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Bank Corporate Governance: A Proposal for the Post-Crisis World

1. Introduction

Legislation and regulation, particularly laws and regulations related to corporate finance and financial markets, tend to follow crisis. The myriad corporate scandals in the previous decade led to a heightened awareness of the role played by corporate governance, so it is hardly surprising that corporate governance has been the focus of regulation for some time now. In the wake of Enron, Tyco, and other high-profile failures, the Sarbanes-Oxley Act of 2002 focused on the internal controls of firms and the risks that poor governance imposed on the market. In the aftermath of the recent financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act unleashed a plethora of changes for markets that involved restrictions on what banks can do, who can regulate them, and how they should be liquidated, as well as mortgage and insurance reform and consumer protection initiatives.

Surprisingly, the duties required of bank directors per se were not a focus of specific attention in either act. We believe the role that bank corporate governance issues played in the financial crisis is not inconsequential and that, as suggested by the recent JPMorgan Chase London Whale fiasco, these bank corporate governance issues pose an ongoing risk to the financial markets. Hence, bank corporate governance in the post-crisis era warrants careful review.

That governance problems can arise in banks is well understood (Levine 2004; Bebchuk and Spamann 2010; de Haan and Vlahu 2013; Adams and Mehran 2008, revised 2011; Calomiris and Carlson 2014). What may not be appreciated, however, is the degree to which the unique features of banking complicate both the role of the board and its governance effectiveness. In an earlier paper (Macey and O’Hara 2003), we reviewed the different models of corporate governance, with a particular focus on the duties that board members owe to different constituencies. We argued that these unique features of banks dictated a heightened “duty of care” for bank directors.[1] We discussed the various legal cases defining the duty of care for directors, and how the courts have vacillated in their application of these duties owed by

[1] The duty of care is the obligation to make reasonable, fully informed decisions and more generally to manage the corporation with the care that a reasonable person would use in the management of her own business and affairs.

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The authors thank William Bratton, Doron Levit, Hamid Mehran, Christian Opp, Michael Wachter, and seminar participants at the Wharton–Penn Law School Institute for Law and Economics seminar for helpful comments. Certain of the themes and arguments in this article have been introduced and extended in “Vertical and Horizontal Problems in Financial Regulation and Corporate Governance,” in A. Demirgüç-Kunt, D. D. Evanoff, and G. G. Kaufman, eds., *The Future of Large, Internationally Active Banks* (Hackensack, N.J.: World Scientific Publishing Co., 2016). The views expressed in this article are those of the authors and do not necessarily reflect the position of the Federal Reserve Bank of New York or the Federal Reserve System.

To view the authors’ disclosure statements, visit https://www.newyorkfed.org/research/author_disclosure/ad_epr_2016_post-crisis-world_macey.html.

directors. Since then, a lot has changed with respect to banking structure and practice, but little has changed with respect to the duties and obligations of bank directors. This inertia with respect to bank directors is all the more puzzling given that Dodd-Frank explicitly addressed the externalities imposed by individual banks on the financial system yet imposed no additional requirements on bank directors to make them responsible for limiting such risks.[2]

In this article, we propose a new paradigm for bank corporate governance in the post-crisis world. We argue that bank directors should face heightened requirements owing to the increased risk that individual banks pose for the financial system. Our thesis is that the greater complexity and opacity of banks, and the increased challenges in monitoring these complex institutions, require greater expertise on the part of bank directors. We propose new "banking expert" and "banking literacy" requirements for bank directors akin to the "financial expert" requirements imposed on audit committees by Sarbanes-Oxley. As we argue, these requirements would mandate a higher level of competence for bank directors, consistent with the greater knowledge required to understand and to oversee today's more complex financial institutions.

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It has been argued that large, complex financial institutions are now simply too large to govern—that "too big to fail" is "too big to exist." This may be true, but before we throw in the towel on the corporate form of bank organization in favor of some regulator-based form of control, we think it makes sense to try to craft a more relevant corporate governance standard for banks. Similarly, it has been argued that mendacity is to blame for the myriad scandals in banking—that bank management, and presumably bank directors, are somehow not sufficiently motivated to "do the right thing." This, in turn, results in a culture problem in banking that leads to bad behavior. While acknowledging the importance of cultural reforms in banking, we argue that operating and monitoring a complex financial institution is extremely difficult, and that one solution to better bank management lies in better bank corporate governance. Our proposals here are a step in that direction.

This article is organized as follows. In the next section, we draw on earlier work as well as lessons learned from the JPMorgan London Whale debacle to talk about how governance problems arise in banks and why these problems differ from those arising in other firms. We discuss how the growing complexity of banks creates a new set of governance problems, and how recent structural changes such as dual boards have contributed to governance failures in banking. In Section 3, we consider how these corporate governance problems have traditionally been dealt with in banks, and we discuss recent approaches taken in the United States and other countries to make bank corporate governance more effective. In Section 4, we set out our alternative approach for bank corporate governance. We argue that bank directors should meet professional standards, as opposed to the amateur standards that apply to other corporate directors. We propose even more rigorous standards for members of bank risk committees, recognizing that failures in bank risk management impose significant costs on the financial system and on the economy more generally.

2. Bank Corporate Governance: Why Is It So Difficult?

Generally speaking, the problem of corporate governance stems from agency problems that emerge when the residual claims on a firm's income take the form of shares of stock that are mostly owned by people who are not involved in the management or operations of the company (Berle and Means 1932; Jensen and Meckling 1976). In order to ameliorate agency costs, over time corporate law has developed the general rule that fiduciary duties should be owed exclusively to shareholders (Macey 1999). The justification for making shareholders the exclusive beneficiaries of the fiduciary duties owed by managers and directors is based on the fact that creditors, as fixed claimants, can safeguard their investments through a combination of pricing and the imposition of contractual protections such as conversion rights or put options (Macey and Miller 1993).

[2] On February 18, 2014, the Board of Governors of the Federal Reserve System approved a final rule implementing the provisions of Section 165 of Dodd-Frank. Under the final rule, U.S. bank holding companies (BHCs) and foreign banking organizations (FBOs) with at least $50 billion in total consolidated assets will be subject to heightened capital, liquidity, risk management, and stress testing requirements, effective January 1, 2015, for BHCs and July 1, 2016, for FBOs. The final rule was available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140218a1.pdf, but as of May 19, 2014, it was no longer available at that site. As noted in Section 3.1 of this article, Section 165(h) of Dodd-Frank requires the formation of risk committees of boards of directors at publicly traded bank holding companies and companies designated by the Financial Stability Oversight Council as systemically important nonbank financial firms.

In our earlier article on corporate governance problems in banks (Macey and O'Hara 2003), we argued that banks are different from other firms and that the economic policies that justify making shareholders the exclusive beneficiaries of fiduciary duties do not apply with the same force to banks that they do to other types of corporations, such as manufacturing or technology companies.[3] We believe these difficulties have only increased in the past decade, with the result being that banks in the post-crisis era face even greater corporate governance difficulties. Specifically, we believe that a variety of features unique to banks make them more risky, fragile, and difficult to monitor and control than other firms (Macey and O'Hara 2003, 97).

2.1 Asset Structure and Liquidity Creation by Banks

First, because of their unusual capital structures, banks have a unique role in generating liquidity for the economy. It is well known that banks' balance sheets are highly leveraged (Bebchuk and Spamann 2010; Flannery 1994), with fixed-claim creditors supplying 90 percent or more of the funding that banks require to operate. Moreover, these fixed-claim liabilities generally are available to creditors (depositors) on demand, while on the asset side of the balance sheet, banks' loans and other assets have longer maturities.

The development of increasingly robust secondary markets and banks' ability to securitize assets has enabled banks to move assets off of their balance sheets, but this process has not led to a reduction in the size of banks' balance sheets: banks tend to grow rather than shrink even as they securitize more of their assets. Because a bank's more transparent and liquid assets tend to be sold either outright or as part of a pool of securitized financial assets, what is left on its balance sheet is generally the more opaque and idiosyncratic assets. Arguably, these evolutionary developments in capital markets have led to a secular deterioration, rather than to an improvement in the transparency and liquidity of bank assets.

The phenomenon of simultaneously holding transparent, liquid liabilities on the one hand and illiquid, opaque assets on the other enables banks to serve the vital economic role of creating liquidity (Diamond and Dybvig 1983). However, to create liquidity, banks must lend the funds that they receive from deposits and other short-term liabilities, and, consequently, banks keep only a small fraction of funds as reserves to satisfy depositors' demands for liquidity. This asset transformation process results in a situation in which no bank has sufficient funds on hand to satisfy the demands of depositors if a significant number demand payment simultaneously.

The mismatch in the liquidity characteristics and term structure of banks' assets leads to bank runs and other systemic problems in the financial system. With greater than a third of U.S. bank liabilities uninsured, rational uninsured depositors (and claimants) will try to be among the first to withdraw before other nimble creditors deplete the banks' assets. Thus, bank depositors, unlike creditors in other companies, are in a situation closely akin to the classic prisoner's dilemma. This prisoner's dilemma can lead to failures in solvent banks because the need for liquidity in the event of a run or panic can lead to fire-sale liquidations of assets, thereby spreading problems to heretofore solvent banks. For bank directors, the need to manage such liquidity risks is fundamental to a bank's survival.

