REGULATORY PLINKO:
A NEW FORM OF REGULATION TO SOLVE AN OLD PROBLEM IN THE UNITED STATES AND THE UNITED KINGDOM

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ABSTRACT

Information asymmetry has long created issues at all levels of the financial industry. The inability of consumers, financial agents, and regulators to know the information necessary to act rationally has had cataclysmic impacts on the economy. Currently, the United States still struggles to handle this problem as regulators struggle to understand necessary aspects of banks and produce regulations that are impossible to comply with. The United Kingdom struggles with information asymmetry as it tries to craft a financial regulatory framework post-Brexit. This Note will attempt to provide a new style of regulation that will reduce information asymmetry while more fairly rewarding good and bad actors in the financial system.

I. INTRODUCTION

Information asymmetry is one of the most persistent and damaging problems in banking and finance.[1] It is an issue at all levels of banking: asymmetrical information between consumers and banks was a major factor in the Great Depression's bank runs,[2] asymmetrical information between banks is blamed for exacerbating the 2008 Global Financial Crisis,[3] and information asymmetry between regulators and banks prevents effective regulation leading to financial crises and massive losses as seen in the London Whale Scandal.[4] However, information asymmetry is a problem that has not been resolved despite substantial efforts by regulators[5] and academics.[6] This Note will provide a new framework of regulation called *Regulatory Plinko*. To utilize this proposed framework, regulators will provide banks with a series of regulations that are non-mandatory in nature. That is, banks will have free choice to choose between two discrete options without recourse for choosing either decision. This allows regulators to force banks to self-sort, providing crucial information about the safety and soundness of banks. Resolving information asymmetry in the United States financial markets should be a priority, as discussed above, but it is also a focus in rapidly evolving financial

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1 Sudipto Bhattacharya & Anjan Thakor, *Contemporary Banking Theory*, 3 J. FIN. INTERMEDIATION 2, 3 (1993).

2 Mark Carlson, *Causes of Bank Suspensions in the Panic of 1893*, FED. RSRV. BD. 2; Frederic S. Mishkin, *Asymmetric Information and Financial Crises: A Historical Perspective*, NAT'L BUREAU ECON. RSCH. 67 (1993).

3 Daniel O. Beltran & Charles P. Thomas, *Could Asymmetric Information Alone Have Caused the Collapse of Private-Label Securitization*, FED. RSRV. BD. 2, 1 (Oct. 2010); Gary B. Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo*, J. FIN. ECON. 425, 425 (2012).

4 *See generally* Arwin G. Zeissler & Andrew Metrick, *JPMorgan Chase London Whale E: Supervisory Oversight*, 1 YALE PROGRAM ON FIN. STABILITY CASE STUDY 103, (2014).

5 *Crisis and Response: An FDIC History, 2008–2013*, FED. DEPOSIT INS. CORP., (2017) 20, 20.

6 Macher et al., *Regulator Heterogeneity and Endogenous Efforts to Close the Information Asymmetry Gap*, 54 J. L. AND ECON. 25, 26 (2011).

markets. One example that will be discussed in this Note is the United Kingdom's financial markets, which are undergoing massive reworks following the United Kingdom leaving the European Union.[7] This Note will argue why *Regulatory Plinko* would be a valuable tool to the United Kingdom's regulators as they and legislators strive to create a new financial regulatory framework post-Brexit.

II. RELEVANT BANKING CONCEPTS

A. NSF Fees and the FDIC

On June 16, 1933, the Banking Act of 1933 was signed into law, and the Federal Deposit Insurance Commission (FDIC) was created.[8] Its goal was, and still is, to maintain stability and public confidence in the nation's financial system.[9] The FDIC insures nearly all commercial banks in the United States, with 4,136 commercial banks being insured in 2022.[10] Additionally, nearly 96% of American households have a checking or savings account with a commercial bank.[11] Because the FDIC insures and thus regulates nearly all commercial banks in the United States, and 96% of Americans have an account with a commercial bank,[12] regulations produced by the FDIC impact a strikingly large number of Americans. This Note will look at two important FDIC letters that guide financial institutions on how they should go about handling fees from re-presented Not Sufficient Fund Fees (NSFs).[13]

NSFs are a form of fee charged to customers by banks when a customer attempts to authorize a charge that they do not have a sufficient balance to cover.[14] Imagine a customer who has $100.00 in his checking account. He allows a merchant

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7 *See generally Financial Services and Markets Act 2023*, U.K. LEGISLATION, (UK), https://www.legislation.gov.uk/ukpga/2023/29/contents (last visited May 31, 2024).

8 *History of Banking and Deposit Insurance History*, THE FED DEPOSIT INS. CORP., https://www.fdic.gov/about/history/deposit-insurance/1930-1939.html (June 27, 2023) [hereinafter *FDIC Great Depression History*].

9 *About*, FED. DEPOSIT INS. CORP. (March 13, 2023), https://www.fdic.gov/about/ [hereinafter *About the FDIC*]; *FDIC Great Depression History*, *supra* note 8.

10 Chizoba Morah, *Are All Bank Accounts Insured by the FDIC?*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/08/fdic-insured-bank-account.asp (June 5, 2024); *About the FDIC*, *supra* note 9.

11 *2021 FDIC National Survey of Unbanked and Underbanked Households*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/household-survey (last visited May 31, 2024).

12 *Id.*

13 *Supervisory Guidance on Multiple Re-Presentment NSF Fees*, FED. DEPOSIT INS. CORP. (Aug. 18, 2022), https://www.fdic.gov/news/inactive-financial-institution-letters/2022/fil22040.html [hereinafter *FDIC 2022 Letter*]; *FDIC Clarifying Supervisory Approach Regarding Supervisory Guidance on Multiple Re-Presentment NSF Fees*, FED. DEPOSIT INS. CORP. (June 16, 2023), https://www.fdic.gov/news/financial-institution-letters/2023/fil23032.html [hereinafter *FDIC 2023 Letter*].

14 Will Kenton, *Non-Sufficient Funds (NSF): What It Means & How to Avoid Fees*, INVESTOPEDIA, https://www.investopedia.com/terms/n/nsf.asp (July 31, 2023).

to initiate an Automated Clearinghouse Transaction (ACH) for $200.00 that is then presented and subsequently denied by his bank. In this instance, he still has $100.00 in his account because the charge was fully denied. However, if the bank charges NSFs, the account holder is then charged a predetermined NSF fee (we'll use the average fee of $34.00), and the customer's account balance drops to $66.00.[15] The FDIC regulation here does not target these fees. Instead, it targets the fees that happen if the merchant presents the ACH again. When this happens, the ACH is not paid again, leaving the account at $66.00, but a second NSF is charged. This reduces the account balance to $32.00. This can happen a third time, taking the account to -$2.00. The first NSF is not subject to the guidance, but each subsequent re-presented NSF is. The first letter, titled "Supervisory Guidance on Multiple Re-Presentment NSF Fees," was issued on August 18, 2023.[16] The second revised letter, bearing the same title, was issued on June 16, 2023.[17] These fees constitute non-interest income for banks, i.e., income not derived from traditional banking activities such as commercial loans, consumer loans, and mortgages.[18] Non-interest income, like fees, constitutes a large fraction of banks' overall income.[19] The number of NSFs is declining,[20] but they are still a large enough issue for consumers that President Joseph R. Biden has attempted to stop banks from collecting them.[21]

The FDIC published guidance that promised to rectify what it has found to be unfair and deceptive practices by commercial banks[22] in violation of Section 5 of the Federal Trade Commission Act's (FTC Act)[23] prohibition of Unfair or Deceptive Acts or Practices (UDAP).[24] The guidance pushed banks to mitigate the risks of violating the FTC Act and UDAP by adopting "Risk Mitigation Practices," including eliminating NSF fees, declining to charge more than one NSF for a single

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15 Rebecca Borné & Ashwin Vasan, *Consumers on Course to Save $1 Billion in NSF Fees Annually, but Some Banks Continue to Charge These Fees*, CONSUMER FIN. L PROT. BUREAU NEWS BLOG (Apr. 13, 2022), https://www.consumerfinance.gov/about-us/blog/consumers-on-course-to-save-one-billion-in-nsf-fees-annually-but-some-banks-continue-to-charge-them/.

