"LEAST-COST" RESOLUTION

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Abstract: This Article reveals how a fundamental tenet of U.S. banking law unintentionally increases concentration, instability, and inequality in the financial system. Since the 1990s, Congress has instructed federal regulators to resolve a failed bank using the strategy—be it a merger or liquidation—that incurs the "least cost" to the federal Deposit Insurance Fund (DIF). The ensuing three decades have demonstrated that, although well-intentioned, this least-cost requirement is flawed in two ways. First, the least-cost requirement overemphasizes costs to the DIF, which contrary to popular belief are not taxpayer money and cannot be predicted accurately. Second, it ignores other critical factors that regulators ought to consider when resolving an insolvent bank, including competition, financial stability, and financial inclusion. This Article traces the origins of the least-cost requirement and draws on case studies, including JPMorgan's acquisition of First Republic Bank in 2023, to show how it has distorted bank resolution in undesirable ways. The Article contends that Congress should repeal the least-cost mandate to allow bank regulators to consider all relevant societal costs when deciding how to resolve a failed bank. Absent this reform, the least-cost requirement will inevitably lead to even more concentration, less inclusion, and increasing fragility in the financial system.

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INTRODUCTION

JPMorgan's acquisition of First Republic Bank after its spectacular collapse in April 2023 sparked immediate outrage among some financial policymakers.[1] Democratic Senator Elizabeth Warren decried regulators' "troubling" decision to sell First Republic to the country's largest bank.[2] Sounding a rare note of bipartisan agreement, Republican Senator JD Vance called JPMorgan's acquisition "a really bad deal for consumers [and] a really bad deal for the risk of our financial system."[3] In critics' view, merging First Republic with JPMorgan exacerbated the "too big to fail" problem, reduced competition, and bailed out wealthy tech companies that had imprudently kept billions of dollars of uninsured deposits at First Republic.[4]

Despite these drawbacks, however, the Federal Deposit Insurance Corporation (FDIC) had little choice but to sell First Republic to JPMorgan. That is because the FDIC's governing statute requires the agency to resolve a failed bank in a way that incurs "the least possible cost" to the Deposit Insurance Fund (DIF).[5] Based on the FDIC's calculations, JPMorgan submitted the best bid of the four banks vying to acquire First Republic in the receivership auction.[6] The FDIC also estimated that selling First Republic to JPMorgan would be cheaper than liquidating the failed bank and reimbursing First Republic's insured depositors.[7] Once the FDIC determined that JPMorgan's bid would incur the least cost to the DIF, it was legally obligated to award First Republic to JPMorgan—regardless of the merger's potential downsides.

Unquestionably, the Federal Deposit Insurance Act's least-cost

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[1] *See* Ben Eisen & Andrew Ackerman, *Why Washington Let JPMorgan Buy First Republic*, WALL ST. J. (May 2, 2023), https://www.wsj.com/articles/how-washington-got-on-board-with-a-big-bank-deal-for-first-republic-609188aa.

[2] Letter from Sen. Elizabeth Warren to Martin J. Gruenberg, Chair, Fed. Deposit Ins. Corp. and Michael Hsu, Acting Comptroller of the Currency, Off. of the Comptroller of the Currency 3 (May 17, 2023), https://www.warren.senate.gov/oversight/letters/warren-questions-banking-regulators-decisions-on-sale-of-first-republic-bank-to-jpmorgan.

[3] *The Consumer Financial Protection Bureau's Semi-Annual Report to Congress*, U.S. SEN. COMM. ON BANKING, HOUS. & URB. AFFS. (June 13, 2023), https://www.banking.senate.gov/hearings/06/06/2023/the-consumer-financial-protection-bureaus-semi-annual-report-to-congress (statement of Sen. JD Vance) (at 1:41:13).

[4] *See* Eisen & Ackerman, *supra* note 1 (summarizing opposition to JPMorgan's acquisition of First Republic).

[5] 12 U.S.C. § 1823(c)(4)(B).

[6] *See Bid Summary, First Republic Bank, San Francisco, CA*, FED. DEPOSIT INS. CORP. (May 31, 2023), https://www.fdic.gov/resources/resolutions/bank-failures/failed-bank-list/first-republic-bid-summary.html [hereinafter *First Republic Bid Summary*].

[7] *See id.* ("The winning bidder's acquisition of all the deposits was the least costly resolution compared to a liquidation alternative.").

requirement was well-intentioned when Congress adopted it in 1991. At the time, regulators had just shuttered more than 1,000 depository institutions at a cost of more than $150 billion during the Savings and Loan (S&L) Crisis.[8] In the aftermath, lawmakers vociferously criticized regulators for using taxpayer funds to bail out insolvent institutions and protect uninsured depositors.[9] By implementing the least-cost mandate, Congress sought to prevent the FDIC from depleting the DIF in the future when alternative, more cost-effective strategies could be used to resolve a failed bank.[10]

This Article contends that the ensuing three decades have demonstrated that the least-cost requirement is misguided and ought to be repealed. The least-cost mandate is flawed in two ways: it overemphasizes costs to the DIF, and it undervalues other societal costs incurred when resolving a failed bank.

First, the least-cost mandate places greater emphasis on the DIF than is warranted. The DIF is funded by assessments levied on depository institutions, with progressively higher assessment rates on larger, complex firms.[11] Thus, when the FDIC draws on the DIF to resolve a failed bank, it later replenishes the fund through assessments on banks, not through Congressional appropriations of taxpayer funds.[12] To be sure, banks may pass on a portion of deposit insurance assessments to customers, but some proportion of FDIC assessment fees are borne by bank shareholders and executives.[13] Since the banking system internalizes at least some of the cost of resolving failed banks, minimizing costs to the DIF should not be the sole decision rule for bank resolution.

Furthermore, the least-cost mandate's exclusive focus on DIF costs is misguided because these costs are nearly impossible to predict with precision. Calculating the liquidation value of a failed bank and valuing takeover bids involves numerous assumptions and estimations about the FDIC's recovery rates on the failed bank's assets, its liability under any loss sharing agreements, and potential profits on equity appreciation rights in the winning

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[8] *See* Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, 13 FDIC BANKING REV. 26, 33 (2000).

[9] *See* Helen Garten, *A Political Analysis of Bank Failure Resolution*, 74 B.U. L. REV. 429, 472-74 (1994).

[10] *See id.* at 475.

[11] *See* 12 U.S.C. § 1817(b); 12 CFR § 327.10 (setting assessment rate schedules).

[12] The FDIC may borrow up to $100 billion from the Treasury Department to replenish the DIF, subject to a mandatory repayment schedule. *See* 12 U.S.C. § 1824(a), (c).

[13] *See generally* Long-Term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions 113, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230829a1.pdf (noting that increased funding costs "may be absorbed to varying degrees by [bank] stakeholders … including equity holders, depositors, borrowers, employees, or other stakeholders").

bidder.[14] These projections are inherently uncertain and may produce widely variable forecasts.[15] In one notable case, the FDIC's cost estimate for resolving Silicon Valley Bank fluctuated by almost $6 billion as it sold the failed bank's assets throughout 2023.[16] The imprecision inherent in projecting costs to the DIF makes it challenging for the FDIC to accurately weigh competing resolution strategies and cautions against using this metric as the sole criterion for deciding how to resolve a failed bank.

In addition to overemphasizing costs to the DIF, the least-cost mandate is unwise for a second reason: it underemphasizes—indeed, completely ignores—other costs bank resolution may impose on society. These externalities come in many flavors. For example, an FDIC auction may lessen competition when a failed bank's primary rival bids more for the failed bank than other suitors that do not compete directly.[17] Similarly, an FDIC auction may increase future financial stability risks if a systemically important bank submits a better bid than other, less systemic banks, as was the case in the First Republic resolution.[18] An FDIC auction could also perpetuate longstanding barriers in access to finance if a minority-owned depository institution is sold to a bank that does not prioritize financial inclusion.[19] Yet under the least-cost mandate, the FDIC is prohibited from considering these potential downsides and must award a failed bank to the highest bidder, regardless of the societal consequences.

By examining the history and implementation of the least-cost requirement, this Article exposes an underappreciated weakness in U.S. banking law. Since the 2008 financial crisis, policymakers and legal scholars have focused on improving resolution strategies for complex financial conglomerates through the Dodd-Frank Act's Orderly Liquidation Authority,

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[14] *See* Jason Allen, Robert Clark, Brent Hickman & Eric Richert, *Resolving Failed Banks: Uncertainty, Multiple Bidding and Auction Design*, 91 REV. ECON. STUDS. 1201, 1206-07 (2024) (describing the bidding process in FDIC auctions).

[15] *See id.*

[16] *See infra* Section II.A.2.

[17] *See* João Granja, Gregor Matvos & Amit Seru, *Selling Failed Banks*, 72 J. FIN. 1723, 1725 (2017) ("Potential acquirers whose market concentration increases most with the acquisition of a failed bank should have a higher willingness to pay for a failed bank…. We find an economically small but statistically significant effect of market concentration.").

[18] *See generally* Kris James Mitchener & Angela Vossmeyer, *How Do Financial Crises Redistribute Risk?* 4 (Nat'l Bureau of Econ. Rsch., Working Paper No. 31537, 2023), https://www.nber.org/papers/w31537 (concluding that each failing bank acquisition during the Great Depression increased the acquirer's systemic risk by 25 percent).

[19] *See* FED. DEPOSIT INS. CORP., OFF. OF THE INSPECTOR GEN., MINORITY DEPOSITORY INSTITUTION PROGRAM AT THE FDIC 12 (2019), https://www.fdicoig.gov/sites/default/files/reports/2022-08/19-002EVAL.pdf (reporting that 62 percent of minority-owned depository institutions that failed between 2002 and 2016 were sold to non-minority-owned bidders).

total loss absorbing capacity requirements, and "living wills."[20] By contrast, experts have largely ignored the FDIC's traditional role in resolving failed banks, as distinct from diversified holding companies.[21] The high-profile collapses of Silicon Valley Bank, Signature Bank, and First Republic Bank in 2023 revealed that renewed attention is needed to the legal framework for depository institution resolution.

Left intact, the least-cost resolution mandate is likely to lead to a more concentrated, less competitive, and increasingly fragile and exclusionary financial system. Indeed, a failed bank's direct competitors often have the strongest incentive to acquire a failed bank in an FDIC auction, precisely because such a merger could enhance the acquirer's market power.[22] Moreover, megabanks like JPMorgan have an inherent advantage when they bid in FDIC auctions because they benefit from a lower cost of funding than banks that are not perceived to be "too big to fail."[23] In this way, future bank failures could produce a significant restructuring of the U.S. financial system, with long-term consequences for economic growth, distributional equity, and financial inclusion. In light of the high stakes, financial policymakers ought to be exceedingly thoughtful about the trade-offs involved in resolving failed banks beyond just direct costs to the DIF. Former FDIC Chair Sheila Bair reached a similar conclusion when reflecting on her experiences during the

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[20] *See, e.g.*, Stephen J. Lubben, *A Functional Analysis of SIFI Insolvency*, 96 TEX. L. REV. 1377 (2018); Steven L. Schwarcz, *Beyond Bankruptcy: Resolution as a Macroprudential Regulatory Tool*, 94 NOTRE DAME L. REV. 709 (2018); Stephen J. Lubben & Arthur E. Wilmarth, Jr., *Too Big and Unable to Fail*, 69 FLA. L. REV. 1205 (2017); Kwon-Yong Jin, Note, *How to Eat an Elephant: Corporate Group Structure of Systemically Important Financial Institutions, Orderly Liquidation Authority, and Single Point of Entry Resolution*, 124 YALE L.J. 1746 (2015); Thomas W. Merrill & Margaret L. Merrill, *Dodd-Frank Orderly Liquidation Authority: Too Big for the Constitution?*, 163 U. PA. L. REV. 165 (2014); Thomas H. Jackson & David A. Skeel, Jr., *Dynamic Resolution of Large Financial Institutions*, 2 HARV. BUS. L. REV. 435 (2012); Stephen J. Lubben, *Resolution, Orderly and Otherwise: B of A in OLA*, 81 U. CIN. L. REV. 485 (2012); Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. ON REGUL. 151 (2011); David Zaring, *A Lack of Resolution*, 60 EMORY L.J. 97 (2010).

[21] For two notable exceptions, see Maziar Peihani, *Resolution of Small and Medium-Sized Deposit-Taking Institutions: Back to Basics?*, 60 AM. BUS. L.J. 419 (2023) (adopting an international, comparative perspective on bank regulation), and Randall D. Guynn, The Deposit Insurance Fund as an Early Resolution Tool (July 15, 2024) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4897571 (urging the FDIC to resolve troubled banks prior to their insolvency).

[22] *See* Granja et al., *supra* note 17, at 1725.

[23] Empirical analyses have demonstrated that banks perceived to be "too big to fail" benefit from an implicit subsidy because market participants expect that the government would bail out such a bank rather than let it collapse. Estimates of the "too big to fail" subsidy range from roughly twenty to one hundred basis points. *See* Nicola Cetorelli & James Traina, *Resolving "Too Big to Fail,"* 60 J. FIN. SVCS. RSCH. 1, 13 n.11 (2021).

2008 crisis, cautioning that regulators "should have more flexibility rather than being compelled to choose the 'least cost' option."[24]

In addition to offering a new perspective on bank resolution, this Article contributes to the burgeoning literature exposing the limits of quantitative cost-benefit analysis in financial regulation and economic policymaking. Professors John Coates and Jeffrey Gordon have documented that agencies and courts increasingly subject financial regulations to quantitative cost-benefit analyses, even when not statutorily required.[25] Both Coates and Gordon contend that applying strict cost-benefit analysis to financial rules may impair social welfare because societal benefits are more difficult to quantify than direct compliance costs on regulated entities.[26] More broadly, Professor Mehrsa Baradaran has argued that the prioritization of measurable costs in the regulatory process leads to systematic under-regulation throughout the U.S. economy.[27] This Article demonstrates that the least-cost requirement is yet another example of financial policymakers fixating on costs they believe they can measure, while deemphasizing other, less quantifiable—but potentially more important—considerations.

This Article proceeds as follows. Part I traces the origins and implementation of the least-cost resolution mandate, including Congress's initial rationale for adopting the requirement and how the FDIC has applied it in practice. Part II then explains how the least-cost test distorts bank resolution in undesirable ways. It demonstrates that the least-cost mandate both overemphasizes costs to the DIF and undervalues other societal costs. Part III anticipates how the least-cost requirement is likely to produce a more concentrated, less inclusive, and increasingly fragile financial system in the future. Accordingly, Part IV recommends that Congress repeal the least-cost mandate. Part IV also suggests strategies for how the federal banking agencies could minimize harmful consequences while working within the constraints of the least-cost test if Congress declines to repeal it. The Article concludes that reforming the least-cost mandate is necessary to ensure that failed bank resolution policy promotes competition, financial stability, and financial inclusion rather than detracting from these important societal objectives.

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[24] Sheila Bair, *It's Time to Rethink the FDIC Approach to Bank Rescues*, FIN. TIMES (Mar. 11, 2024), https://www.ft.com/content/e1ce2ba6-89e3-4132-8061-02120cf8165d.

[25] *See* John C. Coates, IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882, 920-26 (2015); Jeffrey N. Gordon, *The Empty Call for Benefit-Cost Analysis in Financial Regulation*, 43 J. LEGAL STUD. 351, 367 (2014).

[26] *See* Coates, *supra* note 25, at 960; Gordon, *supra* note 25, at 373-75.

[27] *See* MEHRSA BARADARAN, THE QUIET COUP: NEOLIBERALISM AND THE LOOTING OF AMERICA 236-38 (2024).

I. THE LEAST-COST TEST: ORIGINS AND IMPLEMENTATION

When Congress established the FDIC in 1933, it charged the agency with resolving insolvent banks.[28] Roughly sixty years and 1,800 bank failures later, Congress insisted the FDIC use the resolution method for each failure that incurs "the least possible cost" to the DIF.[29] This Part traces the origins and implementation of the least-cost test. Section I.A begins by surveying the tools the FDIC used for resolving failed banks during its early years. Sections I.B and I.C then examine the rationale for the least-cost test's adoption in 1991 and the FDIC's implementation of the least-cost framework thereafter. Section I.D concludes with an overview of legal reforms enacted after the 2008 financial crisis that guide the FDIC's resolution practices today.

A. The FDIC's Traditional Resolution Toolkit

Throughout its history, the FDIC has exercised its power to resolve failed banks in different ways. When the FDIC was first created, the agency was required by law to liquidate an insolvent bank.[30] In the ensuing decades, however, the FDIC sought—and Congress granted—authority to use alternative resolution methods.[31] By the time of the S&L Crisis in the 1980s, the FDIC's resolution toolkit included four different approaches for resolving a failed bank: (1) liquidation, (2) FDIC-assisted merger, (3) open-bank assistance, and (4) establishment of a bridge bank.

Under the FDIC's chartering statute, the agency was originally limited to resolving a failed bank through *liquidation*.[32] In a liquidation—also known as a depositor payout—the FDIC sells a failed bank's assets and distributes the proceeds to each depositor, up to the deposit insurance limit.[33] Any obligations to insured depositors that the FDIC does not recoup by selling the

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[28] *See* Banking Act of 1933, Pub. L. No. 73-66, § 8, 48 Stat. 162, 168-80.

[29] *See* Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 141, 105 Stat. 2236, 2273-77 (codified at 12 U.S.C. § 1823(c)(4)); *see also* FED. DEPOSIT INS. CORP., ANNUAL REPORT 1991, at 127 (documenting 1,895 failed banks between 1934 and 1991).

[30] *See* MICHAEL S. BARR, HOWELL E. JACKSON & MARGARET E. TAHYAR, FINANCIAL REGULATION: LAW AND POLICY 1045 (3d ed., 2021) (noting that the FDIC initially "had only one procedure for making payments to insured depositors").

[31] *See id.* at 1045-46 (describing the expansion of the FDIC's resolution authorities).

[32] *See id.* at 1045.

[33] *See* FED. DEPOSIT INS. CORP., RESOLUTIONS HANDBOOK 19-20 (2019) [hereinafter RESOLUTIONS HANDBOOK], https://www.lb7.uscourts.gov/documents/18c8697.pdf. The FDIC's deposit insurance limit was originally $2,500. *See* Banking Act of 1933, Pub. L. No. 73-66, § 8, 48 Stat. 162, 179. Congress has periodically increased the limit, which is now set at $250,000. *See* 12 U.S.C. § 1821(a)(1)(E).

bank's assets are covered by the DIF.[34] The original approach to liquidation required the FDIC to establish a new entity—known as a deposit insurance national bank (DINB)—and conduct depositor payouts through the DINB.[35] Today, the FDIC can mail checks directly to depositors without creating a DINB.[36]

As the U.S. banking system deteriorated during the Great Depression, the FDIC discovered that liquidating failed banks would soon become prohibitively expensive. Thus, the newly created agency lobbied Congress to expand its resolution toolkit.[37] In response, Congress authorized the FDIC to resolve a failed bank through an *FDIC-assisted merger*.[38] In an assisted merger—also known as a purchase and assumption (P&A) transaction—the FDIC transfers some or all of the assets and liabilities of a failed bank to a healthy institution.[39] In connection with the transaction, the depositors of the failed bank automatically become depositors of the acquirer.[40] An FDIC-assisted merger can be structured as a whole-bank P&A, in which the acquirer assumes all of the failed bank's assets and liabilities, or a partial bank P&A, in which only certain assets and liabilities transfer.[41] The FDIC may facilitate

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[34] Over time, Congress has changed the name of the FDIC's insurance fund(s) and expanded the universe of depository institutions that the FDIC insures. Originally, the FDIC's insurance fund was called the Permanent Insurance Fund (PIF) and insured only commercial banks, while the Federal Savings & Loan Insurance Corporation (FSLIC) insured savings and loan associations, or thrifts. *See* Michael P. Malloy, *Double, Double Toil and Trouble: Bank Regulatory Policy at Mid-Decade*, 63 FORDHAM L. REV. 2031, 2035 (1995). In 1989, Congress changed the name of the PIF to the Bank Insurance Fund (BIF), eliminated the FSLIC, and charged the FDIC with administering a new Savings Association Insurance Fund (SAIF) for thrifts. *See* Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 211, 103 Stat. 183, 218-22 (codified as amended at 12 U.S.C. § 1821(a)). The Federal Deposit Insurance Reform Act of 2005 merged the BIF and the SAIF to create the DIF, which now insures both commercial banks and thrifts. *See* Pub. L. No. 109-171, § 2102, 120 Stat. 9, 9 (codified as amended at 12 U.S.C. § 1821 note). This Article refers only to the DIF for simplicity.

[35] *See* BARR ET AL., *supra* note 30, at 1045.

[36] *See id.* The Banking Act of 1935 authorized the FDIC to pay depositors directly in lieu of creating a DINB. *See* Banking Act of 1935, Pub. L. No. 74-305, § 101, 49 Stat. 684, 695.

[37] *See* Helen A. Garten, *A Political Analysis of Bank Failure Resolution*, 74 B.U. L. REV. 429, 472 (1994) ("[T]he agency argued that it needed flexibility to adopt solutions to bank failure that were less expensive than liquidation and payoff.")

