The Rule of Too Much Law? The New Safety/Soundness Rulemaking Responsibilities of the Federal Banking Agencies

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I. Introduction

Much of the attention and controversy surrounding the enactment in 1991 of the Federal Deposit Insurance Corporation Improvement Act[1] ("FDICIA") has focused on the new "prompt corrective action" powers and responsibilities that Congress has imposed on the federal banking regulators[2] and which was implemented late last year through the agency rulemaking process.[3] Less notice has so far been taken of the closely-related and equally far-reaching new safety/soundness standard-setting duties of the agencies.[4] The specific safety/soundness requirements are submerged within FDICIA's "Prompt Corrective Action" Subtitle, and the rulemaking process implementing these standards is not yet complete.[5] Final rules are only required by August 31, 1993.[6]

Nevertheless, the issues generated by the implementation of the safety/soundness standards have begun to prove just as controversial as those relating to prompt corrective action. The standard-setting requirements have pushed the banking agencies to reach deep into traditional preserves of bank management and ownership. To the extent that these requirements are designed to impose some uniformity across the banking industry as a whole, they have, not surprisingly, been perceived by many bank directors and executives as excessive regulatory intrusions into the business of banking.

This article examines the background, constitutionality and wisdom of the new safety/soundness rulemaking powers. While these powers are probably immune from serious constitutional challenge, the author's view is that they rest on highly questionable policy judgments and will be extraordinarily difficult to implement. Their range and mandatory nature reflect an inappropriate, agency-forcing strategy by Congress.

The article also briefly reviews the proposed safety/soundness rules that have been tentatively approved by the Board of Governors of the Federal Reserve System ("Fed").[7] In the author's opinion, these proposed rules reflect a commendable sensitivity by the agency to the difficulties associated with implementing the congressional requirements, and it is concluded that they probably represent the best the industry could hope for under the circumstances. They are cast largely as a series of flexible guidelines rather than a set of sharp rules.[8] At the same time, the generality of these proposed rules, while making the best of a bad situation in the short term, create long-term traps for industry participants insofar as they depend, for their sensible implementation, on agencies that are not subject to the pressure of a Congress that may one day need to react again to a banking crisis such as the one we have just experienced.

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1. Pub. L. No. 102-242, 105 Stat. 2236 (1991).
2. *See* FDICIA § 131, adding a new section 38 to the Federal Deposit Insurance Act, 12 U.S.C. § 1831o.
3. Department of the Treasury (Office of the Comptroller of the Currency and Office of Thrift Supervision), Federal Reserve System, and Federal Deposit Insurance Coporation, "Prompt Corrective Action: Rules of Practice for Hearings," 57 Fed. Reg. 44,867 (Sept. 29, 1992), adding 12 C.F.R. Pts. 6 and 919, 565, 208 and 263 and 308 and 325. These rules came into effect on Dec. 19, 1992.
4. FDICIA § 132, adding a new section 39 to the FDI Act, 12 U.S.C. § 1831p-1 (initially codified at § 1831s).
5. *See* the joint notice published by all four federal banking regulators: Office of the Comptroller of the Currency, Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Board of Governors of the Federal Reserve System, "Joint Advance Notice of Proposed Rulemaking: Standards for Safety and Soundness," 57 Fed. Reg. 31336 (July 15, 1992) [hereinafter referred to as "Joint Advance Notice"]; and the proposed rules approved by the Board of Governors of the Federal Reserve System, "Notice of Proposed Rulemaking for Safety and Soundness Standards (Section 132 of FDICIA)," presented to the Board Apr. 19, 1993 [hereinafter referred to as "Fed. Proposed Rules"]. At the time this article went to press, the other banking agencies had not yet made their proposed rules available.
6. FDICIA § 132(b).
7. *See* Fed. Proposed Rules, *supra* note 5.
8. *See* further *infra* text accompanying notes 83-84. *Cf.* also *Expect More Use of Guidelines, Top Federal Banking Regulator Says,* 60 Banking Rep. 748 (BNA) (1993) (reporting remarks by a spokesman for the Federal Deposit Insurance Corporation to the effect that bank regulators intend to resort to flexible guidelines rather than detailed regulations).

II. Background

It is important to recognize at the outset that the power of the federal banking agencies to regulate insured depository institutions on the basis of safety/soundness principles is both extensive and well established. As the United States Supreme Court said as long ago as 1947, safety/soundness regulation "[does] not deal with unprecedented economic problems of varied industries. [It] deal[s] with a single type of enterprise and with the problems of insecurity and mismanagement which are as old as banking enterprise."[9] From the very inception of the federal insurance system in 1933, safety and soundness has been a principal concern driving a "cradle to grave"[10] regime of tight regulation;[11] it is a corollary of the federal insurance safety net upon which rests the constitutional and prudential justification for federal regulation of even state chartered depository institutions (whenever those institutions elect to become federally insured). "Unsafe and unsound practices," or being in an "unsafe or unsound condition," have, since at least 1933, always been a permissible basis upon which formal enforcement action could be taken (usually after adjudication before an independent administrative law judge) against insured institutions or their directors and officers.[12]

It is also important to consider the changing regulatory environment within which safety/soundness regulation has been implemented since the New Deal. While the regulators' supervisory powers on matters of safety and soundness have traditionally been highly discretionary, the regulatory environment within which this discretionary safety/soundness regulation was practiced was, until the 1980s, very different from the one that now exists.

The traditional framework was largely determined by the Banking Act of 1933. This legislation not only established the system of federal insurance and safety/soundness regulation, but also -- for better or worse -- set a number of boundary rules that served to define what constituted legitimate banking activities. The securities prohibitions of Glass-Steagall -- what two authors have aptly described as the "legal Maginot line"[13] -- is the most obvious example of such a boundary. During the ensuing three and a half decades other barriers were also enacted,[14] and banks enjoyed the status of a government-sponsored cartel. In return for severe restrictions upon the kinds of activities in which they engage, banks and thrifts were assured a reasonably stable profit base.[15] This was the era in which predominated what one recent commentator has described as "prophylactic" regulation:[16] the strategy of the "New Deal banking legislation, and of bank regulation during the next five decades, was to impose direct controls on the permissible assets, investment policies and activities of individual banking organizations," thereby forcing banks "to follow a particular business plan that was designed to produce a profitable and low-risk banking industry."[17]

It was within these outer boundaries that the regulators applied their supervisory powers over individual depository institutions. Where a particular activity or practice was not already proscribed by Congress in legislation, the determination of its safety or soundness required a highly discretionary judgment by the appropriate regulator with reference to each specific case. As the U.S. Senate Banking Committee acknowledged in 1966, " '[U]nsafe' and 'unsound' have no definite or fixed meaning."[18] Indeed, the concept has been difficult to capture in terms more specific than those contained in the following classic formulation by a former chairman of the now-defunct Federal Home Loan Bank Board:

> Generally speaking, an "unsafe or unsound" practice embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk of loss or damage to an institution, its shareholders, or the agencies administering the insurance funds.[19]

Discerning safety and soundness under these circumstances necessarily involves highly predictive judgments[20] that are cognizant of the difficult business judgments bankers must continually make. The sensitive and complex regulatory decisions that safety/soundness concerns dictate involve, as a practical matter, a delicate, case-by-case, fact-by-fact review of the operations of and circumstances surrounding individual depository institutions -- a review usually made feasible only by the on-site interaction between agency examiners and the management of the institution.

