Article

Solving Banking's "Too Big To Manage" Problem

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INTRODUCTION

In a *Saturday Night Live* sketch that aired during the 2016 Democratic Presidential primaries, a town hall questioner played by *Seinfeld* actress Julia Louis-Dreyfus asks "Bernie Sanders" how he plans to break up the banks. Sanders, portrayed by *Seinfeld* creator Larry David, responds, "Once I'm elected President, I'll have a nice schvitz in the White House gym, then I'll go to the big banks, I'll sit them down, and yada, yada, yada, they'll be broken up."[1]

This sketch illustrates an important paradox: everyone dislikes big banks, but no one knows what to do about them. Bernie Sanders is perhaps the best-known big bank critic, but he is far from alone. Indeed, policymakers as diverse as Elizabeth Warren, John McCain, Newt Gingrich, and even President Donald Trump have called for shrinking the largest financial firms.[2] In

1. *Saturday Night Live: Brooklyn Democratic Debate Cold Open* (NBC television broadcast Apr. 16, 2016), https://www.nbc.com/saturday-night-live/video/brooklyn-democratic-debate-cold-open/3021115 [https://perma.cc/X8QV-5SLK]. After Louis-Dreyfus protests that Sanders "yada yada'd over the best part," Sanders replies, "No, I mentioned the schvitz." *Id.* The exchange parodies the famous *Seinfeld* episode, "The Yada." *Seinfeld: The Yada* (NBC television broadcast Apr. 24, 1997), https://www.youtube.com/watch?v=3CKyWu87W78 [https://perma.cc/EJ8C-Z3UD].

2. *See* Donna Borak, *Warren, McCain Push for Return of Glass-Steagall*,

fact, both the Democratic and Republican parties endorsed breaking up the banks in their policy platforms for the 2016 election.[3]

This apparent consensus in favor of breaking up the banks stems, in large part, from a perception that some U.S. financial institutions are "too big to manage" (TBTM). A financial institution is TBTM if its size prevents executives, board members, and shareholders from effectively overseeing the firm, leading to excessive risk-taking and misconduct.[4] Officials from both the Obama and Trump Administrations have cited the TBTM problem as a catalyst for the 2008 financial crisis.[5] On this view, many of the largest U.S. financial companies collapsed because stakeholders were unable to monitor the firms' risk profiles.

The TBTM problem differs from another common critique of large financial institutions: that they are too big to fail. Critics allege that the U.S. government bailed out major financial companies—including Bank of America, Citigroup, and American International Group—because these firms were so large that they would have threatened the broader financial system had

AM. BANKER (July 11, 2013), https://www.americanbanker.com/news/warren-mccain-push-for-return-of-glass-steagall; Dan Freed, *Gingrich Would Break Up Big Banks*, THE STREET (Nov. 14, 2011), https://www.thestreet.com/story/11309884/1/gingrich-would-break-up-big-banks.html [https://perma.cc/LT2T-WPMZ]; Akane Otani & Ryan Tracy, *President Trump Says He's Looking into Breaking Up Wall Street Banks*, WALL ST. J. (May 1, 2017), https://www.wsj.com/articles/president-trump-says-hes-looking-into-breaking-up-wall-street-banks-1493660319.

3. *See* DEMOCRATIC PLATFORM COMM., 2016 DEMOCRATIC PARTY PLATFORM 10–11 (2016), https://democrats.org/wp-content/uploads/2018/10/2016_DNC_Platform.pdf [https://perma.cc/SAT8-KAUB]; REPUBLICAN PLATFORM COMM., REPUBLICAN PLATFORM 2016 3, 28 (2016), https://prod-cdn-static.gop.com/media/documents/DRAFT_12_FINAL%5B1%5D-ben_1468872234.pdf [https://perma.cc/D4VG-2KLB].

4. *See* Andrew Hill, *When Is a Company Too Big to Manage?*, FIN. TIMES (Feb. 27, 2015), https://www.ft.com/content/87395500-bdd2-11e4-8cf3-00144feab7de.

5. *See* Suzanne McGee, *Financial Nominees Prove Just How Disconnected Trump Is From Reality*, GUARDIAN (Jan. 21, 2017), https://www.theguardian.com/us-news/us-money-blog/2017/jan/21/trump-financial-picks-steve-mnuchin-wilbur-ross [https://perma.cc/3Z3R-SXSY] (quoting Commerce Secretary Wilbur Ross asserting that Wall Street banks were too big to manage before the crisis); Matthew Zeitlin, *Why Tim Geithner Doesn't Think Anybody Will Ever Forgive Him*, BUZZFEED NEWS (May 22, 2014), https://www.buzzfeednews.com/article/matthewzeitlin/why-tim-geithner-doesnt-think-anybody-will-ever-forgive-him [https://perma.cc/5GLJ-SBAJ] (quoting former Treasury Secretary Tim Geithner acknowledging the TBTM problem).

they failed.[6] After the crisis, the Dodd-Frank Act created a new liquidation process that, in theory, would allow the government to wind down a major financial conglomerate with minimal systemic consequences.[7] While some skeptics question whether this mechanism will work in practice,[8] proponents contend that Dodd-Frank's liquidation authority alleviates the too-big-to-fail problem.[9] Because Dodd-Frank does not shrink the size of the largest financial institutions, however, many commentators agree that the TBTM problem persists.[10]

6. *See, e.g.*, Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 951, 993–1014 (2011); *see also* Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 474 (2009) (explaining the "too-big-to-fail" phenomenon).

7. *See* Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Pub. L. No. 111-203, § 204, 124 Stat. 1376, 1454 (2010) (codified at 12 U.S.C. § 5384 (2012)).

8. *See, e.g.*, Peter Conti-Brown, *Elective Shareholder Liability*, 64 STAN. L. REV. 409, 421–23 (2012) (asserting that Dodd-Frank increases the likelihood of future bailouts); John Crawford, *"Single Point of Entry": The Promise and Limits of the Latest Cure for Bailouts*, 109 NW. UNIV. L. REV. ONLINE 103, 110–12 (2014) (expressing skepticism that the new Orderly Liquidation Authority (OLA) will work as intended); Howell E. Jackson & Stephanie Massman, *The Resolution of Distressed Financial Conglomerates*, 3 RUSSELL SAGE FOUND. J. SOC. SCI. 48, 51–56 (2017) (explaining the challenges of implementing the OLA regime); Roberta S. Karmel, *An Orderly Liquidation Authority Is Not the Solution to Too-Big-to-Fail*, 6 BROOK. J. CORP. FIN. & COM. L. 1, 6 (2011) (discussing problems with the OLA regime); Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 439 (2011) (asserting that bailouts are inevitable in modern economies); Stephen J. Lubben & Arthur E. Wilmarth, Jr., *Too Big and Unable to Fail*, 69 FLA. L. REV. 1205, 1223–43 (2017) (discussing shortcomings of the OLA); Steven L. Schwarcz, *Beyond Bankruptcy: Resolution as a Macroprudential Regulatory Tool*, 94 NOTRE DAME L. REV. 709, 718–19 (2018) (questioning OLA's efficacy); David Zaring, *A Lack of Resolution*, 60 EMORY L.J. 97, 138–53 (2010) (proposing improvements to OLA). *See generally* Thomas W. Merrill & Margaret L. Merrill, *Dodd-Frank Orderly Liquidation Authority: Too Big for the Constitution?*, 163 U. PA. L. REV. 165 (2014) (raising constitutional objections to the OLA).

9. *See, e.g.*, Lindsay Dunsmuir & Ann Saphir, *Fed Chair Nominee Powell Sees No Too-Big-to-Fail Banks*, REUTERS (Nov. 28, 2017), https://www.reuters.com/article/us-usa-fed-powell-banks/fed-chair-nominee-powell-sees-no-too-big-to-fail-banks-idUSKBN1DS260 [https://perma.cc/949W-3PQG] (quoting Federal Reserve Chairman Jerome Powell asserting that post-crisis reforms have eliminated the too-big-to-fail problem).

10. *See, e.g.*, BARTLETT COLLINS NAYLOR, TOO BIG: THE MEGA-BANKS ARE TOO BIG TO FAIL, TOO BIG TO JAIL, AND TOO BIG TO MANAGE 45–46 (2016); Ben W. Heineman, Jr., *Too Big to Manage: JP Morgan and the Mega Banks*, HARV. BUS. REV. (Oct. 3, 2013), https://hbr.org/2013/10/too-big-to-manage-jp-morgan

Despite this apparent consensus, policymakers have not settled on a solution to the TBTM issue. Scholars, legislators, and think tanks have proposed various strategies to break up the banks.[11] Some big bank critics, for example, would institute a size limit on U.S. financial institutions.[12] Others favor reinstating the Glass-Steagall Act, which would force financial conglomerates to separate their banking and nonbanking operations.[13] Still others support a "soft break-up," in which stricter regulations would incentivize TBTM firms to shrink.[14] To date, however, none of these reforms has garnered significant political support, and prospects for future legislative action are dim.[15]

In the meantime, the largest U.S. financial conglomerates have grown even bigger since the financial crisis. JPMorgan and Bank of America, for example, are more than fifty percent larger today than they were in 2007.[16] Scandal-ridden Wells Fargo, meanwhile, has more than tripled in size.[17] Amidst this unprecedented growth, JPMorgan's $6 billion London Whale trading

-and-the-mega-banks [https://perma.cc/THT2-KDEK]; Christine Wang, *Wells Fargo Is 'Too Big to Regulate, Manage,' Says Trade Group CEO*, CNBC (Sept. 14, 2016), https://www.cnbc.com/2016/09/14/wells-fargo-is-too-big-to-regulate-manage-says-trade-group-ceo.html [https://perma.cc/7ZUR-PPV7].

11. For simplicity, this Article uses the term "bank" to refer to both a commercial bank and its parent holding company. Where relevant, the Article will distinguish between a bank holding company (BHC) and its subsidiary bank.

12. These proposals would cap a financial institution's assets or liabilities at a specific dollar amount or as a percentage of gross domestic product (GDP). *See infra* Part II.B.1.

13. *See infra* Part II.B.2.

14. *See infra* Part II.B.3.

15. *See infra* Part II.A; *see also* Arthur E. Wilmarth, Jr., *Narrow Banking: An Overdue Reform that Could Solve the Too-Big-to-Fail Problem and Align U.S. and U.K. Regulation of Financial Conglomerates*, 31 BANKING & FIN. SERVICES. POL'Y REP. 1, 2 (2012) ("[I]t seems highly unlikely—especially in light of megabanks' enormous political clout—that Congress could be persuaded to adopt such draconian limits . . . .").

16. *Compare* JPMorgan Chase & Co., Quarterly Report (Form 10-Q) 69 (Aug. 9, 2007), *and* Bank of Am. Corp., Quarterly Report (Form 10-Q) 4 (Aug. 8, 2007), *with* JPMorgan Chase & Co., Quarterly Report (Form 10-Q) 88 (Oct. 31, 2018), *and* Bank of Am. Corp., Quarterly Report (Form 10-Q) 56 (Oct. 29, 2018) (showing that JPMorgan's assets increased from $1.46 trillion to $2.62 trillion and Bank of America's assets increased from $1.53 trillion to $2.34 trillion between June 30, 2007 and September 30, 2018).

17. *Compare* Wells Fargo & Co., Quarterly Report (Form 10-Q) 40 (Aug. 8, 2008), *with* Wells Fargo & Co., Quarterly Report (Form 10-Q) 71 (Nov. 6, 2018) (showing that Wells Fargo's total assets increased from $609 billion to $1.87 trillion between June 30, 2008 and September 30, 2018).

loss, Wells Fargo's fraudulent accounts scandal, and other misconduct by big banks have added urgency to solving the TBTM problem.[18]

This Article presents the first scholarly analysis of the TBTM issue.[19] It asserts that big banks face unique governance challenges—including extreme opacity, run risk, and weak market discipline—that expose these institutions to excessive risk-taking and misconduct.[20] Despite these managerial impediments, however, TBTM banks will not voluntarily break themselves up because they benefit from implicit government subsidies unavailable to smaller firms.[21] Thus, while there are many reasons to believe that some banks are TBTM, there is little reason to trust that banks will solve the issue on their own. A public policy response is therefore necessary to fix the TBTM problem.

This Article contends that existing proposals to solve the TBTM problem suffer from critical shortcomings. Breaking up all of the largest U.S. financial institutions could have detrimental unintended consequences. Once broken up, for example, JPMorgan, Citigroup, and other U.S. firms might struggle to

18. *See* Jeremy C. Kress, *Board to Death: How Busy Directors Could Cause the Next Financial Crisis*, 59 B.C. L. REV. 877, 904–13 (2018) (discussing JPMorgan's London Whale trading losses and Wells Fargo's fraudulent accounts scandal).

19. To be sure, scholars have analyzed other aspects of the "too big" problem. Some contend that banks remain "too big to fail." *See, e.g.*, Roberta S. Karmel, *Is the Public Utility Holding Company Act a Model for Breaking Up the Banks That Are Too-Big-to-Fail?*, 62 HASTINGS L.J. 821, 837–43 (2011); Charles W. Murdock, *The Big Banks: Background, Deregulation, Financial Innovation, and "Too Big to Fail,"* 90 DENV. U. L. REV. 505, 546–51 (2012); Saule T. Omarova, *The "Too Big to Fail" Problem*, 103 MINN. L. REV. 2495, 2499–504 (2019); Mark J. Roe, *Structural Corporate Degradation Due to Too-Big-to-Fail Finance*, 162 U. PA. L. REV. 1419, 1428–29 (2014); Wilmarth, Jr., *supra* note 6, at 963–80. Others assert that banks are "too big to jail." *See, e.g.*, Jerry W. Markham, *Regulating the "Too Big to Jail" Financial Institutions*, 83 BROOK. L. REV. 517, 565–69 (2018); Nizan Geslevich Packin, *Breaking Bad? Too-Big-to-Fail Banks Not Guilty as Charged*, 91 WASH. U. L. REV. 1089, 1092–94 (2014). Still other scholars maintain that banks are "too big to supervise." *See, e.g.*, Lev Menand, *Too Big to Supervise: The Rise of Financial Conglomerates and the Decline of Discretionary Oversight in Banking*, 103 CORNELL L. REV. 1527, 1583 (2018). To date, however, scholars have largely neglected the managerial aspects of the "too big" problem.

20. *See infra* Part I.B.2.

21. *See infra* Part I.B.3.

compete with their larger international counterparts.[22] Similarly, shrinking the banks could reduce economies of scale, making large financial institutions—and the broader financial system—less efficient.[23] Moreover, if policymakers were to reinstate the Glass-Steagall Act, financial institutions might become less diversified and, thus, less stable.[24] In sum, even if it were politically possible, breaking up all large U.S. banks could create more problems than it solves.

This Article proposes a better solution to the TBTM problem. It recommends that financial regulators use their existing statutory authorities to require that a financial conglomerate divest operations when it falls out of compliance with minimum regulatory standards. Regulators could use these authorities to compel a troubled financial conglomerate to sell certain subsidiaries, spin them off to shareholders as separately capitalized companies, or shutter them entirely. Regulators might, for example, order Wells Fargo to divest its scandal-plagued wealth management unit or notoriously troubled Deutsche Bank to cease its U.S. banking operations.[25]

Forced divestitures are better than other plans to break up the banks for four reasons. First, the threat of such a significant sanction would increase financial conglomerates' incentives to

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22. *See, e.g.*, Steve Henn, *Officials Fear Systemic Risks of Bailout*, MARKETPLACE (Oct. 21, 2009), https://www.marketplace.org/2009/10/21/business/fallout-financial-crisis/officials-fear-systemic-risks-bailout/ [https://perma.cc/283L-N993] (statement of Harvard Law School Professor Hal Scott) ("[I]f we break up our banks and Europe doesn't break up theirs and the Chinese don't break up theirs, this is going to have an immense impact on who are the players in the international banking system.").

23. *See* FIN. STABILITY OVERSIGHT COUNCIL, STUDY OF THE EFFECTS OF SIZE AND COMPLEXITY OF FINANCIAL INSTITUTIONS ON CAPITAL MARKET EFFICIENCY AND ECONOMIC GROWTH 9 (2016) [hereinafter 2016 FSOC REPORT] ("The preponderance of evidence from empirical studies . . . seems to be consistent with the notion that financial institutions are characterized by economies of scale.").

24. *See* Jonathan R. Macey & James P. Holdcroft, Jr., *Failure Is an Option: An Ersatz-Antitrust Approach to Financial Regulation*, 120 YALE L.J. 1368, 1411 (2011).

25. *See generally* Emily Glazer, *Whistleblowers Detail Wells Fargo Wealth Management Woes*, WALL ST. J. (July 27, 2018), https://www.wsj.com/articles/whistleblowers-detail-wells-fargo-wealth-management-woes-1532707096 (discussing allegations of illegal sales practices in Wells Fargo's wealth management business); Jenny Strasburg & Ryan Tracy, *Deutsche Bank's U.S. Operations Deemed Troubled by Fed*, WALL ST. J. (June 1, 2018), https://www.wsj.com/articles/deutsche-banks-u-s-operations-deemed-troubled-by-fed-1527768310 (discussing Deutsche Bank's long-standing regulatory problems).

operate prudently. Second, divestitures would safeguard the broader financial system by reducing the systemic footprint of banks that fail to comply with minimum regulatory requirements. Third, in contrast to more draconian break-up proposals, targeted divestitures would affect relatively few firms and thereby preserve economies of scale and scope for most financial conglomerates. Finally, unlike some politically infeasible break-up plans, no new legislation is required because Congress has already authorized regulators to mandate divestitures under existing law.

The financial regulatory agencies, in fact, have several underutilized authorities empowering them to order divestitures.[26] The most promising of these authorities permits the Federal Reserve to compel a poorly managed financial conglomerate to discontinue its nonbanking subsidiaries. Historically, bank holding companies (BHCs) have been limited to engaging in traditional banking and closely related activities, such as taking deposits and making loans.[27] In 1999, however, Congress authorized a new type of BHC—called a financial holding company (FHC)—to engage in an expanded range of financial activities, including investment banking and insurance underwriting.[28] To become an FHC and engage in these activities, a BHC and its subsidiary banks must be well capitalized and well managed, as measured by an annual supervisory examination.[29] Under section 4(m) of the Bank Holding Company Act (BHC Act), if an FHC ceases to be well capitalized and well managed, the Federal Reserve may order it to divest its nonbanking subsidiaries.[30]

The Federal Reserve has never exercised its divestiture authority under section 4(m), despite many opportunities. Indeed, nearly forty percent of large FHCs do not currently satisfy the well-managed requirement to continue engaging in nonbanking activities.[31] The Federal Reserve has not publicly explained why

26. *See infra* Part III.B.

27. *See* 12 U.S.C. § 1843(a)(2) (2012) (authorizing BHCs to engage in banking activities); *see also* 12 U.S.C. § 1843(c)(8) (authorizing BHCs to engage in activities that are "so closely related to banking as to be a proper incident thereto").

28. 12 U.S.C. § 1843(k)(4).

29. 12 U.S.C. §§ 1843(j)(4)(A)–(B), (*l*)(1).

30. 12 U.S.C. § 1843(m).

31. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., SUPERVISION AND REGULATION REPORT 15 (2018) [hereinafter SUPERVISION AND REGULATION REPORT]. It is unlikely, however, that the Federal Reserve would need to compel all of these FHCs to divest their nonbanking operations. Faced with the threat

it declines to enforce section 4(m). This Article asserts that the agency's longstanding neglect of section 4(m) has become a self-fulfilling prophecy. Because the Federal Reserve has not invoked section 4(m) in more than twenty years, the agency now risks that its first use of section 4(m) will be perceived as arbitrary.[32]

This Article urges the Federal Reserve to exercise its section 4(m) power in appropriate circumstances, and it proposes a framework to put this authority into practice. This Article recommends that the Federal Reserve adopt a regulation requiring an FHC to divest its nonbanking operations if it fails to comply with the well-capitalized or well-managed requirements for more than two years. By implementing a regulation through notice-and-comment rulemaking, the Federal Reserve would combat perceptions of arbitrariness when it ultimately exercises its section 4(m) authority. Moreover, by increasing incentives for FHCs to comply with regulatory requirements, and by breaking up FHCs that fail to do so, this divestiture framework could help solve the TBTM problem.

This Article proceeds as follows. Part I describes the origins of TBTM banks and assesses how their vast size impedes effective management, as demonstrated by several high-profile examples. Part II then evaluates three prominent proposals to break up TBTM financial institutions—capping banks' asset size, reinstating Glass-Steagall, and incentivizing a "soft break-up." It concludes that each proposal is politically infeasible and, in any event, could suffer from unintended consequences. Part III introduces divestitures as a better way to solve the TBTM problem. It reviews financial regulators' existing authorities to require divestitures, and it argues that section 4(m) of the BHC Act is the most compelling of these authorities. Part IV proposes a novel framework for the Federal Reserve to put its section 4(m) divestiture authority into practice. Finally, Part V responds to anticipated objections.

I. THE TBTM PROBLEM

The 2008 financial crisis demonstrated unequivocally that some U.S. financial institutions have become too big to manage prudently. This Part examines the problem of TBTM financial

of a significant sanction, firms would invest in improving their risk management and corporate governance. The Federal Reserve, in turn, would upgrade the supervisory status of firms for which a divestiture sanction would be unnecessary. *See infra* Part V.A.