16 *FDIC 2022 Letter*, *supra* note 13.

17 *Id.*

18 Alicia Tuovila, *Net Interest Income: What it is, How it's Calculated, Examples*, INVESTOPEDIA (Apr. 30, 2023), https://www.investopedia.com/terms/n/net-interest-income.asp.

19 Joseph G. Haubirch & Tristan Young, *Trends in the Noninterest Income of Banks*, FED. RSVR. BANK OF CLEV. (Sep. 24, 2019), https://www.clevelandfed.org/publications/economic-commentary/2019/ec-201914-trends-in-the-noninterest-income-of-banks.

20 Offices of Consumer Populations and Markets, *Vast Majority of NSF Fees Have Been Eliminated, Saving Consumers Nearly $2 Billion Annually*, CONSUMER FIN. PROT. BUREAU (Oct. 11, 2023), https://www.consumerfinance.gov/data-research/research-reports/vast-majority-of-nsf-fees-have-been-eliminated-saving-consumers-nearly-2-billion-annually/.

21 *Remarks by President Biden on Protecting American Consumers from Junk Fees* WH.GOV (Oct. 26, 2022), https://www.whitehouse.gov/briefing-room/speeches-remarks/2022/10/26/remarks-by-president-biden-on-protecting-american-consumers-from-junk-fees/.

22 *FDIC 2023 Letter*, *supra* note 13.

23 15 U.S.C. § 45 (2006).

24 *FDIC 2023 Letter*, *supra* note 13.

transaction, providing restitution to harmed customers, and improving disclosure about the fees.[25]

This Note will not directly look at the fees or the regulation specifically. Instead, it will consider the change in the regulation from its initial form to its revised form. Specifically, the initial guidance required institutions to conduct a look back at their ACHs and provide restitution, correct their disclosures, consider additional risk mitigation practices, and monitor activities and customer feedback.[26] The second guidance changed the required lookback to be non-mandatory, absent "a likelihood of substantial customer harm."[27] According to the FDIC, this change from mandatory to non-mandatory is due to the difficulty financial institutions face when attempting to perform the lookback.[28] However, it is also a good example of how non-mandatory regulation can be leveraged by regulators to reduce information asymmetry on regulated entities that could not be learned with mandatory regulations.

The United Kingdom's Financial Conduct Authority (FCA) serves a similar function to the FDIC from a regulatory perspective.[29] Comparing the way in which the FCA successfully implements similar non-mandatory regulations can show why the FDIC should do so as well.

B. What is *Regulatory Plinko*?

For the reader to understand *Regulatory Plinko*, this Note needs to first explain what *Plinko* means. *Plinko* is a common carnival or circus game in which the player drops a round chip from above down to a board with a number of pins.[30] The Plinko disc bounces around through the pins and eventually lands in one of the bottom slots, which often corresponds to a prize.[31] It may appear random which slot the chip lands in, but it is not—the board will create a normal distribution, and across thousands of plays, the board's creator can know exactly how many times a given slot will have a chip land in it.[32] This allows the creator to create the exact

25 *FDIC 2022 Letter*, *supra* note 13.

26 *Id.*

27 *Id.*

28 *Id.*

29 *Compare About the FCA*, FIN. CONDUCT AUTH. (Apr. 18, 2016), https://www.fca.org.uk/about/what-we-do/the-fca ("We work to ensure these markets work well for individuals, for businesses, and for the growth and competitiveness of the UK economy."), *with About*, FED. DEPOSIT CORP., https://www.fdic.gov/about/ (last visited May 31, 2024) ("The Federal Deposit Insurance Corporation (FDIC) is an independent agency created by Congress to maintain stability and public confidence in the nation's financial system. To accomplish this mission, the FDIC insures deposits; examines and supervises financial institutions for safety, soundness, and consumer protection….").

30 Nirmala Naresh & Bridget Royce, *Dropping in on the Math of Plinko*, 19 MATHEMATICS TEACHING IN THE MIDDLE SCHOOL 214, 215 (Nov. 4, 2013).

31 *Id.*

32 Robert E. Burks & Michael J. Jaye, *The Price is Right Again*, 20 J. STATICS EDUC. 1, 9–11 (2012).

number of pin levels to create the distribution they want to get the chips to the prize slots they want to win at the rate that is desired.[33]

Understanding the basics of Plinko, we can now apply it to the proposed non-mandatory regulations. By creating a single instance of non-mandatory regulation, the pure odds of a bank choosing the desired outcome would be 50%.[34] By increasing the number of instances of non-mandatory regulation to two, the odds of choosing the correct choice, on pure chance, would reduce to 25%.[35] Each instance decreases the odds of pure chance leading to correct outcomes, with the odds decreasing all the way to .001% at ten instances.[36] However, the proposed non-mandatory regulation would be crafted by regulators in a way that the odds a bank would choose a given outcome would *not* be random. If regulators created a framework that had ten instances of non-mandatory regulation, the odds that a bank would land in the correct "slot" every time would be so close to zero (.001%) that the regulator could be satisfied that the bank did not end up making the correct decision every time by pure luck. Instead, the bank was able to choose the correct path every time they were given a chance—and are as safe and sound as they make themselves out to be.

III. PURPOSE AND GOALS

A. Purpose and Structure of the Note

This Note will first analyze the value that non-mandatory regulations can provide to regulators. It will look to the literature surrounding quality uncertainty and the "lemon problem," as posited by Akerlof.[37] This problem is relevant because banks and regulators have conflicting goals: banks seek to maximize profits, which often increases risk, and regulators seek to minimize risk, which can hurt profitability. The lemon problem highlights the issue between these two competing goals: banks will seek to hide or minimize the risk regulators can understand by reducing information, but regulators need the information to adequately understand how risky banks are. Non-mandatory regulations can help even out the information mismatch by producing a two-pronged result where both prongs are desirable.

Prong one is banks complying with the non-mandatory regulation. Compliance costs the bank money; but compliance also allows the bank to hide information about a lack of safety and soundness. Prong two is also desirable: Regulators do not get compliance with regulation but instead receive information about the safety and soundness of banks they may have struggled to obtain

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33 Burks et al., *supra* note 32.

34 Courtney Taylor, *Binomial Table for n=10 and n=11*, THOUGHTCO. (Nov. 4, 2019), https://www.thoughtco.com/binomial-table-n-10-n-11-3126257.

35 *Id.*

36 *Id.*

37 George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 THE Q. J. OF ECON. 488, 488 (1970) [hereinafter *Akerlof Market for "Lemons"*].

otherwise. With careful targeting of non-mandatory probative regulation, regulators can accept the cost of non-compliance with less critical regulations in exchange for easy information that was consensually given by the regulated entity. Re-presented NSF fees are a perfect form of this, as they constitute a noteworthy portion of some banks' income while also not impacting the greater financial ecosystem. Non-mandatory regulations involving financial risk regulation, such as capital requirements or high-risk national issues, such as anti-terrorism regulations, would not be considered for this approach.

Additionally, the opaque rationale behind regulation forces banks to discern the goal of the regulator's use of non-mandatory regulation. Banks may comply with chosen regulations even when doing so will increase their risk because failing to do so would signal to regulators that they cannot afford to do anything different and thus are unsafe and unsound. However, regulators may not be using the regulation for that purpose, instead seeking not to overburden those who are regulated.

Next, the Note will argue that in addition to providing information to regulators, non-mandatory regulations provide traditional competitive market pressure that mandatory regulations cannot provide. This market pressure is especially wanting in the field of banking regulation, where banking concentration has greatly increased, and banking regulations often push away from antitrust laws and more towards monopolistic forms.[38]

With these arguments, the Note will demonstrate why the implementation of non-mandatory regulations can be a useful tool for regulators' promotion of safety and soundness in the banking industry. Additionally, implementation of non-mandatory regulations will allow banks to determine for themselves their ability to comply with regulations from a safety and soundness perspective, as well as a competitive perspective where they must determine the impacts of choosing or not choosing to comply where other banks may or may not as well. Finally, the utilization of non-mandatory regulation provides benefits in its removal of informational asymmetry in both the United States and the United Kingdom post-Brexit.