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2.2 Deposit Insurance, Moral Hazard, and the Conflict between Fixed Claimants and Equity Claimants

The existence of federally sponsored deposit insurance means that banks can continue to attract liquidity to fund their operations even after they are insolvent. Thus, unlike other sorts of companies, it is virtually impossible for federally insured banks to become insolvent in the "equitable" sense of being unable to pay their debts as they come due in the ordinary course of business.[4] Federal insurance eliminates the market forces that starve nonfinancial firms of cash. The federal government has attempted to replace these market forces with regulatory requirements, including

[3] The discussion here is also reviewed in Macey and O'Hara 2016.

[4] In bankruptcy law and practice, there are two types of insolvency. Insolvency in the balance sheet sense means that the value of a company's liabilities is greater than the value of its assets. Insolvency in the equity sense means that the firm is unable to pay its debts as they come due in the ordinary course of business (Jurinski 2003, 33).

capital requirements and rules regarding the "prompt resolution" of financially distressed banks. Nevertheless, it seems clear that the well-established tenet of corporate finance that there is a conflict between fixed claimants and shareholders is, as we previously observed, "raised to a new dimension in the banking context" (Macey and O'Hara 2003, 98). In banking, neither creditors nor capital markets have incentives to negotiate for protections against risky, "bet-the-bank" investment strategies or to demand compensation for such risk in the form of higher interest payments.

Bebchuk and Spamann (2010) argue that these agency conflicts manifest particularly in problems with bank executive compensation. They make the intriguing point that governance reforms aimed at aligning compensation with shareholder interests—such as say-on-pay votes, use of restricted stock, and increased director independence—fail in banks because shareholders also benefit from bank management taking on excessive risk. This raises the disturbing specter that bank directors are in fact doing their jobs—but that their jobs do not include adequately recognizing the systemic risks that banks pose for the financial system.

2.3 Monitoring and Loyalty Problems: The London Whale

The moral hazard caused by deposit insurance coupled with imperfections in the regulatory system leads not only to excessive risk taking by banks but also to an industrywide reduction in levels of monitoring within the firm, resulting in a higher incidence of large losses and bank failures caused by fraud.[5] The high incidence of fraud is attributable both to the lack of monitoring by creditors and to the highly liquid form of banks' assets, which makes it easy to divert bank assets to private use relative to less liquid assets such as factories and equipment.

Shareholder incentives to prevent fraud and self-dealing through monitoring exist in banks as they do in other types of companies. As in these other types of companies, however, "such monitoring is notoriously ineffective in many cases because individual shareholders rarely have sufficient incentives to engage in monitoring because of collective-action problems" (Macey and O'Hara 2003, 98).

Perhaps no event illustrates the endemic monitoring and other corporate governance problems in the context of the banking industry more clearly than the London Whale trading loss debacle.[6] The U.S. Securities and Exchange Commission charged JPMorgan Chase with misstating financial results and lacking effective internal controls to detect and prevent its traders' fraudulent overvaluing of investments to conceal hundreds of millions of dollars in trading losses.[7] In the wake of this case, Mary Jo White, the new chair of the SEC, deployed her marquee policy to require admissions of wrongdoing in certain "egregious" cases.[8]

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The SEC's lawsuit against JPMorgan charged the company with violating provisions of Sarbanes-Oxley relating to corporate governance and disclosure. In particular, Sarbanes-Oxley requires public companies to maintain disclosure controls and procedures that ensure that important information reaches the appropriate persons so that timely decisions can be made regarding disclosure in public filings.[9] Also at issue were JPMorgan's alleged violations of SEC regulations requiring corporate managers to evaluate on a quarterly basis the effectiveness of the company's disclosure controls and procedures and to disclose management's conclusion regarding their effectiveness in its quarterly filings.[10] The SEC also alleged that even after JPMorgan announced a trading loss of

[5] See remarks of R. L. Clarke in Comptroller of the Currency News Release no. NR 88-5 (1988, 6) noting that fraud and self-dealing were "apparent" in as many as one-third of the bank failures that occurred during the 1980s. See also Jackson and Symons (1999, 152), citing a study by the U.S. General Accounting Office on bank failures in 1990 and 1991 that reported that in slightly more than 60 percent of these failures (175 out of 286), insider lending was a "contributing factor."

[6] Kevin LaCroix, "A Closer Look at JPMorgan's $920 Million 'London Whale' Regulatory Settlements," *The D and O Diary*, September 20, 2013, available at http://www.dandodiary.com/2013/09/articles/securities-litigation/a-closer-look-at-jp-morgans-920-million-london-whale-regulatory-settlements.

[7] SEC, Order Instituting Cease-And-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, available at http://www.sec.gov/litigation/admin/2013/34-70458.pdf .

[8] See Bruce Carton, "SEC to Require Admissions of Wrongdoing in Settlements of Egregious Cases," *Compliance Week*, June 19, 2013.

[9] SEC Order. Such requirements on internal accounting controls are intended to "provide reasonable assurances that transactions are recorded as necessary to permit preparation of reliable financial statements."

[10] SEC Order.

approximately $2 billion on May 10, 2012, the full extent of the trading losses that occurred during the first quarter of 2012 was not detected and reported.[11] This failure resulted, in part, from the ineffectiveness of internal control functions within the bank's Chief Investment Office, which was known as the Valuation Control Group (CIO-VCG).[12]

Within banks, valuation control units are a critical part of internal controls because they monitor and control for the accuracy of valuations of the financial assets acquired and held by traders and other market professionals within the firm. From a corporate governance perspective, it is obvious that a valuation control group must be independent of the trading desks it monitors in order to be effective. The consequences of a corporate governance failure in this respect are severe because such failures risk both the inaccurate valuation of the bank's assets as well as the material misstatement of the bank's financial condition in its public filings. In the case of JPMorgan, the SEC found that JPMorgan's CIO-VCG was "unequipped to cope with the size and complexity of the credit derivatives" that were the principal assets in the bank's synthetic credit portfolio (SCP).[13] As of March 31, 2012, the SCP contained 132 trading positions with a net notional amount of approximately $157 billion.[14]

The SEC also found that the CIO-VCG "did not function as an effective internal control" during the relevant time period because the CIO-VCG was "understaffed, insufficiently supervised, and did not adequately document its actual price-testing policies."[15] Perhaps more disturbingly, it appeared to the SEC that the price-testing methodology used by CIO-VCG "was subjective and insufficiently independent from the SCP traders, which enabled the traders to improperly influence the VCG process."[16] In addition, during the first quarter of 2012, CIO-VCG failed to escalate to CIO and JPMorgan management significant information that management required in order to make informed decisions about disclosure of the firm's financial results for the first quarter of 2012. As a result, JPMorgan did not in a timely fashion detect or effectively challenge questionable valuations by the SCP traders as the portfolio's losses accumulated in the first quarter of 2012, leading the bank to publicly misstate its financial results for that period.

Another significant corporate governance failure was inadequate communication between JPMorgan's senior management and the audit committee of JPMorgan's board of directors. JPMorgan senior management initiated reviews of the CIO-VCG's work after learning of significant disputes between the bank and its counterparties about the value of the assets held in the synthetic credit portfolio. From these reviews, the bank's management learned that there were problems with the CIO-VCG's price testing and "an undue amount of subjectivity" in its control function. Contrary to the requirements of Sarbanes-Oxley, however, JPMorgan's management did not inform the audit committee or the bank's board of directors that it was aware of significant deficiencies or material weaknesses in the firm's internal control over financial reporting. As the SEC observed in its order, this information must be passed along to the board by management to enable "the Audit Committee to fulfill its oversight role and help to assure the integrity and accuracy of information."

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The internal problems were egregious. For example, when losses were incurred on the traditionally profitable SCP in the first quarter of 2012, the senior SCP trader instructed other SCP traders to stop reporting losses to CIO management unless there was a market-moving event that could easily explain the losses. At least one SCP trader changed his daily marking methodology for the SCP and began assigning values at the point in the bid-offer spread that

[11] SEC Order.

[12] SEC Order.

[13] The SCP was invested in two primary index groups: CDX, a group of North American and emerging markets indexes, and iTraxx, a group of European and Asian indexes. Some indexes referenced companies considered to be investment grade and others referenced companies considered to be high-yield (which generally means that their credit risk is viewed as higher). Investors in CDX and iTraxx indexes, including CIO, can be "long" risk, which is equivalent to being a seller of CDS protection, or "short" risk, which is equivalent to being a buyer of CDS protection. See Annex A to SEC Cease-and-Desist Order.

[14] Annex A to SEC Order.

[15] SEC Order, 2.

[16] SEC Order, 2.

resulted in the highest valuations of the SCP positions, a valuation technique inconsistent with Generally Accepted Accounting Principles (GAAP).[17] Things got much worse when this trader even began valuing assets at prices that were completely "outside every dealer's bid and offer received that day" and thereby "intentionally understated mark-to-market losses in the SCP."[18]

In JPMorgan's $200 million settlement of the SEC's enforcement action against it, the bank acknowledged significant corporate governance failures. For example, the bank admitted that significant facts learned in the course of the various internal reviews were not shared in meetings and calls among the participants in such reviews. As a result, these facts were not escalated to JPMorgan senior management or communicated to the audit committee of the board in a timely fashion.[19] Also apparently missing in action was the bank's risk committee, which was not kept informed of what was clearly a gaping hole in the bank's risk management process.

