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James R. Doty  
*Securities and Exchange Commission*

David C. Mahaffey  
*Securities and Exchange Commission*

Miriam J. Goldstein  
*Securities and Exchange Commission*

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FULL DISCLOSURE, MARKET DISCIPLINE, AND RISK TAKING: RETHINKING CONFIDENTIALITY IN BANK REGULATION

James R. Doty
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INTRODUCTION

The activities that make up the business of banking have undergone major transformations in the last fifty years. These changes, particularly those of the past two decades, have been extensively described elsewhere and need only be summarized here. Inflation in the 1970s and early 1980s, which prompted the elimination of government controls on interest rates paid by banks and thrifts, had a significant impact on the operations of the U.S. banking system, so too did technological advances and the internationalization of financial services markets. Cross-industry


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competition introduced new providers of financial services and non-traditional financial instruments to the banking system.

While the business of banking has undergone a dramatic transformation, the basic structure of this country’s bank regulatory system has not. Today, our bank regulatory framework is largely unchanged from the structure laid out in the 1930s and modified by the Bank Holding Company Act of 1956 (BHCA). We still rely on a framework built around the New Deal assumption that pervasive, detailed regulation of bank activities is required to protect the system against bank panics, or “runs.”

Over the past decade, unfortunately, traditional bank regulation has not prevented the unprecedented failures of banks and thrifts. It is appropriate, on the basis of this record, to ask whether, and to what extent, shortcomings in our bank regulatory system may have contributed to these failures.

In this Article, we focus on one specific defect that has, in our view, weakened our banking system: the premise that banks, unlike other companies, must be shielded from market discipline. This assumption, which lies at the heart of traditional U.S. bank regulation, explains why, historically, the public disclosure of bank financial information has been so narrowly constrained, while other public companies have been subject to more extensive disclosure requirements—and to more effective market discipline.

We believe it is time to relinquish the view that bank regulation should...

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4. See generally Alfred Dennis Mathewson, From Confidential Supervision to Market Discipline: The Role of Disclosure in the Regulation of Commercial Banks, 11 J. CORP. L. 139, 140-42 (1986); Helen A. Garten, Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age, 57 FORDHAM L. REV. 501, 509 (1989); Fischel, supra note 1, at 301-03.
5. From 1985 through 1988, the Federal Savings and Loan Insurance Corporation (FSLIC) resolved 454 thrift insolvencies. Edward J. Kane, The S&L Insurance Mess: How Did It Happen? 26 (1989). Thrift insolvencies accelerated still further as the decade closed: a 17-month period from August 1989 through December 1990 saw 531 thrifts fail, representing approximately $27 billion in assets. GAO Report, supra note 1, at 30. The General Accounting Office (GAO) has estimated that, on a present value basis, the thrift crisis already has cost taxpayers approximately 10% of the value of all insured thrift deposits that existed at the end of 1986. Id. at 31. By contrast, GAO notes, “the level of loss suffered during the Great Depression by depositors in commercial banks before the deposit insurance system was enacted is estimated to have been 1 percent of total deposits.” Id. (footnote omitted).

The commercial banking industry has fared only slightly better than the thrift industry. From 1985 through 1989, the FDIC closed or gave financial assistance to 896 insured banks. Id. at 31, 42. These banks had $109 billion in assets; the FDIC's costs in connection with the resolution of these institutions are estimated at $17 billion. Id.
avoid full disclosure and market discipline. The United States should replace its existing system of over-protective bank regulation with a system modeled on the federal securities laws, with full disclosure the key-stone of the new structure. Strict capital standards and vigilant regulatory supervision must of course play a continuing and prominent role in the new system. But any new bank regulatory scheme also should recognize the critical importance of market discipline to the control of bank risk-taking.

In Part I of this Article, we briefly discuss the principle of disclosure as embodied in the federal securities laws. In Part II, we summarize the role of disclosure in present-day bank regulation. Finally, in Part III, we discuss how the disclosure principles of the federal securities laws would operate when incorporated into the regulation of the banking industry.

I. THE PRINCIPLES OF FULL DISCLOSURE EMBODIED IN THE FEDERAL SECURITIES LAWS

The rise of the modern corporation in the early decades of this century transformed the relationship between business enterprises and their shareholders. As corporations grew, stockholders became more numerous and more widely dispersed. Corporate ownership no longer gave the shareholders effective control of the corporate entity. A leading analysis of the time noted that:

separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear. . . . By the use of the open market for securities, each of these corporations assumes obligations towards the investing public which transform it from a legal method clothing the rule of a few individuals into an institution at least nominally serving investors who have embarked their funds in its enterprise.  

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6. For a discussion of the role of capital standards, see Breeden, supra note 1, at 780-81; Treasury Report, supra note 1, at II-1. For a different view of the importance of bank capital as a regulatory tool, see GAO REPORT, supra note 1, at 83.

7. For a discussion of the need for prompt regulatory intervention, see generally Treasury Report, supra note 1, at ix; GAO REPORT, supra note 1, at 30.