[38] *See* FED. DEPOSIT INS. CORP., MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE 739 (1998) [hereinafter MANAGING THE CRISIS] (discussing the Banking Act of 1935).

[39] *See* RESOLUTIONS HANDBOOK, *supra* note 33, at 16.

[40] *See id.* at 14 (noting that the "the failed institution's customers automatically become customers of the [acquirer] with access to their insured funds").

[41] *See* Michael Ohlrogge, Why Have Uninsured Depositors Become De Facto Insured? 19 (Nov. 5, 2023) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?

such a merger by making loans to, purchasing assets from, or providing guarantees to the acquirer.[42] After the FDIC obtained this authority in 1935, assisted mergers soon became the agency's preferred method for resolving failed banks, and liquidations generally disappeared from use.[43]

The failure, and subsequent merger or liquidation, of thousands of depository institutions in the 1930s and 1940s sparked worries of a "possible shortage of banking services" in affected communities.[44] To address this concern, the FDIC urged Congress to add a third tool to its resolution toolkit: *open-bank assistance*.[45] In 1950, Congress authorized the FDIC to make loans to, purchase assets from, or make deposits in a bank that had failed or was in danger of failing if the FDIC determined that "the continued operation of such bank is essential to provide adequate banking service in the community."[46] Policymakers reasoned that, in such circumstances, restoring a troubled bank to sound financial condition would be preferable to a merger or liquidation.[47] In the ensuing decades, however, the FDIC rarely made a finding of essentiality, and the standard was perceived as too demanding at a time when many local communities were still served by many depository institutions.[48] Accordingly, Congress in 1982 permitted the agency to provide assistance to a bank even if it was not deemed essential, as long as the amount of assistance was less than the estimated cost of its liquidation.[49] Congress

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abstract_id=4624095 (describing partial bank P&As).

[42] *See* 12 U.S.C. § 1823(c)(2).

[43] *See* Garten, *supra* note 37, at 472 ("By the 1940s, federally assisted mergers played a role in virtually all bank failures…").

[44] Garten, *supra* note 37, at 473.

[45] *See id.*

[46] An Act to Amend the Federal Deposit Insurance Act, Pub. L. No. 81-797, ch. 967, 64 Stat. 873, 888-89 (1950).

[47] *See* MANAGING THE CRISIS, *supra* note 38, at 740.

[48] *The Deposit Insurance Flexibility Act: Hearing on H.R. 4603 Before the Subcomm. On Fin. Insts. Supervision, Regul. & Ins. of the H. Comm. on Banking, Fin. & Urb. Affs.*, 97th Cong. 175 (1981) (statement of Paul. A. Volcker, Chairman, Board of Governors, Federal Reserve System) (discussing the difficulty of applying the essentiality standard). The FDIC used open-bank assistance only eight times between 1950 and 1981, out of more than 175 bank failures and assistance transactions. *See* MANAGING THE CRISIS, *supra* note 38, at 153.

[49] Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 111, 96 Stat. 1469, 1469-70 (prohibiting the FDIC from providing assistance "in an amount in excess of that amount which the [FDIC] determines to be reasonably necessary to save the cost of liquidating, including paying the insured accounts of such insured bank" unless the FDIC "determines that the continued operation of such insured bank is essential to provide adequate banking services in its community"). Congress also expanded the type of open-bank assistance the FDIC could provide, including the ability to purchase a bank's preferred stock or other securities, with the exception of common stock. *See* Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1174 (1988).

applied a similar proviso, which came to be known as the "cost test," to FDIC-assisted mergers.[50] The FDIC's use of open-bank assistance increased sharply under this less demanding legal standard.[51]

Despite the FDIC's growing arsenal of resolution tools, a series of large bank failures in the early 1980s revealed the agency's need for even broader authority. The FDIC contended that the "increased numbers of failed banks" and "the relatively large size of some troubled banks" was making it "increasingly difficult to find purchasers for all failed banks."[52] Thus, in 1987, Congress granted the FDIC authority to establish and operate *bridge banks*.[53] When the FDIC opens a bridge bank, it transfers all of a failed bank's assets to the new institution, which the agency itself operates for a limited period of time.[54] As the FDIC explains, the new bank is "designed to 'bridge' the gap in time between the failure of the original institution and the time it takes the FDIC to evaluate and market the institution to a third party."[55] As one legal scholar described it, establishing a bridge bank gives the FDIC "more time to craft an exit strategy."[56] Like FDIC-assisted mergers and open-bank assistance, Congress conditioned the FDIC's establishment of a bridge bank on compliance with the cost test: the agency could only establish a bridge bank if doing so would be less costly to the DIF than liquidation.[57] The FDIC used its bridge bank authority to address the failures of five large holding companies between 1987 and 1989.[58]

Thus, by the late 1980s, the FDIC had four resolution tools at its disposal: liquidation, assisted mergers, open-bank assistance, and bridge banks. The FDIC generally had discretion to choose from among these methods, subject only to the cost test that any non-liquidation method be less costly to the DIF

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[50] *See id.*; *see also* BARR ET AL., *supra* note 30, at 1050 (discussing the "cost test").

[51] *See* MANAGING THE CRISIS, *supra* note 38, at 153, 155 (indicating that the FDIC used open-bank assistance twenty-four times between 1982 and 1986).

[52] *Strengthening the Safety and Soundness of the Financial Services Industry: Hearing Before the S. Comm. on Banking, Housing & Urb. Affs.*, 100th Cong. 103 (1987) (statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation).

[53] Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 503, 101 Stat. 552, 629 (codified as amended at 12 U.S.C. § 1821(n)).

[54] *See* RESOLUTIONS HANDBOOK, *supra* note 33, at 16. The FDIC may operate a bridge bank for up to two years, with the possibility of three one-year extensions. *See* 12 U.S.C. § 1821(n)(9).

[55] RESOLUTIONS HANDBOOK, *supra* note 33, at 16.

[56] Peihani, *supra* note 21, at 425.

[57] Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 503, 101 Stat. 552, 629 (codified as amended at 12 U.S.C. § 1821(n)(2)(A)(i)) (authoring the establishment of a bridge bank "only if the [FDIC] determines that … the amount which is reasonably necessary to organize and operate such bridge bank will not exceed the amount which is reasonably necessary to save the cost of liquidating, including paying the insured accounts of the closed bank or banks").

[58] *See* MANAGING THE CRISIS, *supra* note 38, at 173.

than liquidation.[59] Even with this expansive toolkit, however, the emerging S&L Crisis would soon test the FDIC's resolution capabilities—and Congress' tolerance for costly bank failures.

B. The S&L Crisis and the Adoption of the Least-Cost Test

A wave of failures in late 1980s and early 1990s overwhelmed the federal government's capacity to resolve insolvent firms. This period, which came to be known as the S&L Crisis, claimed more than 2,000 failed banks and thrifts.[60] The causes of the crisis were multifactorial: rising interest rates, reckless real estate lending, and regional recessions collectively destabilized wide swaths of the financial system.[61] The FDIC and its sister agency—the Federal Savings and Loan Insurance Corporation (FSLIC), which insured thrifts—struggled to cope with the onslaught of failures.[62] The FSLIC soon became insolvent, prompting Congress to establish a new taxpayer-funded agency to address the glut of failed thrifts.[63] Meanwhile, the FDIC relied heavily on open-bank assistance and whole-bank FDIC-assisted mergers to resolve failed banks, at great cost to the DIF.[64] The ultimate cost of bank and thrift failures during the S&L Crisis reached close to $200 billion, including more than $130 billion of taxpayer money.[65]

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[59] *See supra* notes 49, 50, and 57 and accompanying text.

[60] *See* FED. DEPOSIT INS. CORP., ANNUAL REPORT 2023, at 188 (documenting 1,140 failed banks between 1986 and 1992); Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, 13 FDIC BANKING REV. 26, 27 (2000) (documenting 1,030 failed thrifts between 1986 and 1992).

[61] *See* FED. DEPOSIT INS. CORP., HISTORY OF THE EIGHTIES: AN EXAMINATION OF THE BANKING CRISES OF THE 1980S AND EARLY 1990S, at 4-37 [hereinafter BANKING CRISES OF THE 1980S AND EARLY 1990S] (examining causes of the S&L Crisis); *see also* Carl Felsenfeld, *The Savings and Loan Crisis*, 59 FORDHAM L. REV. S7, S38-S49 (1991) (discussing causes of the crisis).

[62] *See* Kenneth E. Scott, *Never Again: The S&L Bailout Bill*, 45 BUS. LAW. 1883, 1883 (1990) (discussing the FDIC's and FSLIC's losses during the S&L crisis).

[63] *See* Wayne M. Josel, *The Resolution Trust Corporation: Waste Management and the S&L Crisis*, 59 FORDHAM L. REV. S339, S343-53 (1991) (discussing the creation of the Resolution Trust Corporation (RTC) in 1989). Congress authorized the FDIC to address future thrift failures that arose after the RTC's dissolution in 1996. *See id.* at S344; *see also supra* note 34 (discussing the elimination of the FSLIC and creation of the SAIF).

[64] *See* Gordon & Muller, *supra* note 20, at 186 ("During a wave of bank failures in the 1980s, the FDIC liberally used its open bank assistance powers to resolve failing banks…"); *see also* RESOLUTIONS HANDBOOK, *supra* note 33, at 17 (noting that prior to 1991, the FDIC "had structured most of its transactions to transfer both insured and uninsured deposits").

[65] *See* BANKING CRISES OF THE 1980S AND EARLY 1990S, *supra* note 61, at 39 (noting that the estimated cost of FDIC failed-bank resolutions between 1980 and 1994 was $36.3 billion, and the estimated cost of thrift failures was $160.1 billion, of which $132.1 billion was borne by taxpayers).

The S&L Crisis provoked immediate backlash in Congress. Lawmakers were livid about the use of taxpayer funds to clean up the failed thrifts.[66] Some members were particularly angry that the FDIC had protected the uninsured depositors of large banks, but not smaller ones.[67] In addition, subsequent investigations revealed that the FDIC "may not have marketed large failed banks effectively" and "may have solicited … too few bidders," leading to excessive costs to the DIF.[68] Policymakers generally agreed that the existing resolution framework had not worked well and had proven far too costly.[69]

Congress responded to the S&L Crisis by enacting the Federal Deposit Insurance Corporation Act of 1991 (FDICIA). At the time, the FDICIA was widely considered to be "the most important banking legislation in the United States since the Banking (Glass-Stegall) Act of 1933."[70] Among numerous reforms to strengthen bank oversight and prevent future crises, the FDICIA significantly curtailed the FDIC's discretion when resolving failed banks.[71] The FDICIA provided that when resolving a failed bank, the FDIC must use the approach that is "least costly to the deposit insurance fund of all possible methods."[72] This new "least-cost" test supplanted the prior cost test, which had necessitated only that the FDIC choose a resolution method that was less costly to the DIF than liquidation.[73]

Congress' rationale for enacting the least-cost requirement was two-fold. First, Congress sought to "protect the [DIF] from excessive loss."[74] The DIF balance had fallen from $18 billion in 1987 to $9 billion in 1990, and some contemporaneous estimates projected that the DIF could become insolvent within a year.[75] The least-cost requirement was thus intended to prevent the

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[66] *See, e.g.*, 136 CONG. REC. S17,748 (daily ed. Oct. 2, 1990) (statement of Sen. Frank Lautenberg) ("It is outrageous that taxpayers are being asked to pay billions of dollars to clean up the S&L mess.").

[67] *See* Gordon & Muller, *supra* note 20, at 188 n.107 ("The legislative record suggests that many members were … offended by the disparate treatment of large banks—whose depositors were commonly fully protected—and small banks—where protection was commonly limited to insured depositors….").

[68] George J. Benston & George G. Kaufman, *FDICIA After Five Years*, 11 J. ECON. PERSPS. 139, 153 (1997).

[69] *See* Ohlrogge, *supra* note 41, at 28.

[70] Benston & Kaufman, *supra* note 68, at 140.

[71] *See* Richard Scott Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 ANN. REV. BANKING L. 317, 317 (1993) (summarizing the FDICIA's main provisions, including capital-based prompt corrective action, risk-based deposit insurance premia, and least-cost resolution).

[72] Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 141(a), 105 Stat. 2236, 2274 (codified at 12 U.S.C. § 1823(c)(4)).

[73] *See supra* notes 50 and 59 and accompanying text (discussing the cost test).

[74] H.R. REP. NO. 102-330, at 95 (1991).

[75] *See id.* at 94.

DIF from incurring avoidable losses. Second, Congress adopted the least-cost test to ensure that a bank's uninsured depositors would shoulder at least some losses if the bank were to fail. Many policymakers felt that the FDIC had too often made uninsured depositors whole, such as when an FDIC-assisted merger transferred all of a bank's deposits to a healthy acquirer.[76] Commentators feared that protecting uninsured depositors in resolution created moral hazard and reduced depositors' incentive to monitor their banks ex ante.[77] Congress reasoned that the least-cost test would mitigate moral hazard—and thereby increase market discipline—by limiting the FDIC's ability to protect uninsured depositors in the future.[78]

The FDICIA established a lone, emergency exception to the least-cost test. Lawmakers authorized the FDIC to deviate from least-cost resolution only in situations when using the least-cost approach "would have serious adverse effects on economic conditions or financial stability."[79] Reflecting Congress' commitment to least-cost resolution, it established onerous procedural safeguards around the use of this "systemic risk exception."[80] Specifically, Congress required a two-thirds vote of both the FDIC and Federal Reserve boards of directors, as well as a determination by the Secretary of the Treasury in consultation with the President to invoke the systemic risk exception.[81] These substantive standards and procedural safeguards collectively set a much higher bar than the essentiality threshold for exceptions to the cost test, which was eliminated by the FDICIA.[82] In this way, statutory limits on the systemic risk exception were meant to ensure that the FDIC could not deviate from least-cost resolution "except in truly dire circumstances."[83]

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[76] *See id.* at 93 (noting that "[f]rom 1985 through 1990 … more than 99 percent of uninsured depositors have been fully protected").

[77] *See* Krishna G. Mantripragada, *Depositors as a Source of Market Discipline*, 9 YALE J. ON REGUL. 543, 553-54 (1992) (discussing market discipline by uninsured depositors).

[78] *See* Laurence H. Meyer, Governor, Bd. of Governors of the Fed. Rsrv. Sys., Remarks at the 37th Annual Conference on Bank Structure and Competition of the Federal Reserve Bank of Chicago: Controlling the Safety Net (May 10, 2001), https://www.federalreserve.gov/boarddocs/speeches/2001/200105102/default.htm ("[T]he general thrust of least-cost resolution was to encourage market discipline by putting uninsured depositors and other liability holders at greater risk.").

[79] Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 141(a), 105 Stat. 2236, 2275.

[80] *See* BARR ET AL., *supra* note 30, at 1054-55 (discussing the systemic risk exception).

[81] Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 141(a), 105 Stat. 2236, 2275.

[82] *See supra* notes 49-50 and accompanying text (discussing the cost test and the essentiality exception); *see also* Carnell, *supra* note 71, at 363 (noting that the FDICIA repealed the essentiality exception to the cost test).

[83] BARR ET AL., *supra* note 30, at 1055.

C. The Least-Cost Test in Practice

After its enactment, the least-cost test quickly became the "defining feature of the legal framework governing the FDIC's bank resolution authority."[84] The least-cost test spawned a complex process for determining the most cost-effective resolution method for a failed bank. This Section outlines the FDIC's resolution framework under the least-cost requirement and examines the multiple factors that go into choosing the least-cost approach.

When the FDIC learns that a bank is in danger of failing, it starts preparing to resolve the institution. The FDIC typically begins by identifying banks with satisfactory supervisory ratings that might be interested in acquiring the failing bank.[85] The agency then subjects these banks "to a size constraint that depends on geographic proximity" to the failing bank.[86] The FDIC generally requires that a potential bidder's "total assets must exceed two times the size of the fail[ing] bank if it is located in the same state, four times the size of the fail[ing] bank if is located in a contiguous state, and five times the size of the fail[ing] bank if it is located in a nonadjacent state."[87] Once the FDIC has generated a list of potential bidders, it provides the list to the Office of the Comptroller of the Currency (OCC), the Federal Reserve, and state banking authorities, which may object to the inclusion of any potential bidder.[88] The FDIC then invites potential acquirers to conduct due diligence on the failing bank on a confidential basis.[89]

When it becomes apparent that the failing bank is likely to be closed, the FDIC solicits bids from the pre-identified list of potential bidders. To comply with the least-cost requirement, the FDIC invites bidders to compete on many different dimensions. A typical bid contains at least three different components. First, the bid indicates whether it is *whole bank* or *partial*

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[84] *Id.* at 1054.

[85] *See* Allen et al., *supra* note 14, at 1205; Granja et al., *supra* note 17, at 1768.

[86] Allen et al., *supra* note 14, at 1205.

[87] Granja et al., *supra* note 17, at 1768. The FDIC, however, often deviates from these size parameters. *See id.* at 1768 n.18 ("We find that there seems to be some discretion in how these rules are imposed by the FDIC. Approximately 25% of the winning bidders [in 462 failed bank auctions between 2007 and 2013] do not strictly meet the size criterion.").

[88] *See* RESOLUTIONS HANDBOOK, *supra* note 33, at 11 ("Once the bidders list has been generated, the FDIC must obtain consent from each potential bidders' regulatory (chartering) authority in order to allow them to participate in the failing bank resolution.").

[89] *See id.* at 11 ("The FDIC provides all potential bidders interested in the failing institution with access to the [virtual data room] once they have signed a confidentiality agreement. The [virtual data room] … provides them an opportunity to perform due diligence on a failing institution prior to the bid deadline.").

bank.[90] By offering the partial bank option, the FDIC allows a bidder to exclude certain assets or uninsured deposits that it does not want to acquire.[91] Second, the bid specifies an *asset discount*, or the cash infusion the bank requires from the FDIC to assume the relevant assets.[92] Third, the bid indicates a *deposit premium*, representing the amount that the bidder is willing to pay to acquire the relevant deposits.[93] Since the asset discount typically exceeds the deposit premium, these two components generally net out to the amount of money the bidder demands from the FDIC as assistance to support the transaction.[94]

While the foregoing provisions are components of all bids in a failed bank auction, the FDIC may invite potential acquirers to include additional, optional terms, as well. These additional terms are intended to reduce costs to the DIF. For example, the FDIC may solicit bids with a *loss sharing* provision.[95] When a winning bid includes loss sharing, the FDIC agrees to insure the acquirer against future losses on the failed bank's assets.[96] Bids with loss sharing may limit costs to the DIF because "instead of paying out all losses upfront and drawing down the declining DIF, [loss-share agreements] enable the FDIC to push some of these payments to the future, after the DIF has been stabilized."[97] In addition, a bid may include a *value appreciation instrument* (VAI), which grants the FDIC the right to purchase common stock in the acquirer.[98] A VAI lowers costs to the DIF by "allow[ing] the FDIC to take advantage of the stock-price increase that typically follows the announcement of an FDIC-assisted acquisition."[99] Finally, a bid may include bespoke, *nonconforming* terms that differ from the standard terms the FDIC suggests in its marketing of the failed bank.[100] A bidder may submit multiple bids in a single auction, each with a different combination of terms.[101]

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[90] *See* Allen et al., *supra* note 14, at 1207.

[91] *See id.*

[92] *See id.*

[93] *See id.*

[94] *See* Lynn Shibut, *Bank Resolutions and Receiverships*, *in* CRISIS AND RESPONSE: AN FDIC HISTORY 2008-2013, at 175, 187 (2017), https://www.fdic.gov/resources/publications/crisis-response/book/crisis-response-chapter-6.pdf.

[95] *See* Allen et al., *supra* note 14, at 1206.

[96] In a standard loss-share agreement, the FDIC absorbs 80 percent of losses up to a specified threshold, after which it assumes 95 percent of any additional losses. *See id.*

[97] Amanda Rae Heitz, *The Long-Run Effects of Losing Failed Bank Auctions* 1 (Fed. Deposit Ins. Corp. Ctr. for Fin. Rsrch., Working Paper No. 2022-01, 2022), https://www.fdic.gov/analysis/cfr/working-papers/2022/cfr-wp2022-01.pdf.

[98] *See* Allen et al., *supra* note 14, at 1207.

[99] *Id.*

[100] *See id.* at 7.

[101] *See id.* at 2 ("[U]ncertainty over the FDIC's scoring rule motivates bidders to submit

After receiving bids, the FDIC determines (1) which bid would incur the least cost to the DIF, and (2) whether the lowest-cost bid would be cheaper than liquidation. The FDIC uses a proprietary algorithm to estimate the cost of each bid.[102] The agency then compares the lowest-cost bid to the estimated cost of liquidating the bank.[103] If the lowest-cost bid is cheaper than liquidation, the FDIC resolves the institution by merging it into the winning bidder.[104] The FDIC publishes the names of the institutions that bid on the failed bank, a summary of each bid it received, and the estimated cost to the DIF of the winning bid.[105] However, the FDIC does not identify which institution placed which bid (other than the winning bid), nor does it disclose the estimated costs to the DIF from the losing bids or the estimated cost of liquidating the failed institution.[106] The FDIC's decision about how to resolve a failed bank is not subject to judicial review.[107]

In sum, since the FDICIA, the FDIC has solicited multidimensional bids in an effort to minimize losses to the DIF and impose losses on uninsured

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multiple bids for the same failed bank. Since they do not know precisely how each component will affect FDIC resolution costs, healthy banks can (and often do) submit multiple bids to hedge against randomness in the allocation rule.").