The opacity of bank activities, combined with the complexity of risk management activities involving the valuation and control of complex asset positions, creates significant monitoring difficulties for directors.

The Board of Governors of the Federal Reserve System (the Fed) joined the SEC in suing and settling with JPMorgan Chase & Co., the registered bank holding company that owns and controls the bank.[20] The Fed's order did raise these deficiencies in risk management and oversight, in addition to concerns with the governance, finance, and internal audit functions of the company.[21]

As we argued in Macey and O'Hara (2003), the mismatch between the maturity and liquidity characteristics of banks' assets and liabilities, banks' unusually high leverage, and the moral hazard caused by such institutional features as the Fed's discount window, deposit insurance, and the expectation of bailouts largely defined the unique corporate governance problems experienced by banks.[22] These characteristics remain, but the JPMorgan London Whale debacle underscores an important new dimension of bank corporate governance problems: The opacity of bank activities, combined with the complexity of risk management activities involving the valuation and control of complex asset positions, creates significant monitoring difficulties for directors.[23]

Thus, a large part of the problem with JPMorgan appears to be that the firm's directors lacked the special expertise necessary to evaluate the nature and quality of the information they were getting (or not getting) from managers (Pozen 2010). JPMorgan was not by any means the only financial institution whose board lacked sufficient industry and financial markets expertise. When Citibank teetered on the brink of insolvency, requiring a massive federal bailout, its board was "filled with luminaries from many walks of life—It boasted directors from a chemical company, a telecom giant, and a liberal arts university, for example. Yet in early 2008, only one of the independent directors had ever worked at a financial services firm—and that person was concurrently the CEO of a large entertainment firm" (Pozen 2010).

2.4 Dual Boards and the Oversight of Banks

Yet another governance challenge arises from the unique structure of banks, which are largely controlled by holding companies. With the conversion of Goldman Sachs and Morgan Stanley to bank holding companies and financial holding companies during

[17] Annex A to SEC Order, 2. Under applicable accounting rules, the positions in the synthetic credit portfolio had to be marked "within the bid-ask spread" at the point that is "most representative of fair value in the circumstances," with a particular emphasis on the price at which the traders could reasonably expect to transact. GAAP also allows for the use of midmarket pricing "as a practical expedient for fair value measurements within a bid-ask spread."

[18] Annex A to SEC Order, 3.

[19] Annex A to SEC Order, 11.

[20] In addition to the SEC's enforcement action, the Office of the Comptroller of the Currency, which regulates the national bank subsidiaries of the holding company, and the U.K. Financial Conduct Authority filed lawsuits against JPMorgan Chase, N.A., the bank subsidiary of JPMorgan.

[21] Board of Governors of the Federal Reserve System Order of Assessment of a Civil Money Penalty Issued upon Consent Pursuant to the Federal Deposit Insurance Act, as Amended, September 19, 2013, http://www.federalreserve.gov/newsevents/press/enforcement/enf20130919a.pdf.

[22] See Calomiris and Carlson (2014) for a discussion of the factors leading to bank corporate governance issues in the era predating deposit insurance.

[23] See also Mehran, Morrison, and Shapiro (2011), who make similar complexity and opacity arguments in their analysis of governance problems in the financial crisis.

the financial crisis,[24] every major bank in the United States is now organized as some form of bank holding company (BHC). A BHC is defined as a "company that owns and/or controls one or more U.S. banks or one that owns, or has controlling interest in, one or more banks. A bank holding company may also own another bank holding company, which in turn owns or controls a bank; the company at the top of the ownership chain is called the top holder."[25]

Bank holding companies are, by definition, involved in the business of banking. In fact, bank holding companies are limited by law to activities that are "so closely related to banking as to be a proper incident thereto."[26] Because the BHC controls the bank, the monitoring and control of risk must take place at multiple levels. From a regulatory perspective, the Federal Reserve "is responsible for regulating and supervising bank holding companies, even if the bank owned by the holding company is under the primary supervision of a different federal agency," namely, the Office of the Comptroller of the Currency (OCC) or the Federal Deposit Insurance Corporation (FDIC).[27] When assessing a BHC, however, the Fed will "work cooperatively" with the functional regulator of the subsidiary bank "to address information gaps or indications of weakness or risk identified in a supervised BHC subsidiary that are material to the Federal Reserve's understanding or assessment" of the BHC.[28] This structure of supervision acknowledges that bank holding companies wield control over the banks they hold.

From a governance perspective, the holding company's board inevitably exerts control over the banks within the holding company structure, particularly where, as is often the case, the directors of the bank holding company also sit as officers and directors of the bank. As such, it is each holding company director's duty to control risk down to the level of the banks the BHC holds.[29] This means that the directors of holding companies, like the directors of the banks themselves, must be involved in the governance, risk-management, and monitoring and oversight of the banks and bank affiliates within the holding company structure. The formal corporate separateness of BHCs and the banks they control does not release holding company directors from responsibility for the actions of their subsidiary banks even if some directors are on the board of a BHC but not on the board of the bank.[30]

Howell Jackson has observed that holding companies and the banks they own and control are not truly separate as a practical matter:

> Within bank holding companies, there is a natural tendency of management to centralize decision-making power and resources in the parent bank or BHC. It is doubtful that management would leave the bank and nonbank subsidiaries free to make the important business decisions as to activities, reinvestment of profits, and new markets. It is more likely that there would be significant centralization of decision making at the parent-company level, with management deciding what products and markets will be focused upon and how profits will be reallocated.[31] (Jackson 1994)

Jackson also argues that this interrelatedness of banks and BHCs has increased over time:

> Until twenty years ago [or twenty years prior to the publication of this article by Professor Jackson in 1994], financial holding companies . . . had relatively few affirmative obligations with respect to their regulated subsidiaries. . . . Over the past two decades however, financial holding companies have become increasingly embroiled in the regulatory supervision of subsidiary financial institutions. (Jackson 1994; interpolation ours)

[24] Goldman Sachs Group, Inc., a Delaware corporation, has operated as a bank holding company and a financial holding company since September 2008. It is regulated by the Board of Governors of the Federal Reserve System. Its U.S. depository institution subsidiary, Goldman Sachs Bank USA, is a New York State-chartered bank. Morgan Stanley has operated as a bank holding company and financial holding company under the Bank Holding Company Act since September 2008. It is regulated by the Board of Governors of the Federal Reserve System. See http://www.morganstanley.com/about/press/articles/6933.html.

[25] Under § 2020.1.3.1 of the Bank Holding Company Act of 1956, administered by the Federal Deposit Insurance Corporation (FDIC), a bank holding company is defined as "any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of this Act." A company is defined as having control over a bank or over any company if

> a. the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the bank or company;
>
> b. the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or
>
> c. the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.

[26] Bank Holding Company Act.

[27] National Information Center, *All Institution Types Defined*. Available at http://www.ffiec.gov/nicpubweb/Content/HELP/Institution Type Description.htm.

[28] The Board of Governors' Division of Banking Supervision and Regulation, Bank Holding Company Supervision Manual, § 1050.1.4.1.1 (2011).

[29] For further discussion, see Bai (2011).

[30] See, for example, Ellul and Yerramilli (2010, revised 2011) for a discussion of BHC directors' crucial role in risk management of the entire organization.

[31] See also Jackson and Symons (1999, 304).

Jackson posits that this increased interrelatedness reflects a regulatory push to "transfer front-line supervisory responsibility from governmental agencies to financial holding companies," a push prompted by the fact that "not only are financial holding companies apt to be more proficient than government officials in evaluating institutional behavior, but holding companies also can monitor risks at a lower cost than government agencies, because holding companies already have substantial information about their regulated subsidiaries as a result of ordinary managerial activities" (Jackson 1994, 513).

The Fed evaluates bank holding companies' directors and senior executives based on their ability to identify, measure, and control risk, which includes those risks posed by the underlying banks. Thus, the Fed essentially treats bank holding companies and their bank affiliates as so inextricably linked that, when evaluating BHCs, it analyzes the consolidated organization's financial strength and risks. Additionally, the Fed can examine a bank holding company's subsidiaries directly to "inform itself of the systems for monitoring and controlling risks to such depository institutions" (Macey, Miller, and Carnell 2001, 458).

Since both the holding company and the bank have boards of directors, a natural question is what role should each board play? Thomas C. Baxter, Jr., general counsel and executive vice president of the Legal Group at the Federal Reserve Bank of New York, addresses this point:

> We want the governing body of the holding company to perform two critical functions. First, we want it to understand the risks to the "enterprise," meaning the risks in all of the company's constituent parts. Second, we want the holding company to *take reasonable steps to manage those risks* and keep them within acceptable limits. . . . As I see it, the public interest in the bank subsidiary is protected by a panoply of prudential laws and regulations. The ownership interest of the holding company in the bank is protected by the holding company's ability to control the bank's board of directors. (Baxter 2003, 1-3; emphasis added)

From both a regulatory perspective and a corporate governance perspective, bank safety and soundness is paramount. The well-known "source of strength" doctrine requires that bank holding companies provide financial support to their banking subsidiaries. In particular, § 225.142 of the Bank Holding Company Act provides that "in supervising the activities of bank holding companies, the Board has adopted and continues to follow the principle that bank holding companies should serve as a source of strength for their subsidiary banks." This notion pervades the BHCs' corporate governance and directly impacts the relationship between the BHCs and their subsidiaries.