IV. A BRIEF HISTORY OF MODERN BANKING

A. The Great Depression and the FDIC

On October 28, 1929, the Dow Jones Industrial Average (Dow) declined by almost 13%.[39] The next day, now referred to as "Black Tuesday," the Dow declined another 12%.[40] This trend would continue until the Dow decreased by 89% from its peak—causing one of the most cataclysmic economic shocks in history,

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38 Charles Hickson & John Turner, *Banking Regulation's Impact on Industry Monopoly and Risk*, 96 EUR. BUS. REV. 34, 40 (Nov. 5, 1996).

39 Richardson et al., *Stock Market Crash of 1929*, FED. RSRV. HIST. (Nov. 22, 2013), https://www.federalreservehistory.org/essays/stock-market-crash-of-1929.

40 *Id.*

leading to the Great Depression.[41] In the United States, the Great Depression had disastrous consequences for the public: Nearly one in four Americans were unemployed, hunger marches and riots erupted across the nation, and tanks had to be deployed in Washington D.C. to disperse disgruntled WWI veterans who were not being paid.[42]

One major result of the Great Depression was the collapse of thousands of banks across the United States.[43] In 1929, there were an estimated 25,568 banks in the United States,[44] but by 1933, the year the FDIC was created,[45] the number of banks in the United States had plummeted to around 14,771.[46] These failures had an enormous negative effect on the American public and wiped out nearly $7 billion in depositors' assets (worth around $124 billion today).[47]

With consumer confidence shaken and the economy in shambles, President Franklin D. Roosevelt signed into law the Banking Act of 1933, which created one of the most controversial and impactful economic forces in the United States: the FDIC.[48] Banks could get insurance protecting deposits up to $2,500 (around $76,972 today).[49] Initially, the Banking Act of 1933 required banks to pay a premium of 0.5% of insured deposits and comply with a series of other laws and regulations.[50]

Today, deposits in a single covered account are insured up to $250,000, but banks must comply with an increasingly complex web of regulations.[51] Although it is far from the only regulator that promotes financial soundness in the United States, the FDIC is credited with helping to stop the hemorrhaging of banks

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[41] Richardson et al., *supra* note 39.

[42] *Americans React to the Great Depression*, LIBR. OF CONG., https://www.loc.gov/classroom-materials/united-states-history-primary-source-timeline/great-depression-and-world-war-ii-1929-1945/americans-react-to-great-depression/ (last visited May 31, 2024).

[43] *Social Security History*, SOC. SEC. ADMIN., https://www.ssa.gov/history/bank.html (last visited May 31, 2024).

[44] *History of Bank Failures*, BANKING STRATEGIST, https://www.bankingstrategist.com/history-of-us-bank-failures (last visited May 31, 2024).

[45] *FDIC Great Depression History*, *supra* note 8.

[46] *Id.*

[47] *The Depression*, SOC. SEC. ADMIN., https://www.ssa.gov/history/bank.html (last visited May 31, 2024); *Inflation Calculator*, FED. RSRV. BANK OF MINNEAPOLIS, https://www.minneapolisfed.org/about-us/monetary-policy/inflation-calculator (last visited May 31, 2024).

[48] *FDIC Great Depression History*, *supra* note 8.

[49] *Id.*; *Inflation Calculator*, *supra* note 47.

[50] *FDIC Great Depression History*, *supra* note 8.

[51] *Deposit Insurance*, FDIC, https://www.fdic.gov/resources/deposit-insurance/ (last visited May 31, 2024); *Laws and Regulations*, FDIC (Aug. 31, 2023), https://www.fdic.gov/resources/regulations/; *Risk-Based Assessments*, FDIC (Nov. 16, 2023), https://www.fdic.gov/deposit/insurance/assessments/risk.html; *FDIC Assessment Rates*, FDIC (Jan. 30, 2023), https://www.fdic.gov/deposit/insurance/assessments/proposed.html.

in the United States.[52] In the last decade, only 75 banks have failed—and no insured depositor has lost a penny since the FDIC's inception.[53]

However, without the risk of losing their deposits, creditors (depositors) no longer pressure the debtors (banks) to protect their deposits as they should. Instead, because of the guaranteed insurance offered by the FDIC, they will sit back and allow banks to do what they wish with loans.[54] This moral hazard created by the FDIC's insurance poses a threat to banks, the financial system, and the American public.[55] To try to correct this distortion, the FDIC substitutes itself as the creditor when making demands of the debtor.[56] This practice is referred to as the "substitution hypothesis" and means that the FDIC tries, through regulation, to mimic the demands a creditor would make of a debtor to remove the moral hazard that exists because of insurance.[57] The substitution hypothesis is the foundation for the web of premiums and regulations imposed by the FDIC.[58]

As discussed earlier, the FDIC has an enormously complicated system for calculating the premiums for insurance and for maintaining banks' status as insured institutions.[59] To assess premiums, the FDIC uses a risk-weighted system that considers several factors, primarily the CAMELS rating system, the size of the institution, and the number of years an institution has been insured by the FDIC.[60] However, institutions cannot just pay premiums and be insured; they must also comply with a litany of laws, rules, and regulations.[61] Because of the import of FDIC insurance to the banking system, nearly all banks are insured and thus must comply with these laws and regulations.[62] Therefore, when the FDIC issues regulations such as the one discussed in this Note, nearly all commercial banks in the nation must comply.

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52 *See Payment to Depositors*, FDIC, https://www.fdic.gov/consumers/banking/facts/payment.html (July 27, 2010).

53 *See Bank Failures in Brief – Summary*, FDIC, https://www.fdic.gov/bank/historical/bank/ (last visited DATE); *FDIC: Insured Bank Deposits are Safe; Beware of Potential Scams Using the Agency's Name*, FDIC (Mar. 3, 2018), https://www.fdic.gov/news/press-releases/2020/pr20032.html.

54 Michael C. Keeley, *Deposit Insurance, Risk, and Market Power in Banking*, 80 AM. ECON. REV. 1183, 1183 (1990).

55 *Id.*

56 *Id.*

57 *Id.*

58 John H. Kareken & Neil Wallace, *Deposit Insurance and Bank Regulation: A Partial-Equilibrium Exposition*, 51 J. BUS. 413, 427 (1978).

59 *Risk-Based Assessments*, FDIC, https://www.fdic.gov/deposit/insurance/assessments/risk.html (last updated Nov. 16, 2023); *CAMELS Rating System*, NAT. ARCHIVES (Mar. 9, 2021), https://www.federalregister.gov/documents/2021/03/09/2021-01396/camels-rating-system.

60 *FDIC Assessment Rates*, FDIC, https://www.fdic.gov/deposit/insurance/assessments/proposed.html (last updated July 30, 2023).

61 *See generally* 12 U.S.C. § 1811 *et seq*; *see generally* FDIC Law, Regulations, Related Acts 2000 – Rules and Regulations § 300 *et seq*.

62 Zeissler, *supra* note 4; *Crisis and Response: An FDIC History*, *supra* note 5.

B. The Financial Conduct Authority

Like the United States, the United Kingdom has several regulatory bodies that cover financial institutions. The regulatory body that provides insurance for depositors in the United Kingdom is the Financial Services Compensation Scheme.[63] However, this Note is more concerned with the United Kingdom's Financial Conduct Authority ("FCA"), which regulates financial services firms and financial markets in the United Kingdom.[64]

The FCA is a regulatory body in the United Kingdom that regulates financial firms and financial services.[65] It was created by the Financial Services Act of 2012 and began operating on April 1, 2013.[66] The FCA is the renamed successor of the Financial Services Authority[67] and has four main objectives: one strategic, ensuring that the relevant markets function well; and three operational: the consumer protection objective, the integrity objective, and the competition objective.[68] In discharging its functions, the FCA must, so far as reasonably possible, act in a way that promotes the strategic objective and at least one of the operational objectives.[69]

V. MODERN ISSUES IN BANKING AND SOLUTIONS

A. Monitoring and Oversight in the United States

Regulators employ two main forms of monitoring banks: on-site examining and off-site monitoring.[70] On-site examination involves regulators going to the financial institutions themselves and providing supervision, full-scope examinations, limited-scope examinations, and several other forms of oversight at