8. See Adolph A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 4 (1932). "[A] large body of security holders [was] created who exercise virtually no control over the wealth which they or their predecessors in interest . . . contributed to the enterprise." Id. at 5.

9. Id. at 6.
This corporate revolution provided both the background and the impetus for the federal securities laws. In the period following the close of World War I, fraudulent practices in the securities markets led to the flotation of almost $25 billion in worthless stocks and bonds.¹⁰ Not surprisingly, this appalling record raised concerns in Congress and elsewhere about the manner in which investment bankers conducted their business—questions about the availability of information on security issuers, the nondisclosure of investment bankers’ commissions, and the effect of questionable investment banking practices on the allocation of credit.¹¹ Clearly, prospective investors needed means to obtain adequate information to permit informed decisions regarding investment in new issues of securities.¹²

Congress thus had to restructure “the relations between the corporation as managed by the group in control, and those who hold participations in it—its stockholders, bondholders, and, to some extent, its other creditors.”¹³ Various competing approaches were proposed. One group favored legislation restricted to antifraud provisions, fearing that broader, preventive legislation would impede legitimate businesses.¹⁴ An opposing school urged “merit” legislation, mandating substantive federal evaluation of the terms of particular securities offerings.¹⁵

In the end, neither of these approaches prevailed. Instead, the principle of “disclosure, again disclosure, and still more disclosure”¹⁶ formed

¹¹ See id. See generally Louis D. Brandeis, Other People’s Money and How the Bankers Use It (1932). Other problems were diagnosed as well:
  the common law limitations upon civil recovery [by injured investors]; the inadequacy of current information concerning companies with publicly held securities; the abuse of the proxy device by self-perpetuating managements; the abuse by corporate “insiders” of their favored position in order to trade in their corporations’ securities for their own profit; the “private club” atmosphere of the Nation’s securities exchanges; the ease with which the securities markets could be manipulated; the lack of financial safeguards for brokers and dealers; the disproportionate amount of the Nation’s available credit which at times was channeled into the securities markets at the expense, it was thought, of direct financing of commerce and industry; the practices of protective committees in corporate reorganizations; the abuses of the holding company and the investment company devices; and the irresponsibility of trustees under corporate bond indentures.
¹³ 1 Loss & Seligman, supra note 11, at 178.
¹⁴ Berle & Means, supra note 8, at 7.
¹⁵ Id. at 171-72.
¹⁶ Id. at 27.
the foundation of the Securities Act of 1933 (Securities Act). Congress had evidently heeded the message of President Roosevelt:

There is . . . an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

This proposal adds to the ancient rule of caveat emptor the further doctrine, "Let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.

The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business. As the preamble of the final legislation provided, the Securities Act was designed to "provide full and fair disclosure of the character of securities sold" to the investing public.

The Securities Act requires the preparation of a registration statement and a prospectus, containing accurate and adequate information, in connection with each public offering of securities. Issuers must furnish the prospectus to investors and file it with the government. Issuers, their directors, underwriters, lawyers, and accountants may be held civilly liable for material misstatements or omissions in registration statements.

President Roosevelt, in his 1933 message to Congress, noted that the Securities Act was just a start. "[L]egislation relating to the better super-

18. 77 Cong. Rec. 937 (1933) (message from President Roosevelt on the regulation of securities issues, presented to the Senate, Mar. 29, 1933). Rejecting the concept of merit regulation, President Roosevelt noted that, "[o]f course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit." Id.
19. Preamble to the Securities Act, 48 Stat. 74. Professor Harry Shulman, writing shortly after the legislation's passage, commented that the Securities Act "requires a picture not simply of the show window; but of the entire store. It requires not simply truth in the statements volunteered, but disclosure. And, for false statement, it provides civil liability." Harry Shulman, Civil Liability and the Securities Act, 43 Yale L.J. 227, 242 (1933).
20. Louis Brandeis had earlier called for this essential element of the statutory scheme, writing: [There] must be a disclosure to the investor. It will not suffice to require merely the filing of a statement of facts with the Commissioner of Corporations or with a score of other officials, federal and state. . . .
To be effective, knowledge of the facts must be actually brought home to the investor, and this can best be done by requiring the facts to be stated in good, large type in every notice, circular, letter and advertisement inviting the investor to purchase. BRANDEIS, supra note 11, at 104 (emphasis added).
vision of the purchase and sale of all property dealt in on exchanges, and legislation to correct unethical and unsafe practices on the part of officers and directors of banks and other corporations" was needed to supplement the provisions relating to new issues of securities.21 Commentators expressed particular concern over shareholders' inability to require corporate management to provide information about the finances and condition of the corporation on an ongoing basis.22

In response to these needs, Congress enacted the Securities Exchange Act of 1934 (Exchange Act) as a further step toward "improv[ing] the position of the average investor by obtaining for him better information about securities."23 The Exchange Act requires that issuers provide information concerning already-issued securities, comparable to the information the Securities Act requires for new issues of securities.24 Under the Exchange Act, issuers of securities that are the subject of an effective registration statement also become subject to certain periodic reporting requirements. Periodic reporting is also required under the Exchange Act for issuers whose securities are listed on a national securities exchange.25 To enforce these requirements, the Exchange Act created the Securities and Exchange Commission (SEC).26