32. *See infra* Part III.C.1.

conglomerates. Section I.A begins by reviewing how some U.S. financial companies became TBTM. Section I.B then analyzes why large financial conglomerates might be susceptible to mismanagement. Finally, Section I.C assesses how the TBTM problem contributed to excessive risk-taking and misconduct during and after the financial crisis through brief case studies of American International Group (AIG), JPMorgan, and Wells Fargo.

A. ORIGINS OF THE TBTM PROBLEM

U.S. banks have not always been as large as they are today. To the contrary, TBTM financial conglomerates are a relatively recent phenomenon, with many firms growing dramatically within the past half-century.[33] This rapid consolidation occurred in three distinct phases, as banks took advantage of relaxed geographic restrictions, loosened activities prohibitions, and crisis-era mergers.[34] This Section traces the evolution of U.S. banks from single branch offices to multinational conglomerates.

1. The Demise of Geographic Restrictions

Until the mid-twentieth century, U.S. banks were subject to onerous geographic restrictions that effectively limited their size. Congress prohibited national banks from branching, and many states prevented state-chartered banks from opening more than one office.[35] Even in states that allowed *intra*-state branching, *inter*-state branching was impermissible.[36] When bank owners began to form BHCs to acquire control of multiple banks—and thereby evade branching restrictions—Congress forbade a BHC from acquiring an interstate bank absent statutory authorization from the target bank's home state.[37] No state adopted the requisite authorizing legislation.[38] Thus, for much of the early

33. *See* Hubert P. Janicki & Edward Simpson Prescott, *Changes in the Size Distribution of U.S. Banks: 1960–2005*, 92 FED. RES. BANK OF RICHMOND ECON. Q. 291, 293 fig.2 (2006).

34. *See* MICHAEL S. BARR ET AL., FINANCIAL REGULATION: LAW AND POLICY 54–58, 714–15, 726–29 (2d ed. 2018).

35. Christian A. Johnson & Tara Rice, *Assessing a Decade of Interstate Bank Branching*, 65 WASH. & LEE L. REV. 73, 79–80 (2018) (noting that the Comptroller of the Currency interpreted the National Bank Act to prohibit branching by national banks); *see id.* at 80 (discussing restrictions on state bank branching).

36. *See* BARR ET AL., *supra* note 34, at 42.

37. *See* Bank Holding Company Act of 1956, Pub. L. No. 84-511, § 3(d), 70 Stat. 133, 135 (codified as amended at 12 U.S.C. § 1842(d) (2012)).

38. BARR ET AL., *supra* note 34, at 717.

part of the twentieth century, many U.S. banks operated as single offices, effectively precluding them from doing business beyond their local communities.[39]

These geographic restrictions prevented banks from becoming excessively large. Indeed, even the biggest U.S. banks had, at most, several billion dollars of assets in the mid-twentieth century.[40] Table 1 lists the largest U.S. banking organizations by asset size as of 1940.[41]

Table 1: Largest U.S. Banking Organizations (1940)		
Name	**Asset Size ($ Billions)**	**Assets as % of U.S. GDP**
Chase National Bank	$3.82	3.7%
National City Bank of New York	$3.10	3.0%
Guaranty Trust Company of New York	$2.72	2.6%
Bank of America National Trust	$1.82	1.8%
Continental Illinois National Bank & Trust	$1.62	1.6%
Bankers Trust Company	$1.58	1.5%
TOTAL OF TOP SIX FIRMS	**$14.66**	**14.2%**

Gradually, however, the states and the federal government began to liberalize their branching restrictions. The McFadden Act granted a national bank the same right to branch within its home state as a state-chartered bank located in that state.[42] It was not until the 1970s, though, that states started to permit

39. *See id.* at 714 (describing so-called "unit banks").

40. For data on U.S. banking organizations' asset size as of 1940, see MOODY'S INV'R SERVS., MOODY'S MANUAL OF INVESTMENTS, AMERICAN AND FOREIGN a72–a77 (1941).

41. *Id.* at a72. Comparing a bank's total assets relative to its home country's GDP is a standard method for measuring a bank's size. *See* BARR ET AL., *supra* note 34, at 13. U.S. GDP in 1940 was $102.9 billion. *Table 1.1.5 Gross Domestic Product*, BUREAU ECON. ANALYSIS https://apps.bea.gov/iTable/iTable.cfm?reqid=19&step=2#reqid=19&step=2&isuri=1&1921=survey [perma.cc/352k-4VKY] [hereinafter BUREAU ECON. ANALYSIS].

42. *See* McFadden Act, Pub. L. No. 69-639, § 7, 44 Stat. 1224, 1228 (1927) (codified as amended at 12 U.S.C. § 36(c)(2) (2012)).

interstate branching and acquisitions, thereby authorizing interstate banking for national and state banks.[43] Even then, however, some states impeded interstate banking by imposing conditions on out-of-state entrants or limiting the activities of out-of-state banks.[44]

Eventually, in 1994, the Riegle-Neal Interstate Banking and Branching Efficiency Act (Riegle-Neal) eliminated the remaining barriers to interstate banking, giving rise to a new tier of regional banks.[45] Riegle-Neal permitted national and state banks to branch across state lines and BHCs to acquire out-of-state subsidiary banks, subject to regulatory approval.[46] As a result, banks began consolidating with other firms in neighboring states. In the late 1990s, for example, California-based Wells Fargo & Co. merged with Minnesota-based Norwest Corp., while Wachovia Corp. extended its reach from North Carolina into Virginia by acquiring Central Fidelity Banks Inc.[47]

These mergers resulted in a thriving tier of regional banks that were considerably larger than the single-office banks that

43. *See* BARR ET AL., *supra* note 34, at 726.

44. *See id.*

45. Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-238, 108 Stat. 2338. For background on Riegle-Neal, see generally Patrick Mulloy & Cynthia Lasker, *The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Responding to Global Competition*, 21 J. LEGIS. 255 (1995).

46. 12 U.S.C. §§ 215a-1(a), 1831u(a), 1842(d) (2012). Riegle-Neal authorized a bank to branch interstate only through merger—i.e., by acquiring an out-of-state branch. Riegle-Neal did not permit a bank to establish an interstate branch de novo, and most states continued to prohibit de novo branching by out-of-state banks. Eventually, in 2010, the Dodd-Frank Act removed this final barrier to interstate branching. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 613, 124 Stat. 1376, 1614 (2010) (codified in scattered sections of 12 U.S.C.).

47. Eleena De Lisser, *Wachovia to Spend $2.3 Billion to Buy Central Fidelity Banks*, WALL ST. J. (June 25, 1997), https://www.wsj.com/articles/SB867158156259951000; Matt Murray, *Norwest, Wells Fargo Agree to Form Banking Giant in $31.4 Billion Pact*, WALL ST. J. (June 9, 1998), https://www.wsj.com/articles/SB897306023976625000. This era also featured several significant intrastate mergers, including Chase Manhattan's merger with Chemical Banking in New York and BankAmerica Corp.'s purchase of Security Pacific in California. *See* James Bates, *BankAmerica Takes Over at Security Pacific*, L.A. TIMES (Apr. 22, 1992), https://www.latimes.com/archives/la-xpm-1992-04-22-fi-633-story.html [https://perma.cc/2DXM-EXZT]; Saul Hansell, *Chase and Chemical Agree to Merge in $10 Billion Deal Creating Largest U.S. Bank*, N.Y. TIMES (Aug. 29, 1995), https://www.nytimes.com/1995/08/290/us/banking-s-new-giant-deal-chase-chemical-agree-merge-10-billion-deal-creating.html.

predominated during the era of geographic restrictions. The largest U.S. banking organizations as of 1997 are listed in Table 2.[48]

Table 2: Largest U.S. Banking Organizations (1997)		
Name	**Asset Size ($ Billions)**	**Assets as % of U.S. GDP**
Chase Manhattan	$365.5	4.3%
Citicorp	$310.9	3.6%
Bank of America Corp.	$264.6	3.1%
J.P. Morgan	$262.2	3.1%
Wachovia Corp.	$157.3	1.8%
Bankers Trust Corp.	$140.1	1.6%
TOTAL OF TOP SIX FIRMS	**$1,500.6**	**17.5%**

2. The Gramm-Leach-Bliley Act

A second phase of financial sector consolidation followed in the early 2000s, giving rise to even larger and more diversified financial conglomerates. This era is notable because commercial banks grew not only in scale but also in scope, expanding into investment banking, insurance, and other new activities.

In 1999, the Gramm-Leach-Bliley Act reversed decades-long prohibitions against BHCs engaging in nonbanking activities.[49] Historically, BHCs had been limited to taking deposits, making loans, and engaging in "closely related" activities, such as investment advising and asset management.[50] The Depression-era Glass-Steagall Act, for example, barred commercial banks from engaging in investment banking, including securities underwriting and dealing.[51] Similar laws precluded banks from providing

48. *A Database of 50 Years of Fortune's List of America's Largest Corporations*, FORTUNE (1998), http://archive.fortune.com/magazines/fortune/fortune500_archive/assets/1998/ [https://perma.cc/96DD-VDPK]. U.S. GDP in 1997 was $8.6 trillion. BUREAU ECON. ANALYSIS, *supra* note 41.

49. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 103, 113 Stat. 1338, 1342–51 (1999) (codified at 12 U.S.C. § 1843 (2012)).

50. *See* 12 U.S.C. § 1843(c)(8); 12 C.F.R. §§ 225.28(a)–(b) (2019) (listing activities considered to be "so closely related to banking . . . as to be a proper incident thereto").

51. Banking Act of 1933, Pub. L. No. 73-66, § 20, 48 Stat. 162, 188–89 (1933) (codified at 12 U.S.C. § 377) (repealed 1999).

insurance.[52] But after years of lobbying, Congress lifted these restrictions in the Gramm-Leach-Bliley Act, permitting a new category of BHCs—called FHCs—to engage in an expanded range of financial activities, including investment banking, insurance, and merchant banking.[53]

Congress stipulated that to qualify as an FHC and be eligible to engage in this full panoply of financial activities, a firm must meet heightened regulatory standards.[54] Specifically, the holding company and all its bank subsidiaries must be both "well capitalized" and "well managed."[55] Thus, only companies with high capital ratios and supervisory examination ratings may become and remain FHCs.[56] These standards were intended to ensure that only strong, well-run firms would be permitted to engage in potentially risky financial activities.[57]

Within the next four years, all of the United States' largest BHCs became FHCs and took advantage of this new authority to expand into nonbanking activities.[58] Many of them did so by merger. The most notable such combination—between Citicorp, a BHC, and Travelers, an insurance company—actually pre-

52. *See* BARR ET AL., *supra* note 34, at 698–99 (discussing the 1966 amendments to the BHC Act and Garn-St. Germain Act of 1982).

53. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 103, 113 Stat. 1338, 1342 (1999). Some commentators contend that a series of deregulatory administrative and judicial interpretations throughout the late twentieth century effectively overturned the Glass-Steagall Act's activities restrictions even before Gramm-Leach-Bliley passed. *See, e.g.*, Karmel, *supra* note 8, at 11–22; Arthur E. Wilmarth, Jr., *The Road to Repeal of the Glass-Steagall Act*, 17 WAKE FOREST J. BUS. & INTELL. PROP. L. 441, 449–91 (2017).

54. *See* 12 U.S.C. § 1843(*l*)(1).

55. *Id.* Originally, Gramm-Leach-Bliley required only that the holding company's subsidiary depository institutions be well capitalized and well managed. *See* Gramm-Leach-Bliley Act § 103. The Dodd-Frank Act, however, added the additional requirement that the holding company itself be well capitalized and well managed. *See* Dodd-Frank Act, Pub. L. No. 111-203, § 606(a), 124 Stat. 1376, 1607 (2010).

56. For more discussion of the well-capitalized and well-managed requirements, see *infra* Part III.C.

57. *See* H.R. REP. NO. 106-434, at 151–56 (1999) (Conf. Rep.) (discussing standards for engaging in expanded financial activities).

58. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS. & U.S. DEP'T OF THE TREASURY, REPORT TO THE CONGRESS ON FINANCIAL HOLDING COMPANIES UNDER THE GRAMM-LEACH-BLILEY ACT 2–3 (2003) [hereinafter FINANCIAL HOLDING COMPANY REPORT].

dated Gramm-Leach-Bliley and put significant pressure on Congress to retroactively authorize the merger by passing the Act.[59] Within a year after the Act, commercial bank Chase Manhattan Corp. acquired investment bank J.P. Morgan & Co., creating the second-largest financial services conglomerate, behind only Citigroup.[60] Meanwhile, large U.S. insurance companies like MetLife and investment banks like Charles Schwab & Co. became FHCs and acquired commercial bank subsidiaries.[61]

In large part due to this unprecedented nonbanking expansion, the largest U.S. financial conglomerates more than tripled in size between the passage of the Gramm-Leach-Bliley Act and the beginning of the financial crisis in the mid-2000s.[62] Table 3 depicts the largest U.S. banking organizations as of 2007.[63]

Table 3: Largest U.S. Banking Organizations (2007)

Name	**Asset Size ($ Billions)**	**Assets as % of U.S. GDP**
Citigroup, Inc.	$2,187	15.1%
Bank of America Corp.	$1,721	11.9%
JPMorgan Chase & Co.	$1,562	10.8%
Wachovia Corp.	$783	5.4%
Wells Fargo & Co.	$575	4.0%
U.S. Bancorp	$238	1.6%
TOTAL OF TOP SIX FIRMS	**$7,066**	**48.9%**

59. *See* Lissa L. Broome & Jerry W. Markham, *Banking and Insurance: Before and After the Gramm-Leach-Bliley Act*, 25 J. CORP. L. 723, 757 (2000); Arthur E. Wilmarth, Jr., *Citigroup: A Case Study in Managerial and Regulatory Failures*, 47 IND. L. REV. 69, 73 (2014).

60. *See* Patrick McGeehan & Andrew Ross Sorkin, *Chase Manhattan to Acquire J.P. Morgan for $30.9 Billion*, N.Y. TIMES (Sept. 14, 2000), https://archive.nytimes.com/www.nytimes.com/learning/teachers/featured_articles/20000914thursday.html [https://perma.cc/YVY9-8UXR].

61. *See* FINANCIAL HOLDING COMPANY REPORT, *supra* note 58, at 3.

62. The growth of U.S. financial institutions was also partially attributable to mergers between regional banks. For instance, Bank of America agreed to merge with FleetBoston in 2003, followed by JPMorgan merger agreement with Bank One a few months later. *See* Riva D. Atlas, *Bank of America and FleetBoston Agree to Merger*, N.Y. TIMES, Oct. 28, 2003, at A1; Andrew Ross Sorkin, *$58 Billion Deal to Unite 2 Giants of U.S. Banking*, N.Y. TIMES, Jan. 15, 2004, at A1.

63. For data on U.S. banking organizations' asset size as of 2007, see NAT'L INFO. CTR., BHC PEER GROUP DATA (2007), https://www.ffiec.gov/nicpubweb/content/BHCPRRPT/REPORTS/BHCPR_PEER/Dec2007/PeerGroup_1_December2007.pdf [https://perma.cc/5ZY8-WEWX]. U.S. GDP in 2007 was $14.5 trillion. *See* BUREAU ECON. ANALYSIS, *supra* note 41.

3. Crisis-Era Acquisitions

The most recent phase of bank expansion occurred during the financial crisis, when the government relied on relatively healthy banks to acquire failing firms and thereby stabilize the financial system. This wave of crisis-induced, government-assisted mergers created the megabanks that dominate the U.S. financial system today.[64]

As the financial system spiraled into chaos in 2008, the federal government eagerly encouraged a handful of comparatively strong banks to absorb weaker institutions that were teetering on the brink of insolvency. As a result, the acquiring institutions ballooned dramatically in size. Wells Fargo, for example, more than doubled its asset base by merging with troubled Wachovia in a hastily-arranged deal.[65] JPMorgan overtook Citigroup to become the largest U.S. banking organization by virtue of its government-assisted acquisitions of Bear Stearns, the fifth-biggest U.S. investment bank, and Washington Mutual, the largest U.S. savings and loan association.[66] Bank of America likewise added Merrill Lynch, the third-largest U.S. investment bank, and Countrywide Financial, the biggest U.S. mortgage originator, growing by hundreds of billions of dollars in assets in the process.[67] Perversely, therefore, the financial crisis—which was arguably caused by extremely large banks—resulted in substantially bigger banks.[68]

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64. *See, e.g.*, NAT'L INFO. CTR., BHC PEER GROUP DATA (2018), https://www.ffiec.gov/nicpubweb/content/BHCPRRPT/REPORTS/BHCPR_PEER/June2018/BHCPR_PeerGrp1_20180630.pdf [https://perma.cc/69GJ-S82T] (illustrating the expansive size of the largest banks in 2018).

65. *See* David Enrich & Dan Fitzpatrick, *Wachovia Chooses Wells Fargo, Spurns Citi*, WALL ST. J., https://www.wsj.com/articles/SB122303190029501925 (last updated Oct. 4, 2008, 11:59 PM).

66. *See* Rob Curran, *J.P. Morgan Rises 10% on Takeover of Bear; Broker MF Global Plummets 65%; Lehman Sinks 19%*, WALL ST. J., Mar. 18, 2008, at C8; Robin Sidel et al., *WaMu is Seized, Sold Off to J.P. Morgan, in Largest Failure in U.S. Banking History*, WALL ST. J., https://www.wsj.com/articles/SB122238415586576687 (last updated Sept. 26, 2008).

67. *See* Gretchen Morgenson & Eric Dash, *Troubled Giant in Home Loans Close to Rescue*, N.Y. TIMES, Jan. 11, 2008, at A1; Jonathan Stempel & Elinor Comlay, *Bank of America Takeover to End Independent Merrill*, REUTERS (Sept. 14, 2008, 9:08 PM), https://www.reuters.com/article/us-merrill-bankofamerica/bank-of-america-takeover-to-end-independent-merrill-idUSN1445019920080915 [https://perma.cc/5REF-CY9J].

68. *See, e.g.*, Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41

Since the crisis, the largest U.S. banks have only continued to grow. Post-crisis regulations intended to discourage systemically important banks from expanding have not stopped this trend. To the contrary, U.S. megabanks have dramatically outpaced their smaller rivals in attracting deposits.[69] Thus, due to their crisis-era acquisitions and continued organic growth, JPMorgan and Bank of America have more than doubled in size—and Wells Fargo has tripled—since the onset of the financial crisis.[70] Table 4 depicts the largest U.S. banking organizations as of 2018.[71]

Table 4: Largest U.S. Banking Organizations (2018)		
Name	**Asset Size ($ Billions)**	**Assets as % of U.S. GDP**
JPMorgan Chase & Co.	$2,590	12.5%
Bank of America Corp.	$2,292	11.1%
Citigroup Inc.	$1,912	9.3%
Wells Fargo & Co.	$1,880	9.1%
Goldman Sachs Group, Inc.	$969	4.7%
Morgan Stanley	$876	4.2%
TOTAL OF TOP SIX FIRMS	**$10,519**	**50.9%**

CONN. L. REV. 963, 968, 1002 (2009) (arguing that large, diversified banks triggered the crisis). Moreover, investment banks Goldman Sachs and Morgan Stanley—which had previously avoided Federal Reserve regulation by virtue of an exemption in the BHC Act—opted to become BHCs to access the Federal Reserve's discount window. *See* Jon Hilsenrath et al., *Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid to Ride Out Crisis*, WALL ST. J., https://www.wsj.com/articles/SB122202739111460721 (last updated Sept. 22, 2008, 11:59 PM). For an illustration of the post-crisis expansion of bank holdings, compare NAT'L INFO. CTR., BHC PEER GROUP DATA (2007), *supra* note 63, with NAT'L INFO. CTR., BHC PEER GROUP DATA (2018), *supra* note 64.

69. *See* Rachel Louise Ensign, *Biggest Three Banks Gobble Up $2.4 Trillion in New Deposits Since Crisis*, WALL ST. J., https://www.wsj.com/articles/biggest-three-banks-gobble-up-2-4-trillion-in-new-deposits-since-crisis-1521711001 (last updated Mar. 22, 2018, 7:16 PM) (noting that JPMorgan, Bank of America, and Wells Fargo accounted for forty-five percent of U.S. checking accounts opened in 2017).

70. *See* Matt Egan, *Too-Big-to-Fail Banks Keep Getting Bigger*, CNN (Nov. 21, 2017, 3:43 PM), https://money.cnn.com/2017/11/21/investing/banks-too-big-to-fail-jpmorgan-bank-of-america/index.html [https://perma.cc/T75Q-JZAQ].

71. For more comprehensive data on U.S. banking organizations' asset size as of 2018, see NAT'L INFO. CTR., BHC PEER GROUP DATA (2018), *supra* note 64. U.S. GDP in 2018 was $20.7 trillion. BUREAU ECON. ANALYSIS, *supra* note 41.

B. EXPLANATIONS FOR THE TBTM PROBLEM

The dramatic growth of the largest U.S. banks over the past half-century has important implications for how these firms govern themselves. At baseline, banks pose unique managerial challenges because they are more opaque, riskier, and less susceptible to market discipline than most nonfinancial firms. Governance of the largest banks is especially difficult because size exacerbates each of these managerial impediments. As a result, big banks are susceptible to excessive risk-taking and misconduct. Nonetheless, the TBTM problem persists because shareholders lack both the incentive and ability to force large banks to reduce risks or break themselves up.