It is our contention that the Fed's BHC regulations, the principles of corporate governance developed here, and basic concerns about systemic risk and bank safety all indicate that bank holding company officers and directors have fiduciary obligations that guide—and when necessary, trump—corporate form. Fiduciary duties flow not only to shareholders of the holding company but also to the corporate organization itself. Thus, the responsibility for bank safety and soundness must be shouldered both by holding company directors and officers and by the directors and officers of their subsidiaries, particularly their bank subsidiaries.

It is our contention that the Fed's BHC regulations, the principles of corporate governance developed here, and basic concerns about systemic risk and bank safety all indicate that bank holding company officers and directors have fiduciary obligations that guide—and when necessary, trump—corporate form.

Less clear, however, is how the shared responsibility between the holding company board and the bank board should work in practice in the post-crisis environment. On the one hand, it clearly makes no sense to say that bank holding company officers and directors can ignore issues of safety and soundness that affect their subsidiary banks on the grounds that they are fiduciaries of a different corporate entity, namely the holding company. On the other hand, the notion that the duties and obligations of holding company officers and directors and bank officers and directors are identical and wholly duplicative also appears problematic. To see why, consider the perspective of the OCC, the main regulator of nationally chartered banks, on its expectation for the subsidiary bank's directors. The OCC argues that, "for its part, the primary duty of the subsidiary bank's board of directors is to protect the bank."[32] This may be the view of the OCC, but it is inconsistent with the duties of the directors of bank holding companies, which require that directors of holding companies—like directors of other firms—maximize value for shareholders.

[32] Office of the Comptroller of the Currency, *The Director's Book*, October 2010 (reprinted September 2013), 26.

Unlike banks, bank holding companies are, from a state-law point of view, garden-variety corporations, with garden-variety fiduciary duties that are owed exclusively to shareholders. Not only are they subject to the same corporate governance rules as other companies, but also, unlike banks, which receive charters either from the OCC (national banks) or state bank regulators (state banks), holding companies are chartered by the same state chartering authorities as any other nonbank. For example, Citigroup, which owns a national bank, is chartered in the state of Delaware,[33] as are Morgan Stanley[34] and Goldman Sachs.[35] Thus, there is a significant obstacle to making safety and soundness the primary duty of bank holding company directors or of bank holding companies. And these holding companies determine who sits on the boards of directors of the banks they own or control.

The problem is simple to describe. Because they are considered to be directors of garden-variety corporations, holding company directors (and bank directors too, for that matter), ostensibly have no obligation to mitigate risk, but rather are tasked with maximizing the value of the companies on whose boards they sit. This rule makes perfect sense in the context of nonfinancial corporations, whose failure poses no systemic risk and whose shareholders can eliminate the firm-specific risk of the companies' business activities easily and cheaply through diversification.

However, the federal government, if not the state governments, wants banks and bank holding companies to refrain from engaging in excessive risk taking. Thus, bank holding company directors are pulled in opposite directions by the legal rules that govern their behavior. On the one hand, as established in this section, it is the clear policy of federal banking regulators, particularly the Fed, that holding companies—especially large holding companies whose operations pose systemic risks—should focus primarily on issues of safety and soundness. On the other hand, the state laws that impose fiduciary duties on the directors of all corporations, both banks and nonbanks, require all such directors to maximize the value of the firm, even if doing so causes the company to assume considerable risk. And, because of the low cost of leverage for federally insured banks and for systemically important financial institutions of all kinds, these fiduciary duties will channel directors toward tolerating, if not actively encouraging, risky capital structures and risky investment practices.

[33] See Certificate of Incorporation of Citigroup, available at: http://www.citigroup.com/citi/investor/data/citigroup_rci.pdf.

[34] See Certificate of Incorporation of Morgan Stanley, available at: http://www.morganstanley.com/about/company/governance/certcomp.html.

[35] See Certificate of Incorporation of Goldman Sachs, available at: http://www.goldmansachs.com/investor-relations/corporate-governance/corporate-governance-documents/re-stated-certificate.pdf.

One way to reconcile the apparent deep inconsistency between the fiduciary obligation of bank and bank holding company directors to maximize returns and their statutory and regulatory obligations to promote safety is to prioritize these conflicting dictates. The regulatory and statutory obligations come first. Managers and directors can only maximize profits to the extent that doing so does not conflict with relevant legal rules and regulations. As the influential American Law Institute Principles of Corporate Governance make clear, a corporation "is obliged, to the same extent as a natural person, to act within the boundaries set by law."[36] Or as Milton Friedman admonished, corporations are obligated "to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom."[37]

Bank holding company directors are pulled in opposite directions by the legal rules that govern their behavior.

In our view, the fact that banks and their officers and directors can only maximize profits within the limits of applicable law and regulations is an extremely important feature of the corporate governance landscape. Establishing and maintaining this hierarchy, however, does not resolve entirely the tension between profit maximization and the regulatory and social goals of achieving safer and sounder financial institutions. The reason is that, as we have seen over the past several decades, financial institutions still have latitude to engage in excessive risk taking even after they have complied with the law.

For example, banks must comply with the relevant rules regarding the maintenance of certain capital levels. But even after complying with such rules, banks have ample room to maneuver. For instance, they can, and do, invest in the riskiest assets within a particular risk-weighting class. They also look for loopholes in regulations such as the Volcker Rule in order to squeeze the highest returns they can for their shareholders; of course, this quest for the highest returns involves risk, which is not something that regulators are interested in maximizing.

But the fiduciary duty to maximize profits is not the only obstacle to reaching the goal of incentivizing managers and directors of financial institutions to focus as intensely on keeping

[36] American Law Institute, Principles of Corporate Governance, Section 2.01(b).

[37] Milton Friedman, "The Social Responsibility of Business Is to Increase Its Profits," *The New York Times Magazine*, September 13, 1970.

banks safe as directors of other companies focus on maximizing share prices. In addition to the fact that they have fiduciary duties, it is the case that holding company directors, like the directors of all other corporations, are elected by shareholders. Fixed and contingent claimants, such as depositors, nondepositor creditors, and the U.S. government, lack voting power. In an election between a risk taker and an individual who avoids taking risks, the shareholders will vote for the risk taker. Thus, to the extent that bank or bank holding company directors are able to survive in their jobs in the Darwinian environment that characterizes the democratic process, among the strongest characteristics for survival is a strong proclivity for risk taking.[38]

3. Bank Corporate Governance: Solutions Past and Present

How to resolve the unique moral hazard and corporate governance problems of banks is a matter of long-standing debate. Certainly these problems explain, at least in part, why banks are—and long have been—the subject of much more intensive regulation than virtually all other forms of business.[39] The fact that safeguards for creditors of banks existed long before deposit insurance made the government a contingent claimant on banks' cash flows supports our argument that banks are unique in their susceptibility to insolvency. Moreover, the fact that the power of these safeguards has diminished in certain significant ways is highly relevant to our analysis of how to restructure bank corporate governance in the post-crisis era. In this section, we consider the varied ways that bank governance issues have been addressed in the past, and some new approaches being proposed and implemented in locales both within and outside of the United States.

3.1 Heightened Regulation

Banks are subject to myriad special regulations. The periodic reporting and on-site inspections required by federal and state regulators are only the beginning. Many regulations actually require bank regulators to make subjective determinations of the quality of bank management. This is a responsibility virtually unheard of in a free-market, private enterprise system. In such systems, shareholders generally have plenary authority to decide who manages the companies in which they have invested.

For U.S. commercial banks, regulators use the Uniform Financial Institutions Rating system, generally referred to as CAMELS, to evaluate banks' financial soundness.[40] The CAMELS system evaluates banks' capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. Each of these assessments requires regulators to evaluate the quality of bank management. For example, a bank's capital adequacy ("C") will depend, in part, on management's ability to identify, measure, monitor, and control risks. Assessments of asset quality ("A") require that regulators evaluate assets in light of management's ability to identify, measure, monitor, and control credit risk. The management criterion ("M") reflects the judgment of a bank's primary regulator about the ability of the bank's board of directors and senior officers to identify, measure, monitor, and control the risks of the bank's activities and to assure the bank's safe and efficient operation in compliance with applicable laws. Other criteria evaluate the quality of the control systems implemented by management as well as the banks' funds-management practices.

Banks are subject to myriad special regulations. . . . Many regulations actually require bank regulators to make subjective determinations of the quality of bank management. This is a responsibility virtually unheard of in a free-market, private enterprise system.

Banks whose management is deemed inadequate may be categorized as unsafe and unsound, and are subject to enforcement action, including closure. In addition to implementing the CAMELS system, regulators are required, under the Federal Deposit Insurance Corporation Improvement Act (FDICIA), to promulgate safety and soundness standards for banks' internal controls, information systems, and internal audit systems; loan documentation; credit underwriting;

[38] This argument may explain the empirical finding by Laeven and Levine (2009) that ownership by more institutional investors increases the riskiness of the bank.

[39] With the possible exception of companies that manufacture and use nuclear material, banking is the most regulated industry in the United States. The U.S. Nuclear Regulatory Commission (NRC) is responsible for regulating commercial and institutional uses of nuclear materials, including nuclear power plants. Founded in 1975, the NRC sets limits on radiation exposure from the radioactive materials it licenses and requires those with licenses to keep exposures well below these limits (Fisher 2012).