[102] *See* Granja et al., *supra* note 17, at 1729. By law, the FDIC must document any assumptions it makes with regard to interest rates, asset recovery rates, asset holding costs, and payment of contingent liabilities. *See* 12 U.S.C. § 1823(c)(4)(B)(i). The FDIC's estimate of costs to the DIF includes federal tax revenues the government would forego as a result of the proposed transaction. *See id.* § 1823(c)(4)(B)(ii).

[103] The cost of liquidating the failed bank "may not exceed the amount which is equal to the sum of the insured deposits of such institution … minus the present value of the total net amount the [FDIC] reasonably expects to receive from the disposition of the assets of such institution…." 12 U.S.C. § 1823(c)(4)(D).

[104] This process typically happens over a weekend, with the FDIC closing the failed institution on a Friday and reopening as part of the winning bidder on Monday morning. *See* RESOLUTIONS HANDBOOK, *supra* note 33, at 16.

[105] *See, e.g.*, *First Republic Bid Summary*, *supra* note 6 (identifying JPMorgan Chase, Citizens Bank, Fifth Third Bank, and PNC Bank as bidders in the First Republic auction).

[106] *See, e.g.*, *id.* The FDIC publicly identifies the runner-up bidder one year after the receivership auction. *See Financial Institution Bid Disclosure Policy*, FED. DEPOSIT INS. CORP. (June 18, 2024), https://www.fdic.gov/resources/resolutions/bank-failures/failed-financial-institution-bid-disclosure-policy/index.html.

[107] *See* 12 U.S.C. § 1823(c)(4)(F) ("Any determination which the [FDIC] may make under this paragraph shall be made in the sole discretion of the [FDIC]."). The FDICIA initially instructed the Government Accounting Office (GAO) to audit the FDIC annually to determine the extent of its compliance with the least-cost test. *See* Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 141(a)(2), 105 Stat. 2236, 2276 (codified at 12. U.S.C. § 1823 note). However, Congress repealed the GAO audit requirement just a few years later. *See* General Accounting Office Act of 1996, Pub. L. No. 104-316, § 106(b)(1), 110 Stat. 3826, 3830; *see also* Ohlrogge, *supra* note 41, at 48 (noting that Congress repealed the least-cost audit requirement "as part of an omnibus bill to remove over 100 GAO auditing requirements").

depositors. These bids vary not only in price, but also in the amount of the failed bank's assets and liabilities to be assumed by the acquirer, as well as the FDIC's potential future liability and appreciation rights. At least initially, these reforms had their desired effect. The FDIC effectively stopped using open-bank assistance in the years following the FDICIA.[108] Whole-bank assisted mergers, which had been the dominant resolution method during the S&L Crisis, faded from use in favor of partial-bank transactions that imposed losses on uninsured depositors.[109] As Professor Michael Ohlrogge has documented, the "FDICIA's least-cost requirement was very effective for the 15 years following its passage in constraining FDIC resolution costs and excessive uninsured depositor rescues."[110] Just over a decade later, however, the 2008 financial crisis would once again test the FDIC's resolution capabilities.

D. Bank Resolution After 2008

The 2008 financial crisis devastated the U.S. banking system and prompted further reforms to the FDIC's resolution toolkit. More than 500 banks, including several of the country's largest, failed when the subprime mortgage bubble burst.[111] Many more bank and nonbank financial institutions required extraordinary government support to stay afloat.[112]

Amidst the turmoil, the FDIC stretched the limits of its resolution authority. For the first time ever, policymakers invoked the systemic risk exception to the least-cost requirement.[113] The FDIC used the systemic risk exception not only to provide open-bank assistance to three individual megabanks—Wachovia, Citibank, and Bank of America—but also to issue

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[108] *See* Schwarcz, *supra* note 20, at 718 n.57 (noting that open-bank assistance "has rarely been used" since the least-cost test was enacted).

[109] RESOLUTIONS HANDBOOK, *supra* note 33, at 17 ("Under FDICIA … when transferring the uninsured deposits is not the least costly solution, the FDIC began entering into P&As that included only insured deposits."); *see also* Ohlrogge, *supra* note 41, at 29 (documenting a substantial increase in partial-bank transactions involving only insured deposits between 1992 and 2007).

[110] Ohlrogge, *supra* note 41, at 47; *see also id.* at 29 (noting that in response to the FDICIA, "the FDIC began, for the first time, to allow P&A bids for just the insured deposits (plus some or all assets) of a failed bank, rather than only allowing whole-bank or all-deposit P&A transactions, as it had done throughout the rest of its history").

[111] *See* Doreen Eberley & George French, *Bank Supervision*, *in* CRISIS AND RESPONSE: AN FDIC HISTORY 2008-2013, at 100, 119 (2017), https://www.fdic.gov/resources/publications/crisis-response/book/crisis-response-chapter-4.pdf.

[112] *See, e.g.*, Jeremy C. Kress & Matthew C. Turk, *Rethinking Countercyclical Financial Regulation*, 56 GA. L. REV. 495, 509 (2022) (discussing the Troubled Asset Relief Program).

[113] *See supra* notes 79-83 and accompanying text (discussing the systemic risk exception).

an unprecedented systemwide guarantee of non-interest-bearing deposit accounts and senior unsecured debt of certain financial institutions.[114] At the same time, the FDIC appeared to deviate from its least-cost mandate when resolving banks that had failed.[115] As Professor Michael Ohlrogge has documented, the FDIC reverted to relying on whole-bank assisted mergers that shielded uninsured depositors from losses and inflated costs to the DIF, in apparent contravention of the least-cost requirement.[116]

After the crisis, Congress again overhauled the resolution framework for financial institutions in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank).[117] Most of these reforms focused on special procedures for resolving large, complex financial conglomerates.[118] However, Dodd-Frank included one change relevant to the FDIC's traditional bank resolution authority. Specifically, Dodd-Frank eliminated the FDIC's ability to use the systemic risk exception to provide open-bank assistance, as it had done in the case of Wachovia, Citibank, Bank of America, and the systemwide guarantees.[119] Instead, Dodd-Frank limited the FDIC's use of the systemic risk exception to situations involving a failed bank for which it has already been appointed receiver.[120]

In sum, the 2008 crisis once again pushed the FDIC's resolution

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[114] *See* Whitney Cromie, Myron Kwast & Ashley Mihalik, *Use of Systemic Risk Exceptions for Individual Institutions during the Financial Crisis*, *in* CRISIS AND RESPONSE: AN FDIC HISTORY 2008-2013, at 67, 67 (2017), https://www.fdic.gov/resources/publications/crisis-response/book/crisis-response-chapter-3.pdf (discussing the use of the systemic risk exception for Wachovia, Citibank, and Bank of America); Lee Davison, *The Temporary Liquidity Guarantee Program: A Systemwide Systemic Risk Exception*, *in* CRISIS AND RESPONSE: AN FDIC HISTORY 2008-2013, at 33, 33 (2017), https://www.fdic.gov/resources/publications/crisis-response/book/crisis-response-chapter-2.pdf (discussing the use of the systemic risk exception for systemwide debt guarantees).

[115] *See* Ohlrogge, *supra* note 41, at 32 ("From 1992-2007, the FDIC's average resolution costs equaled 10% of failed banks' assets. From 2008 onwards, average resolution costs have been 18.2% of failed banks' assets.").

[116] *See id.* at 29 (documenting that the FDIC used whole-bank assisted mergers in approximately 30 percent of bank failures between 1992-2007 and approximately 90 percent between 2008-2011); *id.* at 32 ("[T]he probability that uninsured depositors lose money in the event of a bank failure has nearly disappeared, moving from 63% from 1992-2007 to only 6% from 2008 onwards.").

[117] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[118] *See supra* note 20 and accompanying text (discussing Dodd-Frank's Orderly Liquidation Authority, total loss absorbing capacity requirements, and "living wills").

[119] *See* Dodd-Frank Act, § 1106, 124 Stat. 1376, 2125 (codified at 12 U.S.C. §§ 1823(c)(4)(G), 5613). Dodd-Frank created a separate authority enabling the FDIC to establish systemwide debt guarantees like those it issued in 2008, but only after the passage of a joint resolution of Congress. *See id.* §§ 1104-05 (codified at 12 U.S.C. §§ 5611-12).

[120] *See id.* § 1106(b)(1)(B) (limiting the FDIC's use of the system risk exception "for the purpose of winding up [an] insured depository institution for which the [FDIC] has been appointed receiver").

capabilities to the brink. Congress responded by overhauling the agency's legal authorities, but these reforms generally focused on the resolution of large, systemically important financial conglomerates. As Professor Maziar Peihani has observed, "[A]n important question that has not been addressed is the effectiveness of the post-[2008] resolution regime for winding down or restructuring deposit-taking institutions that *do not* qualify as systemically important."[121] The next Part conducts such an assessment of the FDIC's bank resolution framework and its "defining feature," the least-cost requirement.[122] It concludes that the least-cost requirement could perversely impose significant costs on consumers and the broader financial system.

II. THE LEAST-COST TEST DISTORTS BANK RESOLUTION

Although minimizing costs to the DIF sounds appealing in theory, compelling the FDIC to choose the least-cost resolution strategy in fact distorts bank resolution in underappreciated ways. As this Part explains, the least-cost test is flawed for two reasons. First, it overemphasizes costs to the DIF. Contrary to popular belief, the DIF is not funded with taxpayer money, and the FDIC's ability to accurately predict costs to the DIF is limited. Second, the least-cost test underemphasizes—indeed, completely ignores—other costs that bank resolution may impose on society. The least-cost mandate forces the FDIC to overlook potential impairments to competition, financial stability, financial inclusion, market discipline, and an institution's future prospects. For these reasons, selecting a bank resolution strategy based solely on costs to the DIF is likely to produce suboptimal outcomes for society. This Part examines these flaws and then presents three case studies demonstrating the least-cost test's heretofore overlooked weaknesses.

A. The Least-Cost Test Overemphasizes Costs to the DIF

Protecting the DIF is, without question, an important public policy objective.[123] Nonetheless, there are reasons to believe that limiting DIF costs should not be the paramount consideration when resolving a failed bank. This Section contends that the least-cost test's exclusive focus on minimizing costs to the DIF is misguided because such costs are (1) borne, in part, by the banking sector, and (2) difficult to project ex ante. Although DIF costs may be *an* appropriate consideration in how the FDIC resolves a failed bank, the fact that such costs are partially privatized and unpredictable suggests that

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[121] Peihani, *supra* note 21, at 421-22 (emphasis added).

[122] *See supra* note 84.

[123] *See, e.g.*, Jeremy C. Kress, *Modernizing Bank Merger Review*, 37 YALE J. ON REGUL. 435, 466 (2020) (describing protecting the DIF as "[b]ank regulation's primary goal").

they should not be the *sole* deciding factor.

1. The DIF is Not the Public Fisc

The least-cost test's singular focus on limiting costs to the DIF is likely motivated by a belief that DIF funds are taxpayer money. Indeed, as Congress weighed the enactment of the FDICIA, policymakers emphasized that the least-cost requirement's primary goal was minimizing costs to taxpayers.[124] Public figures likewise conflated DIF funds with taxpayer money in the aftermath of the 2023 banking panic.[125] For example, Senator Bill Haggerty insisted that FDIC's resolution of Signature Bank "impos[ed] unnecessary costs on taxpayers."[126]

In reality, however, the DIF is not funded with public money. Instead, the DIF is funded by assessments on depository institutions, with progressively higher assessment rates on larger and riskier firms.[127] Today, each U.S. bank pays an annual DIF assessment equal to its total liabilities multiplied by 2.5 to 42 basis points, depending on its asset size, complexity, and supervisory ratings.[128] When the FDIC invokes the systemic risk exception, it is statutorily obligated to levy an additional, special assessment on depository institutions to replenish the DIF—without resorting to taxpayer funds.[129] Thus, the $121 billion in the DIF as of year-end 2023 is made up entirely of funds contributed by depository institutions.[130] As former Comptroller of the Currency Robert Clarke correctly noted, "[W]e're not talking about taxpayer money here. We're talking about FDIC money which has been paid in by banks in the form of insurance premiums."[131]

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[124] *See, e.g.*, *Economic Implications of the Too Big to Fail Policy: Hearing Before the Subcomm. on Econ. Stabilization of the H. Comm. on Banking, Fin. & Urb. Affs.*, 102nd Cong. 105 (1991) (statement of Robert R. Glauber, Undersecretary, U.S. Department of Treasury) ("Protecting uninsured depositors when it is not the least costly resolution method … increases taxpayer exposure.").

[125] *See, e.g.*, Vivek Ramaswamy, *SVB Doesn't Deserve a Taxpayer Bailout*, WALL ST. J. (Mar. 12, 2013), https://www.wsj.com/articles/silicon-valley-bank-doesnt-deserve-a-taxpayer-bailout-federal-reserve-fdic-risk-startups-treasury-interest-rates-ad440fe9 (arguing that "[t]axpayers shouldn't vindicate SVB's political hubris").

[126] Letter from Sen. Bill Hagerty to Martin Gruenberg, Chairman, Fed. Deposit Ins. Corp. (Mar. 10, 2024), https://subscriber.politicopro.com/f/?id=0000018e-2b12-dba0-abcf-6f971bf90000.

[127] *See* 12 U.S.C. § 1817(b); 12 C.F.R. § 327.10.

[128] *See* FED. DEPOSIT INS. CORP., FDIC ASSESSMENT RATES, https://www.fdic.gov/deposit/insurance/assessments/proposed.html; *see also* 12 C.F.R. § 327.5 (defining a bank's assessment base as its total consolidated assets minus its tangible equity).

[129] *See* 12 U.S.C. § 1823(c)(4)(G)(ii).

[130] *See Quarterly Banking Profile: Fourth Quarter 2023*, 18 FDIC Q., no. 1, 2024, at 31.

[131] *The Failure of the Bank of New England: Hearing Before the S. Comm. on Banking, Hous. & Urb. Affs.*, 102nd Cong. 31 (1991) (statement of Robert L. Clarke, Comptroller,

To be sure, Congress has granted the FDIC a $100 billion line of credit from the Treasury to replenish the DIF, if necessary.[132] However, this authority includes certain protections for taxpayers. The Federal Deposit Insurance Act provides that if the FDIC were ever to tap the Treasury line, it must timely repay the loan, with interest, using assessments paid by the banking sector.[133] Congress has also provided the FDIC authority to borrow from other sources, including the Federal Home Loan Banks and the banking sector itself.[134] As a practical matter, the FDIC has gone out of its way to avoid tapping the Treasury line to avoid even the appearance of taxpayer funding.[135] Thus, policymakers have established several layers of protection to shield taxpayers from absorbing costs to the DIF.

Of course, the least-cost requirement may be warranted if banks pass the cost of DIF assessments onto their customers. However, evidence of this pass-through is mixed. When bank costs rise, shareholders and executives absorb at least some of the burden.[136] As banking lawyer Randall Guynn explained, bank "*shareholders, managers*, and customers … ultimately bear the costs of higher deposit insurance premiums and special assessments in the forms of *reduced share values, reduced compensation* and higher costs or reduced choice of banking products and services, depending on the elasticity of demand . . . ."[137] Although empiricists have not studied which parties bear the costs of DIF assessments, some evidence suggests that banks' ability to pass DIF costs on to their customers may be limited.[138] Moreover, large banks' fierce opposition to the FDIC's special assessments following the invocation of the systemic risk exception in 2023 is evidence that the banking sector internalizes much of these costs, rather than passing them

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Office of the Comptroller of the Currency).

[132] *See* 12 U.S.C. § 1824(a)(1). The FDIC also has authority to borrow short-term working capital from the Federal Financing Bank. *See id.* § 1824(b).

[133] *See id.* § 1824(c)(1).

[134] *See id.* § 1824(d) (authorizing the FDIC to borrow from insured depository institutions); *id.* § 1824(e) (authorizing the FDIC to borrow from the Federal Home Loan Banks). For background on the Federal Home Loan Banks, see Kathryn Judge, *The Unraveling of the Federal Home Loan Banks*, 41 YALE J. ON REGUL. (forthcoming 2024), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4626125.

[135] As Professors Jeffrey Gordon and Christopher Muller noted, the FDIC "resisted drawing on its line of credit at the Treasury to support its dwindling Deposit Insurance Fund [in 2008] precisely to avoid the unfavorable perception of taxpayer funding." Gordon & Muller, *supra* note 20, at 207.

[136] *See* Guynn, *supra* note 21, at 2.

[137] *Id.* (emphasis added).

[138] *See, e.g.*, Greg Buchak, Gregor Matvos, Tomasz Piskorski & Amit Seru, *Fintech, Regulatory Arbitrage, and the Rise of Shadow Banks*, 130 J. FIN. ECON. 453, 468 (2018) (providing evidence that banks are unable to pass through higher regulatory costs to customers by increasing interest rates on loans).

through to customers.[139]

To be sure, protecting the DIF is critically important, even if it is not funded with taxpayer money. The S&L Crisis demonstrated that taxpayers may bear the residual costs of bank failures, and banks likely pass on a portion of DIF assessments to customers despite internalizing some of the costs themselves.[140] Thus, there are compelling reasons for policymakers to try to minimize costs to the DIF by implementing strong prudential regulation that prevents bank failures in the first place.[141] After a bank has failed, however, other public policy objectives—such as preserving competition and promoting financial stability—may be equally, if not more, societally important than limiting costs to the DIF.[142] The least-cost test's narrow focus is therefore unwise because DIF costs are borne in part by the banking sector, while other costs of bank resolution fall on society at large.

2. The FDIC Cannot Predict DIF Costs with Precision

Even if minimizing costs to the DIF were necessary to protect the public, compelling the FDIC to use the least-cost resolution method would be inappropriate because the agency cannot accurately predict DIF costs. Since bank resolution costs are highly uncertain, the least-cost test forces the FDIC to make consequential decisions about the structure of the banking system based on rough, incomplete, and oftentimes inaccurate estimates.

The least-cost test assumes that the FDIC can determine, at the time that a bank fails, which resolution method will incur the least possible cost to the DIF. This assumption is wrong. Calculating the liquidation value of a failed bank and comparing takeover bids involves numerous assumptions and projections about the FDIC's recovery rates on the failed bank's assets, its liability under any loss sharing agreements, and potential profits on equity appreciation rights in the winning bidder.[143] These projections are inherently

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[139] *See, e.g.*, Polo Rocha, *Banks Knock FDIC Over Growing Tab for Last Year's Failures*, AM. BANKER (Mar. 13, 2024), https://www.americanbanker.com/news/banks-knock-fdic-over-growing-tab-for-last-years-failures (noting that "big banks are miffed about their growing tab" from the 2023 bank failures).

[140] *See supra* note 65 and accompanying text (noting that the S&L Crisis cost taxpayers $130 billion); *supra* notes 136-138 and accompanying text (acknowledging that banks may pass through some DIF costs to customers).

[141] *See generally* Jeremy C. Kress & Jeffery Y. Zhang, *The Macroprudential Myth*, 112 GEO. L.J. 569, 578-79 (2024) ("By ensuring an individual bank's viability, microprudential regulation aims to protect ... the Federal Deposit Insurance Corporation's Deposit Insurance Fund … which could incur losses if the bank were to fail.").

[142] *See* discussion *infra* Section II.B.

[143] *See, e.g.*, Sarah Jane Hughes, *Banking and Deposit Insurance: An Unfinished Agenda for the 1990s*, 68 IND. L.J. 835, 841 (1993) (discussing "difficult-to-measure contingent liabilities" to the DIF).

uncertain and may produce widely variable forecasts.[144] Further, the FDIC's actual resolution costs depend on market conditions that develop months or even years after a bank's failure, as the agency sells the failed bank's assets.[145] Therefore, the FDIC is simply making an informed guess when it calculates the liquidation value of a failed bank or compares auction bids with different terms. In practice, these estimates can fluctuate significantly—in some cases by billions of dollars.[146]

Consider the notorious failure of Silicon Valley Bank (SVB) in 2023. When the FDIC announced the sale of all SVB's deposits and certain loans to First-Citizens Bank on March 26, 2023, the agency estimated the cost of SVB's failure to the DIF would be "approximately $20 billion."[147] In May, the FDIC lowered its estimate to $16.1 billion, citing "a decrease in the amount of liabilities assumed by First Citizens relative to the initial estimate, higher anticipated recoveries from certain other assets in receivership, and an increase in the market value of receivership securities."[148] Within eight months, however, the FDIC had increased the estimated cost of SVB's resolution to $21.8 billion, with no explanation for the more than $5 billion fluctuation.[149] To be sure, the FDIC was not subject to the least-cost test in this case because policymakers had invoked the systemic-risk exception.[150] However, the agency's wildly variable estimates for resolving SVB demonstrate just how imprecise such cost estimates can be. Fluctuations of billions of dollars could have a significant impact on how the FDIC decides to resolve a bank when subject to the least-cost test.

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[144] *See* Macey & Miller, *supra* note 49, at 1183 n.130 ("The FDIC generally will accept the highest bid … if its net cost is lower than the estimated costs of a deposit payoff. *These estimates are not very precise*….") (emphasis added).