As a basis for regulatory action, the safety/soundness concept was therefore recognized by judges to be a matter falling so fully with the special expertise of the banking agencies as to warrant a high degree of deference from the courts when agency determinations are challenged on review.[21] At the same time, the courts have not insisted that the regulators always act on an individual, case-by-case basis when making

9. Fahey v. Mallonnee, 332 U.S. 245, 250 (1947).

10. People v. Coast Fed. Sav. & Loan Ass'n, 98 F. Supp. 311, 316 (S.D. Cal. 1951); *see also* Fidelity Fed. Sav. & Loan Ass'n v. De la Cuesta, 458 U.S. 131, 145 (1982) (quoting *Coast Federal).*

11. *See also* United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 329 (1963) (banking has been "one of the longest regulated and most closely supervised of public callings").

12. *See, e.g.*, the Banking Act of 1933, § 30, Act of June 16, 1933, ch. 89, 48 Stat. 193 (authorizing the Comptroller of the Currency to certify directors or officers of national banks to the Federal Reserve Board for removal proceedings where they have persisted in violations of law or "unsafe or unsound practices").

13. JONATHAN R. MACEY & GEOFFREY P. MILLER, BANKING LAW AND REGULATION 496 (1992).

14. For example, the prohibition imposed on commercial and industrial affiliations with banks, that was effected with the passage of the Bank Holding Company Act and amendments.

15. *See, e.g.*, Geoffrey P. Miller, *Anatomy of a Disaster: Why Bank Regulation Failed*, 86 Northwestern Un. L. Rev. 742, 747 (1992) (book review); Geoffrey P. Miller, *The Future of the Dual Banking System*, 53 Brook. L. Rev. 1, 2-7 (1987).

16. HELEN A. GARTEN, WHY BANK REGULATION FAILED, xvi (1991).

17. *Id.*

18. SENATE COMM. ON BANKING AND CURRENCY, FINANCIAL INSTITUTIONS SUPERVISORY ACT OF 1966, S. Rep. No. 1382, 89th Cong., 2d Sess., 1966 U.S.C.C.A.N. 3532, 3539.

19. John E. Horne, Memorandum Submitted to the Chairman of the Senate Comm. on Banking and Currency, 112 Cong. Rec. 26,474 (1966).

20. Franklin Sav. Ass'n v. Director, Office of Thrift Supervision, 934 F.2d 1127, 1145-46 (10th Cir. 1991).

21. *See e.g.*, Franklin Sav. Ass'n v. Director of Thrift Supervision, 934 F.2d 1127, 1145-46 (10th Cir. 1991); First Nat'l Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674, 688-89 (5th Cir. 1983); First Nat'l Bank of Lamarque v. Smith, 610 F.2d 1258 (5th Cir. 1980); Independent Bankers Ass'n of Am. v. Heimann, 613 F.2d 1164, 1168-69 (D.C. Cir.), *cert. denied*, 449 U.S. 823 (1980); Groos Nat'l Bank v. Comptroller of the Currency, 573 F.2d 889, 897 (5th Cir. 1978).

This is not to say that the courts have never overturned the safety/soundness determinations of the regulators. *See e.g.*, Lawrence G. Baxter, *Judicial Responses to the Recent Enforcement Activities of the Federal Banking Regulators,* 59 Fordham L. Rev. S193, S208-16 (1991). On occasions they have, but even then Congress has occasionally stepped in to provide the regulators with specific power to do what the courts said they could not. A well-known example was the case of First National Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674 (5th Cir. 1983), where the court held that the Comptroller's conclusion that the bank, by virtue of its capital condition, was an unsafe and unsound condition, was insupportable. Congress immediately responded by granting the banking agencies the express power to set general and specific minimum capital levels for banking institutions, and to treat failure to conform to these requirements as an unsafe and unsound practice. International Lending Supervision Act of 1983, Pub. L. No. 98-181, § 908, 97 Stat. 1280, 12 U.S.C. § 3907 (1983).

determinations regarding safety and soundness: on the contrary, they have ruled that it is fully acceptable for a banking agency to make generalized pronouncements, when the agency deems this appropriate, regarding what will be an unacceptable, unsafe or unsound practice.[22] In other words, the banking agencies have been accorded a broad latitude to implement their safety/soundness regulatory powers in whatever way they choose, whether it be through individual decision-making or by means of general rules.[23]

Since the late 1970s, however, the business of banking has undergone a sea change. And so, too, has the regulatory environment. Macroeconomic, technological and market forces have threatened the very survival of the banking industry; to foster its revival, Congress, and federal and state regulators, were driven to deregulate the industry. The banking industry entered into a new, more competitive atmosphere.

But the new deregulated environment, accompanied by reduced regulatory capacity during an era of government cutbanks, and unaccompanied by the antidote of market disciple, led to the catastrophes that have afflicted the nation's banking industry. Amid the ensuing public alarm, the Administration and the Congress hastened to cast blame wherever they could -- on each other, on the industry and its alleged "kingpins," and on the regulators.

Whatever the fairness or rationality of this self-exculpatory strategy, the fact remains that the public looked to their elected representatives to do something to protect taxpayers from further jeopardy, and Congress and the Administration hastily complied by passing two major enactments that effected structural and substantive regulatory reform (FIRREA in 1989,[24] and FDICIA in 1991), and by conducting prosecutions, hearings, and investigations, all designed largely to "clean up" the industry and galvanize the regulators into more stringent supervision of the industry. Writing before the passage of FDICIA, Helen Garten had already observed that during the period of deregulation during the 1980s,

> [r]egulation would no longer seek to control bank risk by making investment decisions for the banking industry. Instead, regulation would leave individual banks free to set their own business policies, but would require banks to improve their internal controls and risk management techniques . . . [o]ld prophylactic regulation was gradually being replaced by new prudential regulation.[25]

The effects of the S&L crisis and the insolvency of the federal insurance funds not only accelerated the trend from "prophylactic" to "prudential" regulation but also *transformed* the very nature of prudential regulation itself. Demands for the reintroduction of old-style prophylactic regulation were too unrealistic to muster significant congressional support, but the national political heat, and Democratic congressional antipathy toward and suspicion of a Republican administration, were sufficiently intense as to produce the next best thing: direct prudential regulation by Congress itself. In other words, the regulators were no longer trusted to exercise their discretion regarding banking prudence (safety/soundness); if they and the industry could not get it right in the first place, Congress would have to do it for them -- and this Congress did in one agency-forcing and industry-constricting statutory provision after another, from the new capital standards for thrifts in FIRREA[26] to the safety/soundness standard-setting requirements in FDICIA. Regulation, in other words, was simultaneously made more "prudential" *and* more mandatory, and the traditional environment of broad regulatory discretion and entrepreneurial liberty was very significantly displaced by a congressionally-preordained prudential framework designed to reduce the risk to the federal insurance funds and, in turn, the taxpayers.

III. The 1991 Rulemaking Requirements

The safety/soundness standard-setting requirements in FDICIA find their immediate genesis in a report by the General Accounting Office ("GAO") to the House and Senate banking committees during the early legislative process in 1991.[27] The GAO had studied a number of failed banks and had concluded that one of the causes for their failure was the depletion of capital as a result of asset, earnings and management problems, coupled with a failure by the regulators to take early and forceful enforcement action.[28] The GAO concluded, with the Treasury Department and earlier studies,[29] that a capital "tripwire system" should be adopted as a means of identifying points at which increasingly stringent regulatory intervention should occur to arrest the failure of troubled institutions.