[40] See Macey, Miller, and Carnell (2001, 434). The explication of the rating system in this paragraph draws heavily from pages 434-5 of this source.

interest rate exposure; asset growth; compensation, fees, and benefits; and asset quality, earnings, and stock valuation.[41]

Bank regulators also have the power to remove officers and directors, to ban these persons from ever working for a bank, and to impose civil monetary penalties against a banking institution and its affiliates. So-called prompt corrective-action powers allow regulators to regulate every significant operational aspect of a bank.[42] This oversight means that corporate governance is no longer the ambit of the bank's owners, but rather is conducted through an odd (at least relative to other firms) shared-custody arrangement with the regulators.

There are clearly problems with this hybrid approach. As observed previously, replacing private sector creditors with public sector regulators as the first line of defense against bank fraud and self-dealing creates two problems. First, private sector creditors have stronger incentives than public sector regulators to monitor closely for fraud and self-dealing because the creditors' own money is on the line, while the regulators' money is not. Unlike regulators, private sector creditors will monitor until the losses avoided from such monitoring equal the marginal cost of such activity. Second, because of the lack of private sector market discipline, insufficient incentives exist for bankers to develop mechanisms for providing depositors and creditors with credible assurances that they will refrain from fraudulent activities (Macey and O'Hara 2003, 98-99).

Dodd-Frank requires the Fed to issue regulations requiring systemically important financial institutions (SIFIs) and publicly traded bank holding companies to establish risk committees.

These difficulties may explain why even embedding regulators in the bank has not proved effective. Rather than reporting to an office in a government building, embedded regulators work inside the private sector institutions to which they have been assigned. At JPMorgan Chase, approximately forty examiners from the Federal Reserve Bank of New York and seventy examiners from the OCC were embedded in the bank at the time of the London Whale episode. Yet, the trading losses from that episode were not monitored by embedded regulators because the regulators did not embed any examiners in the unit's offices in either London or New York. Instead, the unit was examined periodically by embedded examiners from other offices of the firm.

The relative lack of oversight of JPMorgan's Chief Investment Office by the legion of regulators embedded in the bank apparently was the result of a lack of understanding of what the office did. Generally speaking, banks' investment offices, known as Treasury units, restrict their activities to hedging and making low-risk, short-term investments with cash on hand. In contrast, the Treasury unit at JPMorgan had a portfolio of almost $400 billion. Far from limiting itself to hedging, the unit had become a profit center that made large bets and claimed to have recorded $5 billion in profit over the three years through 2011.[43] This episode strongly suggests that there are limits to the efficacy of embedded regulators in curtailing risk in the bank.

Section 165(h) of Dodd-Frank requires the Fed to issue regulations requiring systemically important financial institutions (SIFIs) and publicly traded bank holding companies to establish risk committees. Risk committees must have a formal written charter approved by the board of directors, must meet regularly, and must fully document their meetings and their risk management decisions. The specific responsibility of a SIFI's risk committee is to oversee:

> an enterprise-wide risk management framework, which will vary based on [the SIFI's] complexity, size, and inherent level of risk posed to the U.S. financial system. This framework would include (1) risk limitations appropriate to each business line of the company; (2) appropriate policies and procedures for risk management governance, practices, and infrastructure; (3) processes and systems for identifying and reporting risks; (4) monitoring compliance and implementing timely corrective actions; and (5) integrating risk management and control objectives with management's goals and the company's compensation structure.[44]

These risk committees must take responsibility for the oversight of enterprise-wide risk management practices of the company, have at least one director with expertise in risk management, and be chaired by an independent director. Risk committees face certain procedural requirements.

[41] 12 U.S.C. § 1831p-1.

[42] As a practical matter, the FDIC's power to revoke a bank's deposit insurance conveys similar power.

[43] These standards would also apply to insured federal savings associations and to insured federal branches of foreign banks with average total consolidated assets of $50 billion or more. See Silver-Greenberg and Protess (2012).

[44] Paul Hastings LLP Global Banking and Payment Systems Practice, "Federal Reserve Unveils Proposal on Dodd-Frank Enhanced Prudential Requirements and Early Remediation Requirements," January 2012, available at http://www.paulhastings.com/Resources/Upload/Publications/2082.pdf (accessed May 19, 2014).

In order for a director to qualify as independent, the company must indicate in its securities filings that the director satisfies the independence requirements established by the exchange on which the company's securities are listed. For companies whose shares are not publicly traded in the United States, the proposed rule provides that "the director is independent only if the company demonstrates to the satisfaction of the Federal Reserve that such director would qualify as an independent director under the listing standards of a securities exchange, if the company were publicly traded on such an exchange." Other specific requirements for risk committees are that they must report directly to the firm's board of directors, and not be a part of any other committee of the board, such as the audit committee. The director of the risk committee must not be an employee of the bank holding company and must not have been an officer or employee of the bank holding company during the previous three years. It would seem appropriate for the members of the risk committee, including the director of the risk committee, also to be members of the board of directors of the bank. Of course, the director of the risk committee would have to be an independent board member of the holding company, because employees of the holding company are prohibited from serving on the risk committee. Overlap between board members of the holding company and the subsidiary bank will ensure that information flows freely from the subsidiary to the parent and that the local knowledge and expertise of parent-company directors and officers are available to the bank.

Overlap between board members of the holding company and the subsidiary bank will ensure that information flows freely from the subsidiary to the parent.

In addition to requiring that bank holding companies and SIFIs have risk committees, Section 165(h) of Dodd-Frank states that the boards of directors of such companies must appoint a chief risk officer (CRO) to develop and maintain risk-management practices for the entire firm. Specifically, the CRO is responsible for (1) allocating responsibility for monitoring and compliance with delegated risk limits; (2) establishing appropriate policies and procedures for risk management governance, practices, and controls; (3) developing processes and systems for identifying and reporting risks; (4) monitoring and testing these controls; and (5) ensuring that risk management issues are effectively resolved in a timely manner. The CRO's risk management expertise should be appropriate to the company's capital structure, complexity, activities, and size. Additionally, this officer would report directly to the risk committee and CEO and have a compensation structure designed to provide an objective assessment of the risks taken by the company.[45]

Further, with respect to requirements on boards of directors, on January 16, 2014, the OCC proposed minimum standards for the design and implementation of risk governance frameworks by large insured national banks, and minimum standards for boards of directors in overseeing the frameworks' design and implementation.[46] The OCC also proposed a new statute authorizing the agency to prescribe operational and managerial standards for national banks and federal savings associations.[47] This proposal represents a new, and remarkably detailed, regulatory mandate regarding bank governance activities and responsibilities.

In its request for public comments on its proposed minimum standards, the OCC observed that "since large banks are often one of several legal entities under a complex parent company, each bank's board must ensure that the bank does not function simply as a booking entity for its parent, and that parent-company decisions do not jeopardize the safety and soundness of the bank. This often requires separate and focused governance and risk management practices."[48]

The OCC proposal articulates several other expectations. These include the expectation that large institutions have a "well-defined personnel management program that ensures appropriate staffing levels, provides for orderly succession, and provides for compensation tools to appropriately motivate and retain talent, [and] that does not encourage imprudent risk taking,"[49] and a requirement that institutions define and communicate "an acceptable risk appetite across the organization, including measures that address the amount of capital, earnings, or liquidity that may be at risk on a firmwide basis, the amount of risk that may be taken in each line of business, and

[45] Paul Hastings LLP Global Banking and Payment Systems Practice, "Federal Reserve Unveils Proposal," Insights, January 5, 2012, available at http://www.paulhastings.com/publications-items/details/?id=9629de69-2334-6428-811c-ff00004cbded.

[46] Office of the Comptroller of the Currency, "OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches; Integration of 12 CFR Parts 30 and 170." 79 Federal Register, Part VI, 54517-49; 12 CFR Parts 30, 168, and 170 (September 11, 2014). The guidelines would be issued and enforceable under Section 39 of the Federal Deposit Insurance Act, which authorizes the OCC to prescribe safety and soundness standards. 12 U.S.C. § 1831p-1.

[47] OCC Guidelines, 5.

[48] OCC Guidelines, 5.

[49] OCC Guidelines, 5.

the amount of risk that may be taken in each key risk category monitored by the institution."[50]

Additionally, the OCC "expects institutions to have reliable oversight programs, including the development and maintenance of strong audit and risk management functions. This expectation involves institutions comparing the performance of their audit and risk management functions to the OCC's standards and leading industry practices and taking appropriate action to address material gaps."[51] The OCC proposal also "focuses on the board of directors' willingness to provide a credible challenge to bank management's decision-making and thus requests independent directors to acquire a thorough understanding of an institution's risk profile and to use this information to ask probing questions of management and to ensure that senior management prudently addresses risks."[52]

A bank can use its parent company's risk governance profile to satisfy the OCC's new guidelines if the parent's risk profile is substantially the same as its own risk profile.[53] If not, the bank must come up with its own risk governance framework. A bank may, in consultation with OCC examiners, use components of its parent's risk governance framework but should ensure that the risk profile of the bank is easily distinguished and separate from that of its parent for risk management and supervisory reporting purposes, and that the bank's safety and soundness is not jeopardized by decisions made by the parent's board of directors and management.[54]

The OCC's guidelines also set out minimum standards for the design and implementation of banks' frameworks for risk management. Every bank would have to establish and adhere to a formal, written framework that covers: (1) credit risk, (2) interest rate risk, (3) liquidity risk, (4) price risk, (5) operational risk, (6) compliance risk, (7) strategic risk, and (8) reputation risk. Each bank's framework must also account for the risks to the bank's earnings, capital, liquidity, and reputation that arise from all of its activities.