[145] *See* Heitz, *supra* note 97, at 8 (noting that "there is considerable uncertainty pertaining to the value of … failed institutions, along with the expected payments from [loss-sharing agreements]").

[146] As former Assistant Secretary of the Treasury Graham Steele observed, "[E]x ante least-cost estimates are just that—estimates—and can vary significantly from the ultimate cost." Graham Steele, *The End of Banking History: Finishing the Unfinished Business of Financial Reform* 15 n.21, ROOSEVELT INST. (Aug. 2024), https://rooseveltinstitute.org/wp-content/uploads/2024/07/RI_Banking-Unfinished-Business-Financial-Reform_Brief_082024.pdf.

[147] Press Release, Federal Deposit Insurance Corporation, First-Citizens Bank & Trust Company, Raleigh, NC, to Assume All Deposits and Loans of Silicon Valley Bridge Bank, N.A., From the FDIC (Mar. 26, 2023), https://www.fdic.gov/news/press-releases/2023/pr23023.html.

[148] Special Assessment Pursuant to Systemic Risk Determination, 88 Fed. Reg. 32694, 32696 (May 22, 2024).

[149] *See* FED. DEPOSIT INS. CORP., *supra* note 60, at 81.

[150] *See* Press Release, Joint Statement by the Department of the Treasury, Federal Reserve, and FDIC (Mar. 12, 2023), https://www.fdic.gov/news/press-releases/2023/pr23017.html (announcing the use of the systemic risk exception for SVB).

B. The Least-Cost Test Underemphasizes Other Societal Costs

Using DIF costs as the sole decision criterion for resolving failed banks is imprudent for a second reason: it forces the FDIC to overlook other costs that bank resolution may impose on society. Different resolution methods can reduce competition, impair financial stability, undermine financial inclusion, lessen market discipline, or jeopardize an institution's future prospects. Under the least-cost test, however, the FDIC is statutorily prohibited from considering these potential downsides when choosing among competing resolution options. This Section explains how the least-cost test requires the FDIC to ignore many potential drawbacks and instead award a failed bank to the highest bidder, regardless of the societal consequences.

1. Competition

First, the least-cost test ignores the ways in which resolution options could impair competition. Competition among banks is essential to ensure that businesses and individuals have access to high-quality, affordable financial services.[151] As the Supreme Court cautioned in *Philadelphia National Bank*, "[I]f the costs of banking services and credit are allowed to become excessive by the absence of competitive pressures, virtually all costs, in our credit economy, will be affected . . . ."[152] Despite the importance of bank competition, the least-cost test requires the FDIC to ignore the competitive effects of alternative resolution methods. Underemphasizing competition in this way could have harmful long-term societal consequences in the form of less available and less affordable financial services.

To demonstrate how bank resolution could affect competition, consider the hypothetical failure of First State Bank in Ann Arbor, Michigan. Assume that two banks bid in the FDIC receivership auction: Second State Bank, which competes in the Ann Arbor banking market, and Third State Bank, which currently has no offices in Ann Arbor. Further assume that the FDIC determines Second State Bank's bid would cost the DIF $100 million, and Third State Bank's bid would cost the DIF $110 million.[153] From a broad societal perspective, Third State Bank's bid may be preferable because Third State does not currently compete in the Ann Arbor market, and its acquisition of First State would thus not reduce the number of banks in the market. On

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[151] *See* Jeremy C. Kress, *Reviving Bank Antitrust*, 72 DUKE L.J. 519, 555-72 (2022) (discussing the importance of competition in banking).

[152] United States v. Phila. Nat'l Bank, 374 U.S. 321, 372 (1963).

[153] In addition, assume that liquidating First State Bank would cost the DIF more than $100.

the other hand, if Second State Bank wins the receivership auction and acquires First State Bank, Ann Arbor customers would have fewer banking options than they did prior to First State Bank's failure. Under the least-cost test, the FDIC must name Second State Bank as the auction winner, even though the cost differential to the DIF is just $10 million and the anticompetitive consequences could be significant.

The situation described above is not merely hypothetical: empirical studies confirm that failed bank auctions do, in fact, impair competition. One study of bank failures during in the 2008 crisis concluded that "failed banks are predominantly sold to bidders within the same county … with similar assets business lines," as opposed to more distant bidders or bidders with disparate product offerings.[154] Another study found "evidence that FDIC resolutions of failed banks . . . distort market competition."[155] In a majority of bank resolutions, market concentration has risen, with an average increase of more than six percent.[156] Failed bank mergers have translated into anticompetitive outcomes, with acquirers exercising market power to curtail lending, close branches, and decrease depositors' interest rates.[157] In some cases, spikes in market power have been extreme. One study of 318 bank failures between 2007 and 2010 found thirteen instances in which an FDIC auction increased market concentration by an amount that would violate the Department of Justice's guidelines for anticompetitive bank mergers.[158] These studies likely understate the extent to which bank resolution enhances acquirers' market power, as consolidation may impair competition in ways that are not apparent from traditional measures of market concentration.[159]

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[154] Granja et al., *supra* note 17, at 1723 (studying bank failures between 2007 and 2013).

[155] Philip Molyneux & Tim Mi Zhou, *Banking Market Reaction to Auctions of Failed Banks*, 27 INT'L J. FIN. ECON. 518, 518 (2022).

[156] *See* David C. Wheelock, *Have Acquisitions of Failed Banks Increased the Concentration of U.S. Banking Markets?*, 93 FED. RSRV. BANK ST. LOUIS REV. 155, 160 (2011) ("[A] majority of failed bank resolutions during 2007-10 resulted in some consolidation of banking assets and deposits in local banking markets."); Allen et al., *supra* note 14, at 1211 (studying 439 failed bank auctions from 2009 to 2013 and concluding that "[i]ncreases in market concentration vary widely and average 6.4% at the county level").

[157] *See* Siddharth Vij, Acquiring Failed Banks 1 (Aug. 22, 2021) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3234435 ("After acquisition, the winning bank cuts lending to the failed bank's borrowers and closes branches … [and] lowers deposit rates, reflecting increased market power."). Professor Vij concludes that "inviting banks not overlapping geographically with the failed bank would lead to lower disruption as far as lending is concerned." *Id.* at 5.

[158] *See* Wheelock, *supra* note 156, at 161.

[159] *See generally* Jonathan Kanter, Assistant Att'y Gen., U.S. Dep't of Just., Merger Enforcement Sixty Years After Philadelphia National Bank (June 20, 2023), https://www.justice.gov/opa/speech/assistant-attorney-general-jonathan-kanter-delivers-keynote-address-brookings-institution (asserting that antitrust enforcement should "evaluate the many ways in which competition manifests itself in a particular banking market—

Of course, in some cases, competition considerations could weigh in favor of an FDIC-assisted merger instead of an alternative resolution method, such as liquidation. Although liquidating a failed bank obviates the need for an FDIC-assisted merger, liquidation could impair competition if the failed bank's depositors move *en masse* to a dominant bank. That is what many SVB customers had already begun doing prior to SVB's failure—moving their money to JPMorgan and thereby further entrenching JPMorgan's status as the country's dominant bank.[160] In certain cases, then, pursuing an FDIC-assisted merger could be the most pro-competitive resolution option, even if such a merger were to increase local market concentration.

All of this is not to suggest that the least-cost test necessarily leads to anticompetitive outcomes. Rather, the point is that the competitive effects of various resolution methods are best evaluated on a case-by-case, fact-intensive basis. When deciding whether to resolve a failed bank via merger or liquidation—or when comparing auction bids by various potential acquirers—the FDIC may be making a choice with significant consequences for the competitiveness of the banking system. As currently written, however, the least-cost requirement prevents the agency from taking these considerations into account.

2. Financial Stability

In addition to undervaluing competition, the least-cost test also forces the FDIC to ignore how various resolution methods might affect financial stability. This constraint is problematic because certain resolution methods could mitigate systemic risks and strengthen the banking system, while others might increase the chances of a catastrophic financial crisis in the future.

As one example of how bank resolution could affect financial stability, consider the hypothetical failure of Midwest Bank in Chicago, Illinois, with $250 billion in assets. Assume that two banks bid in the FDIC auction: Megabank, a global systemically important bank (GSIB) in New York City with $3 trillion in assets, and West Coast Bank, a regional bank in Los Angeles, California, with $500 billion in assets.[161] Selecting the winner of

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including through fees, interest rates, branch locations, product variety, network effects, interoperability, and customer service").

[160] *See* Lydia Moynihan, *JPM Bankers Pull All-Nighters To Take on Clients of Silicon Valley Bank*, N.Y. POST (Mar. 13, 2023), https://nypost.com/2023/03/10/jpm-bankers-pull-all-nighters-to-take-on-clients-of-silicon-valley-bank/.

[161] GSIBs are banks that have been designated as systemically important based on metrics including their size, complexity, interconnectedness, lack of substitutability, and cross-jurisdictional activity. *See* Basel Comm. on Banking Supervision, *Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement*, BANK FOR INT'L SETTLEMENTS 4-11 (2013), https://www.bis.org/publ/

this auction could have a dramatic effect on the structure and stability of the U.S. banking system. On one hand, Megabank may be viewed as a more stable acquirer to the extent that it enjoys implicit "too big to fail" status, but acquiring Midwest Bank could further increase its systemic footprint and exacerbate the potentially catastrophic consequences if Megabank were to collapse in the future. On the other hand, merging Midwest Bank with West Coast Bank might allocate systemic risks more evenly throughout the banking system. At the same time, choosing the smaller acquirer could increase the chances that the merger might destabilize the combined firm. Reasonable people could disagree as to which of these outcomes would be better for U.S. financial stability. Under the least-cost requirement, however, financial stability considerations are irrelevant to how the FDIC resolves Midwest Bank, and all that matters is which bank submits a better bid.

Although not necessarily conclusive in the foregoing example, the weight of the empirical evidence suggests that selling a failed bank to a large, systemically important firm could increase future financial stability risks. Numerous studies have demonstrated that greater consolidation in the financial sector undermines financial stability.[162] Emergency bank mergers, in particular, tend to increase acquirers' financial stability risks. For example, Professors Kris James Mitchener and Angela Vossmeyer analyzed failed and failing bank mergers during the Great Depression and found that each acquisition increased the systemic risk of the acquirer by an average of 25 percent.[163] Mitchener and Vossmeyer concluded that "merger policies commonly used to deal with troubled financial institutions during crises have important implications for systemic risk."[164] As a former FDIC official put it, "If the only solution is selling a [failed bank] to a larger bank, then that creates an even bigger systemic risk."[165]

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bcbs255.pdf (discussing a commonly accepted methodology for assessing a bank's systemic importance).

[162] *See, e.g.*, Simone Varotto & Lei Zhao, *Systemic Risk and Bank Size*, 82 J. INT'L MONEY & FIN. 45, 53-54 (2018) (concluding that a bank's size, while not determinative, is the primary driver of its systemic riskiness); Grego N.F. Weiss, Sascha Neumann & Denefa Bostandzic, *Systemic Risk and Bank Consolidation: International Evidence*, 40 J. BANKING & FIN. 165, 174-77 (2014) (finding a significant increase in the post-merger systemic risk of consolidating banks and their competitors); *see also* Andre Uhde & Ulrich Heimeshoff, *Consolidation in Banking and Financial Stability in Europe: Empirical Evidence*, 33 J. BANKING & FIN. 1299, 1305-10 (2009) (concluding that national banking market concentration has a negative effect on financial stability).

[163] *See* Kris James Mitchener & Angela Vossmeyer, *How Do Financial Crises Redistribute Risk?* 4 (Nat'l Bureau of Econ. Rsrch., Working Paper No. 31537, 2023), https://www.nber.org/system/files/working_papers/w31537/w31537.pdf.

[164] *Id.* at 1.

[165] Luke Clancy, *Lessons on Bank Resolution, From Silicon Valley to Zurich*, RISK.NET (June 20, 2023), https://www.risk.net/regulation/7956990/lessons-on-bank-resolution-from-

Of course, selling a failed bank to a larger firm is not necessarily detrimental to financial stability. In some cases, merging a failed bank with a larger, stable firm could quell financial stress, especially if the alternative is a liquidation in which uninsured depositors would suffer significant losses.[166] As with competition, however, assessing the financial stability implications of alternative resolution options is best done on a case-by-case basis.[167] As Professors Mitchener and Vossmeyer advised, "A careful consideration of the financial stability risks of mergers is particularly important during periods of banking turmoil."[168] Under current law, however, the least-cost test effectively prevents the FDIC from taking financial stability considerations into account.

3. Financial Inclusion

Another way in which the least-cost test unduly constrains the FDIC is by forcing the agency to disregard the welfare of low- and moderate-income (LMI) communities. When considering a bank merger application, regulators ordinarily must take into account "the convenience and needs of the community to be served," with a specific emphasis on LMI areas.[169] When the FDIC conducts a resolution auction, however, the least-cost test effectively prohibits the agency from considering local community needs. As a result, the least-cost test unintentionally harms LMI communities and perpetuates longstanding barriers in access to finance.

It is well known that the United States has a financial inclusion problem.[170] Millions of Americans—disproportionately minorities—lack access to the traditional banking system.[171] One of the primary ways in which

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silicon-valley-to-zurich (quoting an anonymous former FDIC risk supervisor).

[166] *See, e.g.*, Daniel Hawley, Note, *Coordination Rights After Bank Failure*, 124 COLUM. L. REV. (forthcoming 2024) (manuscript at 37), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4717506 ("Some argue that conglomeration is a net positive for financial stability because gains to diversification, profitability, and regulatory stringency offset systemic costs.").

[167] *See supra* Section II.B.1. Professor Hilary Allen has emphasized the importance of taking a "precautionary approach" to issues of financial stability. Hilary J. Allen, *A New Philosophy For Financial Stability Regulation*, 45 LOY. U. CHI. L.J. 173, 178 (2013).

[168] Mitchener & Vossmeyer, *supra* note 163, at 4.

[169] 12 U.S.C. § 1828(c))(5); *see also id.* § 2903(a)(2) (requiring the relevant banking agency to consider a bank merger applicant's "record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods").

[170] *See, e.g.*, Adam J. Levitin, *The Financial Inclusion Trilemma*, 41 YALE. J. ON REGUL. 109, 111 (2024) (asserting that "a sizeable share of the U.S. population remains without access to mainstream financial services from banks").

[171] BD. OF GOVERNORS OF THE FED. RSRV. SYS., ECONOMIC WELL-BEING OF U.S. HOUSEHOLDS IN 2022, at 39 (2023), https://www.federalreserve.gov/publications/files/2022-

policymakers have tried to remedy this problem is by promoting minority depository institutions (MDIs).[172] An MDI is a depository institution that is majority owned by one or more "socially or economically disadvantaged individuals," including "Black American[s], Native American[s], Hispanic American[s], or Asian American[s]."[173] It is thought that MDIs are uniquely situated to "promot[e] … financial services and credit in traditionally underserved communities."[174] As Acting Comptroller of the Currency Michael Hsu stated, MDIs "know their communities better than anyone and understand where the needs, gaps, and opportunities are" to better serve LMI populations.[175]

To promote financial inclusion, federal law requires bank regulators to seek to support MDIs, with a specific focus on retaining the minority-owned status of an MDI involved in a merger.[176] Congress has directed the Secretary of the Treasury to consult with the banking agencies to develop methods to "promot[e] and encourage[e] creation of new" MDIs and "provid[e] technical assistance to prevent insolvency" of MDIs.[177] The agencies are also required to consult on methods to "preserv[e] the present number of" MDIs and "*preserv[e] their minority character in cases involving mergers or acquisitions*."[178] Consistent with this Congressional mandate, both the FDIC and OCC have adopted policy statements explaining their strategies for supporting and preserving MDIs.[179]

However, federal policies that encourage the preservation of MDIs do not

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report-economic-well-being-us-households-202305.pdf (documenting that 13 percent of Black adults and 10 percent of Hispanics lacked a checking account in 2022).

[172] *See* Lindsay Sain Jones & Goldburn P. Maynard, Jr., *Unfulfilled Promises of the Fintech Revolution*, 111 CALIF. L. REV. 801, 850 (2023) (discussing federal policies promoting MDIs).

[173] 12 U.S.C. § 1463 note.

[174] Maude Toussaint-Comeau & Robin Newberger, *Minority-Owned Banks and Their Primary Local Market Areas*, 41 ECON. PERSPS. 1, 1 (2017); *see also* Allen N. Berger, Maryann P. Feldman, W. Scott Langford & Raluca A. Roman, *"Let Us Put Our Moneys Together": Minority-Owned Banks and Resilience to Crises* 1 (Fed. Rsrv. Bank of Phila., Working Paper No. 23-13, 2023), https://www.philadelphiafed.org/-/media/frbp/assets/working-papers/2023/wp23-13.pdf (finding that "minority-owned banks improve economic resilience in their communities during the global financial crisis (GFC) and the COVID-19 crisis through increased small business and household lending").

[175] *Minority Depository Institution Workstream*, OFF. OF THE COMPTROLLER OF THE CURRENCY, https://www.occ.treas.gov/topics/consumers-and-communities/project-reach/mdi-workstream.html (last visited July 9, 2024).

[176] 12 U.S.C. § 1463 note.

[177] *Id.*

[178] *Id.* (emphasis added).

[179] *See* OCC Policy Statement on Minority Depository Institutions, 87 Fed. Reg. 47,028 (Aug. 1, 2022); Statement of Policy Regarding Minority Depository Institutions, 86 Fed. Reg. 32,728 (June 23, 2021) [hereinafter FDIC MDI Policy Statement].

extend to failed banks. Instead, when an MDI enters receivership, the least-cost requirement governs.[180] As the FDIC has stated, the agency "is required to accept the least costly bid from a bidder *regardless of MDI status*."[181] Thus, when an MDI fails, the FDIC sells the institution to the best bidder, regardless of the bidders' MDI status.

Consider another hypothetical example. Bluff City Bank, a Black-owned MDI in Memphis, Tennessee, has failed. Two banks bid in the FDIC receivership auction. Music City Bank, a Black-owned MDI based in Nashville, Tennessee, that specializes in lending to Black-owned businesses, submits a bid that would cost the DIF $100 million. Capital City Bank, which is not an MDI but wants to expand beyond its hometown of Atlanta, Georgia, submits a bid that would cost the DIF $90 million. Even though Music City Bank might better promote financial inclusion, and even though federal policy generally encourages the preservation of MDIs in mergers and acquisitions, the least-cost test requires the FDIC to sell Bluff City Bank to Capital City Bank, thereby losing its minority-owned status.

The situation described above is not merely hypothetical—in fact, it occurs with remarkable frequency. Thirty-nine MDIs failed between 2002 and 2016.[182] Of those failed MDIs, twenty-four institutions—or 62 percent—were "acquired by non-MDIs since they were the least costly bidders."[183] To be sure, the FDIC does its best to retain the minority-owned status of a failed MDI.[184] When an MDI appears destined for receivership, the FDIC takes special steps to "solicit qualified [MDIs'] interest in the failing institution, discuss the bidding process, and offer to provide technical assistance regarding completion of the bid forms."[185] As the aforementioned data indicate, however, the least-cost test prevents the FDIC from retaining a failed MDI's minority-owned status more than half the time.[186]

Thus, when MDIs fail, the least-cost test necessitates that they often get sold to traditional banks that might not be as strong at promoting financial inclusion. As the FDIC Inspector General concluded in 2019, the least-cost test "effectively overrides the priorities for minority-owned institutions, because all bids are required to be evaluated strictly on the basis of least

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[180] *See* FED. DEPOSIT INS. CORP., *supra* note 19, at 12.

[181] *Id.*

[182] *See* FED. DEPOSIT INS. CORP., ANNUAL REPORT 2017, at 29 (2018), https://www.fdic.gov/about/financial-reports/reports/2017annualreport/2017ar-final.pdf.

[183] FED. DEPOSIT INS. CORP., *supra* note 19, at 12.

[184] FDIC MDI Policy Statement, *supra* note 179, at 32,734. The FDIC specifically commits that it "will attempt to preserve the minority character of failing [MDIs] during the resolution process."

[185] *Id.*

[186] *See supra* note 183 and accompanying text.

possible cost of resolution."[187] In this way, the least-cost test undermines other federal policies designed to promote MDIs and perpetuates longstanding inequities in access to finance.

4. Market Discipline

Bank resolution can impose costs on society in a fourth way: by diminishing market discipline. The United States' deposit insurance system—in which insurance is capped at $250,000 per depositor, per account type, per bank—is premised on the belief that uninsured depositors discipline a bank by moving their money if the bank takes excessive risks.[188] Protecting a failed bank's uninsured depositors in resolution is thought to perpetuate moral hazard by decreasing uninsured depositors' incentives to monitor their banks and thereby encouraging banks to take excessive risks.[189] Thus, the FDIC's choice of resolution method—for instance, merger versus liquidation, or whole-bank merger versus partial-bank merger—can have important long-term consequences for market discipline and bank risk-taking.