63 *Banks, building societies and credit unions*, FIN. SERVICES COMP. SCHEME, https://www.fscs.org.uk/what-we-cover/banks-building-societies-credit-unions/ (last visited May 31, 2024).
64 The Financial Conduct Authority, *About the FCA*, https://www.fca.org.uk/about/what-we-do/the-fca (last visited Dec. 13, 2023).
65 The Financial Conduct Authority, *Authorisation*, https://www.fca.org.uk/firms/authoris ation (last visited May 31, 2024).
66 Financial Services Act 2012 c. 21 § 6(1) *et seq*; FCA HEAD OFFICE, *Financial Conduct Authority Origins*, J. REG. & COMPLIANCE 3 (2013).
67 Financial Services Act 2012 c. 21 § 6(1) *et seq*.
68 Financial Services Act 2012 c. 21 § 6(1C-F) (each objective has a relevant section in the statute – the strategic objective is section 1F, and the operational objectives are sections 1C, 1D, and 1E.).
69 Financial Services Act 2012 c.21 § 6(1B).
70 The Federal Deposit Insurance Corporation, *Off-Site Surveillance Systems*, 1 AN EXAMINATION OF THE BANKING CRISES OF THE 1980S AND EARLY 1990S 477, 477–79 [hereinafter *Off-Site Surveillance*].

the institution itself.[71] This was the traditional form of oversight that regulators employed prior to the 1980s.[72] However, the use of off-site monitoring grew following the Savings and Loans Crisis (S&L Crisis) in the 1980s, which saw 747 institutions close and cost taxpayers an estimated $124 billion.[73] The striking failure of so many institutions forced regulators to reexamine their previous methods of regulation.[74] The crisis, coupled with the rise of computers in the 1990s, allowed regulators to use institutions' own reports to determine the safety and soundness of the institutions.[75] The system used to monitor banks is referred to as the Financial Institution Monitoring System.[76] This system provides monitoring and allows regulators to have access to an institution's inner workings without having to conduct an entire on-site examination.[77] The reports are received quarterly, which allows regulators to respond quickly to shifts in the economy without having to schedule full examinations using just the reports.[78]

Non-mandatory regulations can supplement these two forms of monitoring. Non-compliance with regulation can be an issue that regulators bring up when they conduct their on-site examinations as they regularly address compliance with other regulations.[79] Additionally, the knowledge that an institution did or did not comply with a regulation can signal that an on-site examination should be conducted. Non-compliance with non-mandatory regulations, especially where compliance would be costly, can indicate that an institution cannot afford to dedicate capital to unforeseen issues. Or, far worse, it may indicate that a bank cannot adequately liquidate assets and cover liabilities as they arise.[80] Either way, failure to comply can indicate to regulators that they should provide additional on-site supervision of banks.

However, as noted above, on-site examinations are expensive, time-consuming, and require significant coordination between the regulator and the regulated.[81] Off-site monitoring is the cheaper and more-often-employed form of regulation; non-mandatory regulations can also support regulators' efforts and abilities to predict instability and potential failures.[82] This is because the failure to comply with regulation could provide an important flag for regulators who could further scrutinize reports provided for off-site monitoring. The current system

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[71] *RMS Manual of Examination Policies: Basic Examination Concepts and Guidelines*, *in* Section 1.1-1, 1.1-1, FDIC (2022), https://www.fdic.gov/resources/supervision-and-examinations/examination-policies-manual/section1-1.pdf.

[72] *Off-Site Surveillance*, *supra* note 70, at 477–79.

[73] *Id.*

[74] *Id.*

[75] *Id.*

[76] *Id.*

[77] John Krainer & Jose A. Lopez, *Off-Site Monitoring of Bank Holding Companies*, *in* Number 2002-15, FRBSJ ECON. LETTER 1, 1 (2002).

[78] *Off-Site Surveillance*, *supra* note 70, at 477–79.

[79] *Id.*

[80] Gulde et al, *Liquid Asset Ratios and Financial Sector Reform*, at 5 (International Monetary Fund WP/97/144 1997).

[81] *Off-Site Surveillance*, *supra* note 70, at 477–79.

[82] *Id.*

employed by regulators uses a series of flags to predict bank problems or failures, and well-crafted regulation could be used as a trigger to help predict these problems or failures.[83]

Ultimately, the use of non-mandatory regulation could be an important addition to the current forms of monitoring without burdening the regulation or requiring too many changes to the established systems. Discussions of why regulation was or was not complied with are already commonplace in on-site examinations; the non-mandatory regulations could be one more potential talking point. Off-site monitoring uses systems to predict bank problems and failures using models that rely on flags from the generated reports; adding compliance as a potential flag, especially when considering adequate capitalization or asset transformation, can be a useful way to predict problems.

B. Difficulties in Monitoring and Oversight

Complying with regulations is extremely expensive, costing large financial firms an average of $10,000 per employee per year.[84] However, compliance still fails to provide adequate information about the safety and soundness of banks, as even large banks can still fail in this regulatory environment.[85] The Office of the Comptroller, the regulatory body that issues bank charters, states that, "[n]ational banks and federal savings associations are among the most highly regulated institutions in the country."[86] If banks are so highly regulated, how do they still fail? Many of the issues involve an information mismatch between the regulator and the banks themselves. Banks are highly complex organizations, sometimes to the point of their structure being nearly unpierceable, causing regulators to struggle to find the information they need to make informed decisions.[87]

This information asymmetry is part of a phenomenon known as the "lemon problem" discussed by George A. Akerlof in his seminal paper *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*.[88] Akerlof's Note highlights the issue that arises between two parties who each have insufficient information to make decisions about the quality of a product.[89] Initially, the seller

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83 *Off-Site Surveillance*, *supra* note 70, at 477–79.

84 *Id.*; Clyde Wayne Crews Jr., *Ten Thousand Commandments: An Annual Snapshot of the Federal Regulatory State*, 25 TEN THOUSAND COMMANDMENTS 1, 18 (2018).

85 The Federal Reserve, Board of Governors of The Federal Reserve System, 20230428, *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank – April 2023*, (last visited May 31, 2024).

86 *Laws and Regulations Publications*, OFF. OF THE COMPTROLLER OF THE CURRENCY, https://www.occ.gov/publications-and-resources/publications/laws-and-regulations-pubs/index-laws-and-regulations-publications.html (last visited May 31, 2024).

87 *See* Press Release, U.S. Securities and Exchange Commission, The Security and Exchange Commission, JPMorgan Chase Agrees to Pay $200 Million and Admits Wrongdoing to Settle SEC Charges (Sept. 19, 2013) (Washington D.C.).

88 *Akerlof Market for "Lemons"*, *supra* note 37, at 488.

89 *Id.*

has the information necessary to understand the quality of the product; they understand the initial condition of the product and can make predictions about its performance in the future.[90] The buyer does not possess this information and can only rely on the information offered by the seller to determine the quality of a product.[91]

However, the buyer can use the information provided by the seller to discern the potential quality of a product; in particular, they can look at the use of things like warranties to determine if the product is high quality or not.[92] The rationale is that a seller of a low-quality product will not sell that product with a warranty; they know there is a high risk of that warranty being necessary, which would cost the seller the price of fulfilling the warranty.[93] If a seller does offer a warranty, the buyer can expect the product to be of higher quality as the seller would not want to risk the warranty being necessary.[94]

The lemon problem can be extended to regulators (as buyers) and banks (as sellers). Banks are reluctant to provide too much information about their workings—it's costly and risks punishment from regulators if an issue is found in that information.[95] In this way, information can be analogized to quality from a seller. So, regulators cannot rely on banks to accurately provide the information they need and instead must search for information from other cues provided by banks.[96] One relevant cue could be compliance or non-compliance with regulation. If the regulator provides regulation that gives the bank an option between paying money or not paying money but facing potential risk later, the regulator can learn an important piece of information in the same way buyers learn information from a seller's warranty. By complying, the banks show they are financially sound and can afford to spend large amounts of money on short notice. However, non-compliance signals that they do not have the available money; this is a potential sign of risk.

