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Hearing on
Holding Executives Accountable After Recent Bank Failures

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Chairman Brown, Ranking Member Scott, and Members of the Committee:

Thank you very much for the invitation to testify before you today. My name is Da Lin. I am an Associate Professor of Law at the University of Richmond School of Law, where I study and teach corporate governance and financial regulation.

My testimony today draws substantially on my article, *The Banker Removal Power* (co-authored with Lev Menand),[1] which examines federal banking regulators' authority under § 8(e) of the Federal Deposit Insurance Act, now codified at 12 U.S.C. § 1818(e), to remove institution-affiliated individuals from office for deceptive, unsafe, or unsound practices or to permanently prohibit them from participating in the conduct of the affairs of any insured depository institution. I will briefly explain this authority before making two main points.

First, § 1818(e)'s removal and prohibition authority is not well designed to hold bank directors and senior management accountable for failing to competently oversee the depository institutions under their charge, even when that failure facilitates an outsized accumulation of risks or pervasive misconduct. The essential problems are two-fold. Section 1818(e)'s culpability requirement is overly demanding, requiring "personal dishonesty" or a "willful or continuing disregard" for the safety or soundness of the institution. Yet failed oversight is seldom a demonstrably deliberate act, and senior bank leadership, in particular, are often immunized by the diffuse decision-making processes that characterize most large and midsize banks. Additionally, while § 1818(e) puts the focus on who committed and knew about *discrete* activities, oversight responsibilities generally have a broader *systemic* character. Failed oversight distorts the institutional apparatus within which discrete wrongdoings occur, but responsibility for institution-wide structures, internal controls, and culture fits awkwardly with § 1818(e)'s current framework.

Second, federal banking regulators have expressed discomfort with employing § 1818(e) because of the severity of its consequences. In modern practice, the effect of a § 1818(e) removal and prohibition order has been a lifetime ban from the banking industry. But the critique of permanent industrywide prohibitions as draconian is overstated, and regulators are mistaken in treating this outcome as the only option available to them. Section 1818(e) explicitly provides

[1] *See* Da Lin & Lev Menand, *The Banker Removal Power*, 108 VA. L. REV. 1 (2022).

that regulators can modify or curtail the prohibition by written consent. To clear the brush, Congress should clarify that § 1818(e) remains an enforcement tool that is both focused and flexible. In addition, Congress could also affirmatively create a tiered structure within § 1818(e)'s framework that varies the default terms of any removal or prohibition depending on the individual's role within the institution, his culpability, and the harm to the affected institution.

1. The Existing Legal Framework of Banker Removal and Prohibition

The power of federal regulators to remove bank directors and officers from office for engaging in unsafe or unsound practices was first created in 1933, even though the idea had been circulating in policy circles for decades beforehand.[2] Given the critical public role that banks play as channels for the transmission of monetary policy, proponents of a removal authority argued that bank governance could not be left solely in the hands of private shareholders who might seek to maximize their personal profits at the public's expense.[3] The authority was thus created to buttress bank oversight by public officials and reinforce the role of bank executives as public fiduciaries.

Congress has periodically revisited the removal and prohibition authority after major banking crises over the past nine decades, most recently in 1989.[4] Today, the authority is codified at 12 U.S.C. § 1818(e). A § 1818(e) enforcement action requires regulators to prove three elements: (1) misconduct, (2) effect, and (3) culpability.[5] First, § 1818(e) permits removal and prohibition of an "institution-affiliated party" who participated in a broad range of misconduct, including violations of law, breaches of fiduciary duties, and unsafe or unsound practices.[6] Second, the misconduct must have either harmed (or be likely to harm) the depository institution or personally benefitted the wrongdoer.[7] Finally, the misconduct must involve "personal dishonesty" or demonstrate "willful or continuing disregard" for the safety or soundness of the institution.[8] This culpability requirement is widely acknowledged as the primary obstacle to § 1818(e) enforcement, requiring a state of mind "well beyond mere negligence."[9]

By default, an individual who is the subject of an effective § 1818(e) order may not participate in the conduct of the affairs of *any* insured depository institution.[10] While § 1818(e)(7)(B) authorizes federal banking regulators to curtail the industrywide prohibition and devise a more limited penalty by written consent,[11] my research has not identified any instances in which this authority has been used since 1985. In current practice, the effect of a § 1818(e) order is a lifetime ban from working in the banking industry.

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[2] *See id.* at 10–17.
[3] *See id.*
[4] These changes were enacted through the Financial Institutions Supervisory Act of 1966, Pub. L. No. 89–695, 80 Stat. 1046; the Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95–630, 92 Stat. 3641; and the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101–73, 103 Stat. 183.
[5] 12 U.S.C. § 1818(e)(1).
[6] *Id.*
[7] *Id.*
[8] *Id.*
[9] Kim v. Off. of Thrift Supervision, 40 F.3d 1050, 1054 (9th Cir. 1994).
[10] 12 U.S.C. § 1818(e)(7)(A).
[11] 12 U.S.C. § 1818(e)(7)(B).

