra note 186, at 262–63. The huge number of banks in this country is a strong indication that whatever advantages once existed for individual banks from restricting expansion are gone today. The monopoly rents to individual banks from the former anticompetitive environment probably have been dissipated through new bank charters, new credit unions and other bank substitutes, and through the local expansion of existing bank activities wherever possible.

272. Id. Over the past five years there has been explosive growth in interstate banking. See generally Savage, Interstate Banking Developments, 73 Fed. Reserve Bulletin 79 (1987) (explaining the cause of this growth). A bank holding company can acquire a bank as a subsidiary if the state in which the subsidiary is located authorizes such an acquisition. The Douglas Amendment to the Bank Holding Company Act, 12 U.S.C. § 1842(d) (1982), prohibits a bank holding company from acquiring a bank outside of the state of its principal place of business unless the acquisition “is specifically authorized by the statute laws of the State in which such [target] bank is located, by language to that effect and not merely by implication.” This form of interstate expansion was recently facilitated by a Supreme Court decision upholding the constitutional authority of states to permit bank holding company expansion by some state’s holding companies but not others. Northeast Bancorporation, Inc. v. Board of Governors of the Fed. Reserve Sys., 472 U.S. 159 (1985).
ers on demand and make commercial loans. The Supreme Court recently has endorsed an expansive interpretation of this provision as well. Congress, however, foreclosed future use of the device in 1987.

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273. Section 2(a) of the Bank Holding Company Act defines a bank as "any institution organized under the laws of the United States, . . . which (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans." 12 U.S.C. § 1841(c) (1982).

Because the Bank Holding Company Act restricts the establishment or purchase of "banks," a "nonbank bank" could escape those restrictions. The Supreme Court recently described nonbank banks as institutions that offer services similar to those of banks but . . . were not under [Federal Reserve] Board regulation because they conducted their business so as to place themselves arguably outside the narrow definition of "bank" found in [§ 1841(c)]. Many nonbank banks, for example, offer customers NOW (negotiable order of withdrawal) accounts which function like conventional checking accounts but because of prior notice provisions do not technically give the depositor a "legal right to withdraw on demand." 12 U.S.C. § 1841(c)(1).

Others offer conventional checking accounts, but avoid classification as "banks" by limiting their extension of commercial credit to the purchase of money market instruments such as certificates of deposit and commercial paper.


For a discussion of nonbank banks, see generally, 2 M. Malloy, supra note 39, § 8.2.5 (describing the advantages of nonbank banks and discussing the attitude of courts and administrative agencies to the device); Schellie & Climo, Nonbank Banks: Current Status and Opportunities, 102 Banking L.J. 4 (1985) (defining nonbank banks and describing their advantages and prospects for the future).

274. In Dimension Fin. Corp., 474 U.S. at 361, the Federal Reserve Board sought to regulate nonbank banks by expansively reading § 1841(c)'s definition of what activities constitute banking. The Court unanimously rejected the Board's attempt to ignore Congress's specific language and define "bank" not as § 1841(c) did but rather as "an institution that offers the functional equivalent of banking services." Id. at 373-75.

275. In the Competitive Equality Bank Act of 1987, Congress redefined § 1841(c)'s definition of "bank" to read as follows:

(I) IN GENERAL — Except as provided in paragraph (2), the term 'bank' means any of the following:

(A) An insured bank as defined in section 3(h) of the Federal Deposit Insurance Act.

(B) An institution organized under the laws of the United States, any State of the United States, the District of Columbia, any territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands which both—

(i) accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others; and

(ii) is engaged in the business of making commercial loans.