Congress, in crafting the federal securities laws, avoided both over-regulation (which could have resulted from adopting a scheme of merit regulation) and under-regulation. Recognizing the impossibility of preventing all business failures, Congress did not attempt to remove all risk from the investment markets.27 Instead, in order to protect the investing public without either placing undue obstacles in the way of "hon-

22. See BERLE & MEANS, supra note 18, at 317.
24. See e.g., Hanna & Turlington, supra note 23, at 277; Comment, supra note 23, at 791.
25. See Exchange Act §§ 12(a), 12(g)(1), 13(a), 15 U.S.C. §§ 78l(a), 78l(g)(1), 78m(a) (1988). Since 1964, of course, such reporting has been required only for issuers with $1,000,000 or more in total assets and a class of equity securities held of record by 500 or more persons.
27. "The SEC is not concerned that disclosure may cause a firm to fail or an entire industry to suffer. The SEC's job is to ensure that investors are able to minimize the harm to themselves by making informed investment decisions." Mathewson, supra note 4, at 158.
est business,"\(^{28}\) or providing government guarantees of particular securities issues,\(^ {29}\) Congress adopted a legislative scheme based on the principle of full disclosure. This disclosure policy, in the decades since its adoption, "has become so well established, it is generally regarded as the appropriate or inevitable method of regulating corporate finance."\(^ {30}\)

II. THE LIMITED ROLE OF DISCLOSURE IN PRESENT-DAY BANK REGULATION

A. The Principle of "Confidential Supervision"

Traditional bank regulation, as Professor Mathewson has observed, relies on "confidential supervision" and pervasive regulation, rather than on public disclosure and market discipline.\(^ {31}\)

[T]raditional bank regulatory systems have not used public disclosure of information regarding a bank's affairs to depositors and potential depositors, i.e., the public, as a major means of achieving regulatory goals. Instead, bank regulatory systems have been paternalistic in nature. Bank regulatory policy does not question the premise that a bank's affairs must be monitored, but because depositors cannot be trusted to act responsibly upon learning adverse information, the task of oversight lies with bank regulatory agencies.

* * *

Confidential supervision and bank examinations form the cornerstone of the paternalistic approach. "Confidential supervision" means . . . the control of the flow of information regarding a bank's affairs by the bank regulators through restrictions on the quantity of information made available to the public and controls on the timing of the availability of the information that is released. Confidential supervision has meant more than the confidentiality of bank examination reports. Although some public disclosure is permitted, e.g., publication of call reports, banks traditionally have not been required by regulatory laws to make additional disclosures, and bank regulators have fostered an environment that has tolerated the discretion of banks in releasing information to the public.\(^ {32}\)

Under this system, information about a bank's condition flows to the regulators rather than to the public. Because bank regulators narrowly

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31. Mathewson, supra note 4, at 140-41.
32. Id. at 140-41 (footnotes omitted).
control the public dissemination of such information, banks are to a great
degree insulated from the market discipline that shareholders or depositors
otherwise might exercise. The tasks of controlling banks' excessive
risk-taking and correcting unsafe or unsound bank practices are left
largely to regulatory means. In the performance of these tasks, the
bank regulators rely extensively on prophylactic regulations, including
restrictions on bank business activities and ownership, minimum capital
requirements, and lending limits. Bank examinations and enforcement
actions against banks, of course, play an important role as well.

As Professor Mathewson notes, Congress has not mandated this sys-
tem of confidential supervision. While the federal banking statutes pro-
vide for the confidentiality of bank examination reports, nowhere do
they establish a general rule promoting confidentiality over public disclo-
sure of bank information. Rather, the federal banking regulators created
"confidential supervision" with the aim of preventing bank runs and
out of a mistrust of the public's ability to evaluate information pertaining
to bank condition.

33. See Albert J. Boro, Jr., Comment, Banking Disclosure Regimes for Regulating Speculative
34. See Fischel, supra note 1, at 301; Boro, supra note 33, at 439-40.
35. See Boro, supra note 33, at 440.
36. See Mathewson, supra note 4, at 146. "Congress, however, has accepted implicitly and
countenanced explicitly, but has not ordered, confidential supervision." Id.
38. See Boro, supra note 33, at 434, 435-44.
39. See, e.g., Overby v. United States Fidelity & Guar. Co., 224 F.2d 158, 161 n.2 (5th Cir.
1955) (Affidavit of A.N. Overby, Acting Secretary of the Treasury) (cited in Mathewson, supra note
4, at 140 n.7 ("Reports of examination of national banks contain much information which, at the
very least, if revealed to the public, would be misunderstood owing to inability to evaluate the rela-
tive importance of the matters criticized and discussed. This could not fail to adversely affect the
banks concerned.").

