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BANKING AND THE SOCIAL CONTRACT

Mehrsa Baradaran[1]

TABLE OF CONTENTS

INTRODUCTION....2

I. HISTORY OF THE SOCIAL CONTRACT....6
A. THE COLONIAL TO CIVIL WAR SOCIAL CONTRACT....7
1. *The First and Second Bank of the United States*....10
A. *Federal Instrumentality*....10
2. *Banking Regulation*....11
3. *The Civil War*....13
B. THE GREAT DEPRESSION AND THE NEW DEAL....16
1. *The New Deal Social Contract*....18
2. *Civil Rights and the Social Contract for Equality*....21
C. DEREGULATION....25
1. *Safety and Soundness v. Profitability*....27
2. *Erosion of the Social Contract*....31

II. DEFINING THE SOCIAL CONTRACT....35
A. THE STATE NEEDS BANKS....36
B. BANKS NEED GOVERNMENT SUPPORT....37
1. *Deposit Insurance*....39
2. *Federal Reserve Liquidity Support*....42
3. *Bailouts*....43
a. *TARP*....46
C. THE POST-CRISIS SOCIAL CONTRACT....48
1. *Dodd-Frank*....49
2. *Too Big To Fail*....51

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3. *Corporatism* 54
4. *Breaking up the banks* 55

III. REVISING THE SOCIAL CONTRACT 56
A. SAFETY AND SOUNDNESS 57
B. CONSUMER PROTECTION 59
C. ACCESS TO CREDIT 61

IV. "PUBLIC BENEFIT" AND THE STATUTORY CODE 64

V. CONCLUSION 70

INTRODUCTION

> *"[Government] support cannot go on forever, which underlines why the Social Contract for banks must be redrawn."*
>
> —Paul Tucker, Deputy Governor of the Bank of England

Paul Tucker made a prescient comment while perhaps unintentionally coining the perfect terminology to describe the current problem in banking: the social contract between the government and banks is out of balance, due primarily to the increased size and power of a number of banks. This article will, for the first time, describe the social contract in banking and explain how it has gone awry. The recent financial crisis provides a compelling illustration of my argument. In 2008, Treasury Secretary Henry Paulson sold the Troubled Asset Relief Program ("TARP") to Congress and the public as an undertaking that would help relieve Americans' mortgage debts through modifications and other direct relief. Congress passed the Act and Henry Paulson immediately took advantage of the broad discretion given to him under TARP to inject billions of dollars directly into the country's largest banks by purchasing preferred shares.[2] Paulson reasoned that this was necessary to allow these banks to start lending again. However, the deal struck with

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[2] NEIL BAROFSKY, BAILOUT: AN INSIDE ACCOUNT OF HAW WASHINGTON ABANDONED MAIN STREET WHILE RESCUING WALL STREET 25 (2012).

the banks provided no requirements or incentives to actually increase lending.[3] Once the banks had money in hand, it became apparent that they had no intention of using the funds to facilitate credit.[4]

In response to the voiced outrage of several congressmen and public figures over the diversion of funds from the public to the banks, the Treasury Department proposed and Congress approved another program in March 2009. The Home Affordable Modification Program ("HAMP"), a $50 million TARP carve-out, would go directly to homeowners and fulfill the original purpose of TARP by restructuring mortgages to make them more affordable and decrease the number of foreclosures. Incredibly, these funds also ended up going directly to banks. In fact, HAMP's faulty design caused many problems for mortgage borrowers across the country and even led to an increased number of unnecessary foreclosures. When Treasury Secretary Tim Geitner was asked about HAMP's failures to help mortgage borrowers, his response was one of most telling exchanges of the financial crisis: "We estimate that [the banks] can handle ten million foreclosures, over time… this program will help foam the runway for them."[5] When asked about the one program that was specifically targeted to help the American public, the Treasury Secretary responded that it would make banks more profitable. This revelatory comment is at the heart of the misunderstanding that has pervaded American banking policy for the past 30 years.

The misunderstanding concerns the nature of the relationship between banks and the state. One consequence of the confusion is the Treasury's assumption that the government's paramount objective is assuring bank profitability. To be sure, regulators should work to secure a profitable and successful banking industry, but bank profitability is a means to an end and not an end itself. The proper end is ensuring that the nation's banks do what the public needs them to do and not the other way around.

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[3] *Id.* at 27.

[4] Mike McIntire, *Bailout is a No-Strings Windfall to Bankers, if Not to Borrowers*, N.Y. TIMES, Jan. 18, 2009, at A1.

[5] BAROFSKY, *supra* note 2, at 156.

The public needs a safe and reliable banking system, without which the economy cannot reach optimal performance. Banks also need government support, without which their customers would lack sufficient trust to permit them to function properly. Thus, banks and the government are engaged in a partnership or agreement. The basic agreement consists of a government promise that it will protect banks from runs, liquidity shortages and investor irrationality and a promise made by banks that they will operate safely, play their essential role in financing the expansion of the economy and serve the needs of their customers and local communities. This arrangement has been effective for much of U.S. history and is still intact with regard to most U.S. banks, but has fallen apart with the largest and most powerful banks, those that have been called "Too Big To Fail." These banks make up less than 1% of the banks in the country, but control most of the country's assets and wield a disproportionate amount of political power.[6]

It is these banks that were most involved in unsafe practices and these banks to which the various bailout measures were directed. These large banks are the banks in which the U.S. government is most invested, and yet these are the banks least invested in the public welfare of the country. This is why the social contract must be re-asserted. Populist movements from the right and the left such as the Tea Party and Occupy Wall Street have demonstrated, although sometimes vaguely, the people's unease with the current state of the social contract.[7] President Obama has gone so far as to tell Wall Street firms that he is standing between them and the pitchforks.[8]

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[6] Richard Fisher, President of the Fed. Reserve Bank of Dallas, Ending 'Too Big to Fail': A Proposal for Reform Before It's Too Late, Remarks Before the Comm. of the Republic (Jan. 16, 2013)(transcript available at http://www.dallasfed.org/news/speeches/fisher/2013/fs130116.cfm).

[7] Ed Pilkington, *Occupy Wall Street: Tea Party Leaders Admit Similarities – But Not Too Many*, GUARDIAN, Oct. 7, 2011, http://www.guardian.co.uk/world/2011/oct/07/occupy-wall-street-tea-party-comparison (explaining that one of the few similarities between the two activist movements is the frustration with the treatment of big banks).

[8] Lindset Ellerson, *Obama to Bankers: I'm Standing 'Between You and the Pitchforks*,' ABC NEWS (Apr. 3, 2009), http://abcnews.go.com/blogs/politics/2009/04/obama-to-banker/.

The recent crisis made clear that bailouts were economic and political necessities and will likely always remain necessities so long as large and systemically dominant firms exist. Therefore, the government will also continue to stand between the banks and the pitchforks. Both sides need to recognize this inevitable relationship. At the same time, the government must reassert and clarify the essential nature of this relationship and demand the reciprocity on which this social contract was premised. In particular, the government must make clear that in exchange for this necessary and continued support, the government will require certain banks to fulfill obligations for the benefit of society.

There is a long and rich philosophical discussion about the social contract between individuals and society. In general, social contract theory posits that individuals consent to surrender some natural liberty in exchange for protection or other benefit conferred by society.[9] This article does not intend to wade into social contract theory as applied by Hobbes, Kant, Rousseau, Rawls and others to the individual and society.[10] However, the relationship between the government and banks resembles a social contract because it involves the sacrifice of certain liberties that individuals make for the protection of the state. Here, banks gain specified protections from the government in exchange for

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[9] J. W. GOUGH, THE SOCIAL CONTRACT: A CRITICAL STUDY OF ITS DEVELOPMENT 140 (2nd ed. 1957).

[10] Hobbes's explanation of the social contract begins with the "state of nature," wherein every individual has complete freedom and acts purely in his own self-interest. Because this state of nature is intolerable, individuals agree with each other to surrender complete liberty in exchange for a society ruled by a sovereign authority. THOMAS HOBBES, LEVIATHAN OR THE MATTER, FORME, & POWER OF A COMMON-WEALTH ECCLESIASTICAL AND CIVILL 66 (Oxford Univ. Press 1967). Locke's state of nature includes a natural law, which contains a right of property. Individuals agree with each other to give up their right to enforce this natural law to the society. The society establishes a legislative authority whose role is to enforce the natural law for the benefit of the people. Rousseau regarded the social contract as an agreement among individuals to surrender their natural liberty. Ernest Barker, *Introduction* to SOCIAL CONTRACT: ESSAYS BY LOCKE, HUME AND ROUSSEAU at v, xliv (Oxford Univ. Press 1946). This surrender, however, is not in exchange for a society ruled by a sovereign, but rather is a submission to the "general will." JEAN-JACQUES ROUSSEAU, THE SOCIAL CONTRACT 55 (Christopher Betts trans., Oxford Univ. Press 1994) (1762). Rawls adapted social contract theory into a theory of justice. Unlike those before him, Rawls begins with a hypothetical situation in which individuals contract from behind a "veil of ignorance." The result is a set of principles of justice for the basic structure of society. JOHN RAWLS, A THEORY OF JUSTICE 136 (Harvard Univ. Press 1971).

operating within the limits of the law much like the average citizen must do in order for the state to function properly. Acknowledging the social contract does not necessarily require more regulation especially of the most complex and costly kinds. It requires instead a new way of viewing the relationship between banks and the state that fully recognizes the obligations on both sides.

This article asserts that there are three major tenets of the social contract: (1) safety and soundness, (2) consumer protection, and (3) access to credit. Regulators can and should require banks to meet standards in these areas to benefit society even if these measures reasonably reduce bank profits. Implicit in the social contract is the idea that each party must give up something in the exchange. This article provides policymakers not only the appropriate narrative and justifications needed to frame their regulatory philosophy, but it also provides important textual support from the most prominent acts of banking legislation to give regulators the authority and charge to ensure that banks fulfill the public's needs.

In Part I, this article provides a historical background of the social contract and demonstrates that the social contract between banks and the government has existed since the inception of banking in this country and has changed several times to meet changing circumstances and needs. In Part II, the article describes the various governmental measures that protect banks and essentially serve as a safety net and why this government support justifies imposing public obligations on banks. Part III defines the critical elements of any social contract going forward, such as safety and soundness, consumer protection, and access to credit. Part IV demonstrates how regulators can build on existing language and tests in banking legislation to recognize and enforce banking's social contract.

I. HISTORY OF THE SOCIAL CONTRACT

To reveal that a social contract exists, this article briefly outlines the changing nature of the bank/government relationship through various phases of U.S. history. This section considers banking history in three phases: (1) the colonial and Civil War era "nation-building" phase, (2) the

Great Depression and the "New Deal in Banking" phase, and (3) the "deregulatory phase" from the 1970s through the early 2000s. To be sure, banking changed significantly within each phase, but the general contours of the social contract remained roughly the same.

A. The Colonial to Civil War Social Contract

Banking started in America to aid the colonies to build an economy from scratch. The New World, unlike the more established Old World, did not have a financial system or large pools of money to borrow or lend. The first bank created in the new world, the Bank of Pennsylvania, was a public bank created to aid the cash-strapped colonies feed the troops during the Revolutionary War.[11] The first national bank, the Bank of New England, was approved by Congress in 1781 and was formed by private and foreign funds.[12] Alexander Hamilton, a then 24-year old soldier and vocal advocate of establishing a national bank, wrote "tis by introducing order into our finances by restoring public credit not by gaining battles that we are finally to gain our object."[13] His time in the army had convinced him that "military operations could not be made more effective without more money and more money could not be procured without new means."[14] The Bank of Pennsylvania was a public enterprise,[15] but did not become the "national bank" it was intended to be and was slowly absorbed into private business.[16] Nevertheless, Hamilton argued that banks, "within reasonable limits, ought to consider it as a principle object to promote beneficial public purposes."[17] When Alexander Hamilton responded to President Washington's inquiry about the advisability of a national bank, he wrote that "such a Bank is not a

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[11] Robert Morris said the bank was "in fact nothing more than a patriotic subscription of continental money … for the purpose of purchasing provisions for a starving army." BRAY HAMMOND, BANKS AND POLITICS IN AMERICA: FROM THE REVOLUTION TO THE CIVIL WAR 45 (Princeton Univ. Press 1957)(quoting ALEXANDER HAMILTON, THE WORKS OF ALEXANDER HAMILTON 233 (H.C. Lodge ed., 1904)).

[12] HAMMOND, *supra* note __, at 47.

[13] *Id.* at 47.

[14] *Id.* at 40.

[15] *Id.* at 46-51.

[16] *Id.* at 63.

[17] *Id.* at 76.

mere matter of private property, but a political machine of the greatest importance to the State."[18]

The first few banks of the new world were started as public entities that would meet the credit demands of the public and the new government. By 1790, four banks were in business in four cities—Philadelphia, New York, Boston, and Baltimore[19]—and "each bank was a public bank; that is, it was distinctively more than a private institution…though its active management was private, it was bound as well as enfranchised by governmental authority, and the state was as often as not, a shareholder."[20] Bray Hammond, the leading expert on early U.S. banking describes the arrangement as such: "the community, whether shrewdly or not, had adapted private initiative and wealth to public purposes, granting privileges and exacting duties in return….there persisted a strong conviction that a charter was a *covenant*."[21] Thus, the founders and early colonial governments viewed banks as a "unique institution" that was a "public" good.[22]

Public opinion toward banking was mixed, but there was widespread suspicion of bank power and a distaste for banking that caused many to oppose their creation. Alexander Hamilton was the early bank advocate and Thomas Jefferson, its early opponent.[23] But they advocated and opposed banks based on a similar understanding of the potential for banks to shape the economy and change society. Hamilton recognized that banks would be pivotal in turning an agrarian and rural economy into an interconnected economy with central planning and development. It was this same transformation and banks' central role in it that Jefferson opposed.[24] Jefferson was not alone in his disdain for banks. Most of the public viewed banks as corrupt, lacking the commitment to

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[18] 23 ALEXANDER HAMILTON, THE PAPERS OF ALEXANDER HAMILTON 287 (Harold C. Syrett ed., Columbia Univ. Press 1976).

[19] HAMMOND, *supra* note __, at 61; *See also* GROSSMAN, *supra* note __, at 221.

[20] HAMMOND, *supra* note __, at 67.

[21] *Id.* at 67 (emphasis added).

[22] *Id.* at 68.

[23] Although Thomas Jefferson's opposition came to an end as he recognized the benefits of banking to the country. GROSSMAN, *supra* note __, at 225.

[24] SUSAN HOFFMAN, POLITICS AND BANKING: IDEAS, PUBLIC POLICY, AND THE CREATION OF FINANCIAL INSTITUTIONS 22-25 (2001).

agrarian thrift and hard work that were representative of the early colonies. In 1811, former President John Adams wrote: "Our whole banking system I ever abhorred, I continue to abhor, and shall die abhorring."[25] William Gouge said in 1833 that banking was "the *principal* cause of social evil in the United States."[26] He viewed bank's vast monetary power and capabilities as a privilege given to corporations and denied to individuals.[27] This disdain for banks dictated that the banks of the new world be kept under the supervision of the state.

Such sentiments were rooted in the traditional agrarian beliefs that feared concentrated monetary power. Thus, there was widespread fear of banking monopolies or conglomerates that would amass political power and influence and wield it to thwart the budding democracy.[28] Banks were described as "artificial creature[s] endowed with powers not possessed by human beings and incompatible with the principles of a democratic order...having not principle but that of avarice which dries and shrivels up all the manly, all the generous feeling of the human soul, will never be varied in its object and if continued will accomplish its end to engross all the wealth, power and influence of the state."[29]

Early supporters of banks, such as Thomas Paine, believed that banks would strengthen the nation by facilitating commerce.[30] The public would benefit and the economy would prosper, Paine argued, by the increased efficiency in trade facilitated by banking.[31] Many people in burgeoning regions, incited by the colonial mercantilist spirit of capitalism, hailed banks for playing a central role in the "wondrous growth" of American communities.[32] This formative tension between

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[25] HAMMOND, *supra* note __, at 36 (emphasis in original).
[26] *Id.* at 37.
[27] HOFFMAN, *supra* note __, at 61-62.
[28] *Id.* at 40.
[29] HAMMOND, *supra* note __, at 54-55 (quoting William Findley).
[30] *Id.* at 60.
[31] *Id.* (Thomas Paine wrote, "the principle public use of it [the bank] at this time is for the promotion and extension of commerce. The whole community derives benefit from the operation for the bank. If facilitates the commerce of the country. It quickens the means of purchasing and paying for country produce and hastens on the exportation of it. The emolument, therefore, being to the community, it is the office and duty of government to give protection to the bank.").
[32] *See* HAMMOND, *supra* note __, at 7-39, 629-30.

traditional agrarian morality and the new mercantilist spirit of laissez faire shaped the evolution of the social contract. As banking developed in the early nation-building era, so did ideological conflict between banks-as-self-interested-commercial-enterprises and banks-as-public-entities with compromises on both sides.[33] Banks would be allowed to expand, but they would have to honor a distinctively public mission.

1. The First and Second Bank of the United States

The debates over the first and second banks of the United States have filled volumes. This article will not recapitulate complex national dialogue involved in the chartering of these two institutions. Instead, it will focus on a point of central importance here: these banks were viewed as public-serving institutions that would help the country in many ways, including by standardizing American currency. During the debates over the first and second national banks, policymakers on both sides recognized that centralized banking could be used to solve formidable national problems with regard to the money supply.[34] Scholars have noted that these early banks "shared a common purpose: advancement of the commonwealth through [their] assistance to economic progress."[35]

A. Federal Instrumentality

The federal instrumentality doctrine was first introduced in *McCulloch v. Maryland*, where Chief Justice Marshall declared unconstitutional a state tax on the Second Bank of the United States[36] because the Second Bank

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[33] *See Id.* at 64 (stating that "[t]he conflict of the principles and interests – economic, social, moral, and political – in the first lustrum was to recur often and far more momentously in the country's later history").

[34] "Congress established the second Bank of the United States to provide a uniform currency, intending thereby to bring economic chaos under control for the benefit of the government and the people." HOFFMAN, *supra* note __, at 46. The second bank of the United States was built not only to handle the monetary affairs of the central government, but was also explicitly charged with improving the economy. The interests of the general public were integral to the bank's design. HOFFMAN, *supra* note __, at 50.

[35] PAUL B. TRESCOTT, FINANCING AMERICAN ENTERPRISE: THE STORY OF COMMERCIAL BANKING 6, 40 (Harper & Row 1963).