This section of the Act "closes the nonbank bank loophole in the Bank Holding Company Act by redefining the term 'bank' . . . to include an FDIC-insured institution whether or not it accepts demand deposits or makes commercial loans." S. Rep. No.
The final means of geographic expansion possible for banks consists of a variety of long standing miscellaneous devices such as soliciting deposits by mail, establishing interstate loan production offices, sharing automatic teller machine networks, staking out minority equity positions in out-of-state banks, and establishing nonbanking subsidiaries of bank holding companies.\footnote{276}

Despite the growing trend towards permitting geographic expansion, the prospects for a robust market for corporate control do not appear to be great. An additional set of regulations that deal specifically with takeovers of banks by other banks protects incumbent management of depository institutions and retards the market for corporate control in the banking industry. It is these regulations that deprive the market of effective monitoring of banks by outside bidders and prevents inept or incumbent management teams from being replaced.\footnote{277}

Three statutes control bank takeover activity.\footnote{278} The Bank Merger


\footnote{276}{See Savage, supra note 272, at 80–82 (describing various forms of interstate expansion adopted by the various states); see also Miller, supra note 60, at 183–85 (listing mail solicitations, ATM networks, and minority shareholder positions).}

\footnote{277}{The difficulties inherent in unfriendly bank takeovers were illustrated in 1986 in the unsuccessful attempt by First Interstate Bancorp to acquire the troubled Bank of America. Largely because of regulatory difficulties, First Interstate was never even able to present its terms to the shareholders of the holding company. At present writing, the Bank of New York Co. has announced its intention to acquire Irving Bank Corp. However, observers of the takeover have suggested Irving may be able to fend off the proposed acquisition. See Snags Seen in Proposed Irving Merger, Am. Banker, Sept. 30, 1987, at 1.

After a protracted struggle, Irving appeared to have successfully fended off the Bank of New York's hostile bid when it defeated the Bank of New York's attempt to elect a slate of 16 directors to Irving's board in May, 1988. See Irving Wins Proxy Battle, Results Indicate, Am. Banker, May 17, 1988, at 1. In July, 1988, however, a court appointed referee ruled that the Bank of New York had gained a bylaw change that opened the door to another meeting of Irving shareholders. The bylaw allows 10% of Irving shareholders to call a special shareholders' meeting, at which a new election for directors might take place. This bylaw change gives the Bank of New York, which owns 4.9% of Irving's outstanding shares, the opportunity to call such a special meeting and attempt once again to displace the Irving board of directors. Referee Affirms Irving Board, Amends Tally, Am. Banker, July 8, 1988, at 2.

Irving won the May election by 231,000 votes. However, 318,000 of Irving's votes (i.e., the margin of victory) came from shareholders friendly to Irving who were issued an "unusual" type of "poison preferred stock" which gave them 1.471 votes per preferred share. The Bank of New York is challenging the issuance of these preferred shares. Id.


\footnote{278}{In addition to these provisions, the Competitive Equality Banking Act of 1987 permits out of state banks or bank holding companies to acquire insured banks that are in danger of failing provided that they meet certain size requirements. See Competitive
Act 279 governs mergers between banks; the Bank Holding Company Act 280 governs purchases of stock in banks by bank holding companies; and the Change in Bank Control Act 281 governs acquisitions of banks by individuals. Together, these statutes dramatically increase the time required for a hostile bidder to take control of any target bank. This delay makes hostile takeovers exceedingly rare in banking for two reasons. First, in the words of a client memorandum on the subject of bank takeovers by a major New York takeover firm, "for as long as a transaction is not closed it is, or at least is perceived to be, at the mercy of competitive bidders or others who might, for whatever reason, have an interest in breaking up the marriage." 282 The second obstacle to hostile takeover bids comes in the form of market risk, a term used to describe the risk that market conditions will change between the time of the bid and the time regulatory approval is granted, thus negating the benefits of the deal for one side or the other. 283

With the passage of the Change in Bank Control Act in 1980, it "is now impossible for someone to take control of a commercial bank without prior regulatory approval or review." 284 The Change in Bank Control Act prevents any person from acquiring control of an FDIC insured bank unless the appropriate federal regulatory agency has been given sixty days prior written notice of the proposed acquisition. 285 This mandatory sixty day delay period may be extended to an even longer