Supporters of the tradition of confidential supervision argue that retail depositors do not need
information about the financial condition of their banks—"deposit insurance remove[s] any 'invest-
ment' aspect of the deposit instruments." Friedman & Friesen, supra note 1, at 455. With
the increasing significance of uninsured deposits and institutional, nonretail depositors, however, this
argument has lost much of whatever force it may once have commanded. See id. See also GAO
REPORT, supra note 1, at 27, 98, 157-58 (estimating that uninsured deposits and other nondeposit
liabilities fund approximately 40% of the assets of all U.S. banks, and noting that time deposits
exceeding the insurance limit amount to $409 billion, or approximately 14.7% of total funds on
deposit); id. at 161 (noting that one class of institutional depositors—private pension funds—holds
approximately $92.1 billion in time deposits over $100,000, or 15.5% of total uninsured deposits in
U.S. depository institutions). Many of the proposals currently under consideration in Congress
would give an even greater role to uninsured deposits. For example, the Treasury's proposed legisla-
tion would provide for more stringent calculation of the $100,000 limit on insured deposits main-
tained at one institution, eliminate deposit insurance for brokered deposits, limit pass-through

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Notwithstanding the historical bias in favor of confidential regulation, banks and thrifts are not wholly exempt from the obligation publicly to disclose financial and other significant information affecting their operations. For example, banks must file, and the public may obtain access to, both quarterly reports of condition and income—"call reports"—and Uniform Bank Performance Reports.40 However, the primary purpose for requiring publication of call reports is not to provide information to depositors and prospective depositors to use in deciding whether to make a deposit or leave a deposit in the bank; the purpose is to periodically demonstrate to the public that the bank is financially healthy and thus preserve confidence in the banking system.41

In addition to the disclosure requirements imposed by banking law, certain banking organizations are required under the federal securities laws publicly to disclose their financial condition. Publicly owned bank holding companies and thrift holding companies are subject to the reporting requirements of the Exchange Act, as interpreted and enforced by the SEC.42 Publicly owned banks and thrifts that are not part of holding companies are also subject to Exchange Act reporting requirements. Under section 12(i) of the Exchange Act, however, these banks and thrifts must file their reports with federal banking regulators rather than with the SEC.43

A number of factors undercut the value of the Exchange Act's reporting requirements as a means of ensuring public disclosure of bank financial information. First is the bifurcation of responsibility for the interpretation and enforcement of these requirements. Currently, the SEC reviews the disclosure statements of roughly 13,500 public companies, including 1,400 bank and thrift holding companies. Four separate bank regulatory agencies—the Board of Governors of the Federal Re-

deposit insurance, and, more generally, mandate the "least cost resolution" of failed depository institutions. See S. 713, 102d Cong., 1st Sess. (1991).


41. Mathewson, supra note 4, at 144-45 (footnote omitted).


43. Id. § 12(i), 15 U.S.C. § 78l(i) (1988). As Professor Mathewson has shown, the debates over § 12(i) provide a snapshot of the various conventional arguments in favor of nondisclosure as a means of preserving effective bank regulation and preventing bank runs. See Mathewson, supra note 4, at 151-60. In 1964, Congress resolved the issue by subjecting banks to Exchange Act disclosure requirements, but at the same time vesting authority over such disclosures in the banking regulators.
serve System (Federal Reserve), the FDIC, the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS)—regulate the disclosure statements of some 700 publicly held banks and thrifts. With multiple regulators enforcing Exchange Act disclosure requirements, regulatory overlap and redundancies occur. Moreover, the banking regulators need not follow the SEC's interpretations of the Exchange Act disclosure requirements. Thus, discrepancies arise in both the interpretation and the application of the statutory standards, leading to confusion and disparate treatment of financial institutions based upon their type of charters.

For example, the SEC has long required that Exchange Act periodic reports include audited financial statements. The OCC, however, requires only verified financial statements in connection with the periodic reports that national banks file pursuant to Exchange Act section 12(i). The principal accounting officer and internal auditor of the reporting bank, rather than an independent auditor, may provide the necessary verification. Similarly, until December 14, 1990, the FDIC allowed state nonmember banks to include merely verified financial statements in their periodic reports.

The federal banking regulators and the SEC differ in the levels of detail they require in describing the reporting entity's business. The SEC requires a bank or thrift holding company to disclose various statistics relating to loans, deposits, investments, yields, average rates of return, risk elements, and an analysis of the allowance for loan losses in the "Description of Business" sections of its annual report. The OCC and the Federal Reserve, however, do not require statistical disclosure in Ex-

44. In carrying out their responsibilities under this subsection, ... [the banking agencies] shall issue substantially similar regulations to regulations and rules issued by the Commission ... unless they find that implementation of substantially similar regulations with respect to insured banks and insured institutions are not necessary or appropriate in the public interest or for protection of investors.


change Act reports that the banks they supervise file.\textsuperscript{50}

Second, the limited applicability of Exchange Act reporting requirements to banking organizations also undermines the extent to which those requirements can ensure full disclosure. Only 1,100 bank holding companies and fewer than 300 thrift holding companies are required to file periodic reports with the SEC.\textsuperscript{51} Only 700 banks and thrifts must file Exchange Act reports with their respective federal banking regulators.\textsuperscript{52} Yet, as of June 30, 1990, there were nearly 16,000 banks and thrifts in the United States.\textsuperscript{53} Clearly, a large percentage of banking organizations escape Exchange Act disclosure requirements by virtue of their ownership structures. The information the Exchange Act requires may, as to these banks, simply be unavailable to the public.