1. Impediments to Effective Bank Governance

All banks, regardless of size, face significant managerial challenges. Banks are unusually opaque, risky, and insulated from market discipline, relative to nonfinancial firms. These three characteristics, in turn, impede effective bank governance.

First, opacity—or information asymmetries between a bank's risk takers and its other stakeholders—can prevent management from effectively overseeing the firm's risk profile. Given the numerous transactions in which banks engage on a daily basis, it may not be possible for managers to identify and effectively mitigate the bank's risk exposures.[72] Although financial institutions have developed sophisticated risk management and reporting techniques to enhance managerial oversight, risk takers at the firm may nonetheless cause significant losses by the time management detects a problem.[73] Opacity can be particularly

72. *See* Gerard Caprio, Jr. & Ross Levine, *Corporate Governance in Finance: Concepts and International Observations*, *in* FINANCIAL SECTOR GOVERNANCE: THE ROLES OF THE PUBLIC AND PRIVATE SECTORS 17, 29–35 (Robert E. Litan et al. eds., 2002) (discussing the opacity problem in banking); *see also* Luc Laeven, *Corporate Governance: What's Special About Banks?*, 5 ANN. REV. FIN. ECON. 63, 67 (2013) ("[B]anks are more opaque than the typical nonfinancial firms because of large informational asymmetries surrounding loan quality . . . . Trading activities may also make banks more opaque than nonfinancial companies without such activities . . . because trading positions and associated risk profiles can be easily changed in real time.").

73. This is exactly what happened at JPMorgan, for example, when a rogue trader dubbed the "London Whale" amassed an outsized stake in volatile credit derivatives before being detected by the firm's risk management function. The London Whale trades cost JPMorgan more than $6 billion in losses. *See* STAFF OF S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 113TH CONG., JPMORGAN

problematic when a bank's compensation structure incentivizes employees to take excessive risks.[74]

Second, the inherent riskiness of a bank's highly leveraged capital structure creates unique management challenges. In contrast to many nonfinancial firms, banks fund themselves overwhelmingly with debt, rather than equity.[75] Much of this debt is short-term, in the form of deposits and other runnable instruments, which creditors can withdraw with little warning.[76] This combination of high leverage and short-term funding provides bank managers a relatively small margin for error. Even a minor drop in a bank's asset values or loss of funding can quickly lead to insolvency.

Third, banks are shielded from some forms of market discipline that could otherwise improve corporate governance. A nonfinancial firm's creditors typically exert some level of control over the company's management by entering into debt covenants or by declining to roll over their loans if the firm becomes too risky.[77] Creditors insist on these protections to increase the likelihood that the firm will be able to repay its debts, and this market discipline can lead to better managerial oversight and more appropriate risk-taking.[78] However, a bank's most significant

CHASE WHALE TRADES: A CASE HISTORY OF DERIVATIVES RISKS AND ABUSES 2, 94 (Comm. Print 2013) [hereinafter SENATE JPMORGAN REPORT].

74. *Cf.* Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 255–74 (2010) (discussing bankers' incentives to take excessive risks). For further discussion of the problem of compensation structures in financial institution corporate governance, see Jeffrey N. Gordon, *Corporate Governance and Executive Compensation in Financial Firms: The Case for Convertible Equity-Based Pay*, 2012 COLUM. BUS. L. REV. 834, 848–50 (2012).

75. *See* Kose John et al., *Corporate Governance in Banks*, 24 CORP. GOVERNANCE 303, 304 (2016) ("[T]he average leverage of banks, measured as the ratio of debt to assets, is between [eighty-seven] and [ninety-five] percent, whereas the average leverage of nonfinancial companies is in the range of 20–30 percent." (internal citation omitted)); Jonathan R. Macey & Maureen O'Hara, *The Corporate Governance of Banks*, 9 FED. RESERVE BANK N.Y. ECON. POL'Y REV. 91, 97 (2003) ("Although it is not uncommon for typical manufacturing firms to finance themselves with more equity than debt, banks typically receive ninety percent or more of their funding from debt.").

76. *See* Laeven, *supra* note 72, at 67 (internal citation omitted) ("[M]uch of the debt held by banks is short-term, whereas assets tend to be longer-dated. Such maturity transformation exposes banks to liquidity risk and bank runs . . . .").

77. *See* Caprio & Levine, *supra* note 72, at 22.

78. *See* Charles K. Whitehead, *Creditors and Debt Governance*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 68, 70 (Claire A. Hill & Brett H. McDonnell eds., 2012).

creditors—its depositors—generally lack incentive to monitor the bank because they are insured by the Federal Deposit Insurance Corporation (FDIC).[79] This is the classic moral hazard problem in banking: depositors do not effectively discipline a bank's management because depositors know that the FDIC will shield them from losses the bank might incur. The bank, knowing that its creditors will not discipline it, therefore takes greater risks.[80]

In sum, banks of all sizes experience significant governance challenges because of their distinctive characteristics. Opacity, high leverage, and lack of market discipline—features that are endemic to the banking business model—undermine the effective management of these institutions.

2. Unique Governance Challenges for TBTM Banks

Although banks of all sizes face managerial challenges, these difficulties are especially pronounced for large firms. Indeed, size intensifies all three major impediments to effective bank governance.

First, larger banks are, by their nature, more opaque than smaller firms. Simply put, it is harder for executives, directors, and shareholders to know what is going on inside a bank with 250,000 employees, compared to a bank with 250 employees. Moreover, larger BHCs tend to have numerous subsidiaries spanning multiple regulatory jurisdictions, increasing their organizational complexity and information asymmetries.[81] The opacity and complexity of larger BHCs therefore inhibits effective managerial oversight.

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79. *See* 12 U.S.C. § 1821(a)(1) (2012) (providing that FDIC shall insure depositors up to $250,000 per ownership account category, per depositor, per institution).

80. *See, e.g.*, Christopher M. Bruner, *Corporate Governance Reform in a Time of Crisis*, 36 J. CORP. L. 309, 311–12 (2011); Harris Weinstein, *Moral Hazard Deposit Insurance and Banking Regulation*, 77 CORNELL L. REV. 1099, 1101–02 (1992).

81. *See* LINDA GOLDBERG & APRIL MEEHL, STAFF REP. NO. 880, FED. RESERVE BANK OF N.Y., COMPLEXITY IN LARGE U.S. BANKS 3–4 (2019) (using industry codes and geographic distribution of subsidiaries to measure a BHC's complexity); Nicola Cetorelli et al., *Evolution in Bank Complexity*, 20 FED. RESERVE BANK N.Y. ECON. POL'Y REV. 85, 104–05 (2014); Mark D. Flood et al., *The Complexity of Bank Holding Companies: A Topological Approach* 33–49 (Nat'l Bureau of Econ. Research, Working Paper No. 23755, 2017) (assessing a BHC's complexity relative to the number and geographic distribution of its subsidiaries).

These managerial challenges, in fact, have strong grounding in organizational behavior theory. Social scientists have documented that executives experience a "loss of control" as their organizations grow and become more complex.[82] That is, subordinates can only accomplish a portion of their supervisors' wishes, and they only communicate a fraction of their knowledge to their supervisors. As a result, both managerial control and information transmission diminish as the hierarchies within an organization expand.[83] The loss of control phenomenon helps explain why a multinational financial conglomerate may be more susceptible to misconduct or excessive risk-taking than a smaller bank.

Second, larger banks are riskier than smaller competitors. In practice, large banks rely more on short-term wholesale financing like repurchase agreements, securities lending, and derivatives compared to smaller banks, which fund themselves primarily with deposits.[84] This heavy reliance on short-term financing poses unique managerial challenges for large banks because wholesale financing is not as "sticky" as deposit funding.[85] Short-term financing tends to evaporate quickly during a crisis, as the financial sector experienced in 2008.[86] Thus, big bank executives have an especially narrow margin for error.

Finally, larger banks suffer from even weaker market discipline than smaller firms. Banks of all sizes have some unsecured creditors and uninsured depositors who are not explicitly protected by the FDIC's safety net, with its $250,000 limit.[87] These

82. *See* Oliver E. Williamson, *Hierarchical Control and Optimum Firm Size*, 75 J. POL. ECON. 123, 127–30 (1967); *see also* Guillermo A. Calvo & Stanislaw Wellisz, *Supervision, Loss of Control, and the Optimum Size of the Firm*, 86 J. POL. ECON. 943, 943–44 (1978).

83. Williamson, *supra* note 82, at 123 ("[T]he larger . . . the organization, the better the chance that its top decision-makers will be operating in purely imaginary worlds.").

84. *See, e.g.*, Thomas M. Hoenig, *Community Banks and the Federal Reserve*, 88 ECON. REV. 5, 8 (2003) ("[S]mall banks are more heavily dependent on retail deposits for their funds than large banks.").

85. *See, e.g.*, DONG BEOM CHOI & HYUN-SOO CHOI, STAFF REP. NO. 759, FED. RESERVE BANK OF N.Y., THE EFFECT OF MONETARY POLICY ON WHOLESALE FUNDING 2 (2017).

86. *See* Paolo Saguato, *The Liquidity Dilemma and the Repo Market: A Two-Step Policy Option to Address the Regulatory Void*, 22 STAN. J.L. BUS. & FIN. 85, 106–11 (2017) (analyzing short-term funding markets during the 2008 financial crisis).

87. The FDIC insures a depositor up to $250,000 per ownership account category, per institution. 12 U.S.C. § 1821(a)(1) (2012).

unprotected creditors should have an interest in overseeing the bank's risk profile to ensure the bank can repay its debts. But unsecured and uninsured creditors of banks that are perceived as "too big to fail" lack this incentive. That is because creditors of the very biggest banks believe that the government would bail them out if such an institution were to fail.[88] That is exactly what happened in the 2008 financial crisis, when the FDIC guaranteed all deposits above the deposit insurance limit even though they were not protected by an explicit guarantee ex ante.[89] This implicit government guarantee persists even after Dodd-Frank. Although the statute purported to end the too-big-to-fail problem through the creation of a new resolution authority to safely wind down failing firms, the biggest banking organizations continue to borrow at unusually low rates, suggesting that creditors view anti-bailout pledges as non-credible.[90] Accordingly, even unsecured and uninsured depositors lack appropriate incentives to discipline managers of the largest banks.

In sum, big banks face unique corporate governance challenges. Large financial firms are especially opaque, risky, and insulated from market discipline. These impediments are the root of the TBTM problem that too often exposes big banks to misconduct and excessive risk-taking.

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88. *See* BARR ET AL., *supra* note 34, at 256–57. For a thorough discussion of the limitations of market discipline in banking, see generally David Min, *Understanding the Failures of Market Discipline*, 92 WASH. U. L. REV. 1421 (2015).

89. *See* BARR ET AL., *supra* note 34, at 983–84. Moreover, the Federal Reserve's emergency loans to save AIG and facilitate the acquisition of Bear Stearns have been characterized as bailouts of those firms' unsecured long-term creditors. *See, e.g.*, Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts*?, 35 J. CORP. L. 469, 485–86 (2010) (asserting that bailouts granted unsecured creditors greater relief than would have been awarded in bankruptcy).

90. *See, e.g.*, Bhanu Balasubramnian & Ken B. Cyree, *Has Market Discipline Improved After the Dodd-Frank Act?*, 41 J. BANKING & FIN. 155, 165 (2014) (concluding that Dodd-Frank reduced, but did not eliminate, implicit government subsidies for firms perceived as too big to fail); Viral V. Acharya et al., *The End of Market Discipline? Investor Expectations of Implicit Government Guarantees* 30–33 (Munich Personal RePEc Archive, Working Paper No. 79700, 2016) (finding that Dodd-Frank did not significantly reduce investors' expectations for government bailouts of large financial firms); *see also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-14-621, LARGE BANK HOLDING COMPANIES: EXPECTATIONS OF GOVERNMENT SUPPORT (2014), https://www.gao.gov/assets/670/665162.pdf [https://perma.cc/NL44-PMG6] [hereinafter EXPECTATIONS OF GOVERNMENT SUPPORT] (suggesting implicit government subsidies may result in lower funding costs in some models).

3. TBTM Banks Will Not Break Themselves Up

In light of these governance challenges, one might expect TBTM banks to break themselves up voluntarily. In theory, shareholders should have strong incentives to shrink a TBTM bank to ensure that it operates prudently.[91] But this does not happen in practice. In fact, TBTM banks will not break themselves up for three reasons.

First, as discussed above, a bank perceived as "too big to fail" benefits from an implicit government subsidy that would be unavailable if the firm were to shrink itself to a more manageable size.[92] Banks believed to be "too big to fail" borrow relatively cheaply because creditors expect that the government would not let such a firm collapse, fearing risks to the broader financial system.[93] By some estimates, this implicit subsidy reached more than 600 basis points in the lead-up to the financial crisis.[94] While the magnitude of the subsidy has diminished since the crisis, big banks continue to enjoy a funding advantage over smaller firms.[95] Shareholders of a TBTM bank may therefore be reluctant to lose that subsidy by breaking up the firm.[96]

Second, even if shareholders wanted to break up a TBTM bank, they could face insurmountable legal obstacles. Banking laws deter shareholders from promoting significant corporate governance reforms and structural changes, such as a break-up. Under the BHC Act, a shareholder or association of shareholders who "directly or indirectly exercises a controlling influence over the management or policies" of a bank becomes subject to onerous regulation as a BHC.[97] The Federal Reserve has applied this provision stringently.[98] While a minority shareholder may consult with management about changes in the bank's strategy, anything more than that—for instance, coordinating with other shareholders or initiating a proxy contest—could constitute a

91. For a discussion of bank shareholders' incentives and the increasing role of asset managers in bank governance, see Yesha Yadav, *Too-Big-To-Fail Shareholders*, 103 MINN. L. REV. 587, 631–37, 656–57 (2018).

92. *See supra* text accompanying notes 87–90.

93. *See supra* text accompanying notes 87–90.

94. *See* EXPECTATIONS OF GOVERNMENT SUPPORT, *supra* note 90, at 51.

95. *See* Acharya et al., *supra* note 90, at 35.

96. *See* Roe, *supra* note 19, at 1428–29.

97. 12 U.S.C. § 1841(a)(2)(C) (2012).

98. *See* Kress, *supra* note 18, at 922 n.266 (referencing instances in which the Federal Reserve has found a controlling influence).

"controlling influence."[99] These severe restrictions help explain why shareholder activism is less prevalent in banking than in other industries.[100]

Finally, even if shareholders were willing and legally able to break up a TBTM bank, they would almost certainly meet stiff managerial resistance. Bank executives have strong incentives to oppose a break-up, since they would earn less compensation at a smaller institution.[101] Moreover, a break-up would undermine executives' well-documented motivations to "empire build" by continually growing their firms.[102] Unsurprisingly, therefore, many top bank executives are on record as opposing break-ups.[103] Given executives' ability to influence shareholder votes, managerial resistance would significantly reduce the likelihood of a TBTM bank breaking itself up voluntarily.[104]

Collectively, the implicit government subsidy, legal obstacles, and managerial resistance will deter shareholders from even attempting to break up a TBTM bank. Thus, while there are many reasons to believe that some banks are TBTM, there is little reason to trust that banks will solve the problem on their own.

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99. *See* Board of Governors of the Federal Reserve System, Policy Statement on Equity Investments in Banks and Bank Holding Companies 11–12 (Sept. 22, 2008) https://www.federalreserve.gov/bcreg20080922b1.pdf [https://perma.cc/U59P-PH77] (to be codified at 12 C.F.R. § 225.144).

100. *See, e.g.*, William Sweet, *Shareholder Activism in the U.S. Banking Industry*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Dec. 3, 2013), https://corpgov.law.harvard.edu/2013/12/03/shareholder-activism-in-the-us-banking-industry/ [https://perma.cc/N94T-E44Z].

101. *See* Murdock, *supra* note 19, at 548 (asserting that managerial resistance is the "biggest barrier" to breaking up large banking organizations).

102. *See, e.g.*, Ole-Kristian Hope & Wayne B. Thomas, *Managerial Empire Building and Firm Disclosure*, 46 J. ACCT. RES. 591, 592–93 (2008) (describing "the empire building" phenomenon).

103. *See, e.g.*, Tom Braithwaite, *Dimon Warns Breaking Up JPMorgan Would Hurt U.S. Financial Power*, FIN. TIMES (Jan. 14, 2015), https://www.ft.com/content/7e907a18-9c04-11e4-a6b6-00144feabdc0 (discussing JPMorgan Chase CEO Jamie Dimon's opposition to a break-up); Ben McLannahan & Barney Jopson, *BofA's Moynihan Calls Big Bank Break-Up 'Crazy,'* FIN. TIMES (May 3, 2017), https://www.ft.com/content/4c2422ca-3061-11e7-9555-23ef563ecf9a (describing Bank of America CEO Brian Moynihan's resistance to breaking up the banks).

104. *See, e.g.*, Fabrizio Ferri & David Oesch, *Management Influence on Investors: Evidence from Shareholder Votes on the Frequency of Say on Pay*, 33 CONTEMP. ACCT. RES. 1337, 1339 (2016) (finding that a managerial recommendation on a shareholder proposal shifts the votes of more than 25% of investors).

C. MANIFESTATIONS OF THE TBTM PROBLEM

The TBTM problem manifested itself in several high-profile ways during and after the 2008 financial crisis. Some of the most significant crisis-era failures, such as AIG, were triggered by the TBTM problem.[105] Even after the crisis, JPMorgan's London Whale trading scandal and Wells Fargo's fraudulent account scandal were at least partially attributable to the vast size of those firms. This Section assesses how the TBTM problem contributed to misconduct and excessive risk-taking at AIG, JPMorgan, and Wells Fargo. A common theme emerges from these three narratives: each firm transgressed because of ineffective risk management, impeded by its massive size.

1. AIG

AIG's rise and subsequent collapse epitomized TBTM finance in the lead-up to the 2008 financial crisis. Founded in the early twentieth century, AIG grew into the largest U.S. insurance holding company with a focus on traditional life and health business lines.[106] In 1998, however, AIG began issuing credit default swaps (CDS) through its Financial Products division.[107] These instruments guaranteed corporate debt and, eventually, mortgage-backed securities in exchange for a small fee.[108] As the housing bubble inflated in the early 2000s, AIG earned steady profits on its CDS.[109] At the same time, AIG invested collateral from securities lending counterparties in the booming mortgage-backed securities market.[110] When the housing bubble burst, however, AIG suffered massive liquidity strains. The firm's CDS counterparties insisted that AIG post margin, and its securities

105. In addition to its substantial insurance operations, AIG operated a federal savings bank and was regulated as a savings and loan holding company by the Office of Thrift Supervision. *See* William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 988 (2009).

106. *See id.* at 944. For a compelling discussion of AIG's historically conservative approach to insurance underwriting, see RODDY BOYD, FATAL RISK: A CAUTIONARY TALE OF AIG'S CORPORATE SUICIDE 53–54 (2011).

107. *See* THE FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 120 (2011) [hereinafter FINANCIAL CRISIS INQUIRY REPORT].

108. *See id.* at 140–41.

109. *See id.* at 140.

110. *See* Daniel Schwarcz & Steven L. Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. CHI. L. REV. 1569, 1585–86 (2014).

lending counterparties demanded return of their collateral.[111] These claims were too much for AIG, which began to shed assets at fire sale prices to satisfy the mounting demands.[112] Eventually, the U.S. government stepped in with an $85 billion bailout—which it later increased to more than $182 billion—to save AIG and its counterparties.[113]

AIG's massive size undoubtedly contributed to its epic collapse. For years, AIG's long-time CEO, Maurice "Hank" Greenberg, famously monitored even the smallest risk exposures as the company grew into a $1 trillion conglomerate.[114] When Greenberg departed in 2005, however, he left a company that was too big for his replacement, Martin Sullivan, to manage. Under Sullivan's watch, for example, AIG failed to implement effective valuation models for its CDS, despite warnings from its auditor.[115] Furthermore, it was during Sullivan's tenure that AIG's securities lending business started investing collateral in mortgage-backed securities.[116] Because of AIG's expansive size, however, its risk management systems and personnel did not detect the correlated risks building throughout its disparate business lines.[117] As a Federal Reserve official would later conclude, Sullivan was "too removed from the activities on the ground to understand the risks."[118] In this way, AIG illustrates the potential

111. *See id.*

112. *See* FINANCIAL CRISIS INQUIRY REPORT, *supra* note 107, at 347–49.

113. *See* William K. Sjostrom, Jr., *Afterword to The AIG Bailout*, 72 WASH. & LEE L. REV. 795, 796, 819 (2015).

114. *See* BOYD, *supra* note 106, at 63, 74–75 (discussing Greenberg's oversight of AIG's risk profile); Sjostrom, Jr., *supra* note 105, at 946 (describing AIG's balance sheet).

115. *See* CONG. OVERSIGHT PANEL, JUNE OVERSIGHT REPORT: THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT'S EXIT STRATEGY 28 (2010).

116. *See id.* at 33.

117. *See id.* at 36–38 (discussing AIG's risk management deficiencies); *see also* Edward Simpson Prescott, *Too Big to Manage? Two Book Reviews*, 99 ECON. Q. 143, 148 (2013) ("[U]nder the Sullivan regime, there is evidence that AIG's senior management was unaware of the risks that AIGFP was actually taking."). Professor Richard Squire asserts that AIG's correlated risk-taking strategy was economically rational, from the perspective of AIG's shareholders. *See* Richard Squire, *Shareholder Opportunism in a World of Risky Debt*, 123 HARV. L. REV. 1151, 1183–91 (2010). The weight of the evidence, however, suggests that AIG's senior-most management did not fully appreciate the extent of the firm's correlated risks.