[36] McCulloch v. Maryland, 17 U.S. 316, 436 (1819); *State Power to Tax National Banks,* 82 HARV. L. REV. 284 (1968).

was an "instrument employed by the government."[37] Because Congress established the bank with a purpose of fostering a unified national economy, federal instrumentality status was necessary to protect the special relationship between the bank and the nation from state intrusion.[38] The Court rejected the state's contention that a bank was not a federal instrumentality because it had mostly private ownership and functioned as a commercial bank.[39] The bank and its branches were federal instrumentalities, exempt from state taxation despite private ownership, because they were chartered by the government to serve the public.[40] These landmark cases reveal that the earliest concept of federal instrumentality rested on the fact that Congress created a Bank of the United States to expressly and practically serve public economic needs.

2. *Banking Regulation*

Even early on, the proponents of banks had at least some sense that banks must be saved from themselves in some matters. Thus, Hamilton laid out basic limitations on bank liabilities.[41] "The early years of the republic are often spoken of as if the era were one of laissez faire in which government authority refrained from interference in business and benevolently left it a free field. Nothing of the sort was true in banking."[42] As a result, these early banks were inherently connected to government. This was also because they were modeled after the public

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[37] *McCulloch,* 17 U.S. at 436.

[38] Chief Justice Marshall declared that federal instrumentalities needed protection from state taxation because "the power to tax involves the power to destroy." *Id.* at 431. In another early case, *Osborn*, the Court upheld *McCulloch* in holding that a state cannot tax the Bank of the United States. Osborn v. Bank of U.S., 22 U.S. 738, 767-70 (1824).

[39] In fact, four-fifths of the banks starting capital was provided by private investors and government control of the bank was restricted. STAFF OF NAT'L MONETARY COMM., 61ST CONG., FIRST AND SECOND BANKS OF THE U.S. 152 - 155 (Comm. Print 1910).

[40] *Osborn*, 22 U.S. at 769 ("This public benefit may consist of the facilities afforded to the State, in the management of its fiscal concerns; or it may consist in the convenience to the community in the transaction of mercantile and other money affairs. It may arise from the payment of annual revenue, or a stipulated sum, into the public treasury...the character of civil institutions does not grow out of their incorporation, but out of the manner in which they are formed, and the objects for which they are created").

[41] HAMMOND, *supra* note __, at 132.

[42] *Id.* at 185.

banks of the old world, such as the Bank of England, whose primary purpose was to serve the State.[43]

During the 19th Century, a shift in the banking industry occurred, as banks were primarily chartered by states as opposed to the federal government.[44] But states, in keeping with past practice, relied on banks to perform necessary economic functions.[45] One historian asserts: "In practice state legislatures viewed banking corporations as instrumentalities of the state, established to serve various public purposes as well as the private interests of stockholders and borrowers."[46] Indeed, this conception of banking as a state instrumentality continued into the early 20th century. In *Schaake v. Dolley*, a 1911 case where Kansas denied a banking charter because the local economy could not support another bank, the Kansas Supreme Court states that banking is not "a matter of private concern only, like the business of merchants, and for all purposes of legislative regulation and control it may be said to be 'affected with a public interest.'" The court emphasized that because of the position of banks as recipients of the "public patronage," that they become "a trustee of the fiscal affairs of the people and of the state." The court makes clear that banking needs to be distinguished from "ordinary private business" because of its "public nature," which shows that it is "properly subject to the police power of the state."[47]

In particular, early state laws attempted to keep banks small and short-lived, in keeping with widely held fears of concentrated economic

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[43] *Id.* at 58. "Banking regulations in the United States were, by both nineteenth and twentieth century standards, quite restrictive, resulting in a banking system characterized by a large number of small banks." GROSSMAN, *supra* note __, at 222.

[44] HOFFMAN, *supra* note __, at 71.

[45] States chartered banks to perform a variety of public purposes, such as "to provide credit for trade, manufacturing, and agriculture; to provide circulating medium for every day economic transactions; to act as fiscal agents of the state; to generate revenue for state government operations, obviating the need for taxation to finance public improvements; and to regulate other banks in the state." *Id.* at 72.

[46] *Id.* at 87. "In authorizing them, legislators knew they were providing economic and social infrastructure; they did so with explicit attention to having enough for everyone and their purposes included deliberate geographic and functional allocation." *Id.* at 90.

[47] Schaake v. Dolley, 118 P. 80, 83 (Kan. 1911).

power.[48] New York banking laws, for example, set maximum capital standards, and most bank charters came with expiration dates. Legislatures renewed the charters subject to conditions or most commonly denied requests for charter extensions.[49] In addition, state law imposed participation requirements to prevent privately controlled banks from being dominated by a few individuals or economic interests.[50] In short, states allowed banks to profit, but they also acted to limit bank's power and size in the interest of serving the public good.[51]

3. The Civil War

A major change in banking was precipitated by the Civil War: the great stresses caused by the conflict spurred the re-entry of the federal government into bank chartering and regulation.[52] A lack of government credit and funding in the face of war compelled President Lincoln and Treasury Secretary Salmon Chase to loosen the Jacksonian treasury requirements, which forbade the national government from regulating

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[48] GROSSMAN, *supra* note __, at 222.

[49] HOFFMAN, *supra* note __, at 78. "Prospective bankers had to lobby the legislature in order to be granted a charter; they might be successful if they were, in the view of the legislature, of good character and if the legislature felt that the area needed another bank." GROSSMAN, *supra* note __, at 138.

[50] HOFFMAN, *supra* note __, at 78.

[51] Although there is certainly support for the proposition that banking and the state were intertwined in early American history, there is also some evidence that in some states banking was less regulated than today and these banks were purely driven by profit. The United States had a brief period of Free Banking from 1836 to 1863 where there was no National Bank and states allowed relatively easy entry into banking. Free banking, which was originally implemented in New York and replicated elsewhere was "an application of laissez faire to the monetary function….[It] broke with the Hamiltonian concept of banking and the principles that supervision of banking as a monetary function was a responsibility of the federal government." HAMMOND, *supra* note __, at 573. Many banks were formed during this time and some came to be called "wildcat banks" because many were located in rural locations and operated outside the purview of the law. RICHARD SCOTT CARNELL ET AL., THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 7-8 (Vicki Been et al. eds., 4th ed. 2009); GROSSMAN, *supra* note __, at 139. Most scholars view this short-lived era as a failure although that assessment is not uncontested. CARNELL ET AL., *supra* note __, at 8; HAMMOND, *supra* note ___, at 599 ("the results of the Jacksonian [laissez faire] revolution were obvious in monetary inflation, in speculation, in wasted labor, in business failures, in abandonment of an efficient means of credit control, and in corruption of a sound monetary system.")

[52] HAMMOND, *supra* note __, at 359 ("[T]he South's rebellion was an extreme version of what Maryland tried to do about the federal bank of the United States.")

the monetary system using bank notes, or adopting modern credit practices.[53] The war created such a financial burden on the government that it had to borrow money from state banks.[54] The federal government turned to the banks of New York, Boston, and Philadelphia to finance the war and borrow money. Indeed, the U.S. treasury depended entirely on private state bankers for money.[55] This dependence led the federal government to push for a transition from species to paper currency, which would require more trust in the banking system and a stronger tie between banks and the federal government. In recognizing its need to expand federal power, the North made unprecedented assertions of federal power through the legal tender and national currency acts of 1862 and 1863. The federal government's transition to paper money stood for the proposition that banks and the government needed to work together to promote national economic growth, stability, and well-being.[56]

The currency debates highlight the philosophical underpinnings of the banks' developing relationship with the government, as "the idea for a national banking system and for a national currency became synonymous to people."[57] Banking policy was, in many respects, as politically controversial and deeply-rooted as the issue of slavery because it came to represent the tension between state and federal power. Arguments against a national currency and a national banking system paralleled those used in defense of secession. Many challenged the constitutionality of Treasury Secretary Chase's proposal for national banks, which would be "subordinate to congressional authority and wholly independent of the state legislatures." Yet "the new spirit of nationalism being fostered by the war" led others to believe that public welfare required a national banking system.[58] Newspapers like the New York Times supported a nationalized legal tender because it was an assertion of the nation's

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[53] The Independent Treasury Act of 1846 forbade the national government from regulating the monetary system, using bank notes, or adopting modern credit practices. HAMMOND, *supra* note __, at 20-21.

[54] *Id.*, at Ch. 2.

[55] *Id.*

[56] *Id.* at 97 ("The perfection of economy in time, labor and expense would seem to have been attained in a [paper currency] worthy of and honorable to a Christian society.").

[57] *Id.* at 143.

[58] *Id.* at 144.

Constitutional sovereign power that affirmed the principles the union stood for.[59] Critics believed that national banking/currency would make wealthy men wealthier and would press states into federal servitude.

The establishment of national banking and a national currency was the birth of the partnership between the federal government and banks to enact monetary policy. National banks were created for this purpose and were treated as "federal instrumentalities," or tools of the federal government to accomplish its aims. The process of replacing state bank notes with a national paper money system would force banks to assume responsibility for the nation's economic survival by making banks carry out the government's monetary policy.[60] A well-regulated national banking system would be "relied upon to carry the nation through its financial difficulties."[61]

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In sum, banks and banking in the U.S. were initiated to support the early colonies, then the states, and then the nation and the union. Banks were chartered and regulated to fulfill state or national policies aimed at benefitting the public as a whole in ways that reached far beyond merely ensuring a thriving and profitable banking industry. Although there was little in the way of an explicit social contract during the early colonial and post-civil war era, from the beginning, public issues were fought on the turf of banking policy. Although there was no government safety net during this time, the granting of a bank charter and the use of banks for monetary policy were ways in which the banks and the government relied on each other. This idea of conceptual unity carried with it, in its nature, a recognition that banks were subject to governmental control. And in fact many controls were imposed, especially restrictions on bank size. There was, however, a deep problem with this form of the banking social contract: It left banks open to failures that resulted from financial

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[59] *Id.* at 204 (quoting the Times)("All persons who regard the government as anything more than a confederation of states to be broken or weakened at will by secession or rebellion – all who believe the federal authority a power for the general good of the whole people as well as the symbol of sovereignty and allegiance – will welcome this resumption of one of its most important rights and duties.").

[60] *Id.* at 167.

[61] *Id.* at 177.

mismanagement and bank runs.[62] This problem manifested itself with catastrophic consequences during the Great Depression.

B. The Great Depression and the New Deal

The Great Depression and the New Deal that followed marked a pivotal moment in American regulatory history. And no sector was affected more than banking. If the public opinion toward banks was skeptical before the 1930s, it turned outright hostile during the 1930s as the American people faced unprecedented suffering due to bank failures across the nation. In "Other People's Money" Louis Brandeis made the case against the newly developed "Money Trusts," or investment banks and bankers, whose goals he saw as to exact inordinate securities underwriting fees and enrich themselves through the use of the deposits of the middle class. This view mirrored that of Thomas Jefferson nearly a century earlier.[63] The problem with this oligarchy, Brandeis argued, was that it would lead to injuries inflicted on the very people whose deposits were used to secure such dominant positions.[64] Another, no less serious, evil was the Money Trust's success in suppressing competition and innovation.[65]

Brandeis criticized the disproportionate influence investment bankers wielded from their control of other people's money.[66] "If the banker's power were commensurate only with their wealth, they would have relatively little influence on American business."[67] Instead, the large investment banks of the time controlled, either directly or indirectly, a

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[62] GROSSMAN, *supra* note __, at 230-245.

[63] "If the American people ever allow private banks to control the issue of their currency, first by inflation, then by deflation, the banks and corporations that will grow up around them will deprive the people of all property until their children wake up homeless on the continent their Fathers conquered...I believe that banking institutions are more dangerous to our liberties than standing armies... The issuing power should be taken from the banks and restored to the people, to whom it properly belongs." THE JEFFERSON MONTICELLO, http://www.monticello.org/site/jefferson/private-banks-quotation (last visited Feb. 10, 2013).

[64] LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY: AND HOW THE BANKERS USE IT 18-19, 46 (Richard M. Abrams ed., Harper & Row 1967).

[65] *Id.* at 63–67.

[66] *Id.* at 18.

[67] *Id.*

staggering twenty-two billion dollars, more than three times the value of all property, real and personal, in all of New England.[68] With large investments in American business, including railroads, industrial corporations, and life insurance companies, banks and their investment bankers requested directorships on company boards. J. P. Morgan itself held seventy-two directorships in forty-seven of the largest corporations in the country.[69] The other two banks stood not far behind. Here was Jefferson's worst fear coming to pass.

In addition to recommending conflict-of-interest legislation that would deter banker directorships, Brandeis suggested a more fundamental solution—turning banks into public-service corporations.[70] Comparing them to the country's railways, then an essential utility of commerce, he argued that banks should be treated not as private business, but as a public service. "The dependence of commerce and industry upon bank deposits, as the common reservoir of quick capital is so complete, that deposit banking should be recognized as one of the businesses affected with a public interest."[71] Brandeis quoted Senator Owen, Chairman of the Committee on Banking and Currency, to add historical support for this suggested transformation:

> My own judgment is that a bank is a public-utility institution and cannot be treated as a private affair, for the simple reason that the public is invited, under the safeguards of the government, to deposit its money with the bank, and the public has a right to have its interests safeguarded through organized authorities. The logic is beyond escape. All banks in the United States, public and private, should be treated as public-utility institutions, where they receive deposits.[72]

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[68] *Id.* at 33. The key to this control lied in combinations. J. P. Morgan & Co., along with two New York banks, National City and First National, constituted the Money Trust. *Id.* at 28.

[69] *Id.* at 32.

[70] *Id.* at 64.

[71] *Id.*

[72] *Id.* Justice Holmes conceded that even if the state did not take on nationalized banking, private banking could compete efficiently in the market if it could focus on people instead of profits, which they termed "democratic banking." *Id.* at 214.

1. The New Deal Social Contract

Drawing in part of Brandeis's concept, President Roosevelt seized on the calamity of the Great Depression to initiate a new form of social contract with banks. The government decided that it needed a stable banking system that was not prone to conglomeration and excessive power. Therefore, it put in place activity restrictions, enforced antitrust rules, and provided a government safety net in exchange for federal support. This safety net would minimize banks' vulnerability to runs, a contagion that had quickly spread across the banking sector. Banks vigorously opposed Roosevelt's imposition of activity restrictions as well as deposit insurance, but President Roosevelt used the public's anger at the banks to catalyze public and legislative support for these measures.[73]

The most important and most comprehensive demands on banks had to do with making banks less risky by keeping them from engaging in nonbanking, or commercial activities. The Glass Steagall Act limited banking activity to traditional bank functions and prohibited banks from engaging in riskier activities, such as underwriting and proprietary trading. These controls were aimed at keeping banks small and constraining their market footprint. The second part of the deal made with banks after the Great Depression focused on using banks to promote public objectives, specifically by increasing access to credit. Roosevelt recognized that banks had public-serving functions and aggressively enlisted them to meet public needs.

The government chartered specific banking institutions that would play a major part in aiding the poor and middle class in buying homes and providing access to low-cost credit. Congress established the Federal Home Loan Bank System in 1932 to "maintain and promote homeownership in the United States." In addition, the National Credit Union Act (NCUA) was created to facilitate the chartering and regulation of federal credit unions that would lend primarily to consumers, not businesses, and the National Housing Act provided federal funds to support Savings and Loan Associations specifically charged with

financing home purchases, by insuring these deposits.[74] In addition, Fannie Mae and Freddie Mac were chartered as government organizations to aid in the underwriting of home mortgages to enable home ownership by more of the public.[75]

Although some banks aimed to serve the poor before the Great Depression, the New Deal solidified their place in the national economy and gave them a formal charge that would be backed by governmental support. Unfortunately, these banks also ceased to fulfill their obligations to the poor during the 1980s during the deregulation that homogenized banking.[76] These banks could not maintain profitability in the face of the market changes during the 1980s. And because the social contract forged during the New Deal had eroded by that time, the government did not step in to subsidize these failing banks.[77]

The social contract forged during the Great Depression stabilized US banking for several decades. The banking sector grew steadily from 1933 until the mid-1970s without experiencing any financial panic or collapse. Banks operated conservatively and regulators, unchallenged, enforced the Glass Steagall Act and other New Deal regulatory mandates. During this time, banking regulation was motivated by the goal of soundness and stability and the policy goal of directing credit toward public-serving goals that were deemed worthwhile. These aims were achieved through anticompetitive regulations and activity restrictions, which protected banking stability and profitability, but which also stifled financial innovation. During this era, banks were stable and profitable. Therefore, neither the government nor the banking industry agitated for a change of policy.

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[74] JONATHAN R. MACEY & GEOFFREY P. MILLER, BANKING LAW AND REGULATION 28-29 (1997); FDIC, HISTORY OF THE 80S , VOL . 1: AN EXAMINATION OF THE BANKING CRISIS OF THE 1980S AND EARLY 1990S 170 (1997).

[75] Andrea J. Boyack, *Laudable Goals and Unintended Consequences: The Role and Control of Fannie Mae and Freddie Mac*, 60 AM. U. L. REV. 1489, 1495 (2011).

[76] Mehrsa Baradaran, *How the Poor Were Cut Out of Banking*, 62 EMORY L.J. 483 (2013).

[77] For a more comprehensive discussion of why these banks stopped fulfilling their public-serving mission, *see* Baradaran, *supra* note __.

In sum, the Great Depression and the New Deal that followed led to the first wave of comprehensive activity restrictions imposed on banks. This New Deal-era social contract with banks focused on safety and soundness, which was meant to protect depositors as well as the U.S. economy from catastrophic bank failure.[78] For the first time, the federal government provided federally-funded deposit insurance to prevent confidence-destroying runs from wreaking havoc on banks.[79] In return, the federal government imposed a framework of banking controls intended to minimize the moral hazard effects of deposit insurance and to protect the insurance fund from losses.[80] Moral hazard is defined as a "lack of incentive to guard against risk when one is protected from its consequences."[81] These controls on banks resulted in reduced bank size and influence as well as a marked reduction in bank failures for over 50 years.[82]

The New Deal social contract kept the banking system safe and functional as the country developed a modern economy. The State needed banks to be reliable and banking regulation in that era achieved that purpose. The banking sector experienced measured growth and

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[78] GROSSMAN, *supra* note __, at 247-249 (cataloguing the most important banking reforms initiated during the aftermath of the great depression: deposit insurance, the separation of banking and commerce, and interest rate ceilings).

[79] Lee J. Alston, Wayne A. Grove & David C. Wheelock, *Why Do Banks Fail? Evidence from the 1920s* 31 EXPLORATIONS IN ECON. HISTORY 409, 415-418 (1994) *see also* David C. Wheelock, *Regulation, Market Structure, and the Bank Failures of the Great Depression*, 77 FED. RESERVE BANK OF ST. LOUIS REVIEW 27 (1995).

[80] *See* Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401, 402 (1983)(showing that banking is unstable without deposit insurance); *see also* Andrew G. Haldane, Exec. Dir., Fin. Stability, Bank of Eng., Banking on the State, Presentation at the Fed. Reserve Bank of Chicago twelfth annual International Banking Conference on The International Financial Crisis: Have the Rules of Finance Changed? (Sept. 25, 2009)(transcript available at http://www.bis.org/review/r091111e.pdf)(explaining that the reason deposit insurance was introduced in the United States was to protect depositors from the bank runs experienced during the Great Depression).