In addition to the limited applicability of the securities disclosure requirements, Exchange Act reports are not disseminated broadly. The Exchange Act entitles only shareholders to receive the periodic disclosures. While securities analysts use Exchange Act disclosures in preparing research reports, these reports are primarily written for, and read by, securities investors. Neither the Exchange Act nor federal banking law requires banks to furnish copies of securities-type disclosures or the information contained in their call reports to their depositors.\textsuperscript{54} As a result, depositors typically have access to less information regarding the condition of their banks than do investors in other publicly held companies. Depositors, therefore, are less able to influence the banks that hold their money, thus generally lessening market discipline.

In response to the inconsistencies and inefficiencies that Exchange Act section 12(i) creates, two authoritative studies conducted over the course of the last seven years have recommended consolidating in the SEC responsibility for the securities disclosures of all banks and thrifts.\textsuperscript{55} There is considerable support for these recommendations on Capitol Hill. In

\begin{itemize}
  \item \textsuperscript{50} See Letter from Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, to Sen. Christopher J. Dodd, “Responses” attachment at 6-7 (May 10, 1991) (available from authors).
  \item \textsuperscript{51} See id. at 2.
  \item \textsuperscript{52} See id. at 15.
  \item \textsuperscript{53} See GAO REPORT, supra note 1, at 24.
  \item \textsuperscript{54} See U.S. SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE FINANCIAL GUARANTEE MARKET: THE USE OF THE EXEMPTION IN SECTION 3(a)(2) OF THE SECURITIES ACT OF 1933 FOR SECURITIES GUARANTEED BY BANKS AND THE USE OF INSURANCE POLICIES TO GUARANTEE DEBT SECURITIES 96 (1987).
  \item \textsuperscript{55} See Treasury REPORT, supra note 1, at 59; BLUEPRINT FOR REFORM, supra note 45, at 28, 64. See also S. 713, 102d Cong., 1st Sess. § 242(f) (1991).
\end{itemize}
addition to the Treasury Department's original legislative proposal for comprehensive financial services modernization, at least three major bills pending in Congress at the time this Article went to press would repeal section 12(i). The sponsors of these bills generally would agree that "[b]y centralizing regulatory responsibility" for bank and thrift securities disclosure in the SEC, repeal of section 12(i) would "help to ensure that investors in the securities of banks and savings associations receive the benefit of full and fair disclosure under the [Exchange] Act."57

These bills fail, however, to extend to depositors the benefits of the type of disclosure required under the Exchange Act. If market discipline is to assume a broader role in bank regulation—as we recommend in the balance of this Article—depositors, no less than investors, must have access to full financial information about the banks that hold their money. Without complete data, depositors cannot make informed decisions about the banks in which they leave their money. If depositors cannot exercise market discipline, regulatory oversight remains the sole means of checking excessive risk-taking and abusive bank practices. This check is inevitably far less effective than if regulatory oversight were combined with market discipline.

B. The Need for Market Discipline as a Supplement to Traditional Bank Regulation

Five years ago, Professor Mathewson observed that traditional bank regulation, emphasizing confidential supervision, had failed to prevent and may have contributed to the escalation of bank failures and the increased exposure of the federal deposit insurance funds. Events since 1986 have only confirmed this conclusion. Bank and thrift failures accelerated and FSLIC reserves were depleted, leaving the FDIC insurance funds in need of a massive infusion of money by the end of fiscal 1991.59


58. See Mathewson, supra note 4, at 163.

59. The Administration has asked Congress for $80 billion to continue the savings and loan cleanup, and $70 billion to recapitalize the Bank Insurance Fund. See, e.g., Testimony of Nicholas F. Brady, Secretary of the Treasury and Chairman of the Oversight Board of the Resolution Trust Corporation, before the Senate Comm. on Banking, Housing and Urban Affairs (June 26, 1991) at 4 ($80 billion in RTC re-funding); Testimony of L. William Seidman, Chairman, FDIC, before the
A number of factors contributed to the bank regulatory system's failure to maintain stability (the goal cited to justify the principle of confidential supervision). First was the close identification of some officials—primarily, thrift regulators—with the industry for whose oversight they were charged. Indeed, the Federal Home Loan Bank Board (FHLBB) was responsible for both the promotion and the regulation of the thrift industry. At the same time, the FHLBB also was responsible for protecting the federal savings and loan insurance funds and for reviewing the financial statements supplied to potential investors by thrifts seeking new capital. Torn between these conflicting responsibilities, and unable to absorb the costs of liquidating all the insolvent thrifts, the FHLBB sought to maintain the aura of industry stability and thrift profitability through efforts to keep insolvent thrifts in operation.