118. Prescott, *supra* note 117, at 157.

danger of financial institutions that are so big and complex that key stakeholders cannot effectively oversee them.

2. JPMorgan

The TBTM problem, of course, outlasted the financial crisis, as JPMorgan's London Whale trading losses vividly demonstrated.[119] Before the crisis, JPMorgan's Chief Investment Office (CIO) hedged the firm's macroeconomic risk exposures.[120] In 2012, however, the head of the CIO adopted a new strategy: the unit would attempt to generate windfall profits by buying and selling CDS.[121] Embracing this new approach, a CIO trader—later dubbed the "London Whale"—amassed huge positions in CDS indices.[122] To facilitate his risk-taking, the trader and his associates deliberately mismarked their positions and cajoled the CIO's management into changing the unit's risk models.[123] The CDS market, however, quickly turned against JPMorgan. Within a few months, the London Whale's trading positions suffered steep losses, and the head of the CIO instructed the traders to stop trading.[124] By the time JPMorgan wound down the London Whale portfolio, the firm incurred $6.2 billion in losses and more than $1 billion in fines for inadequate risk monitoring.[125]

Similar to AIG, JPMorgan's vast size impaired the firm's ability to detect and prevent trading losses. Most obviously, JPMorgan's $2 trillion balance sheet obscured the London Whale exposures, allowing the CIO traders to amass their positions without attracting managerial or supervisory attention.[126] More subtly, however, JPMorgan's sprawling reach hid deficiencies in

119. For detailed discussions of the London Whale losses, see Jill E. Fisch, *The Mess at Morgan: Risk, Incentives and Shareholder Empowerment*, 83 U. CIN. L. REV. 651, 655–59 (2015); Kress, *supra* note 18, at 908–13; Hillary A. Sale, *J.P. Morgan: An Anatomy of Corporate Publicness*, 79 BROOK. L. REV. 1629, 1636–39 (2014); Heidi Mandanis Schooner, *Big Bank Boards: The Case for Heightened Administrative Enforcement*, 68 ALA. L. REV. 1011, 1014–18 (2017).

120. *See* SENATE JPMORGAN REPORT, *supra* note 73, at 21–22.

121. *See id.* at 220.

122. *See id.* at 228–40.

123. *See id.* at 261–70, 326–37.

124. *See id.* at 255–56.

125. *See id.* at 6; Fisch, *supra* note 119, at 654.

126. *See* SENATE JPMORGAN REPORT, *supra* note 73, at 18–19, (demonstrating how the Office of the Comptroller of the Currency failed to detect escalating risks in the CIO given JPMorgan Chase's massive size).

CIO's risk management. JPMorgan's board of directors and senior executives, for example, permitted the CIO to operate without a line-of-business chief risk officer, in contrast to all of JPMorgan's other business lines.[127] Likewise, JPMorgan's leaders were slow to address the fact that CIO's senior-most risk officer reported directly to the head of the CIO, rather than to the firm-wide chief risk officer.[128] This reporting structure tied CIO's risk managers to the business line and enabled the CIO traders to influence the unit's risk models.[129] Thus, JPMorgan's size and complexity not only hid the CIO's CDS exposures, it also distracted the firm's senior leaders from risk management deficiencies that, if corrected, could have prevented the London Whale trading losses.

3. Wells Fargo

Finally, Wells Fargo's recent scandals demonstrate the potential for TBTM financial institutions to harm their customers. In 2016, Wells Fargo settled charges that its employees opened more than 3.5 million unauthorized checking, savings, and credit card accounts to meet aggressive cross-selling goals.[130] Wells Fargo eventually agreed to refund $142 million to customers who had accounts opened without their permission over a fifteen-year period.[131] Critically, Wells Fargo's misconduct was not limited to fraudulent bank accounts. To the contrary, Wells Fargo has settled allegations that it illegally repossessed military members' cars,[132] charged auto loan borrowers for insurance without their knowledge,[133] and improperly levied fees for extending mortgage

127. *See id.* at 187–90.

128. *See id.* at 342–45.

129. *See id.*

130. *See* Laura J. Keller, *Wells Fargo Boosts Fake-Account Estimate 67% to 3.5 Million*, BLOOMBERG (Aug. 31, 2017), https://www.bloomberg.com/news/articles/2017-08-31/wells-fargo-increases-fake-account-estimate-67-to-3-5-million.

131. *See* Kartikay Mehrotra, *Wells Fargo's Fake Account Customers to Get 'Imperfect' Closure*, BLOOMBERG (May 30, 2018), https://www.bloomberg.com/news/articles/2018-05-30/wells-fargo-s-fake-account-customers-to-get-imperfect-closure.

132. *See* Devlin Barrett & Emily Glazer, *Wells Fargo Reaches Settlement Over Car Repossessions*, WALL ST. J. (Sept. 29, 2016), https://www.wsj.com/articles/wells-fargo-reaches-settlement-over-car-repossessions-1475173677.

133. *See* Renae Merle, *Wells Fargo Says It Faces $1 Billion Penalty for Mortgage, Auto Business Misdeeds*, WASH. POST (Apr. 13, 2018), https://www.washingtonpost.com/news/business/wp/2018/04/13/wells-fargo-says-it-faces-1

rate-locks.[134] Moreover, press reports suggest that government investigators are looking into inappropriate conduct relating to Wells Fargo's add-on products and wealth management services.[135] In response to this pervasive misconduct, the Federal Reserve imposed an unprecedented asset cap on Wells Fargo until the company corrects its governance deficiencies.[136]

Wells Fargo's expansive size was at least partially responsible for its consumer abuses. The firm grew extremely rapidly during the financial crisis. As discussed above, Wells Fargo acquired Wachovia, a company nearly fifty percent larger than itself.[137] Wells Fargo's governance and controls, however, were poorly equipped to handle this significant acquisition and subsequent organic growth. For example, a report commissioned by Wells Fargo's independent directors concluded that the firm's sprawling organizational structure inhibited effective risk management while the sales practice violations occurred.[138] Wells Fargo's directors and executives were unable to hold business-line and risk managers accountable given its highly decentralized structure.[139] Even after Wells Fargo's unauthorized accounts came to light, the firm failed to prevent misconduct from spreading to other, non-core segments of the holding company.[140]

-billion-penalty-for-mortgage-auto-business-misdeeds/?utm_term=.c26c048615f9 [https://perma.cc/NBG4-PHZN].

134. *See id.*

135. *See* Emily Glazer, *Wells Fargo's Latest Challenge: Refunds for Pet Insurance, Legal Services*, WALL ST. J. (July 19, 2018), https://www.wsj.com/articles/wells-fargos-latest-challenge-refunds-for-pet-insurance-legal-services-1532009933; Emily Glazer, *Wells Fargo's Wealth Management Unit Attracts Justice Department Attention*, WALL ST. J. (Mar. 1, 2018), https://www.wsj.com/articles/wells-fargos-wealth-management-unit-attracts-justice-department-attention-1519920782.

136. *See* Press Release, Bd. of Governors of the Fed. Reserve Sys., Responding to Widespread Consumer Abuses and Compliance Breakdowns by Wells Fargo, Federal Reserve Restricts Wells' Growth Until Firm Improves Governance and Controls (Feb. 2, 2018), https://www.federalreserve.gov/newsevents/pressreleases/enforcement20180202a.htm [https://perma.cc/FCV7-XYK9].

137. *See* Enrich & Fitzpatrick, *supra* note 65 and accompanying text.

138. INDEP. DIRS. OF THE BD. OF WELLS FARGO & CO., SALES PRACTICES INVESTIGATION REPORT 8 (2017), https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/presentations/2017/board-report.pdf [https://perma.cc/2GP5-SG52] ("Wells Fargo's decentralized organizational structure and the deference paid to the lines of business contributed to the persistence of this [sales-driven] environment.").

139. *See id.* at 13 ("[T]he culture of substantial deference accorded to the lines of business carried over into the control functions.").

140. *See supra* notes 130–33.

In this way, therefore, Wells Fargo illustrates the potential threat that a TBTM financial institution's excessive size could pose to its customers.

In sum, the vast size of AIG, JPMorgan, and Wells Fargo prevented managers, directors, shareholders, and regulators from effectively overseeing these firms. To be sure, size alone did not cause these firms' difficulties. But the companies' unprecedented size exacerbated their complexity, internal control problems, and cultural issues.[141] These examples are representative of widespread corporate governance deficiencies at the United States' largest financial institutions, both before and after the financial crisis.[142] The frequency of misconduct and excessive risk-taking among these firms underscores the urgency of solving the TBTM problem.

II. BARRIERS TO EXISTING BREAK-UP PROPOSALS

Despite the gravity of the TBTM problem, policymakers have done little to address the issue. To be sure, policymakers from across the political spectrum acknowledge that the largest U.S. banks are too big.[143] Some policymakers have even proposed legislation to rein in the size of these firms by capping banks' asset size, reinstating the Glass-Steagall Act, or incentivizing a "soft break-up." Nonetheless, policymakers have not coalesced around a viable solution to the TBTM problem. This Part assesses two primary reasons why the United States has failed to address the TBTM issue. First, the most prominent proposals to break up the banks have faced insurmountable political barriers. Second, even if these break-up proposals were politically feasible, they could involve undesirable policy trade-offs.

A. POLITICAL INFEASIBILITY

The most significant shortcoming of existing break-up proposals is that they have proven politically infeasible. Ostensibly, both major political parties acknowledge the TBTM problem and support breaking up large banks, according to their official platforms.[144] Despite this apparent bipartisan consensus, however,

141. *See, e.g.*, Hilary J. Allen, *The Pathologies of Banking Business as Usual*, 17 U. PA. J. BUS. L. 861, 884–88 (2015) (analyzing how cultural issues contributed to JPMorgan's London Whale losses).

142. *See, e.g.*, Markham, *supra* note 19, at 523–64 (documenting misconduct by large financial institutions).

143. *See supra* note 2 and accompanying text.

144. *See supra* note 3 and accompanying text.

legislative initiatives to break up the banks have languished in Congress. Indeed, none of the break-up proposals currently pending before Congress has received a hearing or a committee vote.[145] Even in the immediate aftermath of the financial crisis, Democratic majorities in Congress declined to adopt meaningful limits on bank size as part of the Dodd-Frank Act.[146]

Congress has not only failed to solve the TBTM problem, it has in fact made the problem worse. In early 2018, Congress adopted the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), the most significant financial reform legislation since Dodd-Frank.[147] Although primarily focused on easing regulatory burdens for small and midsized banks, the legislation also weakened constraints on big banks. For example, EGRRCPA relaxed liquidity requirements for the largest firms, freeing them to hold fewer riskless assets.[148] The legislation also gave the largest U.S. financial institutions a new legal tool to challenge capital, stress testing, and other risk-mitigating rules in court.[149] EGRRCPA, in sum, compounded the TBTM problem.

Policymakers' failure to address the TBTM problem suggests that breaking up the banks may be an effective campaign talking point, but in practice, there is insufficient political will to follow through. Breaking up the banks is popular among the electorate, with pluralities of both Democratic and Republican

145. For a discussion of the break-up proposals currently pending before Congress, see *infra* Part II.B.

146. *See, e.g.*, *Roll Call Vote 111th Congress—2nd Session*, U.S. SENATE, https://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=111&session=2&vote=00136 [https://perma.cc/L576-PWVH] (rejecting an amendment to cap BHC size by 61-33 vote).

147. Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, 132 Stat. 1296 (2018).

148. *See id.* § 403; *see also* Manuela Tobias, *Is the Senate Banking Bill a Big Win for Wall Street? Yes and No*, POLITIFACT (Mar. 20, 2018), https://www.politifact.com/truth-o-meter/statements/2018/mar/20/heidi-heitkamp/senate-banking-bill-win-advantage-wall-street/ [https://perma.cc/6Q9Z-937T].

149. *See* David Dayen, *Revenge of the Stadium Banks*, THE INTERCEPT (Mar. 2, 2018), https://theintercept.com/2018/03/02/crapo-instead-of-taking-on-gun-control-democrats-are-teaming-with-republicans-for-a-stealth-attack-on-wall-street-reform/ [https://perma.cc/TE23-SWR9]; Jeremy Kress, *Beware of the Bank Deregulation Trojan Horse*, THE HILL (Feb. 7, 2018), https://thehill.com/opinion/finance/372764-beware-of-the-bank-deregulation-trojan-horse [https://perma.cc/5877-A9WV] (describing statutory language that large banks could use to challenge enhanced regulations).

voters supporting the idea.[150] Candidates might therefore campaign on breaking up the banks, even if they have little intention of pursuing a break-up once in office. Further, some observers contend that the divergence between legislators' pro-break-up rhetoric and pro-bank policies is attributable to the financial sector's considerable lobbying power.[151] Whatever the reason for the divergence, recent experience demonstrates that policymakers lack the political will to break up the banks, despite rhetoric to the contrary.

In sum, the political feasibility of breaking up the banks is dubious, at best. Both major political parties and their key leaders purport to favor breaking up the banks. Yet legislative proposals to break up the banks have stalled and, at the same time, Congress has actually weakened constraints on the largest banks. Even the strongest financial reform advocates therefore acknowledge that legislative efforts to break up the biggest banks are likely politically unrealistic.[152]

B. SUBSTANTIVE SHORTCOMINGS

Even setting politics aside, however, existing proposals to break up the banks involve undesirable policy trade-offs. This Section evaluates the three most prominent break-up proposals—capping banks' asset size, reinstating the Glass-Steagall Act, and incentivizing a "soft break-up." It concludes that even if a break-up were politically possible, the economic costs of forcing all large U.S. financial institutions to shrink might, on net, exceed the benefits.

1. Capping Banks' Size

Some big bank skeptics have proposed to solve the TBTM problem by limiting banks' size. Under this relatively straight-

150. *See, e.g.*, Peter Schroeder, *Poll: Bipartisan Backing for Breaking Up Big Banks*, HILL (Jan. 20, 2015), https://thehill.com/policy/finance/230058-poll-bipartisan-backing-for-breaking-up-big-banks [https://perma.cc/945V-FHYD].

151. *See, e.g.*, Andrew Baker, *Restraining Regulatory Capture? Anglo-America, Crisis Politics and Trajectories of Change in Global Financial Governance*, 86 INT'L AFF. 647, 651 (2010) (discussing lobbying by the financial sector); Kevin Young & Stefano Pagliari, *Capital United? Business Unity in Regulatory Politics and the Special Place of Finance*, 11 REG. & GOVERNANCE 3 (2015) (examining efficacy of financial sector lobbying).

152. *See, e.g.*, Wilmarth, Jr., *supra* note 15, at 2 (2012) ("[I]t seems highly unlikely—especially in light of megabanks' enormous political clout—that Congress could be persuaded to adopt such draconian limits . . . .").

forward approach, Congress would cap a BHC's assets or liabilities at a set dollar amount or a certain percentage of U.S. gross domestic product (GDP). Any BHC that exceeds the prescribed threshold would be required to break itself up. For example, Senator Bernie Sanders has sponsored legislation that would limit a BHC's liabilities to 3% of U.S. GDP, or approximately $584 billion.[153] Some academics would go much further. Professor Jonathan Macey, for instance, has suggested capping a BHC's liabilities at $3 billion.[154] By way of comparison, JPMorgan—the largest U.S. BHC—has $2.4 trillion in liabilities.[155]

Proponents of capping bank size argue that if some banks are TBTM, the most logical response is to enact hard balance sheet limits and thereby prevent firms from growing too large.[156] As Professor Simon Johnson succinctly put it, "Our largest banks are too big to manage. We need to cap their assets."[157] On this reasoning, a bank's executives, directors, and shareholders would be better able to monitor its risk profile if the firm's balance sheet were subject to reasonable legal limits.[158] Proponents insist that capping bank size would have additional benefits, beyond making banks easier to manage. For instance, limiting bank size could reduce the implicit government subsidy through which firms perceived as "too big to fail" borrow at artificially

153. Too Big to Fail, Too Big to Exist Act, S. 3542, 115th Cong. (2018). Sanders' proposal would limit a BHC's "total exposures," including its on-balance-sheet liabilities and off-balance-sheet exposures—*e.g.*, derivatives. A previous proposal by Senators Sherrod Brown and Tom Harkin would have capped a BHC's non-deposit liabilities at 2% of U.S. GDP. *See* SAFE Banking Act of 2012, S. 3048, 112th Cong. (2012).

154. *See* Macey & Holdcroft, Jr., *supra* note 24, at 1404. More generously, Professors Simon Johnson and James Kwak have proposed capping bank size at four percent of U.S. GDP, or approximately $570 billion. *See* SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 214 (2010).

155. JPMorgan Chase & Co., Quarterly Report (Form 10-Q) 88 (Oct. 31, 2018).

156. The BHC Act imposes "soft limits" on a bank's size. Under the Act, the Federal Reserve may not approve a merger or acquisition if the resulting BHC would have more than 10% of the total nationwide deposits or liabilities. 12 U.S.C. §§ 1843(d)(1), 1852(b) (2012). These limitations, however, apply only when a BHC expands through merger or acquisition. The BHC Act does not prevent a BHC from growing organically above the 10% deposit or liability cap.

157. Simon Johnson, *Keep It Simple, Stupid*, SLATE (Oct. 28, 2012), https://slate.com/business/2012/10/too-big-to-fail-our-banks-are-too-big-we-need-to-cap-their-assets.html [https://perma.cc/9U9F-R8TM].

158. *See supra* note 81 and accompanying text.

low rates.[159] Reducing this subsidy could, in turn, eliminate competitive distortions by allowing smaller firms to compete on a level playing field.[160] Further, subjecting firms to a hard size limit could mitigate the moral hazard problem and thereby constrain excessive risk-taking.[161]

Despite these potential advantages, there are at least three important reasons to be cautious about imposing a hard limit on banking organizations' balance sheets. First, although the empirical evidence is somewhat mixed, the weight of the research suggests that banks experience economies of scale.[162] In other words, larger banks may be more economically efficient than smaller banks, even ignoring the implicit "too-big-to-fail" subsidy.[163] Larger banks may be able to serve customers more effi-

159. *See* JOHNSON & KWAK, *supra* note 154, at 218.

160. *See id.* at 218–19.

161. *See* CHAIRPERSON OF THE FIN. STABILITY OVERSIGHT COUNCIL, STUDY OF THE EFFECTS OF SIZE AND COMPLEXITY OF FINANCIAL INSTITUTIONS ON CAPITAL MARKET EFFICIENCY AND ECONOMIC GROWTH 12 (2011) [hereinafter 2011 FSOC REPORT].

162. *See* 2016 FSOC REPORT, *supra* note 23, at 9.

163. *See, e.g.*, Joseph P. Hughes & Loretta J. Mester, *Who Said Large Banks Don't Experience Scale Economies? Evidence from a Risk-Return-Driven Cost Function*, 22 J. FIN. INTERMEDIATION 559, 581–82 (2013) (finding evidence of scale economies unrelated to the too-big-to-fail subsidy for BHCs with more than $100 billion in assets); Anna Kovner et al., *Do Big Banks Have Lower Operating Costs?*, 20 FED. RESERVE BANK N.Y. ECON. POL'Y REV. 1, 22 (2014) (finding an inverse relationship between U.S. BHC asset size and noninterest expense ratios, suggesting economies of scale); Diego Restrepo-Tobón et al., *Obelix vs. Asterix: Size of US Commercial Banks and Its Regulatory Challenge*, 48 J. REG. ECON. 125, 160 (2015) (concluding that most U.S. commercial banks with more than $1 billion in assets experience economies of scale); David C. Wheelock & Paul W. Wilson, *The Evolution of Scale Economies in US Banking*, 33 J. APPLIED ECON. 16, 23–27 (2018) (finding that U.S. BHCs experienced increasing returns to scale between 2006 and 2015). *But see* Richard Davies & Belinda Tracey, *Too Big to Be Efficient? The Impact of Implicit Subsidies on Estimates of Scale Economies for Banks*, 46 J. MONEY, CREDIT & BANKING 219, 243–44 (2014) (finding no evidence of economies of scale in BHCs with more than $50 billion in assets after controlling for the too-big-to-fail subsidy); Guohua Feng & Xiaohui Zhang, *Returns to Scale at Large Banks in the US: A Random Coefficient Stochastic Frontier Approach*, 39 J. BANKING & FIN. 135, 144 (2014) (concluding that 90% of U.S. commercial banks with more than $1 billion in assets do not experience economies of scale); Hulusi Inanoglu et al., *Analyzing Bank Efficiency: Are "Too-Big-to-Fail" Banks Efficient?*, *in* THE HANDBOOK OF POST CRISIS FINANCIAL MODELING 110, 113 (Emmanuel Haven et al. eds., 2016) (finding negative returns to scale among the fifty largest U.S. commercial banks).

ciently because of advantages in information technology or because they can spread fixed costs over a larger revenue base.[164] While evidence of economies of scale is strong for most banks, the research does not clearly establish that increasing returns to scale extend to the very largest firms.[165] Nonetheless, the data on economies of scale in banking suggest a cautious approach to breaking up the banks, because capping bank size could lead to a less efficient financial system overall.