Finally, the removal authority is one of several tools available to federal banking regulators to hold individual bank affiliates accountable for deceptive, unsafe, or unsound practices. Other enforcement mechanisms range from informal board resolutions and memoranda of understanding, which are non-public and not legally binding;[12] to cease-and-desist orders, which may order individuals to change unsafe practices or refrain from certain acts in the future;[13] and civil money penalties, under which the maximum penalties are tiered to distinguish among individuals with different states of mind.[14] Important functional differences exist among these options. Unlike cease-and-desist orders or civil money penalties, both of which are fundamentally activity-centric, the removal and prohibition authority focuses on calibrating decision-making incentives at the level of individual bankers, much as private shareholders hold corporate fiduciaries accountable by controlling their election and termination.

2. The Obstacles to Director and Officer Accountability for Oversight Failure

The U.S. banking system no longer looks the way it did in 1989 when the removal and prohibition power was last substantively revised. Banks have consolidated over the past quarter century to give rise to sprawling, complex conglomerates that are engaged in a broad spectrum of financial activities.[15] Correspondingly, the role of senior bank leadership has also changed. For directors and top management at all but the smallest community banks, oversight is increasingly the linchpin of their responsibilities. These duties encompass supervising the institution's risk appetite, making major strategic and operational decisions, and ensuring that effective reporting and compliance systems exist that escalate information to facilitate timely decision-making.[16]

A common theme that links the major banking scandals since the 2008 financial crisis is that they involve failed oversight, rather than active participation, by senior officers and boards of directors. The problem is nearly always too little supervision: either bank leadership neglected known issues, or they were uninformed because they did not establish effective reporting systems or internal controls. For example, Wells Fargo's sales practice problems spanned over a decade, starting in 2002 and continuing until the accounts scandal broke publicly in 2013.[17] Despite their knowledge of the unlawful practices, there was "great reluctance" by Wells Fargo's senior management "to make any meaningful changes to the business model because [it] was

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[12] For a description of informal bank supervisory responses, see generally Daniel K. Tarullo, *Bank Supervision and Administrative Law*, 2022 COLUM. BUS. L. REV. 279, 305–06.

[13] 12 U.S.C. § 1818(b).

[14] 12 U.S.C. § 1818(i).

[15] The number of FDIC-insured banks has, for example, declined by nearly half from 2002 to 2022. Michelle W. Bowman, Bd. of Governors of the Fed. Rsrv. Sys., The Consequences of Fewer Banks in the U.S. Banking System, Remarks at the Wharton Financial Regulation Conference (April 14, 2023). Conversely, the share of U.S. banking assets and domestic deposits held by the ten largest banks more than doubled between 1990 and 2005. Kenneth D. Jones & Robert Oshinsky, *The Effect of Industry Consolidation and Deposit Insurance Reform on the Resiliency of the U.S. Bank Insurance Fund*, 5 J. FIN. STABILITY 57, 58 (2009).

[16] *See generally* BD. OF GOVERNORS OF THE FED. RSRV. SYS., SR 21-3/CA 21-1, SUPERVISORY GUIDANCE ON BOARD OF DIRECTORS' EFFECTIVENESS (2021).

[17] Notice of Charges for Orders of Prohibition and Orders to Cease and Desist and Notice of Assessments of a Civil Money Penalty, Carrie Tolstedt et al., Off. of the Comptroller of the Currency Nos. AA-EC-2019-70, AA-EC-2019-71, AA-EC-2019-72, AA-EC-2019-81, AA-EC-2019-82, at 3 (Jan. 23, 2020).

tremendously profitable and central to the Bank's success."[18] JPMorgan Chase's internal risk limits and advisories were breached more than 330 times during the quarter when the "London Whale" trades happened.[19] Even though the breaches were reported to top bank executives, including the chief executive officer, those risks "were largely ignored or ended by raising the relevant risk limit."[20]

Likewise, we are still piecing together the details of why Silicon Valley Bank ("SVB") and Signature Bank of New York ("SBNY") failed, but it is already clear that flawed oversight by senior officers and directors was a root cause of the problem. The review conducted by the Federal Reserve ("Fed") on SVB's collapse concluded that SVB's directors did not ensure that adequate information about the bank's risks came to their attention.[21] SVB's senior executives, in turn, neglected obvious risks inherent in the bank's business model and balance sheet strategies, despite the fact that SVB had repeatedly failed its own internal liquidity stress tests and had breached certain risk limits on and off since 2017.[22] The review conducted by the Federal Deposit Insurance Corporation ("FDIC") on SBNY's failure similarly concluded that SBNY's senior management pursued rapid, unrestrained growth without appreciating or adequately controlling its increasing liquidity risks.[23] Both banks experienced "a textbook case of mismanagement."[24]