[81] GOOGLE, https://www.google.com/search?q=definition+of+moral+hazard&aq=f&oq=definition+of+moral+hazard&aqs=chrome.0.57j62l2.6303&sourceid=chrome&ie=UTF-8 (last visited Feb. 5, 2013).

[82] GROSSMAN, *supra* note __, at 232-237, 240, 266 (outlining the numerous bank failures that occurred between 1873 and 1932 in contrast to how few occurred after that time).

success while the rest of the economy generally thrived. Such an arrangement cannot be replicated today, despite some calls to do so, because the financial sector has grown much larger and more complex. What can be emulated is the articulated quid pro quo established between banks and the government that assured that banks would do what the government needed them to do and the government fulfilled its promise of providing a safety net and restoring public trust in banking.

2. Civil Rights and the Social Contract for Equality

The social contract initiated during the great depression was amended during the Civil Rights Era to make the nation's banks responsive to the state's goals of racial equality. What the Civil Rights Era reforms added to this public-protecting conception of the government/banking relationship was that the social contract had to work to protect *all* members of the public, not just some. This amendment reinforced the relationship between the government and the banks initiated during the New Deal by simply expanding the public benefits that that relationship produced. In keeping with the goal of ensuring benefits to *the public*—as opposed to only some favored members of it—a new set of laws emerged, which increased access to credit by eliminating discrimination in lending and banking services.

There were over twenty civil rights reforms between 1968 and 1988 that declared and implemented citizens' "right" to bank without discrimination.[83] The largest and most important were the Fair Housing

[83] For examples, *see* Community Reinvestment Act, 12 U.S.C. § 2901 (1977)(stating that regulated banking institutions must show that they are meeting the credit need within the communities they do business, including low to moderate income community members); Fair Housing Act, 42 U.S.C. § 3604 (1968)(making it unlawful to discriminate when extending housing credit on the basis of "race, color, religion, sex, familial status, or national origin); Federal Trade Commission Improvement Act, 15 U.S.C. § 57a (1980)(gives the Federal Reserve the power to identify unfair practices, including discrimination, and construct regulations to prohibit and enforce against these unfair acts); Home Mortgage Disclosure Act, 12 U.S.C. § 2803 (1975)(requiring that depository institutions report the race, ethnicity, sex, and income of borrowers and applicants and the prices on these loans to ensure that discriminatory practices are not being pursued); Women's Business Ownership Act, 15 U.S.C. § 631 (1988)(affords women who own businesses protection against discrimination based on gender, such as

Act of 1968 ("FHA"), Equal Credit Opportunity Act of 1974 ("ECOA"), the Home Mortgage Disclosure Act of 1975 ("HMDA"), and the Community Reinvestment Act of 1977 ("CRA").[84] The civil rights reforms oblige banks to foster economic equality and to refrain from discrimination against customers or neighborhoods. These reforms focus on removing barriers to credit for people of color as well as low-income communities. This imposition of normative values on banks was premised on the importance of banking services to all members of all communities.

These reforms reflected both an extension of the civil rights legislation of the era as well as a response to market conditions. As the banking sector suffered competition from the capital markets in the 1970s and 1980s, banks increasingly shed lower income and minority customers and closed branches in low income neighborhoods in order to cut costs, a process called "redlining."[85] The effect was a cyclical decline due to lack of credit in these communities. Businesses left, people lost jobs, banks continued to close, and crime increased, accelerating the downward spiral.[86] Many of these communities have yet to recover from the exodus of businesses caused by bank departures that occurred during that era. The new laws were in part framed to induce banks to avoid business decisions that imposed negative externalities on already-disadvantaged people and communities, and thereby frustrated government's efforts to address historic discrimination.

In addition to market forces, there was also evidence of discrimination in lending.[87] If access to credit enables people to escape poverty, these anti-discrimination policies were meant to ensure that a portion of the population was not stunted economically from upward

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requiring a legitimate justification for denying credit); *see also* David A. Skeel, Jr., *Racial Dimensions of Credit and Bankruptcy*, 61 WASH. & LEE L. REV. 1695, 1706-1712 (2004).

[84] 42 U.S.C. §§ 3601-3619 (1968); 15 U.S.C.A. § 1691 (1974); 12 U.S.C.A. § 2801-2810 (1975); 12 U.S.C.A. § 2901-2909 (1977).

[85] JOHN P. CASKEY, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWNSHOPS AND THE POOR (1994).

[86] TRANSFORMING THE U.S. FINANCIAL SYSTEM: EQUITY AND EFFICIENCY FOR THE 21ST CENTURY 120 (Gary A. Dymski, Gerald Epstein & Robert Pollin eds., 1993).

[87] DANIEL IMMERGLUCK, CREDIT TO THE COMMUNITY: COMMUNITY REINVESTMENT AND FAIR LENDING POLICY IN THE UNITED STATES 65 (2004).

mobility.[88] The CRA coupled with several other civil rights era legislative acts were the first time the government explicitly mandated that banks take action in these communities and combat discrimination. When introducing the Senate Bill that would largely become the CRA in the Senate, Senator Proxmire, Chairman of the Senate Committee on Banking, Housing and Urban Affairs commented that the bill was based on a few "widely shared assumptions," including the assumption that "a public charter conveys numerous economic benefits and in return it is legitimate for public policy and regulatory practice to require some public purpose . . . ."[89] Later, the Chairman compared a bank charter to "a franchise to serve local convenience and needs" and suggested that "it is fair for the public to ask something in return."[90]

The mandate that banking should be free of discrimination persists today. The Department of Justice has recently brought charges and eventually settled several cases against banks under the Fair Housing Act and the ECOA for discrimination against minority borrowers. The justice department used the controversial theory of "disparate impact," which can establish wrongdoing even without evidence of intentional discrimination as long as it can be shown that minorities were statistically given inferior mortgages than whites with similar economic backgrounds.[91] The CFPB has also embraced the theory, stating "We

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[88] Geoffrey D. Korff, *Reviving the American Dream*, 113 PENN. ST. L. REV. 417, 437 (2008).

[89] Warren L. Dennis, *The Community Reinvestment Act of 1977: Its Legislative History And Its Impact On Applications For Changes In Structure Made By Depository Institutions To The Four Federal Financial Supervisory Agencies*,(U.S. Dep't of Hous. and Urban Dev., Working Paper No. 24, 1978), *available at* http://faculty.msb.edu/prog/CRC/pdf/wp24.pdf (Report presented to HUD).

[90] *Id.* This contention was not without opposition. Jonathan Macey and Geoffrey Miller who penned the most influential criticism of the CRA, contended that the CRA indeed inappropriately treats "depository institutions as some form of public utility that can be assessed to serve general social needs." Their argument was that if the government wants to subsidize the poor, it should do so directly and leave banks out of it. Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291, 296 (1993). They also claim that paradoxically, "financial services…can be afforded to low-income and moderate-income consumers by further deregulation in the financial services industry." *Id.*

[91] Charlie Savage, *Wells Fargo Will Settle Mortgage Bias Charges*, N.Y. TIMES. (July 12, 2012), http://www.nytimes.com/2012/07/13/business/wells-fargo-to-settle-mortgage-discrimination-charges.html; Charlie Savage, *Countrywide Will Settle a Bias Suit*, N.Y.TIMES, (Dec. 21, 2011), http://www.nytimes.com/2011/12/22/business/us-

cannot afford to tolerate practices, intentional or not, that unlawfully price out or cut off segments of the population from the credit markets."[92] The use of disparate impact analysis in the lending context sent shockwaves through the banking world.[93] This was not the first time the Justice Department has used disparate impact to enforce the ECOA, however. In 1994, the DOJ entered a consent decree with a Washington D.C. bank for ignoring African American communities in the D.C. area.[94] Regulators defend the use of disparate impact as a useful tool to prevent inequality in lending.[95]

The many laws catalogued here that require nondiscrimination in banking contrast starkly with the absence of comparable laws requiring general corporations to refrain from discrimination. Banking regulators see it as part of their mission to keep banking free from discrimination.

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settlement-reported-on-countrywide-lending.html.; U.S. DEPT. OF JUSTICE, OFFICE OF PUBLIC AFFAIRS, JUSTICE DEPARTMENT REACHES $21 MILLION SETTLEMENT TO RESOLVE ALLEGATIONS OF LENDING BY DISCRIMINATION BY SUNTRUST MORTGAGE (2012), *available at* http://www.justice.gov/opa/pr/2012/May/12-crt-695.html; MORTGAGE (2012), *available at* http://www.justice.gov/opa/pr/2012/May/12-crt-695.html; Complaint, United States of America v. Wells Fargo Bank, NA, No. 1_12CV01150, 2012 WL 2849496 (D.D.C. 2012), *available at* http://www.justice.gov/iso/opa/resources/951201271211371999513б.pdf (DOJ Wells Fargo complaint).

[92] *CFPB Embraces 'Disparate Impact' Theory of Discriminatory* Lending, AMERICAN BANKER (Apr. 18, 2012), http://www.americanbanker.com/video/cfpb-disparate-impact-discriminatory-lending1048536-1.html.

[93] Frank Keating, *ABA Statement on Department of Justice Use of 'Disparate Impact,'* AMERICAN BANKERS ASSOCIATION (July 12, 2012), http://www.aba.com/Press/Pages/071212DOJDisparateImpact.aspx (ABA asking DOJ to stop using disparate impact); U.S. DEPT. OF JUSTICE, OFFICE OF PUBLIC AFFAIRS, JUSTICE DEPARTMENT REACHES $335 MILLION SETTLEMENT TO RESOLVE ALLEGATIONS OF LENDING DISCRIMINATION BY COUNTRYWIDE FINANCIAL CORPORATION (2011), *available at* http://www.justice.gov/opa/pr/2011/December/11-ag-1694.html; Shannon Henry, *FDIC Offers Self-Testing Guide To Help Lenders Root Out Bias*, AMERICAN BANKER (Aug. 4, 1994), http://www.americanbanker.com/issues/159_74/-43181-1.html.

[94] Consent Decree, United States v. Chevy Chase Fed. Sav. Bank (D.D.C., Aug. 22, 1994), available at http://www.justice.gov/crt/about/hce/documents/chevychasesettle.php.

[95] James P. Scanlan, *'Disparate Impact': Regulators Need a Lesson in Statistics*, AMERICAN BANKER (June 5, 2012), http://www.americanbanker.com/bankthink/disparate-impact-regulators-need-a-lesson-in-statistics-1049886-1.html (highlighting "federal agencies' failure to recognize a fundamental statistical concept results in encouraging lenders to take actions that make them more likely targets for litigation.").

The FDIC states that it is "committed to expanding economic inclusion in the financial mainstream by ensuring that all Americans have access to safe, secure, and affordable banking services."[96] The FDIC makes clear that this guarantee applies only to banks and does not extend to other corporations or nonbanking services.[97]

The right to bank has been recognized in public policy much more so than the right to purchase most other consumer products or services. Equal access to credit has been an articulated and enforced tenet of the banking regulatory framework for more than 40 years. Enforcing non-discrimination in banking looks more like enforcing nondiscrimination in public utilities or common carriers, than in other areas of commerce, which the government leaves largely to market norms. The prevalence of these laws in banking does not mean that banks should be viewed as public utilities. However, they do show that the government views access to credit and banking services as an important right that should be provided to all citizens without unnecessary barriers. This has implications in forming the new social contract as outlined below.

C. Deregulation

Beginning in the late 1970s and 1980s, the banking sector started facing an identity crisis. After years of operating a safe and boring model dictated by the regulations imposed during the New Deal, the model seemed to be falling apart. Due to technological advances and financial innovation, capital markets and commercial paper markets started to offer safe and enticing alternatives to bank customers and banks quickly started to lose market share and profitability.[98] There was something of a

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[96] FDIC, WHAT IS ECONOMIC INCLUSION? (2012), http://www.economicinclusion.gov/whatis/.

[97] *Id.* ("Participation in the banking system also protects households from theft and reduces their vulnerability to discriminatory or predatory lending practices. In addition, households that use non-bank financial services providers do not receive the full range of consumer protections available through the banking system."); *see also Overview of Mortgage Discrimination*, FINANCIAL WEB: THE INDEPENDENT FINANCIAL PORTAL, http://www.finweb.com/mortgage/overview-of-mortgage-discrimination.html.

[98] FDIC, MANDATE FOR CHANGE: RESTRUCTURING THE BANKING INDUSTRY 7-23 (1987) [hereinafter FDIC, Mandate for Change]; Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, Statement Before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial

perfect storm that came together in the 1980s. In the same period, (1) some forms of deregulation (e.g. of airlines) generated popularity and success; (2) some forms of bank deregulation (e.g.. decreased controls on interstate banking) generated new competition that advantaged (at least in the short term) the general public; (3) the economy was humming, thus increasing public confidence in free-market forces; (4) new competitive pressures were being placed on banks (particularly through the availability of money market accounts, competition from foreign banks, and the increased accessibility and liquidity of the capital markets)[99]; and (5) the growth of political power of large business institutions including bank holding companies, created new opportunities for the exertion of pressure on lawmakers to go along with anti-regulatory demands.

The New Deal social contract proved to be outdated for the demands, speed, size, and complexity of modern finance. Slowly, banks and policymakers chipped away at the walls erected during the New Deal in the name of safety. This led first to regulators becoming more concerned with bank profitability than bank safety—a byproduct of the size and complexity of new financial institutions, and second, the changes led to an erosion of parts of the New Deal social contract.

Services, U.S. House of Representatives (Feb. 13, 1997), *in* 83 FED. RES. BULL. 249, 249 (1997)("[T]echnology already has resulted in a blurring of product and service-defining lines so dramatic as to make many financial products virtually indistinguishable from each other and the old rules inapplicable."); Congressman James A. Leach, Keynote Address at the Fordham Journal of Corporate and Financial Law Symposium: The Future of Law and Financial Services, *in* 6 FORDHAM J. CORP. & FIN. L. 9, 11 (2001)("Customers came to prefer and use new and more sophisticated products that, particularly in the banking industry, made many traditional banks irrelevant. . . . Banking was truly on a trend that might be described as "in eclipse," but even this is an understatement."); Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 304 (1987) ("[B]anks now face formidable competition in virtually every product or service they offer."); C. Todd Conover, Comptroller of the Currency, *Interstate Banking: Bringing Down the Walls*, 4 ANN. REV. BANKING L. 115, 117 (1985) ("[T]here is not a single service or product line today that is offered exclusively by commercial banks.").

[99] Grossman, *supra* note ___, at 260-262 (explaining the process of disintermediation that occurred during this time due to the interest rate caps on bank accounts and inflation and high interest from other sources).

1. Safety and Soundness v. Profitability

During this era of both growth and transformation in finance, banks needed to adapt in order to survive and remain profitable. Their safe lending and borrowing business could not keep them afloat anymore without more freedom to take risks and expand. Concerns about banks' profitability led to growing pressure to deregulate banks and allow them to compete more freely with other institutions.[100] The prevailing feeling was that banks could not effectively compete against these new products because regulations were holding them back.[101] In response, Congress passed seven Acts over the span of two decades which together effectively deregulated the banking industry.[102] Among other things, these Acts deregulated deposit interest rates, dismantled geographic restraints

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[100] Helen A. Garten, *Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age*, 57 FORDHAM L. REV. 501, 505-06 (1989)("The need to find new profit sources has been the most significant force behind deregulation of the banking industry."); Fischel et al., *supra* note __, at 304 ("[I]ncreased competition has substantially eroded, if not obliterated altogether, the effectiveness of much banking regulation."). The push for banking deregulation came from many directions, including the federal government, regulators, the banking industry, consumers, and scholars. KERRY COOPER & DONALD R. FRASER, BANKING DEREGULATION AND THE NEW COMPETITION IN FINANCIAL SERVICES 17-19 (1984); Garten, *supra* note __ at 502.

[101] See, e.g., FDIC, Mandate for Change 22 ("If banking companies are to maintain the earnings potential fundamental to their continued viability, they must have the opportunity to offer the products and services necessary to compete on even terms with their new competitors"); Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, Statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (Dec. 1, 1987), *in* 74 FED. RES. BULL. 91, 94 (1998); Garten, *supra* note __, at 507, 525 (noting that "many of the traditional tenets of bank regulation . . . have hindered banks in competing" and "[b]y imposing restrictions on the products and services that banks could offer . . . traditional regulation kept banks from competing with these new entrants").

[102] Gramm-Leach-Bliley Financial Modernization Act, Pub L. No. 106-102, 113 Stat. 1338 (1999); Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (1994); Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (1991); Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (1989); Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552 (1987); Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (1982); Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980); *see also* Arthur E. Wilmarth, *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215 (2002)(explaining the shifts in banking during this time).

on bank expansion, repealed Glass-Steagall barriers between banking and securities activities, and allowed the formation of large financial institutions.[103] The slow demise of the Glass Steagall Act brought with it more powerful and profitable banks. But that was the point. Regulators were admittedly trying to do anything in their power to make banks profitable again, even if it meant allowing concentrations of power or conglomeration. As long as the venture was profitable, it was viewed as a positive as far as the regulators were concerned.[104]

This deregulation reflected an underlying shift in thinking about banks. Safety and soundness concerns were relegated behind profitability.[105] This shift occurred partly because the regulatory tools of the past (interest rate caps and activity restrictions) aimed at ensuring bank safety were no longer warranted. Due to disintermediation,[106] banks were rapidly losing market share and these restrictions exacerbated them. The regulators had to adjust their strategy to help banks remain safe and profitable. However, during this adjustment, the regulatory philosophy also changed such that along with lifting onerous and outdated restrictions, regulators also abandoned previous banking policy goals,

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[103] RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 24 (Vicki Been et al. eds., 4th ed. 2009).

[104] O.C.C. Interpretive Letter No. 1101, reprinted at 2008 WL 3274067 (2008), *available at* http://www.occ.gov/static/interpretations-and-precedents/jul08/int1101.pdf; Saule T. Omarova*, The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking",* 63 U. MIAMI L. REV. 1041, 1090 (2009); HOFFMAN, *supra* note ___, at 241.

[105] *See* Garten, *supra* note __, at 541 (analogizing the shift of banking regulatory strategy to the different perspectives of corporate debtholders and equityholders—the debtholder/old banking regulation is more concerned with safety and soundness while the equityholder/new regulation is more concerned with profitability); Anthony Saunders, *Bank Holding Companies: Structure, Performance, and Reform*, *in* RESTRUCTURING BANKING AND FINANCIAL SERVICES IN AMERICA 156, 172 (William S. Haraf & Rose Marie Kushmeider eds., 1988); Diamond & Dybvig, *supra* note ___, at ___. For a comprehensive analysis of how the OCC supplanted safety and soundness concerns for profitability in allowing risky derivative transactions, see generally, Omarova, *supra* note ___.