Second, capping bank asset size could hinder U.S. banks' international competitiveness. Multinational corporate clients currently rely on the largest U.S. financial institutions for complex services including securities underwriting, cash management, foreign exchange, and payment and clearing.[166] Opponents of breaking up the banks contend that smaller banks cannot provide these services on a global scale.[167] As a result, they claim, financial activity would migrate overseas if the United States were to limit the size of its banks.[168] Even some of the strongest proponents of capping bank size concede that U.S. financial institutions might shift internationally if the United States broke up its banks and other countries did not.[169] Thus,

164. *See, e.g.*, 2011 FSOC REPORT, *supra* note 161, at 10; Kovner et al., *supra* note 163, at 2.

165. *See* Lawrence G. Baxter, *Betting Big: Value, Caution and Accountability in an Era of Large Banks and Complex Finance*, 31 REV. BANKING & FIN. L. 765, 808 (2012) ("The ultimate record [of economies of scale] is mixed, however, with very large banks (assets exceeding $500 billion) not doing nearly as well as their much smaller counterparts ($20 million to $100 billion in total assets) . . . ."). *Compare* Restrepo-Tobón et al., *supra* note 163, at 128 (concluding that commercial banks with more than $500 billion in assets generally do not experience economies of scale), *with* Wheelock & Wilson, *supra* note 163, at 26 (finding evidence of increasing returns to scale for BHCs with more than $1 trillion in assets).

166. *See* BUS. ROUNDTABLE, BUSINESS ON BANKING: HOW LARGE U.S. FINANCIAL INSTITUTIONS HELP COMPANIES CREATE GROWTH AND OPPORTUNITY FOR AMERICA 5–12 (2013).

167. *See* THE CLEARING HOUSE, UNDERSTANDING THE ECONOMICS OF LARGE BANKS 41 (2011).

168. *See* Henn, *supra* note 22 (statement of Harvard Law School Professor Hal Scott); *see also* Peter J. Wallison, *Breaking Up the Big Banks: Is Anybody Thinking?*, AM. ENTERPRISE INST. 2 (Sept. 18, 2012), http://www.aei.org/publication/breaking-up-the-big-banks-is-anybody-thinking/ [https://perma.cc/E2SH-95KB].

169. *See* JOHNSON & KWAK, *supra* note 154, at 217–18 (acknowledging that breaking up U.S. banks could affect international competition but insisting that U.S. nonfinancial companies could access financial services from smaller U.S. banks or foreign banks).

capping bank asset size could impair the U.S. financial system and, by extension, the broader U.S. economy.

Finally, despite its intuitive appeal, capping bank size would be a crude solution to the TBTM problem because it ignores other risk factors that exacerbate managerial challenges. Although bank size may be the dominant cause of the TBTM phenomenon, factors like complexity and interconnectedness no doubt contribute to a bank's governance difficulties.[170] Thus, it might be the case that a $2 trillion "plain vanilla" bank that only takes deposits and makes consumer loans is easier to manage than a $250 billion financial conglomerate that deals in complicated securitizations and derivatives.[171] Capping bank size, however, is a risk-insensitive approach that does not account for the range of factors that contribute to the TBTM problem.

In sum, while capping bank size could mitigate the TBTM problem, this approach might have the unintended consequence of reducing economic efficiency and impairing U.S. banks' international competitiveness. Moreover, to the extent that other factors like complexity and interconnectedness exacerbate a bank's governance challenges, limiting the bank's size would not completely solve the TBTM issue. Accordingly, it is not clear that the benefits of capping bank size would necessarily outweigh the costs.

2. Reinstating the Glass-Steagall Act

As an alternative to breaking up the banks based on their size, some scholars and policymakers have proposed breaking them up based on their activities. Specifically, some financial reform advocates support reinstating the Glass-Steagall Act, returning to the pre-Gramm-Leach-Bliley era when commercial banks were prohibited from affiliating with other financial companies. If the United States were to reinstate Glass-Steagall, therefore, all FHCs would be required to divest their investment

170. *See* Lawrence G. Baxter, *Götterdämmerung*, 19 N.C. BANKING INST. 91, 97 n.20 (2013).

171. For detailed discussions of potential risks in securitization, see Patricia A. McCoy et al., *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327, 1366–73 (2009); Steven L. Schwarcz, *The Future of Securitization*, 41 CONN. L. REV. 1313, 1317–24 (2009); Dov Solomon, *The Rise of a Giant: Securitization and the Global Financial Crisis*, 49 AM. BUS. L.J. 859, 871–89 (2012); Matthew C. Turk, *Securitization Reform After the Crisis: Regulation by Rulemaking or Regulation by Settlement?*, 37 REV. BANKING & FIN. L. 861, 870–74 (2018).

bank and insurance subsidiaries and to cease other activities impermissible for regular BHCs. In Congress, Senators Elizabeth Warren, John McCain, and Angus King introduced bipartisan legislation that would reinstate Glass-Steagall.[172] In academia, Professors Arthur Wilmarth and Ganesh Sitaraman have likewise called for returning to pre-Gramm-Leach-Bliley activities restrictions.[173]

Proponents argue that reinstating Glass-Steagall would have several salutary effects. First, they contend that separating banking from other financial activities would reduce the size of the largest U.S. financial firms and thereby mitigate the TBTM problem.[174] De-linking commercial and investment banking, for example, would shrink some of the biggest FHCs by close to fifty percent.[175] Moreover, Glass-Steagall advocates insist that separating financial conglomerates' various business lines would reduce their complexity, making financial firms easier to manage and regulate.[176] Finally, proponents contend that reviving Glass-Steagall would reduce market concentration in the financial sector, thereby enhancing competition and reducing the financial sector's political influence.[177]

Like capping bank size, however, reinstating Glass-Steagall could involve undesirable trade-offs. Most significantly, separating commercial banking from other financial activities could perversely increase risk in the financial system.[178] Economic theory predicts that diversified financial institutions will be more stable

172. *See* 21st Century Glass-Steagall Act of 2017, S. 881, 115th Cong. (2017).

173. *See* Wilmarth, Jr., *supra* note 6, 1034–52 (2011) (describing proposal to limit nonbanking activities by banks and their affiliates); Ganesh Sitaraman, *The Case for Glass-Steagall Act, the Depression-Era Law We Need Today*, GUARDIAN (June 16, 2018), https://www.theguardian.com/commentisfree/2018/jun/16/case-glass-steagall-act-ganesh-sitaraman [https://perma.cc/D7Y9-BJZA].

174. *See, e.g.*, Tamar Frankel, *Dismantling Large Bank Holding Companies for Their Own Good and for the Good of the Country*, 32 BANKING & FIN. SERVS. POL'Y REP. 12, 18 (2013) ("Breaking up BHCs into their unique services allows for a far more effective management . . . .").

175. *See* Brian Cheung & Razi Haider, *In Calls to Revive Glass-Steagall, Policy and Politics Square Off*, S&P GLOBAL MKT. INTELLIGENCE (Oct. 18, 2016), http://m.bankingexchange.com/images/Dev_SNL/102716_GlassSteagall.pdf [https://perma.cc/7L2S-73KT].

176. *See* Frankel, *supra* note 174, at 18; Sitaraman, *supra* note 173.

177. *See* Frankel, *supra* note 174, at 18–19; Sitaraman, *supra* note 173.

178. *See* Macey & Holdcroft, Jr., *supra* note 24, at 1411.

than highly concentrated firms.[179] Consistent with this theory, empirical research confirms that diversified financial companies are less prone to income shocks and thus more resilient over time.[180] For example, when a financial conglomerate experiences a downturn in commercial banking, stable investment banking or insurance revenues might mitigate its losses. In fact, that is exactly what happened during the 2008 financial crisis, when diversified financial conglomerates outperformed pure investment or commercial banks.[181] Had these conglomerates been prohibited from diversifying into other financial activities, they might have collapsed and further exacerbated the crisis.[182] Reinstating Glass-Steagall could therefore reduce the financial system's resilience.

Moreover, breaking up financial conglomerates by activity could eliminate synergies among various financial services. Some empirical evidence suggests that financial conglomerates benefit not only from economies of scale, but also economies of scope. That is, some research indicates that a financial conglomerate may provide a range of services—from commercial loans to merger-and-acquisition advising and cash management—more efficiently than individual firms offering those services separately.[183] The data are not conclusive, however, and a sizeable

179. *See, e.g.*, Peter S. Rose, *Diversification of the Banking Firm*, 24 FIN. REV. 251, 251 (1989) ("Diversification of banks and bank holding companies into nonbank product lines may reduce the risk to banking returns or cash flows provided appropriate portfolio conditions are satisfied.").

180. *See* 2011 FSOC REPORT, *supra* note 161, at 17 ("[M]ost of the empirical literature suggests that diversification . . . reduce[s] institutions' individual probability of failure . . . ."); *see also* Rose, *supra* note 179, at 260 (finding evidence of diversification benefits in financial services); William K. Templeton & Jacobus T. Severiens, *The Effect of Nonbank Diversification on Bank Holding Company Risk*, 31 Q.J. BUS. & ECON. 3, 9 (1992) (concluding that diversification into nonbank activities reduces BHC riskiness). *But see* Arthur E. Wilmarth, Jr., *Too Big to Fail, Too Few to Serve? The Potential Risks of Nationwide Banks*, 77 IOWA L. REV. 957, 986–90 (1992) (contending that diversification has frequently failed to yield benefits predicted by economic theory).

181. *See, e.g.*, William M. Isaac & Richard M. Kovacevich, *The Shattered Arguments for a New Glass-Steagall*, WALL ST. J. (Apr. 25, 2017), https://www.wsj.com/articles/the-shattered-arguments-for-a-new-glass-steagall-1493160658.

182. *See* James A. Fanto, *"Breaking Up Is Hard to Do": Should Financial Conglomerates Be Dismantled?*, 79 U. CIN. L. REV. 553, 578 (2011).

183. Most of the evidence of economies of scope focuses on the European financial sector. *See, e.g.*, Yener Altunbas & Phil Molyneux, *Economies of Scale and Scope in European Banking*, 4 APPLIED FIN. ECON. 367, 371–72 (1996) (finding positive economies of scope in some Spanish, German, and French banks); Mark Dijkstra, *Economies of Scale and Scope in the European Banking*

body of research refutes evidence of economies of scope in financial services.[184] Nonetheless, there is at least some support for the view that financial services clients may be better off when they can go to a diversified conglomerate as a "one stop shop" for all of their financial service needs.[185] In sum, separating commercial banking from investment banking, insurance, and other financial activities could conceivably reduce consumer welfare and overall economic efficiency.

3. Incentivizing a "Soft Break-Up"

A third possible solution to the TBTM problem would impose onerous regulations on the largest banks, thereby encouraging such firms to break themselves up. This "soft break-up" strategy would be functionally similar to a tax on bank size or complexity.[186] If calibrated appropriately, graduated capital and liquidity requirements could deter firms from becoming excessively large or risky. Broadly speaking, Dodd-Frank adopted a soft break-up approach, with the biggest and most complex BHCs subject to stricter prudential standards than smaller, simpler

Sector 2002-2011 23–28 (Amsterdam Law Sch. Legal Studies Research Paper No. 44, 2013) (finding positive economies of scope in banking that increased during the financial crisis). However, some industry-led research finds economies of scope in the U.S. financial sector. *See, e.g.*, THE CLEARING HOUSE, *supra* note 167, at 17 (concluding that economies of scope provide $15–35 billion in value to U.S. banking customers annually). Relatedly, there is evidence that U.S. commercial banks' expansion into other financial activities increased competition and reduced costs for those services. *See, e.g.*, Dongcheol Kim et al., *The Impact of Commercial Banks on Underwriting Spreads: Evidence from Three Decades*, 43 J. FIN. & QUANTITATIVE ANALYSIS 975, 998 (2008).

184. *See* Kevin J. Stiroh et al., *The Dark Side of Diversification: The Case of US Financial Holding Companies*, 30 J. BANKING & FIN. 2131, 2158–60 (2006) (concluding that diversification benefits in financial holding companies are more than offset by increased exposure to highly volatile but less profitable non-interest activities); *see also* Luc Laeven & Ross Levine, *Is There a Diversification Discount in Financial Conglomerates?*, 85 J. FIN. ECON. 331, 363–65 (2007) (concluding that economies of scope are insufficient to produce a diversification premium in financial conglomerates); Markus M. Schmid & Ingo Walter, *Do Financial Conglomerates Create or Destroy Economic Value?*, 18 J. FIN. INTERMEDIATION 193, 214–15 (2009) (finding evidence of diseconomies of scope among diversified financial institutions).

185. *See, e.g.*, BIPARTISAN POLICY CENTER, THE BIG BANK THEORY: BREAKING DOWN THE BREAKUP ARGUMENTS 20 (2014) ("Banks and their customers can realize added value when banks provide services complementary to their primary offerings. . . . It is more economically efficient for banks to provide many of these services in combination.").

186. *See* BARR ET AL., *supra* note 34, at 765–66.

firms.[187] Some critics, however, contend that Dodd-Frank did not go far enough, as evidenced by the largest U.S. banks' continued growth.[188] Thus, several policymakers have proposed to significantly increase prudential standards for the largest firms. For example, a bipartisan bill led by Senators Sherrod Brown and David Vitter would triple capital requirements for financial institutions with more than $500 billion in assets.[189] Similarly, in academia, Professors Anat Admati and Martin Hellwig have advocated for dramatically increasing capital requirements for the largest BHCs.[190]

Advocates contend that a soft break-up would mitigate the TBTM problem in several ways. First, proponents insist that ratcheting up costly prudential regulations on the largest firms would incentivize those firms to shrink, making them easier to oversee.[191] Further, soft break-up advocates assert, substantially increasing capital requirements would alleviate the moral hazard problem for any bank that declined to break itself up. Higher capital requirements would mean that more equity holders have skin in the game and, thus, an incentive to monitor the bank's risk profile.[192] Moreover, a soft break-up has two important advantages over alternative break-up strategies. First,

187. *See id.* at 756–58 (describing Dodd-Frank's graduated system of prudential regulation). Noting that some financial companies have divested business lines in response to these heightened regulations, Aaron Levine and Joshua Macey describe Dodd-Frank as akin to a Pigouvian tax. *See* Aaron M. Levine & Joshua C. Macey, Note, *Dodd-Frank Is a Pigouvian Regulation*, 127 YALE L.J. 1336, 1363–401 (2018).

188. *See, e.g.*, David Harrison & Ryan Tracy, *Fed's Neel Kashkari: Break Up the Big Banks*, WALL ST. J. (Feb. 16, 2016), https://www.wsj.com/articles/minneapolis-fed-chief-says-dodd-frank-act-didnt-go-far-enough-1455636718.

189. Terminating Bailouts for Taxpayer Fairness Act of 2013, S. 798, 113th Cong. (2013). Federal Reserve Bank of Minneapolis President Neel Kashkari has proposed to raise big bank capital requirements to roughly the same level, with the express intent of encouraging large firms to shrink. *See* FED. RESERVE BANK OF MINNEAPOLIS, THE MINNEAPOLIS PLAN TO END TOO BIG TO FAIL 63–64 (2017).

190. *See* ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT 176–83 (2013); *see also* Anat R. Admati et al., *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity Is Not Socially Expensive* 54–57 (Stanford Univ. Rock Ctr. for Corp. Governance, Working Paper No. 161, 2013).

191. *See* ADMATI & HELLWIG, *supra* note 190, at 221.

192. *See id.* at 95. Moreover, with a higher capital buffer, if a firm did experience distress, it would have a bigger cushion to absorb losses. *See id.* at 220; *see also* Paolo Saguato, *The Ownership of Clearinghouses: When "Skin in the*

because a soft break-up could be calibrated based on a firm's risk profile as well as its size, this approach would be more risk-sensitive than either capping a bank's size or restricting its activities.[193] Finally, a soft break-up may be more realistic than other break-up alternatives because federal regulators already have authority to impose heightened prudential standards, and new legislation would thus be unnecessary.[194]

Despite these potential advantages, however, using a soft break-up to solve the TBTM problem could be suboptimal for two important reasons. First, it is not obvious that a soft break-up would, in fact, shrink the largest banks. Financial institutions are notorious for circumventing capital rules and other prudential regulations through regulatory arbitrage, as occurred with securitizations and credit derivatives in the lead-up to the financial crisis.[195] Thus, a soft break-up could perversely lead to banks becoming more complex as they shift or re-characterize their activities to evade onerous regulations. Moreover, history suggests that a soft break-up's efficacy would wane over time, as banks lobby policymakers to water down the content of prudential regulations.[196] Finally, because a soft break-up, by definition, lacks hard limits on banks' size, a firm could continue to grow by financing its expansion with equity, as the largest U.S. banks have done since Dodd-Frank.[197] In sum, a soft break-up strategy might not actually address the TBTM problem in practice.

Game" is Not Enough, the Remutualization of Clearinghouses, 34 YALE J. REG. 601, 635–40 (2017) (discussing skin-in-the-game incentives for financial firms).

193. *See supra* note 170 and accompanying text.

194. *See, e.g.*, 12 U.S.C. § 5365(b)(i) (2012).

195. *See, e.g.*, Viral V. Acharya et al., *Capital, Contingent Capital, and Liquidity Requirements*, *in* REGULATING WALL STREET: THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE 143, 147–50 (Viral V. Acharya et al. eds., 2011) (explaining how banks used securitization to engage in regulatory arbitrage); Erik F. Gerding, *Credit Derivatives, Leverage, and Financial Regulation's Missing Macroeconomic Dimension*, 8 BERKELEY BUS. L.J. 29, 48, 69–70 (discussing regulatory arbitrage using credit derivatives); Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 J. CORP. L. 211, 227–35 (1995) (explaining how derivatives are used for regulatory arbitrage).

196. *See, e.g.*, Wilmarth, Jr., *supra* note 53, at 449–91 (describing the gradual decline of Glass-Steagall).

197. *See supra* notes 16–17 (describing growth of large banks); *see also* SUPERVISION AND REGULATION REPORT, *supra* note 31, at 14 (2018) (depicting increase in large financial institutions' capital ratios).

Second, to the extent that soft break-up measures would shrink the largest banks, this approach could suffer from drawbacks similar to alternative break-up strategies. For example, the U.S. financial system could become less efficient if enhanced prudential regulations succeed in getting the biggest banks to break themselves up.[198] Similar to a hard cap on bank size, an effectively implemented soft break-up could jeopardize large firms' economies of scale and thereby increase the costs of financial services for consumers.[199] Moreover, as discussed above, regulatory pressure to downsize or exit complex activities could impair U.S. firms' international competitiveness, causing financial activity to migrate overseas.[200] Thus, in addition to its questionable efficacy, a soft break-up could have problematic side effects.

All of this is not to say that policymakers should not strengthen prudential safeguards. To the contrary, enhanced capital and liquidity regulations are eminently sensible tools to reduce the likelihood that a bank will experience financial distress.[201] As a response to the TBTM problem, however, a soft break-up would involve many of the same undesirable trade-offs as other break-up options.

In sum, even if breaking up the banks were politically feasible, compelling the largest U.S. financial institutions to shrink could create more problems than it solves. In theory, any of the three primary break-up options could mitigate the TBTM issue. In practice, however, they might also decrease efficiency, hinder international competitiveness, or increase risk in the U.S. financial system. In light of these potential downsides, therefore, unilaterally breaking up the banks may be a suboptimal approach to the TBTM problem.

III. DIVESTITURES: A BETTER WAY TO SOLVE THE TBTM PROBLEM

This Part proposes a better solution to the TBTM problem. It recommends that regulators compel a BHC to divest operations if the firm falls out of compliance with minimum regulatory

198. *See supra* notes 162–65 and accompanying text.

199. *See supra* notes 162–65 and accompanying text.

200. *See supra* notes 166–69 and accompanying text. In addition to these shortcomings, designing and enforcing an effective soft break-up strategy would be more administratively difficult than a straightforward cap on bank size or activities restrictions.

201. *See, e.g.*, ADMATI & HELLWIG, *supra* note 190, at 176–83.

standards. Section III.A explains why forced divestitures are superior to other break-up strategies. Section III.B then analyzes the numerous existing but unused statutory authorities through which regulators could compel divestitures. Finally, Section III.C focuses on the most promising of these authorities—section 4(m) of the BHC Act—through which regulators could force a noncompliant FHC to divest its nonbanking operations. Rather than waiting for new tools to address the TBTM problem, therefore, policymakers should make better use of their existing divestiture authorities.

A. THE CASE FOR DIVESTITURES

Under the optimal approach to the TBTM problem, a regulatory agency would require a BHC to divest operating segments if the company fails to meet minimum regulatory standards. Regulators would use this authority sparingly and only after other supervisory actions failed to remediate the firm's underlying issues. Regulators might, for example, order Wells Fargo to divest its scandal-plagued wealth management unit or notoriously troubled Deutsche Bank to divest its U.S. banking operations.[202] To comply with a divestiture order, the company could then sell subsidiaries, spin them off to shareholders, or shutter them entirely. Using divestitures in this way would be superior to other break-up alternatives for four distinct reasons.

First, divestitures would safeguard the financial system by reducing the size and complexity of the most problematic BHCs. Selling, spinning off, or closing subsidiaries could shrink a financial conglomerate's balance sheet and simplify its structure, thereby making the firm easier to manage.[203] Further, by reducing the company's systemic footprint, divestitures would limit the potential financial stability risks if the firm were to become insolvent.[204] Importantly, as a remedial measure, divestitures

202. *See* Bethany McClean & Ethan Wolff-Mann, *Wells Fargo Pushed Wealth Advisors to Use High-Fee Products, Cross-Sell*, YAHOO FIN. (Aug. 21, 2018), https://finance.yahoo.com/news/exclusive-wells-fargo-pushed-wealth-advisors-use-high-fee-products-cross-sell-131824414.html [https://perma.cc/2PF6-6T78] (describing misconduct in Wells Fargo's wealth management segment); Strasburg & Tracy, *supra* note 25 (discussing Deutsche Bank's protracted managerial and financial problems).