280. The relevant provision of the Bank Holding Company Act is currently codified as amended at id. § 1842.
281. Id. § 1817(j).
283. Id. at 5.
284. E. Symons & J. White, supra note 44, at 498.
period by the relevant regulatory agency,\textsuperscript{286} and still longer if the
agency determines that the bidding firm has not furnished all the inform-
ation required under the statute.\textsuperscript{287}

While an agency theoretically could expedite the decision-making
process by issuing written notice of its intent not to disapprove a pro-
posed takeover, federal regulators do not have the ability to grant auto-
matic approvals of proposed takeovers by individuals because the
federal banking agency is required to provide the appropriate state
banking agency with a copy of the bidder’s notice of his proposed ac-
quision.\textsuperscript{288} The federal regulators are required to provide the state
regulator with thirty days in which to make its views known.\textsuperscript{289}

The Change in Bank Control Act requires that the acquirer pro-
vide the relevant federal banking agency with his identity and the iden-
tity of each person on whose behalf he is making the acquisition,\textsuperscript{290}
along with their financial statements for the current year and the previ-
sous five years,\textsuperscript{291} the terms and conditions of the proposed acquisi-
tion,\textsuperscript{292} the identity of the acquirer and the source and terms of her
funding,\textsuperscript{293} and a description of the plans the acquirer has for the tar-
get bank.\textsuperscript{294}

These disclosure requirements track the disclosure provisions that
the Williams Act imposes on all firms,\textsuperscript{295} which make takeovers more
costly and reduce the monitoring of potential targets by prospective
bidders by permitting other bidders to free-ride on the costly research
done by the first bidders.\textsuperscript{296} What makes the Change in Bank Control
Act particulary costly is its requirement that bidders disclose their iden-
tity and plans in advance of an acquisition of control. This requirement

\textsuperscript{286} Id.
\textsuperscript{287} Id. § 1817(j)(1)(A) (Supp. IV 1986). The agency’s extension of the time pe-
riod may not, however, “exceed 2 additional times for not more than 45 days each time
....” Id. § 1817(j)(1).
\textsuperscript{288} Id. § 1817(j)(2)(A). The only exception is when the federal bank administra-
tors must act immediately to prevent a probable failure of the bank involved in the pro-
posed acquisition. Id.
\textsuperscript{289} Id.
\textsuperscript{290} Id. § 1817(j)(6)(A) (1982).
\textsuperscript{291} Id. § 1817(j)(6)(B).
\textsuperscript{292} Id. § 1817(j)(6)(C).
\textsuperscript{293} Id. § 1817(j)(6)(D).
\textsuperscript{294} Id. § 1817(j)(6)(E).
\textsuperscript{295} Section 13(d) of the Williams Act requires any person who obtains a beneficial
interest of more than five percent in a company to file with the SEC. 15 U.S.C.
§ 78m(d)(1) (1982). Such five percent purchasers must disclose the information con-
tained in Item 4 of Schedule 13D. Securities Exchange Act, Schedule 13D, Item 4, 17
C.F.R. § 240.13d-1, 240.13d-7 (1987). In addition, under rule 14D-1, any person who
makes a tender offer that will result in his becoming the beneficial owner of more than
five percent of any class of a company’s equity securities must file a schedule 14D-1. 17
\textsuperscript{296} See generally Easterbrook & Fischel, supra note 265, at 4–7 (discussing the
adverse effects of disclosure of information in the market context).
of advance regulatory approval of control transactions greatly facilitates the ability of other potential bidders to free-rider on the information generated by the initial bidder. This free-riding enables the management of target banks to engage in defensive tactics much earlier than would be possible in the absence of the statute. By contrast, the Williams Act imposes no advance notice requirement.297 Significantly, when the Williams Act initially was introduced in the Eighty-Ninth Congress, it did require disclosure twenty days in advance of a tender offer or large block acquisition,298 but the statute eventually was reformed to eliminate the advance disclosure requirements.299

