Too Big To Manage: It's Not the Law

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In an accompanying note, we describe the difference between a *poorly managed large bank* and a *bank that is too large to be managed any way but poorly* (also known as "Too Big to Manage"). The former is a problem Congress has recognized and provided numerous tools for regulators to redress. In contrast, Congress has never recognized, much less provided tools to redress, the latter. To the extent it authorizes regulators to dismember banks, it is only in clearly and narrowly prescribed circumstances.

Redressing Poor Management and Its Consequences

Congress has established several regimes for redressing poor management at a bank, when that poor management is reflected in unsafe or unsound practices or capital depletion.

First, Section 8 of the FDI Act authorizes the federal banking agencies (the OCC for national banks, the FDIC for state nonmember banks, and the Federal Reserve for state member banks) to issue cease and desist orders to "restrict the growth of the institution," require the bank to "dispose of any loan or asset involved," or "place limitations on the activities or functions of an institution."[1] But the limits of this authority are clear and strict. *First*, such actions are only authorized where used to "correct or remedy any conditions resulting from any violation [of law] or [unsafe or unsound] practice"; that is, they are authorized only to correct specific problems, not as general or generic punishment or deterrent. *Second*, those problems must be quite serious; as explained by the D.C. Circuit Court of Appeals, an unsafe or unsound practice for purposes of Section 1818 "refers only to practices that threaten the financial integrity of the institution."[2] *Third*, the remedies include the specific power to require the bank to "dispose of any loan or asset involved," not the power to require disposal of any business unit or subsidiary involved (or uninvolved).

Second, Congress has authorized a federal banking agency to prohibit a bank from increasing the size of its assets – but not decreasing the size of its assets -- if it fails to meet a set of safety and soundness standards prescribed by the agencies and fails to submit and implement a remediation plan.[3] Likely because this authority comes with

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[1] 12 U.S.C. 1818(b)(6) & (7).

[2] *Johnson v. OTS*, 81 F.3d 195, 204 (D.C. Cir. 1996); see also *Gulf Federal Savings & Loan Association v. Federal Home Loan Bank Board*, 651 F.2d 259 (5th Cir. 1981) ("The breadth of the 'unsafe or unsound practice' formula is restricted by its limitation to practices with a reasonably direct effect on an association's financial soundness."); *Seidman v. Office of Thrift Supervision*, 37 F.3d 911 (3d Cir. 1994) ("The imprudent act must pose an abnormal risk to the financial stability of the banking institution…. Contingent, remote harms that could ultimately result in 'minor financial loss' to the institution are insufficient to pose the danger that warrants cease and desist proceedings."); *Hoffman v. FDIC*, 912 F.2d 1172, 1174 (9th Cir. 1990) (requiring "abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds").
There is a minority of circuits that has a somewhat lower standard for what constitutes an unsafe and unsound practice, but even there the bar is still extremely high. These circuits primarily endorse the so-called Horne standard –described it as: "any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk of loss or damage to an institution, its shareholders, or the agencies administering the insurance funds." See, e.g., *First National Bank of Eden v. Department of the Treasury*, 568 F.2d 610 (8th Cir. 1978). That said, the law of the D.C. Circuit is effectively dispositive, given that the defendant in any action under 12 U.S.C. 1818 has the option of appealing to the D.C. Circuit, in addition to the relevant circuit for traditional venue purposes. Thus, a bank seeking to challenge an action can do no worse than the law of the D.C. Circuit.

[3] 12 U.S.C. 1831p-1.

procedural rights for the bank, it is a dead letter, as the banking agencies can achieve similar results through actual or threatened ratings downgrades that are non-public and effectively unappealable.[4]

Third, a prompt corrective action framework permits a federal banking agency to limit the growth of a bank or require that the bank divest subsidiaries. Here again, there are strict limits — it may do so only where the bank is either (i) significantly undercapitalized or (ii) undercapitalized and has failed to submit or implement an acceptable capital restoration plan.[5]

Fourth, with respect to the managers producing unsafe or unsound practices, the FDI Act also authorizes federal banking agencies to issue cease-and-desist orders against institution-affiliated parties (including bank managers and directors) or issue orders to remove such persons from office or limit their future ability to work at banks.[6]

Fifth, Congress has prescribed specific penalties for violation of the consumer protection laws applicable to banks – for example, the Truth in Lending Act, RESPA, and the CARD Act. None of those penalties include growth restrictions or forced divestitures.

