Testimony before the

Senate Committee on Banking, Housing and Urban Affairs

by

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"Holding Executives Accountable After Recent Bank Failures"

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Chairman Brown, Ranking Member Scott, and members of the Committee, thank you for this opportunity to participate in today's hearing on the accountability of bank executives. In my testimony, I offer two central observations.

First, bank executives play a critical role in maintaining the strength of our financial system. Banks are special and uniquely important in maintaining the stability and strength of entire economy. Likewise, bank executives play a special role that requires a diligence and care that sets them apart from the managers of nonbank firms.

Second, Congress has recognized the importance of bank executives' responsibilities by authorizing federal bank regulators to hold executives accountable for management failures. Existing law, however, could be reformed to provide stronger accountability for bank executives who act negligently or for board members who fail in their oversight responsibilities. Imposing higher accountability standards is consistent with the special responsibilities of bank managers. Strengthening existing accountability standards, in matters involving both failed institutions and open ones, will encourage prudent management of bank operations which, in turn, will contribute to the safety and soundness of the financial system.[1]

[1] See generally Heidi Mandanis Schooner, *Big Bank Boards: The Case for Heightened Administrative Enforcement*, 68 Alabama Law Review 1011 (2017).

Bank Executives Fulfill a Special Role in Ensuring Banks' Safety and Soundness

Banks are special – they differ fundamentally from other financial and nonfinancial firms. This "specialness" derives from the unique services they provide customers in the form of both payments and liquidity.[2] These services also make banking inherently risky. Among other things, banks rely on significant leverage in the form of demand deposits to fund their longer-term assets. This asset-liability term mismatch makes banks financially fragile. To address this fragility, the federal government extends banks a public safety net in the form of discount window access and federal deposit insurance. Such characteristics also justify extensive regulation of banks' operations, but the responsibility for the safety and soundness of the institution ultimately rests with bank management.

Bank managers bear this risk because of their intimate knowledge of and control over their firms' operations. Through their superior knowledge, capable managers can mitigate the many risks faced by the institution. By virtue of their position, bank executives establish the risk management culture, expectations, and incentives for all bank employees and, thereby, create the conditions for success of the institution.

The risks associated with poor bank management are significant. Failures of risk management and corporate governance were a critical factor contributing to the 2008-2009 financial crisis.[3] That crisis caused the deepest and longest U.S. recession since World War II.[4] Nevertheless, in the years since that crisis, we have continued to see stunning examples of management neglect in cases like the JPMorgan London Whale episode, the Wells Fargo account opening scheme, and the Deutsche Bank money laundering scandal. Governance failures are also at the root of the very recent failures of Silicon Valley Bank and Signature Bank.[5] Moreover, it is safe to conclude that future analysis of this week's failure of First Republic Bank will generate similar conclusions. In his testimony before this committee,

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[2] For the classic exploration of banks' special role in the economy, see E. Gerald Corrigan, *Annual Report 1982; Are Banks Special?*, Minneapolis Fed. Reserve Bank (1982).
[3] Fin. Crisis Inquiry Comm'n, The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, xviii-xix (2011).
[4] John Weinberg, Federal Reserve Bank of Richmond, The Great Recession and Its Aftermath, Federal Reserve History.
[5] Board of Governors of the Federal Reserve System, Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank (April 2023); Federal Deposit Insurance Corporation, FDIC's Supervision of Signature Bank (April 28, 2023); U.S. Government Accountability Office, Bank Regulation: Preliminary Review of Agency Actions Related to March 2023 Bank Failures, GAO-23-106736 (April 2023).

Vice Chair Michael Barr highlighted this point, describing the failure of Silicon Valley Bank as a "textbook case of mismanagement."[6]

Given the specialness of banks, bank mismanagement carries distinct consequences from those associated with nonbank corporate mismanagement. Bank managers owe fiduciary duties to their institutions just like the officers and directors of any corporation.[7] But fiduciary duties were developed around the shareholder profit maximization model which is ill-suited to the management of federally-insured depository institutions. Bank executives are responsible for managing inherently risky institutions that are crucial to sustaining the health of the economy and thus the wellbeing of all citizens. They are responsible for institutions that rely on taxpayer backing in the form of deposit insurance and emergency liquidity. Recent events amply illustrate the extent of this dependence. Bank management is a heavy responsibility, indeed.