The GAO report went further, however, to emphasize that capital indicators would be insufficient without additional mechanisms to ensure effective internal bank operating, management and safety/soundness controls.[30] The Congress and regulators were urged to develop "accepted definitions of inherently unsafe activities and conditions that would trigger mandatory enforcement actions."[31] These recommendations directly influenced the drafting, first in the House and subsequently in the Senate, of the prompt corrective action provisions of

22. *See* Independent Bankers Ass'n of American v. Heimann, 613 F.2d 1164, 1168-69 (D.C. Cir. 1989), *cert. denied,* 449 U.S. 823 (1990).

23. *Id.,* 613 F.2d at 1169 ("Absent a clear congressional expression to the contrary, the Comptroller is entitled to accomplish his regulatory responsibilities over 'unsafe and unsound' practices both by cease and desist proceedings and by rules defining and explicating the practices which in his discretion he finds threatening to a stable and effective national bank system") (footnote omitted).

24. Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73 ("FIRREA").

25. Garten, *supra* note 16, xvi-xvii.

26. FIRREA § 301 (creating new § 5(t) of the Home Owners Loan Act, 12 U.S.C. § 1464(t)).

27. *See* GENERAL ACCOUNTING OFFICE, DEPOSIT INSURANCE: A STRATEGY FOR REFORM, GAO.GGD-91-26 (March 1991) (Report to the Chairman, Committee on Banking, Finance and Urban Affairs, House of Representatives) [hereinafter referred to as "STRATEGY FOR REFORM"].

28. *See* GENERAL ACCOUNTING OFFICE, BANK SUPERVISION: PROMPT AND FORCEFUL REGULATORY ACTIONS NEEDED, GAO/GGD-91-69 (April 1991) (Report to the Chairman, Subcommittee on Financial Institutions Supervision, Regulation and Insurance Committee on Banking, Finance and Urban Affairs, House of Representatives). The methods employed in the GAO study are somewhat questionable. *See, e.g.,* the interchange between the GAO and the agencies concerning the earlier draft. *Id.* Appendix II.

29. *See* DEPARTMENT OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS, 38-41, X-10 - X-24 (Feb. 1991).

30. *See* STRATEGY FOR REFORM, *supra* note 27, 61-65.

31. *Id.* at 61.

FDICIA,[32] including the safety/soundness standard-setting section[33] which complements the related, but independent, capital classification and tripwire system that constitutes the centerpiece of FDICIA's prompt corrective action framework.[34]

FDICIA created a basis for early agency intervention that is not directly based on a depository institution's capital condition. The Act added a new section 39 ("section 39") to the Federal Deposit Insurance Act ("FDI Act"),[35] entitled "Standards for Safety and Soundness."[36] In this new section 39, the agencies are directed to prescribe, through a rulemaking process,[37] a series of safety/soundness standards applicable to depository institutions and their holding companies. The standards to be prescribed are classified as follows:

- □ **operational and managerial controls**[38]
  - ■ internal controls, information systems, and internal audit systems
  - ■ loan documentation
  - ■ credit underwriting
  - ■ interest rate exposure
  - ■ asset growth
  - ■ compensation, fees, and benefits
  - ■ any other operational and managerial standards deemed appropriate by the agencies
- □ **asset quality, earnings and stock valuation standards**[39]
  - ■ maximum capital-to-classified-assets ratios
  - ■ minimum earnings sufficient to absorb losses without impairing capital
  - ■ minimum ratio of market value to book value ratios for publicly-traded shares ("to the extent feasible")
  - ■ any other standards related to asset quality, earnings or stock valuation deemed appropriate by the agencies
- □ **compensation standards**[40]
  - ■ standards prohibiting employment contracts, compensation, benefits, fees, perquisites, stock options, postemployment benefits or other compensatory arrangements that would be "excessive" or would lead to "material financial loss to the institution"
  - ■ standards specifying when any compensation arrangements would be excessive (in the light of various enumerated factors such as the combined value of all cash and noncash benefits, financial condition of the institution, any involvement by the beneficiary in fraudulent acts, omissions, or breaches of fiduciary duty concerning the institution)
  - ■ any other compensation standards deemed by the agencies to be appropriate[41]

Once the regulations have been promulgated and have come into effect,[42] failure by any insured depository institution to meet the standards will trigger the enforcement provisions of section 39. Institutions that fail to meet the standards will be required by the appropriate banking regulators to submit a plan indicating how they will correct the deficiencies.[43] (This corrective plan is a quite independent requirement from the capital restoration plans required in terms of FDICIA's capital-tripwire provisions.[44]) The plans must be submitted within 30 days[45] and the agency must respond within a similar period of time.[46]

If an institution fails to submit or to implement a plan, the appropriate agency can issue an order requiring submission or implementation. The agency can also impose a host of specific requirements, including, to mention but a few, prohibiting asset growth in the institution, requiring the institution to increase its tangible-equity-to-asset ratio, restricting the payment of interest rates on deposits, and requiring divestiture of subsidiaries, employment of qualified officers and the election of a new board of directors.[47] The agencies are not only empowered to add these specific orders to their general compliance orders, they are also *required* to take one or more of these actions where the institution concerned fails to meet FDICIA's operational and managerial standards, asset quality, earnings and stock valuation standards, where the institution commenced operations or was acquired less than 24 months before the failure to meet the safety/soundness standards, or where the institution concerned had experienced "extraordinary growth" (as defined by the appropriate agency) during the 18-month period prior to the first failure in compliance with the

32. *See e.g.*, Richard S. Carnell, *Prompt Corrective Action Under the FDIC Improvement Act of 1991*, in PRACTICING LAW INSTITUTE, LITIGATING FOR AND AGAINST THE FDIC AND THE RTC: 1992 27, 74-75 (Commercial Law and Practice Course Handbook Series Number 625) (1992). (Mr. Carnell was Senior Counsel to the Senate Banking Committee).

33. FDICIA § 132.

34. *Id.* § 131.

35. Added by FDICIA § 132 and now codified at 12 U.S.C. § 1831p-1.

36. For clarity, it is the FDI Act section to which subsequent reference will be made in this article.

37. The standards must be prescribed by "regulation." FDI Act § 39(d). There is no doubt that "regulation" is intended to mean "rule," as this latter term is defined under the rule making requirements of the Administrative Procedure Act, 5 U.S.C. §§ 551(4) (defining a "rule" to include any agency statement "of general or particular applicability and future effect designed to implement; interpret, or prescribe law or policy"), and 553(c) (requiring informal public notice-and-comment procedure before promulgation). The agencies have already indicated this assumption in their Joint Advance Notice and in the Fed Proposed Rules, *supra* note 5.

38. FDI Act § 39(a), 12 U.S.C. § 1831p-1(a).

39. FDI Act § 39(b).

40. *Id.* § 39(c). The standards relating to compensation do not appear to be applicable to holding companies. *See* Joint Advance Notice, *supra* note 5, 57 Fed. Reg. at 31340(IV(G)); and Carnell, *supra* note 32, 42. The Fed does not propose to apply compensation standards to holding companies. *See* Fed Proposed Rules, *supra* note 5 (explanatory Staff Memo at 5).