There are several grounds upon which the appropriate federal banking agency may disapprove the proposed acquisition of a federally insured bank. Not only may a takeover be disapproved if it would lessen competition300 or result in a monopoly,301 but the regulators also may disapprove a proposed acquisition if they do not think well of the financial condition302 or management abilities of the acquirer.303 While these latter provisions have a surface appeal, upon reflection it is clear that banking administrators should not disapprove proposed acquisitions on the basis of the regulators' opinions of management quality or financial condition. Making an acquisition of a depository institution requires substantial capital. Not only must the acquisition be financed, but it must be financed in a manner that complies with


The Hart-Scott-Rodino Act of 1976 does require pre-acquisition filings if the persons who are parties to the transaction and the assets to be acquired are of a certain size. 15 U.S.C. § 18a (1982). Specifically, the requirement applies if one party to a transaction has sales or assets of $100 million or more and the other party has sales or assets of $10 million if engaged in manufacturing (or assets of $10 million if not engaged in manufacturing), and if the acquiring person will hold 15 percent of the voting stock or assets of the acquired person or voting stock or assets with a value in excess of $15 million. R. Gilson, The Law and Finance of Corporate Acquisitions 1084–85 (1986). But Hart-Scott-Rodino imposes substantially shorter advance notification provisions for tender offers—15 days for cash tender offers extendable by regulatory agencies to an additional ten days—than the banking regulations discussed above. 15 U.S.C. § 18a(b)(1)(B) (1982). Unlike the banking statutes, there was considerable sensitivity to the need for speed in consummating a tender offer. As Congressman Rodino said when the statute was promulgated, in "cash tender offers, more so than in other mergers, the equities include time and the danger of undue delay." 122 Cong. Rec. 30,877 (1976).


299. See Macey & Netter, supra note 297, at 194–35.


301. Id. § 1817(j)(7)(A).

302. Id. § 1817(j)(7)(C).

303. Id. § 1817(j)(7)(D).
regular capital-adequacy guidelines. As such, the typical bank acquisition will not involve a large cash purchase followed by the sale of major facets of the target firm's assets in order to finance the acquirer's purchase. Such a transaction would likely run afoul of bank capital-adequacy guidelines because the surviving bank would be left with an insufficient level of equity capital. Rather, the vast majority of bank acquisitions involve the issuance of equity. Shareholders of the bank being acquired will insist upon getting fair value for their shares, and shareholders of the acquirer will demand that the acquisition not dilute their equity interests. As a consequence, the danger that an acquirer might jeopardize the financial stability of the target, thereby prejudicing the interests of depositors, is not a realistic concern.

Similarly, regulators should not block proposed bank acquisitions on the grounds that they doubt the competence of the acquirer. If the acquirer is able to finance the acquisition while maintaining the capitalization of the target bank, then the capital markets believe the acquirer can adequately manage the bank. Thus, regulators should not block proposed acquisitions because they are concerned about the management abilities or financial condition of the acquirer so long as the target bank will emerge from the transaction with the same or better capitalization ratios as before.

As mentioned above, the Change in Bank Control Act applies whenever an individual seeks to gain control of an FDIC insured bank. In the more likely event that a bank wants to merge with another bank, the Bank Merger Act governs the terms of the transaction. And, if a corporation or bank holding company wants to launch a takeover of a bank, the Bank Holding Company Act applies.