Federal Law Recognizes Bank Management's Responsibility for Prudent Operations

In the United States and around the world, the importance of management to bank safety and soundness is recognized from cradle to grave: law and regulation expressly demand competent bank management from the institution's initial chartering to the supervision of the bank's ongoing operations, through to the resolution of a failed institution.

The Office of the Comptroller of the Currency (OCC) is responsible for granting federal bank charters, those held by some of the largest banking institutions. In evaluating a charter application, the OCC considers, among other factors, bank managers' competence, experience, and ability as well as their familiarity with national banking laws and regulation.[8] State bank chartering authorities consider similar factors.[9] Once a bank is operating, it is examined by bank regulators periodically with large institutions being subjected to ongoing examination. Banks are evaluated by examiners using the Uniform

[6] Michael S. Barr, Vice Chair for Supervision, Board of Governors of the Federal Reserve System, Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Mar. 28, 2023) at 2.
[7] Briggs v. Spaulding, 141 U.S. 132 (1891).
[8] 12 C.F.R. § 5.20(f)(2).
[9] See e.g., California Financial Code § 1022.

Financial Institutions Rating System, known as CAMELS, which assesses capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. Observe that while management is only one of a list of six components used in examining a bank's operations and condition, it functions as a precondition to each of the other components. Maintenance of adequate capital requires effective management. Sensitivity to market risk requires effective management, and so on.

Federal law also imposes liability on bank officers and directors for mismanagement. Perhaps the most high-profile cases brought against bank officers and directors by federal regulators are the professional liability claims brought by the Federal Deposit Insurance Corporation (FDIC) as receiver of a failed bank.[10] As receiver, the FDIC steps into the shoes of the failed bank[11] which empowers the FDIC to sue officers and directors for breach of the fiduciary duties owed to the bank. Unlike the administrative enforcement powers discussed below, the FDIC's receivership cases are filed civilly, utilizing statutory authority granted to the FDIC to bring claims for monetary damages, imposing liability on officers and directors for gross negligence, and preserving state law claims with a lower standard of proof, e.g., breach of ordinary care.[12] Some recent proposals would include explicit authorization for the FDIC to bring actions in cases involving gross negligence in the performance of oversight responsibilities. This reform recognizes the critical importance of the board of directors' oversight function.

While the FDIC's suits against officers and directors of failed banks are the most notorious, such cases have limited importance for the officers and directors of large financial institutions since such institutions rarely fail.[13] This context places special importance on federal regulators' administrative enforcement powers. Congress conferred

[10] 12 U.S.C. § 1821(c). From 2007 to 2021, the FDIC, as receiver, filed claims against 178 individual officers or directors of failed banks. FDIC Professional Liability Annual Report for 2021, at 4.
[11] 12 U.S.C. § 1821(d)(2).
[12] 12 U.S.C. § 1821(k). The savings clause provides: "Nothing in this paragraph shall impair or affect any right of the Corporation under other applicable law."
[13] The failure of Washington Mutual, with combined assets of $307 billion and total deposits of $188 billion, is the largest bank failure in U.S. history. The recent failures of First Republic Bank, Silicon Valley Bank, and Signature Bank rank as the second, third, and fourth largest bank failures. In 2011, the FDIC, as receiver, brought suit against former officers and directors of WaMu claiming negligence, gross negligence, and breach of fiduciary duty. FDIC v. Killinger, et al., No. 11CV00459, (U.S.D.C., W.D. Washington). The case was settled.

authority on the banking agencies[14] to bring enforcement actions against banking institutions and, most relevant here, "institution-affiliated parties," (IAPs), which includes directors and officers of insured depository institutions.[15] Three types of administrative enforcement proceedings, discussed below, are most relevant to bank management: cease and desist proceedings; civil money penalties; and orders of suspension or prohibition.[16]

Bank regulatory agencies have the authority to issue a cease and desist order against an IAP who is engaging, has engaged, or is about to engage in an unsafe or unsound banking practice, or has violated a law, rule, regulation, or condition imposed in writing by the agency.[17] The cease and desist power includes the authority to require respondents to make restitution or provide reimbursement, indemnification, or guarantee against loss if the respondent was unjustly enriched or acted in reckless disregard of the law,[18] but not on the basis of negligent or even grossly negligent behavior.