C. Issues with Information Asymmetry

Information asymmetry between regulators and regulated firms has been identified as a major characteristic of finance and a major driver of banking regulation.[97] Information asymmetry is the assumption that regulated firms have privileged knowledge about their own private information, and that information is

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[90] *Akerlof Market for "Lemons"*, *supra* note 37, at 488.
[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] *Id.*; Edward J. Kane, *Masters of Illusion: Bank and Regulatory Accounting for Losses in Distressed Banks* 16–17 (Inst. for New Econ. Thinking, Working Paper No. 136, 2020), https://doi.org/10.36687/inetwp136.
[95] Stephanie Chaly, James Hennessy, Lev Menand, Kevin Stiroh & Joseph Tracy, *Misconduct Risk, Culture, and Supervision*, FED. RSRV. BANK OF N.Y. 3 (2017).
[96] Chaly et al, *supra* note 95, at 5.
[97] Macher, *supra* note 6, at 25.

carefully restricted or revealed in order to achieve the firm's goals.[98] However, information asymmetry is uniquely impactful in the realm of banking, where the informational mismatch can cause cataclysmic impacts on the economy between firms and consumers or firms and other firms.[99] Historically, information asymmetry was viewed as most harmful when it involved banks and consumers.[100] However, information asymmetry also creates issues between competing firms that engage in interbank lending, particularly with repo transactions.[101]

Because of the impact information asymmetry has on regulators, firms, and consumers, reducing asymmetry ought to be a priority. Doing so would make markets more stable, reduce consumer fears, and reduce regulatory burdens.[102] A common purpose among the three primary regulators of banks—the FDIC, Federal Reserve, and OCC—is to make banks safe and sound.[103] To both enforce and determine safety and soundness, regulators use a variety of methods that include capital adequacy requirements, reporting requirements, and other rules that ensure banks do not take on too much risk.[104] However, this regulation is largely confined to being *ex ante* and prevents the ascription of moral responsibility to regulated entities.[105]

Contemporary regulation is *ex ante* because it compels banks, both proscriptively and prescriptively, to follow certain regulations with the assumption that compliance with these regulations will produce a safe and sound bank.[106] Additionally, compelling banks to follow regulations likely prevents the ascription

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[98] Macher, *supra* note 6, at 26.
[99] Metrick, *supra* note 3, at 1.
[100] Carlson, *supra* note 2, at 1.
[101] Beltran, *supra* note 3, at 2; Metrick, *supra* note 3, at 1.
[102] Carlson, *supra* note 2, at 1; Beltran, *supra* note 3, at 1; Metrick, *supra* note 3, at 1.
[103] *What We Do*, FDIC (May 15, 2020), https://www.fdic.gov/about/what-we-do/index.html ("The FDIC directly supervises and examines more than 5,000 banks and savings associations for operational *safety and soundness*") (emphasis added); *Understanding Federal Reserve Supervision*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. (Apr. 27, 2023), https://www.federalreserve.gov/supervisionreg/understanding-federal-reserve-supervision.html ("In providing financial services, banks take risks. Bank examiners—employees of the Federal Reserve and other bank regulators—monitor and assess how well banks manage and control their risks as well as the strength of their financial and managerial resources. This is what is referred to as [']*safety and soundness*['] of banks.") (emphasis added); 12 C.F.R § 30.2 (1995) ("Section 39 of the FDI Act, 12 U.S.C. 1831 p–1, requires the Office of the Comptroller of the Currency (OCC) to establish *safety and soundness* standards") (emphasis added).
[104] *Understanding Federal Reserve Supervision*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. (Apr. 27, 2023), https://www.federalreserve.gov/supervisionreg/understanding-federal-reserve-supervision.html.
[105] Macher, *supra* note 6, at 26.
[106] *Understanding Federal Reserve Supervision*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. (Apr. 27, 2023), https://www.federalreserve.gov/supervisionreg/understanding-federal-reserve-supervision.html.

of moral responsibility for their actions.[107] Creating regulations in line with those recommended in this Note will allow *ex post* regulations, which will resolve information asymmetry and allow the ascription of moral responsibility to banks as agents.

The resolution of information asymmetry is valuable for the reasons discussed above.[108] However, how do non-mandatory regulations allow for the ascription of moral responsibility, and why should we care? To answer the first question, how do non-mandatory regulations allow for the ascription of moral responsibility, consider the following hypothetical. An old woman is standing on a street. You, freely and willingly, walk over and help her cross the street. Assuming we agree that helping an old woman cross the street is a good thing, we can ascribe morality to your decision to help her cross the street. You are a good person for doing so.

Now, consider a second hypothetical. The same woman is on the same street corner, needing help across. Before deciding whether you are going to help her, a masked man walks up behind you, puts a gun to your head, and tells you to help her cross the street or you will be shot. You do so, and the masked man lets you go safely. Because you did not freely help her cross the street, it does not seem like we can ascribe morality to your actions. The actions you took were the same; however, the force used by the masked man changes how we analyze your morality.

Returning to reality, the person helping the old woman cross the street represents the banks, and the masked man with the gun represents the regulators. Current regulations force the banks to "help the old lady cross the street." Banks are forced to behave in a "moral" (safe and sound) way by the regulators. After helping her cross the street, banks will argue that they are good agents because they helped her. If the masked man is brought up, they will argue they would have helped her regardless of the force.

As we have seen, this claim of morality is incorrect for two reasons: the presence of the masked gunman removes freedom, and thus the imputation of morality. There is no way to say, *ex post*, that the bank would have helped the woman without the presence of the masked gunman. This provides the rationale behind the second question: Why should we care about the ascription of morality to banks? First, banks constantly claim they are trustworthy, safe, and sound. Because regulators force their behavior, we cannot know whether this claim is true. They may be trustworthy and safe and sound, or they may not be. We should want to know the answer to this question. Second, banks also constantly claim they do not need regulators to behave correctly.[109] However, this is an *ex post* statement that

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[107] MARCO HAUSMANN & JÖRG NOLLER, FREE WILL HISTORICAL AND ANALYTIC PERSPECTIVES, 283 (2021) (ebook) ("Kant holds that transcendental freedom of the will… is a necessary condition for moral imputation.").

[108] *See generally* Metrick, *supra* note 4; *Crisis and Response*, *supra* note 5, at 20.

[109] *See* Emily Ekins, *Wall Street vs. The Regulators: Public Attitudes on Banks, Financial Regulation, Consumer Finance, and the Federal Reserve*, CATO INST. (Sept. 19, 2017), https://www.cato.org/survey-reports/wall-street-vs-regulators-public-attitudes-banks-financial-regulation-consumer.

cannot be confirmed because we cannot prove they would have behaved in the same way had the regulators not been present.

By creating non-mandatory regulations, we can remove the presence of the masked gunman. We create a scenario where an old woman is sitting on a street corner where the banks are. If they are as trustworthy and safe and sound as they claim, they should help her across. If they don't help her, we now know that they are liars and not to trust them. In the hypothetical, there is only one agent. However, there are several thousand regulated banks in America.[110]

Many banks will likely help the "old woman cross the street." They can be flagged as trustworthy, and we gain little information about them. However, some will not help her and thus self-flag themselves as untrustworthy. Because these banks had previously claimed they would help her and didn't, we can ascribe immorality to them. They are immoral, and punishment is more deserved and appropriate.

This is not a purely ethical hypothetical, as coercion and removal of free will have been recognized as important factors of consent in numerous Supreme Court cases.[111] So, expanding the idea of consent as an important factor in evaluating the behavior and merit of agents' actions is not a unique or novel application.

This Note should not be construed as wanting to grant serious latitude to banks in major areas. It should not be compared to Clinton-era deregulatory pushes, which are hotly debated as a driver of the 2008 financial crisis.[112] Nor should it be compared to the now infamous 2004 SEC rule change[113] that deregulated investment banks and allowed them to use alternative models to determine appropriate deductions for capital—a rule that is also pointed to as a mistaken grant of freedom to financial institutions and as a major contributor to the 2008 financial crisis.[114] Instead, the use of non-mandatory regulations should be implemented

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110 *BankFind Suite: Find Annual Historical Bank Data*, FDIC, https://banks.data.fdic.gov/explore/historical/?displayfields=stname%2ctotal%2cbranches%2cnew_char%2coffices%2cunit%2cbranchin&selectedenddate=2022&selectedreport=cbs&selectedstartdate=1934&selectedstates=0&sortfield=year&sortorder=desc. (last visited Oct. 10, 2024).

111 *See generally* New York v. U.S., 505 U.S. 144, 145 (1992); South Dakota v. Dole, 483 U.S. 203, 206–08 (1987); Charles C. Steward Mach. Co. v. Davis, 301 U.S. 548, 609–612 (1937).