203. *See* Flood et al., *supra* note 81, at 49–50 (concluding that the number and geographic dispersion of a conglomerate's subsidiaries contributes to its operational complexity).

204. *Cf.* LUC LAEVEN ET AL., IMF STAFF DISCUSSION NOTE SDN/14/04, BANK SIZE AND SYSTEMIC RISK 14–18 (2014) (discussing stability risks of large banks).

could be targeted to financial institutions that fail to meet minimum supervisory standards. The financial regulatory agencies' continuous, on-site monitoring of the largest financial firms would help identify TBTM conglomerates whose financial or managerial deficiencies warrant divestitures.[205] Thus, divestitures could reduce the systemic footprint of the companies most likely to propagate risk through the financial sector.

Second, in contrast to more draconian break-up proposals, targeted divestitures would affect relatively few firms and thereby preserve economies of scale and scope for most financial conglomerates. One of the primary drawbacks of the most prominent break-up proposals is that they would indiscriminately break up large, diversified conglomerates and thereby sacrifice the economic efficiencies that such institutions can create, if managed appropriately.[206] By contrast, Congress has set narrow parameters under which regulators may compel divestitures.[207] These strict statutory standards—discussed further in Sections III.B and III.C—ensure that relatively few firms would be subject to divestiture orders. Thus, regulatory divestitures would be superior to other approaches to the TBTM problem because they would only break up financial conglomerates that fail to meet supervisory standards, while allowing the majority of firms to continue operating at their existing scale and scope.

Third, the threat of divestiture would enhance financial institutions' incentives to operate prudently. Recent enforcement sanctions—ranging from fines to, in Wells Fargo's case, an asset cap—generally lack sufficient punitive weight to change banks' behavior.[208] For example, Wells Fargo's executives estimated that the unprecedented asset cap the Federal Reserve imposed

205. *See, e.g.*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., SR 12-17, CONSOLIDATED SUPERVISION FRAMEWORK FOR LARGE FINANCIAL INSTITUTIONS 9–10 (2012) (discussing continuous, on-site supervision of large financial institutions). For a discussion of the regulatory agencies' role as supervisors, see JOHN ARMOUR ET AL., PRINCIPLES OF FINANCIAL REGULATION 579–86 (2016). For thoughtful historical analyses of financial supervision, see Menand, *supra* note 19, at 1541–74; Rory Van Loo, *Regulatory Monitors*, 119 COLUM. L. REV. 369, 381–84 (2019).

206. *See supra* notes 162–65, 183–85, 188–89 and accompanying text.

207. *See infra* Parts III.B–C.

208. *See* Jeremy Kress, *Fed Should Force Wells Fargo into Being a Simpler Bank*, AM. BANKER (Oct. 26, 2018), https://www.americanbanker.com/opinion/fed-should-force-wells-fargo-into-being-a-simpler-bank [https://perma.cc/HS9C-ATYZ] (discussing shortcomings of recent enforcement actions).

in the aftermath of the fraudulent accounts scandal would impair the firm's after-tax net income by just $100 million.[209] Divesting certain operating segments, by contrast, would meaningfully sanction a financial conglomerate for past misconduct or excessive risk-taking.[210] If regulators were to use their divestiture authority, firms would respond by investing in risk management and reducing their risk profiles to avoid being the target of a divestiture order. Some conglomerates might even shrink themselves voluntarily to reduce the threat of such a significant sanction. In sum, an active divestiture regime would have a salutary deterrent effect on TBTM firms.

Finally, in contrast to other, politically infeasible break-up proposals, divestitures do not require new legislative action. To the contrary, Congress has already authorized regulators to mandate divestitures under several laws dating back as early as the 1970s.[211] Congressional observers, on the other hand, forecast dim prospects for legislative action on *any* financial services policies—let alone legislation as significant as breaking up the banks—in the near future.[212] Policymakers' best hope of addressing the TBTM problem, therefore, is by using their existing divestiture authorities.

In sum, regulatory divestitures are superior to other breakup plans for several compelling reasons.[213] In particular, divestitures would reduce the systemic footprint of problematic financial firms, preserve economies of scale and scope for most institutions, increase banks' incentives to operate prudently, and not require new legislation. To best address the TBTM problem, therefore, regulators should exercise their little-known and underutilized divestiture authorities.

209. *See* Ross Kerber, *Wells Fargo Trims Expected Hit from Regulatory Cap on Assets*, REUTERS (May 10, 2018), https://www.reuters.com/article/us-wells-fargo-investors/wells-fargo-trims-expected-hit-from-regulatory-cap-on-assets-idUSKBN1IB1FR [https://perma.cc/8L8V-2GV5].

210. *See, e.g.*, Kress, *supra* note 208 (estimating that divesting Wells Fargo's nonbank operations would decrease the firm's revenue by approximately 15%).

211. Parts III.B and III.C explore these authorities.

212. *See* Neil Haggerty, *Divided Congress = Gridlock for Financial Services Policy*, AM. BANKER (Nov. 7, 2018), https://www.americanbanker.com/news/divided-congress-gridlock-for-financial-services-policy [https://perma.cc/GX8E-JD3Y].

213. For an argument in favor of divestitures as a sanction in the corporate criminal law context, see W. Robert Thomas, *Incapacitating Criminal Corporations*, 72 VAND. L. REV. 905, 941–42, 950–54 (2019).

B. EXISTING DIVESTITURE AUTHORITIES

As noted above, the financial regulatory agencies have numerous existing authorities empowering them to order divestitures. The statutory criteria for compelling a divestiture vary. In some cases, regulators must demonstrate that the financial institution has engaged in misconduct; under other authorities, regulators have to show that the company poses a threat to financial stability. The divestiture authorities, however, all have one thing in common: regulators have invoked them exceedingly rarely, if at all. This Section explores the numerous ways in which regulators could compel a financial institution to divest operations, if the agencies chose to do so.

In perhaps the broadest existing divestiture authority, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) authorizes the federal banking agencies to compel a divestiture by a bank that engages in an "unsafe or unsound practice" or violates a law or regulation.[214] Congress has never defined "unsafe or unsound practice,"[215] but courts have interpreted the phrase expansively.[216] FIRREA therefore gives the agencies wide latitude to bring enforcement actions against banks. The agencies exercise this enforcement authority routinely, yet they invariably seek remedies, such as fines, that are far more modest than divestiture.[217] Regulators have pursued divestitures in response to unsafe or unsound practices or violations of law only in exceedingly rare circumstances.[218]

214. Pub. L. No. 101-73, § 902, 103 Stat. 183, 450 (1989) (codified at 12 U.S.C. §§ 1818(b)(6)–(7) (2012)) (authorizing the federal banking agencies to require a firm to "dispose of any loan or asset" or to "place limitations on the [firm's] activities or functions").

215. *See* Heidi Mandanis Schooner, *Fiduciary Duties' Demanding Cousin: Bank Director Liability for Unsafe or Unsound Banking Practices*, 63 GEO. WASH. L. REV. 175, 188 (1995).

216. *See, e.g.*, *in re* Seidman, 37 F.3d 911, 928 (3d Cir. 1994) (interpreting "unsafe or unsound practice" to refer to any action or inaction that is contrary to generally accepted standards of prudent operation and that could pose an abnormal risk to the institution's financial stability). More recently, the Office of the Comptroller of the Currency has interpreted the phrase even more broadly, insisting that regulators need not demonstrate that the practice posed a risk to the financial stability of the institution. *See* Patrick Adams, Enforcement Action No. OCC AA-EC-11-50, 2014 WL 8735096, at *11, *13, (Sept. 30, 2014).

217. *See* BARR ET AL., *supra* note 34, at 910–12 (discussing federal banking agencies' enforcement practices).

218. *See, e.g.*, Charter Pac. Bank, FDIC Enforcement Action No. 00-034b (Feb. 28, 2002) (ordering divestiture of bank's credit card division).

Similarly, pursuant to a 1978 amendment to the BHC Act, the Federal Reserve may compel a BHC to divest a subsidiary when its continued operation "is inconsistent with sound banking principles."[219] This authority is designed to protect a holding company's insured depository institution when another subsidiary—for example, its investment bank—poses a risk to the depository institution's stability.[220] The Federal Reserve, however, has never attempted to enforce this provision.[221]

A third authority permits the federal banking agencies to order a divestiture by a bank experiencing severe financial stress. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) established a prompt corrective action (PCA) regime that applies increasingly stringent constraints on a bank when its regulatory capital ratios fall below minimum requirements.[222] As a last step before placing a bank into receivership, regulators may use their PCA authority to compel divestitures of business lines or subsidiaries when the bank becomes "significantly undercapitalized," with a common equity tier 1 capital ratio of less than 3% under current law.[223] Most often, however, the regulatory agencies take other reme-

219. Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-630, § 105, 92 Stat. 3641, 3646 (codified at 12 U.S.C. § 1844(e)(1) (2012)).

220. *See id.*

221. Thomas M. Hoenig, President, Fed. Reserve Bank of Kan. City, Address at The William Taylor Memorial Lecture, It's Not Over 'Til It's Over: Leadership and Financial Regulation 4 (Oct. 10, 2010) ("[T]he [BHC] Act allow[s] regulators to force the termination of activities or sale of subsidiaries that are a risk to the safety and soundness of an affiliate bank. To my knowledge, this authority has never been successfully used for a major banking organization.").

222. *See* FDIC Improvement Act of 1991, Pub. L. No. 102-242, § 131, 105 Stat. 2236, 2258 (codified at 12 U.S.C. § 1831o (2012)). Dodd-Frank directs the Federal Reserve to establish an "early remediation" regime for BHCs that would be comparable to the PCA framework for banks. *See* 12 U.S.C. § 5366(c)(2) (2012). The Federal Reserve proposed an early remediation rule in 2012 but has never finalized this framework. *See* Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 596 (proposed Jan. 5, 2012).

223. 12 U.S.C. § 1831o(f)(2)(I) (permitting regulators to require (1) a significantly undercapitalized depository institution to divest subsidiaries, or (2) any company that controls the depository institution to divest the institution or other subsidiaries); 12 C.F.R. § 324.403(b)(4)(iii) (2019) (establishing regulatory capital thresholds for classification of depository institutions as significantly undercapitalized).

dial actions—such as ordering the bank to raise capital or restricting its interest rates—instead of ordering divestitures when a firm becomes significantly undercapitalized.[224]

Still other statutory provisions allow federal regulators to break up a financial conglomerate if necessary to preserve U.S. financial stability. Under Dodd-Frank, for example, the Federal Reserve and Financial Stability Oversight Council (FSOC) may require a financial institution to divest assets or subsidiaries if the firm "poses a grave threat to the financial stability of the United States."[225] Similarly, the Federal Reserve and FDIC may order a financial institution to divest specified assets or operations if the company repeatedly fails to submit a credible "living will" explaining how the company would be resolved in the event of its material financial distress or failure.[226] The agencies, however, have never used either of these authorities.

In sum, financial regulators have no shortage of tools with which to compel divestitures, but they have consistently declined to use these authorities. In some respects, the agencies' hesita-

224. *See, e.g.*, N. Cty. Bank, FDIC Enforcement Action No. 10-431PCAS (June 24, 2010) (requiring that a significantly undercapitalized bank either recapitalize or be acquired).

225. 12 U.S.C. § 5331(a), (a)(5) (2012) (requiring the Board to order divestiture if the Board determines that less aggressive tactics would be "inadequate to mitigate a [financial] threat"). For background on FSOC and its role as a systemic risk regulator, see generally Hilary J. Allen, *Putting the "Financial Stability" in Financial Stability Oversight Council*, 76 OHIO ST. L.J. 1087, 1113–38 (2015) (explaining FSOC's structure and mandate); Jeremy C. Kress, Patricia A. McCoy & Daniel Schwarcz, *Regulating Entities & Activities: Complementary Approaches to Nonbank Systemic Risk*, 92 S. CAL. L. REV. (forthcoming 2019) (manuscript at 17–24) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3238059) (charting FSOC's evolution from an entity-based to an activities-based approach to nonbank systemic risk); Daniel Schwarcz & David Zaring, *Regulation by Threat: Dodd-Frank and the Nonbank Problem*, 84 U. CHI. L. REV. 1813, 1834–38 (2017) (discussing FSOC's designation power); Christina P. Skinner, *Regulating Nonbanks: A Plan for SIFI Lite*, 105 GEO. L.J. 1379, 1387–90 (2017) (examining FSOC's role in filling "institutional gap[s]").

226. 12 U.S.C. § 5365(d)(5)(B) (2012) ("The Board . . . may jointly direct a nonbank financial company . . . to divest certain assets . . . [if] the company has failed, within the 2-year period . . . to resubmit the resolution plan with such revisions as were required."); *Living Wills (or Resolution Plans)*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., https://www.federalreserve.gov/supervisionreg/resolution-plans.htm [https://perma.cc/6GUE-SQWN] ("[R]esolution plans . . . commonly known as a living will, must describe the company's strategy for rapid and orderly resolution in the event of material financial distress or failure of the company.").

tion is understandable. For example, a regulator might be reluctant to order a divestiture under FIRREA because the nebulous "unsafe or unsound" standard could be vulnerable to legal challenge.[227] Furthermore, requiring a financially distressed depository institution to divest operations under FDICIA could perversely hasten its demise if the firm were to sell the assets at a loss.[228] And given the relative calm in financial markets since Dodd-Frank's enactment, it is reasonable to conclude that no institution has posed a grave threat sufficient to warrant divestiture under Dodd-Frank's financial stability provisions. Thus, while divestitures are, in theory, a promising response to the TBTM problem, these divestiture authorities suffer from potentially problematic limitations that hamper the agencies' ability to use them in practice.

The foregoing divestiture authorities, however, are not exhaustive. A final statutory provision offers regulators the most promising strategy to use divestitures to address the TBTM problem, but only if the Federal Reserve changes its enforcement policies.

C. SECTION 4(M): THE MOST PROMISING DIVESTITURE AUTHORITY

Under the optimal approach to the TBTM problem, the Federal Reserve would exercise its statutory authority to compel divestitures by an FHC that falls out of compliance with regulatory requirements. Section 4(m) of the BHC Act permits the Federal Reserve to order an FHC to divest its nonbank subsidiaries when the company or its depository institution subsidiary ceases to be "well capitalized" or "well managed," as defined by regulation.[229] The Federal Reserve, however, has never publicly used this authority, opting instead to put noncompliant FHCs in a "penalty box" devoid of meaningful constraints.[230] Section III.C.1 explains

227. *See supra* note 216 and accompanying text (discussing judicial and administrative interpretations of "unsafe or unsound practices").

228. *See* Anderi Shleifer & Robert Vishnay, *Fire Sales in Finance and Macroeconomics*, 25 J. ECON. PERSPECTIVES 29, 29 (quoting KENNETH R. FRENCH ET AL., THE SQUAM LAKE REPORT 67 (2010)) ("A bank that simply suffers large losses may be forced to reduce its risk by selling assets at distressed or fire-sale prices . . . .").

229. 12 U.S.C. § 1843(*l*)(1), (m)(4) (2012).

230. *See* Brian Christiansen, *Sending Financial Holding Cos. To the 'Penalty Box,'* LAW360 (Mar. 14, 2012, 2:20 PM), https://www.law360.com/articles/303446 [perma.cc/729V-Q7K4] (describing the "penalty box" for noncompliant

why the Federal Reserve's current approach to noncompliant FHCs is unsatisfactory. Section III.C.2 then contends that the Federal Reserve's untapped power to require divestitures by noncompliant FHCs represents the most promising strategy for addressing the TBTM problem.

1. The Federal Reserve Has Neglected Section 4(m)

Section 4(m) of the BHC Act grants the Federal Reserve wide latitude to sanction an FHC when it ceases to meet eligibility standards. This Section explains the Federal Reserve's current, permissive approach when an FHC falls out of compliance and why this lenient strategy is misguided.

a. Understanding the Current Approach

Recall that FHCs are a special subset of BHCs permitted to engage in an expanded range of financial activities. As discussed in Section I.A.2, BHCs were historically limited to commercial banking and some "closely related" activities like investment advising and asset management.[231] In 1999, however, the Gramm-Leach-Bliley Act created a new category of BHCs, called FHCs, permitted to engage in an expanded range of financial activities, including investment banking, insurance underwriting, and merchant banking.[232]

Not all holding companies are eligible to become FHCs, however. To the contrary, FHCs must meet heightened regulatory standards to ensure that only strong, well-run firms engage in potentially risky financial activities. As amended by Gramm-Leach-Bliley and Dodd-Frank, section 4 of the BHC Act provides that to become and remain an FHC, both the holding company itself and all of its insured depository institution subsidiaries must be "well capitalized" and "well managed."[233] By regulation, the federal banking agencies consider a holding company or depository institution to be "well capitalized" if it maintains capital ratios roughly 25% higher than minimum requirements.[234] In

FHCs); Kress, *supra* note 208 (noting that Federal Reserve has never publicly used its 4(m) divestiture authority).

231. *See supra* note 50 and accompanying text.

232. *See supra* note 53 and accompanying text.

233. 12 U.S.C. § 1843(*l*)(1) (2012). In addition, for a company to become an FHC, all of its subsidiary depository institutions must have at least a satisfactory rating under the Community Reinvestment Act (CRA). 12 U.S.C. § 2903(c)(1) (2012).

234. *Compare* 12 C.F.R. § 225.2(r)(1)(i)–(ii) (2019) (providing that a BHC

addition, the Federal Reserve deems a holding company or depository institution to be "well managed" if it receives satisfactory management and composite ratings at its annual supervisory examination.[235] A BHC that meets these standards may elect to become an FHC and thereby engage in the full range of financial activities without further Federal Reserve approval.[236] Since Gramm-Leach-Bliley's enactment, hundreds of holding companies, including all of the largest firms, have elected to become FHCs.[237]

Section 4(m) of the BHC Act prescribes certain remedial measures if a company that elects to become an FHC later falls out of compliance with the "well-capitalized" or "well-managed" standards. The statute provides that a noncompliant FHC must execute an agreement—commonly referred to as a "4(m) agreement"—with the Federal Reserve in which the company commits to correcting its deficiencies within 180 days.[238] As part of the 4(m) agreement, the Federal Reserve "may impose such limitations on the conduct or activities of th[e FHC] . . . as [it] determines to be appropriate under the circumstances. . . ."[239] If the FHC does not return to compliance within the requisite 180 days, section 4(m) expressly authorizes the Federal Reserve to order the company to divest either its depository institutions or its BHC-impermissible activities.[240] In practice, such a divestiture order would be akin to revoking the company's FHC status,

must maintain a 10% total risk-based capital ratio and 6% tier 1 risk-based capital ratio to be "well capitalized"), *and* 12 C.F.R. §§ 6.4(b)(1)(i)–(ii), 208.43(b)(1)(i)–(ii), 325.103(b)(1) (2019) (providing that an insured depository institution must maintain a 10% total risk-based capital ratio and 6% tier 1 risk-based capital ratio to be "well capitalized"), *with* 12 C.F.R. §§ 3.10(a)(2)–(3), 217.10(a)(2)–(3), 324.10(a)(2)–(3) (2019) (requiring a BHC or insured depository institution to maintain, at a minimum, an 8% total risk-based capital ratio and 6% tier 1 risk-based capital ratio).

235. 12 C.F.R. § 225.2(s)(1)(i)(A)–(B).

236. 12 C.F.R. §§ 225.82(a), (b)(3), (b)(5), 225.85 (2019). Section 4(k)(4) of the BHC Act and Federal Reserve regulations enumerate the "financial in nature" activities that are permissible for FHCs. 12 U.S.C. § 1843(k)(4) (2012); 12 C.F.R. § 225.86 (2019).

237. *See supra* note 58 and accompanying text.

238. *See* 12 U.S.C. § 1843(m); Kress, *supra* note 208 ("[T]he Fed typically orders a noncompliant FHC to execute a 'section 4(m) agreement.'").

239. 12 U.S.C. § 1843(m)(3).

240. *Id.* §§ 1843(m)(4)(A)–(B) ("[T]he Board may require such [FHCs] . . . to divest control of any subsidiary depository institution; or at the election of the [FHC] instead to cease to engage in any activity . . . that is not an activity that is permissible for [BHCs].").

since the company would have to limit itself to activities permissible for a traditional BHC or else exit the regulated banking sector entirely.

The Federal Reserve, however, has never publicly exercised its section 4(m) divestiture authority, despite numerous opportunities to do so.[241] Section 4(m) agreements are typically treated as confidential supervisory information, as are the examination ratings on which a holding company's well-managed status is based.[242] Nonetheless, the Federal Reserve has released aggregate data indicating that more than forty percent of large FHCs received unsatisfactory composite ratings at their most recent supervisory examinations and thus fail to meet the well-managed criteria to maintain their FHC status.[243] In fact, in every year since 2009, between one-third and one-half of the largest holding companies did not satisfy the well-managed requirement.[244] Recent media leaks have revealed that Wells Fargo and Deutsche Bank received supervisory downgrades in 2017 and are thus among the noncompliant FHCs.[245] If these companies failed to correct their managerial deficiencies within the requisite 180 days—and it is virtually certain they did not do so—the Federal Reserve could order them to divest.[246] Yet the Federal Reserve has never used this power.