The agencies' enforcement powers include authority to remove a bank manager from office or prohibit that party from participating in any depository institution's affairs. The removal and prohibition authority requires the agency to determine that: (1) the IAP has, inter alia, violated a law or regulation or engaged in an unsafe or unsound banking practice, or breached their fiduciary duty; and (2) by reason of such violation, practice, or breach, the bank suffered or will probably suffer financial loss or other damage, or the interests of the bank's depositors have been or could be prejudiced, or the IAP has received financial gain or other benefit; and (3) the violation, practice, or breach involved personal dishonesty or demonstrated willful or continuing disregard for the safety or soundness of the bank.[19] Currently, poor or negligent conduct is insufficient grounds for removal or prohibition.

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[14] The federal banking statutes use the term "appropriate Federal banking agency" (AFBA) to identify which federal banking agency has the authority to bring an administrative enforcement action, among other things. The AFBA for a national bank is the OCC; for a state member insured bank and any bank holding company, it is the Federal Reserve; for a state nonmember insured bank, it is the FDIC. 12 U.S.C. 1813(q).
[15] 12 U.S.C. § 1813u(1).
[16] Note that the Federal Reserve may utilize the enforcement powers discussed above in supervising bank holding companies, 12 U.S.C. § 1818(b)(3), and designated nonbank financial companies, 12 U.S.C. § 5362.
[17] 12 U.S.C. § 1818(b)(1).
[18] 12 U.S.C. § 1818(b)(6).
[19] 12 U.S.C. § 1818(e)(1). The statute provides for notice and hearing before removal. 12 U.S.C. § 1818(e)(4). An IAP who is subject to a removal or prohibition order is also prohibited from participating in the conduct of the affairs of any insured depository institution unless the director received written consent from the agencies. 12 U.S.C. § 1818(e)(7)(A)-(B).

IAPs also face potential liability for three tiers of civil money penalties (First Tier penalty of up to $5,000 for each day the violation continues; Second Tier up to $25,000 per day; and Third Tier up to $1,000,000 per day).[20] Unlike higher tier violations, First Tier penalties (available for any violation of law or regulation[21]) are significant because, as strict liability violations, they require no proof of culpability. Second Tier penalties require an agency determination of (1) a First Tier violation or recklessly engaging in an unsafe or unsound practice or breach of fiduciary duty, and (2) that such violation, practice, or breach is part of (a) a pattern of misconduct, or (b) causes or is likely to cause more than minimal loss to the bank, or (c) results in pecuniary gain or other benefit.[22] Third Tier penalties are available if the agency determines that the respondent (1) knowingly violated a law or regulation or engaged in unsafe or unsound practices or breached fiduciary duty and (2) either knowingly or recklessly causes a substantial loss to the bank or receives a substantial pecuniary gain or other benefit by reason of such practice.[23]

Bank Executives' Accountability Should Match their Responsibilities

Recent reform proposals seek to impose consequences, through clawbacks of executive compensation, on bank executives of failed banks. The relevance of this reform became clear when the Federal Reserve released its report on the failure of Silicon Valley Bank. The report finds that the "incentive compensation arrangements and practices at [Silicon Valley Bank Financial Group] encouraged excessive risk taking to maximize short-term financial metrics."[24] Banker compensation should not encourage, let alone reward, excessive risk taking that leads to significant losses or, worse, a bank's failure. Clawbacks, especially mandatory clawbacks, are an appropriate consequence for such mismanagement. Moreover, mandatory clawbacks can help maintain, or restore, the public's confidence in our financial system.