[106] Disintermediation describes the elimination of financial intermediaries, such as banks, resulting from high inflation rates and stagnant interest offered by banks (due to regulatory caps). Depositors can get better returns by investing in mutual funds or securities and thus banks lose customers and revenue.

such as avoiding concentrations of power.[107] In addition, the shifting focus to bank profitability allowed risky behavior that was profitable in the short term, but systemically destabilizing in the long term. Perhaps most importantly, regulators fought the idea that banks were "special" in the way that they had been in the past.[108]

To be clear, deregulation was not viewed as supplanting or abrogating safety and soundness concerns. Quite the opposite, regulators felt that in order to protect bank safety, they needed to assure their profitability. In fact, profitability became of such paramount concern that many today view safety and soundness as synonymous with profitability.[109] But profitability was not the measure of safety and soundness in the previous half a century. Rather, safety was defined by reference to vulnerability or exposure to excessive risk. During deregulation, bank profitability became a proxy for safety and soundness. Therefore, bank regulators shed regulations that threatened profitability. The OCC for example, through interpretive letters, allowed banks to engage in highly risky derivatives transactions without examining the risks involved by instead emphasizing the potential profits of the venture.[110] However, these "profitable" transactions were laden with risks and have since exposed many banking institutions to heightened vulnerability. The sheer size of the derivatives market is also staggering as the industry now dwarfs the

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[107] *See e.g.*, FDIC, Mandate for Change 137-142. Undoubtedly, increased geographic expansion and relaxed limits on bank mergers would cause conglomeration. Yet these moves were encouraged by regulators in order to allow banks to compete. The slow demise of the Glass-Steagall Act would also bring with it more powerful and profitable banks. But that was the point. Regulators were admittedly trying to do anything in their power to make banks profitable again, even if it meant allowing concentrations of power or conglomeration. Wilmarth, *supra* note ___, at 241.

[108] For the original debate on the "specialness" of banking, compare E. Gerald Corrigan, *Are Banks Special?*, 1982 FED. RES. BANK MINNEAPOLIS ANN. REP. 2, available at http://www.minneapolisfed.org/pubs/ar/ar1982a.cfm with Richard C. Aspinwall, *On the "Specialness" of Banking*, 7 ISSUES IN BANK. REG. 16 (1983). Though remnants of the debate still remain, the view that banks are not special largely won out. Eric J. Gouvin, *Of Hungry Wolves and Horizontal Conflicts: Rethinking the Justifications for Bank Holding Company Liability*, 1999 U. ILL. L. REV. 949, 961 (1999).

[109] Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 90 (2008), ("[Banking] agencies are designed with a primary mission to protect the safety and soundness of the banking system. This means protecting banks' profitability.").

[110] Omarova, *supra* note ___, at ___.

size of the nation's capital markets and GDP.[111] Regulators saved banking by allowing banks to become profitable and compete with nonbanks, but the focus on profitability did not shift once it became apparent that profitability is not always synonymous with safety.

For example, during the Savings and Loan crisis of the 1980s and 1990s, regulators continued to deregulate the industry with the hope that if troubled S&Ls could engage in more expansive and riskier activities, they could regain profitability and recover their losses. The strategy, termed "gambling for resurrection,"[112] was indicative of the regulatory philosophy of the time. Many blamed the industry's lack of profitability on onerous regulation and advocated deregulation so that S&Ls could compete with other market entities on an even playing field.[113] It was thought that regulations were impeding profitability and their safety could only be achieved through competition. This did not come to pass. Instead, deregulation caused many of the most unscrupulous characters in the financial world to flock to S&L ownership and use them as private piggy banks insured by the government.[114] The eventual colossal failure of the industry cost the government upwards of $125 billion of tax-payer funds.[115]

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[111] *It's A (Not So) Small World, After All*, EQUITAS, CAPITAL ADVISORS, LLC, http://www.equitas-capital.com/2012/research/its-a-not-so-small-world-after-all/.

[112] GROSSMAN, *supra* note ___, at 270 (*citing* James R. Barth, Philip F Bartholomew & Carol J. Labich, *Moral Hazard and the Thrift Crisis: An Analysis of 1988 Resolutions*, Proceedings of a Conference on Bank Structure and Competition (May 3-5, 1989)(Federal Reserve Bank of Chicago), p. 25)).

[113] Fred E. Case, *Deregulation: Invitation to Disaster in the S&L Industry*, 59 FORDHAM L. REV. S104-S105 (1991)("The FHLBB did little to enlighten the debates over deregulation because it quickly chose to advocate deregulation under the influence of its politically appointed chairmen. [T]he deregulation concept was adopted first and most enthusiastically by FHLBB Chairman Preston Market, and was promoted in varying degrees by succeeding chairmen.")

[114] FDIC, *supra* note 76, at 168-188, 173, 178-79 (in Chapter Four: The Savings and Loan Crisis and Its Relationship to Banking).

[115] *Id.* at 187 (*citing* FINANCIAL CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 36 (2011), http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf).

2. Erosion of the Social Contract

In addition to supplanting safety and soundness concerns with profitability, concerns about consumer protection and access to credit were also compromised during this era. For example, the Office of the Comptroller (OCC) and the Office of Thrift Supervision (OTS) announced comprehensive preemption to protect all national banks and thrifts from state consumer protection laws. The rationale was that these public-protecting laws rendered banks less efficient and profitable by limiting the kinds and amounts of loans that these banks could make.[116] Access to credit was also diminished during this e as community banks, thrifts, and credit unions were forced to compete with the large banking sector. These banks either closed or changed their public-serving mission during this time, withdrawing from underserved communities in search of higher profits.[117]

Ultimately, this period of deregulation resulted in an asymmetrical erosion of the social contract with banks. The revisions abrogated many of the safety and soundness regulations and public-serving obligations imposed on banks, but did not take away the government safety net, such as FDIC Insurance and access to the Fed Discount window. To be fair, many bankers and supporters of deregulation advocated for a complete market model and an imposition of market discipline without any government support.[118] However, policymakers, wary of the bank failures so common prior to FDIC insurance, continued to support government insurance. Thus, a lop-sided arrangement was forged between banks and the state and continued until it was fully tested in 2008.

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[116] U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 2, 7, http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.; O.C.C. Interpretive Letter No. 999, reprinted at 2004 WL 3418860, *available at* http://www.occ.gov/static/interpretations-and-precedents/aug04/int999.pdf.

[117] Baradaran, *supra* note ___, at 42, 48, and CASKEY, *supra* note ___, at 8, 91.

[118] Arthur J. Rolnick, *Too Big to Fail: Market Discipline as a Regulator of Bank Risk*, FEDERAL RESERVE BANK OF MINNEAPOLIS, http://www.minneapolisfed.org/publications_papers/studies/tbtf/market.cfm?.

To maintain profitability, several bedrock principles of banking policy were sidelined. First, the principle of avoiding concentrations of power was abandoned, despite its centrality to Jefferson and Brandeis' fears and its recognition as a guiding principle of several acts of banking legislation.[119] Geographic expansion and bank mergers were encouraged by regulators to allow banks to compete. Second, the separation of banking and commerce was also mostly deserted.[120] Strict separation of commerce and banking within the banking structure gave way to more "competitive" and "efficient" structures that increased complexity and opacity in banking. Slowly, the "Thou Shalt Not's" of Glass Steagall were replaced with a more fluid system that depended on firms' internal models of risk weighing.[121] Regulation in this area became increasingly complex, but the strong drift was in the direction of more flexibility and discretion in enforcing standards.[122]

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[119] One purpose of both the Bank Holding Company Act and the Glass Steagall Act was to avoid concentrations of power. Saule T. Omarova & Margaret E. Tahyar, *That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States*, 31 REV. BANKING & FIN. L. 113, 132 (2011); Carol Conjura, Independent Bankers Association v. Conover*: Nonbank Banks Are Not in the Business of Banking*, 35 AM. U. L. REV. 429, 476 n. 1 (1986)("Congress' primary purpose in enacting the BHCA was to … prevent concentrated control over commercial bank credit. Glass-Steagall Act, ch. 89, 48 Stat. 162 (1933)(codified as amended in scattered sections of 12 U.S.C.); *see* S. REP NO. 1095, 84th Cong., 2d Sess. 1-2, *reprinted in* 1956 U.S.C.C.A.N. 2482, 2482-83 (stating that Congress intended to safeguard against undue concentration in control of banking activities).").

[120] Mehrsa Baradaran, *Reconsidering the Separation of Banking and Commerc*e, 80 GEO. WASH. L. REV. 385, 427-428 (2012); Arthur E. Wilmarth, Jr., *Wal-Mart and the Separation of Banking and Commerce*, 39 CONN. L. REV. 1539, 1550, 1569 (2007); Omarova, *supra* note ___, at 1090, 1094.

[121] Andrew G. Haldane, Exec. Dir., Fin. Stability and member of the Fin. Policy Comm., & Vasileios Madouros, Economist, Bank of Eng., Speech Delivered at the Federal Reserve Bank of Kansas City's 36th Economic Policy Symposium: The Dog and the Frisbee 18 (Aug. 31, 2012) (transcript available at http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech596.pdf).

[122] *Id.* at 6-7 (explaining the growing complexity of banking regulation); Mark S. Weisman, Ann M. Dougherty, *Banks and Bank Holding Companies: Going for Brokerage Under Glass-Steagall*, 4 ANN. REV. BANKING L. 315, 320 (1985)("[New securities instruments] challenged the regulators to exceed the bounds of historical definitions that were previously used to determine the scope of Glass-Steagall's prohibitions so that banks would be able to keep pace with competition in an evolving marketplace. Although the language and legislative history of Glass-Steagall both demonstrate that Congress intended to leave little discretion to regulators, recent interpretations by the

The results of these reforms set the stage for calamity. For several decades, banks became very profitable and the financial world grew exponentially as barriers were removed. Even so, bank failures started to occur much more commonly during the deregulatory era. Empirical research finds that "the probability of a banking crisis occurring was similar during 1880-1913 and 1973-1997…and essentially zero during 1945-1971."[123] Then came the financial crisis of 2008. This crisis was the culmination of two decades of bank deregulation. But the response to the crisis was not the response that would match the deregulatory philosophy. Instead of allowing the market to enforce its discipline and allow banks to fail, as was dictated by the repudiation of the social contract, the government stepped in and bailed out the banking industry.

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The 1980s brought, in effect, an abandonment of both the conceptual vision of banks as inextricably bound to the state and the practical emphasis on steady and conservative (and thus public-protecting) approaches to banking regulation that took hold after the Depression.[124] During this timeframe, which spanned the mid-1970s until the crisis of 2008, bankers agitated to be relieved of certain aspects of the social contract.[125] Banks asked to be freed from onerous government restrictions. They sought to be treated more like ordinary corporations and less like public utilities. They got what they wanted for the most part as many century-old restrictions on operations were abandoned. At best,

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OCC and Board have attempted to limit the original scope of these prohibitions." [The authors explain the functional and contextual approaches to regulation developed in the 1980s.] "This approach, however, 'invites an individualized definitional process under the Act and endorses, *de facto*, a substantial degree of administrative agency discretion to apply the Act on the basis of changed situations and evolving circumstances.'")(*quoting* Pitts and Williams*, The Glass-Steagall Act: Key Issues for the Financial Services Industry,* 11 SEC. REG. L.J. 234 (1983)).

[123] Michael Bordo, Barry Eichengreen, Daniela Klingbiel & Maria Soledad Martinez-Peria, *"Is the Crisis Problem Growing More Severe?"* ECONOMIC POLICY 32: 53-82 (Apr. 2001).

[124] For a thorough account of the changes that occurred during the deregulatory era including conglomeration, increased risk, and reduced regulatory oversight, see Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks,* 2002 U. ILL. L. REV. 215, 476.

[125] *See* discussion *infra* Part V.A.

deregulation brought mixed, and some would say, disastrous results.[126] Banks started to fail in high pre-depression numbers.[127]

The bank deregulation that took hold in the 1980s was not just an experiment in the ongoing effort to find the right balance of government involvement in private markets as conditions change over time. Rather, it reflected a foundational shift from both the conceptual and the practical understanding of banking that has run through our nation's history. To be sure, this program of deregulation might have been driven by a public-regarding effort to help society as a whole by increasing bank competitiveness, fostering the development of new bank products, generating expanded capital formation, and increasing economic efficiency. But in all of this, policymakers lost their way because they lost sight of the special social contract that must exist with banks.

The above history makes the case that there has been a social contract between the government and its banks. This arrangement has evolved with the needs of the nation as well as the economy. The basic outline of the social contract has been that in exchange for protection from the state, banks would provide economic services to meet certain public needs. Below, the article will explore the present day social contract. First, I will define why such a social contract does and should exist

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[126] Patricia A. McCoy, et al., *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327, 1329 (2008)(explaining that the secondary markets existed since the 1980s but that it was the deregulation and the lax enforcement of the regulation that remained that caused the financial crisis); *see also* L. Randall Wray, *Lessons from the Subprime Meltdown* 53 (Levy Econ. Inst., Working Paper No. 522, 2007)(stating that the financial crisis is a prime example of the damage deregulation can cause). *See, e.g.,* Anthony Faiola et al., *What Went Wrong,* WASH. POST, Oct. 15, 2008, at A1 (arguing that financial regulators' lack of sufficient oversight and deregulatory policies contributed to the financial collapse); Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy,* N.Y. TIMES, Oct. 9, 2008, at A1 (discussing the possibility that the financial crisis could have been avoided if Alan Greenspan has exercised more oversight of certain firms and financial products.). Even Alan Greenspan, former Chairman of the Board of Governors of the Federal Reserve and a former proponent of deregulation, has admitted that some of the assumptions of deregulation may have been flawed. *See* Alan Greenspan, *We Will Never Have a Perfect Model of Risk,* FIN. TIMES (London), Mar. 17, 2008, at 13.

[127] "The probability of a banking crisis occurring was similar during 1880-1913 and 1973-1997, approximately double this rate during the turbulent interwar period of 1919-1939, and essentially zero during 1945-1971." GROSSMAN, *supra* note ___, at 266 (*citing* Bordo et. Al. (2001)).

today—why banks and the government still need each other. Second, I will make the case that the safety net that exists today was not meant to support the large banks that currently dominate the market. And finally, I will propose that either the banking structure should be modified to match the safety net provided or a new social contract should be forged—one that recognizes safety and soundness, consumer protection, and access to credit as its principal tenets.

II. DEFINING THE SOCIAL CONTRACT

This section provides the justification for enforcing a social contract between banks and the state. The state needs banks to perform specific functions that enable trade and commerce. Banks, in turn, need both government recognition and a safety net to gain costumer trust. The government safety net involves a permanent system that provides insurance and liquidity for banks to enable them to withstand economic stress and customer runs. This part of the safety net has operated without much controversy since the Great Depression.

The second part of the government safety net is a more recent phenomenon and involves discretionary emergency bailouts.[128] Though new, bailouts are likely to continue because their primary recipients are the largest U.S. banks that control the majority of banking assets and whose failures would cause many problems. Their status as likely bailout recipients is demonstrated in their epithet, Too Big To Fail (TBTF). This section makes the claim that the full government safety net needs to be accounted for in constructing a social contract suited for the modern banking world.

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[128] Gretchen Moregenson, *One Safety Net that Needs to Shrink*, N.Y. TIMES, Nov. 3, 2012, http://www.nytimes.com/2012/11/04/business/one-safety-net-that-needs-to-shrink.html (discusses how Dodd-Frank "widened the federal safety net" by allowing several clearinghouses the authority to have access to the Federal Reserve's fund in a period of crisis); *Harry's Bank Bailout: How Long do Bankers Expect to Rely on a 'Temporary' Rescue Plan?*, WALL ST. J., Dec. 10, 2012, http://online.wsj.com/article/SB10001424127887324478304578171742093199244.html.

A. The State Needs Banks

Basic economics explains why government needs a well-functioning banking sector. Adam Smith, in *Wealth of Nations* declares "It is not by augmenting the capital of the country, but by rendering a greater part of that capital active and productive than would otherwise be so, that the most judicious operations of banking can increase the industry of a society."[129] Joseph Schumpeter calls the banker "the Ephor[130] of the exchange economy…. [The banker] stands between those who wish to form new combinations and the possessors of productive means. He is essentially a phenomenon of development."[131] Banks create money[132]and credit[133] as they turn consumer deposits into loans. There is even evidence that banking activity not only enables but spurs real economic development.[134]

Banks facilitate efficient trade and transaction-making and enable the flow of resources across the economy. Banking is also the medium through which the government, through the Federal Reserve, can implement fiscal and monetary policy.[135] Therefore, the government needs banks to have a stable-growth economy, credit accessibility and

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129 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 191, 394 (Hayes Barton Press 2001) (1776).

130 "[O]ne of five ancient Spartan magistrates having power over the king." *Ephor Definition*, MERRIAM-WEBSTER.COM,, http://www.merriam-webster.com/dictionary/ephor.

131 JOSEPH A. SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT: AN INQUIRY INTO PROFITS, CAPITAL, CREDIT, INTEREST, AND THE BUSINESS CYCLE 74 (Transaction Publishers 1983).

132 JOHN HICKS, A THEORY OF ECONOMIC HISTORY 78, 94-97 (Oxford University Press 1969).

133 HENRY THORNTON, AN ENQUIRY INTO THE NATURE AND EFFECTS OF THE PAPER CREDIT OF GREAT BRITAIN [1802] 176 (Frank Cass & Co Ltd 1962) (1939).

134 GROSSMAN, *supra* note ___, at 7-9.

135 Y. Nancy Ni, *The Federal Reserve's Multi-Faceted Response to the Credit Crisis*, 27 REV. BANKING & FIN. L. 240 (2008). The Federal Reserve requires national and state-member banks to hold liquidity reserves (currency) at the Federal Reserve. By requiring a higher percent reserve, it can effectively destroy money circulating in the economy, thereby limiting inflation. CARNELL ET AL., *supra* note ___, at 50. The Federal Reserve's use of banks to create and destroy money provides monetary, and thereby economic, stability. BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE FEDERAL RESERVE SYSTEM: PURPOSES AND FUNCTIONS, MONETARY POLICY AND THE ECONOMY, http://www.federalreserve.gov/pf/pdf/pf_2.pdf.

uniform monetary policy.[136] Moreover, banks operate with heightened leverage and their failure is much more problematic than that of other businesses because of systemic risk and monetary supply concerns.[137] Thus, the state has an interest in ensuring against this failure—an interest that doesn't exist for other commercial entities. Governments protect banks because they need them to be stable.