41. In response to industry protests, Congress, in section 956 of the Housing and Community Development Act of 1992, Pub. L. No. 102-550, 106 Stat. 3895, amended § 39(d) of the FDI Act to prevent the regulators from prescribing specific levels or ranges of compensation in their compensation standards. Section 956, however, preserves the regulators' ability, under § 38, to restrict compensation for directors, officers and employees of undercapitalized institutions, and it does not affect the regulators' powers under other provisions of the FDI Act to impose specific compensation restrictions in the case of individual institutions.

42. The regulations must become effective by no later than December 1, 1993. FDICIA § 132(c).

43. FDI Act § 39(e)(1)(A). Congress has recently amended § 39(e)(1)(A) to eliminate the requirement of a plan in the case of failure to meet the compensation standards required under § 39(c). Housing and Community Development Act of 1992, § 956(2).

44. *Id.* § 38, added by FDICIA § 131. The corrective plan may, however, be incorporated with a capital restoration plan where an institution is undercapitalized. FDI Act § 39(e)(1)(B).

45. Or sooner, by regulation.

46. FDI Act § 39(e)(1)(C).

47. *Id.* § 39(e)(2).

safety/soundness standard.[48] In addition, the agencies may now enforce their orders by means of civil money penalties imposed through agency proceedings as well as with orders secured in federal district court.[49]

This safety/soundness regulatory system is still further complicated by the manner in which it implicates other requirements established by FDICIA. As the banking agencies have pointed out in their Joint Advance Notice,[50] some of the general requirements in section 39 are also addressed specifically elsewhere. For example, section 305(b) of FDICIA requires the agencies to revise their risk-based capital standards to take adequate account of interest rate risk -- a concern also covered by the asset quality and earnings standards requirements of section 39. Section 304 of FDICIA, which specifically requires the imposition of restrictions on real estate lending, provides another example. In the present context, the most obvious area of overlap relates to section 38 of the Federal Deposit Insurance Act -- FDICIA's "prompt corrective action" provision. Section 38(g) expressly authorizes the appropriate banking agency to downgrade an institution's capital status, irrespective of the institution's actual capital level, if the agency determines that the institution is in an unsafe or unsound condition or if it deems the institution to be engaging in an unsafe or unsound practice. Such a downgrading then permits the agency to take direct prompt corrective action under section 38 quite independently from any action the agency might also be able to take under section 39.[51]

IV. Constitutional Issues

Can such intrusive standard-setting requirements be constitutional? After all, the U.S. Constitution was once thought to require a separation of powers not only between the branches of government but also between government and the *economy.*[52] Many bankers might be inclined to view the safety/soundness standard-setting requirements as more a congressional hijacking of the business of banking than an effort to regulate that business.

It is unlikely, however, that any serious constitutional challenge against section 39 could be made at this stage. The only conceivable challenges might be: (i) that the standard-setting requirements constitute an *excessive delegation of power* by Congress to the banking agencies; (ii) that the intrusive nature of these requirements constitutes a *regulatory taking;* (iii) that the promulgation of safety/soundness standards violates *substantive due process;* or (iv) that the enforcement of the safety/soundness standards violates *procedural due process.* The first three challenges would attack section 39 on its face (i.e., no matter how the agencies go about setting the safety/soundness standards). The fourth challenge would represent an attack, not on the standards themselves, but on the manner by which the agencies enforce them against individual banks.

(i) *Excessive Delegation.* In theory, at least,[53] Congress may not delegate its legislative powers under Article I of the Constitution. Section 39 certainly delegates very broad powers to the banking agencies. But the courts are extremely unlikely to declare this delegation unconstitutional.

First, the Supreme Court has always accepted delegations of power to agencies when these have been accompanied by "intelligible principles" or "standards" by which the delegated power is to be exercised. As long as Congress has provided some guidance in the governing statute as to how the agency is to exercise its power to "fill in the gaps," the courts have regarded the delegation of power to be sufficiently structured as to be acceptable.[54] Whatever one might think of its content, section 39 is not short of detailed guidance concerning the factors which the agencies should take into account when developing their safety/soundness standards, nor is it short on verbiage as to how these standards should be implemented. In this respect, section 39 contains the kind of voluminous (albeit conflicting) guidance that was quite validly supplied to the U.S. Sentencing Commission for the development of the federal Sentencing Guidelines,[55] and it is likely to be regarded as sufficiently detailed on this account alone.[56]

Second, the Court has already specifically accepted the delegation of wide discretionary power to regulate on grounds of safety and soundness. Not long after the Court actually did enforce the non-delegation doctrine -- when one might have expected the doctrine to have some vigor -- the Court was presented, in *Fahey v. Mallonnee,*[57] with the complaint that the power of the old Federal Home Loan Bank Board to make rules for the reorganization, restructuring, merger, seizure or liquidation of savings institutions was couched in unconstitutionally-vague terms. (The phrase "unsafe and unsound" was not even in the statute but had been used by the Board in its regulations.) The Court rejected the non-delegation argument, holding that the statutory power, and concepts such as "unsafe and unsound" that had been used by the Board in its rule, were commonly understood within the industry as a sufficient basis

48. *Id.* § 39(e)(3).

49. FDI Act § 8(i)(1) & (2)(A)(ii), as amended by the Housing and Community Development Act of 1992, § 1603(d)(3)(A) (enforcement), § 1603(d)(4) (civil penalites).

50. *See supra* note 5.

51. FDI § 38(g). For a detailed analysis of the application of this subsection and its interaction with the other prompt corrective action provisions of FIRREA, *see* Lawrence G. Baxter, "Review of PCA Decisions" (report presented to the Administrative Conference of the United States, May 1993).

52. This conception of separation of powers seems to have underlain one of the early Supreme Court decisions involving the Contract Clause in Article I, § 10 of the U.S. Constitution. *See* LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW 613-15 (2 ed. 1988).

53. The non-delegation doctrine has only been applied by the U.S. Supreme Court in three early cases, and in only two of those cases was it held that power had unconstitutionally been delegated to the executive branch. *See* Panama Refining Co. v. Ryan, 293 U.S. 388 (1935) (declaring unconstitutional a provision in the New Deal National Industrial Recovery Act ("NIRA") that authorized the President to prevent the interstate transportation of "hot oil"); A.L.A. Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935) (declaring unconstitutional another provision of NIRA that allowed the President to approve codes of "fair competition" for an industry); Carter v. Carter Coal Co., 298 U.S. 238 (1936) (federal statute unconstitutional because it delegated governmental power to private parties). Although lip service is still given to the doctrine, and the cases cited have never been overruled, it would require a very extreme case for the Court to invoke this doctrine as the basis for declaring a statute unconstitutional. *See generally, e.g.,* RICHARD J. PIERCE, SIDNEY A. SHAPIRO & PAUL R. VERKUIL, ADMINISTRATIVE LAW AND PROCESS 54-55 (2 ed. 1992); PETER L. STRAUSS, AN INTRODUCTION TO ADMINISTRATIVE JUSTICE IN THE UNITED STATES 20-23 (1989).

54. *See, e.g.,* Touby v. United States, 111 S. Ct. 1752, 1755-58 (1991) (explaining the Court's "intelligible principle" doctrine).

55. *See* Mistretta v. United States, 488 U.S. 361 (1989) (upholding the delegation of power to the U.S. Sentencing Commission to formulate sentencing guidelines).