Consider another example. Imagine that the fictional American National Bank, with $100 billion in assets, has failed. At the time of its insolvency, American National Bank had $80 billion in insured deposits and $20 billion in uninsured deposits and other liabilities. Assume that liquidating American National Bank would cost the DIF $10 billion after paying out all the insured depositors and recouping funds from the sale of the bank's assets.[190] Further assume that the FDIC receives one bid in the receivership auction: Federal Bank offers to assume all of American National Bank's assets and deposits—insured and uninsured—in exchange for a $5 billion payment from the DIF. In compliance with the least-cost requirement, the FDIC must merge American National Bank with Federal Bank because the whole-bank bid minimizes near-term costs to the DIF. This outcome, however, ignores the

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[187] FED. DEPOSIT INS. CORP., *supra* note 19, at 12.

[188] *See* Mantripragada, *supra* note 77, at 553-54 (discussing market discipline by uninsured depositors); *see also* 12 U.S.C. § 1821(a)(1)(E) (capping federal deposit insurance at $250,000).

[189] *See* William M. Isaac, *The FDIC Has a Proven Way to Avoid Moral Hazard*, WALL ST. J. (Mar. 28, 2023), https://www.wsj.com/articles/a-proven-way-to-avoid-moral-hazard-receivership-certificate-modified-deposit-payoff-fdic-fed-8b74dc06 ("If the government protects every depositor in a bank failure … it erodes marketplace discipline and makes banks less stable going forward.").

[190] In this example, as is typical, the FDIC does not receive 100 cents on the dollar when selling the failed bank's assets. Asset discounts may occur when the bank's assets are declining in value prior to the bank's failure or when the FDIC's asset fire sale depresses their value. *See generally* Shibut, *supra* note 94, at 179-80 (discussing FDIC asset fire sales).

long-run costs that could arise if other banks' uninsured depositors observe that American National Bank's uninsured depositors were made whole and therefore become less likely to monitor risk-taking by their own banks.[191]

The situation described above is not unusual. In fact, the frequency with which the FDIC resolves failed banks through whole-bank assisted mergers that protect uninsured depositors has been well documented.[192] In cases like the foregoing example where a whole-bank assisted merger is the cheapest resolution option, the least-cost test may force the FDIC to make an undesirable trade-off between short-term DIF costs and long-run moral hazard.[193] As Professors Jonathan Macey and Geoffrey Miller put it, "[W]hile [assisted merger] transactions provide benefits to the FDIC in the short run because they protect its cash position, the long-run results may take the form of increased bank failures due to excessive risk taking by banks."[194] In this way, the least-cost test could unduly limit the FDIC to considering only near-term costs to the DIF while undervaluing potential long-run consequences of shielding uninsured depositors from losses.

5. Future Prospects

A final way in which bank resolution may impose societal costs is by jeopardizing an institution's long-term viability. Ordinarily, federal regulators are required to consider a bank's "future prospects" when deciding whether to approve or deny a merger or acquisition.[195] This statutory mandate makes sense: Congress believed that when a bank submits an application under the Bank Merger Act, regulators ought to evaluate whether the resulting organization will be capable of thriving.[196] Under the least-cost

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[191] *See* Mantripragada, *supra* note 77, at 553-54 ("[W]hat is important is the depositors' perception of the de facto limits on deposit insurance coverage, not the de jure limits. The greater the de facto protection … the weaker the depositor-imposed discipline. Under a de facto 100% coverage of all deposits, the depositor-induced market discipline will be non-existent.").

[192] *See, e.g.*, Macey & Miller, *supra* note 49, at 1183 (noting the FDIC's preference for assisted mergers over liquidations). In fact, Professor Michael Ohlrogge has found that the FDIC's preference for whole-bank assisted mergers may be so strong that the agency sometimes chooses this option even when it is not the cheapest resolution method, in apparent contravention of the least-cost requirement. *See* Ohlrogge, *supra* note 41, at 28-29.

[193] To be sure, it may often be the case that a liquidation or insured-deposit-only assisted-merger is cheaper for the DIF than a whole-bank assisted-merger. However, as Professor Ohlrogge has found, even during time periods where the FDIC has adhered strictly to the least-cost test, more than 25 percent of bank resolutions involved a whole-bank assisted-merger that protected uninsured depositors. *See* Ohlrogge, *supra* note 41, at 29.

[194] Macey & Miller, *supra* note 49, at 1184.

[195] 12 U.S.C. § 1828(c)(5).

[196] Request for Comment on Proposed Statement of Policy on Bank Merger

requirement, however, the FDIC may not consider a bank's future prospects when it is in receivership. This prohibition can be problematic in certain cases, such as when one potential acquirer might adopt a riskier business model than other potential acquirers. This situation could arise, for example, when the FDIC accepts bids from private equity funds, which have a mixed track record of investing in banks.

Since the 2008 financial crisis, private equity firms have identified failed and failing banks as potentially lucrative investment opportunities. Private equity-affiliated bidders acquired 62 failed banks between 2009 and 2014, out of a total of 482 bank failures during that time span.[197] The federal banking agencies took several actions to facilitate these investments, relaxing regulatory barriers that had previously limited private equity involvement in the banking system.[198] The agencies justified these accommodations, in part, on the dire need for capital injections and the dearth of healthy banks able to acquire failed institutions.[199] Even after the 2008 crisis subsided, however, some policymakers continued to advocate for additional private equity investment in the banking sector, particularly in failed and failing banks.[200]

Although retrospective studies of private equity investments have reached divergent conclusions, there is reason to suspect that allowing a private equity firm to acquire a failed bank could imperil the bank's future prospects relative to other potential acquirers. On one hand, some studies suggest that failed banks that were acquired by private equity investors during the 2008 crisis performed relatively well, achieving higher deposit and loan growth than failed banks that were acquired by traditional banks.[201] These

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Transactions, 89 Fed. Reg. 29222, 29230 (proposed Apr. 19, 2024) (noting that under the "future prospects" statutory factor, the FDIC "assess[es] whether the resulting [bank] will be able to operate in a safe and sound manner on a sustained basis following consummation of the merger").

[197] *See* Emily Johnston-Ross, Song Ma & Manju Puri, *Private Equity and Financial Stability: Evidence from Failed Bank Resolution in the Crisis* 9 (Nat'l Bureau of Econ. Rsch., Working Paper No. 28751, 2021), https://www.nber.org/system/files/working_papers/w28751/w28751.pdf.

[198] *See* Frank Righeimer Martin, *Private Equity Investments in Failed Banks" Appropriate Investors Welcome*, 14 N.C. BANKING INST. 403, 405 (2010) ("Beginning in the fall of 2008, a series of actions by the [federal banking agencies] lowered barriers for private equity investment in failed insured depository institutions.").

[199] *See id.* at 404 (noting that "the need for capital is too great to dismiss private equity completely").

[200] *See* Gillian Tan, *FDIC's McKernan Says Failed-Bank Auctions Aren't Competitive*, BLOOMBERG (May 3, 2023), https://news.bloomberglaw.com/banking-law/fdics-mckernan-says-failed-bank-auctions-arent-competitive.

[201] *See* Johnston-Ross et al., *supra* note 201, at 4-5 (finding that private equity-acquired banks "experience a significantly higher increase … in branch-level deposits compared to other failed banks" and affected counties "witness higher growth in small business lending, both in terms of number and amount"); *see also* George French, Donald Hamm, Scott Leifer,

studies also document that private equity-linked bids helped lower the FDIC's resolution costs by roughly $3 billion.[202] On the other hand, however, a study by Professor Robert DeYoung and colleagues suggests a troubling reason behind private equity-acquired banks' seemingly strong performance: greater risk taking.[203] The researchers found that private equity investors generated strong financial returns on their bank investments, but they did so by significantly increasing banks' risk exposure.[204] This conclusion is consistent with evidence that private equity investments in nonbank financial companies are associated with increased risk-taking.[205] Thus, it appears that private equity investment in failed and failing banks may help minimize short-term costs to the DIF and improve troubled banks' near-term performance, but the trade-off could be elevated risk-taking in the longer-term.

Consider a final hypothetical example. Imagine that First Bank of Springfield, with $20 billion in assets, has failed. Two bidders participate in the receivership auction: Metropolitan Bank, a midsize regional bank in a neighboring state with a strong supervisory record, and Vertex Capital, a private equity-sponsored consortium with no previous experience investing in banks. The FDIC determines that Metropolitan Bank's bid would cost the DIF $2 billion and Vertex Capital's bid would cost the DIF $1.5 billion.[206] In this situation, the FDIC is legally required to award First Bank of Springfield to Vertex Capital because it submitted the least-cost bid. This outcome is

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Derek Sturtevant, Ann Taylor & Catherine Topping, *Private-Equity-Backed Acquisitions of Failed Banks, 2008-2013*, at 21 (Fed. Deposit Ins. Corp. Staff Studs., Report No. 2021-01, 2021), https://www.fdic.gov/analysis/cfr/staff-studies/2021-01.pdf (concluding that the FDIC's approach to encouraging private equity bidders in failed bank auctions was "consistent with the safety and soundness of resulting banks").

[202] *See* Johnston-Ross et al., *supra* note 201, at 3 (estimating that private equity acquisitions between 2009 and 2014 "allowed the FDIC to reduce resolution costs by $3.63 billion"); French et al., *supra* note 201, at 15 (estimating that private equity acquisitions between 2008 and 2014 lowered the FDIC's resolution costs by $3.3 billion).

[203] *See* Robert DeYoung, Michal Kowalik & Gokhan Torna, Private Equity Investment in U.S. Banks 3 (Jan. 23, 2023) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4011362.

[204] *Id.* at 3 (concluding that private equity investments in banks between 2004 and 2016 were associated with higher net income and return on assets, but also increased accounting- and market-based measures of bank risk). As the researchers concluded, "Consistent with the historical reservations held by U.S. bank regulators, private equity investments in commercial banking companies do appear to increase the risk profiles of these firms." *Id.*

[205] *See, e.g.*, Divya Kirti & Natasha Sarin, *What Private Equity Does Differently: Evidence from Life Insurance*, 37 REV. FIN. STUDS. 201, 211-21 (2024) (finding that after a private equity firm invests in a life insurance company, the insurer shifts its bond portfolio to riskier assets).

[206] Assume that liquidating First Bank of Springfield would be more expensive than either bid.

compulsory even if the FDIC believes that Metropolitan Bank is better positioned to restore First Bank of Springfield to a safe and stable operating condition. In this case, the FDIC has no flexibility to assess the resulting institution's future prospects after it invites private equity firms to bid in the receivership auction.

This is not to suggest that private equity bidders should be categorically excluded from participating in FDIC auctions. Indeed, one could imagine a scenario in which a private equity firm is the only viable bidder in a failed bank auction, or where the private equity firm's bid is significantly stronger than any traditional bank bidder. In such a situation, the cost savings to the DIF could outweigh any uncertainty regarding the institution's future prospects. Under currently law, however, the least-cost test prevents the FDIC from assessing such tradeoffs when comparing competing bids.

C. Least-Cost Case Studies

The previous Section described several hypothetical examples in which the least-cost test could prevent the FDIC from considering salient societal costs when resolving a failed bank. Many of these situations have, in fact, played out in reality. This Section examines three such cases: JPMorgan's 2023 acquisition of First Republic Bank, One West Bank's takeover of IndyMac during the 2008 crisis, and a small Indiana bank's acquisition of its longtime rival in 2011. Collectively, these real-life examples illustrate the least-cost test's excessively narrow scope.

1. JPMorgan-First Republic

JPMorgan's acquisition of First Republic Bank demonstrated how the least-cost test forces the FDIC to ignore competition- and financial stability-related considerations. When First Republic Bank collapsed in May 2023, it became the second largest bank failure in U.S. history with $229 billion in total assets.[207] First Republic was done in by a similar combination of factors that had sunk SVB and Signature Bank just a month earlier: sizeable losses on fixed-rate assets and a massive outflow of uninsured deposits in a rising interest-rate environment.[208] Although policymakers had invoked the systemic risk exception for SVB and Signature Bank, they elected not to do so for First Republic.[209] Thus, the FDIC was bound by the least-cost

[207] *See* Rachel Louise Ensign, Eliot Brown, AnnaMaria Andriotis & Gina Heeb, *Why First Republic Bank Collapsed*, WALL ST. J. (May 1, 2023), https://www.wsj.com/articles/first-republic-bank-collapse-why-banking-crisis-61660d96.

[208] *See id.*

[209] *See* James Politi, Colby Smith, James Fontanella-Khan, Stephen Gandel & Brooke

requirement when resolving First Republic.

Four banks submitted bids in First Republic's receivership auction: JPMorgan, PNC, Fifth Third, and Citizens.[210] JPMorgan was by far the largest of the four potential suitors. At the time, JPMorgan was already the biggest financial conglomerate in the United States and the most systemically important banking organization in the world.[211] In fact, JPMorgan was so big—controlling more than 12 percent of U.S. deposits—that it ordinarily would have been prohibited from acquiring another bank.[212] Since First Republic had failed, however, a statutory exception allowed JPMorgan to bid in the receivership auction.[213] The other three bidders for First Republic were all considerably smaller and more geographically limited than JPMorgan.[214] *Bloomberg* noted that JPMorgan was "four times larger than all three other bidders" combined.[215]

According to public reports, JPMorgan won the auction for First Republic in an extremely close bidding war. The FDIC estimated that JPMorgan's whole-bank bid—which included a loss-sharing provision and a $50 billion low-interest loan from the FDIC to JPMorgan—would cost the DIF "about $13 billion."[216] Although the FDIC does not disclose the estimated cost of losing bids, public reports soon emerged that PNC's bid had been very close

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Masters, *How Jamie Dimon Swooped on the Remains of First Republic*, FIN. TIMES (May 1, 2023), https://www.ft.com/content/5fbdf550-a8d9-455c-b62b-ff542b1c18bd.

[210] *See First Republic Bid Summary*, *supra* note 6.

[211] *See* NAT'L INFO. CTR., LARGE HOLDING COMPANIES (Mar. 31, 2023), https://www.ffiec.gov/npw/Institution/TopHoldings (listing JPMorgan Chase & Co. as the largest holding company with more than $3.7 trillion in assets as of March 31, 2023); *see also* FIN. STABILITY BD., 2023 LIST OF GLOBAL SYSTEMICALLY IMPORTANT BANKS (G-SIBS) 3 (2023), https://www.fsb.org/wp-content/uploads/P271123.pdf (identifying JPMorgan Chase as the world's most systemically important banking organization).

[212] *See* 12 U.S.C. § 1828(c)(13)(A) (prohibiting federal regulators from approving a bank merger if the resulting institution would control more than 10 percent of the total deposits of insured depository institutions in the United States). At year-end 2022, JPMorgan controlled $2.3 trillion out of the $19.2 trillion in deposits of U.S. banks. *See* JPMORGAN CHASE & CO., ANNUAL REPORT 2022, at 100 (2023), https://www.jpmorganchase.com/content/dam/jpmc/jpmorgan-chase-and-co/investor-relations/documents/annualreport-2022.pdf; *Quarterly Banking Profile: Fourth Quarter 2022*, 17 FDIC Q., no. 1, 2023, at 9.

[213] *See* 12 U.S.C. § 1828(c)(13)(B) (providing that the 10 percent nationwide deposit cap does not apply to a merger or acquisition involving a failed or failing bank).

[214] Hannah Levitt & Max Abelson, *It Was a Tough Year For Almost Every Bank Not Named JPMorgan*, BLOOMBERG (Dec. 27, 2023), https://www.bloomberg.com/news/articles/2023-12-27/it-was-a-tough-year-for-almost-every-bank-not-named-jpmorgan (discussing the size of PNC, Fifth Third, and Citizens relative to JPMorgan).

[215] *See* Levitt & Abelson, *supra* note 214.

[216] Press Release, Fed. Deposit Ins. Corp., JPMorgan Chase Bank, National Association, Columbus, Ohio, Assumes All the Deposits of First Republic Bank, San Francisco, California (May 1, 2023), https://www.fdic.gov/news/press-releases/2023/pr23034.html.

to JPMorgan's bid.[217] By some estimates, the spread between the two bids was less than $1 billion.[218]

The competing bids by JPMorgan and PNC—despite being close in value—would have reshaped the U.S. banking system in remarkably different ways. JPMorgan's winning bid cemented its status as the United States' dominant financial firm, helping to vault the bank over the $4 trillion asset threshold and widening the size gap between it and its next closest competitors, Bank of America, Citigroup, and Wells Fargo.[219] By contrast, if First Republic had been awarded to PNC, "the deal would have been transformative."[220] As the *New York Times* reported, acquiring First Republic "would have bolstered [PNC's] position to challenge the nation's four large commercial lenders."[221] In addition, awarding First Republic to PNC—which is not a GSIB—would have avoided the additional concentration of risk in JPMorgan, the world's most systemically important bank.[222] In the face of these paradigm-shifting implications, the putative $1 billion differential in DIF costs between JPMorgan's and PNC's bids appears relatively insignificant.

Of course, policymakers may reasonably have believed that awarding First Republic to JPMorgan would stabilize the U.S. banking system more credibly than if it had been awarded to the smaller, lesser-known PNC. That appears to have been the view of Acting Comptroller of the Currency Michael Hsu who, as both JPMorgan's primary bank regulator and a member of the FDIC Board, not only helped oversee the First Republic receivership auction but also approved JPMorgan's Bank Merger Act application.[223] Regulators

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[217] *See* Letter from Senators JD Vance and Elizabeth Warren to Martin Gruenberg, Chairman, Fed. Deposit Ins. Corp. 2 (Dec. 8, 2023), https://www.vance.senate.gov/wp-content/uploads/2023/12/Senators-Vance-Warren-Letter-to-FDIC.pdf.

[218] *See id.* ("Senator Vance's office has learned from government officials and industry leaders, who have purported to be privy to the auction process, that the final spread between JPMorgan's bid and the next most viable bid was likely closer to $1 billion.").

[219] *See* Gary Sernovitz, *Jamie Dimon's $4 Trillion Machine*, N.Y. MAG. (Dec. 7, 2023), https://nymag.com/intelligencer/article/jp-morgan-chase-jamie-dimon-biggest-big-bank.html.

[220] *See* Maureen Farrell, Matthew Goldstein & Lauren Hirsch, *Late-Night Negotiating Frenzy Left First Republic in JPMorgan's Control*, N.Y. TIMES (May 1, 2023), https://www.nytimes.com/2023/05/01/business/first-republic-jpmorgan-fdic.html.

[221] Farrell et al., *supra* note 214.

[222] *See* FIN. STABILITY BD. *supra* note 211, at 3 (identifying JPMorgan as the world's most systemically important bank and not including PNC on the list of GSIBs).

[223] Hsu testified before Congress that if regulators had sold First Republic to a different acquirer, "I fear that there would have been greater financial instability that weekend." *Oversight of Financial Regulators: Financial Stability, Supervision, and Consumer Protection in the Wake of Recent Bank Failures*, U.S. SEN. COMM. ON BANKING, HOUS. & URB. AFFS. (May 18, 2023) https://www.banking.senate.gov/hearings/oversight-of-financial-regulators-financial-stability-supervision-and-consumer-protection-in-the-wake-

may also have preferred JPMorgan's bid over PNC's on the ground that the larger bank would be better equipped to integrate First Republic's operations.[224] Thus, reasonable people could reach differing conclusions as to which potential acquirer would be better for the banking system.

Whatever view one holds as to the desirability of JPMorgan's acquisition of First Republic, it is odd that the FDIC was legally barred from taking any of these considerations into account. Instead, the least-cost mandate effectively put the FDIC's resolution process on autopilot: once the FDIC determined that JPMorgan's bid would incur the least cost to the DIF, the FDIC was statutorily required to sell First Republic to JPMorgan, regardless of the broader societal implications.

2. IndyMac

A second failed bank acquisition, OneWest Bank's takeover of IndyMac in 2008, demonstrated how the least-cost test underemphasizes a failed bank's future prospects. Based in California, IndyMac Federal Bank had become one of the United States' largest mortgage lenders during the mid-2000s' subprime boom.[225] In late 2007, however, IndyMac began incurring steep losses as the housing bubble started to burst.[226] By July 2008, IndyMac's primary federal regulator, the Office of Thrift Supervision (OTS), revoked IndyMac's charter and shut down the firm.[227] The OTS's decision occurred unexpectedly, and the FDIC "did not have the time to search for an acquiring institution."[228] Accordingly, the FDIC established a bridge bank to maintain IndyMac's operations while planning for its eventual resolution.[229]

Eventually, the FDIC put IndyMac up for auction in December 2008.[230]

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of-recent-bank-failures (statement of Acting Comptroller Michael Hsu at 2:04:26).

[224] *See* Farrell et al., *supra* note 214 (noting that regulators "were more inclined to accept" JPMorgan's bid because JPMorgan "was likely to have an easier time integrating First Republic's branches into its business and managing the smaller bank's loans and mortgages").

[225] *See* Mallory Dreyer, *The Resolution and Restructuring of IndyMac Bank* 1 (Yale Program on Fin. Stability, Working Paper No. 4041, 2020), https://elischolar.library.yale.edu/ypfs-documents/4041/. IndyMac was technically chartered as a thrift institution, not a bank. *See id*. This Article refers to IndyMac as a bank for simplicity.

[226] *See id.* at 2.

[227] *See id.* at 3.

[228] *Id.* at 12.