The Bank Merger Act restricts the ability of banks to launch hostile takeovers of other banks in two ways. First, whenever an insured bank launches a two-tier bid, in which it makes a tender offer for a controlling interest in another bank to be followed by a subsequent merger, the Act applies to the merger in the second stage of the transaction. In

305. See Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Definition of Capital to be Used in Determining Capital Adequacy of National and State Member Banks and Bank Holding Companies (1983), reprinted in E. Symons & J. White, supra note 44, at 289-91 (describing bank capital adequacy requirements); see also, Coffee, Shareholders Versus Managers, supra note 242, at 41-52 (explaining why bust-up mergers result in high leverage for surviving firm).
306. If bank failure policies are changed, as suggested above, and if the newly reorganized bank were to fail, the costs would largely be shared by uninsured depositors, equity claimants, and the FDIC. Clearly, uninsured depositors who felt that the new venture had a low probability of success would withdraw their funds and redeplore them. As such, the new equity claimants have a strong incentive to provide such depositors with credible assurances that their funds will be safe.
308. Id. § 1842.
addition, the Act applies whenever a bank assumes liability to pay deposits of another bank, which is the case whenever a bank seeks to take over another bank in a hostile transaction.

Like the Change in Bank Control Act, the Bank Merger Act requires the prior approval of the relevant federal banking administrator before one bank can merge or consolidate with another bank.\textsuperscript{309} In addition, unless the appropriate agency decides it must act immediately in order to prevent the probable failure of one of the banks involved in the transaction, the acquirer must publish notice of the proposed transaction, prior to its approval by the relevant administrative agency, in a newspaper of general circulation in the community where the banks involved are located.\textsuperscript{310} The notice must be published "at appropriate intervals" for thirty calendar days.\textsuperscript{311}

In addition to the publication requirement, the Bank Merger Act further requires that the relevant administrative agency notify the Attorney General and the other two federal banking agencies of the proposed transaction. The Attorney General and these administrative agencies must report to the governing agency within thirty days on the competitive factors involved in the transaction.\textsuperscript{312}

And, as with the Change in Bank Control Act, no control transaction will be approved if the responsible agency thinks ill of the managerial expertise or financial resources of the acquiring bank.\textsuperscript{313} But, unlike the Change in Bank Control Act, the Bank Merger Act does not allow transactions between currently solvent banks to take place until thirty days after regulatory approval has been granted, thus greatly in-

\begin{itemize}
\item \textsuperscript{309} Id. § 1828(c)(1)-(2).
\item \textsuperscript{310} Id. § 1828(c)(3). The public-interest justification for requiring advanced notification is not clear. Perhaps advance notification permits customers, and other banks, to register their concern about the possible anti-competitive effects of a proposed merger, but customers seldom are involved in the process, and competitors have such an obvious conflict of interest in opposing the proposed merger that it is doubtful that their input would be useful.
\item An additional justification for publication of banks' merger plans is that it notifies local community groups and political organizations of proposed mergers so that they will have the opportunity to object. Under the Community Reinvestment Act, id. §§ 2901-2905, banks may not expand through merger or otherwise unless the merging banks have met the credit needs of the communities they currently serve. In determining whether a bank has met community needs, the federal regulators must "assess the institution's record of meeting the credit needs of the entire community, including low and moderate income neighborhoods." Id. § 2903. For a useful analysis of the Community Reinvestment Act, see T. DiLorenzo, The Anti-Business Campaign of the Legal Services Corporation 9 (Center for the Study of American Business at Washington University, monograph, Apr. 1988) (arguing that community activists who oppose bank mergers under the Community Reinvestment Act are acting contrary to the public interest by forcing side payments to the community groups and wasting the bank's assets).
\item \textsuperscript{311} 12 U.S.C. § 1828(c)(3)(C), (c)(4) (1982). If the regulators declare that an emergency exists, the period is reduced to ten days.
\item \textsuperscript{312} Id. § 1828(c)(4).
\item \textsuperscript{313} Id. § 1828(c)(5).
\end{itemize}
creasing the market risk to which the acquiring firm is exposed.314