56. In *Mistretta,* the Court demonstrated a current clear reluctance to uphold constitutional attacks on legislation based on the non-delegation doctrine. For discussion, *see, e.g.,* Pierce, Shapiro & Verkuil, *supra* note 53, 55.

57. 332 U.S. 245 (1947).

upon which the agency could proceed.[58] It is quite unlikely that the Court would suddenly now conclude that the concept, buttressed as it is with a multitude of congressional admonitions and exhortations, has become too vague for regulatory action.[59]

Finally, it is worth observing that a non-delegation attack would, if successful, prove somewhat self defeating. The corollary to a declaration that section 39 constitutes an unconstitutional delegation of power is that Congress must enact the rules for safety and soundness itself. Faced with a choice between Congress and the regulators, I suspect that most bankers would prefer that the regulators be the ones who determine safety/soundness standards, if such standards must be set (and Congress in its current mood is highly likely to persist in this view). The regulators not only have a good deal more capacity to develop these standards, but they are also much closer to their regulated industry and are therefore more likely to be sensitive to the complex exigencies of banking entrepreneurship.

(ii) *Regulatory Takings.* A bank owner or manager might be forgiven for feeling that the impending safety/soundness standards virtually wrest away the ability to control or manage the bank. The requirements of section 39 certainly threaten to reduce substantially the entrepreneurial freedom hitherto enjoyed by bankers. Hence another intuitive objection to section 39 might be that it constitutes a "taking" of property without just compensation -- which is forbidden by the Takings Clause of the Fifth Amendment. The form of "taking" would be somewhat unusual, since it would not take the form of physical deprivation of the bank; rather, the taking would come in the form of regulatory restrictions so severe as to deprive the owners of banks of the value of their banks. Such a taking has come to be known as a "regulatory taking" and, in the Supreme Court's jurisprudence, where regulation becomes so extreme as to extinguish the value of the property in question it is regarded as a taking for which there must be "just" compensation.[60]

Congress' regulatory power in the sphere of banking, with respect to national banks, federally chartered savings associations, all members of the Federal Reserve System (federal and state), and all depository institutions that are federally insured (whether federal or state), is beyond question. As to whether there should be compensation for such regulation, while it might perhaps remain an open question whether specific contracts between the federal government and individual depository institutions can be abrogated without compensation,[61] it is difficult to see how banks could ever satisfy the legal requirements for compensation as a result of more onerous safety/soundness standards.

First, the *amount* of compensation, and even the cause of the losses complained of, are likely to be imponderable: the purpose of more onerous safety/soundness requirements is to improve the condition of banks, not damage them. While bankers might disagree with the strategy adopted by Congress in this regard, it would be virtually impossible to demonstrate that a particular deterioration in the condition of a bank was caused by the safety/soundness rules alone. In this respect, the courts are unlikely to find that the "economic impact of the regulation," and the "character of the governmental action" (which falls well short of outright physical occupation) are sufficiently severe or unambiguous to satisfy the case-by-case, multi-factor analysis used in determining whether there has been a taking that demands compensation.[62]

Second, all depository institutions falling within the scope of section 39 do so because they are federally insured. A large proportion are also either federally (or "nationally") chartered or at least members of the Federal Reserve System. The impact of section 39 is, by its terms, restricted to "insured" institutions: state institutions may decline federal insurance and, if necessary, withdraw from membership of the Federal Reserve System. Congress is well within its regulatory powers in conditioning the grant of federal deposit insurance (and, for that matter, federal charters and federal reserve facilities) upon the observance of standards relating to safety and soundness, no matter how ill-advised those standards might be perceived to be. To put this in the more technical takings language of the courts: (a) insured depository institutions are unlikely to possess "property" rights that are sufficiently unqualified to provide the basis for compensation;[63] (b) the owners of banks are unlikely to possess "reasonable investment-backed expectations"[64] of compensation in the event of more severe regulation; and (c) directors and officers whose compensation might be restricted by the new safety/soundness standards are highly unlikely, working as they do in "one of the longest regulated and most supervised of all public callings,"[65] to be regarded as having employment contracts that validly embrace a "historically rooted expectation of compensation"[66] from the

,58. *See also* Farmers State Bank, Kanawha v. Bernau, 433 N.W. 2d 734, 741 (Iowa 1988).

59. The real problem is, of course, that § 39 constitutes a typical example of congressional smoke blowing: the section is full of detail, which creates the illusion that Congress has charged the agencies with concrete duties to correct the problems of safety and soundness, but it reality the detail is an embroglio of grand aspirations and contradictory responsibilities. About a decade ago, the Supreme Court seemed to indicate that it was going to use the non-delegation doctrine as a means of forcing Congress to enact more coherent legislation, but more recently it seems to have abandoned that strategy. *See, e.g.*, Pierce, Shapiro & Verkuil, *supra* note 53, 53-54.

60. *See, e.g.*, Lucas v. South Carolina Coastal Council, 112 S. Ct. 2886 (1992); Pennsylvania Coal Co. v. Mahon, 260 U.S. 393, 415 (1922) ("while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking").

61. Compare, *e.g.*, TransOhio Savings Bank v. Director, Office of Thrift Supervision, 967 F.2d 598 (D.C. ir. 1992) (government cannot contract away the sovereign power of Congress to change the terms of agreements to which insured depository institutions are subject); and Winstar Corporation v. United States, 994 F.2d 797, 1993 WL 173069 (Fed. Cir. 1993) (divided panel, holding that the plaintiffs had "assumed the risk that the law would change," *slip op.* at 13, and reversing decisions of the Claims Court which had held that even if Congress can impinge upon existing contracts the contracts in question appeared to have created unambiguous rights and compensation should be paid for the "taking" that the breach involves).

62. *See* Kaiser Aetna v. United States, 444 U.S. 164, 175 (1979); and, in the context of hanks and thrifts, California Housing Securities v. United States, 959 F.2d 955 (Fed. Cir.), *cert. denied,* 113 S. Ct. 324 (1992); Golden Pacific Bancorp v. United States, 25 Cl. Ct. 768 (1992); American Continental Corp. v. United States, 22 Cl. Ct. 692 (1991).

63. Even under the Supreme Court's recent, most favorable decision for those who seek to rely on the Takings Clause for compensation, Lucas v. South Carolina Coastal Council, 112 S. Ct. 2886 (1992), federally-insured depository institutions would not succeed because they would have to acknowledge that they "necessarily expect the uses of [their] property to be restricted, from time to time, by various measures newly enacted by the State in legitimate exercise of its police powers; [a]s long recognized, some values are enjoyed under an implied limitation and must yield to the police power.' " *Id.* at 2899 (quoting from Pennsylvania Coal Co. v. Mahon, 260 U.S. 393, 413 (1992)).

64. On the "reasonable, investment-backed expectations" element of the *Kaiser Aetna* compensation test (*see supra* text accompanying note 62), *see* most recently Justice Kennedy's concurrence in Lucas v. South Carolina Coastal Council, 112 S. Ct. 2886, 2903 (1993).

65. Fahey v. Mallonnee, 332 U.S. 245, 250 (1947).

66. Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419 441 (1982).

the United States in the event of regulatory impairment.

(iii) *Substantive Due Process.* A substantive due process challenge could have two dimensions: first, a claim that the safety/ soundness standards constitute an oppressive or arbitrary government imposition upon private property and liberty interests; and, second, that some of them, including the restrictions upon "excessive" compensation, constitute an "impairment of contracts" (the Contracts Clause of the U.S. Constitution being incorporated against the federal government via the Due Process Clause of the Fifth Amendment[67]). Neither dimension stands any chance of being sustained in an attack against the section 39.