[229] Technically, the FDIC did not have authority to establish a bridge bank for a thrift institution like IndyMac. Instead, the FDIC used its authority as conservator to operate the firm. However, "the conservatorship approach taken for IndyMac … is essentially the same" as a bridge bank. *Id.* at 4.

[230] *See Bid Summary, IndyMac Federal Bank FSB, Pasadena, CA,* FED. DEPOSIT INS. CORP. (Mar. 19, 2009), https://www.fdic.gov/resources/resolutions/bank-failures/failed-

One bidder—a private equity consortium including financiers Steven Mnuchin, George Soros, and John Paulson—offered to acquire all of IndyMac in a whole-bank assisted merger.[231] Five other bidders sought to acquire a subset of IndyMac's deposits or assets.[232] The FDIC concluded that the private equity bid would incur the least cost to the DIF, which the FDIC estimated to be up to $9.4 billion.[233] Similar to the First Republic case, however, the margin between the winning bid and the second-place bid was narrow.[234] The FDIC estimated that the next-best bid, in which U.S. Bancorp would acquire all of IndyMac's deposits and Goldman Sachs would acquire all of IndyMac's assets, would have increased the DIF's losses by less than $1 billion relative to the winning bid.[235] The FDIC awarded IndyMac to the private equity consortium in accordance with the least-cost requirement, and the group installed Mnuchin as chief executive officer and changed the bank's name to OneWest.[236]

Almost as soon as the private equity consortium assumed control of the bank, allegations arose that OneWest began engaging in underhanded, anti-consumer, and potentially illegal business practices. At a time when many banks were foreclosing on delinquent mortgages, consumer advocates singled out OneWest's foreclosure tactics as unusually aggressive.[237] Most infamously, OneWest's successor bank attempted to foreclose on a 90-year-old woman's house after she underpaid her mortgage by 27 cents.[238] In addition, the FDIC received a letter purportedly from a group of OneWest employees claiming that OneWest executives instructed them to "reject as many loan modification applications as possible and created an environment that encouraged loan modification staff to misinform borrowers about their eligibility status, routinely shred loan modification applications, and

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bank-list/indymac-bid-summary.html [hereinafter *IndyMac Bid Summary*].

[231] *See id.* For background on the private equity consortium, see *Equity Partnership Is Formed to Buy Remnants of IndyMac Bank for $13.9 Billion*, N.Y. TIMES (Jan. 2, 2009), https://www.nytimes.com/2009/01/03/business/03indy.html.

[232] *See IndyMac Bid Summary*, *supra* note 230.

[233] *See* Press Release, Fed. Deposit Ins. Corp., FDIC Board Approves Letter of Intent to Sell IndyMac Federal (Jan. 5, 2009), https://archive.fdic.gov/view/fdic/3862.

[234] *See supra* notes 217-218 and accompanying text (discussing narrow margin in the First Republic failed bank auction).

[235] *See* Jim Wigand & John Bovenzi, *Steven Mnuchin Bought IndyMac Fair and Square*, WALL ST. J. (Jan. 19, 2017), https://www.wsj.com/articles/steven-mnuchin-bought-indymac-fair-and-square-1484784634.

[236] *See* Dreyer, *supra* note 225, at 6.

[237] *See* Lorraine Woellert, *Trump Treasury Pick Made Millions After His Bank Foreclosed on Homeowners*, POLITICO (Jan. 1, 2016), https://www.politico.com/story/2016/12/trump-treasury-foreclosed-homes-mnuchin-232038.

[238] *See id.*

inappropriately deny loan modifications."[239] In 2016, housing advocates filed a complaint with the Department of Housing and Urban Development alleging that OneWest "discriminated against blacks, Hispanics and Asians and avoided putting branches in minority communities."[240] Three years later, OneWest settled the allegations without admitting guilt.[241]

Of course, it is impossible to know whether IndyMac's post-resolution business practices would have been more reputable if it had been sold to one or more traditional banks instead of a private equity consortium. Indeed, many traditional banks committed similarly egregious consumer abuses during the same time period.[242] However, evidence that private equity acquirers tend to adopt risky business strategies suggests that keeping IndyMac's operations within the traditional banking system could have resulted in better outcomes for the bank and its customers.[243] Under the least-cost requirement, though, the FDIC was prohibited from weighing tradeoffs involved in the private equity consortium's bid that was least costly to the DIF but may not have been least costly to society as a whole.

3. Integra Bank

The resolutions of First Republic and IndyMac were notable for their large size, but the least-cost requirement may be problematic for smaller banks, as well. The failure of Integra Bank in 2011 exemplified how the least-cost test can imprudently constrain the FDIC when resolving a small community bank.

Founded in 1850 under the name Canal Bank, the bank that became Integra had long been a mainstay in its hometown of Evansville, Indiana.[244]

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[239] FED. DEPOSIT INS. CORP., OFF. OF THE INSPECTOR GEN., EXECUTIVE SUMMARY: AUDIT OF ONEWEST BANK'S LOAN MODIFICATION PROGRAM 1 (2011), https://www.fdicoig.gov/sites/default/files/reports/2022-08/11-004EV.pdf. The FDIC concluded, after an investigation, that the allegations in the letter were "factually inaccurate." *Id.* at 2.

[240] Lorrain Woellert, *Mnuchin-Founded Company Accused of Housing Discrimination*, POLITICO (Nov. 17, 2016), https://www.politico.com/blogs/donald-trump-administration/2016/11/steven-mnuchin-onewest-bank-donald-trump-231580.

[241] *See* Andrew Khouri, *HUD Approves Settlement With OneWest Bank Resolving Redlining Allegations*, L.A. TIMES (July 29, 2019), https://www.latimes.com/business/story/2019-07-29/hud-settlement-onewest-bank-redlining-allegations.

[242] *See, e.g.*, Mark Memmott, *Big Banks Agree to Pay $8.5 Billion to Settle Mortgage Foreclosure-Abuse Claims*, NPR (Jan. 7, 2013), https://www.npr.org/sections/thetwo-way/2013/01/07/168790359/big-banks-agree-to-pay-8-5-billion-to-settle-foreclosure-abuse-claims (describing settlement resolving allegations that 10 large banks improperly foreclosed on homeowners).

[243] *See supra* notes 203-205 and accompanying text.

[244] *See* Susan Orr, *Artifacts Telling Story of Failed Integra Bank on Display This Week*

For decades, the bank specialized in serving Evansville and nearby rural communities.[245] In the early 2000s, however, the bank embarked on an expansion strategy.[246] It changed its name to Integra, opened commercial loan offices in Cleveland, Columbus, and Louisville, and bought a Chicago-based bank that specialized in commercial construction loans.[247] The strategy quickly backfired. As the real estate market soured in the mid-2000s, Integra's new commercial loan portfolio plummeted in value.[248] Integra accepted $83.5 million in government assistance from the Troubled Asset Relief Program in 2009, but even that was not enough to stave off its collapse.[249] Two years later, regulators shuttered the bank.[250]

Three banks bid on Integra in the ensuing FDIC receivership auction.[251] Old National Bank—the largest bank in Evansville and Integra's longtime rival—submitted the best bid, estimated to cost the DIF $170 million.[252] A second bank, First Financial from Hamilton, Ohio, submitted a bid that was nearly identical to Old National's.[253] The banks offered the same deposit premium, the same single-family mortgage loss share, and the same commercial mortgage loss share.[254] The only differences between the two bids were (1) Old National's bid contained a lower asset discount ($111 million versus $149 million), and (2) Old National offered the FDIC a value appreciation instrument capped at $4 million, while First Financial did not.[255]

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at Evansville Library, EVANSVILLE COURIER & PRESS (Apr. 25, 2012).

[245] *See* Francesca Jarosz, *The Man Who Fought for Integra*, EVANSVILLE COURIER & PRESS (Aug. 28, 2011).

[246] *See* Susan Orr, *Why Integra Bank Failed*, EVANSVILLE COURIER & PRESS (Apr. 21, 2012).

[247] *See id.*

[248] *See id.*

[249] *See id.*

[250] *See id.*

[251] *See Bid Summary, Integra Bank National Association, Evansville, IN*, FED. DEPOSIT INS. CORP. (July 29, 2011), https://www.fdic.gov/resources/resolutions/bank-failures/failed-bank-list/integra-bid-summary.html [hereinafter *Integra Bid Summary*].

[252] *See* Press Release, Fed. Deposit Ins. Corp., Old National Bank, Evansville, Indiana, Assumes All of the Deposits of Integra Bank, National Association, Evansville, Indiana (July 29, 2011), https://archive.fdic.gov/view/fdic/4289 (noting that Old National Bank's bid was estimated to cost the FDIC $170.7 million); *see also* FED. DEPOSIT INS. CORP., DEPOSIT MARKET SHARE REPORTS—SUMMARY OF DEPOSITS, https://www7.fdic.gov/sod/sodMarketBank.asp (select the Evansville, IN-KY Metropolitan Statistical Area and the June 30, 2011 report date) [hereinafter Evansville Market Share Data] (listing Old National Bank as the largest bank in the Evansville banking market as of June 30, 2011).

[253] *See Integra Bid Summary*, *supra* note 251.

[254] *See id.*

[255] *See id.* For the terms of Old National's value appreciation instrument, see Exhibit 10.1, Old National Bank Cash-Settled Value Appreciation Instrument (July 29, 2011), https://www.sec.gov/Archives/edgar/data/707179/000095012311072759/c20850exv10w1.

Thus, Old National's bid cost the DIF $42 million less than First Financial's bid.[256] The FDIC named Old National the winner of the receivership auction in accordance with the least-cost requirement.[257]

For Old National, acquiring Integra was a coup. Integra had been widely regarded as Old National's primary competitor.[258] By purchasing Integra, Old National firmly established itself as the dominant bank in the Evansville market and blocked other banks, including First Financial, from entering through acquisition.[259] At the same time, the merger enabled Old National to cut costs by reducing payroll and closing overlapping branches.[260] As one analyst remarked, "It is not very often that you get the opportunity to acquire an in-market competitor as a way to lower expenses."[261] Investors reacted very favorably to the acquisition. On the Monday after the merger, Old National's stock surged, and it was "the top gainer of the day on the New York Stock Exchange" among publicly traded banks.[262]

While Old National benefited from Integra's failure, the Evansville community suffered. As a result of Integra's merger with Old National, the Evansville banking market became "highly concentrated" under then-applicable Department of Justice antitrust guidelines.[263] Following the

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[256] I calculated this figure by taking the difference between the two bids' asset discounts ($149 million – $111 million = $38 million) and adding the $4 million value appreciation instrument.

[257] The third bidder, Great Southern Bank from Springfield, Missouri, submitted one or more bids that were more costly that the winning and runner-up bids. *See Integra Bid Summary*, *supra* note 251.

[258] *See, e.g.*, Alan Kline, *Old National's Stock Surges on Earnings, Integra Deal*, AM. BANKER (Aug. 2, 2011) (describing Integra as Old National's "longtime rival"); *see also* Matthew Monks, *Is the Bank Merger Wave Finally Building in the Heartland?*, AM. BANKER (Feb. 13, 2012) (describing Integra as Old National's "crosstown rival").

[259] Prior to the merger, Old National had 27.54 percent deposit market share, Ohio-based Fifth Third Bank had 25.02 market share, and Integra had 15.11 percent market share. No other bank had more than 8 percent market share. *See* Evansville Market Share Data, *supra* note 252.

[260] *See* Robert Barba, *Old National (Ind.) Plans to Close 23 More Branches*, AM. BANKER (Sept. 12, 2011) (noting that the acquisition "has largely been viewed as an opportunity for Old National to slash expenses since the banks operated in the same markets").

[261] *See* Robert Barba, *Old National Looks to Integra to Get Leaner*, AM. BANKER (Aug. 2, 2011) (quoting Sterne Agee & Leach Inc. analyst Kenneth James).

[262] Kline, *supra* note 258.

[263] *See* U.S. DEP'T OF JUST. & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES 19 (2010), https://www.justice.gov/atr/file/810276/dl (defining a highly concentrated market as a market with a Herfindahl Hirschman Index (HHI) above 2,500). The HHI measures market concentration by summing the squared market shares of every competitor in a market, with a higher HHI indicating a more concentrated market. *See* Kress, *supra* note 151, at 544. The market shares of the banks in the Evansville banking market are listed in Evansville

merger, two banks—Old National and Fifth Third—collectively controlled more than 67 percent of the market.[264] Under normal circumstances, a bank merger producing such concentration would elicit a potential antitrust challenge.[265] In this case, however, Old National's acquisition of its primary rival was exempt from antitrust oversight because Integra had failed.[266] After the merger, Old National closed 32 of Integra's 52 branches, including all of the former Integra branches in Evansville.[267] More than thirteen years later, the Evansville banking market remains highly concentrated in 2024, and Old National continues to dominate with 35 percent deposit market share.[268]

The aftermath of Integra's failure could have been better for the Evansville community had the FDIC not been bound by the least-cost requirement. Selling Integra to runner-up First Financial instead of Old National would have introduced a new competitor into the Evansville market.[269] Had First Financial entered Evansville in Integra's place, the market would have remained unconcentrated.[270] Further, First Financial would have had incentive to continue operating Integra's Evansville branches, rather than shuttering them like Old National.[271] To be sure, some Evansville residents were grateful that Integra was sold to the local Old National instead of an out-of-market bank like First Financial.[272] While there

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Market Share Data, *supra* note 252. Summing the squared market shares of the post-merger competitors results in an HHI of 2,554, above the "highly concentrated" threshold.

[264] Evansville Market Share Data, *supra* note 252.

[265] *See* U.S. DEP'T OF JUST., BANK MERGER COMPETITIVE REVIEW—INTRODUCTION AND OVERVIEW 3 (1995), https://www.justice.gov/sites/default/files/atr/legacy/2007/08/14/6472.pdf (providing that the DOJ and the banking agencies "are likely to examine a transaction in more detail" if it results in an HHI of more than 1,800 and an increase of more than 200).

[266] *See* 12 U.S.C. § 1828(c)(6) (exempting a bank merger from DOJ review if the relevant banking agencies "has found that it must act immediately to prevent the probable failure of one of the insured depository institutions involved").

[267] *See* Susan Orr, *Integra Facilities to Close*, EVANSVILLE COURIER & PRESS (Sept. 10, 2011).

[268] *See* Evansville, IN-KY Banking Market, FED. RSRV. BANK OF ST. LOUIS CASSIDI (June 30, 2024), https://cassidi.stlouisfed.org/markets/18060/hhi (reporting that the Evansville banking market had a weighted deposit HHI of 1,979).

[269] *See* Evansville Market Share Data, *supra* note 252 (indicating that First Financial had no presence in Evansville prior to Integra's failure).

[270] *See id.* Summing the squares of the market shares prior to Integra's failure results in an HHI of 1,722.

[271] *See supra* note 267 and accompanying text (discussing Old National's closure of Integra's Evansville branches).

[272] For example, former Integra branch manager Deborah Behme took "comfort in the fact that Old National is a long-established local institution, just like Integra was." Susan Orr, *'Very Sad Day' at Integra: Emotional Employees Say Goodbye as 9 Branches Close*, EVANSVILLE COURIER & PRESS (Oct. 1, 2011). As Behme told a reporter, "At least someone got us who has the same kind of history in this city as we did." *Id.*

is some evidence that locally owned banks like Old National serve their communities more effectively than out-of-market banks,[273] the least-cost requirement prevented the FDIC from even considering the potential trade-offs between (1) retaining local control of Integra, and (2) promoting competition in the Evansville market. Instead, the $42 million difference between Old National's and First Financial's bids forced the FDIC to award Integra to its biggest rival, regardless of the competitive consequences.

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In sum, the least-cost requirement inappropriately limits the factors the FDIC may consider when resolving a failed bank. The least-cost test simultaneously overvalues costs to the DIF, which are partially privatized and unpredictable, and undervalues other critical social costs. Because of its excessively narrow scope, the least-cost requirement could lead to a significant restructuring of the U.S. financial system, with troubling implications for long-term economic growth, distributional equity, and financial inclusion. As the next Part explains, these potential unintended consequences have become even more concerning as the financial sector has changed in the three decades since the least-cost requirement was adopted.

III. THE LEAST-COST TEST IS INAPPROPRIATE FOR THE MODERN BANKING SYSTEM

The foregoing analysis demonstrated that the least-cost requirement distorts bank resolution by prioritizing costs to the DIF over other relevant—and potentially more important—considerations. This Part examines major changes in the U.S. banking sector since the least-cost requirement was enacted. It reveals that, whatever the merits of the least-cost test in the early-1990s, such a narrow decision rule is particularly inappropriate for today's financial system.

Congress enacted the least-cost requirement at a time when the U.S. banking sector looked much different than it does today. In 1991, the United States had nearly 15,000 banks that were limited to engaging in traditional

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[273] *See, e.g.*, Julapa Jagtiani & Raman Quinn Maingi, *How Important Are Local Community Banks to Small Business Lending? Evidence from Mergers and Acquisitions*, 12 J. MATHEMATICAL FIN. 382, 404 (2022) (finding that large, out-of-market acquirers divert small business lending from their targets' local communities to the acquirers' local communities, leaving the targets' communities worse off); *see also* Richard M. Brunell, *The Social Costs of Mergers: Restoring "Local Control" as a Factor in Merger Policy*, 85 N.C. L. REV. 149, 214-20 (2006) (discussing the preservation of local control as a factor in bank merger enforcement).

banking activities within circumscribed geographic locations.[274] Three decades later, the structure and regulation of the U.S. banking system has changed considerably. The number of U.S. banks has dropped by more than two-thirds.[275] Freed from rigid geographic and activity restrictions, many banks have now grown to a size unheard of just thirty years ago.[276]

Against this backdrop, the least-cost test is no longer an appropriate lodestar for resolving a failed bank. When Congress adopted the least-cost test after the S&L Crisis, protecting the DIF was one of the most urgent priorities facing financial policymakers.[277] In the ensuing three decades, however, other policy priorities—such as combatting systemic risk and preventing excessive concentration—have emerged as key issues.[278] Perversely, the least-cost test compounds the systemic risk and excessive concentration problems that now beset the U.S. financial system. This Part examines the changes in the U.S. banking system since the least-cost requirement was first adopted and explains how the least-cost test exacerbates the most pressing policy issues that have arisen in the ensuing three decades.

A. The Transformation of the U.S. Banking System

For almost the entire twentieth century, the United States' banking system featured thousands of small banks that were rooted in their local communities and focused on traditional banking activities like issuing deposits and making loans. In this respect, the United States was unique among developed

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[274] *See BankFind Suite: Find Annual Historical Bank Data*, FED. DEPOSIT INS. CORP. [hereinafter *FDIC BankFind Suite*], https://banks.data.fdic.gov/bankfind-suite/historical (reporting that the United States had 11,927 commercial banks and 2,649 savings institutions in 1991); *see also* BARR ET AL., *supra* note 30, at 726-28, 746-47 (discussing bank activity and geographic restrictions).

[275] *See FDIC BankFind Suite*, *supra* note 274 (reporting that the United States had 4,036 commercial banks and 563 savings institutions in 2023).

[276] *See* Jeremy C. Kress, *Solving Banking's "Too Big to Manage" Problem*, 104 MINN. L. REV. 171, 183-87 (showing that the six largest U.S. banking organizations collectively controlled assets equivalent to 17.5 of U.S. gross domestic product (GDP) in 1997 compared to 50.9 percent of U.S. GDP in 2018).

[277] *See* Hughes, *supra* note 143, at 837-38 ("The FDICIA's principal aims were to recapitalize the [DIF], to protect the integrity of the deposit insurance funds, and to protect the taxpayer from further bailouts of those funds.").

[278] For example, Congress stated that one of its primary goals in the Dodd-Frank Act was "end[ing] 'too big to fail.'" Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1376 (2010) (preamble). In 2021, President Joseph Biden issued an executive order encouraging the federal banking agencies and Department of Justice to take steps to reduce excessive concentration in banking and other sectors of the economy. *See* Promoting Competition in the American Economy, Exec. Order No. 14,036, 86 Fed. Reg. 36,987, 36988-89 (July 14, 2021).

countries.[279] As Professor Kathryn Judge described, "In contrast to places such as Canada, which embraced a banking system composed almost entirely of very large banks, the United States generally imposed strict limitations on the ability of banks to open branches or expand into other domains."[280] State laws prohibited banks from branching across state lines, and in some cases within their home states.[281] The National Bank Act authorized banks to engage in only a narrow range of deposit-taking and lending activities that were considered to be "the business of banking."[282] The Glass-Steagall and Garn-St Germain Acts even prohibited banks from affiliating with, or operating as part of the same conglomerate as, investment banks and insurance companies.[283] Thus, as late at the 1980s, the U.S. banking system was dominated by diffuse, locally oriented banks that specialized in corporate and retail lending.

That all began to change in the 1990s. In the aftermath of the S&L Crisis, many lawmakers came to believe that allowing banks to grow and diversify would enhance their stability.[284] Policymakers also embraced the idea that liberalizing regulatory constraints would help the U.S. financial sector compete internationally.[285] With these goals in mind, Congress eliminated most barriers to interstate bank expansion in the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994.[286] Continuing a trend started in the 1980s, regulators relaxed bank activity restrictions, allowing depository institutions to engage in increasingly exotic financial activities including securitizations and derivatives.[287] In 1999, the Gramm-Leach-

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[279] *See* CHARLES W. CALOMIRIS & STEPHEN H. HABER, FRAGILE BY DESIGN 17 (2014) ("No other country had a banking system anything like this. . . .").