241. *See supra* note 230 and accompanying text.

242. *See* Margaret E. Tahyar, *Are Bank Regulators Special?*, 6 BANKING PERS. 22, 27 (2018), https://www.theclearinghouse.org/-/media/new/tch/documents/banking-perspectives/bp-q1-2018-book-v2.pdf [https://perma.cc/K27B-Z7ZC] ("Because the Federal Reserve treats the failure to be well managed as confidential supervisory information, the existence and scope of 4(m) limitations are confidential.").

243. SUPERVISION AND REGULATION REPORT, *supra* note 31, at 15 fig.14.

244. *See id.* By contrast, few FHCs have fallen out of compliance with the "well capitalized" standard since the financial crisis. *See, e.g.*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., DODD-FRANK ACT STRESS TEST 2018: SUPERVISORY STRESS TEST METHODOLOGY AND RESULTS 29–30 tbls.4.A–C (2018) (demonstrating that all large FHCs are well-capitalized and, based on supervisory models, would remain so during a severe recession).

245. *See* Emily Glazer, *Wells Fargo Earns New Ire from Bank Overseers*, WALL ST. J. (Jan. 5, 2018, 5:56 PM), https://www.wsj.com/articles/wells-fargo-earns-new-ire-from-bank-overseers-1515187163 ("In mid-2017, the OCC downgraded one element in Wells Fargo's CAMELS rating. . . . Management[] was downgraded to a 3 from a 2 . . . signif[ying] that oversight 'needs improvement.'"); Strasburg & Tracy, *supra* note 25 ("The Federal Reserve has designated Deutsch Bank . . . as being in a 'troubled condition.'").

246. *See* Kress, *supra* note 208 (expressing doubt that regulators have upgraded Wells Fargo's supervisory rating).

Rather than exercise its section 4(m) divestiture authority, the Federal Reserve typically takes a much more permissive approach: it routinely extends a noncompliant FHC's section 4(m) agreement.[247] The Federal Reserve, in other words, gives the company additional time in which to remediate the deficiencies that it failed to address within the initial 180-day period. Banking industry lawyers often refer to the time a noncompliant FHC spends subject to a section 4(m) agreement as the "penalty box."[248] The practical effect of being in the penalty box, however, is virtually meaningless.

During the pendency of a section 4(m) agreement, the Federal Reserve generally permits a firm to continue engaging in all of its existing activities, including investment banking, insurance underwriting, and merchant banking.[249] The only substantive constraints in most section 4(m) agreements are prohibitions on commencing a new financial activity or acquiring shares of a company engaged in a BHC-impermissible activity.[250] These restrictions, however, have little practical effect on the largest FHCs, which already engage in the full panoply of financial activities and may therefore continue these activities even when they are not "well capitalized" or "well managed." Thus, despite statutory authority to limit a noncompliant FHC's activities or even mandate divestitures, the Federal Reserve routinely permits such a firm to continue conducting business as usual.

The Federal Reserve's reasons for neglecting its section 4(m) authority are not clear, as the agency has never publicly explained why it permits chronically noncompliant FHCs to continue engaging in expanded financial activities.[251] To be sure, the Federal Reserve's reluctance to invoke section 4(m) could be attributable to regulatory capture.[252] Similarly, the agency's inaction might reflect limitations in its ability to supervise big

247. *See* T.J. Grasmick, *Dodd-Frank and Reconsidering Financial Holding Company Status*, LEXOLOGY (Sept. 13, 2010), https://www.lexology.com/library/detail.aspx?g=f663b8fa-8f11-4b9c-94f5-df2f059e75d8 [https://perma.cc/82BN-CKPY] ("[I]n practice, cure agreements usually require extensions and become little more than an additional supervisory burden.").

248. *See* Christiansen, *supra* note 230.

249. *See* Christiansen, *supra* note 230 ("During the conformance period, the FHC generally is permitted to retain existing activities."); *supra* note 53 and accompanying text.

250. *See* Christiansen, *supra* note 230.

251. *See, e.g.*, *supra* note 230 and accompanying text.

252. *See, e.g.*, Kevin Wack, *Fed Faulted for Failing to Do More to Prevent Regulatory Capture*, AM. BANKER (Dec. 7, 2017, 1:31 PM), https://www

banks and accurately assess their managerial capabilities.[253] While these rationales may be partially true, they likely do not fully explain the Federal Reserve's reluctance to use section 4(m). Indeed, the agency has adopted meaningful post-crisis regulatory reforms despite regulatory capture concerns.[254] Moreover, there are reasonable steps the Federal Reserve could take to enhance its supervisory processes if it wanted to use section 4(m), as discussed below in Section V.D.

The most plausible explanation for the Federal Reserve's passive approach to section 4(m) is that its inaction has become a self-fulfilling prophecy. The Federal Reserve is well known for being a conservative institution built on tradition and "secret lore."[255] In the immediate aftermath of Gramm-Leach-Bliley, the notoriously pro-industry Alan Greenspan-era Federal Reserve opted not to use the agency's new section 4(m) divestiture authority.[256] This industry-friendly precedent made it less likely that the Federal Reserve would invoke section 4(m) in the future. Indeed, if the Federal Reserve were to order a noncompliant FHC to divest its financial activities today, the agency would no doubt face criticism that it was acting arbitrarily and capriciously, given its decades-long neglect of section 4(m).[257] Accordingly, the Federal Reserve does not use its section 4(m) authority today, at least in part, because it has never used it in the past.

Whatever the reason, the Federal Reserve has consistently taken an extremely permissive approach to chronically noncompliant FHCs. Rather than using its divestiture authority, the Federal Reserve does the bare minimum that it is required to do

.americanbanker.com/news/fed-faulted-for-failing-to-do-more-to-prevent-regulatory-capture [https://perma.cc/GDR7-4HLE].

253. *See* Menand, *supra* note 19, at 1583–86 (discussing practical constraints on the Federal Reserve's supervisory discretion).

254. For an overview of post-crisis regulatory reforms adopted by the Federal Reserve and other financial regulators, see Jacob J. Lew, *Eight Years After the Financial Crisis: How Wall Street Reform Strengthened Our Financial System and Laid the Foundation for Long-Run Growth*, 19 N.Y.U. J. LEGIS. & PUB. POL'Y 611, 614–19, 621–24 (2016).

255. Tahyar, *supra* note 242, at 24.

256. For background and discussion of Alan Greenspan's deregulatory ideology, see SEBASTIAN MALLABY, THE MAN WHO KNEW: THE LIFE AND TIMES OF ALAN GREENSPAN 58–75 (2016).

257. As this Article suggests, however, the Federal Reserve could avoid allegations of arbitrariness by promulgating a rule establishing in advance how it plans to implement section 4(m). *See infra* Part IV.

by statute: it keeps such companies in an extended, but functionally meaningless, penalty box.

b. Drawbacks of the Current Approach

The Federal Reserve's lenient approach to noncompliant FHCs is flawed for three important reasons. First, the ineffectual section 4(m) penalty box fails to hold noncompliant FHCs accountable for their weak supervisory condition, thereby exposing the financial system to risks. Second, the Federal Reserve's practice of continually extending section 4(m) agreements without imposing meaningful constraints is contrary to Congressional intent. Finally, the lack of transparency and clear guidelines in the Federal Reserve's current approach raises questions about democratic accountability and the rule of law.

The primary drawback of the Federal Reserve's light-touch approach is that it does not adequately penalize an FHC for failing to comply with the "well-capitalized" or "well-managed" requirements. These eligibility standards are supposed to ensure that only strong, well-run firms are able to engage in risky financial activities that, if mismanaged, could threaten the stability of the financial system.[258] The absence of meaningful constraints in a section 4(m) agreement, however, gives a company little additional incentive to remediate its deficiencies when it falls out of compliance with the "well-capitalized" or "well-managed" criteria. The lack of urgency, in turn, exposes the financial sector to serious risks. Indeed, many of the United States' largest financial conglomerates still engage in potentially volatile nonbanking activities despite not satisfying the requisite prudential standards.[259]

258. *See, e.g.*, Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 261 (2010) ("[A]s a factual matter, non-bank activities of bank holding companies are riskier than their banking activities."); *see also* Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies, 83 Fed. Reg. 61408, 61415 (proposed Nov. 29, 2018) (to be codified in scattered sections of 12 C.F.R.) ("Nonbank activities may involve a broader range of risks than those associated with purely banking activities . . . . If not adequately managed, the risks associated with nonbanking activities could present significant safety and soundness concerns and increase financial stability risks."). As Professor Saule Omarova contends, risks associated with one particular FHC-permissible activity—physical commodities trading—may be especially pronounced. *See* Saule T. Omarova, *The Merchants of Wall Street: Banking, Commerce, and Commodities*, 98 MINN. L. REV. 265, 343–46 (2013).

259. *See supra* notes 243–45 and accompanying text.

Relatedly, this permissive approach to noncompliant FHCs runs counter to Congressional intent. Under its current stance, the Federal Reserve essentially treats the "well-capitalized" and "well-managed" standards as qualification thresholds that companies must satisfy at a single point in time, when they first elect to become FHCs.[260] After a company has elected FHC status, however, the Federal Reserve allows it to fall out of compliance while continuing to engage in the full range of financial activities.[261] This perverse outcome is not what Congress intended when it created the FHC designation. Rather, the BHC Act makes clear that the "well-capitalized" and "well-managed" eligibility standards are to be applied on an ongoing basis, with meaningful consequences for FHCs that fall out of compliance.[262] Moreover, the Federal Reserve's refusal to enforce section 4(m) is particularly troubling in light of the Dodd-Frank Act's expansion of the "well-capitalized" and "well-managed" standards to cover not only an FHC's subsidiary banks—as Gramm-Leach-Bliley originally provided—but also the holding company itself.[263] By strengthening the FHC qualification thresholds, Congress effectively endorsed section 4(m) as a response to the TBTM problem.

Finally, the Federal Reserve's current approach to section 4(m) raises serious questions about transparency, democratic accountability, and the rule of law. Under the existing system, the Federal Reserve and other federal banking agencies might lack appropriate incentives to upgrade a firm's supervisory rating

260. *See supra* Part III.C.1.a.

261. *See supra* notes 249–50 and accompanying text.

262. Notably, the BHC Act establishes a mild sanction when an FHC's subsidiary depository institution receives a less than satisfactory CRA rating. *See supra* note 233 (describing CRA eligibility requirement). Specifically, the Act provides that the FHC may not commence a new BHC-impermissible activity or acquire control of a company engaged in a BHC-impermissible activity if its depository institution subsidiary falls out of compliance with the CRA requirement. 12 U.S.C. § 1843(*l*)(2) (2012). The BHC Act's possible divestiture sanction for noncompliance with the well-capitalized and well-managed requirements is, by comparison, relatively severe. In practice, however, the Federal Reserve applies a penalty for falling out of compliance with the prudential requirements that is equivalent to the mild penalty for CRA noncompliance. The Federal Reserve should not treat both types of noncompliance equally, however, because an FHC's failure to remain well capitalized or well managed suggests that the firm poses potential safety-and-soundness and financial stability concerns, while its failure to maintain a satisfactory CRA rating does not. *See supra* notes 233, 258 and accompanying text.

263. *See supra* note 55.

when it eventually corrects its deficiencies.[264] On this view, an agency might assign and maintain unsatisfactory supervisory ratings, at least in part, to avoid embarrassment were another financial crisis to happen at a time when financial institutions are all highly rated, as occurred in 2008.[265] Persistent unsatisfactory supervisory ratings can have adverse consequences for a firm—ranging from branching restrictions to limits on mergers and acquisitions.[266] Nonetheless, the supervisory agencies might allow these unsatisfactory ratings to persist, while the Federal Reserve continues extending the applicable section 4(m) agreement without making difficult, public decisions about when and under what circumstances more severe sanctions should apply.[267] In this way, the agencies can leave firms in supervisory limbo in an effort to shield themselves from public criticism if a highly-rated firm were to collapse. Accordingly, the Federal Reserve's poorly defined approach to confidential section 4(m) agreements calls into question the legitimacy of the "secret realm" of bank supervision.[268]

In sum, the Federal Reserve's current treatment of noncompliant FHCs fails to sufficiently penalize those firms, runs counter to Congressional intent, and raises questions about supervisory agencies' transparency and legitimacy. Even more troublingly, by failing to meaningfully sanction FHCs when they fall out of compliance with prudential standards, the Federal Reserve has neglected a potentially powerful tool for addressing the TBTM problem.

264. By law, an individual firm's supervisory ratings are confidential. *See* Tahyar, *supra* note 242, at 24. The Federal Reserve, however, recently began releasing aggregate data on holding company ratings. *See* SUPERVISION AND REGULATION REPORT, *supra* note 31, at 15 fig.14.

265. *See* SUPERVISION AND REGULATION REPORT, *supra* note 31, at 15 fig.14 (showing that nearly all large holding companies received satisfactory supervisory ratings in 2007 and 2008).

266. *See* 12 U.S.C. § 36(g)(2)(A) (2012) (prohibiting a national bank from interstate de novo branching unless the bank is well managed); 12 U.S.C. § 1831u(b)(4)(B) (2012) (prohibiting an interstate bank merger unless the resulting bank would be well managed upon consummation of the transaction).

267. Moreover, as Margaret Tahyar asserts, this "secret realm" of confidential supervisory oversight gives agencies extraordinary discretion to grant waivers, make exceptions, or otherwise vary the terms supervisory restrictions, without appropriate checks and balances. *See* Tahyar, *supra* note 242, at 26–28.

268. *Id.* at 26.

2. The Promise of Section 4(m) Divestitures

A more coherent approach to section 4(m) would be policymakers' best strategy for addressing the TBTM problem. Requiring divestitures under section 4(m) in appropriate circumstances would not only restore meaning to the "well-capitalized" and "well-managed" standards, it would also protect the financial system from FHCs that are too big or complex to satisfy those prudential safeguards. By establishing a framework for compelling divestitures by noncompliant FHCs, the Federal Reserve could achieve benefits similar to other divestiture authorities, but with the additional advantages of appropriate thresholds and predictability.

Like other divestiture authorities, using section 4(m) to compel divestitures by individual firms would have several advantages over broader break-up proposals. For example, section 4(m) would affect only the riskiest FHCs, as measured by their capital ratios and supervisory exams, thereby preserving economies of scale and scope for most financial firms.[269] In this way, section 4(m) appropriately recognizes that not all large financial conglomerates are TBTM. However, if a firm demonstrates that it is TBTM and fails to improve its weaknesses, section 4(m) provides a mechanism to shrink the firm's systemic footprint and make it easier to manage.

Moreover, similar to other divestiture authorities, section 4(m) would enhance FHCs' incentives to comply with regulatory requirements.[270] Whereas the Federal Reserve's current, lenient approach to section 4(m) is unlikely to deter FHCs from misconduct or excessive risk-taking, compulsory divestitures for noncompliant FHCs would increase firms' incentives to operate prudently and invest in risk management and compliance systems. And, like other existing divestiture authorities, section 4(m) is superior to legislative break-up proposals because it does not require new congressional action.

While section 4(m) shares many of the same advantages as other divestiture authorities, it has two important features that distinguish it from regulators' other divestiture powers. First, section 4(m)'s "well-capitalized" and "well-managed" standards are appropriate thresholds at which regulators should mandate that a financial conglomerate break itself up. Many other divestiture authorities, by contrast, set too stringent a threshold for

269. *See, e.g.*, *supra* notes 203–08.

270. *See supra* notes 208–13.

when regulators may force a financial institution to divest. For example, waiting until a financial institution poses a "grave threat" to U.S. financial stability before ordering a divestiture could be too late to mitigate risks to financial stability.[271] Likewise, compelling a divestiture only when a depository institution becomes "significantly undercapitalized" could be insufficient to save the firm from failure.[272] By comparison, section 4(m) strikes the appropriate balance by revoking an FHC's status when it fails to meet heightened capital and management standards but before it poses an imminent threat to the financial system.

Section 4(m)'s "well-capitalized" and "well-managed" criteria are not only better calibrated than other divestiture standards, they are also more predictable and, accordingly, more likely to survive judicial review. Many existing divestiture authorities are highly discretionary, and regulators have established little guidance for how they might be interpreted. FIRREA's broad "unsafe or unsound practice" standard, for example, has been characterized as "ambiguous" and "vague."[273] Critically, the standard has been subject to protracted and recurring judicial battles, as agencies and litigants wrangle over what constitutes an unsafe or unsound practice.[274] The BHC Act's "inconsistent with sound banking principles" standard likewise lacks a broadly accepted definition.[275] Regulators, therefore, might be appropriately cautious to stake a penalty as significant as divestiture on such an ambiguous—and legally vulnerable—statutory standard.

Section 4(m)'s divestiture criteria, by contrast, are reasonably well defined. Indeed, the "well-capitalized" standard is strictly numeric—10% total and 6% tier 1 risk-based capital—leaving little room for regulatory discretion.[276] Even the "well-

271. 12 U.S.C. § 5331(a) (2012).

272. 12 U.S.C. § 1831o(f), (f)(2)(I) (2012).

273. Thomas L. Holzman, *Unsafe or Unsound Practices: Is the Current Judicial Interpretation of the Term Unsafe or Unsound?*, 19 ANN. REV. BANKING L. 425, 425, 435 (2000).

274. *See id.* at 436–41, 444–52 (cataloguing the evolution of judicial circuit splits over the term "unsafe or unsound"); *see also* Patrick Adams, Enforcement Action No. OCC AA-EC-11-50, 2014 WL 8735096, at *11, *13, (Sept. 30, 2014) (discussing OCC's evolving interpretation of "unsafe or unsound practice").

275. Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-630, § 105, 92 Stat. 3641, 3646 (codified at 12 U.S.C. § 1844(e)(1)(2012)); *see* Hoenig, *supra* note 221 (noting that the Federal Reserve has never used the BHC Act authority to compel a divestiture).

276. *See supra* note 234 (describing risk-based capital requirements).

managed" standard, which necessarily relies on supervisors' discretionary exam ratings, is clearer than the other divestiture authorities.[277] Indeed, the regulatory agencies publish detailed supervisory manuals establishing guidelines for assessing exam ratings.[278] Most prominently, the Federal Reserve recently promulgated, through notice-and-comment rulemaking, revised standards for assessing supervisory ratings, including thorough explanations of its evaluation criteria.[279] Section 4(m)'s standards, therefore, are significantly clearer than the more discretionary standards in other divestiture authorities. Divestiture standards under section 4(m) would be easier for regulators to apply, clearer for financial institutions to understand, and more likely to survive judicial review.

Thus, using section 4(m) to compel divestitures by noncompliant FHCs would be the optimal solution to the TBTM problem. By exercising its section 4(m) powers, the Federal Reserve could shrink the most problematic firms without the drawbacks of more draconian break-up plans. Moreover, in contrast to other divestiture authorities, section 4(m) establishes an appropriate threshold for when financial conglomerates should be required to divest, and it is less susceptible to judicial challenge. Accordingly, the Federal Reserve should use its section 4(m) divestiture authority in appropriate circumstances as a strategy to combat the TBTM problem.

IV. A DIVESTITURE FRAMEWORK

For the foregoing reasons, the Federal Reserve should adopt a policy specifying when it will require a noncompliant FHC to divest operations. This Part sketches out a framework in which the Federal Reserve would provide a noncompliant FHC two years to correct its deficiencies and, if the FHC fails to remediate

277. *Compare supra* note 235 and accompanying text (discussing section 4(m)'s "well-managed" standard), *with supra* notes 214–17, 273–74 and accompanying text (examining FIREA's "unsafe or unsound" standard), *and supra* notes 219–21 and accompanying text (describing the BHC Act's "inconsistent with sound banking principles" standard).

278. *See, e.g.*, FDIC, RISK MANAGEMENT MANUAL OF EXAMINATION POLICIES §§ 2.1–7.1 (2017) (providing detailed information about CAMELS rating system); *see also* Uniform Financial Institutions Rating System, 61 Fed. Reg. 67021, 67025–29 (Dec. 19, 1996) (establishing guidelines for CAMELS supervisory rating system).

279. *See* Large Financial Institution Rating System; Regulations K and LL, 83 Fed. Reg. 58724, 58734–39 (Nov. 21, 2018) (describing the CAMELS rating system).

its issues during that time, an additional two years to divest its depository institution subsidiaries or BHC-impermissible activities. When put into practice, this new framework will mitigate the TBTM problem by imposing a fair, but meaningful divestiture sanction on FHCs that fail to satisfy statutorily mandated prudential standards.

To implement an effective divestiture policy, the Federal Reserve should adopt a regulation pre-committing that it will use its section 4(m) divestiture authority when an FHC has been out of compliance with the well-capitalized or well-managed standard for two years. Recall that the BHC Act requires a noncompliant FHC to correct its deficiencies within 180 days, after which the Federal Reserve may compel divestitures.[280] This 180-day grace period is almost certainly too short for a noncompliant FHC to remediate its financial or managerial issues. Indeed, firms typically need at least a full annual examination cycle to demonstrate improvement sufficient to merit an upgrade of an unsatisfactory supervisory rating.[281] The Federal Reserve should thus use its discretion to lengthen the statutory timeframe to two years. Accordingly, the new policy would provide a noncompliant FHCs two examination cycles in which to raise sufficient capital or improve its managerial deficiencies. Two years provides an FHC ample time to fix its problems, but not so long as to allow its deficiencies to pose a threat to the broader financial system.