Banking regulators periodically sanction bank directors and senior management who have failed in their oversight responsibilities with cease-and-desist orders and civil money penalties, but § 1818(e) removal and prohibition actions are extremely rare. In a study of all § 1818(e) orders issued by the Fed against affiliates of domestic banks and bank holding companies between 1989 and 2019, I found only three instances (out of 190 total orders) in which poor supervision or reckless management provided the basis for the enforcement action.[25] Two of these three cases involved employees who jointly supervised a single rogue trader.[26] A 2014 report by the Offices of Inspector General of the federal banking agencies similarly observed that the § 1818(e) orders they studied primarily sanctioned individuals who committed dishonest acts.[27] The report found "very few" removal and prohibition actions that were based

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[18] *Id.* at 15.
[19] Majority & Minority Staff of S. Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affs., 113th Cong., Rep. on JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses 7 (Comm. Print 2013).
[20] *Id.*
[21] BD. OF GOVERNORS OF THE FED. RSRV. SYS., REVIEW OF THE FEDERAL RESERVE'S SUPERVISION AND REGULATION OF SILICON VALLEY BANK 2–3, 47 (2023).
[22] *Id.*
[23] FED. DEPOSIT INS. CORP., FDIC'S SUPERVISION OF SIGNATURE BANK 7–11 (2023).
[24] Letter from Michael S. Barr, Vice Chair for Supervision, Bd. of Governors of the Fed. Rsrv. Sys. (April 28, 2023), https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf (regarding review of the Federal Reserve's supervision and regulation of Silicon Valley Bank).
[25] Lin & Menand, *supra* note 1, at 51–52.
[26] *Id.*
[27] OFFS. OF INSPECTOR GEN., FED. DEPOSIT INS. CORP., BD. OF GOVERNORS OF THE FED. RSRV. SYS. & CONSUMER FIN. PROT. BUREAU, DEP'T OF THE TREASURY, ENFORCEMENT ACTIONS AND PROFESSIONAL LIABILITY CLAIMS AGAINST INSTITUTION-AFFILIATED PARTIES AND INDIVIDUALS ASSOCIATED WITH FAILED INSTITUTIONS 4 (2014) [hereinafter OIG Report].

solely on a disregard for safety and soundness, despite the fact that most institutions in the sample had not been operated in a safe and sound manner.[28]

Two related factors help explain this paucity of removals for flawed oversight, especially against senior bank leadership. First, § 1818(e)'s high culpability requirement poses a disabling obstacle. Failed supervision is seldom a deliberate act, and it is even less likely to be *provable* as one. Top bankers, in particular, are often shielded from knowledge of operational details by the diffuse decision-making processes that characterize most large and midsize banks. The challenge of proving "willful" complicity increases with the distance from the actual wrongdoer, especially when the misconduct relates to complex, abstruse issues such as measuring financial risk.

Second, there is a mismatch between § 1818(e)'s singular focus on who committed and knew about discrete practices and the reality of oversight responsibilities, which have a broader systemic character. For those in oversight roles, searching for their awareness of discrete wrongdoing ignores crucial questions, such as whether those individuals tried to be brought into significant risk and compliance matters and whether they established systems, structures, and internal controls designed to effectively prevent and promptly detect operational-level risks. For example, until Wells Fargo eliminated its sales targets in 2016, its top executives had implemented "better tools and systems to detect employees who did not meet [those] sales goals than it did to catch employees who engaged in sales practices misconduct."[29] This structure is a clear manifestation of deficient supervision, and it undoubtedly skewed the incentives of lower-level Wells Fargo employees. But because § 1818(e) trains its focus on discrete acts of wrongdoing, regulators lacked clear authority to assess responsibility solely for the flawed institutional apparatus within which the violations occurred.

Modernizing § 1818(e) to facilitate director and senior officer accountability for failed oversight is critical to remedying the stark distributional consequences of the current system. The problems that I describe above substantially raise the cost of removing bank leadership relative to lower-echelon subordinates. My study of § 1818(e) orders issued by the Fed shows that over the past thirty years, the agency has shifted from primarily punishing senior management and directors to targeting rank-and-file employees. In the early 1990s, the Fed used the removal and prohibition authority primarily against bank leadership. Between 1989 and 1993—the first five years for which enforcement data is publicly available—over 75% of domestic § 1818(e) orders issued by the Fed targeted presidents, chief executive officers, board chairmen, and board directors. Over time, however, lower-level employees have come to dominate Fed enforcement. In the five years ending in 2019, 72% of domestic § 1818(e) actions by the Fed barred low- and mid-level employees who had already been terminated from their jobs. All twenty-one orders issued by the Fed between 2008 to 2009 (during and immediately after the financial crisis) affected only lower-level employees. While it is possible that the public data is skewed because the Fed disproportionately relies on threats of removal or prohibition to discipline bank leadership, this norm is nevertheless problematic to the extent it creates an impression among senior bankers that the government will not actually use its most severe enforcement tool against them.