The 1980 and revised 2001 essays "Are Banks Special?" prepared by Gerald Corrigan, former Chairman of the Federal Reserve of New York, place banks at the center of the economy and justify stringent supervision of banks because of their unique status as intermediaries.[138] He proposed three characteristics that made banks "special." First, they issue transaction accounts (i.e., they hold liabilities that are payable on demand at par and that are readily transferable to third parties). Second, they are the backup source of liquidity for all other institutions, financial and nonfinancial. Third, they are the transmission belt for monetary policy.[139] As Corrigan points out, the functions of a bank are too important for banks to be regulated like other market entities.[140] In his essay, Corrigan states that "the presence of the public safety net implies *unique public responsibilities* on the part of banks."[141]

B. Banks Need Governmental Support

Banks invest in long-term, illiquid assets (i.e. loans) and pay for these assets using short-term liabilities (i.e. deposits). Banks provides businesses and individuals with production-driving liquidity by investing in their illiquid assets. This structure exposes banks to runs. Banks rely on the statistical probability that not all depositors will seek to reclaim

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[136] John L. Douglas, *The Role of a Banking System in Nation-Building*, 60 ME. L. REV. 511, 512, 529 (2008) (stating that banks are integral to any nation and a growing economy).

[137] CARNELL ET AL., *supra* note ___, at 43-47.

[138] Gerald Corrigan, *Are Banks Special*, FED. RES. BANK OF MINNEAPOLIS ANNUAL REPORTS (1982), http://www.minneapolisfed.org/pubs/ar/ar1982a.cfm. Corrigan, in articulating this point, was reacting to the market pressure to deregulate banks and was attempting to make a stand against those who claimed that banks should be treated like corporations.

[139] *Id.*

[140] *Id.*

[141] *Id.*

their funds at one time. But public fears of bank insolvency can sometimes erode depositor trust, causing runs and potentially a bank's bankruptcy. Banks have used various tactics throughout their history to appear trustworthy to their customers who need to be induced to place their hard-earned money in a bank's care. Early banks would display their specie, i.e. gold, for all to see or open the vault door to reveal their piles of currency or build marble buildings and gold safes to give the appearance of unlimited funds.[142] Some art history literature suggests that many banks are made to look like Greek temples to create the appearance that they have always been and always will be.[143] For many years after the Great Depression, banks discouraged their employees from working at night lest the public perceive trouble at a bank.[144] Bankers understood that bank runs were not a result of actual insolvency, but the result of fear, perceived insolvency, or even another bank's failure. Even the safest bank could experience a run if the public's confidence faltered.[145] Therefore, public perception of the safety of banks is the lynchpin to a successful banking sector.

How does the banking system secure public confidence? Through government sponsorship and financial support. The currency of banks is trust. The monetary system falls apart when trust is lacking. Diminished trust in the banking system and in the ability of banks to honor contracts and credit agreement leads to diminished lending and catastrophic financial consequences. An important element of the public's trust in the banking system derives from the public's knowledge that banking is heavily regulated and overseen by the government. People trust banks because they know that the government watches over them closely—for example, that the FDIC inspects banks and enforces regulations. In addition, the government provides a safety net to struggling banks.[146]

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[142] Niall Ferguson, THE ASCENT OF MONEY: A FINANCIAL HISTORY OF THE WORLD (2008).

[143] Jeffrey Sklansky, *"A Bank on Parnassus": Nicholas Biddle and the Beauty of Banking*, COMMON-PLACE (Apr. 2006), http://www.common-place.org/vol-06/no-03/sklansky/

[144] CARNELL ET AL., *supra* note __, at 46.

[145] *Id.*; Diamond & Dybvig, *supra* note ___, at 402.

[146] HEIDI MANDANIS SCHOONER & MICHAEL W. TAYLOR, GLOBAL BANK REGULATION 51-71 (2010).

This is the primary reason that the government bailed out the banking system: to restore trust in the nation's banks.

The government uses several methods to instill public trust in the banking sector. Some are day-to-day measures, such as oversight and deposit insurance and some are emergency measures used during times of systemic failure. The various components of the standard and emergency safety net for banks are outlined below. They include deposit insurance, Federal Reserve liquidity support, and bailouts.

1. Deposit Insurance

Perhaps the most direct way banks have garnered consumer trust is through government guarantees. Deposit insurance started in the U.S. on the state level in 1829,[147] but it wasn't until the Great Depression that the federal government, through the FDIC began to insure bank deposits against losses.[148] Deposit insurance immediately reduced bank runs without interfering with the banks' asset liability structure.[149] By removing depositor's fear of loss, deposit insurance effectively eliminates any incentive they might have to withdraw their funds before they are needed.[150] Moreover, deposit insurance reduces systemic risk caused by a lack of confidence in the entire banking industry during times of economic distress.[151]

Federal insurance has also been more effective than either state or private deposit insurance. Private insurance schemes have not been attempted on a large scale and have not been successfully implemented on a small scale.[152] Economists Diamond and Dybvig, in their seminal

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[147] GROSSMAN, *supra* note ___, at 104 (*citing* Calomiris and Bodenhorn).
[148] Diamond & Dybvig, *supra* note ___, at 415.
[149] *Id.* at 402.
[150] *Id.* at 415; Cynthia Lichtenstein, *Defining Our Terms Carefully and in Context: Thoughts on Reading (and in One Case, Rereading) Three Books*, 31 REV. BANKING & FIN. L. 695, 708 (2012).
[151] Diamond & Dybvig, *supra* note __, at 404.
[152] *Id.* at 413, 416; Michael Quint, *About 10% of Credit Unions are Privately Insured*, N.Y. TIMES, Jan. 3, 1991, http://www.nytimes.com/1991/01/03/business/about-10-of-credit-unions-are-privately-insured.html?pagewanted=all&src=pm; JANET LUNDY & BENJAMIN D. FINDER, COST SHARING FOR HEALTH CARE: FRANCE, GERMANY, AND SWITZERLAND 1-20 (The Henry J. Kaiser Family Foundation, Jan. 2009).

work on deposit insurance, conclude that deposit insurance is best administered by the government and that "competitive markets cannot provide this liquidity insurance"[153]for a variety of reasons, but especially because "private insurance company is constrained by its reserves in the scale of unconditional guarantees which it can offer."[154] State insurance funds have also been unsuccessful. Several states have tried to implement deposit insurance systems, but none were able to survive a systemic crisis.[155] The Federal Deposit Insurance Fund (FDIC) has an advantage over state schemes because of its larger size and its ability to access liquidity through the Treasury Department and the Federal Reserve.[156]

It is of course possible to have a banking system that does not rely on deposit insurance—one that is closer to a free market ideal. Even today, some industry observers continue to denounce deposit insurance.[157] These free-market advocates would like to see the momentum of the deregulatory era accelerated and fully actualized. Removing deposit insurance, they claim, reduces moral hazard because it allows for market discipline.[158] Removing government support from the banking system would certainly eliminate the moral hazard issues and possibly reduce some of the inefficiencies in banking that excess regulation has caused. But this arrangement would be a reversal of a century-old banking framework. It would be a new relationship altogether—similar to the one that corporations generally have with the State—they are taxed and regulated to prevent harm to consumers, but not protected by the state in the same way as banks. This is not to say that such an arrangement

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153 Diamond & Dybvig, *supra* note __, at 403.
154 Diamond & Dybvig, *supra* note __, at 413, 416.
155 CARNELL ET AL., *supra* note __, at 18; *see also* GROSSMAN, *supra* note ___, at 104-105, 240-241 (explaining that although several states set up deposit insurance schemes in the 1800s and 1900s, "each ran into difficulty with the decline in agricultural prices in the 1920s, and either collapsed or became inoperative.").
156 Laura Bruce, *How the FDIC Pays for Bank Failures*, BANKRATE.COM, (Oct. 16, 2008), http://www.bankrate.com/finance/savings/how-the-fdic-pays-for-bank-failures-1.aspx (discussing FDIC's authority to borrow from the Treasury Department in the event the FDIC fund goes negative).
157 John A. Allison, *The Cure for the Banking Industry, Part II: More Private Capital, Less Public Risk*, AMERICAN BANKER (Sept. 25, 2012), http://www.americanbanker.com/bankthink/cure-for-banking-industry-part-two-more-private-capital-less-public-risk-1052773-1.html.
158 Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L. J. 193, 208 (2008).

could not be attempted again and perfected, but it would be a marked departure from the banking policy of this country. Most observers agree, however, that deposit insurance is the best way to keep the banking sector stable and reliable.[159] Indeed, every developed country has a deposit insurance scheme in place.[160]

And while this article makes the case for a renewed and well-defined social contract, some have suggested that in the case of deposit insurance, ambiguity of the terms of the contract is preferable. For example, a fire insurer will require the insured home to install smoke detectors in order to minimize moral hazard.[161] But in the absence of a working smoke detector, moral hazard could also be significantly reduced if a homeowner were not certain that the insurer would compensate for losses if the house were destroyed. Historically, the relationship between the bank and its insurer has not been clearly defined with some contending that this "constructive ambiguity" in which "a rescue is by no means certain, can help alleviate moral hazard."[162] This argument certainly justifies ambiguity of terms for small and mid-sized banks that go through the FDIC resolution process and are not assured survival. In other words, many small and mid-sized banks have been allowed to "burn." However, as I demonstrate below, failures of large banks have not been as prevalent. Indeed, bailouts of large firms are increasingly understood to be inevitable, which makes it very difficult to reduce moral hazard by relying on uncertainty. Therefore, a better approach with these large banks for which moral hazard run high is to be clear on what their obligations are—better to install working smoke detectors because the rescue is likely and expensive.

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[159] Ash Demirguc-Kunt & Enrica Detragiache, *Does Deposit Insurance Increase Banking System Stability?: An Empirical Study* (revised Apr. 2000), http://siteresources.worldbank.org/INTFR/Resources/475459-1108066643741/asli_enrica.pdf ("…the impact of deposit insurance on bank stability tends to be stronger the more extensive is the coverage offered to depositors, where the scheme is funded, and where the scheme is run by the government rather than by the private sector.").

[160] Haldane, Banking on the State, *supra* note ___.

[161] GROSSMAN, *supra* note ___, at 85.

[162] *Id.* at 85-86

2. Federal Reserve Liquidity Support

Struggling banks are also given government support in their day-to-day operations. The Federal Reserve provides favorable term rates to banks in distress to alleviate their temporary liquidity problems.[163] The Federal Reserve can provide this support to banks by providing an antidote to bank runs through its discount window.[164] To meet the needs of its creditors, banks would otherwise have to sell their illiquid assets at a substantial discount, or a "fire sale," often accelerating a bank's decline. The discount window can prevent this slide into insolvency by providing liquidity as a lender of last resort.[165] Instead of the bank selling its assets at liquidation prices, it can borrow from the Federal Reserve discount window and present its assets (subject to Federal Reserve approval) as collateral, usually at a "haircut."[166] Therefore, the Federal Reserve can provide otherwise unavailable capital assistance in times of systemic stress, thus effectively subsidizing the banking sector.[167] When other corporations experience financial distress or failure, they also need credit

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[163] The Federal Reserve discount window gives loans to banks that are secured by collateral, such as government securities or other high-quality debt. The Fed also discounts eligible paper at low rates approved by the Fed. *See* FED. RESERVE SYS. STUDY GRP. ON ALT. INSTRUMENTS FOR SYS. OPERATIONS, FED. RESERVE SYSTEM, ALTERNATIVE INSTRUMENTS FOR OPEN MARKET AND DISCOUNT WINDOW OPERATIONS app.3.A at 29 -33 (2002), *available at* http://www.federalreserve.gov/boarddocs/surveys/soma/alt_instrmnts.pdf.

[164] The Federal Reserve's discount window "allows eligible institutions to borrow money from the central bank, usually on a short-term basis, to meet temporary shortages of liquidity caused by internal or external disruptions. The term originated with the practice of sending a bank representative to a reserve bank teller window when a bank needed to borrow money." *Discount Window*, WIKIPEDIA, http://en.wikipedia.org/wiki/Discount_window (last visited Feb. 2, 2013, 6:58PM); Diamond & Dybvig, *supra* note __, at 414.

[165] Haldane, *supra* note ___.

[166] A "haircut" is a discount applied informally to the market value of a firm's collateral in order to account for the risks of the loan. *The Federal Reserve Discount Window,* FEDERAL RESERVE DISCOUNT WINDOW, PAYMENT SYSTEM RISK (last updated July 21, 2010), http://www.frbdiscountwindow.org/discountwindowbook.cfm?hdrID=14&dtlID=43#introduction (a haircut requires that the collateral to be worth more than the credit extended providing oversecurity of the debt).

[167] This support creates a significant moral hazard. *See, e.g.,* SCHOONER & TAYLOR, *supra* note ____, at 60-66 ("The moral hazard is that the insured will allow him or herself to incur greater losses knowing that a third party is footing the bill."); Cheryl D. Block, *Measuring the True Cost of Government Bailout*, 88 WASH. U. L. REV. 149, 180 (2010).

and they often get it through Chapter 11 or other bankruptcy restructuring. However, the credit they receive is given at a higher than normal interest rate. The discounted rates banks receive give them a subsidy as compared to other firms.

In the event of industry wide strain, the Federal Reserve creates an additional safety net by providing liquidity to banks.[168] This window was used often by the largest banks during the recent crisis. The Federal Reserve lent upwards of $12 billion to struggling banks during this time to alleviate the credit crunch.[169]

3. Bailouts

In addition to the permanent bank safety net, governments bail out banks in times of emergency. Some bailouts of the nation's banks have occurred through formal measures, such as TARP, which I address below. But authorities can use "soft" bailout strategies as well. In 2008, for example, the Federal Reserve established several lending facilities pursuant to its emergency statutory power under 13 (3) of the Federal Reserve Act.[170] These programs significantly expanded the federal safety net because several of them, including the largest, Term Securities Lending Facility (TALF), were designed to grant nonbanks (or non-depository financial institutions) access to the Federal Reserve's liquidity

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[168] During the recent crisis, the Federal discount window was opened to both banks as well as shadow banks that needed the liquidity to avoid failure. *The Federal Reserve's 'Breathtaking' 7.7 Trillion Bank Bailout*, THE WEEK (Nov. 28, 2011), http://theweek.com/article/index/221883/the-federal-reserves-breathtaking-77-trillion-bank-bailout.

[169] Bob Ivry et al., *Secret Fed Loans Gave Banks $13 Billion Undisclosed to Congress*, BLOOMBERG (Nov. 27, 2011), http://www.bloomberg.com/news/2011-11-28/secret-fed-loans-undisclosed-to-congress-gave-banks-13-billion-in-income.html.

[180] 12 U.S.C. § 343 (2006); *Credit and Liquidity Programs and the Balance Sheet: Other Lending Facilities*, BD. OF GOVERNORS OF THE FED. RESERVE SYSTEM (July 30, 2012), http://www.federalreserve.gov/monetarypolicy/bst_lendingother.htm. For a comprehensive and detailed explanation of the various bailout used by the Federal Reserve during the aftermath of the financial crisis, *See* Christian Johnson, Exigent and Unusual Circumstances: The Federal Reserve and the U.S. Financial Crisis (Sept. 7, 2010) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_ id=1584731,

support facilities, such as the discount window discussed above.[171] These funds went directly to the largest U.S. financial institutions, now operating as Bank Holding Companies (BHCs).[172] These facilities operated at a high balance of $923 billion in 2008 and 2009, but have a current balance of $50 billion.[173] In other words, one of the lessons of the 2008 financial crisis was that the federal safety net may, under certain circumstances, be extended to any institution that borrows short to lend long, especially if that institution is deemed TBTF.[174]

Although FDIC insurance was an effective (and arguably the most effective) measure against runs in the banking industry, it could not prevent the most recent financial run and is no longer enough because the recent crisis involved large financial firms 'running' other financial firms.[175] The implications for the social contract are clear: the state chose to preserve trust in the banking system instead of letting these large firms fail or go through the bankruptcy process. And they did so because they thought they had no choice.[176] Bailouts were therefore politically and

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171 *See* Meena Thiruvengadam, *Investment Bank Borrowing at Discount Window Hits Record,* WALL. ST. J., Sept. 26, 2008, http://online.wsj.com/article/SB122237806611776365.html.

172 MATTHEW SHERMAN, A SHORT HISTORY OF FINANCIAL DEREGULATION IN THE UNITED STATES 15 (2009).

173 Johnson, *supra* note ___, at 24-35.

174 Gary Gorton, "Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007," paper prepared for the Federal Reserve Bank of Atlanta's 2009 Financial Markets Conference: Financial Innovation and Crisis (May 11-13, 2009); The typical government safety net has historically only applied to the traditional banking system (i.e. commercial banks), but the recent crisis was not a crisis of commercial banks, it was centered instead on the shadow banking sector, or in other words, the largest U.S. banks, which are now BHCs.

175 *Id.*

176 Robert Weisman, *Former Treasury Secretary Paulson Defends '08 Bailouts*, THE BOSTON GLOBE, June 19, 2012, http://www.bostonglobe.com/business/2012/06/19/hank/1YGbMFJDMprNQFeZmduikI/story.html; Annalyn Censky, *Bernanke: Fed Was 'Helpless' in Lehman Failure*, CNN MONEY, Mar. 27, 2012, http://money.cnn.com/2012/03/27/news/economy/bernanke-gwu-lecture/index.htm; Ronald Orol, *Geithner Defends Bank Bailouts at Town-Happ Meeting,* MARKET WATCH, WALL STREET JOURNAL Sept. 10, 2009, http://articles.marketwatch.com/2009-09-10/economy/30800986_1_rescue-funds-town-hall-meeting-town-hall; Lowell Sun, *Barney Frank Defends Bailout*, YOUTUBE (July 27, 2011), http://www.youtube.com/watch?v=aUAsZW1cg7Y.

economically expedient.[177] Bailouts are "an inevitable feature of modern economies [because] the interconnectedness of firms means that the entire economy bears the risk of an individual firm's failure."[178] Although the government has recently forsaken any future bailouts, the economic realities of banking make it clear that bailouts are sometimes a political necessity and cannot be regulated away.[179]

One way to address the problem of soft or discretionary, but inevitable bailouts is to force large financial institutions to pay for them ex ante. Most insurance funds, including the FDIC fund, work this way. Insured entities pay premiums for the insurance and these premiums are adjusted based on the risks posed to the insurance fund—bad drivers pay more for car insurance than good drivers. Likewise, risky banks pay more than safer banks.[180] A similar system could be set up to formalize emergency bailouts. This solution is problematic and perhaps unrealistic for at least two reasons. First, all parties must recognize that these bailouts will continue to occur. Policymakers have not conceded this in the aftermath of the crisis. In fact, they have made repeated declarations that they will no longer bail out the banks.[181] Second, there must be a way to price accurately for the risks posed by the specific institution. After the crisis, many of the metrics used to predict bank risk, such as capital and comprehensive CAMELS ratings,[182] have come under attack because

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[177] Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L. J. 435, 443 (2011).

[178] *Id.* at 439.