Critical to the effort to mask problems at insured thrifts was the misuse or disregard of accounting standards and disclosure requirements. The creation of "appraised equity capital" provides one example. Guidelines the FHLBB established in 1982 permitted thrifts to include, for purposes of calculating their net worth, the amount of unrealized appreciation in the value of certain capital assets that was above the depreciated costs of those assets. The rule was a permissive, one-way provision: thrifts were not simultaneously required to recognize unrealized declines in the value of their other capital assets. The FHLBB was frank about its aims in promulgating this rule. "[G]iven the industry's present difficulties in gaining access to the traditional capital markets, and the need to maintain public confidence in the industry during this period of financial and operational transition," the FHLBB deemed it appropriate to "depart[ ] from past [FHLBB] policy and generally ac-


61. See generally Mayer, supra note 40, at 32.


63. See 47 Fed. Reg. 52,961 (Nov. 24, 1982); Breeden, supra note 62, at S80; Mayer, supra note 40, at 70.

64. See Breeden, supra note 62, at S80.
accepted accounting principles" and to adopt the rule.\textsuperscript{65} The FHLBB thus admitted its intent to lull investors into a sense of confidence that the institution's true condition did not warrant—the very antithesis of full disclosure.\textsuperscript{66}

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989\textsuperscript{67} (FIRREA) did much to alleviate the first of these problems. It replaced the FHLBB with the OTS and clearly defined the mandate of the new agency as a regulatory—and not a promotional—function. In addition, FIRREA expressed a renewed commitment to provide bank regulators with needed resources.

FIRREA, however, did not resolve all of the flaws of our system of banking regulation. Importantly, FIRREA did not sufficiently enhance disclosure or the role of market discipline in bank regulation.\textsuperscript{68} Instead, it continued the existing model of bank regulation, with its emphasis on pervasive regulation of banks' business activities.

One problem with that model is the fact that "[d]etailed regulation that attempts to influence the day-to-day operation of a business is often impossible to administer effectively."\textsuperscript{69} In addition, many of the prophylactic restrictions bank regulators relied on in the detailed, day-to-day regulation of the industry were designed to address issues other than bank safety.\textsuperscript{70} Some of the provisions that "bar banks from particular activities or investments rather than simply [regulating] the conduct of

\textsuperscript{65} 47 Fed. Reg. at 52,962; see Breeden, supra note 62, at S80.
\textsuperscript{66} If more proof were needed, it could be found in the FHLBB's warning:

[I]nstitutions should be aware that the use of financial statements in connection with the public offer and sale of securities which depart in a significant manner from those prepared in accordance with generally accepted accounting principles, such as those which might include amounts for appraised equity capital, may raise questions under the anti-fraud provisions of the federal securities laws administered by the Securities and Exchange Commission. Accordingly, institutions subject to such limitations should refrain from public dissemination of financial statements... which include items such as amounts of appraised equity capital which are not consistent with the requirements of generally accepted accounting principles.

47 Fed. Reg. at 52,964.


\textsuperscript{68} FIRREA required the federal banking agencies to adopt uniform accounting principles, and also required the disclosure of enforcement actions taken against banks. Pub. L. No. 101-73, §§ 913, 1215, 103 Stat. 183, 483-484, 529 (codified at 12 U.S.C.A. §§ 1818(u), 1833d (West 1990)).

\textsuperscript{69} Garten, supra note 4, at 547.

\textsuperscript{70} See, e.g., Macey, supra note 60, at 1291 (Glass-Steagall Act restrictions on combinations of the banking and investment banking businesses); Jonathan R. Macey & Geoffrey P. Miller, Bank Failures, Risk Monitoring, and the Market for Bank Control, 88 COLUM. L. REV. 1153, 1170, 1213 (1988) (branching, interstate banking, and antitakeover restrictions).
those activities" may instead increase bank vulnerability by handicapping bank competitiveness and foreclosing the diversification of various risks. Moreover, even those prophylactic rules designed to protect bank safety and soundness may not effectively restrain risky behavior, since they apply uniformly to all banks—sound institutions as well as undercapitalized and reckless ones.

The prevailing philosophy of nondisclosure, and the resulting elimination of market incentives, bears a large measure of responsibility for the regulatory failures of the past decade. The policy of confidential supervision allows bank management to conceal excessive and inefficient risk-taking, while insulating itself from market discipline—allowing deposits and capital to flow to banking organizations that an informed public would have shunned.

III. INCORPORATING THE PRINCIPLE OF FULL DISCLOSURE IN A NEW BANK REGULATORY SYSTEM

Recent developments and the problems of traditional bank regulation have led many commentators and regulators to conclude that Congress must reform the traditional regulatory model to allow for more market discipline of banks. Adverse incentives "rig the regulatory game hopelessly in favor of risky bankers," making it highly unlikely that traditional regulatory supervision will alone prevent excessive risk taking. Depositors, on the other hand, particularly depositors with uninsured funds at risk, have the incentive to protect their funds by controlling bank risk taking.