[280] Kathryn Judge, *Brandeisian Banking*, 133 YALE L.J. F. 916, 918 (2024).

[281] *See* BARR ET AL., *supra* note 30, at 746-47 (discussing geographic restrictions).

[282] 12 U.S.C. § 24 (Seventh); *see also* BARR ET AL., *supra* note 30, at 202-20 (discussing the business of banking).

[283] *See* BARR ET AL., *supra* note 30, at 726-29 (discussing affiliation restrictions).

[284] *See, e.g.*, Patrick Mulloy & Cynthia Lasker, *The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Responding to Global Competition*, 21 HARV. J. LEGIS. 255, 269 (1995) (noting that Congress believed relaxing regulatory constraints "would promote diversification of banks' assets and loan portfolios and help banks survive downturns in local economies").

[285] *See, e.g., H.R. 1062, The Financial Services Competitiveness Act of 1995, Glass-Steagall Reform, and Related Issues (Revised H.R. 18)—Part I: Hearing Before the H. Comm. on Banking & Fin. Servs.*, 104th Cong. 223 (1995) (statement of Eugene A. Ludwig, Comptroller of the Currency) ("Both [activities and geographic] diversification are needed to ensure that our banks can … remain competitive in international financial markets.")

[286] Pub. L. No. 103-328, § 102, 108 Stat. 2338, 2343-52 (1994) (codified in scattered sections of 12 U.S.C.).

[287] *See, e.g.*, ARTHUR E. WILMARTH, JR., TAMING THE MEGABANKS 149-69 (2020) (documenting regulatory interpretations that liberalized bank activities restrictions in the 1980s and 1990s); Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed*

Bliley repealed New Deal-era affiliation restrictions, thereby permitting banks to form diversified financial conglomerates that included investment banks, insurance companies, and other nonbank affiliates.[288]

The effects of these policy changes were swift and dramatic. As Professors Saule Omarova and Graham Steele put it, the 1990s-era reforms "unleashed massive industry consolidation and the emergence of financial conglomerates that were larger and more complex than their predecessors."[289] As big banks expanded across state lines and ultimately across the country, the number of "community banks," or smaller banks that focus on lending in their local neighborhoods, plummeted from more than 13,000 in 1990 to just over 4,000 today.[290] By 2022, six large bank holding companies (BHCs)—JPMorgan, Bank of America, Citigroup, Wells Fargo, Goldman Sachs, and Morgan Stanley—had amassed more assets than all other BHCs combined.[291] JPMorgan alone now controls $4 trillion in assets—more than seven times the size of the largest BHC in 1990 after adjusting for inflation.[292] Thus, the reforms of the 1990s "transformed the U.S. financial industry from a decentralized system of independent financial sectors into a highly consolidated industry dominated by a small group of huge financial conglomerates."[293]

Suffice it to say, the U.S. banking system looks much different today than

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the 'Business of Banking,' 63 U. MIAMI L. REV. 1041, 1077-90 (2009) (cataloguing how the OCC expanded the definition of "business of banking" to include derivatives activities).

[288] Pub. L. No. 106-102, § 103, 113 Stat. 1338, 1342-51 (1999) (codified at 12 U.S.C.§ 1843 (2012)).

[289] Saule T. Omarova & Graham S. Steele, *Banking and Antitrust*, 133 YALE L.J. 1162, 1185 (2024).

[290] *See* FED. DEPOSIT INS. CORP., COMMUNITY BANKING STUDY, at 2-6 (2012), https://www.fdic.gov/resources/community-banking/report/2012/2012-cbi-study-full.pdf (reporting that there were 13,150 community banks and thrifts in 1990); *Quarterly Banking Profile: Fourth Quarter 2023*, 18 FDIC Q., no. 1, 2024, at 26 (reporting that there were 4,140 community banks and thrifts in 2023).

[291] These BHCs collectively controlled $13.99 billion in assets—more than 53 percent of all assets owned by U.S. BHCs. *See Large Holding Companies*, NAT'L INFO. CTR. (June 30, 2022), https://www.ffiec.gov/npw/Institution/TopHoldings (listing the asset sizes of the largest BHCs); *U.S. Top Tier Bank Holding Companies*, FED. RSRV. BANK OF CHI. (June 30, 2022), https://www.chicagofed.org/banking/financial-institution-reports/top-banks-bhcs (reporting that 3,482 U.S. BHCs collectively controlled $26.25 billion in total assets).

[292] *See* JPMORGAN CHASE & CO., EARNINGS RELEASE FINANCIAL SUPPLEMENT: FIRST QUARTER 2024, at 3 (2024), https://www.jpmorganchase.com/content/dam/jpmc/jpmorgan-chase-and-co/investor-relations/documents/quarterly-earnings/2024/1st-quarter/9387d4e9-a7dc-4613-822d-6848965485ee.pdf (reporting that JPMorgan held $4.09 trillion in total assets); *see also Top 100 Bank Holding Companies*, AM. BANKER, Oct. 9, 1990, at 12 (reporting that Citicorp was the largest U.S. BHC in 1990, with $227.8 billion in total assets). According to the Consumer Price Index , one dollar in 1990 is equivalent to $2.39 in 2024. *See* U.S. INFLATION CALCULATOR, https://www.usinflationcalculator.com.

[293] WILMARTH, JR., *supra* note 287, at 192.

it did when policymakers enacted the least-cost requirement three decades ago. The structure of the banking system, the prudential regulatory framework, and the sector's competitive dynamics now bear strikingly little resemblance to the status quo in 1991. To date, however, policymakers have not reassessed the least-cost requirement to ascertain whether it remains appropriate in light of these significantly changed circumstances. The next Section contends that, upon reevaluation, the least-cost requirement is no longer fit for purpose and in fact worsens the most pressing problems facing the modern banking system.

B. The Least-Cost Test Exacerbates Contemporary Financial Policy Challenges

As the U.S. banking system has evolved in response to late-twentieth century policy changes, new challenges have emerged. Most notably, scholars and policymakers have raised alarms about the increasing fragility and concentration of the modern financial system.[294] As banks have grown to unprecedented size and financial crises have become more frequent, commentators contend that the largest financial firms are now "too big to fail,"[295] "too big to jail,"[296] "too big to manage,"[297] and "too big to supervise."[298] Meanwhile, small businesses warn that entrepreneurs face a

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[294] *See, e.g.*, Ben S. Bernanke, *The Real Effects of Disrupted Credit: Evidence from the Global Financial Crisis*, 49 BROOKINGS PAPERS ON ECON. ACTIVITY 251, 254 (2018) (discussing financial fragilities related to the 2008 financial crisis); Kanter, *supra* note 159 (highlighting increased concentration within the U.S. banking system); Christopher R. Leslie, *Banking Deserts, Structural Racism, and Merger Law*, 108 MINN. L. REV. 695, 759-62 (2023) (warning about bank consolidation's harmful consequences for low- and moderate-income communities); Kress, *supra* note 151, at 555-72 (documenting negative consequences of bank consolidation).

[295] *See, e.g.*, Roberta S. Karmel, *Is the Public Utility Holding Company Act a Model for Breaking Up the Banks That Are Too-Big-to-Fail?*, 62 HASTINGS L.J. 821, 837-43 (2011); Saule T. Omarova, *The "Too Big to Fail" Problem*, 103 MINN. L. REV. 2495, 2499-504 (2019); Mark J. Roe, *Structural Corporate Degradation Due to Too-Big-to-Fail Finance*, 162 U. PA. L. REV. 1419, 1428-29 (2014); 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, 963-80 (2011).

[296] *See* Jerry W. Markham, *Regulating the "Too Big to Jail" Financial Institutions*, 83 BROOK. L. REV. 517, 565-69 (2018); Nizan Geslevich Packin, *Breaking Bad? Too-Big-to-Fail Banks Not Guilty as Charged*, 91 WASH. U. L. REV. 1089, 1092-94 (2014); Sharon E. Foster, *Too Big to Prosecute: Collateral Consequences, Systemic Institutions and the Rule of Law*, 34 REV. BANKING & FIN. L. 655, 685-90 (2015).

[297] *See* Kress, *supra* note 276, at 188-95.

[298] *See* Lev Menand, *Too Big to Supervise: The Rise of Financial Conglomerates and the Decline of Discretionary Oversight in Banking*, 103 CORNELL L. REV. 1527, 1583 (2018).

dearth of traditional banking options as local community banks disappear.[299]

As discussed in Part II, the least-cost requirement forces the FDIC to ignore considerations, such as promoting competition and mitigating systemic risk, that have emerged as contemporary policy priorities.[300] But the problem is even worse than that: *the least-cost requirement is systematically biased toward increasing concentration and systemic risk*. Indeed, a failed bank's direct competitors typically have the strongest incentive to bid in the failed bank auction, precisely because such a takeover could enhance the acquirer's market power.[301] Moreover, megabanks like JPMorgan have an inherent advantage over other banks when bidding in FDIC auctions because they benefit from an implicit "too big to fail" subsidy that artificially lowers their cost of funding.[302] As a result, if left intact, the least-cost requirement is likely to produce even more concentration, less competition, and increasing fragility in the U.S. financial system.

Consider competition. Researchers have found that bidders exhibit higher willingness to pay in FDIC auctions when they previously competed head-to-head with the failed bank.[303] By acquiring a former competitor, a bidder not only enhances its market power but also may block other banks from entering a local market.[304] Thus, all else equal, bidders tend to submit better bids when acquiring the failed bank would increase local market concentration.[305] As a result, the hypothetical example in Section II.C.3—

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[299] *See, e.g.*, *Navigating Regulations: Alternative Pathways to Investing in Small Businesses: Hearing Before the Subcomm. on Oversight, Investigations, and Reguls. of the H. Comm. on Small Bus.*, 118th Cong. 5-6 (2024) (statement of Mary Kennedy Thompson, Chief Operating Officer, Neighborly), https://www.congress.gov/118/meeting/house/116897/witnesses/HHRG-118-SM24-Wstate-KennedyThompsonM-20240312.pdf ("In years past, small business owners like me … could depend on their local bankers and community banks to be a willing partner, providing capital at reasonable interest rates. . . . But in the era of bank consolidation and mega-mergers, this breed of banker has faded away.")

[300] *See supra* Section II.B.

[301] *See* Granja et al., *supra* note 17, at 1725 (concluding that bidders whose market concentration increases the most with the acquisition of a failed bank have a higher willingness to pay).

[302] *See* Nizan Geslevich Packin, *Supersize Them? Large Banks, Taxpayers and the Subsidies That Lay Between*, 35 NW. J. INT'L L. & BUS. 229, 243-53 (2015) (discussing the too-big-to-fail subsidy).

[303] *See* Granja et al., *supra* note 17, at 1725; Arnold R. Cowan & Valentina Salotti, *The Resolution of Failed Banks During the Crisis: Acquirer Performance and FDIC Guarantees, 2008-2013*, 54 J. BANKING & FIN. 222, 233 (2015) (concluding that "acquirers pay[] a premium for failed banks that contribute to geographic focus").

[304] *See* Wheelock, *supra* note 156, at 160 ("[A] local bank might purchase a failed competitor to deter entry by outside competitors.").

[305] *See* Granja et al., *supra* note 17, at 1756 (concluding that potential acquirers whose acquisition would increase market concentration are more likely to win an FDIC auction);

wherein the least-cost test compelled the FDIC to sell Integra Bank to its direct competitor even though a slightly costlier bid would preserve competition—is actually quite common.[306] One study of more than 400 FDIC auctions between 2007 and 2013 found that only 2 percent of all possible bidders would increase market concentration in any relevant market, but the least-cost bidder actually did increase market concentration 60 percent of the time.[307] As the researchers concluded, "This result suggests that market concentration plays a role in potential acquirer decisions."[308] Since a failed bank's direct competitors exhibit higher willingness to pay in FDIC auctions, the least-cost requirement systematically biases outcomes toward increasing market concentration and decreasing competition.

Next, consider the unique risks posed by large, complex financial conglomerates. Due to their systemic importance, these firms benefit from implicit government subsidies.[309] Market participants generally expect that if such a firm were to experience economic distress, the government would bail it out rather than let it collapse.[310] As a result, the biggest banks have traditionally been able to borrow at favorable rates relative to smaller competitors.[311] This implicit subsidy gives big banks an inherent advantage

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see also Cowan & Salotti, *supra* note 303, at 233.

[306] *See supra* Section II.C.3.

[307] *See* Granja et al., *supra* note 17, at 1755-56.

[308] *Id.* at 1756. To be sure, there are many reasons why a geographically proximate bidder might have a higher willingness to pay for a failed bank compared to a more distant bidder. For example, a geographically proximate bidder might have better "soft information" that enables it to serve local customers more effectively, or such a bidder might find it easier to integrate the failed bank's operations. *See* Granja et al., *supra* note 17, at 1746 (suggesting reasons why local potential acquirers might have a higher willingness to pay); *see also* Cowan & Salotti, *supra* note 303, at 233; Wheelock, *supra* note 156, at 160. However, Professors João Granja, Gregor Matvos, and Amit Seru conclude that market concentration likely influences bidders' willingness to pay, independent of other potential motivating factors. *See* Granja et al., *supra* note 17, at 1759.

[309] *See* Packin, *supra* note 302, at 243-53.

[310] *See id.* at 231-32.

[311] *See id.* at 248-53. By one estimate, the implicit subsidy reached more than 600 basis points in the lead-up to the 2008 financial crisis. *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-14-621, LARGE BANK HOLDING COMPANIES: EXPECTATIONS OF GOVERNMENT SUPPORT 51 (2014). Although the size of the too-big-to-fail subsidy has shrunk since the 2008 crisis, it still persists. Typical estimates of the too-big-to-fail subsidy since 2008 have ranged from roughly 22 to 100 basis points. *See* Nicola Cetorelli & James Traina, *Resolving "Too Big to Fail"* 1-2, 1 n.3 (Fed. Rsrv. Bank of N.Y., Staff Rep. No. 859, 2018), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr859.pdf (summarizing various estimates); *see also* Asani Sarkar, *Did Subsidies to Too-Big-To-Fail Banks Increase During the COVID-19 Pandemic?*, FED. RSRV. BANK OF N.Y.: LIBERTY ST. ECON. (Feb. 11, 2021), https://libertystreeteconomics.newyorkfed.org/2021/02/did-subsidies-to-too-big-to-fail-banks-increase-during-the-covid-19-pandemic.html (documenting that the too-big-to-fail subsidy increased by 50 to 80 basis points during the

when they bid in FDIC auctions: they can afford to submit better bids than smaller competitors because their funding costs are artificially low.[312]

Moreover, the largest financial conglomerates may have special incentive to participate in FDIC auctions. Participants in such auctions are exempt from the federal law that otherwise prevents a bank with more than 10 percent of nationwide deposits from acquiring another bank.[313] Accordingly, megabanks like JPMorgan and Bank of America that exceed the 10 percent deposit cap may be uniquely motivated to bid in FDIC auctions, since they present the sole opportunity for such a bank to grow via merger or acquisition.[314] In this way, the least-cost test may bias FDIC auctions in favor of systemically important financial conglomerates that have built-in funding advantages and unique motivations to bid on failed banks.

In sum, the least-cost requirement exacerbates public policy problems that have emerged in the three decades since its enactment. Excessive concentration and "too big" banks were on few people's radars when Congress adopted the least-cost test in the early 1990s. Yet just three decades later, the banking landscape has changed considerably, and the least-cost mandate intensifies the fragility and concentration problems that now beset the U.S. financial system. Revisiting the least-cost requirement in light of these changes suggests that using DIF costs as the sole decision criterion for resolving failed banks is an outdated—and potentially counterproductive—approach. Accordingly, policymakers should eliminate the least-cost requirement to prevent further concentration and systemic risk, as the next Part recommends.

IV. MODERNIZING BANK RESOLUTION

This Article has demonstrated that the least-cost requirement distorts bank resolution by prioritizing costs to the DIF over other relevant—and potentially more pressing—considerations. This Part contends that Congress should therefore repeal the least-cost test and replace it with a legal

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Covid-19 pandemic).

[312] *See generally* Packin, *supra* note 302, at 258-60 (noting that the implicit subsidy grants too-big-to-fail banks competitive advantages over other banks).

[313] *See* 12 U.S.C. § 1828(c)(13)(A); *see also supra* note 212 (discussing the 10 percent nationwide deposit cap).

[314] *See supra* note 212 (noting that JPMorgan exceeds the 10 percent nationwide deposit cap). Like JPMorgan, Bank of America also exceeds the deposit cap. *See* BANK OF AMERICA., ANNUAL REPORT 2022, at 58 (2023), https://investor.bankofamerica.com/regulatory-and-other-filings/annual-reports/content/0000070858-23-000121/0000070858-23-000121.pdf (reporting that Bank of America controlled $1.93 trillion in deposits as of year-end 2022); *supra* note 212 (noting that there were $19.2 trillion in deposits at U.S. banks as of year-end 2022).

framework that grants the FDIC broader discretion to consider societal costs when resolving a failed bank. Section V.A proposes such legislative reforms. Section V.B then outlines more modest steps policymakers could take as a next-best option to limit adverse effects if Congress chooses to retain the least-cost requirement. Whether Congress eliminates the least-cost requirement entirely or policymakers take more incremental steps to mitigate its unintended consequences, reforms are necessary to ensure that failed bank resolution policy promotes competition, financial stability, and financial inclusion, rather than detracting from these important societal objectives.

A. Repealing the Least-Cost Test

The optimal fix for the least-cost requirement is to repeal it. In its place, Congress should authorize the FDIC to consider a broad range of factors when resolving a failed bank. This Section analyzes two potential replacements for the least-cost test: (1) reinstating the "cost test," which previously allowed the FDIC to choose any resolution method that is cheaper than liquidation,[315] and (2) removing cost constraints entirely. It concludes that Congress should revert to a modified version of the cost test, with an explicit instruction that the FDIC should seek to minimize total social costs when resolving a failed bank. This Section also considers potential drawbacks to this approach, which can likely be addressed by increasing transparency around the FDIC's resolution decisions.

As an initial matter, Congress should amend the Federal Deposit Insurance Act to remove limits on the factors the FDIC may consider when resolving a failed bank. Instead of instructing the FDIC to choose the resolution strategy that is "the least costly to the [DIF] of all possible methods,"[316] federal law should direct the agency to select the approach that "minimizes costs to society." The statute should enumerate the following as a non-exhaustive list of considerations the FDIC may take into account: competition, financial stability, market discipline, the institution's future prospects, and costs to the DIF.[317] Under this approach, DIF costs would become one of many relevant factors, instead of the sole decision criterion, when the FDIC resolves a failed bank.

This reform would grant the FDIC flexibility to address a bank failure in the way it determines to be most socially beneficial. In some cases, this might mean choosing the resolution strategy that incurs the least cost to the DIF. But DIF costs alone would no longer dictate the FDIC's decision making. Instead, the FDIC could choose from among different resolution methods—

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[315] *See supra* notes 49-50 (discussing the cost test).
[316] 12 U.S.C. § 1823(c)(4)(A)(ii).
[317] *See supra* Section II.B (discussing the potential societal costs of bank resolutions).

be it a whole-bank assisted merger, partial-bank assisted merger, bridge bank, or liquidation—depending on the circumstances. Similarly, the FDIC could choose from among competing auction bids based on the characteristics of the bidder, rather than just the bid amount. Thus, the FDIC might prioritize bids by banks that do not compete directly with the failed bank or by banks that pose lesser financial stability risk, even if they are not the least costly to the DIF. At its core, this reform would reconceptualize the FDIC's role in bank resolutions. Instead of viewing the FDIC's role as simply the protector of the DIF, the agency would appropriately be reconceived as a steward of the banking system as a whole.

If Congress were to eliminate the least-cost requirement, it would have to confront whether the FDIC should be subject to *any* statutory constraints. For example, policymakers could reinstate the cost test, which until 1991 required the FDIC to choose a resolution method that was less costly to the DIF than liquidation.[318] There are strong arguments both for and against reviving the cost test. On one hand, limiting the FDIC to resolution strategies that are cheaper than liquidation could help prevent the agency from spending profligately out of the DIF and jeopardizing its solvency. On the other hand, as already noted, DIF costs are not the public fisc and resolution cost estimates are rarely accurate, so policymakers might reasonably allow the FDIC to select a resolution method even if the agency believes it would incur higher DIF costs than liquidation.[319]

On balance, it would probably be best for lawmakers to revive the cost test as a constraint on the FDIC's discretion, subject to some leeway. The optimal rule would require the FDIC to use a resolution strategy that is estimated to cost the DIF less than some multiple—perhaps 150 or 200 percent—of the estimated costs of liquidation. This "modified" cost test would provide the FDIC some additional discretion beyond the "strict" cost test in light of the fact that liquidation cost estimates are notoriously imprecise.[320] Absent this constraint, FDIC officials would have free rein to pursue resolution strategies that would drain the DIF when simply liquidating the failed bank would be more cost-effective from the DIF's perspective. Using liquidation costs as a constraint is appropriate because it helps ensure that uninsured depositors do not enjoy unlimited de facto deposit insurance, and it thereby limits moral hazard.[321] Policymakers would still retain discretion to override this modified cost test by invoking the systemic risk

[318] *See supra* notes 49-50.