The Bank Holding Company Act, which governs bank acquisitions by corporations, including bank holding companies, closely resembles the Bank Merger Act. A corporation or bank holding company must obtain approval of the Board to acquire more than five percent of a bank's stock, to acquire all or substantially all of a bank's assets, or to merge or consolidate with another bank holding company. The Federal Reserve Board has the authority to approve these transactions,315 but the supervising agency of the bank being acquired must also be notified of the proposed transaction. For example, if the bank being acquired is a state chartered bank, the Federal Reserve Board must give the relevant state banking supervisor thirty days in which to prepare a report on the acquisition of the bank by a corporation. If the bank being acquired is a national bank, the Comptroller must be given an opportunity to express his views.316 If the state supervisory authority or the Comptroller disapprove of the transaction, the Board is required to hold a hearing at which all interested parties have a reasonable opportunity to testify. In addition, further delay is built into the system because the Federal Reserve Board may not begin the hearings until ten days after the Board has given written notice to the acquiring corporation of the decision of the disapproving authority.317

Thus, the Bank Holding Company Act grants the Federal Reserve Board what in practical effect amounts to veto power over proposed takeovers of banks by bank holding companies and other corporations. The prior regulatory approval deprives bidders of any element of surprise and enables the regulatory authority with the closest relationship to the target firm to cause lengthy delays by requiring that hearings be held. At these hearings the incumbent management of the banks being acquired can cause even more delay by providing lengthy testimony on the proposed takeover.

Unlike the Bank Merger Act, there is no requirement under the Bank Holding Company Act that the Federal Reserve notify the Attorney General in advance of the transaction. The absence of this notification requirement does not expedite takeovers by corporations however. First, the Holding Company Act, as mentioned above, contains a requirement not present in the Bank Merger Act that the appropriate state supervisory authority be notified. These state supervisory authorities often will be reluctant to approve these transactions when the new corporate structure removes the surviving bank from the state's regulatory jurisdiction. And, while the Bank Holding Company Act does not require prior regulatory approval of the Attorney General, the Justice

314. Id. § 1828(c)(6). This period can be shortened if needed to avert the "probable failure of one of the banks involved." Id.
315. Id. § 1842(a)(1).
316. Id. § 1842(b).
317. Id.
Department has a 30-day period after an approval in which to attack the bank holding company acquisition in court.\textsuperscript{318}

A useful contrast to the various bank merger statutes is the Williams Act, which regulates tender offers and open market purchases of registered or widely traded securities.\textsuperscript{319} The statute was rejected in the form in which it was first introduced by Senator Williams because it was widely thought to reflect a pro-management bias. But this statute, even in its earliest incarnation, did not place constraints on control transactions as severe as those imposed on banks. For example, early versions of the Williams Act that required a five day advance filing before the commencement of a tender offer were rejected because it was felt that “prior review was not necessary and in some cases might delay the offer when time was of the essence.”\textsuperscript{320} The Bank Merger Act and the Bank Holding Company Act both require a minimum of thirty days notice to regulators, and the Change in Bank Control Act envisions an advance notice period of at least sixty days before approval of a transaction. Once Congress enacted the Williams Act, it contained no advance notice requirement at all in order to avoid “tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid.”\textsuperscript{321}

By contrast with the certainty of the Williams Act, bidders attempting to acquire control of a bank must await agency approval for an uncertain period, the length of which is within the discretion of the administrative agency. This delay increases the probability that the proposed acquisition will lose economic value in the eyes of one party or the other. If one of the parties is risk averse, it will demand compensation for this risk. If both sides are risk averse, they will both demand compensation, possibly negating the transaction. In addition, a forewarned target has greater opportunity to find a white knight who can free-ride on the search costs already expended by the acquirer. As a consequence, an acquirer must increase its estimate of the search costs to reflect the probability that the search will be fruitless because of a free-rider, successful defensive tactics, or regulatory disapproval.\textsuperscript{322}