[50] OCC Guidelines, 5.

[51] OCC Guidelines, 5-6.

[52] OCC Guidelines, 6.

[53] The risk profiles of a parent company and a bank would be considered substantially the same if, as of the most recent quarter-end Federal Financial Institutions Examination Council Consolidated Report of Condition and Income, or Call Report, the following conditions are met: (1) the bank's average total consolidated assets represent 95 percent or more of the parent company's average total consolidated assets; (2) the bank's total assets under management represent 95 percent or more of the parent company's total assets under management; and (3) the bank's total off-balance-sheet exposures represent 95 percent or more of the parent company's total off-balance-sheet exposures ("OCC Guidelines," 11).

[54] "OCC Guidelines," 11.

The OCC identifies three "lines of defense" for bank risk: front-line units, independent risk management, and internal audit. The three units should remain independent of one another. The bank's board of directors and its CEO retain substantial responsibility for risk management. But, as a law firm with substantial experience in representing banks before the OCC has observed, "if adopted as proposed, the Guidelines' detailed requirements regarding roles, responsibilities, and reporting structures would represent a significantly enhanced level of regulatory intervention into bank management and internal processes."[55]

The OCC's proposed guidelines impose specific risk-management-related responsibilities on the CEO and new standards for banks' boards of directors.[56] These board standards stipulate that:

1. Each member of the bank's board of directors has a duty to oversee the bank's compliance with safe and sound banking practices. Consistent with this duty, the board of directors should ensure that the bank establishes and implements an effective risk governance framework that meets the minimum standards described in these guidelines. The board of directors or the board's risk committee should approve any changes to the risk governance framework.
2. The bank's board of directors actively oversees the bank's risk-taking activities and holds management accountable for adhering to the risk governance framework. In providing active oversight, the board of directors should question, challenge, and when necessary, oppose recommendations and decisions made by management that could cause the bank's risk profile to exceed its risk appetite or jeopardize the safety and soundness of the bank.
3. When carrying out his or her duties, each member of the board of directors should exercise sound, independent judgment.

[55] Sullivan and Cromwell, LLP, "Heightened Risk Governance Standards for Banks and Bank Boards of Directors: Proposed OCC 'Guidelines' Would Establish Heightened Standards for Large National Banks' Risk Governance Frameworks and Boards of Directors, and Accelerate Trends of Regulatory Involvement and Reliance on Enforcement," January 21, 2014, at 2, available at https://www.sullcrom.com/files/Publication/5a0f2ae7-09cf-4f18-a9be-5910c9775b0b/Presentation/PublicationAttachment/559b34e5-b3b6-43a1-ac66-619e6d61d4e6/SC_Publication_Heightened_Risk_Governance_Standards_for_Banks_and_Bank_Boards_of_Directors.pdf.

[56] Under the OCC guidelines, the CEO is responsible for developing a strategic plan of at least three years that includes a comprehensive assessment of risks to the bank during the time period covered by the plan, along with an explanation of how the bank will update the framework to account for changes in the bank's risk profile. The strategic plan must be approved by the bank's board of directors and reviewed, updated, and approved to reflect changes in the bank's risk profile or operating environment. The CEO is also required to oversee the day-to-day activities of the chief risk executive and the chief accounting executive.

4. At least two members of the board of directors should not be members of (either) the bank's management or the parent company's management.[57]
5. The board of directors should establish and adhere to a formal, ongoing training program for independent directors. This program should include training on (a) complex products, services, lines of business, and risks that have a significant impact on the bank; (b) laws, regulations, and supervisory requirements applicable to the bank; and (c) other topics identified by the board of directors.[58]
6. The bank's board of directors should conduct an annual self-assessment that includes an evaluation of its effectiveness in meeting the standards for directors contained in section III of the OCC guidelines.[59]

The OCC's proposed rule posits that "one of the primary fiduciary duties of a Bank's Board is to ensure that the institution operates in a safe and sound manner." As Sullivan and Cromwell's memorandum points out,

> This statement is troublesome in multiple respects. First, it provides that the Board has an obligation to "ensure" a result, which is a standard that is beyond existing law and often achievability. Second, there may be an implicit suggestion that this "fiduciary duty" is owed to someone, e.g., the OCC, other than the shareholder(s). Third, the statement suggests that there is a separate fiduciary duty beyond the two widely recognized duties of loyalty and care.[60]

The OCC also asserts that boards of directors of national banks "must ensure . . . that parent company decisions and 'complex banking structures' do not jeopardize the safety and soundness of the bank."[61] This is a strange assertion in light of the fact that it is the Fed, and not the OCC, that regulates the parent companies of banks. Given this fact, it is not clear how this could be accomplished."[62]

The OCC's proposed guidelines represent the most complete articulation to date of the expectations that regulators have for bank directors with regard to ensuring the safety and soundness of banks. These guidelines raise more questions than they answer. In particular, there is no indication of where profit maximization fits into the OCC's vision of bank corporate governance. Even more significantly, there is no indication of how the competing duties and responsibilities of bank and holding company directors are to be reconciled. In other words, as so often is the case, the regulations purport to compel behavior without taking into account the incentives of the regulated officers and directors. This is particularly relevant in light of the fact that officers and directors of banks likely are interested in such things as promotions, compensation, and continued tenure in their jobs—and it is the holding companies, not the OCC, that controls these matters.

3.2 Multiple Liability for Bank Shareholders

The system of double and sometimes triple liability for bank shareholders was an ingenious device for dealing with banks' moral hazard and balance sheet instability. In the late nineteenth century, decades before deposit insurance was introduced, states imposed double, triple, and, in the cases of New Hampshire and Pennsylvania, even unlimited "joint and several liability"[63] on bank shareholders. These state laws prevented the issuance of corporate charters to banks whose shareholders did not agree to pay up to the amount of their original investment into the estate of the bank if it ever should become insolvent. The National Bank Act of 1863 extended this liability regime to shareholders in national banks, requiring that "each shareholder shall be liable to the amount of the par value of the shares held by him, in addition to the amount invested in such shares."[64]

The historical system of multiple liability for bank shareholders did more than protect depositors and other creditors from the consequences of bank failure ex post. It also had the effect of reducing moral hazard ex ante because shareholders, who controlled banks' boards of directors, realized that they would be personally liable for much, if not all, of the negative

[57] The OCC requests comment regarding the composition of a bank's board, including whether the minimum number of two independent directors required under the guidelines is the appropriate number, whether there are other standards the OCC should consider to ensure the board's composition is adequate to provide effective oversight of the bank, and whether there is value in requiring the bank to maintain its own risk committee and other committees, as opposed to permitting the bank's board to leverage the parent's board committees.

[58] This requirement is along the lines of a policy suggested by Acharya et al. (2009) that independent board members be educated in the operational details and complex procedures of large complex financial institutions.

[59] "OCC Guidelines," 75-8.

[60] Sullivan and Cromwell, 11.

[61] "OCC Guidelines," 75.

[62] Sullivan and Cromwell, 11.

[63] Joint and several liability is a liability designation in civil cases that provides that all defendants are responsible individually, as well as collectively, for 100 percent of the damages. Successful plaintiffs in cases in which joint and several liability is imposed may elect to collect the entire judgment from a single party, or from multiple parties in various amounts.

[64] National Banking Act of 1863, Ch. 58, 12 Stat. 665.

consequences of excessive risk taking. And multiple liability worked to stem depositors' losses in the Great Depression, despite the very large number of bank failures.[65] In other words, shareholders, not depositors, internalized the costs of bank failures before the Banking Act of 1933 initiated de jure deposit insurance for all deposit accounts under the statutory limit (currently $250,000).[66] Deposit insurance made the pre-Depression multiple liability regimes unnecessary from the point of view of many depositors. On the supply side, the credit enhancement for depositors provided by multiple liability was replaced by the credit enhancement provided by deposit insurance. As a result, banks no longer faced the same demand for a mechanism to signal that they would keep moral hazard in check. By 1935, the federal and state multiple liability regimes had been eliminated.[67]

> *To a very large extent, all of the modern banking regulations that we observe . . . have arisen because much of the cost of bank failure has shifted from bank shareholders to bank regulators.*

To a very large extent, all of the modern banking regulations that we observe, including capital requirements, reserve requirements, enhanced supervision, embedded regulators, and prompt intervention, have arisen because much of the cost of bank failure has shifted from bank shareholders to bank regulators.

3.3 Capital and Liquidity Requirements

In general, there are no laws requiring companies to maintain any particular level of capital as a protective cushion for creditors and other constituencies. Of course, this is not the case in banking. Capital requirements of various sorts, including simple limits on overall leverage and various forms of risk-based capital rules, are a standard feature of bank regulation. The purpose of these capital requirements is to reduce the probability of failure and to reduce moral hazard by forcing bank shareholders to bear a larger share of the losses experienced by the claimants on the cash flows of distressed firms.