In the first place, the Court has, except where certain "fundamental rights" (which do not include economic interests such as banking) are concerned, long backed away from any serious substantive due process scrutiny of the rationality of legislation restricting private activities.[68] In the realm of economic regulation, the Court will accept almost any conceivable rationale, including ones not even considered by Congress, as providing support for the legislation.[69] Section 39 is easily sustainable on this account.[70]

Second, the Contracts Clause has very weak force in the case of compensation or related contracts entered into within so heavily regulated an industry as federally-insured banking. It is quite likely that a court would insist, as courts have done in the context of regulatory takings cases,[71] that anyone who enters employment or invests in banking must be aware of the fact that his or her conditions of employment or investments are subject to the varying safety/ soundness requirements of the federal government.[72] And the Contract Clause applies with even weaker force against the federal government, as opposed to the States,[73] where it seems to have no greater application than does the substantive due process doctrine just described.[74]

As a basis for challenging the constitutional validity of congressional legislation regulating the banking industry, substantive due process is almost as dead as the Dodo.

(iv) *Procedural Due Process.* The Due Process Clause in the Fifth Amendment applies most vigorously in the case of government denials of so-called "procedural due process." Under procedural due process, the government is ordinarily required to provide individuals or institutions a fair hearing before it deprives them of any constitutionally-protected liberty or property interest. The safety/soundness standards might be regarded as inflicting such a deprivation (especially where they infringe compensation agreements). Procedural due process will, however, really only become relevant after the standards have been implemented and when they come to be enforced.

While the standards are being developed in rulemaking, procedural due process will, for all practical purposes, simply be irrelevant. An argument that the initial implementation of section 39 would constitute a procedural due process violation (*i.e.,* the taking of property without a proper hearing) would certainly fail. In the first place, the section commands the agencies to act by means of rulemaking, and procedural due process is not directly applicable when an agency acts "legislatively" (*i.e.,* by promulgating rules of general application, as opposed to "judicially" -- or on a case-by-case basis).[75] Second, the agencies are in any event directed to implement section 39 by means of *regulations.*[76] This automatically triggers the notice-and-comment rulemaking requirements of the Administrative Procedure Act[77] which require the agencies to provide interested parties with notice of their proposed rules and an opportunity to comment. Even if it could be argued that protected "liberty" or "property" interests were at stake,[78] this provision supplies more "process" than would probably be "due" under the Due Process clause of the Fifth Amendment.

On the other hand, procedural due process may become relevant when the safety/soundness standards are *enforced* against individuals and institutions. As described earlier, the agencies can impose restrictions upon, and even take enforcement action against, institutions that fail to meet the safety/soundness standards and fail to submit acceptable remedial plans. At present it is quite possible that an individual or institution would be able to demonstrate that his/her or its property interests are implicated and that he/she/it should be given a due process hearing. Provision for some form of hearing may well be provided by the rules implementing section 39, as is indeed the case with the Fed's proposed rules,[79] so it is difficult to anticipate at this stage whether a due process challenge would become available. It should also be borne in mind that procedural due process only requires *procedures;* it does not prevent the government from infringing property interests once the procedures have been properly followed.

V. The Fed's Proposed Rules

At the time of this writing, none of the agencies had yet published their notices of

67. The Contracts Clause of Article I, § 10, applies only to the States, but the Supreme Court has at times seemed to regard its substance as applicable against the federal government as a matter of due process. *See* Lynch v. United States, 292 U.S. 717, 733 (1934). As will be discussed below, however, the Clause's "due process" applicablity against the federal government is considerably weaker and, in any event, would not avail the banking industry.

68. *See generally, e.g.,* Tribe, *supra* note 52, 567-86 (describing the rise and fall of the economic substantive due process era).

69. *See, e.g.,* Williamson v. Lee Opitcal Co., 348 U.S. 483 (1955); United States v. Carolene Products Co., 304 U.S. 144 (1938).

70. Though spare in its explanation of the need for § 39, the legislative history clearly indicates a reliance upon the views of the General Accounting Office and others suggesting the need for tighter regulation over the safety/soundness standards that should be observed by the banking industry. Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991, Report of the U.S. Sen. Committee on Banking, Housing, and Urban Affairs (to accompany S. 543), 102d. Cong., 1st Sess. 38 and 32-43 (1991). Whether Congress chose the appropriate means to deal with the problem is irrelevant to the question of whether the legislation is constitutionally-sustainable.

71. *See* the cases cited *supra* in notes 60-66.

72. *See* Home Building & Loan Ass'n v. Blaisdell, 290 U.S. 398, 435 (1934). Although the Court has been prepared to apply the Contract Clause on a few occasions since *Blaisdell,* it is unlikely that it would find legislation such as that contained in § 132 to be so "oppressive and unnecessary" an impairment of bankers' compensation contracts as to render the provision unconstitutional. Compare Tribe, *supra* note 52, 616-17.

73. *See, e.g.,* Pension Benefit Guaranty Corp. v. R.A. Gray & Co. 467 U.S. 717, 733 (1933).

74. *See* Tribe, *supra* note 52, 617.

75. Bi-Metallic Investment Co. v. State Board of Equalization, 239 U.S. 441 (1915).

76. FDICIA § 132(b).

77. 5 U.S.C. § 553; and *see supra* note 37.

78. *See supra,* text accompanying notes 63-66 (considering whether banks and bankers would be considered to possess constitutionally-protected "liberty" or "property" interests for Fifth Amendment purposes).

79. *See* Fed. Proposed Rule, *supra* note 5, § 263.302 (providing, except where the agency deems immediate action necessary, for prior written notice by the agency to a state member bank or bank holding company of the agency's intention to issue an order requiring correction of a safety/soundness deficiency and providing an opportunity for a written response within 14 calendar days). Where an order is issued with immediate effect, the institution may submit a written appeal within 14 days and the agency must consider the appeal within 60 days. *Id.* § 263.302(b).

proposed rulemaking in the *Federal Register.* The Fed, however, had made its proposed rules available to the public,[80] and the indication was that the proposals of the other agencies were likely to be substantially similar.[81]

The Fed proposals were developed in response to more than 400 comment letters that had been sent to the agencies after publication of the Joint Advance Notice.[82] According to the staff memo accompanying the proposed rules, "[t]he overwhelming majority of commenters urged the agencies to use general standards rather than specific item-by-item requirements."[83] As the following chart indicates, the proposed rules strongly reflect such an approach. Even where the standards adopt a quantitative approach (as in the case of classified assets to capital ratios and minimum earnings standards), the proposals emphasize that the numerical results will not constitute automatic triggers for agency action, nor will they operate to immunize an institution with earnings and asset quality difficulties from appropriate corrective action. Instead, the quantitative standards will be used as early warning signals by the agency in order to:

> alert institutions and agencies to developing conditions that are of sufficient magnitude that a plan should be submitted to the appropriate agency for evaluation. The Board's proposed quantitative standards are meant to supplement, rather than replace, the detailed analyses of these areas that occur during the examination.[84]