Under the current regulatory structure, every transfer of control of an insured bank involves at least three regulatory authorities. By dramatically increasing the costs of acquiring banks, this byzantine regulatory structure effectively deprives prospective bidders of incentives to engage in costly monitoring activities that serve the socially desirable goal of identifying undervalued and mismanaged banks. The regulatory structure thus increases the incidence of bank failure by lowering

\begin{footnotesize}
\textsuperscript{318} Id. § 1849(b). In cases of emergency, this period is shortened to five days. Id.
\textsuperscript{319} See generally L. Loss, Fundamentals of Securities Regulation ch. 7(E) (1983) (discussing the provisions of the Williams Act).
\textsuperscript{321} Id. at 3.
\textsuperscript{322} See Easterbrook & Fischel, supra note 226, at 705, 711 n.32.
\end{footnotesize}
the motivating influence that the prospect of hostile takeover has on incumbent management.

The current regulatory structure governing bank takeovers also increases the likelihood of bank failure by eliminating the least cost route of exit through which poorly managed or obsolete banks can leave the banking business. Exit under these circumstances is feasible under the current regulatory scheme only when the incumbent management of the troubled bank recognizes the need to have the bank's assets redeployed. It is clear, however, that in many cases incumbent management, for reasons of its own, will not willingly agree to a merger. In such cases, the only way that the bank's assets will be redeployed is through the insolvency process, which is not only far more cumbersome, but also far more costly to third parties.323

Furthermore, the statutes governing bank transfers of control serve no socially desirable policy function to offset the costs involved.324 Rather, these statutes primarily serve the interest of incumbent management by protecting them against displacement by hostile takeovers.

Besides the argument that the current regulatory scheme is needed to insure that banks are not taken over by unsavory characters, the most often heard justification for the current regulatory structure is that it prevents transactions between banks that lead to undue levels of economic concentration. This argument is wholly unconvincing.325 No one has suggested that monopoly problems are more acute for banks than for other businesses or that the problems require intervention by more than one regulatory agency.

C. Suggestion for Reform of the Market for Bank Control

United States banks are small by international standards and the banking industry is atomistic by comparison to other countries.326

323. Third party claimants whose claims would have been paid in a merger but not in an insolvency are harmed.

324. Macey, supra note 234 (discussing and refuting claims that anti-takeover statutes serve such socially desirable purposes as preventing expropriation of wealth by shareholders, protecting the jobs of local workers, and eliminating managerial preoccupation with short-term profits at the expense of long-term corporate development).

325. See Jensen & Ruback, supra note 243, at 27 ("The evidence indicates that merger gains do not come from the acquisition of market power, but rather from . . . efficiencies . . . available to rival firms. . . .")


In terms of assets, U.S. banks do not even appear among the top five banks in the world, and only one U.S. bank (Citibank) ranks among the top ten banks. In terms of total size of deposits, there are no U.S. banks among the top fifteen banks in the world. There are only four U.S. banks (Citibank, Bank of America, Chase Manhattan Bank and Morgan Guaranty Trust Company) among the top fifty in the world in terms of assets. When ranked by deposits, only three U.S. banks make the top fifty in the world (Ci-
These facts may provide additional reasons why regulators should encourage rather than discourage mergers of healthy banks as well as of unhealthy banks, assuming the existence of economies of scale or scope in banking.\textsuperscript{327} Because mergers are low-cost economic substitutes for insolvency proceedings, it is particularly ironic that regulators rush to approve mergers between healthy banks and insolvent banks, while the regulatory structure impedes the consolidation of healthy banks at every turn.

Bank holding companies and banks that can amass the necessary capital ought to be permitted to launch tender offers for other banks with a minimum of regulatory interference. First, banking regulators ought to promulgate unambiguous and widely known standards regarding concentration levels for purposes of bank mergers.\textsuperscript{328} These standards would permit a prospective offeror to know in advance whether its purchase is likely to be attacked under the antitrust laws. For an industry in which regulators have the authority to block the entry of new competitors by refusing to grant them bank charters, it is ironic that mergers can be turned down on competitive grounds. If a merger truly resulted in a diminution in competition, the problem could be remedied by passing new laws permitting more liberal expansion of branch activity and by making it easier for individuals to obtain bank charters (subject to the power of the chartering agency to reject unqualified or unreliable applicants), thus increasing competition in the provision of bank services.