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[20] 12 U.S.C. § 1818(i)(2).
[21] 12 U.S.C. § 1818(i)(2)(A). First Tier penalties are also available based on a violation of any agency order, written agreement, or condition. *Id*.
[22] 12 U.S.C. § 1818(i)(2)(B).
[23] 12 U.S.C. § 1818(i)(2)(C).
[24] Board of Governors of the Federal Reserve System, Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank (April 2023) at 75.

While I support increased accountability for bank managers of failed banks, I urge that such proposals be considered in conjunction with reforms that would improve the accountability of managers of both failed and open institutions by strengthening existing administrative enforcement mechanisms. Strengthening existing administrative enforcement mechanisms applicable to officers and directors of open as well as closed banks offers at least two important advantages. It would help prevent needless bank failures caused by bank mismanagement and the associated losses to the Deposit Insurance Fund. In addition, strengthening agency enforcement tools would better level the competitive playing field between large and small banks. Officers and directors of the smallest, least complex, community bank, are held to the same statutory liability standards as the officers and directors of the largest, most complex, international banks. Given the reality of too-big-to-fail, only the managers of the relatively smaller banks are the targets of civil suits brought by the FDIC as receiver.

Current proposals would expand the remedies associated with the administrative cease and desist authority to explicitly include clawbacks of executive compensation. Existing cease and desist authority may, in fact, include the power to clawback IAP compensation as a form of restitution, but these bills make clawbacks an explicit remedy which would clarify Congress' intent. The cease and desist authority could also be strengthened by allowing for remedies based on negligent, grossly negligent behavior and failure of oversight, instead of the current law's very high recklessness standard, as discussed above.

While current statutory authority for second-tier civil money penalties and cease and desist actions may be available based on negligence, the statutory prerequisites for orders of removal or prohibition are especially high (again, akin to intentional or reckless behavior). The high level of culpability has been justified given that in a removal or prohibition action an individual's livelihood is at stake. Certainly, removal from a position as a bank executive and/or a prohibition from serving in the industry have serious implications for the respondents in such actions. Yet, when balanced against the impact of poor management on the soundness of an institution and the implications for the financial system and broader economy, a policy of strict accountability should prevail. For example, if a bank executive were to engage in negligent or grossly negligent behavior or if bank directors are negligent in their oversight responsibilities, it is appropriate to explicitly empower the banking agencies with the authority to remove them from their positions and prohibit their future affiliation with any bank. When balancing the potential negative externalities resulting from negligent management against the loss to individuals, the public interest should be prioritized.

Other objections to enhanced administrative enforcement powers include the potential for abuse by regulators and the related chilling effect on a bank's ability to attract and retain qualified officers and directors. These concerns are legitimate but less serious in the case of larger institutions. While smaller banks may suffer at the hand of overly zealous or arbitrary enforcement, large institutions have the financial and political resources to defend such actions. Moreover, administrative enforcement actions are subject to judicial review.[25] With regard to the ability to attract and retain qualified management, in my prior experience as counsel for a regional bank holding company, I observed that the institution's business model and connections to the community it served were the most powerful incentives for attracting and retaining qualified management. I am skeptical that qualified individuals would avoid serving as part of a bank's management team because the federal regulators could remove them for negligent or grossly negligent behavior. If that is not the case, then such an individual is probably not well-suited to the management of an insured depository institution.

Explicit consequences for negligent, grossly negligent behavior and failure of oversight could provide powerful incentives for bank executives to exercise prudence in managing fragile and often complex organizations. Individuals lacking confidence in their ability to act with such care in their management responsibilities should decline to serve in that capacity.

Conclusion

The recent failures of Silicon Valley Bank, Signature Bank, and First Republic Bank highlight the importance of vigilance in maintaining the safety and soundness of our

[25] The respondent in a removal proceeding, for example, may seek judicial review under the Administrative Procedure Act. 12 U.S.C. § 1818(e), (f), and (h).

financial system. Bank executives form the frontline defense against bank failure. When bank executives fail in their responsibility to protect the safety and soundness of their institutions, they should be held accountable to the public. Congress can enhance accountability through reforms aimed at the mismanagement of a failed bank. Measures to enhance the accountability of managers of open institutions should be given equal consideration.