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[28] *Id.*

[29] Notice of Charges for Orders of Prohibition and Orders to Cease and Desist and Notice of Assessments of a Civil Money Penalty, *supra* note 17, at 4.

3. Regulators' Discomfort With Lifetime Industrywide Prohibitions

Setting aside legal constraints on when removal and prohibition is appropriate, federal banking regulators have also expressed discomfort about leveraging § 1818(e) unless there was unmistakable bad faith. The effect of a § 1818(e) order, which in modern practice means a lifetime ban from the banking industry, contributes to a narrative of extreme caution toward using the mechanism. A common critique from banking regulators is that § 1818(e) is a draconian remedy that "tak[es] away" the "[l]ivelihood[s]" of bankers whose careers span years or even decades.[30] Even though regulators retain authority to modify the consequences of a § 1818(e) order, they have not used that discretion in practice. As a result, § 1818(e) is often perceived as an all-or-nothing proposition, a blunt response that may produce unintended consequences.

I believe this view is flawed for two reasons. First, the critique of permanent industrywide prohibitions as draconian is overstated. For example, independent directors of large corporations, including banks, are often former senior executives; with an average age of 63, their livelihoods are rarely at risk.[31] The critique also elevates the perspective of individual bankers over the public's interest and the safety and soundness of the banking system. The discomfort surrounding § 1818(e)'s consequences is particularly troubling when considered in combination with the stark disparity between the number of removal and prohibition orders issued against bank leadership and rank-and-file bank employees, which I discussed above.

Second, there is no sound statutory basis for a rigid view of § 1818(e). The statute expressly delineates a process by which federal banking regulators can limit or curtail the industrywide prohibition by written consent.[32] Not only do regulators have this authority, they have used it to vary the scope, duration, and other terms of prohibition in the past. Section 1818(e) orders issued by the Fed from the early 1980s were bespoke: in some cases, banning the individual from the banking industry for a limited number of years and, in other cases, banning the individual from working at a particular institution.[33] Regulators could return to this practice today without any change in the underlying statute.

However, Congress could also further create a tiered structure within § 1818(e)'s framework that varies the default terms of any removal or prohibition depending on the individual's role within the institution, his culpability, and the harm to the affected institution. Besides changing the duration of prohibitions, options for intermediate penalties include restricting the size of the banks at which the individual may work, restricting the types of positions the individual may hold, and restricting the activities in which the individual may engage. On the other hand, once a bank is in receivership, a lower culpability threshold, such as negligence, should support a broad industrywide prohibition against senior directors and officers

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[30] OIG REPORT, *supra* note 27, at 23.
[31] SPENCER STUART, 2022 U.S. SPENCER STUART BOARD INDEX HIGHLIGHTS 3 (2022).
[32] 12 U.S.C. § 1818(e)(7)(B).
[33] BD. OF GOVERNORS OF THE FED. RSRV. SYS., ANNUAL REPORT ON FORMAL ENFORCEMENT ACTIONS 38, 40–41 (1985); BD. OF GOVERNORS OF THE FED. RSRV. SYS., ANNUAL REPORT ON FORMAL ENFORCEMENT ACTIONS 47 (1981).

who failed to properly oversee the institution under their charge. Facilitating flexible alternatives to a permanent industrywide prohibition has distinct advantages. Scholars have observed that the harshest penalties are often least effective in deterring misconduct in practice because they are infrequently or inconsistently enforced.[34] If banking regulators could circumscribe the prohibition terms according to the particular context of each case, they may be more likely to view § 1818(e) as an appropriate, proportionate sanction and therefore more likely to invoke this authority.

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Although I have some reservations about other legislative proposals currently under consideration by this Committee, including the design of regulation that aims to defer senior executives' incentive-based pay and claw back pay that has already been awarded, I will refrain from making specific comments on the substance of those proposals today. I want to emphasize, however, that those mechanisms cannot replicate or replace a potent removal and prohibition authority in strengthening bank governance. They function fundamentally differently and are not substitutes. When effectively structured and used, the removal and prohibition authority can ensure that federal banking regulators do not need to continue to rely on bankers whom they no longer trust to act competently or in the general public interest. I thank the Committee for their attention to these pressing reforms.

[34] *See, e.g.*, Samuel W. Buell, *Criminal Procedure Within the Firm*, 59 STAN. L. REV. 1613, 1655 (2007) (noting that the "probability of sanction is at least as important as . . . severity of sanction in determining the effectiveness of legal prohibitions in deterring violations").