Providing depositor discipline depends in considerable part on deposit

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71. Garten, supra note 4, at 509. See also id. at 507, 525; TREASURY REPORT, supra note 1, at I-16; Fischel, supra note 1, at 319-21; Macey & Miller, supra note 70, at 1169-71.
72. Macey & Garrett, supra note 60, at 222-23.
73. See Boro, supra note 33, at 459, 462.
74. For regulatory perspectives, see, e.g., TREASURY REPORT, supra note 1, at III-10; 50 Fed. Reg. 20,609 (1985) ("As the regulatory restrictions which had previously constrained bank actions are removed, the market takes on greater importance as a mechanism for promoting sound bank management and reducing the potential for inappropriate or abusive behavior by encouraging funds flows to the vast majority of banks that are prudently operated. Thus, the availability of relevant information is essential to an evaluation of bank condition and the effectiveness of the resulting market discipline.") For other commentary, see, e.g., Macey & Garrett, supra note 60; Mathewson, supra note 4; Boro, supra note 33.
75. TREASURY REPORT, supra note 1, at III-9. See also id. at III-27 to III-28.
76. See discussion infra notes 79, 80.
77. See, e.g., Mathewson, supra note 4, at 167.
insurance reform and modification of the “too big to fail” policy. Unless depositors have money at risk, they have little incentive to monitor the condition of their banks. The creation of those incentives is thus an essential element of banking reform.

The other key ingredient for successful depositor discipline is full and accurate information. Only with access to adequate information will depositors have the ability to monitor the soundness of their banks and to exercise discipline on an ongoing basis.

“Adequate information,” for these purposes, means information that meets at least three criteria. First, the information disclosed to the public must be prepared according to meaningful accounting standards and presented in a form that is understandable and readily comparable to the information that competitors provide. Second, the information must be made easily accessible to depositors. As Louis Brandeis noted seventy-five years ago, simply requiring filings with a government agency is not enough; the information must be “brought home” to those directly concerned. Finally, the regulated firms must provide the information on a regular basis. Sporadic disclosure leads to rumors that can have a particularly destabilizing effect. “[I]naccurate information may crowd out accurate information,” and runs on the disclosing bank, or even on banks

78. See, e.g., TREASURY REPORT, supra note 1, at III-10, III-20 to III-27, III-29 to III-31; Macey & Garrett, supra note 60, at 223, 237.

79. See TREASURY REPORT, supra note 1, at III; Macey & Garrett, supra note 60, at 215. Of course, uninsured funds already make up a significant portion of total bank deposits in the U.S. See supra note 39. Thus, even in the absence of new limitations on the scope of the federal safety net, a sizeable group of depositors already have incentives to exercise market discipline over their banks.

80. A number of reforms could encourage greater depositor monitoring of bank health—among them, imposing mandatory losses of a specified percentage, or “haircuts,” on depositors with accounts in excess of the insurance limit. See TREASURY REPORT, supra note 1, at III-13 to III-27. The creation of such depositor incentives to monitor the riskiness of their banks is a subject outside the scope of this Article.

81. “Increased depositor discipline resulting from eliminating coverage of uninsured depositors . . . would simply be after-the-fact discipline, which already exists.” TREASURY REPORT, supra note 1, at III-35. Notwithstanding this concern, the Treasury Department has focused almost exclusively on the “moral hazard” problem—the reduction in depositors’ incentives to monitor the condition of their institutions attributable to the existence of deposit insurance. The Treasury more or less ignores the question of depositors’ ability to conduct such monitoring. As a result, the Treasury’s legislative proposals emphasize direct limitations on the federal safety net, but do little to expand disclosure requirements as a means to enhance market discipline.

82. See discussion supra note 20.

unrelated to the subject of the rumor, are more likely to result. The largest depositors may be the quickest to withdraw their money. Given the fiduciary duty of some institutional investors to protect their funds, and the many investment options available to such funds, managers are unlikely to leave them in a potentially risky bank.

Mandating full and regular disclosure will not prevent all bank failures. Protecting every bank from failure has not been and should not be the goal. To the contrary, earlier, rather than later, failure of an unsound bank is probably desirable: the resolution costs are most likely lower earlier in the process.

The broader goal—maintaining a stable banking system—is served by providing for ongoing and accurate disclosure of bank information. With full and regular disclosure, depositor discipline could work at a number of levels, and would not have to take the form of sudden bank runs. At earlier stages, depositors may well demand higher rates of return on funds they place with riskier banks. Banks with stronger capital positions should be able to raise capital at lower rates, however, thus saving money and offsetting the systemic costs that riskier banks create. Because higher interest rates on deposits mean lower rates of return for shareholders, shareholders also would have an incentive to force bank management to reduce risks.

More generally, the public would gain confidence in the accuracy of bank-provided information and become less susceptible to rumors.