Most important, the Comptroller, the Federal Reserve Board and the FDIC should announce a policy of automatic approval of bank take-over proposals so long as the acquiring bank is itself considered to be financially stable. In all cases, the review process should be kept as short as possible, and when feasible, kept confidential from the management of the target bank until the Williams Act requires disclosure.

The banking agencies should consider adopting a procedure similar to that which the Federal Communications Commission (FCC) has adopted in order to expedite the approval process for transfers of broadcast licenses in the context of tender offers for corporate control. Ordinarily an applicant for transfer of a license must follow a "long-form" application procedure.\textsuperscript{329} In the context of tender offers for broadcast companies, however, the FCC allows the use of a "short-form" application for special temporary authorization to have a voting trusteeship operate the acquired company pending receipt of long-

\textsuperscript{327} See Baltensperger, Economies of Scale, Firm Size, and Convention in Banking, 4 J. Money, Credit & Banking 467 (1972).

\textsuperscript{328} E.g., 1984 Justice Department Merger Guidelines.

form approval. If the short-form application is approved, the acquirer may consummate the tender offer and pay for the tendered shares even though the FCC has not granted long-form approval. During the interim period between approval of the short-form application and final approval of the long-form application, the trustees control the stock of the acquired company.

In addition, Congress should revise the bank takeover statutes to mitigate the constraints on hostile acquisitions of banks. Indeed, there is a strong argument that the market for control of banks should be less constrained than the market for corporate control generally. Because most of the fixed claimants of banks have their claims insured by the FDIC, they have no incentive to monitor the banks themselves and so the need for outside monitoring of banks is more acute than for other firms. A robust market for bank control would provide at least one level of outside monitoring of bank management and would therefore reduce the incidence of failure resulting from management ineptitude.

**Conclusion**

In the modern corporation there exists two principal sources of constraints on management’s activities—the market for corporate control and the wide variety of contractual provisions and incentive plans through which shareholders and fixed claimants regulate excessive risk taking and control managerial misfeasance.

The current regulatory scheme governing the behavior of banks greatly reduces the efficacy of both these sets of constraints. The current policy of waiting until a bank has officially been declared insolvent before permitting merger activity eliminates the disciplinary effect that the market for corporate control might have on bank management. The goal of the regulatory system should be to provide private parties with incentives to monitor bank management and control excessive risk taking by banks. This can be done by eliminating the provisions of the Bank Merger Act, the Change in Bank Control Act and the Bank Holding Company Act that require prior regulatory approval of bank takeovers and permit such transactions to be delayed by lengthy hearings. In addition, regulatory policies concerning bank failures and brokered deposits should be amended to recognize that some bank failures serve important social goals and thus should be allowed to occur in such a way that uninsured depositors face loss of their deposits. But even when the decision is made to salvage a bank after it has become insolvent by merging it with another bank, uninsured depositors should in

331. See supra notes 183–221 and accompanying text.
332. See supra notes 71–182 and accompanying text (describing bank failure policies).
every case be required to bear their full pro rata share of the losses from bank failure.

These proposed major changes to the rules governing bank takeovers and procedures for handling insolvencies would reduce the incidence of bank failures by providing a continuous source of monitoring and discipline of bad management teams. Such monitoring would not only reduce the high incidence of bank failures due to fraud and mismanagement, but would also reduce the incidence of failures due to insufficient asset diversification and fluctuations in the business cycle, as superior management teams capable of properly diversifying banks' asset portfolios replace those teams unwilling or unable to do so.