112 *The Financial Crisis and the Role of Federal Regulators: Hearing Before the Comm. On Oversight and Gov't Reform*, 110th Cong. 11–36 (2008) (statement of Alan Greenspan, Former Chairman of the Federal Reserve Board) ("Well, you know, it is instructive to go back to the early stages of the subprime market, which has essentially emerged out of the CRA."); Jihad Dagher, *Regulatory Cycles: Revisiting the Political Economy of Financial Crises*, at § 3.9 ¶ 4 (Int'l Monetary Fund, Working Paper No. 18/8, 2018), https://www.imf.org/en/Publications/WP/Issues/2018/01/15/Regulatory-Cycles-Revisiting-the-Political-Economy-of-Financial-Crises-45562.

113 Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities; Supervised Investment Bank Holding Companies; Final Rules, 69 Fed. Reg. 34428, 34428 (Jun. 21, 2005) (to be codified at 17 C.F.R. pts. 200, 240).

114 CATE REAVIS, THE GLOBAL FINANCIAL CRISIS OF 2008: THE ROLE OF GREED, FEAR, AND OLIGARCHS, 10 MIT Sloan Sch. of Mgmt., rev. Mar. 16, 2012.

prudently for far less important matters than the creditworthiness of borrowers or alterations to capital calculations. The use of non-mandatory regulations should be narrowly tailored to focus on ensuring consistency between the assurances from banks and their behavior when given the chance to behave freely in less important circumstances.

D. Enforcement

On-site examinations and off-site monitoring allow regulators to find issues and predict potential issues that have not manifested.[115] However, these issues must ultimately be remedied through regulators' enforcement powers.[116] Non-mandatory regulations can be used as a bargaining chip when regulators decide which remedy is the proper one and can also be used to further other enforcement purposes. There are 29 enforcement methods available to the FDIC for a variety of issues.[117]

However, there are four main enforcement methods that can be particularly useful for regulators: written agreements,[118] cease and desist orders,[119] assessment of civil monetary penalty,[120] and Regulation Z ("reimbursements").[121] Although the other types of enforcement could be used in conjunction with non-mandatory regulations, they are not as easily applicable and will not be explored in this Note.

As noted,[122] codes aa, bb, and WA have been combined into a single class of written agreements. Although there are differences between these codes, they are primarily the same in construction and enforcement, just having different levels of severity and different uses in conjunction with additional codes.[123] Effectively, they are just contracts between the FDIC and the bank.[124] The FDIC comes to the bank with an issue the FDIC wishes to be corrected, such as the bank engaging in unsafe

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[115] *Off-Site Surveillance*, *supra* note 70, at 477-79.

[116] *Understanding Federal Reserve Supervision*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. (Apr. 27, 2023), https://www.federalreserve.gov/supervisionreg/understanding-enforcement-actions.html.

[117] *FDIC Enforcement Decisions and Orders*, FDIC (Jan. 4, 2021), https://orders.fdic.gov/s/types-of-action [hereinafter *FDIC Enforcement*].

[118] *See FDIC Enforcement*, *supra* note 117. ("Written Agreements" is primary concerned with Code bb Section 8(a) written agreements and Code WA Written Agreements, as they are the most relevant for the focuses of this note; but it should also include Code aa Section 8(b) written agreements as the termination of deposit insurance over non-mandatory regulation seems extraordinarily unlikely but could conceivably occur under 12 CFR § 308.120 because of the latitude it provides the FDIC).

[119] *Id.* ("Cease and desist orders" includes both Code b Consent Orders/Order to Cease and Desist and Code c&b Temporary Order to Cease and Desist because they primary cover the same process but are concerned with different stages in that process).

[120] *Id.* ("Civil monetary penalty" refers to Code k Assessment of Civil Money Penalty).

[121] *Id.* ("Regulation Z" refers to code Z Regulation Z).

[122] *Id.*

[123] *FDIC Enforcement*, *supra* note 117.

[124] 12. C.F.R. § 354.3.

practices, and the bank or its parent company commits to abide by the agreement and its conditions.[125] Failure to do so is effectively a breach of contract, which means the FDIC does not need to affirmatively prove that the bank was engaging in unsafe practices—only that the bank breached the written agreement.[126] Written agreements are frequently used in place of cease and desist orders because of the increased flexibility they provide both the FDIC and the bank due to the ability to contract out issues instead of having to have a true cease and desist created and enforced.[127]

As noted,[128] cease and desist orders include both code b and b&c due to their substantial similarity and their being combined in official manuals.[129] FDIC cease and desist orders require substantially more effort and administrative resources to create and enforce.[130] They are similar to traditional legal cease and desist orders and are used in instances where an institution has engaged in or is about to engage in, "unsafe and unsound practices" or "[a] violation of a law and/or regulation, written agreement with the FDIC, or written condition imposed by the FDIC in connection with the granting of any application or other request."[131] The cost of these orders and the burden on the FDIC make them less desirable than written agreements,[132] but they are important tools to stop institutions from engaging in behavior the FDIC believes is impermissible.

Civil monetary penalties are a form of fine imposed on institutions when they violate any law or regulation, any final or temporary order, or any prior written agreement.[133] Civil monetary penalties are an effective means of rectifying previous wrongs while also providing a strong deterrent effect due to their size.[134] The penalties have three tiers: tier 1, which is a penalty of $5,500 per day; tier 2, which is a penalty of $27,500 per day; and tier 3, which is a penalty of $1 million or 1% of total assets per day.[135] They can be used independently of all other enforcement means or as a provision in a written agreement.[136]

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[125] 12. C.F.R. § 354.4(a).
[126] *Id.* § 354.6.
[127] RICHARD S. CARNELL ET AL, THE LAW OF FINANCIAL INSTITUTIONS 337 (Wolters Kluwer, 7th ed., 2021).
[128] *FDIC Enforcement*, *supra* note 117.
[129] *Formal and Informal Enforcement Actions Manual, Chapter 4: Cease and Desist Actions*, FDIC (Jul. 2022), https://www.fdic.gov/regulations/examinations/enforcement-actions/ch-04.pdf [hereinafter *FDIC Manual Chapter 4*].
[130] *Id.* at 4-1.
[131] *FDIC Manual Chapter 4*, *supra* note 129, at 4-1.
[132] *See id.* at 4-2 (although the penalty for failing to follow a prior written agreement is often an order).
[133] *Id.* at 4-7.
[134] *Formal and Informal Enforcement Actions Manual Chapter 9 – Restitution and Civil Money Penalties*, FDIC, 9-15 (Jun. 2022), https://www.fdic.gov/regulations/examinations/enforcement-actions/ch-09.pdf [hereinafter *FDIC Manual Chapter 9*].
[135] *See generally id.* at 9-1.
[136] *Id.*

Finally, reimbursements under Code Z can be used to require a banking organization to reimburse customers for a violation of consumer protection laws.[137] The restitution used in the guidance, which is the focus of this Note, is a form of reimbursement under this code.[138] Specifically, restitution is an equitable remedy used to compensate the harmed party for losses suffered or as a form of disgorgement due to unjust enrichment resulting from violations or practices.[139] Although both reimbursements and civil monetary penalties involve the institution paying a monetary price as a result of misconduct, they are different in their purpose.[140] Reimbursements are meant to make the harmed whole and are paid to the harmed parties, but civil monetary penalties are punitive in nature, paid to the U.S. Treasury, and are not received by the harmed.[141]

E. Benefits of Compliance

Much of this Note has focused on why banks resist compliance and paints banks as unwilling to comply with compliance regulations, as there is little-to-no benefit to them, but a great cost associated with compliance. However, this is an unfair presentation, and it is important to discuss the benefits received from compliance and the reasons why banks would want to go along with the proposed system on their own. First, compliance with laws often goes in line with consumer expectations.[142] Best seen with the Great Depression, consumers react poorly when banks are unsafe or risky.[143]

Additionally, consumers still view banks negatively overall, with 77% stating they believe banks would harm them if the banks thought they could make money doing so and get away with it.[144] Further, the American public does not necessarily want *more* regulations; instead, they want *effective* regulations.[145] On top of this, Congress has signaled support for reducing regulations on banks when the regulations have become too burdensome and fail to provide the promised benefits.[146] This supports the notion that banks' compliance with the spirit of regulations is beneficial for the banks themselves. If they comply, it is likely banks will receive greater support from the public and Congress, which will, in turn,

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137 *FDIC Enforcement*, *supra* note 117.