The proposed rules also add some procedural protection for institutions where the agency intends to take action to enforce compliance with a safety/soundness plan. A written hearing procedure is envisaged.[85] In normal situations, this hearing will be provided before the enforcement order is issued, but where the Board "finds it necessary in order to carry out the purposes of section 39," provision has been made for the order to issue immediately with the opportunity for a written hearing to take place thereafter as an "appeal."[86] Section 39 is entirely silent regarding procedural protection for institutions, and the written hearing procedures have been added by the Fed because of "the potential effect of such [an] order on the bank or company subject to the order."[87] The procedures are sparse, however, and nothing like as protective to institutions as the formal adjudication requirements applicable in the case of enforcement proceedings under section 8.[88] Moreover, it is by no means clear whether judicial review would be available to an institution affected by a safety/soundness enforcement order.[89] Whether the procedures are adequate to provide a "meaningful hearing" as might be required by the Fifth Amendment's Due Process Clause will probably depend on the specific circumstances surrounding the dispute between the institution and the agency.[90]

80. *See supra* note 5.
81. *See* Fed Proposed Rules, *supra* note 5, Staff Memo, at 1 (indicating preparation of a joint, interagency notice).
82. Fed Proposed Rules, *supra* note 5, at 10.
83. *Id.* at 2.
84. *Id.* at 20.
85. Fed Proposed Rules, *supra* note 5, 12 C.F.R. § 263.303. *See also supra* note 79.
86. *Id.* § 263.402(a)(2).
87. Fed Proposed Rules, *supra* note 5, at 29.
88. *See* FDI Act § 8(h)(1), 12 U.S.C. § 1818(h)(1).
89. *See* further Baxter, Review of PCA Decisions, *supra* note 51, at 28-35.
90. *See* further *supra* text following note 78.

Fed Proposed Rules

SUBJECT	METHOD AND CONTENT	Proposed Rule
Operational & managerial standards (*Section 39(a)*)	Stated in terms of overall goals and functions **Examples of Agency's description of proposed rule**:	**12 C.F.R.:**
	Internal controls:- "internal controls must provide for effective risk assessment"	§ 208.62(a)
	Internal audit systems:- system must possess certain necessary components (qualified & independent auditors; audit must include testing & review of internal controls and information systems; adequate documentation of tests performed & corrective action taken; provision for results to be reviewed & acted on by management)	§ 208.62(b)
	Loan documentation:- no specific requirements, but quality of documentation to be evaluated according to whether, e.g., bank's loan documentation enables bank "to make an informed lending decision and to assess risk as necessary"	§ 208.62(c)
	Interest rate exposure:- large institutions "would be expected to maintain a system for the measurement and management of ... risk;" smaller institutions might not be required to have a sophisticated system	
	Asset growth:- no specific quantitative limits; instead, "bank would be required to base its asset growth on a plan that reflects consideration of the source, volatility and use of the funds that support asset growth; any increase in credit risk; and the effect of growth on the bank's capital"	§ 208.62(f)
	Compensation, fees & benefits:- "Board does not believe that it would be appropriate to define how banks are to determine compensation;" instead, reliance is placed on the provisions of section 39(c) (see below)	§ 208.62(g)

Fed Proposed Rules (Continued)

Asset quality, earnings & stock valuation standards (*Section 39(b)*)	Quantitative standards proposed, but these are only "designed to detect a deterioration in overall financial condition ... rather than the existence of operational or managerial deficiencies. Specifically, these standards are meant to alert institutions and the agencies to developing conditions ... of sufficient magnitude that a plan should be submitted" **Ratios proposed:** *Maximum ratio of classified assets to capital*:- 0.75 *Minimum earnings sufficient to absorb losses without impairing capital*:- compliance with minimum capital requirements; projection of aggregate net loss/profit over previous four quarters, over forthcoming four quarters *Minimum ratio of market value to book value*:- no minimum ratio feasible	§ 208.63(a) § 208.63(b)
Compen-sation standards (*Section 39(c)*)	Statutory standard relied upon: basic test is "whether the compensation paid is disproportionate to the services actually performed by the individual being compensated." Board "will consider all relevant factors, including those set out in section 39(c)"	§ 208.64
Bank holding companies	Application of same operational & management standards except for credit underwriting & loan documentation (where these are inappropriate) Consolidation of asset quality, etc., standards only in case of holding companies with assets >$150 million For holding companies with assets <$150 million, a deficiency in any subsidiary depository institution will be attributed to holding company	§ 225.81(b) § 225.81(b)(3) § 225.81(b)(3)(iii)

VI. Policy Assessment

Section 39 shifts the focus of safety/soundness regulation from ad hoc supervision to generalized standards. One should not discount the virtues -- even to the banking industry itself -- of agency action through generalized standard setting (or "rulemaking"[91]). When it is appropriate to treat large numbers of institutions in like fashion, for example, when a particular practice is generally agreed by responsible bankers and the regulators to be unsafe or unsound, then it is both fair and efficient to prohibit that practice through a general standard or rule. It is fair because the standard gives all bankers advance notice of what they may expect from the regulators. The notice-and-comment process whereby the standard is promulgated, and fact that the agency's policy is enshrined in a publicly-pronounced standard, make it easier to evaluate the policy and, in the long run, easier to change if the policy proves to be bad. A general standard is also more efficient because it broadcasts the permissible scope of banking activity to the whole industry at once. Bankers would not have to learn what the regulators expect by watching the regulators' individual enforcement actions over an extended period of time: they know as soon as the standard is published.[92] Rulemaking, after all, is an essential feature of the Rule of Law.

But sometimes one can have too much law. Rulemaking is only virtuous where it makes good sense. It works where an industry is highly homogenous, where the practices sought to be proscribed are almost always inappropriate, where it is clear that the regulators are in a better position to determine what is acceptable than are the regulated, and where the standard or rule can be stated with enough clarity that it serves as a meaningful guide. Where, instead, a rule applies woodenly to those who don't need it as well as those who do, it is overinclusive and imposes inefficiencies on the former and, in turn, on the economy as a whole.

The congressional wish-list of standards contained in section 39 betrays a simplistic concept of banking regulation. It seems to assume that with, enough attention and effort, regulators will be able, *in rules generally applicable to all depository institutions, large or small, healthy or not,* to give safety/soundness standards more content than could Congress when it used terms such as "to the extent feasible," "excessive compensation," and "material financial loss to the institution" (to use some of the rather vacuous terms employed in section 39). Congress, in other words, seems to assume that the problems underlying the current state of the banking industry -- many of which (such as the inability to branch nationwide and engage meaningfully in rapidly-changing financial services markets) it has proven unable to resolve itself -- can somehow be swept under a blanket of "regulation by the numbers."

When one reviews the multitude of conflicting issues raised for discussion by the regulators in their Joint Advance Notice,[93] it

91. The standards must be implemented through "regulations" or "rules." *See supra* note 37, and text accompanying notes 76-77.

92. For a general disquisition on the virtues of agency rulemaking over ad hoc discretionary decision making, *see, e.g.,* National Petroleum Refiners Ass'n v. Federal Trade Commission, 482 F.2d 672 (D.C. Cir. 1973), *cert. denied,* 415 U.S. 915 (1974). In the specific context of safety/soundness regulation, *see* Independent Bankers Ass'n of America v. Heimann, 613 F.2d 1164, 1169 (D.C. Cir. 1979), *cert. denied,* 449 U.S. 823 (1980).