The policy would pre-commit that, if an FHC does not return to compliance within two years, the Federal Reserve will order the FHC to divest its depository institution subsidiaries or its BHC-impermissible activities within the following two years. Thus, after two years of noncompliance, the FHC would have an additional two years in which to sell, spin off, or close its banking or BHC-impermissible nonbanking operations. This two-year deadline would give a firm sufficient time to plan and execute a divestiture. The Federal Reserve's order would be final. Even if the FHC were to correct its deficiencies during the second two-year period, it would still be required to divest. The policy would, however, provide for a possible extension of the divestiture deadline if the Financial Stability Oversight Council determined that

280. *See supra* notes 238, 240 and accompanying text.

281. *See* Grasmick, *supra* note 247 ("[S]ince it generally takes at least 1 or 2 examination cycles before a bank enforcement can be terminated and 3 and 4 CAMELS ratings can be upgraded, cure agreements often cannot be satisfied as quickly as Regulation Y contemplates.").

a longer divestiture deadline would be necessary to preserve financial stability.[282]

Importantly, the Federal Reserve should adopt this section 4(m) framework through notice-and-comment rulemaking. Subjecting the policy to public notice-and-comment would accomplish several important objectives. First, it would provide the financial sector and the public an opportunity to provide feedback on the policy, perhaps strengthening the framework and increasing its legitimacy. Moreover, in contrast to informal guidance, a formal regulation would reduce the Federal Reserve's supervisory discretion that has plagued section 4(m) enforcement in the past.[283] In addition, given the gravity of the divestiture sanction, it would be appropriate for the Federal Reserve to notify the financial sector before adopting such a significant change in its enforcement practices. Finally, by promulgating its framework through rulemaking, the Federal Reserve would avoid allegations of arbitrariness if it were to order a section 4(m) divestiture with no notice after twenty years of failing to enforce the provision.[284]

In sum, this proposed framework would rationalize and clarify the Federal Reserve's heretofore obscure, ad hoc approach to section 4(m) enforcement. The policy sketched out in this Part would give a noncompliant FHC a two-year deadline to remediate its problems, after which it would have to divest operations within the following two years, subject to extension by the FSOC. This framework would finally give meaning to the BHC Act's heightened prudential standards for FHCs that engage in expanded financial activities. The policy, in turn, would mitigate the TBTM problem by shrinking firms whose supervisory records indicate that they are too large or complex to oversee effectively.

V. RESPONDING TO OBJECTIONS

Critics might raise several objections to this proposed divestiture framework. For example, opponents might contend that a section 4(m) divestiture would destabilize an FHC or the broader financial system, punish the FHC inappropriately, or constitute a regulatory taking. Further, critics might question

282. For further discussion of the financial stability implications of divestitures, see *infra* Part V.A.

283. *Cf. supra* note 277 and accompanying text.

284. *See supra* text accompanying note 257.

whether the Federal Reserve will, in practice, follow through with ordering a noncompliant FHC to divest. As this Part explains, however, none of these potential objections withstands scrutiny.

A. WOULD DIVESTITURES BE DESTABILIZING?

Some critics might oppose a robust section 4(m) divestiture regime on the ground that such divestitures could destabilize individual institutions and, by extension, the broader financial system. According to this critique, to the extent that a noncompliant FHC is already in some degree of financial or managerial distress, compelling the firm to divest significant segments might further weaken its condition. Moreover, if many firms were required to divest simultaneously—recall that at least forty percent of large institutions are currently not well managed[285]—the ensuing transactions could disrupt the wider financial sector.

These objections, however, are unpersuasive for two reasons. First, if structured appropriately, a divestiture need not destabilize a troubled financial institution. To the contrary, a divestiture could have a salutary effect on a firm to the extent that it spins off or shuts down weak or non-core operations. For example, insurance conglomerates MetLife and AIG recently divested sizable segments in response to regulatory pressures, yet neither firm suffered significant operational or financial disruption.[286] Moreover, the two-year period in which to complete a mandatory divestiture under the proposed framework would provide an institution ample time to plan and execute an orderly divestiture, thereby minimizing potential adverse effects.

Second, widespread divestitures are unlikely. Although many FHCs do not satisfy the well-managed requirement, these firms have relatively little incentive to improve their supervisory condition under the current section 4(m) enforcement regime.[287]

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285. *See supra* note 243 and accompanying text.

286. *See* Aaron Back, *Gloom Could Lift for MetLife After Brighthouse Split*, WALL ST. J. (Oct. 6, 2016, 3:25 PM), https://www.wsj.com/articles/gloom-could-lift-for-metlife-after-brighthouse-split-1475781921; Agnel Philip & Sonali Basak, *AIG Asset Sales Near $100 Billion With Mortgage Unit Exit: Table*, BLOOMBERG (Aug. 19, 2016, 7:01 AM), https://www.bloomberg.com/news/articles/2016-08-19/aig-asset-sales-near-100-billion-with-mortgage-unit-exit-table.

287. *See supra* notes 248–54 and accompanying text (discussing the Federal Reserve's lenient approach to noncompliant FHCs).

However, firms would invest in improving their risk management and corporate governance if the Federal Reserve were to credibly commit that noncompliant FHCs must divest operations. Thus, the prospect of pervasive divestitures would be remote. Rather, after the Federal Reserve first orders a noncompliant FHC to divest, the remaining noncompliant firms would take the necessary steps to return to compliance. Moreover, even if supervisory conditions were to warrant numerous, simultaneous divestitures, the FSOC could grant extensions as necessary to ensure the transactions do not threaten financial stability. In sum, therefore, the proposed section 4(m) divestiture framework is unlikely to have a destabilizing effect.

B. DOES THE PUNISHMENT FIT THE CRIME?

Next, critics might contend that, at least in some situations, the section 4(m) divestiture sanction would be inappropriate given the nature of a firm's supervisory problems. According to this objection, if a noncompliant FHC's managerial issues are confined to its bank subsidiary—as appears to be the case with Wells Fargo, for example[288]—it would be unfair to force the company to divest its investment bank and other nonbank operations.[289] In such circumstances, opponents might object that the divestiture punishment is inconsistent with the firm's underlying problems.

This objection is easily rebutted. Congress envisioned this exact situation, and it specifically authorized the Federal Reserve to revoke a firm's FHC status due to protracted supervisory issues in its bank subsidiary. In fact, when Congress first created the FHC designation, the condition of a company's bank subsidiary was the *only* prudential requirement for becoming

288. *See* Ethan Wolff-Mann, *Every Wells Fargo Consumer Scandal Since 2015: A Timeline*, YAHOO FIN. (Aug. 8, 2018), https://finance.yahoo.com/news/every-wells-fargo-consumer-scandal-since-2015-timeline-194946222.html [https://perma.cc/S636-WS7X] (cataloguing Wells Fargo's supervisory problems).

289. A noncompliant FHC, of course, would have the option of divesting its subsidiary depository institutions in lieu of its BHC-impermissible activities. *See* 12 U.S.C. § 1843(m)(4) (2012). However, a predominantly bank-focused financial conglomerate like Wells Fargo would almost certainly choose to retain its core banking operations. *See* Cheung & Haider, *supra* note 175, at 2 tbl.1 (indicating that approximately 85% of Wells Fargo's revenues derive from its traditional banking business).

and remaining an FHC, and the condition of the firm's nonbanking operations was irrelevant.[290] It was not until two decades later, in Dodd-Frank, that Congress added the additional requirement that the holding company itself—including its nonbank operations—satisfy the well-capitalized and well-managed requirements.[291] Accordingly, Congress has expressly indicated that revoking a company's FHC status is an appropriate punishment when the firm's bank subsidiary experiences protracted supervisory issues, regardless of the condition of the firm's nonbank operations.

Moreover, it is perfectly sensible that prolonged bank-level supervisory problems should disqualify an FHC from engaging in expanded financial activities. Financial or managerial deficiencies at a conglomerate's bank subsidiary could be an early warning signal for emerging issues in the firm's nonbanking operations. Indeed, if the firm cannot appropriately manage risks in its bank, it is reasonable to doubt its ability to oversee potentially riskier and more volatile nonbanking activities.[292] In this way, divesting BHC-impermissible activities would be both punitive and prudential. A mandatory divestiture would penalize a noncompliant FHC for failing to meet supervisory expectations, and it would reduce the systemic footprint of a firm with demonstrated weaknesses in critical areas. Accordingly, claims that the Federal Reserve should refrain from ordering section 4(m) divestitures because the punishment does not fit the crime are unconvincing.

C. Are Divestitures Regulatory Takings?

Critics might further object that a section 4(m) divestiture order would constitute an impermissible regulatory taking. On this view, a divestiture mandate would violate the Takings Clause of the Fifth Amendment, which requires just compensation when the government appropriates private property for public use.[293] A noncompliant FHC might challenge a divestiture order in court on this basis.

290. *See* Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 103, 113 Stat. 1338, 1346–47 (1999).

291. *See* Pub. L. No. 111-203, § 606, 124 Stat. 1376, 1607 (2010).

292. *See* Bebchuk & Spamann, *supra* note 258, at 260–61 (characterizing nonbank activities as risky).

293. U.S. CONST. amend. V.

Such a challenge, however, would be highly unlikely to succeed. The Federal Reserve's authority to compel divestitures under section 4(m) is supported by decades of regulatory takings jurisprudence. When evaluating whether a regulatory action constitutes a taking, a court typically considers, among other factors, the extent to which the action interferes with the claimant's "distinct investment-backed expectations."[294] The highly regulated nature of the banking sector precludes a firm from showing that a divestiture order interfered with its investment-backed expectations. Indeed, courts have consistently held that a company's participation in a highly regulated industry like finance weighs strongly against the firm's regulatory takings claim.[295] When a BHC elects to become an FHC, it does so with the knowledge that failing to remain well capitalized and well managed could result in a section 4(m) divestiture order.[296] Accordingly, a regulatory taking challenge to such a divestiture would almost certainly fail.

D. DO SUPERVISORY RATINGS HAVE PREDICTIVE VALUE?

Critics might also contend that supervisory ratings are lagging indicators of a bank's condition and, therefore, lack predictive power. Because a bank's rating is treated as confidential supervisory information, this claim is difficult to assess on a firm-by-firm basis.[297] Nonetheless, critics may cite aggregate data

294. Penn. Cent. Transp. Co. v. City of New York, 438 U.S. 104, 124 (1978).

295. *See, e.g.*, Branch v. United States, 69 F.3d 1571, 1575 (Fed. Cir. 1995) (internal citation omitted) ("Banking is a highly regulated industry, and an individual engaged in that industry is deemed to understand that if his bank . . . is operated in violation of laws or regulations, the federal government may 'take possession of its premises and holdings.'"); *see also* Fahey v. Mallonee, 332 U.S. 245, 255–56 (1947) (rejecting savings and loan institution's challenge to its conservatorship because the company accepted the benefits of insured depository status with the knowledge that it would be placed into conservatorship if it became insolvent); Golden Pac Bancorp v. United States, 15 F.3d 1066, 1074 (Fed. Cir. 1994) (rejecting a BHC's regulatory takings claim against OCC for placing its insolvent bank subsidiary in a receivership on the ground that the intrusion did not interfere with the BHC's reasonable, investment-backed expectations); Cal. Hous. Secs., Inc. v. United States, 959 F.2d 955, 958–59 (Fed. Cir. 1992) (denying savings and loan institution's claim that liquidation by the Office of Thrift Supervision constituted a regulatory taking because the company voluntarily entered a highly regulated industry).

296. This expectation would become even clearer if the Federal Reserve were to promulgate a divestiture framework through notice-and-comment rulemaking, as proposed in Part IV.

297. *See supra* note 242 and accompanying text.

suggesting that supervisory ratings generally were not predictive of the 2008 crisis, with fewer than ten percent of banks and large BHCs rated in less-than-satisfactory condition in 2006 and 2007.[298] If, as this data indicate, supervisory ratings do not correlate with a firm's future performance, then breaking up firms with weak supervisory ratings may be inappropriate or ineffective.

There is ample evidence, however, that ratings downgrades and other supervisory warnings can be leading indicators of a bank's distress or misconduct in certain circumstances. To be sure, supervisory ratings may not be predictive of market-wide crises, such as the one that occurred in 2008. In such cases, supervisors likely suffer from similar cognitive biases as the banks themselves—for instance, the shared assumption that housing prices would not simultaneously decline nationwide.[299] The publicly-available evidence, however, suggests that supervisors are reasonably competent at identifying an individual firm's idiosyncratic managerial problems that could lead to material financial loss or consumer harm. The Office of the Comptroller of the Currency (OCC), for example, flagged Wells Fargo's aggressive sales practices as a problem in 2010—before the worst of the fake accounts scandal—and factored these supervisory concerns into Wells Fargo's operational risk rating.[300] Likewise, the Federal Reserve downgraded Deutsche Bank's U.S. operations to troubled condition in 2017, before the firm's solvency was called into serious doubt.[301] More examples of the predictive value of supervisory ratings would undoubtedly be available but for the secrecy generally afforded to confidential supervisory information.

298. *See, e.g.*, SUPERVISION AND REGULATION REPORT, *supra* note 31, at 15 fig.14; Greg Baer & Jeremy Newell, *How Bank Supervision Lost Its Way*, BANK POLICY INST. (May 25, 2017), https://bpi.com/how-bank-supervision-lost-its-way/ [https://perma.cc/72MS-S4ED].

299. *See, e.g.*, Kress et al., *supra* note 225, at 33–35 (discussing regulators' challenges in identifying systemically risky activities).

300. *See* Office of Enter. Governance and the Ombudsman, Office of the Comptroller of the Currency, Lessons Learned Review of Supervision of Sales Practices at Wells Fargo 7 (2017), https://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-wells-fargo-supervision-lessons-learned-41917.pdf [https://perma.cc/TN63-DP8R] ("[T]he OCC identified concerns with [Wells Fargo's] aggressive sales practices as early as 2010 . . . . The aggressive sales concern was a factor contributing to the [redacted] operational risk rating."). The OCC acknowledges, however, that it did not effectively follow up on these concerns. *See id.* at 7–9 (discussing missed opportunities for earlier supervisory actions).

301. *See* Strasburg & Tracy, *supra* note 25.

Moreover, the argument against breaking up noncompliant FHCs based on the weak predictive value of supervisory ratings suffers from an obvious logical flaw. The critics' argument hinges on evidence that the agencies overestimated institutions' condition in the lead-up to the 2008 crisis, at which point many firms failed despite satisfactory ratings.[302] But just because satisfactory supervisory ratings do not always predict strong future performance, it does not necessarily follow that less-than-satisfactory supervisory ratings are equally skewed. To the contrary, one would expect less-than-satisfactory ratings to be more accurate—and therefore more predictive—than satisfactory ratings. That is because supervisors could inadvertently overlook financial or managerial weaknesses and inaccurately assign satisfactory ratings—as they did in the lead-up to the 2008 crisis. But to assign a less-than-satisfactory rating, a firm's supervisors must proactively identify and document serious deficiencies in a firm's condition. In all likelihood, therefore, "false satisfactory" ratings are more common than "false unsatisfactory" ratings, alleviating concerns about unwarranted divestitures.

Finally, supervisors need not identify poorly managed firms with perfect accuracy for the proposed divestiture framework to work. As long as supervisors are reasonably accurate in assigning less-than-satisfactory ratings, the deterrent effect of the divestiture sanction will incentivize FHCs to maintain strong internal controls and sufficient financial resources.[303] The mere threat of an unsatisfactory rating will be sufficient for many firms to improve their weaknesses, in light of the potential divestiture sanction. Accordingly, even if supervisory ratings do not always correlate with a firm's future performance, reasonably accurate ratings attached to a meaningful divestiture sanction will help reduce systemic risks and consumer harms.

E. WILL SUPERVISORS FOLLOW THROUGH?

Finally, critics might question whether supervisory agencies will, in practice, compel a noncompliant FHC to divest. Critics have long alleged that the federal banking agencies are too lenient with troubled financial institutions.[304] The Federal Reserve's

302. *See, e.g.*, Baer & Newell, *supra* note 298 ("In 2007, a small percentage was rated as weak, but hundreds failed.").

303. *See, e.g.*, Schwarcz & Zaring, *supra* note 225, at 1858–59 (arguing that supervisory sanctions need not be perfectly tailored because reasonably well-designed sanctions will deter firms from conduct that could lead to sanction).

304. *See, e.g.*, *Improving Financial Institution Supervision: Examining and*

historic resistance to enforcing section 4(m) supports this view.[305] Some have attributed this leniency to regulatory capture,[306] others contend that agencies act conservatively to avoid litigation risk.[307] Thus, even if the Federal Reserve were to adopt the proposed divestiture framework, a banking agency might forebear from downgrading a firm's supervisory rating—or prematurely upgrade such a rating—to shield an FHC from adverse consequences or to protect the agency from litigation.

This critique poses a serious challenge to the proposed divestiture framework because section 4(m) relies on supervisors to evaluate a firm's supervisory status in good faith and to follow through with a divestiture order if conditions warrant. Policymakers, however, could take several steps to alleviate these concerns. For example, Congress could demand that the Federal Reserve periodically report on the number of FHCs that fail to satisfy the well-capitalized and well-managed requirements, and for how long the firms have been out of compliance. This approach would preserve the traditional confidentiality of an individual firm's supervisory status, while increasing transparency into the Federal Reserve's enforcement practices. Congress could investigate, for example, if the banking agencies developed a pattern of upgrading an FHC's supervisory status immediately before the two-year deadline when it would have been subject to a divestiture order under the section 4(m) framework.

If enhanced oversight is insufficient to ensure that supervisors follow through with divestitures when appropriate, then Congress or the agencies themselves could dramatically enhance transparency by mandating publication of individual firms' su-

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Addressing Regulatory Capture: Hearing Before the Subcomm. On Fin. Insts. & Consumer Prot. Of the S. Comm. On Banking, Hous., & Urban Affairs, 113th Cong. 52–55 (2014) [hereinafter *Regulatory Capture Hearing*] (statement of David O. Beim, Professor of Professional Practice, Columbia Business School); *id.* at 56–69 (statement of Robert C. Hockett, Edward Cornell Professor of Law, Cornell Law School).

305. *See supra* Part III.C.1.a (describing the Federal Reserve's permissive approach to section 4(m)).

306. *See, e.g.*, *Regulatory Capture Hearing*, *supra* note 304, at 53–54 (statement of David O. Beim, Prof. of Professional Practice, Columbia Business School) ("We did . . . find a great deal of the weak form of regulatory capture, an obvious pattern of timidity toward the banks being regulated.").

307. *See* Lawrence G. Baxter, *Judicial Responses to the Recent Enforcement Activities of the Federal Banking Regulators*, 59 FORDHAM L. REV. S193, S228 (1991) (noting federal banking agencies' litigation aversion).

pervisory ratings. As Margaret Tahyar has explained, the statutory basis for the agencies' assertions of confidentiality over supervisory ratings and examination reports "is less solid than one might think."[308] Some commentators have thus called for the agencies to release individual firms' supervisory ratings to increase market discipline on firms in less than satisfactory condition.[309] Publishing supervisory ratings could have the added benefit of disciplining the agencies. With transparent ratings, the public could assess whether the agencies declined to downgrade a firm, or upgraded its rating too hastily, to avert a section 4(m) divestiture. In sum, therefore, while the banking agencies' reluctance to take significant enforcement actions could impede a section 4(m) divestiture regime, increasing transparency in the supervisory process would substantially mitigate this concern.

CONCLUSION

The United States' largest banking organizations have a TBTM problem. Some financial conglomerates are so vast and complex that their executives, directors, shareholders, and regulators are unable to oversee them effectively. Recognizing this problem, policymakers have proposed breaking up the biggest financial institutions by capping banks' size, reinstating Glass-Steagall, or incentivizing a "soft break-up." In general, however, these proposals are neither politically feasible nor conceptually satisfying.

This Article, therefore, has proposed a better way to solve banking's TBTM problem. Compulsory divestitures by firms that fail to satisfy regulatory standards would shrink problematic financial conglomerates, increase incentives for firms to operate prudently, and preserve economies of scale and scope for most companies. Importantly, these objectives are achievable without new legislation because regulators already have several divestiture authorities under existing law.

Section 4(m) of the BHC Act is the most promising of these divestiture authorities. The Federal Reserve has historically neglected section 4(m), permitting FHCs that are not well capitalized or well managed to continue engaging in the full panoply of financial activities. By rationalizing its approach, however, the

308. *See* Tahyar, *supra* note 242, at 24 (implying that supervisory materials do not fit squarely within the Freedom of Information Act).

309. *See, e.g.*, Karen S. Petrou, *Make Camels Ratings Public Already*, AM. BANKER (May 17, 2016, 12:00 PM), https://www.americanbanker.com/opinion/make-camels-ratings-public-already [https://perma.cc/QL7H-4THM].

Federal Reserve could mitigate the TBTM problem. Under the framework proposed in this Article, financial conglomerates could continue engaging in the full range of activities as long as they remain well run and financially sound. Firms that are too big or complex to comply with these standards, however, would be forced to sell, spin-off, or cease operations impermissible for a traditional BHC. By adopting this approach, the Federal Reserve could finally give meaning to section 4(m) and, in the process, solve banking's TBTM problem.