[319] *See supra* Section II.A (discussing the least-cost test's overemphasis on protecting the DIF).

[320] *See supra* Section II.A.2 (discussing the imprecision of resolution cost estimates).

[321] *See supra* Section II.B.3 (discussing uninsured deposits and moral hazard).

exception in emergency circumstances.[322]

Of course, even with the modified cost test as a safeguard, expanding the FDIC's discretion over bank resolution could intensify the risk of potential abuses. Despite its drawbacks, one of the least-cost test's strengths is that it provides a hard-and-fast decision rule that, in theory, minimizes opportunities for official misconduct. Even with the least-cost test, however, there is evidence that the FDIC may sometimes manipulate the bank resolution process to benefit favored parties.[323] For example, economist Deniz Igan and colleagues have found that banks that lobby their regulatory agencies are significantly more likely to win FDIC resolution auctions.[324] These researchers also concluded that a bidder is more likely to win an FDIC auction when it has one or more board members who serve or have previously served on advisory committees to the banking regulators.[325] Eliminating the least-cost test and granting the FDIC more discretion could intensify opportunities for abuse.

Congress can likely mitigate the potential for official misconduct by establishing and enforcing rigorous transparency requirements for FDIC resolutions. Under the current system, the FDIC's resolution process is subject to virtually no oversight—Congress simply trusts the FDIC to calculate resolution costs and abide by the least-cost mandate.[326] Eliminating the least-cost test and granting the FDIC greater discretion would amplify the need for the agency to disclose and explain its reasoning. Thus, for each bank failure, Congress should require the FDIC to (1) publish estimated costs to the DIF of each resolution method it considered, (2) identify other social costs that it took into account, and (3) explain how it weighed all the relevant costs and selected the ultimate resolution strategy.[327] For larger bank failures—

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[322] *See supra* notes 80-82 (discussing the systemic risk exception).

[323] *See, e.g.*, Ari Kang, Richard Lowery & Malcom Wardlaw, *The Costs of Closing Failed Banks: A Structural Estimation of Regulatory Incentives*, 28 REV. FIN. STUDS. 1060, 1062 (2014) (concluding that the FDIC was more likely to forebear in closing a distressed bank during the 1980s and 1990s when the bank's home state was represented in leadership positions or banking committees in the U.S. House of Representatives).

[324] *See* Deniz Igan, Thomas Lambert, Wolf Wagner & Eden Quxian Zhang, *Winning Connections? Special Interests and the Sale of Failed Banks*, 140 J. BANKING & FIN. 106496, at 2 (2022) ("Bidders lobbying banking regulators and, in particular, the FDIC increase their probability of winning an auction by 18.5 percentage points.").

[325] *See id.*

[326] *See supra* note 107 (noting that Congress repealed the requirement that the GAO audit the FDIC's least-cost determination in 1996).

[327] To be clear, Congress should not require the FDIC to quantify total social costs when selecting its preferred resolution method. Forcing the FDIC to quantify social costs would likely overvalue factors that the FDIC can estimate directly, such as DIF costs, and undervalue immeasurable or longer-run considerations, such as potential reductions in competition or impairments to financial stability. *See, e.g.*, Coates, *supra* note 25, at 960

perhaps firms with more than $50 billion in assets—FDIC officials could be required to testify before the relevant Congressional banking committees to explain their decision making and answer lawmakers' questions.

Of course, subjecting the FDIC to more oversight could increase the risk that the agency's resolution decisions will be—or appear to be—influenced by politics. Indeed, if the current resolution framework already favors politically connected banks, as researchers have suggested, intensifying political oversight could worsen the problem.[328] Although concerns about political influence are worthy of continued attention, it should not stop lawmakers from mandating stronger oversight as an antidote to potential abuses of the FDIC's discretion. Politically connected banks may benefit under the current, secretive system because "private information is more valuable and public interest appraisal is more complicated."[329] Subjecting the FDIC to stronger transparency requirements would help to alleviate political influence by lessening the value of private information. Further, opening the FDIC's reasoning to public scrutiny would inform the democratic process by allowing the public to assess whether the FDIC weighs competing costs in a manner consistent with the public's priorities.

In sum, Congress ought to replace the least-cost test with a more discretionary standard that allows the FDIC to choose a resolution method that minimizes total costs to society. This grant of authority should be limited in two ways: by (1) restricting the FDIC to resolution methods with estimated DIF costs below 150 or 200 percent of the estimated cost of liquidation, and (2) requiring the FDIC to publicly report on, and in some cases testify about, its decision making process. Taken together, these reforms would help ensure that the United States' bank resolution framework promotes social welfare, rather than detracting from it.

B. Working Within the Least-Cost Test

Despite compelling reasons to repeal the least-cost requirement, the prospects for near-term legislative reform are uncertain, at best. Congress did not pass any financial reforms in the window immediately following the March 2023 bank failures, and political momentum for related legislation appears to have dwindled.[330] Accordingly, policymakers should develop

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(asserting that social benefits are more difficult to quantify than direct compliance costs on regulated entities). Instead, Congress should reject the least-cost test's strict quantification requirement and direct the FDIC to conduct a more qualitative, holistic evaluation of total social costs.

[328] *See* Kang et al., *supra* note 323; Igan et al., *supra* note 324.

[329] Igan et al., *supra* note 324, at 3.

[330] *See, e.g.*, John Heltman, *Whatever Happened to Deposit Insurance Reform?*, AM. BANKER (Mar. 5, 2024), https://www.americanbanker.com/opinion/whatever-happened-to-

fallback strategies to mitigate the unintended consequences of the least-cost requirement if Congress does not act. This Section suggests three such approaches: (1) invigorating Bank Merger Act reviews of FDIC-assisted acquisitions; (2) including long-term DIF costs in the FDIC's least-cost calculations; and (3) prohibiting megabanks from winning FDIC resolution auctions unless they are the only bidders. Although these strategies would be less effective than repealing the least-cost test, they would help blunt the least-cost test's negative side-effects as the long as it remains on the books.

1. Invigorating Bank Merger Act Reviews

Although the FDIC must name the least-cost bidder the winner of a failed-bank auction, that bidder's primary regulator is not required to approve the ensuing transaction. To the contrary, the Bank Merger Act instructs the winning bidder to submit a merger application to its primary regulator, be it the Federal Reserve, the OCC, or FDIC.[331] That regulator is then statutorily required to conduct its own, independent evaluation of the proposed transaction, including its effects on competition, financial stability, and local convenience and needs.[332] Bank Merger Act reviews following an FDIC resolution auction have traditionally been treated as pro forma.[333] If taken more seriously, however, Bank Merger Act applications could present an opportunity for the regulatory agencies to block harmful mergers and thereby mitigate some of the least-cost test's adverse effects.

A bank's primary regulator has two opportunities to weigh in on the bank's fitness to acquire a failed bank: (1) before authorizing the bank to bid, and (2) after the bank is named the winner of the FDIC auction and submits its Bank Merger Act application.[334] At the outset of the bidding process, there

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deposit-insurance-reform ("A year ago … there seemed to be a great deal of urgency in Congress to create some kind of backstop for uninsured deposits . . . . Yet here we are today, and whatever urgency used to be evident in the need to expand deposit insurance has evaporated.").

[331] *See* 12 U.S.C. § 1828(c)(2) (requiring a bank to obtain prior approval from its primary regulator before merging or consolidating with, or acquiring the assets or assuming the deposits of, another bank). The bank's holding company may also be required to submit a separate application to the Federal Reserve. *See id.* § 1842(a) (requiring a bank holding company to obtain prior approval before acquiring control of a bank).

[332] *See id.* § 1828(c)(5).

[333] *See, e.g.*, OFF. OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S LICENSING MANUAL: FAILURE ACQUISITIONS 4 (2019), https://www.occ.gov/publications-and-resources/publications/comptrollers-licensing-manual/files/failures.pdf (noting that the OCC reviews a draft Bank Merger Act application before authorizing a bank to bid in an FDIC auction).

[334] *See supra* note 88 and accompanying text (noting that a bank's primary regulator may object to the bank being included on the FDIC's bid list); *supra* notes 331-332

may be persuasive reasons for a regulatory agencies to err on the side of authorizing many banks to bid. A larger pool of bidders could motivate participants to submit stronger bids and reduce the chances that the FDIC fails to find a willing acquirer. However, on the back-end—after the FDIC has performed its least-cost analysis and identified a winner—a primary regulator could be more discerning when evaluating the winning bidder's Bank Merger Act application. The regulator could, in fact, deny the Bank Merger Act application if it determines that the proposed merger does not satisfy the statutory standards and that an alternative bidder would be preferable.[335] Although there does not appear to be historical precedent for a regulator denying an auction winner's bank merger application, authority would presumably revert to the FDIC to award the failed bank to the runner-up bidder.[336]

JPMorgan's Bank Merger Act application was a contested issue in its FDIC-assisted acquisition of First Republic. Recall that JPMorgan's bid for First Republic reportedly beat PNC's bid by $1 billion.[337] After being named the winner of the auction, JPMorgan submitted a Bank Merger Act application to its primary regulator, the OCC.[338] Acting Comptroller of the Currency Michael Hsu then had a choice to approve or deny JPMorgan's application. Hsu opted to approve, concluding that all statutory factors were consistent with approval.[339] Senator Elizabeth Warren later challenged Hsu's conclusion, asserting that JPMorgan's acquisition increased financial stability risks to a far greater extent than if PNC had been chosen to acquire First Republic.[340] Hsu defended himself, insisting that if he had denied JPMorgan's application, "I fear that there would have been greater financial instability that weekend."[341] At a minimum, this exchange reinforces that a

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(discussing the Bank Merger Act application requirement).

[335] *See* 12 U.S.C. § 1828(c)(5) (enumerating factors a regulator must consider when acting on a bank merger application).

[336] The runner-up bidder would then submit its own Bank Merger Act application to its primary regulator.

[337] *See supra* note 218 and accompanying text.

[338] *See* Letter from Stephen A. Lybarger, Deputy Comptroller for Licensing, Off. of the Comptroller of the Currency, to John H. Tribolati, Sec'y, JPMorgan Chase Bank, National Association and JPMorgan Chase & Co. 2 (May 1, 2023), https://www.occ.gov/topics/charters-and-licensing/app-by-jp-morgan-chase-bank.pdf (discussing JPMorgan's application).

[339] *See id.* at 3.

[340] *See* Press Release, At Hearing, Senator Warren Warned of Heightened Risk of Concentration in the Banking System Following JPMorgan Acquisition of First Republic Bank (May 18, 2023), https://www.warren.senate.gov/newsroom/press-releases/at-hearing-senator-warren-warned-of-heightened-risk-of-concentration-in-the-banking-system-following-jpmorgan-acquisition-of-first-republic-bank.

[341] *Id.*

bank's primary regulator has a choice to approve or deny an FDIC-assisted merger application—and that a different decisionmaker might have reached a different conclusion in the JPMorgan-First Republic case.

Of course, as Acting Comptroller Hsu's comments suggest, invigorating Bank Merger Act review of FDIC-assisted acquisitions could have potential downsides. As Hsu noted, denying a bank's merger application after the FDIC names the bank the winner of the auction could sow confusion and perhaps propagate financial panic.[342] In addition, if banks know that their primary regulator might deny an FDIC-assisted merger application, they could be less likely to participate in an FDIC auction in the first place. Primary regulators ought to weigh these considerations before acting on Bank Merger Act applications for FDIC-assisted transactions. However, in some circumstances, rejecting a Bank Merger Act application could be an appropriate step to limit the least-cost test's adverse consequences.

2. Considering Long-Term Costs to the DIF

The FDIC could mitigate the least-cost test's unintended consequences by including long-term DIF costs in its least-cost calculations. Recall that the least-cost requirement instructs the FDIC to resolve a failed bank in a way that is "least costly to the [DIF] of all possible methods . . . ."[343] As a matter of practice, the FDIC has traditionally interpreted the least-cost mandate narrowly to refer only to the direct costs to the DIF of resolving the particular bank in question.[344] However, the FDIC need not necessarily interpret the least-cost test so narrowly. In fact, there is some evidence that Congress intended the FDIC to take into account not only a bank resolution's immediate, direct costs to the DIF but also its longer-term, indirect costs.[345] If the FDIC considered long-term DIF costs—such as the cost to resolve the winning bidder in an FDIC auction, should it later fail—the agency could help ensure that the least-cost test promotes financial stability, rather than detracting from it.

Banking lawyer Randall Guynn contends that the FDIC is, in fact, required to consider long-term DIF costs when applying the least-cost test.[346] Guynn notes that the Federal Deposit Insurance Act specifies the costs that the FDIC must minimize: "the *total amount* of the expenditures by the [FDIC]

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[342] *See id.*

[343] 12 U.S.C. § 1823(c)(4).

[344] *See* RESOLUTIONS HANDBOOK, *supra* note 33, at 13 (describing the FDIC's least-cost calculations).

[345] *See* Guynn, *supra* note 21, at 65-74 (discussing the least-cost test's legislative history).

[346] *See id.*

and obligations incurred by the [FDIC] (including *any immediate and long-term* obligation of the [FDIC] and *any direct or contingent liability for future payment* by the [FDIC])."[347] Guynn then points to instructive legislative history, including a statement in the Senate Report on the FDICIA that directed the FDIC, when applying the least-cost test to a resolution strategy, to "consider whether that strategy may increase the likelihood of competing institutions failing at a loss to the insurance fund."[348] According to Guynn, this evidence indicates that "the FDIC is required to consider the reasonably foreseeable future costs to the DIF of the failure of any institution that offered the highest bid, either because it was unhealthy or because its failure might destabilize the U.S. financial system . . . ."[349]

If, as Guynn urges, the FDIC were to consider long-term costs to the DIF when applying the least-cost test, certain resolution auctions could result in different outcomes. In particular, if the FDIC were to add in long-run costs, bids by large banks would be disadvantaged because big bank failures tend to be more economically damaging than smaller bank failures.[350] Thus, under this approach, the FDIC might have concluded in 2023 that expanding JPMorgan—the world's most systemically important bank—would pose unreasonable long-term risks to the DIF and instead awarded First Republic to PNC as the least-cost bidder.[351] Considering these long-term costs would thus help mitigate the least-cost test's unintended consequences and produce better outcomes for both the DIF and overall societal welfare.

Of course, factoring long-term DIF costs into least-cost calculations would be inferior to repealing the test outright. For one thing, considering long-term DIF costs would be a significant change in the FDIC's longstanding interpretation of the Federal Deposit Insurance Act and, as such, could create litigation risk for the agency.[352] In addition, considering long-term DIF costs would address only societal costs relating to future financial

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[347] *Id.* at 45 (quoting 12 U.S.C. § 1821(c)(4)(a)(ii)) (emphasis added by Guynn).

[348] *Id.* at 73 (quoting S. REP. NO. 102-167, at 46 (1991)). Although the statutory text of the least-cost requirement differs from that in the Senate version of the FDICIA, Guynn insists that the differences are immaterial. *See id.* at 72-73.

[349] *Id.* at 73.

[350] *See, e.g.*, Amy G. Lorenc & Jeffery Y. Zhang, *How Bank Size Relates to the Impact of Bank Stress on the Real Economy*, 62 J. CORP. FIN., no. 101592, 2020, at 14 (concluding that financial stress at large banks has a significantly stronger, negative impact on the real economy compared to smaller banks).

[351] *See supra* Section II.C.1 (discussing the First Republic receivership auction).

[352] *See, e.g.*, *The Supreme Court's Double Hammer to Agencies: Loper Bright and Corner Post Set New Precedents for Challenging Federal Agency Action*, CROWELL (July 7, 2024), https://www.crowell.com/en/insights/client-alerts/the-supreme-courts-double-hammer-to-agencies-loper-bright-and-corner-post-set-new-precedents-for-challenging-federal-agency-action (asserting that the end of *Chevron* deference "marks an end to agenc[ies] flip-flopping" their interpretations of statutes).

instability. It would not alleviate the other societal costs that the least-cost test imposes on society, such as impairments to competition or the quality of local banking services.[353] Thus, the FDIC could help prevent some of the least-cost test's negative consequences by considering long-term DIF costs, but repealing the requirement outright would still be more effective at promoting overall social welfare.

3. Restricting Megabanks from Winning FDIC Auctions

A final way in which policymakers could mitigate the least-cost test's adverse effects is by limiting when a megabank can win an FDIC auction. Recall that participants in FDIC auctions are exempt from the federal law that prevents a bank with more than 10 percent of nationwide deposits from acquiring another bank.[354] Thus, megabanks like JPMorgan and Bank of America may acquire a failed bank even though they would not be permitted to buy another bank under normal circumstances.[355] There may be good reasons for this special exception that allows megabanks to participate in FDIC auctions. Indeed, a megabank's bid could be the only thing that prevents the FDIC from undertaking a costly liquidation if no other banks bid in a receivership auction.

However, the rationale for allowing a megabank to acquire a failed bank is far less compelling when other qualified bidders are willing and able to acquire a failed bank. When multiple banks bid in an FDIC auction, there is little reason for policymakers to tolerate the threats to competition and financial stability that could materialize if a megabank were declared the winner.[356] Thus, Congress should adopt amend existing law to prohibit a bank with more than 10 percent in nationwide deposits from winning an FDIC auction *unless that bank is the only bidder*.

The Senate Banking Committee in fact adopted such an amendment after JPMorgan's acquisition of First Republic. A provision in the RECOUP Act—which responded to the March 2023 bank failures—would prohibit a banking agency from approving an application by a bank with more than 10 percent of nationwide deposits if any other bank bid in the FDIC auction.[357] The provision's sponsor, Senator JD Vance, explained that it "would mean that if the FDIC takes a bank into receivership, we only allow a massive bank to buy the failed bank's assets [if] there's no other alternative and no other buyer on

[353] *See supra* Section II.B (documenting the societal costs bank resolution may impose).
[354] *See supra* note 313 and accompanying text.
[355] *See supra* note 314 and accompanying text.
[356] *See supra* Sections II.B.1-2 (discussing competition and financial stability).
[357] RECOUP Act of 2023, S. 2190, 118th Cong. § 6 (2023).

the table."[358] The Senate Banking Committee overwhelmingly adopted the RECOUP Act by a 21-2 vote.[359] However, prospects for the bill to advance through the full legislative process remain uncertain.[360]

Restricting a megabank's ability to win an FDIC auction could limit the least-cost test's harmful downsides, but this approach is far from perfect. Narrowing the circumstances in which a megabank could prevail would likely dissuade megabanks from participating in an FDIC auction in the first place. If megabanks choose not to participate, FDIC auctions could become less competitive and, in some circumstances, the FDIC may be forced to liquidate a failed bank in the absence of a viable bidder. Moreover, in contrast to the two previous policy recommendations in this Section—which regulators may implement under existing law—this reform requires Congressional action.[361]

In sum, policymakers could adopt several worthwhile reforms to the United States' bank resolution framework that stop short of fully repealing the least-cost test. These reforms, collectively or in isolation, could help mitigate the least-cost requirement's most damaging unintended consequences. Despite their promise, however, these fallback options are decidedly second-best to outright repeal of the least-cost requirement. The best way to prevent the least-cost test's harmful consequences is for Congress to eliminate it entirely.

CONCLUSION

This Article has shown that the least-cost requirement—a centerpiece of U.S. banking law for more than 30 years—is fundamentally flawed. Although minimizing costs to the DIF sounds like a worthy policy objective, the least-

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[358] Press Release, Sen. JD Vance, Vance Amendment to Discourage Megabank Acquisitions Passes Senate Committee (June 22, 2023), https://www.vance.senate.gov/press-releases/vance-amendment-to-discourage-megabank-acquisitions-passes-senate-committee/.

[359] *See* Press Release, U.S. Senate Comm. Banking, Hous. & Urb. Affs., Brown Advances Bipartisan Bills to Hold Bank Executives Accountable and Curb the Flow of Deadly Fentanyl into Communities (June 21, 2023), https://www.banking.senate.gov/newsroom/majority/brown-advances-bipartisan-bills-hold-bank-executives-accountable-curb-flow-deadly-fentanyl-into-communities.

[360] *See* Andrew Olmem, Matthew Bisanz & Jeffrey P. Taft, *The Senate Banking Committee Passes RECOUP Act, But Next Steps Remain Uncertain*, MAYER BROWN (June 29, 2023), https://www.mayerbrown.com/en/insights/publications/2023/06/the-senate-banking-committee-passes-recoup-act-but-next-steps-remain-uncertain. (noting that the RECOUP Act's future "remains uncertain")

[361] *See supra* Sections IV.B.1 (urging regulators to invigorate Bank Merger Act reviews) and IV.B.2 (suggesting that the FDIC incorporate long-term DIF costs into least-cost calculations).

cost test has had, and will continue to have, detrimental unintended consequences. Forcing the FDIC to resolve failed banks in a way that is least costly to the DIF ignores important factors that policymakers ought to consider when resolving an insolvent bank, including competition, financial stability, and financial inclusion. Repealing the least-cost test and replacing it with a more expansive alternative is therefore essential to foster a more competitive, stable, and inclusive financial system.