138 *Id.*; *see FDIC 2022 Letter*, *supra* note 13, at 1-2.

139 *FDIC Manual Chapter 9*, *supra* note 134, at 9-22.

140 *Id.* at 9-1.

141 *Id.*

142 *The Compliance Function in Banks*, BASEL COMM. ON BANKING SUPERVISION, 9 (Apr. 2005), https://www.bis.org/publ/bcbs113.pdf.

143 *See generally FDIC Great Depression History, supra* note 8.

144 Emily Ekins, *Wall Street vs. The Regulators: Public Attitudes on Banks, Financial Regulation, Consumer Finance, and the Federal Reserve*, CATO INST. (Sept. 19, 2017), https://www.cato.org/survey-reports/wall-street-vs-regulators-public-attitudes-banks-financial-regulation-consumer.

145 *Id.*

146 MARC LABONTE, CONG. RSCH. SERV., R43999, AN ANALYSIS OF THE REGULATORY BURDEN ON SMALL BANKS 25 (2015).

reduce support for regulations overall. Ultimately, if the Regulatory Plinko proposed is adopted, it would provide a means for banks to show that they can be trusted to behave in a safe and sound manner and reduce their regulatory burden overall.

A second reason banks support compliance regulation is because it is a tool for risk management.[147] The actual risk-taking desire of banks is hotly contested, with claims that banks create portfolios that are risk-averse, risk-neutral, and risk-seeking.[148] However, there is a consensus that banks seek to control the risks of their portfolios and seek to maximize shareholder value without assuming too much risk.[149] Ultimately, compliance with laws can improve banks' ability to control risk to their liking. As seen with cases such as the London Whale, failing to comply with regulations puts banks at enormous risk of loss—a risk that is unforeseen and not controlled adequately.[150]

F. A (Short) History of Brexit

Brexit is the common name used to refer to the United Kingdom formally leaving the European Union.[151] This dramatic event occurred following a referendum held in June 2016, where a majority of voters in the United Kingdom voted to leave the European Union.[152] Over the following four years, the United Kingdom entered a transitionary period which finally ended on December 31, 2020.[153]

The United Kingdom's exit from the European Union had profound impacts on the financial markets in both the United Kingdom and the European Union.[154] Primarily, and most importantly to this Note, it allowed the United Kingdom to

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[147] René Stulz, *Risk Management, Governance, Culture, and Risk Taking in Banks*, FRBNY ECON. POL'Y REV. 43, 54 (2016).

[148] *Compare* Kazuhiro Takino & Yoshikazu Ishinagi, *Are Banks Risk-Averse or Risk-Neutral Investors*, J. OF BEHAV. AND EXPERIMENTAL FIN. 1, 7 (2023) *and* Yasuno Nishiyama, *Are Banks Risk-Averse*, E. ECON. J. 471, 486 (2007) *with* Joseph P. Huges et al, *Recovering Technologies that Account for Generalized Managerial Preferences: An Application to Banks That Are Not Risk-Neutral* 24-25 (Off. of the Comptroller of the Currency Econ. Working Paper, Paper No. 97-11, 1997), https://www.occ.gov/publications-and-resources/publications/economics/working-papers-archived/economic-working-paper-1997-11.html.

[149] Takino, *supra* note 148, at 7; Nishiyama, *supra* note 148, at 486; Huges et al., *supra* note 148, at 1.

[150] *See generally* Zeissler & Metrick, *supra* note 4.

[151] NIGEL WALKER, BREXIT TIMELINE: EVENTS LEADING TO THE UK'S EXIT FROM THE EUROPEAN UNION 3 (2021).

[152] *Id.*

[153] *Id.*

[154] CHRISTY PETIT & THORSTEN BECK, RECENT TRENDS IN UK FINANCIAL SECTOR REGULATION AND POSSIBLE IMPLICATIONS FOR THE EU, INCLUDING ITS APPROACH TO EQUIVALENCE 8 (2023) [hereinafter PETIT]; Iscenko et al, *Economics for Effective Regulation*, 5 (Fin. Conduct Auth., Occasional Paper 13, 2016) [hereinafter Iscenko]; GLEN HEPBURN, ALTERNATIVES TO TRADITIONAL REGULATION, 8 (2008) [hereinafter HEPBURN].

regain control over its own rules and legislative processes surrounding its financial system.[155] However, this newfound freedom has its own risks, as now the United Kingdom must determine how to exist in a world without the support—and constraints—of the European Union.[156] This process is ongoing, with major legislative reforms being implemented in 2023.[157] Given the magnitude of the reforms and the still unknown reactions by regulated entities, the boon of non-mandatory regulations could be harnessed by regulators in the United Kingdom, provided allowances are made in legislation.[158] However, given the rapid and regular changes to legislation occurring in the United Kingdom, it seems more feasible that these and other possible allowances will occur in contrast to the normal legislative stickiness discussed in the literature surrounding financial reform.[159]

G. Value of Non-Mandatory Regulation in The United Kingdom

Implementation of non-mandatory regulations would be helpful for the United Kingdom, particularly because of the decrease in information that is available to them following Brexit.[160] Information asymmetry is not a problem unique to the United States financial market.[161] Because of its prominence in all markets and the negative impact it can have, attempts to determine the extent of asymmetry and how to reduce its impact have been discussed throughout literature,[162] parliamentary debates,[163] and regulations by the FCA.[164] While a wide variety of information asymmetries are discussed in these sources, the conclusion is the same: the lack of parity between parties and counterparties is detrimental to all parties in the financial system.[165]

Brexit provides regulatory opportunities and costs to the United Kingdom: there is a strong opportunity to reshape its regulatory framework as it sees fit without having to work within the European Union's constraints,[166] while also having to regulate in ways and areas not previously needed.[167] In particular,

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155 PETIT, *supra* note 154, at 8.
156 *See* PETIT, *supra* note 154, at 8.
157 *See generally* FSMA 2023, *supra* note 7.
158 FSMA 2023, *supra* note 7, § 38 ¶ 28(2)(a); Financial Services and Markets Act 2000, Part 9A, c. 2. § 138I(1)(b).
159 *See generally* FSMA 2023, *supra* note 7; Roberta Romano, *Are There Empirical Foundations for the Iron Law of Financial Regulation?*, 2 Yale L. & Econ. Research Paper (forthcoming, 2023), https://ssrn.com/abstract=4340042.
160 PETIT, *supra* note 154, at 8.
161 Iscenko, *supra* note 154, at 5.
162 PETIT, *supra* note 154, at 8; Iscenko, *supra* note 154, at 5; HEPBURN, *supra* note 154, at 8.
163 *See* 826 Parl Deb HL (5th ser.) (2023) col. 1343 (UK).
164 Fin. Conduct Auth., FCA RISK OUTLOOK 2013 15 (2013); Fin. Conduct Auth., FCA MISSION: OUR FUTURE APPROACH TO CONSUMERS 25 (2017).
165 *See generally* Metrick, *supra* note 4; *see Crisis and Response*, *supra* note 5, at 20.
166 PETIT, *supra* note 154, at 8.
167 *Id.*

removing the need to work with the European Union will supposedly allow for a more "dynamic, stable, and competitive financial sector" that has "agility, consistently high regulatory standards, and openness."[168] By leaving the European Union, the United Kingdom can now allow its own regulatory bodies to make rules and regulations, no longer having those rules superseded by European Union policies when those policies are repealed.[169]

However, Brexit presents issues due to the lack of regulatory architecture in the United Kingdom, and a question of where authority comes from and how it must be vested.[170] Because of the ongoing, experimental, and unclear nature of current UK regulations, the time for testing non-mandatory regulations is ripe. The goal of "dynamic" and "agil[e]" financial markets is well met by the proposed regulations in this Note.[171]

Additionally, new styles of regulation can create fears of being "sticky."[172] Legislative "stickiness" refers to the struggle of enacted laws to be changed after being implemented.[173] This is owed to legislators' desire to reinforce the status quo, a lack of demand to change the status quo, and a lack of desire to return to issues that are "resolved."[174]

However, these issues do not appear to be present in the current regulatory environment of the United Kingdom. The status quo has been shattered with the United Kingdom's exit from the European Union, as all regulatory power previously held by the European Union is now held by the United Kingdom.[175] Legislators have a grave demand to change the status quo, as withdrawing from the European Union proffered promises about freedom and a focus on domestic priorities in the United Kingdom's financial markets that need to be met by new legislation.[176] Finally, the matters are far from "resolved" as there is continuing legislation being produced in the area, with the Financial Services and Markets Act of 2023 (FSMA) being the most recent major step in a continuing shift from

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[168] Press Release, HM Treasury, Financial Services: The Edinburgh Reforms (Dec. 9, 2022).