[179] Block, *supra* note __, at 149; Levitin, *supra* note __, at 514, 439 ("Law is an insufficient commitment device for avoiding bailouts altogether. It is impossible to produce binding commitment to a preset resolution process, irrespective of results. The financial Ulysses cannot be bound to the mast. Although we may want Ulysses to be bound to the mast when the sailing is smooth to avoid the sirens' call of politically directed state intervention in the market, the situation changes once the ship has hit the rocks. Once the ship is foundering, we do not want Ulysses to be bound to the mast, lest he go down with the ship and drown.").

[180] CARNELL ET. AL., *supra* note ___, at 316-318.

[181] Frank James, *Obama: Financial Bill Means 'No More…Bailouts, Period,'* THE TWO-WAY: BREAKING NEWS FROM NPR (July 15, 2010), http://www.npr.org/blogs/thetwo-way/2010/07/15/128549117/obama-financial-bill-means-no-more-bailouts-period.

[182] The CAMELS rating system, which stands for Capital, Asset quality, Management, Earnings, asset Liability management, is a comprehensive evaluation of a bank's risk profile. CARNELL ET AL. *supra* note ___, at 633-640.

many of the banks that failed met these requirements right up until the point of failure.[183]

Despite these difficulties, the premise that future bailouts needs to be accounted for today in structuring bank regulation is at the heart of the social contract. Recognizing that bailouts will always be a part of the bank/government partnership is a crucial starting point in framing the social contract. Because such bailouts are inevitable, large banks and their rescuing government need to clarify the terms of their relationship. Otherwise, it is likely that when banks are in smooth waters and bailouts are not needed, they will tend to forget their tie to the government and the populace and focus only on profits instead of the needs of the public.

a. TARP

Although the bailout of the nation's financial firms involved a variety of measures, including expanded access to the fed discount window and increased FDIC deposit limits,[184] the largest component of the bailout was the Troubled Asset Relief Program ("TARP"). In England, Paul Tucker urged all banks to "recognize that their relatively calm passage through the crisis to date owes a lot to government standing behind their peers."[185] The same is true here and the government accomplished the rescue mainly through TARP. Through TARP, the federal government

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[183] Tom Hinkel, *CAMELS Ratings and Financial Regulatory Reform: the (M)anagement Element*, SAFE SYSTEMS NEWSLETTER (Aug. 2010), http://news.safesystems.com/2010/08/camels-ratings-and-financial-regulatory-reform-the-management-element/#_ftn2 (Both Washinton Mutual and Indy Mac Bank had favorable CAMELS ratings just before failure in 2008.).

[184] Bob Ivry, Bradley Keoun & Phil Kuntz, *Secret Fed Loans Gave $13 Billion Undisclosed to Congress*, BLOOMBERG, Nov. 27, 2011, http://www.bloomberg.com/news/2011-11-28/secret-fed-loans-undisclosed-to-congress-gave-banks-13-billion-in-income.html; *The Federal Reserve's 'Breathtaking' 7.7 Trillion Bank Bailout*, THE WEEK, Nov. 28, 2011, http://theweek.com/article/index/221883/the-federal-reserves-breathtaking-77-trillion-bank-bailout; Press Release, FDIC, Basic FDIC Insurance Coverage Permanently Increased to $250,000 Per Depositor (July 21, 2010) (*available at* http://www.fdic.gov/news/news/press/2010/pr10161.html)(FDIC limits and secret emergency loans by Fed.).

[185] Paul Tucker, Deputy Governor, Fin. Stability, Bank of England, at the British Bankers' Association Annual International Banking Conference: Restoring Confidence – Moving Forward (June 30, 2009) (transcript available at http://www.bankofengland.co.uk/publications/Documents/speeches/2009/speech396.pdf).

under two administrations invested approximately $431 billion to shore up the nation's banks.[186] Most of these funds went to the largest banks.[187] As mentioned above, the initial purpose of TARP, as articulated by Treasury Secretary Henry Paulson and others, was to provide mortgage relief to cash-strapped homeowners.[188] Instead, these funds went to shore up these large banks through the government purchase of their liabilities and through cash infusions.[189]

In giving this aid to the large banks, the government never explicitly demanded anything in return, and it quickly became apparent that banks would not use these funds for public-serving purposes. Instead, they shored up their balance sheets by saving their cash for a rainy day.[190] Soon, the public also learned of bonuses given to bank executives with TARP funds.[191] Clearly, the banking sector, which was not accustomed to meeting public needs, rejected their intermediary function—that it was their responsibility to take these government funds and lend. The New York Times quoted one banker and recipient of $300 million in TARP funds stating: "Make more loans? We're not going to change our business model or our credit policies to accommodate the needs of the public sector."[192] Neither did the Treasury make any demands that the money be used to reach the public.[193] Treasury Secretary Geitner seemed

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[186] CONGRESSIONAL BUDGET OFFICE, REPORT OF THE TROUBLED ASSETS RELIEF PROGRAM – MARCH 2012 (Mar. 28, 2012), http://www.cbo.gov/publication/43138.

[187] *Bailout Recipients*, PROPUBLICA: JOURNALISM IN THE PUBLIC INTEREST (last update Feb. 15, 2013), http://projects.propublica.org/bailout/list.

[188] Emergency Economic Stability Act, 12 U.S.C.A. § 5201 (2008).

[189] Mike McIntire, *Bailout is a No-Strings Windfall to Bankers, if Not to Borrowers*, N.Y. TIMES, Jan. 18, 2009, at A1.

[190] Christopher Carey, chief financial officer of City National said that the banks planned to retain the TARP money to build a "fortressed balance sheet" in case the economy gets worse. BAROFSKY, *supra* note __, at 99.

[191] While most of this outrage focused on AIG, there were other incidents of this as well, including an incident involving Citigroup. *See* Michael Shnayerson, *Wall Street's $18.4 Billion Bonus*, VANITY FAIR, March 2009, www.vanityfair.com/politics/features/2009/03/wall-street-bonuses200903#.

[192] McIntire, *supra* note ___.

[193] Neil Barofsky, *Where the Bailout Went Wrong*, N.Y. TIMES, Mar. 29, 2011, www.nytimes.com/2011/03/30/opinion/30barofsky.html?_r=0 ("Treasury, however, provided the money to banks with no effective policy or effort to compel the extension of credit. There were no strings attached: no requirement or even incentive to increase lending to home buyers, and against our strong recommendation, not even a request that banks report how they used TARP funds.").

satisfied that banks were returning to profitability and used that as a metric for measuring success.[194] Some inside the administration[195] and outside[196] challenged this perspective and claimed that the funds should have gone to taxpayers directly and not to poorly managed banks. But to date, policymakers have not proposed that banks should have been obligated to use the government money to help the public, even if that would have hurt their bottom line.[197] The Treasury seemed to believe that the most it could ask of banks is to stay profitable and then to hope that once they are profitable enough, they would start to lend to the public.[198] For example, in discussing mortgage modifications, the Treasury discussed the program as one that will be good for consumers and also better for banks because they will be able to avoid costly foreclosures.[199]

C. The Post-Crisis Social Contract

The post-crisis reforms have not fundamentally changed the status quo with respect to banks' duties to the public. However, a new relationship has been formed between the large banks and the government. Due to several new reforms, the large banks and the government are now working together in designing banking regulation. Below, I will describe the new reforms, the nature of the TBTF problem, the effect of these banks on government policy, and the reasons the new government-bank partnership is not likely to be public-protecting.

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194 SHEILA BAIR, BULL BY THE HORNS: FIGHT TO SAVE MAIN STREET FROM WALL STREET AND WALL STREET FROM ITSELF (First Free Press 2012).
195 *Id.*
196 BAROFSKY, BAILOUT *supra* note 2, at 155-157.
197 Deborah Solomon, *Will TARP Make a Profit? That's the Wrong Question*, BLOOMBERG, Apr. 27, 2012, www.bloomberg.com/news/2012-04-27/will-tarp-make-a-profit-that-s-the-wrong-question.html.
198 "In addition to failing to include terms that would provide incentives to increase lending, Treasury didn't require the banks to report on how they were using TARP funds." , *supra* note ___ at 73; Barofsky, *supra* note 196.
199 *See* Memorandum from The Treasury on The Case for Principal Reduction 1 (July 31, 2012) (attached to Letter from Timothy Geithner, Secretary of the Treasury, to Chris DeMarco, Acting Director, FHFA, available at blogs.reuters.com/felix-salmon/files/2012/07/Sec-Geithner-Letter-to-FHFA-on-Principal-Reduction.pdf)("The available evidence on HAMP-PRA, as well as industry practice, indicates that targeted principal reduction makes economic sense for the holder of the credit risk….").

1. Dodd-Frank

Dodd-Frank was the regulatory response to the financial crisis of 2008. Although it attempts to ensure financial stability and banking accountability, it is widely regarded as falling short of those goals.[200] Some claim that the Act introduces complexity that not only misses big problems, but also increases costs of compliance.[201] Others claim that these reforms are not likely to end future bailouts or restore safety and soundness.[202] Above all, Dodd-Frank was a missed opportunity for the government to reassert its relationship with the nation's banks.[203]

Dodd-Frank and other post-crisis regulatory reforms have not addressed the proper question—specifically, what duties do banks owe to society? Instead, assuming that the status quo is tenable, policymakers have plugged holes and filled gaps in a tattered and spent regulatory structure created during the deregulatory era. Indeed, there were public

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200 DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES 140 (John Wiley & Sons 2011)(explaining how Dodd-Frank encourages delay and bailout rather than truly holding banks accountable); *The Dodd-Frank Act: Too Big Not To Fail*, THE ECONOMIST (Feb. 8, 2012), www.economist.com/node/21547784;

Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 951, 956 (2011) (concluding that Dodd-Frank is ultimately too weak to prevent the "too big to fail" problem); Brett H. Mcdonnell, *Financial Regulation Reform and Too Big to Fail*, 1 BUS. L. BRIEF (AM. U.) 116 (2012)("Perhaps the leading critique of the Dodd-Frank Act from the left is that it does too little to address the problem of too big to fail ("TBTF") financial institutions. This critique is not unique to the left--many on the right make similar arguments.").

201 Haldane, The Dog and the Frisbee, *supra* note ___, at 12.

202 *See* SKEEL, *supra* note 203, at 140; Jonathan R. Macey & James P. Holdcroft, Jr., *Failure Is an Option: An Ersatz-Antitrust Approach to Financial Regulation*, 120 YALE L.J. 1368, 1389 (2011)("In fact, there is reason to believe that the Dodd-Frank Act actually will increase the probability that financial institutions in general, and insurance companies in particular, will be bailed out in the future."); Eugene A. Ludwig, *Assessment of Dodd-Frank Financial Regulatory Reform: Strengths, Challenges, and Opportunities for A Stronger Regulatory System*, 29 YALE J. ON REG. 181, 192 (2012)("Dodd-Frank, however, severely overcompensates for lax regulation. Too many of the legislation's components are largely unnecessary, and its sheer magnitude could actually challenge safety and soundness by focusing an excessive amount of management attention on less critical issues."); Mark A. Calabria, *Dodd-Frank Law: Regulations Won't Fix What's Wrong*, CATO INSTITUTE (Dec. 6, 2011), www.cato.org/publications/commentary/doddfrank-law-regulations-wont-fix-whats-wrong (arguing that the safety and soundness provisions of Dodd-Frank are misguided).

203 SKEEL, *supra* note ___, 94.

humiliations focused on individual wrongdoing by bank executives,[204] lawsuits exposing banks' fraud and malfeasance,[205]and a myriad of explanations of the crisis.[206] But the dominant assumption remained that foremost among policymakers' concerns was that the large banks remain stable and profitable.[207]

The relationship between the government and its banks has been misunderstood for so long that even those reforms that Dodd-Frank has advanced have been met with strong opposition not just from Wall Street,[208] but also from Congress, other regulators,[209] and the Federal Circuit Courts.[210] Wall Street lobbyists, many of whom are ex-regulators, vigorously fought the new rules on behalf of banks right after those banks were bailed out by the federal government.[211] Follow-up lobbying weakened the reforms and secured enough loopholes in the remaining

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204 Nathan Vardi, *Goldman Sachs' Long Day in Washington*, FORBES (Apr. 27, 2010), www.forbes.com/sites/streettalk/2010/04/27/goldman-sachs-long-day-in-washington/.

205 Chris Isidore, *Bank of America Sued for Alleged Mortgage Fraud*, CNN MONEY (Oct. 25, 2012), http://money.cnn.com/2012/10/24/news/companies/bank-of-america-lawsuit/index.html.

206 Adam J. Levitin, *The Crisis Without A Face: Emerging Narratives of the Financial Crisis*, 63 U. MIAMI L. REV. 999, 1001 (2009)(summarizing initial explanations of the crisis).

207 *See* discussion *infra* Section III.A.

208 Ryan Grim, *Wall Street Opposes Wall Street Reform*, HUFFINGTON POST (May 25, 2011), http://www.huffingtonpost.com/2010/06/28/wall-street-opposes-wall_n_627870.html

209 John Berlau, *Democrats Now Rejecting Dodd-Frank*, NEWSMAX (Oct. 30, 2012), www.newsmax.com/BerlauMN/Democrats-Dodd-Frank-reform/2012/10/30/id/462037; Ben Protess, *Former S.E.C. Chief Says Dodd-Frank Misses Goals*, N.Y. TIMES, July 12, 2011, http://dealbook.nytimes.com/2011/07/12/former-s-e-c-chairman-criticizes-dodd-frank/.

210 The D.C. circuit has presented significant challenges to banking and securities regulators by invalidating many of their proposed rules or sending them back for further analysis. Ben Protess, *As Wall Street Fights Regulation, It Has Backup on the Bench*, NEW YORK TIMES (Sept. 24, 2012), http://dealbook.nytimes.com/2012/09/24/as-wall-street-fights-regulation-it-has-backup-on-the-bench/; Ben Protess, *Judge Strikes Down a Dodd-Frank Trading Rule*, N.Y. TIMES, Sept. 28, 2012, http://dealbook.nytimes.com/2012/09/28/judge-strikes-down-dodd-frank-trading-rule/.

211 *See, e.g.,* Eric Lichtblau, *Ex-Regulators Lobby to Shape Overhaul,* N.Y. TIMES, July 28, 2010, at B1 (noting that about 150 ex-financial regulators registered as banking lobbyists from 2009 to 2010).

legislation to allow business as usual for these banks.[212] Congress, which passed Dodd-Frank, also opposed funding and appointing a director to the agency meant to enforce its provisions.[213]

To be sure, reforms are under way. Many will make banks safer and protect consumers.[214] In Part IV, I outline several of the major reforms put in place by Dodd-Frank, including the Consumer Financial Protection Bureau ("CFPB") and other safety and soundness measures meant to reduce risks and increase transparency.

2. Too Big To Fail

The social contract outlined above has worked fairly well with the small and mid-sized banks of this country, but has failed with respect to the large banks. This is in part due to the fact that these large banks are recent additions to the banking fold. Many of these large banks were operating as investment banks, but they are now bank holding companies: many of them hold depository institutions (commercial banks), but their assets are also non-depository assets tied up in the securities, credit, insurance, and derivatives markets. They operate in almost every developed country in the world and they have extensive political influence. Large banks (or "mega banks") are those with assets

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212 Saule T. Omarova, *Wall Street As Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 464 (2011).

213 James B. Stewart, *As Watchdog Starves, Wall Street is Tossed a Bone*, N.Y. TIMES, July 15, 2011, http://www.nytimes.com/2011/07/16/business/budget-cuts-to-sec-reduce-its-effectiveness.html?pagewanted=all; Phil Mattingly & Joshua Gallu, *U.S. Congress Blunts Agency Fund Request to Enforce Dodd-Frank,* BLOOMBERG, Dec. 20, 2010, http://www.bloomberg.com/news/2010-12-22/dodd-frank-enforcement-funds-delayed-as-lawmakers-pass-stopgap-legislation.html; George Zornick, *GOP Blocks Cordray's Nomination to Head the CFPB,* THE NATION (Dec. 8, 2011), http://www.thenation.com/blog/165054/gop-blocks-cordrays-nomination-head-cfpb; Brian Montopoli, *Senate GOP Blocks Possible Elizabeth Warren Recess Appointment,* CBS NEWS, May 27, 2011, http://www.cbsnews.com/8301-503544_162-20066828-503544.html.

214 Emily McCormick, *The Good Side of Dodd-Frank: How the Law Will Benefit the Banking Industry,* BANK DIRECTOR (Jan. 23, 2013), http://www.bankdirector.com/board-issues/legal/the-good-side-of-dodd-frank-how-the-law-will-benefit-the-banking/(citing generally-accepted positive aspects of Dodd-Frank such as its consumer protection focus, creation of the Bureau of Consumer Financial Protection, leveling of the playing field between banks and non-bank financial institutions, and creation of the Financial Stability Oversight Council).

between $250 billion and $2.3 trillion. There are only twelve of these behemoths after the crisis and they represent only 0.2 percent of all banks, but together they hold almost 70 percent of the country's banking assets.[215]

There are several reasons for the discrepancy between small and large banks and the breakdown of the social contract with the latter. First, as their name indicates, because these banks are too big to fail, they are too big to punish or even threaten. Regulatory discipline has failed with the large banks—these banks cannot be easily punished for their bad behavior, and therefore moral hazard runs high. Regulators have authority over these firms, but because their activities are so complex and fast-moving, regulators often cannot keep up. Small banks that are failing must submit to the FDIC resolution process, where the regulators take over the failing bank immediately and manage either its liquidation or reorganization. The process is smooth and speedy. In contrast, large banks—because so many of their assets are non-depository and tied up in capital or derivative markets all over the world—cannot easily be restructured through a bankruptcy. Therefore, holding the Sword of Damocles over banks' heads is only meaningful to those who don't have the shield of being too big to fail. Dodd-Frank's living will provision promises to ensure the orderly liquidation of these large banks in the event of a future collapse.[216] However, most experts are skeptical that the living wills can or will be enforced absent major reforms to the structure of these provisions as well as to these banks.[217]

Second, market discipline has also failed with these mega-banks. Richard Fisher, the president of the Dallas Federal Reserve observed of these large banks that "the forces of market discipline from shareholders and unsecured creditors are limited…. TBTF status exerts *perverse market discipline* on the risk-taking activities of these banks."[218] Because the creditors of these banks are aware of their TBTF status, they receive

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215 Fisher, *supra* note ___.

216 Dodd-Frank Act § 165, 12 U.S.C.A. § 5365 (2010).

217 *See* SKEEL, *supra* note 203, at 141 ("[M]anagers are unlikely to devise serious and realistic plans unless regulators are unusually vigilant in enforcing the new obligation [to draft a living will].").