Along with most observers, we are of the view that requiring appropriate levels of capital is critical to achieving a safe and sound banking system. Unfortunately, we also believe, for several reasons, that reasonably stringent bank capital requirements, while important, are only part of a properly functioning regulatory and governance system. Among our concerns about relying too heavily on bank capital requirements to avoid the financial meltdowns associated with banking crises is that "banks can respond to higher capital requirements in ways that make them less rather than more safe."[68] For example, banks avoid complying with the spirit of higher capital requirements by selling risky assets to "off-balance-sheet" entities, such as Structured Investment Vehicles (SIVs) and Variable Interest Entities (VIEs). Banks also can limit the effectiveness of higher capital requirements by investing in increasingly risky assets. Doing this increases the expected returns on whatever new levels of capital are required. This strategy is effective because risk weightings are distributed among rather crude categories of assets and often do not adequately reflect the true risk of the assets in a particular risk-weighting category, either because the chosen weights are wrong or because the categories are too broad.[69]

Another problem with bank capital requirements is that capital levels do not adjust at nearly the same speed at which assets can deteriorate. Many examples from the 2008 financial crisis illustrate this observation, as financial firms that were considered well-capitalized became insolvent in days, sometimes in mere hours. During the financial crisis, a number of financial institutions saw their capital levels, as expressed as Tier 1 common equity, erode by more than 500 basis points.[70] A study by the Federal Reserve has shown that even the higher proposed levels of capital used in the Basel III rules, which establish a minimum Tier 1 common equity plus the conservation buffer of 7 percent for most banks and 8 to 9.5 percent for systemically important financial institutions, would not have been sufficient for some banks.[71]

[65] During the period of the Great Depression (1929-1933), although 9,000 banks failed or suspended operations, depositor losses amounted to only $1.3 billion, a figure that pales in comparison to the $85 billion in losses borne by holders of common and preferred stock over the same timeframe (Friedman and Schwartz 1963, 440). During the Depression era, the number of banks in the United States fell from 24,633 to 15,015, a decline of 39 percent. The 5,712 banks that failed during this time had total deposits of $1.6 billion. Total losses to depositors were $565 million, which was 1 percent of average deposits during this period (Calomiris 2013, 166).

[66] Macey and O'Hara (2003, 100).

[67] Macey and O'Hara (2003, 100).

[68] Elliott (2010, 17).

[69] Hoenig (2013).

[70] Rosengren (2013, Figure 1).

[71] Rosengren (2013).

Thus, bank capital requirements need to be set in coordination with other regulations and with a good system of supervision and examinations, ideally aided by transparent accounting that allows the capital markets and ratings agencies to form their own judgments about the true riskiness of the activities of the banks. Simply put, "high capital levels alone are not enough."[72]

Bank liquidity requirements raise similar issues. The OCC, the Board of Governors of the Federal Reserve System, and the FDIC recently issued a notice of proposed rulemaking that would impose a quantitative liquidity requirement consistent with the liquidity coverage ratio established by the Basel Committee on Banking Supervision.[73] The liquidity coverage ratio proposal would apply to specified financial companies with $250 billion or more in total consolidated assets or $10 billion or more in on-balance-sheet foreign exposure; to systemically important nonbank financial institutions; and to banking subsidiaries of one of these companies that have assets of $10 billion or more. The purpose of the proposed liquidity coverage ratio is to strengthen the liquidity risk management of the companies to which it applies by requiring them to keep certain levels of high-quality liquid assets in order to meet the proposed rule's quantitative liquidity standard. The quantitative liquidity standard is the ratio of a company's high-quality liquid assets to its projected net cash outflows over a thirty-day period. A company would have to calculate and maintain a liquidity coverage ratio equal to or greater than 1.0 on each business day.[74]

In our view, the proposed liquidity requirements, like the capital ratios discussed above, are not a panacea for the broad societal externalities created by bank crises. While liquidity is important, liquidity does not measure solvency. It measures only the ability of a firm to meet its short-term, immediate requirements for cash. Still more is needed.

3.4 Enhanced Duty of Care

Another important way that bank regulation and bank corporate governance standards differ from those of other types of corporations is that bank directors have historically been held to higher standards than other directors.[75] Specifically, the fiduciary duty of care, which is the duty to make reasonable, fully informed decisions and to engage in the levels of monitoring and oversight of risk that are sufficient to the particular needs of the business, has been enforced more strictly against bank directors than directors of other companies. Courts attribute their tougher enforcement of directors' duties to the fact that "banks are charged with serving the public interest, not just the interests of the shareholders."[76]

It is highly significant, in our view, that courts have historically held directors of banks not merely to the standard to which they held other corporate directors, but to a higher standard that encompassed the concept of professionalism. Courts would, for example, impose personal liability on bank directors who approved transactions that were deemed to be "so improvident, so risky, so unusual and unnecessary as to be contrary to fundamental conceptions of prudent banking practices."[77] Requiring bank directors to conform to prudent banking practices brought the standards for bank directors close to the standards imposed on professionals such as doctors and engineers. These professionals must perform their functions to the standards generally held by those in their profession.

In contrast, in the corporate world in general, directors and officers are required to act and to make decisions in the same manner as a reasonable person would believe appropriate under similar circumstances.[78] Put simply, directors of most U.S. corporations are held to the same negligence standard as people participating in any amateur activity, such as recreational golf or pleasure driving. Conduct that meets the standards expected of nonprofessionals is all that is required.

As noted above, this low standard for director conduct stands in sharp contrast to the conduct required of professionals. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)[79] formally eliminated from U.S. common law the notion of higher standards for bank directors:

> A director or officer of an insured depository institution may be held personally liable for monetary damages . . . for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional

[72] Rosengren (2013).

[73] See Federal Reserve, "Notice of Proposed Rulemaking," available at http://www.regulations.gov/#!documentDetail;D=FRS-2013-0354-0001.

[74] "Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring" (PDF): See "Basel III: International Framework for Liquidity Risk Measurement, Standards, and Monitoring," December 2010, available at http://www.bis.org/publ/bcbs188.pdf , and "Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools," January 2013, available at http://www.bis.org/publ/bcbs238.pdf .

[75] Macey and O'Hara (2003, 111).

[76] Macey and O'Hara (2003, 111).

[77] Litwin v. Allen, 25 N.Y.S. 2d 667 (1940).

[78] Model Business Corporation Act, § 8.30(b).

[79] 12 U.S.C. § 1821(k).

tortious conduct, as such terms are defined and determined under applicable State law.[80]

By affirming that bank directors need only meet the standard of gross negligence for personal liability, FIRREA removed a potentially effective mechanism for incentivizing bank directors to consider the risk posed by banks to the greater financial system. We will return to this issue in the next section, but we note for now that the notion that U.S. bank directors could (and should) face higher burdens than other directors has long antecedents.

3.5 Global Approaches—Duty of Trust and Strict Liability

Outside the United States, bank directors have faced significantly higher burdens, with some jurisdictions viewing bank failures as a criminal offense on the part of directors. Brazil, for example, holds banks' executives and directors personally liable for the debts of failed institutions even when no fault is proven.[81] The U.K. government, following on the recommendation of the Parliamentary Commission on Banking Standards, recently introduced a new criminal offense for reckless misconduct in the management of a bank. This criminal liability would apply to both executive and non-executive directors of a bank.[82] The maximum sentence for the offense is seven years in prison, an unlimited fine, or both.

The notion that "reckless management" is a crime is rather alien to the U.S. perspective that business failure is not a criminal offense but rather a natural, albeit unfortunate, outcome of business judgment in an uncertain world. In our view, criminalizing bank failure is not a viable approach to resolving the difficulties of bank corporate governance. It does, however, change the calculus for bank directors with respect to the acceptable level of risk for a financial institution.

A similar change in calculus can arise from the concept found in Germany, Switzerland, and Austria called *Untreue*. This "breach of trust" is defined as "a derogation of duty that causes real harm to the institution," and it has been the basis for charges against bankers at WestLB, BayernLB, HSH Nordbank, and Sal. Oppenheim.[83] Indeed, the chief executive officer of WestLB paid a fine of 150,000 euros to settle charges relating to breach of trust. More intriguing are the cases involving board members of these failed financial institutions. The management board of the German bank HSH Nordbank went on trial for breach of trust stemming from risk management failures relating to a collateralized debt obligation (CDO) and other off-balance-sheet activities that resulted in the bank having to be bailed out to the tune of 30 billion euros.[84] This case, which represented the first time German prosecutors had tried to blame an entire board for a bank's failure, ended in an acquittal for all defendants.[85] Similarly, seven former directors of Landesbank Baden-Württemberg, or LBBW, Germany's largest public sector lender, were charged with breach of trust in connection with moving risky assets to special purpose vehicles allegedly to hide the riskiness of the bank. This case ended in settlement, with the directors of LBBW agreeing to make contributions to charity in lieu of fines.[86]

In the United States, bank directors and managers can be criminally prosecuted for fraud and for violating federal securities laws or provisions of those laws, and such was the fate that befell more than 800 bankers jailed in the aftermath of the savings-and-loan crisis. But pursuing such cases, particularly against bank directors, is notoriously difficult owing to the challenge of linking wrongdoing to those actually running the bank.[87] The rarity of this outcome means that bank director behavior is unlikely to be affected.

What is clear from this review is that corporate governance problems are remarkably resilient. While some approaches have been more successful than others, in general even the most extreme outside constraints have failed to resolve bank governance problems. In our view, this suggests that it would be wise to use a new approach, one that explicitly recognizes the inherent difficulty of managing and controlling risk in the post-crisis era.