[169] *See* HM TREASURY, FINANCIAL SERVICES FUTURE REGULATORY FRAMEWORK REVIEW: PROPOSALS FOR REFORM: RESPONSE TO THE CONSULTATION, 2022, CM. 737, at 16 (UK).

[170] HM TREASURY, *supra* note 169.

[171] *See infra* Section VI.A.

[172] Romano, *supra* note 159, at 2.

[173] *Id.* at 4.

[174] *Id.*

[175] *See generally* Financial Services and Markets Act 2023, c.1 § 1.(3) (Eng.), https://www.legislation.gov.uk/ukpga/2023/29/contents. ("Any rights, powers, liabilities, obligations, restrictions, remedies and procedures which—(a) continue to be recognised and available in domestic law by virtue of section 4 of the European Union (Withdrawal) Act 2018, and (b) are derived from any provision of legislation referred to in Schedule 1, cease to be so recognised and available in domestic law.").

[176] HOUSE OF COMMONS, TREASURY COMMITTEE, THE ECONOMIC AND FINANCIAL COSTS AND BENEFITS OF THE UK'S EU MEMBERSHIP: CLAIMS MADE BY THE CAMPAIGN GROUPS, 2016–2017, HC 122, ¶ 59 (UK).

European Union policies to new rules and legislative opportunities.[177] Additionally, the FSMA reserves the power to make additional transitional amendments[178] and the power to restate and modify saved legislation.[179] These powers demonstrate a clear intent by the legislature or Parliament to continue to adopt and modify the laws of financial sectors as needed.

Another important issue that the implementation of non-mandatory regulations may help to resolve in the United Kingdom is "dynamic uncertainty." Dynamic uncertainty is the term used to refer to the phenomena of regulated entities responding in unpredictable ways following regulation.[180] Although dynamic uncertainty is a term usually used in literature on terrorism,[181] Roberta Romano argues that its impact is also felt in financial regulatory fields.[182] This fear that regulated entities will respond in unpredictable ways seems very well-founded, as it has been an issue in the past following major legislative reforms.[183] Non-mandatory regulations provide different choices to regulated actors. By providing numerous different regulations with different path outcomes, regulators in the United Kingdom can reduce the risk posed by dynamic uncertainty by determining which regulated actors are more often behaving in an undesirable way and responding appropriately with legislation or new rules.

The FCA should have power under the FSMA to create these types of rules, but there could be issues with the requirement to consult the public and the FSMA's requirement to engage with parliamentary committees. Normally, the FCA must consult with the relevant parliamentary committee when it publishes a draft of proposed rules 138I.[184] The proposed use of non-mandatory regulation would require publishing the draft of rules in a way "best calculated to bring them to the attention of the public."[185] Additionally, the FCA is required to consult with relevant parliamentary committees and discuss the proposed rules as drafted.[186] However, this consultation would directly go against the point of the proposed non-mandatory regulation: that regulated entities do not know what purpose the regulation serves.[187]

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[177] Financial Services and Markets Act 2023, c.1. § 2 (Eng.), https://www.legislation.gov.uk/ukpga/2023/29/contents.
[178] *Id.* § 3.
[179] *Id.* § 4.
[180] Romano, *supra* note 159, at 11.
[181] *Id.*
[182] *Id.*
[183] *See* CHRISTOPHER HEADY & GARETH D. MYLES, INCENTIVISING COMPLIANCE WITH FINANCIAL REGULATION 23 (Fin. Conduct Auth., Occasional Paper No. 25, 2016) ("HMRC has been confronted by large-scale avoidance of taxation with an industry… This failure in compliance mirrors the extensive mis-selling of products in the financial services sector: both are not clearly illegal contravention of the regulations but an attempt to bypass or exploit the regulations.").
[184] Financial Services and Markets Act 2023, c.3 § 38. ¶ 28(2)(a) (Eng.), https://www.legislation.gov.uk/ukpga/2023/29/contents.
[185] Financial Services and Markets Act 2000, Part 9A, c.2, § 138I(1)(b) (Eng.), https://www.legislation.gov.uk/ukpga/2000/8/section/138I.
[186] Financial Services and Markets Act 2023, *supra* note 184, § 38. ¶ 28(3).
[187] *See generally id.*

By having clear public discussion and consultation with parliament, the most important part of non-mandatory regulation is destroyed.

To implement the proposed changes properly, the FSMA would need to be amended in two ways: first, grant the FCA more latitude over not having to report to Parliament when they believe doing so would go against public interest;[188] and second, remove the requirement to consult the public when doing so would go against public interest.[189] This would remove the most serious issues preventing the FCA from implementing non-mandatory regulations as proposed.

VI. POLICY DECISIONS MOVING FORWARD

A. Policy Decisions

The use of non-mandatory regulation can be an important tool in regulators' belts. Non-mandatory regulations allow banks to choose between having to comply with regulation, which will cause them to incur a loss of assets, or non-compliance, which will act as a signal to regulators about potential safety and soundness issues. The first option allows banks to willingly sacrifice assets to maintain their information. This sacrifice of funds satisfies the desire of the regulators, and the lack of information does not materially impact the ability of regulators to peer into the workings of banks. Non-compliance allows banks to make decisions about their own ability (and desire) to sacrifice assets but allows regulators a cheap source of information regarding banks' safety and soundness. Either way, regulators achieve a significant win by attaining compliance or receiving information.

Access to information would be cheap, providing regulators an effective and efficient way to bridge the information asymmetry between themselves and the banks. Therefore, this style of regulation is an attractive way to ease the lemon problem, allowing regulators to better achieve their ends of safety and soundness in the financial system. However, banks that are less safe or sound may not want to provide this information. Showing they are unsafe or unsound flags the regulator and may incur additional oversight or penalties. If banks are unsure about the purpose of the non-mandatory regulation, they may be overly concerned about non-compliance and choose to comply with regulations, which subsequently makes them less safe and sound. The use of non-mandatory regulations must be curated to try to prevent this ratchet effect; not doing so will risk aggravating banks and preventing them from making sound decisions about asset allocation, which undermines their ability to transform assets through maturity mismatches and hurts their ability to stay solvent and profitable.

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[188] This would be an amendment to the already existing exception present in Financial Services and Markets Act 2023 Part 1. Chapter 3. Section 38 ¶ 29(5).

[189] These changes would need to be made carefully to ensure the legislative intent behind the notice is still protected; Parliament clearly finds notice to the public and its committees to be incredibly important and rules that are too broad would risk the FCA taking its power too far.

The second benefit of non-mandatory regulation is the value this style of regulation provides to the banks as members of a competitive market. Normally, regulators have enormous sway over banks' market decisions. Non-mandatory regulations allow banks themselves to decide what is the proper course in complying or not. If they see competitors complying, feel pressure from consumers, or are worried about their image, they may comply. If not, they can choose not to comply. This freedom promotes traditional capitalistic values while still having the hand of the regulator guide the market.

VII. CONCLUSION

Ultimately, the use of non-mandatory regulation, especially in the Regulatory Plinko style proposed, could allow regulators to effectively test the ability of banks to make the correct choice when given an option and have the confidence that the correct choice was not made by pure chance. This provides vital feedback about the regulated banks for free by forcing banks to self-sort. As discussed, banks that behave well and act correctly when given a chance should be rewarded. However, punishing banks that claim to be safe and moral actors but fail to act in accordance with these claims is also more desirable within the Regulatory Plinko framework. By creating a style of regulation that tests banks' claims without unduly burdening them, regulators in both the United States and the United Kingdom can create better regulations that comport with public desires and legislative intent.