218 Fisher, *supra* note 218.

discounted prices and less market vigilance. Therefore, the government safety net gives TBTF banks a subsidy greater than that enjoyed by other insured banks. Moreover, the subsidy for these banks "has risen following the financial crisis."[219]

Third, the activities of these firms are inherently more risky and more of a threat to systemic stability. These firms operate in a variety of markets and in many countries and their non-depository activities are the bulk of their balance sheets. Their size and interconnectedness expose these firms to contagion making them more vulnerable to collapse.[220] They are also very highly leveraged with an average leverage ratio of 1 to 25 compared to commercial banks, which are 1 to 12.[221] In addition to their leverage, the markets in which they operate are higher risk than commercial banks. Commercial banks still profit from traditional lending and depository activities while these large banks do everything else that makes the capital, credit, and derivatives markets run.

Finally, because of their size and importance, these banks are very politically powerful. And this power and influence is the reason the social contract is askew. In fact, the crisis augmented these banks' already growing power and influence. Recently, through certain measures in the Dodd-Frank Act, a new relationship has been formed between the government and the largest banks. The partnership is formed because once a firm is labeled a "systemically important financial institution" ("SIFI"), it is watched closely by the newly-formed Financial Stability Oversight Counsel ("FSOC"), which includes the leaders of all the banking regulators, but is chaired by the Treasury, the most political of the bank regulators.[222] There are many provisions of Dodd-Frank that give FSOC unfettered discretion in regulating these firms. In effect, the SIFIs work closely with FSOC in formulating regulation and implementing reforms. These large banks will influence banking policy,

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[219] *Id.*

[220] Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 463 (2011).

[221] Yalman Onaran, *U.S. Banks' Leverage Should Be Halved to Cut Risks, Bair Says,* BLOOMBERG, Sept. 26, 2012, http://www.bloomberg.com/news/2012-09-26/u-s-banks-leverage-should-be-halved-to-cut-risks-bair-says.html

[222] The Treasury is the only banking regulator that is located in the president's cabinet. It is widely regarded as being the most politically sensitive. In contrast, both the FDIC and the Federal Reserve are independent agencies. SKEEL, *supra* note ___, at 12.

and perhaps more general government policy, going forward. This is indeed the fruition of Jefferson and Brandeis' greatest fears.

3. Corporatism

David Skeel refers to this partnership as Corporatism—a conflict-prone relationship between the most powerful banks and the federal government.[223] Corporatism strengthens bank power, size, and influence over policymakers. The partnership benefits both the large banks and the federal government. On the one hand, the largest banks get to remain large, receive a market subsidy and have the ear of the Treasury. It is also more likely these firms will be bailed out in the future. Cross-country studies support this conclusion, showing that the more connected a firm is to the rescuing institution, the more likely a bailout will occur.[224] On the other hand, once the government gets control over large powerful institutions it is able to use them for its own political ends, including as tools of domestic and foreign policy on issues well outside the realm of banking. Skeel uses as an example by analogy, the Obama administration giving Fiat a larger ownership stake in Chrysler in exchange for its promise to promote the administration's policy goal of energy efficiency by promising to roll out a more energy-efficient car in the U.S.[225]

This newly-formed relationship, which benefits both the government and the banks leaves out a critical part of the social contract—the people. Although the government represents the people, its aims, as it relates to bank policy, may diverge from public need. This is true for many political economy reasons—such as re-election concerns, lobbying, and the fact that interested minorities often exert more political pressure than the diffuse populace. Thus, political aims are not always matched with the people's. This problem is exacerbated now as banks and policymakers become closer and work together to shape policy. There is necessarily a

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[223] SKEEL, *supra* note ____, at 11. He distinguishes Corporatism from a Brandeisian approach, which would have lessened the power of the largest banks. The modern Brandeisians advocated breaking up the banks and ending TBTF bailouts because of a fear that the banking oligarchy would use their resources to "capture" or co-opt the state.

[224] GROSSMAN, *supra* note ___, at 97.

[225] SKEEL, *supra* note ___, at 93.

tension between the desires of banks and the desires of the public. Banks desire high profits and insofar as stability leads to profits, banks also desire stability. There is also a tension between offering profitable credit products and offering ones that are safe and fair. The public wants stability, access to credit, and fair and safe products. When these goals conflict, banking regulators must be the public representative that forces banks to meet these needs. Corporatism makes that difficult. This is the reason the social contract must be re-written to explicitly require regulators to take account of the public's needs.

4. Breaking up the banks

One option, proposed by many, to remedy the current problem with the large banks is for the government to break them up. Many advocate that these banks be broken up along their activity lines.[226] For example, a large bank holding company could be broken up into several independent units, such as an insurance firm, a broker-dealer, a hedge fund, a commercial banking network, and a securities underwriter. This division harkens back to the Glass-Steagall era separation of banking and commerce. It has the advantage of containing FDIC insurance and other federal subsidies within the banking unit and preventing the FDIC subsidy from subsidizing unregulated portions of the firm. Without the TBTF imprimatur shielding the firm from market discipline, counterparties could more easily monitor those units engaged in higher risk "commercial ventures."

This course of action would essentially rewrite the New Deal Era social contract for a changed world. Although breaking up these large firms is the best and perhaps only way to ensure systemic stability, it may not be practically or politically feasible. The financial landscape may be too changed to try to force a 1930s-era separation on these firms. In

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[226] Brad Miller, *The Right Way to Break Up the Banks,* BLOOMBERG, Oct. 21, 2012, http://www.bloomberg.com/news/2012-10-21/use-stand-alone-subsidiaries-to-break-up-megabanks.html ("According to Bair, megabank operations should be 'simplified and subsidiarized' into 'discrete, separately managed legal entities' based on business lines."); Roberta S. Karmel, *An Orderly Liquidation Authority Is Not the Solution to Too-Big-to-Fail*, 6 BROOK. J. CORP. FIN. & COM. L. 1, 44 (2011)("[Stiglitz] suggests a 'three-pronged attack': (1) breaking up institutions that are too big to fail; (2) "restricting ... activities in which [the] remaining institutions can be engaged….").

addition, it is unlikely, given the influence of these large firms, that any effort to break them up could overcome the political opposition that will likely be unleashed. This is not to say that it should not be attempted, but given the substantial barriers in achieving a break-up of the large banks, policymakers need to reconsider the social contract as it applies to the situation today.

III. REVISING THE SOCIAL CONTRACT

If the banks are to remain large and powerful and capable of causing systemic panic and collapse with only the government standing between them and failure, the government must demand more from these banks than they currently do. I propose a three-part social contract. Not all of these suggestions are unique, but so far they have stood alone as independent proposals for banking reform. In reviving the social contract, the government needs to be clear that of paramount importance in banking are safety and soundness, consumer protection and access to credit. These three pillars should define the new social contract between government and banks. This charge requires an ideological shift in our understanding of banks and the government's regulatory mission. Banks must retain the ability to make profits for their shareholders, but that cannot be the only requirement imposed by regulators on banks. Banks do not operate in the markets like most other corporate entities. They are tasked with public functions and given access to public safety nets. They allow other corporations to increase profits and function free of state control, but they themselves are necessarily tethered to the state. And this tethering has implications that have been ignored by modern policymakers.

The ideological shift I advocate requires regulators to emphasize the public's needs when regulating banks. The public needs banks that are safe, that are accessible to all, and that deal fairly with consumers. Regulators should ensure that banks meet these needs, even if the changes result in banks forgoing maximum profitability. This charge differs from corporatism, which as described above is the formation of a close relationship between large banks and the government in which a quid pro quo of powers and influence are exchanged. Corporatism does not ensure that public needs are met first and leads to a problematic

concentration of political and economic power. On the other hand, I also do not advocate making banks into public utilities, as advocated by Brandeis. Market competition is not the enemy of sound banking. With targeted regulation, it is possible to allow banks to compete for customers and do so responsibly while meeting public needs.

A. Safety and Soundness

As the details of many of the regulations are still being negotiated, scholars and industry observers have suggested a variety of measures to ensure safety and soundness in banking. These proposals include prohibitions on derivatives trades,[227] higher capital reserves,[228] contingent capital,[229] self-regulation,[230] and more thorough regulatory oversight.[231] Such proposals are on the right track as they do not focus on profits, but rather prohibit activities that are risky, force banks to invest in products with their own money ("skin in the game"), or call for more stringent and comprehensive supervision of banks. This article does not advocate any particular measure, but makes the claim that a strong regulatory focus on safety and soundness must be implemented and enforced by regulators if the federal government is going to bear the costs of bank failures. The social contract must be rewritten to include such measures so long as the government has such a large stake in bank success.

As discussed above, bank profitability cannot serve as a regulatory proxy for bank safety and soundness. While it is true that a profitable bank is often a safe one and that profitability can be a good indicator of a

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[227] Thomas M. Hoenig & Charles S. Morris, *Restructuring the Banking System to Improve Safety and Soundness*, FDIC (May 2011), http://www.fdic.gov/about/learn/board/Restructuring-the-Banking-System-05-24-11.pdf.

[228] Anat R. Admati et al., *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity Is Not Expensive* 5-6 (Rock Ctr. for Corporate Governance at Stanford Univ., Working Paper No. 86, 2010), *available at* http://ssrn.com/abstract=1669704.

[229] Wulf A. Kaal, *Initial Reflections on the Possible Application of Contingent Capital in Corporate Governance*, 26 NOTRE DAME J.L. ETHICS & PUB. POL'Y 281, 293 (2012).

[230] Omarova, *Wall Street as Community of Fate: To-ward Financial Industry Self-Regulation*, *supra* note ___, at 417-418.

[231] Edgar Ortega Barrales, *Lessons from the Flash Crash for the Regulation of High-Frequency Traders*, 17 FORDHAM J. CORP. & FIN. L. 1195 (2012).

bank's stability, it is not necessarily so. As the last three decades have demonstrated, banks can be profitable and still engage in unsafe practices. Therefore, while profitability can signal safety and soundness, the scope of the regulatory inquiry into safety and soundness needs to be more nuanced. How can safety and soundness be measured if not by bank profitability? Before deregulation, bank safety was a matter of bright line rules and prohibitions. Safety was assured by prohibiting banks from engaging in risky business practices. Going back to those prohibitions would be like putting the proverbial genie back in the bottle.

The shadow banking system and modern financial innovation make the stark separations once laid down by the Glass Steagall Act nearly impossible to re-create. The Volker Rule, currently part of Dodd-Frank, could potentially re-impose a portion of the Glass Steagall Act divisions as adapted to the modern financial system and effectively silo high-risk activities, such as proprietary trading, from the rest of the firm.[232] This would come short of breaking up the banks, but would at least separate activities within each large bank.

The Dodd-Frank Act does indeed focus on safety and soundness, but it is too soon to say whether its stated goals of enforcing "strict oversight of financial institutions that pose systemic risks" will lead to reduced risk-taking by these firms.[233] Most of the Dodd-Frank reforms have yet to be implemented and as with most financial regulation, many of these changes will be discretionary. The FSOC will be responsible for overseeing systemic risk problems and for addressing those concerns with firms designated SIFIs. Will these regulators be able to spot the subprime-mortgage crisis of the future? Much will depend on whether the regulators are able to see beyond profits secured during the next bubble to identify underlying and latent risks. An analysis of whether recent reforms have shifted regulatory focus away from profits to actual risk-taking is outside the scope of this article and likely premature. Too much work on implementing these reforms remains to be done.

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[232] R. Rex Chatterjee, *Dictionaries Fail: The Volcker Rule's Reliance on Definitions Renders It Ineffective and A New Solution Is Needed to Adequately Regulate Proprietary Trading*, 8 B.Y.U. INT'L L. & MGMT. REV. 33, 42 (2011); Macey & Holdcroft, Jr., *supra* note ___, at 1399.

[233] Macon Phillips, *Overhaul*, THE WHITE HOUSE BLOG (Feb. 25, 2009), http://www.whitehouse.gov/blog/09/02/25/Overhaul/.

B. Consumer Protection

Perhaps the biggest lapse in regulatory oversight over the last thirty years has been in protecting consumers from harmful, obscure, and sometimes predatory credit products. Scholars have made a strong case that the credit markets in this country are broken, that consumer credit products are wrought with fraud, discrimination, and unnecessary complexity.[234] Banks and credit card companies have made their products more opaque and more costly to the average customer and because consumers cannot adequately gauge the level of risk in certain terms, they have gone largely uncontested. There have also been reports of fraud and discrimination in mortgage lending during the lead-up to the financial crisis.[235] Large banks have been the biggest offenders because of their standardized products and their insatiable appetite for subprime loans during the housing bubble.

Targeted consumer protection laws can deter these banks and other financial services providers from taking advantage of their customers to make a profit. If the government is to support banks, it must assure that consumers are protected from discrimination, fraud, and predatory behavior in lending. Moreover, these reforms might actually help ensure the safety and soundness of the financial system because many of the products that are harmful to consumers are also harmful to markets and the economy in general. Subprime mortgages are an illustrative example.

A few scholars, led by Elizabeth Warren, proposed the establishment of a new regulator to protect consumers from unregulated and unsafe banking products.[236] These scholars point out that because safety and

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[234] Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1 (2008); Elizabeth Warren, *Unsafe at Any Rate*, DEMOCRACY: A JOURNAL OF IDEAS (Summer 2007), http://www.democracyjournal.org/pdf/5/Warren.pdf; Adam J. Levitin, *Rate-Jacking: Risk-Based & Opportunistic Pricing in Credit Cards*, 2011 UTAH L. REV. 339, 365 (2011).

[235] Charlie Savage, *Wells Fargo to Settle Mortgage Bias Charges,* N.Y. TIMES, July 12, 2012, http://www.nytimes.com/2012/07/13/business/wells-fargo-to-settle-mortgage-discrimination-charges.html?_r=0; Charlie Savage, *$335 Million Settlement on Countrywide Lending Bias,* N.Y. TIMES, Dec. 21, 2011.

[236] Bar-Gill & Warren, *supra* note ___; Adam J. Levitin, *Hydraulic Regulation: Regulating Credit Markets Upstream*, 26 YALE J. ON REG. 143 (2009).

soundness has been equated with profitability, consumer protection is not enforced by and actually contradicts the mission of the Federal Banking regulators.[237] These calls for a consumer protection agency have been answered by Dodd Frank's creation of the Consumer Financial Protection Bureau ("CFPB"). This agency is poised to play a critical role in the rewriting of the social contract with banks in the area of consumer protection if it has the support of the legislature and engages in robust rulemaking and enforcement.[238]

The large banks vigorously opposed this agency and continue to appeal many of its decisions. There were many political battles over the establishment of such an agency, making it one of the most contested aspects of Dodd-Frank. It became quickly apparent that Elizabeth Warren whose name became synonymous with the agency, would not be chosen to lead it because the opposition from the banking sector was too strong. It is too soon to say whether the agency will remain strong in the

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[237] Levitin, Senate Testimony at 15 ("Now, 'bank safety and soundness' is a technical term. It means profitability" but "consumer protection is sometimes at loggerheads with bank profit….[T]he OCC has amply proven that when tasked with both bank safety-and-soundness—that is profitability—and consumer protection, it will always favor banks over consumers."); Bar-Gill & Warren, *supra* note ___, at 90 (2008) ("[Banking] agencies are designed with a primary mission to protect the safety and soundness of the banking system. This means protecting banks' profitability. Consumer protection is, at best, a lesser priority . . . ."); Creola Johnson, *The Magic of Group Identity: How Predatory Lenders Use Minorities to Target Communities of Color*, 17 GEO. J. ON POVERTY L. & POL'Y 165, 205 (2010) (noting that federal banking regulators' stated goal is safety and soundness, but they are usually focused on profitability and often oppose states' attempts at consumer protection); Arthur E. Wilmarth, *The Financial Services Industry's Misguided Quest to Undermine the Consumer Financial Protection Bureau*, 31 REV. BANKING & FIN. L. 881, 932 (2012) ("[D]uring the credit boom banking agencies focused on near-term profitability as a key indicator of the 'safety and soundness' of financial institutions."); Bob Herbert, Op-Ed., *Derailing Help for Consumers*, N.Y. TIMES, Mar. 26, 2010, http://www.nytimes.com/2010/03/27/opinion/27herbert.html?_r=0 (describing safety and soundness as a "euphemism" for "profitability"); *see also* OIG, EVALUATION OF PROMPT REGULATORY ACTION IMPLEMENTATION 4, 6, 11-12, 33-37 (2011) (noting regulators' difficulty restricting risky behavior while institutions are profitable).

[238] But as Elizabeth Warren artfully articulated, the agency must be strong in order to be effective: "My first choice is a strong consumer agency. My second choice is no agency at all and plenty of blood and teeth left on the floor." *Fight For The CFPA Is 'A Dispute Between Families And Banks,' Says Elizabeth Warren*, HUFFINGTON POST (May 25, 2011), http://www.huffingtonpost.com/2010/03/03/fight-for-the-cfpa-is-a-d_n_483707.html.

face of mounting opposition, but its charge to protect the public from fraudulent or discriminatory banking products is a crucial tenet of the social contract.

C. Access to Credit

As stated above, post-crisis banking reform has focused on safety and soundness, and consumer protection is arguably addressed by the CFPB, whose success will be determined over time. However, neither Dodd-Frank nor any other regulatory proposal, program, or talking point has addressed increased access to credit. Although the idea has been in the background of some of the post-crisis dialogue, including in the mortgage relief context,[239] it has not been embraced or advocated by any policymakers to date. This may have to do with a widespread belief that that the financial crisis was, in part, precipitated by an overabundance of consumer access to mortgage credit. Therefore, the case for increasing access to credit is not an obvious one. Financial support for the banking system goes hand in hand with ensuring that the banking system remains safe and low risk and prohibiting banks from taking advantage of customers is fairly uncontroversial. But why should government investment in banking impose duties on banks to increase access to credit? The answer is that access to credit is one of the theoretical reasons banks were supported by the government in the first place and, I argue, a reason to continue their support.

Bank credit not only allows the economy to grow wealth, but also allows individual families to do so. Any difference in access (for example, the rich having more access than the poor) runs counter to the justifications for state support of banks. It was this disparity of access that made Thomas Jefferson wary of bank power. Currently, a few large and powerful banks control the majority of assets in the banking sector and also the majority of credit. The social contract must require that these banks focus on increasing lending to the poor. Not all banks should have the same responsibilities, such as providing small loans to the poor, because not all banks are capable of executing the task. But

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[239] MYFICO, MORTGAGE RELIEF FOR U.S. HOMEOWNERS, http://www.myfico.com/mortgagerelief/.

government sponsorship of banks needs to both carve out a place for and support banks that are tasked with such a mission. As the government is currently most invested in large banks, it is only fair that these large banks bear some of that responsibility.

Insofar as economic mobility (or at least prohibiting economic disenfranchisement) is a social good, and credit is the necessary tool to economic advancement, banks must be involved at some level in enhancing accessibility for certain communities. The number of unbanked or underbanked, or people without bank accounts or not using them, has increased since the financial crisis and is now 30% of the population.[240] If the banking system is to be supported by the government, all should be able to access it. Of course, there are complex reasons why some people may choose to not have a bank account, such as lack of sufficient funds, class and cultural barriers, lack of trust of the banking system, etc. If these barriers are caused by the banking system, they should be eliminated, although some of these obstacles may not be surmountable by regulating bodies and banks.