[80] 12 U.S.C. § 1821(k).

[81] "Prosecuting Bankers: Blind Justice," *The Economist*, May 4, 2013.

[82] HM Treasury, "Financial Services (Banking Reform) Bill, Government Amendments: Criminal Sanctions," October 2013, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/245758/HoL_Policy_Brief_-_Criminal_Sanctions.pdf.

[83] HM Treasury, "Financial Services Bill."

[84] This duty of trust does not just attach to financial firms. Board members of the German firm Mannesmann were also charged with Untreue in connection with that firm's takeover by Vodaphone last year. See "Breach of Trust? German Corporate Governance is Literally on Trial," *The Economist*, February 20, 2013.

[85] For details on this verdict, see http://www.dw.com/en/hsh-nordbank-executives-acquitted-for-financial-crisis-wrongdoing/a-17769276.

[86] "German Court Closes LBBW Bank Case with Settlement," *Reuters*, April 24, 2014, available at http://www.reuters.com/article/lbbw-courts-idUSL6N0NG3BF20140424.

[87] "Prosecuting Bankers: Blind Justice," *The Economist*.

4. Bank Governance in the Post-Crisis World: A Proposal

Several factors suggest that it may be time to impose a more rigorous standard on the directors of certain financial institutions, particularly those institutions deemed to be systemically important by regulatory authorities. The fact that an institution is systemically important seems to us reason enough to expect directors of such institutions to be able to perform their functions at the level of other directors at comparable financial institutions. The vast complexity not only of the businesses of banking and finance but also of the laws and regulations that govern financial institutions, particularly in the wake of Dodd-Frank, provide additional support for the argument that bank directors should be held to higher standards than the amateur standard that governs directors generally. Our proposal here is particularly relevant for directors of bank holding companies, who currently face no special requirements as to qualifications.[88]

While our proposal that bank directors should have special expertise is new, the idea that corporate directors in general should have special expertise is not new, though the idea has not been well developed in the literature. Some scholars define the term "professional director" simply as a director who serves on multiple boards and adduce evidence that board membership of such professional directors correlates with improved performance for the companies on whose boards those directors serve.[89] Others use the term "professional" to refer to the particular, industry-specific expertise that certain directors have.[90] We use the term in the latter sense.

Among the earliest and most persuasive arguments for requiring corporate directors to have substantial industry-specific expertise was made by Yale law professor and future Supreme Court Justice William O. Douglas. Douglas (1934) argued that experts on the board "would be invaluable . . . in determining the course of conduct for the managers" and would be "better qualified to determine financial and commercial policy." For these reasons, Douglas argued that outside experts on boards of directors "should have a position of dominance and power on the board" so that they could "make their directive influence effective" by means of their "real power over executive management." In arguing for directors with sufficient industry expertise, Robert Pozen has observed,

> Lack of expertise among directors is a perennial problem. Most directors of large companies struggle to properly understand the business. Today's companies are engaged in wide-ranging operations, do business in far-flung locations with global partners, and operate within complex political and economic environments. Some businesses, retailing, for one, are relatively easy to fathom, but others—aircraft manufacture, drug discovery, financial services, and telecommunications, for instance—are technically very challenging. I remember catching up with a friend who had served for many years as an independent director of a technology company. The CEO had suddenly resigned, and my friend was asked to step in. "I thought I knew a lot about the company, but boy, was I wrong," he told me. "The knowledge gaps between the directors and the executives are huge." (Pozen 2010)

Just as the idea that some directors should be held to higher standards is not alien to the academic literature, neither is it new to policymakers. As noted above, Dodd-Frank requires that at least one of the members of the risk committees of BHCs and SIFIs must have risk management experience commensurate with the firm's capital structure, risk profile, complexity, size, and activities. The Sarbanes-Oxley Act explicitly set higher requirements for qualified audit committees by requiring all members to be independent and at least one member to be a "financial expert" as defined by SEC rules.[91] Indeed, one of the motivations behind Sarbanes-Oxley was to strengthen audit committees to "avoid future auditing breakdowns," which were contributing to a loss of confidence in the integrity of U.S. companies and markets.[92] Our argument here is that the failure of risk management at financial

[88] Interestingly, directors of subsidiary banks do face additional requirements. For example, the OCC notes in *The Director's Book* that "In addition to the citizenship and residency requirements contained in 12 USC 72, the qualifications of a candidate seeking to become a member of the board of directors of a national bank include (1) basic knowledge of the banking industry, the financial regulatory system, and the laws and regulations that govern the operation of the institution; (2) willingness to put the interests of the bank ahead of personal interests; (3) willingness to avoid conflicts of interest; (4) knowledge of the communities served by the bank; (5) background, knowledge, and experience in business or another discipline to facilitate oversight of the bank; and (6) willingness and ability to commit the time necessary to prepare for and regularly attend board and committee meetings (Office of the Comptroller of the Currency 2010, 4).

[89] Keys and Li (2005).

[90] Pozen (2010).

[91] An "audit committee financial expert" is defined as a person who has the following attributes: (1) an understanding of generally accepted accounting principles and financial statements; (2) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves; (3) experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities; (4) an understanding of internal controls and procedures for financial reporting; and (5) an understanding of audit committee functions." See Trautman (2013).

[92] See Senate Report No.107-205, as cited in Tsacoumis, Bess, and Sappington (2003).

institutions, particularly systemically important ones, can lead to outcomes of even greater consequence, and that current steps are insufficient to address the magnitude of the problem of excessive risk taking by financial institutions.

How might such a system work? We suggest a two-part structure involving differential standards for both bank risk committee members and bank directors. With respect to risk committee members, we note that risk management of a complex financial institution is not something easily grasped by a typical corporate director; it instead requires specialized expertise. Indeed, the shareholder advisory services ISS and Glass Lewis both recommended voting against the members of JPMorgan Chase's Risk Committee, citing their lack of risk management experience. We believe that risk management committees should be composed only of individuals who can demonstrate expertise in evaluating and monitoring the risk control systems of a bank. Allowing "amateur hour" with respect to this oversight function at large complex financial institutions is simply irresponsible in post-crisis financial markets.

Such individuals, whom we will call "banking experts," would have acquired, either through experience or education, the skills needed to monitor the risk management functions of the bank. For smaller financial institutions, the expertise required might be more limited, given that risk management at such institutions generally involves less complex methodologies (such as gap analysis, liquidity monitoring, and the like). For large, complex financial institutions, the needed skill set will be larger, requiring familiarity with risk modeling, valuation of complex derivatives, synthetic asset replication, hedging strategies, and so on. The specific qualifications for being a banking expert could be modeled after those required of audit committee financial experts.

Second, we also propose higher professional standards for bank directors. As we have argued in this article, bank corporate governance weaknesses pose an ongoing threat to the financial system. While heightened oversight of banks is surely called for, such oversight will be successful only to the extent that the directors of financial institutions have both the incentives and the experience and skill required to be successful in carrying out their oversight responsibilities. At a minimum, we believe bank directors should be "banking literate," where such literacy is defined as an understanding of the basic functions of banking, the nature of risk in complex financial organizations, and the complex regulatory structure defining banking. Such literacy, which would be a prerequisite for becoming a director, could be acquired through experience or through education.

We suspect that some may object to these proposals on the grounds that if having more qualified directors was valuable, then bank shareholders would demand this on their own. Alternatively, others may argue that if higher requirements are desirable for banks, then perhaps they should be required of firms more generally. We think the response to both objections is actually the same: banks are different from other firms. As we have argued, bank shareholders do not have properly aligned incentives to limit bank risk, so externally imposed requirements may be necessary. Other firms can adequately address corporate governance deficiencies internally, so requiring higher standards for all corporate directors is unnecessary.

Another objection to our proposal involves a more subtle point about bank risk taking. There is empirical research that indicates that banks with more knowledgeable directors are more likely to take on greater risk than other banks. One could argue that our proposal could actually exacerbate the risk-taking problem at banks rather than ameliorate it because our proposal would place more knowledgeable directors on boards. We have two responses to this. First, ignorance is not a good strategy for risk control—relying on directors' lack of knowledge to restrain risk is surely not a formula for a safe and sound banking system. We completely agree, however, that knowledge alone is not sufficient to achieve the goal of safety and soundness in banking. In addition to knowledge and competence, there must also be a culture within banks that considers prudent banking to be a way of life rather than an oxymoron. Culture starts at the top, so efforts by regulators to highlight the importance of cultural issues within banks should be viewed as fully compatible with our proposals to improve corporate governance in banking.

Finally, a legitimate concern is that our proposal would cause the demand for qualified bank directors to exceed the supply. We acknowledge that it will take time and effort to groom enough competent directors for all of the important financial firms in the economy. But if better directors result in creating better banks, then the returns to searching for, educating, and empowering those directors will pay off for all concerned.

5. Conclusion

Who will control large, complex financial institutions? Without better corporate governance, the answer may be the regulators—or no one at all. In this article, we have set out the myriad problems connected with bank corporate governance and noted how these seem to have taken on even greater complexity in the post-crisis world. We have argued that bank governance needs to change to reflect the realities of complex financial organizations. Our proposal to impose higher professional standards on bank directors and risk committee members is a first step in that direction.

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