84. See, e.g., Mathewson, supra note 4, at 176 ("If a bank fails as a result of a rumor-created run, depositors may speculate that the entire banking system is not telling the truth. Fearing the unsoundness of the entire system, depositors may withdraw funds from the system itself, rather than merely transfer funds from one institution to another.").
85. Boro, supra note 33, at 461 (footnotes omitted).
86. See Macey & Miller, supra note 70, at 1195 ("the evidence strongly indicates that bank runs occur to banks that deserve such treatment by their depositors. Consequently, the widespread withdrawal of funds by depositors should be viewed as a healthy occurrence, not as a sign of market failure, because such runs demonstrate that depositors are monitoring the banks in which their deposits are kept."). (footnote omitted).
87. See id. at 1193-99; Macey & Garrett, supra note 60, at 228-36. But see Helen A. Garten, Banking on the Market: Relying on Depositors to Control Bank Risks, 4 YALE J. ON REG. 129, 130-32 (1986); Garten, supra note 83, at 1181-87 (1989) (questioning effectiveness of depositor discipline through means other than bank runs).
88. See Macey & Miller, supra note 70, at 1196-98; Macey & Garrett, supra note 60, at 229.
89. See Macey & Miller, supra note 70, at 1197; Macey & Garrett, supra note 60, at 229.
90. Boro, supra note 33, at 483; 50 Fed. Reg. 20,609, 20,614 (1985) ("When the public's perception that a bank is experiencing difficulties is not met with an adequate response, the informational void is filled by rumors and half-truths. Therefore, the systematic, dependable disclosure of information will promote public confidence in banks and reduce the likelihood of deposit runs.").
positors would be less likely to assume that bad news about one unsound bank indicated problems in other, unrelated banks or in the banking system generally. This enhanced willingness to distinguish between sound and unsound banks would significantly reduce the likelihood of a generalized bank panic.\textsuperscript{91} Moreover, providing information in a steady flow would lessen the bombshell effect of bad news. As a result, the market would have time to exercise discipline by means other than sudden, mass withdrawals of deposits.\textsuperscript{92}

In addition, better disclosure would encourage bank management to behave prudently, further reducing the exposure of the federal deposit insurance system. "Bank managements would normally seek to avoid disclosure by routinely working to identify emerging problems in their institutions and taking appropriate remedial action on a timely basis."\textsuperscript{93}

Moreover, we question any assumption that enhanced disclosure requirements would place U.S. banks at a competitive disadvantage if banks in other countries continue to follow a model of confidential regulation. While the international competitiveness of U.S. banks is, of course, a matter of great importance, those who predict adverse consequences to U.S. banks from enhanced disclosure obligations should bear the burden of substantiating their predictions.

This is particularly true where the goals of the reforms are as important as they are in this instance, and where the chances are good that other countries may follow our example and adopt similar requirements for their own institutions. As U.S. accounting and disclosure standards have constructively influenced securities regulation abroad, we should not be quick to abandon transparency as a guiding principle where the disclosure standards affect banking institutions.

**CONCLUSION**

The U.S. bank regulatory structure, dedicated to the preservation of public confidence in the banking system, has long been based on the principle of "confidential supervision." Traditional bank supervision has re-

\textsuperscript{91} See Boro, supra note 33, at 483; Macey & Miller, supra note 70 at 1159.

\textsuperscript{92} See Friedman & Friesen, supra note 1, at 457; Boro, supra note 33, at 448, 461.

On the other hand, a policy that disfavors the disclosure of adverse news and other information may also perversely increase the likelihood of bank runs. See supra note 58 and accompanying text. See also Mathewson, supra note 4, at 175-77; Boro, supra note 33, at 459.

lied on prophylactic regulation and the examination process, while relieving banks of disclosure obligations and insulating them from market discipline. In the past decade, however, the traditional bank regulatory system has failed to prevent an unprecedented number of bank collapses. It is therefore necessary to re-evaluate the principle of nondisclosure that lies at the heart of our bank regulatory system.

Underlying the various arguments for a policy of "confidential" bank supervision is the implicit assumption that banks are somehow special, and should be recognized as different from other corporate enterprises, because of their functions as deposit takers and credit intermediaries. These functions, however, are no longer unique to banks. Instead, one of banks' principal distinguishing features is the enormous commitment that the federal government and U.S. taxpayers assume to back banks' assets through federal deposit insurance. As a result, when confidential bank regulation fails to prevent bank failures, taxpayers as well as depositors and bank investors bear the costs.

Given the "specialness" of banks—the public's stake in bank health, attributable to taxpayer backing of deposit insurance—there is an obvious need to make bank regulation as effective as possible. The failure of confidential supervision suggests that we must carve out a broader role for market discipline in the control of bank risk taking. We do not suggest eliminating all traditional regulatory tools. To the contrary, government regulation, combined with full disclosure, is necessary to preserve the public's confidence in the banking system. Depositor discipline, however, in addition to full disclosure like that required for reporting companies under the securities acts, can serve "as an important supplement to the supervisory process." Congress should not overlook the value of these tools in the course of the ongoing effort to modernize the U.S. bank regulatory system.

95. See Friedman & Friesen, supra note 1, at 427; Macey & Miller, supra note 70, at 1162.
96. Boro, supra note 33, at 459.
97. See Macey & Garrett, supra note 60, at 223; Boro, supra note 33, at 455-57.