However important, focusing on bank accounts blurs the real needs of the poor, which are access to small loans and good credit options. Many low-income individuals are increasingly relying on fringe banks for their credit needs, and these fringe banks often engage in unscrupulous practices and charge very high interest rates.[241] Many of these fringe banks are highly profitable organizations that are either partnered with or financed by the large banking sector. Access to safe credit is crucial in allowing the poor to escape poverty. The premise of supporting banks with government funds is that they act as intermediaries in the economy—allowing businesses and individuals to use their services to grow their limited funds. Currently, the U.S. banking system is bifurcated with one regulated and government-sponsored banking system for the rich and another unregulated, usurious and costly fringe banking system for the poor. To be clear, lending to the poor is not always profitable. A

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[240] FDIC, 2011 FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS (2012), http://www.fdic.gov/householdsurvey/

[241] CHRISTOPHER L. PETERSON, TAMING THE SHARKS: TOWARDS A CURE FOR THE HIGH-COST CREDIT MARKET 12 (2004); CASKEY, *supra* note ___; Michael Barr, *Banking the Poor*, 21 YALE J. ON REG. 121 (2004).

bank spends the same amount of resources lending $1000 or $100,000. Therefore, rational profit-seeking banks wisely focus on larger loans leaving the smaller loans to the payday lenders and others who are willing to take on this risk for the high profits earned through usurious interest rates and other questionable practices.[242]

In the past, the state has supported specific banking charters aimed at providing credit to the poor. Charters for credit unions and savings and loan associations were both created after the New Deal to accomplish this very purpose.[243] These financial institutions served low-income customers who did not otherwise have access to credit in accordance with a social contract meant to extend the banking safety net to all citizens. These banks were successful for many years but, due to financial pressure in the 1970s and 1980s and their subsequent deregulation, many struggled to survive.[244] There are currently few banks designed primarily to provide access to the poor while the unbanked population steadily increases.

There are many possible ways that the banking system in partnership with the federal government could achieve this goal.[245] Specialized charters could be subsidized by either the FDIC fund, which collects fees from larger banks, or non-profit arms of large banks or stand-alone subsidiaries of larger banks could be established with specific charters focused on credit access for the poor. Providing small loans to the poor is not profitable and therefore traditional banks will not step in to fill this gap unless incentivized to do so. Yet, because banking has public support, banks can fairly be asked to fulfill this important public mission.

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In sum, the social contract with banks must take into account the needs of the public, and that means *all* the public. The social contract must first be understood and then verbalized by regulators. This will require a shift in regulatory focus. Specifically, regulators should consider

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242 Baradaran, *supra* note __.
243 *Id.*
244 *Id.*
245 Baradaran, *supra* note __, at __.

public needs, such as safety and soundness, consumer protection, and access to credit, when using their discretionary powers to allow banks to perform certain activities. This public focus should also be reflected in legislation and regulation governing banks. Fortunately, as the next section demonstrates, it already is. But although the necessary language already exists in various statutes, it must be enforced and given "teeth" by regulators.

IV. "PUBLIC BENEFIT" AND THE STATUTORY CODE

The public mission of banks is written into the text of nearly all major banking legislation. For banks to gain approval for mergers, expansions, or new activities, their primary regulator uses a variety of factors to determine whether the proposed change should be permitted. Most of these tests include an explicit "public benefit" inquiry. In other words, in order to gain approval from its regulators, a bank needs to show that the proposed activity is beneficial to the public. Because much of this legislation was written during and after the New Deal, at a time when the social contract was more clear, it is not surprising that the needs of the public would be an articulated aspect of any regulatory decision.

For example, under the Bank Holding Act, bank holding companies that wish to acquire or merge with a bank or nonbank or partake in certain nonbanking activities must undergo a public benefit test.[246] The BHC public benefit test requires affirmative public benefits rather than mere absence of adverse effects.[247] Section 1842(c)(2) requires the Federal Reserve Board to consider the convenience and needs of the community affected by the merger or acquisition of a bank by a bank

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[246] 12 U.S.C. § 1842(c)(2) (2011); 12 U.S.C. § 1843(j)(2)(A) (2011). In order to pass the public benefits test under the Bank Holding Company Act, a bank holding company, in its application process, must prove more than simply no adverse effects would arise; it must prove some reasonable expectation of public benefits. However, if the Board finds some adverse effects then it is required to find more than speculative or scant public benefits. Money Station, Inc. v. Bd. of Governors of Fed. Reserve System, 81 F.3d 1128, 1134 (D.C. Cir. 1996).

[247] Roger E. Alcaly, *Neither Convenient Nor Needed: The Convenience and Needs and Public Benefits Tests of the Bank Holding Company Act*, 96 BANKING L. J. 325, 328 (1979).

holding company.[248] The Federal Reserve's Regulation Y also includes a public benefit test for approving mergers or new activities by banks.[249] The test asks, for example, whether the merger or proposed activity will lessen competition or whether the change will "meet the convenience and needs of the community."[250] The National Bank Act also requires the OCC to analyze public benefits, such as community development, philanthropy, and the needs of the community, when national banks are formed or acquire or merge with other national or state banks interstate.[251] The Reigle-Neal Act's public benefit test requires interstate bank mergers applicants to prove that the merger will not violate concentration limits and that the applicant is in compliance with the CRA.[252]

Despite the public benefit test's salience, in practice no searching inquiry into the actual needs of the public is undertaken. In fact, the factors that are used to determine "public benefit" are those that often benefit the banks themselves. The Federal Reserve Board and the OCC have broad discretion in applying these factors on a case-by-case basis.[253] The OCC has stated that it gauges "public benefit" using a cost-benefit analysis of decreasing competition, the needs of the community, and performance of the Community Reinvestment Act.[254] Bank regulators

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[248] 12 U.S.C. § 1842(c)(2) (2011). Section 1843(j)(2)(A) lays out a cost benefit analysis of nonbanking activity or acquisition for regulators to consider such as increased convenience, competition, and efficiency that must outweigh adverse effects such as concentration of resources, unfair competition, conflicts of interest, or unsound banking practices. 12 U.S.C. § 1843(j)(2)(A) (2011).
[249] 12 C.F.R. § 225.26 (2005). Regulation Y lists public benefit factors the Board must consider when approving non-banking proposals, such as "greater convenience, increased competition, and gains in efficiency."
[250] Id. 12 C.F.R. § 225.13(a)(1), (2) (2005). Moreover, the Board must consider whether the acquisition will meet the convenience and needs of the community, including its Community Reinvestment Act record performance, affected by the acquisition. 12 C.F.R. § 225.13(b)(3) (2005).
[251] 12 U.S.C. § 24, eighth, eleventh (2008).
[252] 12 U.S.C. § 1831u(b)(2), (3) (2011).
[253] National Courier Association v. Board of Governors of the Federal Reserve System, 516 F.2d 1229, 1234 (D.C. Cir. 1975).
[254] *See,* Decision of the OCC on the Applications of Bank of America, Corporate Decision #97-52, 8-9 (June 25, 1997) (*available at* http://www.occ.gov/static/interpretations-and-precedents/jul97/cd97-52.pdf); Decision of the OCC on the Applications of Bank One, Corporate Decision #97-33, 5-

often interpret these public benefit tests as either advancing efficiency or increased competition.[255] For example, Regulation Y, which mirrors the BHC, explains that the Board must determine "whether the performance of the notificants' activities can reasonably be expected to produce benefits to the public (such as greater convenience, increased competition, and gains in efficiency) that outweigh possible adverse effects (such as undue concentration of resources, decreased or unfair competition, conflicts of interest, and unsound banking practices)."[256] Regulators rarely require much more than a cost benefit type analysis to cross the public benefit hurdle. They rarely question whether a bank's engagement in a particular activity actually benefits the public. Instead, the regulatory focus has been much more on profitability and has been aligned with the corporation's own interest.[257] In other words, if an activity results in increased profits to the corporation, that alone is a significant benefit unlikely to be outweighed by negative public effects, such as decreased competition.[258]

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6 (June 1, 1997) (*available at* http://www.occ.gov/static/interpretations-and-precedents/jun97/cd97-33.pdf.).

[255] Indep. Ins. Agents of Am., Inc. v. Bd. of Governors of the Fed. Reserve System, 658 F.2d 571, 574 (8th Cir. 1981) ("the Board must carefully consider many factors under the public benefits test including, but not limited to, the precise manner in which the "de novo" entry is to be affected, the dangers of undue concentration of resources, decreased or unfair competition, conflicts of interest and unsound banking practices."); *Id.* at 574-575; Roger E. Alcaly, *Neither Convenient Nor Needed: The Convenience and Needs and Public Benefits Tests of the Bank Holding Company Act*, 96 BANKING L. J. 331 (1979). A Fed study revealed that the Board consistently cited six types of public benefits: improvements of convenience and needs of the community, increased competition, operational efficiency, expanded financial resources for the firm to be acquired and/or the bank holding company, improved management for the acquired firm, and other benefits unique to the particular case. Michael A. Jessee & Steven A. Seelig, *An Analysis of the Public Benefits Test of the Bank Holding Company Act*, FEDERAL RESERVE BANK OF NEW YORK, MONTHLY REVIEW, 151 (June 1974). The study further finds that, as of February 1974, only twenty-nine orders of denials where published, and in every denial, the primary reason was reduction of existing or potential competition. *Id.* at 157.

[256] *Id.*

[257] Roger E. Alcaly, *Neither Convenient Nor Needed: The Convenience and Needs and Public Benefits Tests of the Bank Holding Company Act*, 96 BANKING L. J. 331 (1979); *Am. Land Title Ass'n v. Bd. of Governors of the Fed. Reserve System*, 892 F.2d 1059, 1065 (D.C. Cir. 1989)(holding that convenience can equal one-stop shopping for customers).

[258] A 1977-1978 Federal Reserve survey concluded that it was difficult to demonstrate whether "the public interest standards of the act have fostered the public welfare significantly." Joseph E. Rossman & B. Frank King, *Convenience and Needs: Holding*

My own review of hundreds of agency opinions, specifically related to BHC's seeking merger approvals, from the 1970s until today, reveals that the public benefit test has become less searching over time. In the 1970s, I found several examples of banks being denied merger approvals because the proposed merger did not meet public needs and convenience.[259] The trend was also that regulators made a searching inquiry into the needs of the community and provided examples of how a specific merger would enhance the welfare of the community.[260] After the enactment of the CRA, in 1977, the focus of the public benefit test shifted to ask whether the bank was in compliance with the CRA, which served as a rubber stamp for meeting the public benefit test.[261] Regulators did consider whether there were serious anti-competitive concerns, but if those were not present, there wasn't an inquiry as to *benefits* of the merger.[262] When regulators did evaluate the actual public benefit, often the benefits were those that accrued to the bank, not the public.[263] In one example, a merger involving the second-largest banking corporation in

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Company Claims and Actions 1-2 (Federal Reserve Bank of Atlanta, Working Paper, Aug. 1977); David R. Allardice, *Convenience and Needs Considerations: A Post-Audit Survey* 2-8 (Federal Reserve Bank of Chicago, Research Paper No. 78-2, Sept. 1978). Anthony W. Cyrnak, *Convenience and Needs and Public Benefits in the Bank Holding Company Movement*, in THE BANK HOLDING COMPANY MOVEMENT TO 1978: A COMPENDIUM 286 (1978).

259 North Shore Capital Corp., 58 Fed.Res.Bull. 809, 810 (F.R.B.), 1972 WL 27551 (denied BHC formation because public needs and convenience was already being met).

260 First Alabama Bancshares, Inc., 57 Fed.Res.Bull. 404, 412 (F.R.B.), 1971 WL 24190 (approving merger because Alabama was one of the least economically developed states and due to anticompetitive monopoly concerns); Texas Commerce Bancshares, Inc., 58 Fed.Res.Bull. 984, 986 (F.R.B.), 1972 WL 27646 (new services included petroleum financing services that the community currently lacked and needed), Western Michigan Corp., 63 Fed.Res.Bull. 506, 508 (F.R.B.), 1977 WL 39198 (lending capacity increased, upgraded agricultural loan services, and new savings programs).

261 Nationsbank Corp. Charlotte, North Carolina, 1993 WL 741754 at *7 (F.R.B.) (fourth-largest commercial bank in US merger application approved where the only mention of "convenience and needs factors" was that the bank had favorable CRA ratings).

262 Mercantile Bancorporation, Inc., 78 Fed.Res.Bull. 377 (F.R.B.), 1992 WL 104382 (approved by concluding that no anticompetitive concerns existed "that are not outweighed by the public benefits in this case" and identifying none of those benefits.); Nationsbank Corp. Charlotte, North Carolina, 1993 WL 741754 at *8 (F.R.B.) (no anticompetitive concerns, and no discussion of public benefits).

263 Citizen's Financial Group, Inc., 71 Fed.Res.Bull. 473, 475 (F.R.B.), 1985 WL 68579 ("[approval] will provide Applicant greater resources for expansion and greater flexibility for diversification of business activities…[and] thus should allow Applicant to *continue to compete effectively* with other large Rhode Island financial organizations….")(emphasis added).

Minnesota was approved by the Federal Reserve, in the face of strong anti-competitive concerns, because of "the significant public benefit of *resolving the capital deficiency of an impaired institution* in a private transaction without cost to the federal deposit insurance funds."[264]

In addition to the public benefit test being watered-down by contemporary regulators, it has been completely left out of major banking legislation during and after the deregulatory era. The GLB Act was the first major banking regulation that did away with any public benefit inquiry. The act was passed in 1999 after two decades of deregulation. The Act does reinforce the CRA requirements for public benefit by codifying that nothing in the Act changes these requirements.[265] This last concession was a major sticking point in the legislation and was heavily contested, but written into the Act in order to get it passed.[266] The compromise was that the GLB Act required the Federal Reserve and the Treasury Department to study whether these programs were generally *profitable*.[267] The Federal Reserve found that the majority (61%) were generally profitable for large institutions.[268]

The Dodd-Frank Act also does not include a "public benefit" test anywhere in its text.[269] It is possible that the new rules enacted by the agencies will add a public benefit component to Dodd-Frank. The Act does, however, implement a new policy consideration under the BHCA cost benefit analysis. Regulators must now also consider whether a merger or acquisition will create detrimental systemic risk to the financial industry and whether that risk outweighs any benefit expected from the merger or acquisition.[270]

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[264] Norwest Holding Co., 76 Fed.Res.Bull. 873, 875 (F.R.B.), 1990 WL 319857.

[265] 12 U.S.C. § 1811 (note) (1999).

[266] *The Gramm-Leach-Bliley Act P.L. 106-102 Financial Services Modernization Working Summary No. 4,* Gibson Dunn & Crutcher, LLP, at 84 (Dec. 16, 1999), *available at* http://cyber.law.harvard.edu/rfi/casebook/gibson.pdf ("The CRA provisions of the Act were the most contentious and were the last major provision to be agreed to.").

[267] 12 U.S.C. § 2901, § 2908 (1999).

[268] BD. OF GOVERNORS OF THE FED. RESERVE SYS., REPORT TO CONG. PURSUANT TO SEC. 713 OF THE GRAMM-LEACH-BLILEY ACT OF 1999 (July 17, 2000) (available at http://www.federalreserve.gov/communitydev/files/cra_cratext.pdf).

[269] CITE text of Dodd Frank

[270] Dodd-Frank Wall Street Reform and Consumer Protection Act, Ch. 7, Pub. L. No.

In sum, the public benefit test was written into the banking regulator code during the New Deal era social contract and re-enforced by the legislation that followed it, but has since been diluted or excised from new legislation. Just as safety and soundness became synonymous with profitability so too did the "public benefit test." To show a public benefit, a bank need only prove that the proposed activity increases efficiency and competition, which do favor the public tangentially, but are not direct benefits. For example, in the lead up to the financial crisis, many banks started engaging in highly risky derivatives trading and bundling of Mortgage Backed Securities (MBS) into tranches of Collateralized Debt Obligations (CDO). These transactions, which were approved by regulators increased efficiency and competition among banks, however, if the public need was considered seriously, it would have become apparent to the regulators that these transactions involved now-infamous fraud, and unscrupulous lending practices. These transactions may have increased profits for banks, but they were not beneficial to the public needs of safety and soundness, consumer protection and access to credit.[271]

Although the public benefit inquiry has not been a demanding one, the charge still exists in banking legislation and provides an explicit mandate to regulators to use their authority to consider public needs. Regulators can and should take up this statutory charge and conduct a

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111-203 (2010); Daniel K. Tarullo, Governor, Fed. Reserve Bd., Industrial Organization and Systemic Risk: An Agenda for Further Research at the Conference on the Regulation of Systemic Risk, Federal Reserve Board, Washington, D.C. (Sept. 15, 2011) (available at http://www.federalreserve.gov/newsevents/speech/tarullo20110915a.htm).

[271] Although subprime lending did increase access to credit, it was not good credit or even credit that many were seeking. Many of these loans were originated to meet the demands of banks and not necessarily the demands of consumers. It was clear from the beginning of the crisis that it was Wall Street, not Main Street, demand that led to the glut of subprime lending. Toward the end of the crisis, banks were desperately seeking new customers to meet the demands of the insatiable CDO markets, which led to some of the most fraudulent actions by mortgage originators, such as no-doc loans, thin FICO file loans, and "liar loans." Lynn E. Turner, Statement Before the Senate Committee on Banking, Housing, and Urban Affairs On Enhancing Investor Protection and the Regulation of the Securities Markets 1 (Mar. 10, 2009), available at http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=16e2bab5-2d77-4f6e-a471-933a438f6cac

searching inquiry into whether certain changes in banking do actually benefit the public. The legislative history of most of these provisions support using them to demand that banking activities consider the effect on the public. This statutory authority should give regulators at least some greater capacity to push forward the public purpose notion that should be a central component of the social contract. Banks have duties to the state and the public and if a proposed activity has the potential to harm the public, that activity should be discouraged.

V. CONCLUSION

This article makes the case that given the unique features of banks and their dependence on their sponsoring government, there is an implicit social contract between banks and the state. This social contract is supported by history as well as the legislative code. This article lays out the contours of the historic social contract and proposes that the social contract of the future focus on three pillars: safety and soundness, consumer protection, and access to credit. Revising the social contract does not entail more, and certainly not more complex, regulation. What it does require is an understanding that banks are not like other corporations because of their relationship with their sponsoring state and the public safety net that enables their success and continued existence and a firm conviction that this relationship should inform regulatory philosophy. Specifically, regulators should not look primarily at profitability when gauging safety and soundness, they should be concerned with strong protections of consumers, and they should engage the banking system in increasing access to credit to all citizens. Regulators should build on the "public benefit" tests incorporated in much of banking regulation to develop a new regulatory paradigm built on a reinvigorated social contract that will ensure banks meet the needs of the public in the years to come.