93. *See supra* note 5.

quickly becomes evident that any standards that are eventually promulgated will have to be riddled with exceptions and discretionary ameliorations if they are to prove anything other than a set of exhortations that any competent banker would already know. Yet if the standards do contain numerous exceptions, one might well ask what the point of the original standard-setting exercise was anyway? It is therefore not surprising that the safety/soundness standard-setting requirements have been strongly condemned by senior regulators at the Treasury,[94] OCC,[95] Fed,[96] and OTS,[97] as well as by prominent bankers.[98]

The agencies appear to have striven hard to "create standards that are neither so specific that they result in micro-management and excessive regulatory burden nor so general that they do not serve the purpose of [section 39]."[99] To the extent that the proposed standards have been matched with those of "well-run institutions,"[100] they might play an educative role for the management of maverick institutions during the periods that agency examiners are unable to address the problems of these institutions directly. And it is probably as well that certain basic principles of sound bank management should be officially identified and spelled out.

The real problem, however, is with section 39 itself. Janus-like, it both *takes away* too much of the agencies' power and *gives them too much.*

The section takes away too much power from the agencies because it forces them to develop a generalized blanket of safety/soundness regulation even where regulatory prudence might dictate an ad hoc, discretionary approach. In other words, the agency-forcing provisions contained in section 39, requiring as they do that the agency create generalized safety/soundness *"standards"* applicable to the whole banking industry, are designed to eliminate as far as possible the highly discretionary judgments the agencies have hitherto made with regard to individual depository institutions.[101] This seems to defeat some of the purpose of expert agency regulation.

On the other hand, section 39 might well have conferred too much power on the agencies in at least two respects. First, a disturbing feature of the whole prompt corrective action structure, including both sections 38 and 39 of the FDI Act, is the lack of clarity provided by those sections as to when prompt corrective action or safety/soundness standards might be used in place of the formal enforcement powers relating to safety and soundness that are available under section 8 of the FDI Act.[102] Sections 38 and 39 contain far fewer procedural safeguards than are provided for under section 8, yet it appears that the banking agencies will often be able to take action more directly by proceeding under the former provisions. For example, conduct that might well be adjudicated as safe in a formal enforcement action could be vaguely proscribed as unsafe or unsound under a section 39 safety/soundness standard; an institution that then "failed to meet" that standard would find itself subject, without further adjudication, to the implementation orders described earlier.[103]

Secondly, the necessarily-generalized format of the safety/soundness standards might, in the long term, have given hostage to fortune. While the agencies have reflected a commendable sensitivity to the need for flexibility across the industry by recognizing the need for these standards to be stated for the most part in very general terms, their benign generality could easily turn into capricious vagueness if the political context in which banking regulation exists were to become hostile to banking institutions. Were yet another financial crisis to beset the industry, leading to another congressional panic, the banking agencies would likely be driven by Congress to enforce their safety/soundness powers very aggressively to restrict as far as possible the range of risks banks can undertake. The existence of safety/soundness standards inevitably provides the agencies and their examiners with considerable leverage over banking institutions. The very fact that the standards have been cast in general terms could then end up depriving those institutions of the ability to predict or protest effectively the exercise of the agencies' enforcement powers.

VII. Conclusion

It is tempting to conclude that section 39 is a misguided effort by Congress to drive banking regulation from the back seat. Bankers have reason to be grateful for the fact that it is the banking agencies, and not Congress itself, that have to formulate the safety/soundness standards. As the agencies' Joint Advance Notice and the Fed's proposed rules indicate, the agencies are more closely in touch with the practical exigencies of, and wide variations within, the industry, and they appear somewhat bewildered themselves as to how they should go about formulating the standards. For the moment, at least, they are likely to provide a much more sympathetic and balanced atmosphere in which bankers can make their case than does Congress in its present mood, and bankers should exploit this opportunity to the fullest extent during the notice and comment period for the development of the standards.[104]

Section 39 will probably be improved by its implementing rules. Yet one cannot help but wonder whether the agencies will be able to remain moderate in their deployment of the powers prescribed by section 39 if economic and political circumstances deteriorate. Let us hope that they are not ultimately left to drive their safety/soundness regulatory responsibilities with Congress' rear-view mirror as their only guide.

94. *See Economy Should Reach 2.5 or 3 Percent Growth, Robson Tells Thrift Trade Group,* BNA Banking Daily, June 24, 1992; and *Treasury Aide Blasts Rule on Executive Pay,* Am. Banker, June 23, 1992, at 2 (reporting views of Treasury Deputy Secretary John Robson condemning the "regulatory excess" represented by provisions such as § 39).

95. *See, e.g., FDICIA Puts Regulators Between a Rock and a Hard Place, Says OCC's Steinbrink,* 2(26) FDIC Watch 5 (July 6, 1992), 2(27) *id.* 5 (July 13, 1992) (reporting the text of a speech by Acting Comptroller of the Currency, Steven Steinbrink to Women in Housing, Inc.); *Condition of Banking System Improving, Though Risks Linger and Future Unclear,* 58 Banking Rep. (BNA) 1033 (1992) (reporting on testimony by Acting Comptroller Steinbrink, before the Senate Banking Committee on June 10, 1992); *Bankers, Regulators Agree; Blame Belongs to Congress,* 2(29) FDIC Watch 1 (Aug. 10, 1992) (reporting, inter alia, on views expressed by the OCC's chief national bank examiner).

96. *See, e.g.,* Statement by John P. LaWare, Member, Board of Governors of the Federal Reserve System, before the Subcommittee on Banking, Finance and Urban Affairs, U.S. House of Representatives, June 23, 1992, 78 Fed. Reserve Bull. 607 (Aug. 1992) (objecting to the need for detailed regulations on safety/soundness issues); Statement by John P. LaWare, Member, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, June 10, 1992, *id.* 597 (criticizing Congress' "shotgun approach" to bank regulation).

97. *See Bankers, Regulators Agree, supra* note 95 (reporting views expressed by the Deputy Director for Regional Operations in the Office of Thrift Supervision, to the effect that Congress may have prescribed an "impossible task").

98. *See, e.g., Bankers, Regulators Agree, supra* note 95; *Regulators, Banking Panel Members Fault FDICIA's Regulatory Burden; Urge Changes,* 58 Banking Rep. (BNA) 1126 (1992) (reporting views of representatives of the American Bankers Association and the Independent Bankers Association of America calling for the scrapping of major portions of FDICIA).

99. Fed Proposed Rules, *supra* note 5, at 3 (accompanying staff memo).

100. *Id.* at 4.

101. It should be borne in mind that § 39 does not actually reduce the agencies' existing power to take individualized, safety/ soundness action against particular institutions. In this respect, their power remains undiminished. But precisely because of the highly discretionary nature of the safety/soundness judgment, it has often been the case in the past that the agencies have decided not to act against an institution – for example, where a practice that might be dangerous for some institutions is, given the particular circumstances, quite safe for the particular institution in question. To this extent, § 39's requirement that the agencies adopt general standards constitutes a reduction of their power.

102. 12 U.S.C. § 1818.

103. *Supra* text accompanying notes 43-49. For fuller discussion, *see* Baxter, *Review of PCA Decisions, supra* note 51, 10-11, 38.

104. *Cf.* also Eugene M. Katz, *New Era of Bank Regulation on the Way,* Am. Banker, Sept. 16, 1992, at 4 (emphasizing the importance of industry input in the regulators' standard-setting decisions). At the time of this writing, the agencies' notices of proposed rulemaking had not yet been published in the Federal Register. A comment period of at least 30 days must be provided for after publication.