Thus, although the federal banking agencies have multiple enforcement powers, those powers do not include permitting the agencies to take action to restructure banks on the basis of size or complexity.

Limitations on Size and Structure

The absence of such authority is cast into greater relief by the fact that elsewhere, Congress *has* in some cases authorized limitations on the size and structure of banks. Thus:

- Congress has enacted laws prohibiting a bank from engaging in any inter-state acquisition that would leave it with more than 10 percent of U.S. insured deposits.[7] The cap is fixed in law, and no agency is granted authority to lower it.
- Congress has enacted a similar financial sector concentration limit, which generally prohibits a financial company from merging or consolidating with, or acquiring, another company if the resulting company's liabilities upon consummation would exceed 10 percent of the aggregate liabilities of all financial companies.[8] The cap is fixed in law, and no agency is granted authority to lower it.
- Congress has authorized structural changes to a bank if it fails to file a credible resolution plan under Title I of the Dodd-Frank Act.[9] That review is conducted by the Federal Reserve and the FDIC, and the focus of that review is not whether a bank's structure makes it difficult to manage as a going concern but rather whether its structure makes it incapable of being resolved in an orderly way if it fails.
- The Bank Holding Company Act permits the Federal Reserve (and only the Federal Reserve) to require divestiture of non-banking operations that constitute a serious risk to the financial safety and stability of a bank holding company, or to require divestitures by a financial holding company that fails to meet defined criteria for FHC status.[10] Similarly, the Federal Reserve may (acting with the Financial Stability Oversight

[4] Thus, the OCC has never issued an order under this authority.
[5] 12 U.S.C. 1831o. Similarly, Section 24 of the National Bank Act permits the OCC to order divestiture of certain "financial subsidiaries" in certain circumstances — but almost no banks have such subsidiaries, and a range of criteria (unrelated to size and complexity) must be met before it may do so. *See* 12 U.S.C. 24(e).
[6] *See* 12 U.S.C. 1818(b); (e).
[7] 12 U.S. Code § 1831u(b)(2)(A).
[8] *See* 12 U.S.C. 1852.
[9] *See* 12 U.S.C. 5331(a), 5365(d)(5)(B).)
[10] *See* 12 U.S.C. 1843(m), 1844(e).

Council) order the largest bank holding companies to divest assets or businesses that pose a "grave threat" to U.S. financial stability.[11]

The imposition of size and structure limitations is not just another tool in the regulatory toolbox provided to the federal banking agencies by Congress. Where these limitations are permitted, they are explicit and targeted – not an invitation for a federal banking agency to substitute its judgment for that of a bank's management and board of directors and dictate that the bank make itself more "manageable" through divestitures. Indeed, the only legal authority that *does* authorize the federal banking agencies to decide how a bank is to be structured and managed underscores the gravity, severity and magnitude of such a step: conservatorship. A conservator of a national bank under conservatorship *would* be permitted to "possess[] and control" that bank, and thus conduct whatever divestures or other break-up maneuvers it deemed fit.[12] But Congress specified criteria that must be met for conservatorship and a legal process that must be followed. It has always been viewed as a major step, requiring hard evidence and meeting a clear statutory standard, and one certain to be contested. TBTM, which is conservatorship in acronymic clothing, should be thought of in the same way.

Conclusion

"Too Big to Manage" is not the law. And that is fortunate, because it is a bad idea.

[11] *See* 12 U.S.C. 1842(d)(2)(A).
[12] *See, e.g.*, 12 U.S.C. 203; 206.