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Regional Banking Outlook

JAMES F. BAUERLE

REVIVAL

The Financial Panic of 2008 has produced soul searching and legislative reform proposals on a level not seen since the Thrift Crisis 20 years ago. Presently Congress is debating a series of structural changes that will significantly affect banking institutions. Higher levels of minimum capital, special requirements for so-called systemically important institutions, enhanced regulatory authority to resolve troubled institutions and redrawn regulatory jurisdictions are among the most far reaching proposals. Most of the law revision effort pertains especially to the nation's largest financial institutions, including broker-dealer and commodity firms as well as banks. For the crisis revealed the vulnerability of banks previously considered too large, too well capitalized and too diversified to fail, such as Washington Mutual, Citibank, Wachovia, and National City.

A central tension that has surfaced in the legislative process concerns the concentration of power in the hands of a few actors, either in the market or the government. Members of Congress have recognized that the crisis and the period of industry consolidation that preceded it yielded four super-sized banking institutions. Bank of America, J.P. Morgan Chase, Citibank, and Wells Fargo currently hold 17 percent, 15 percent, 14 percent and nine percent, respectively, of all U.S. banking assets, or a combined total of 56 percent.¹ The consensus view is that each of these banks is too important to the

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nation's financial system to be permitted to fail. Each is also large enough to exercise significant anticompetitive influences in the market. Former Chairman of the Board of Governors of the Federal Reserve System Paul Volcker has advocated breaking up these institutions into smaller ones in the manner of the breakup of AT&T into regional telephone companies two decades ago. Other influential experts have suggested a more stringent regulatory regime apply to the largest banks as a means of protecting the public.

Regrettably, the debate over the implications of too big to fail banks has not included any meaningful discussion of the role of regional banking. Is there a need for institutions having assets in the range \$1-100 billion? If a niche exists for regional banks, what are its characteristics and how must institutions position themselves to succeed in this market? Is amelioration of the negative consequences of a highly concentrated national banking market part of the mission of regional banks? If so, should Congress or the states promote the formation of new regional franchises and the growth of existing ones?

Addressing these questions and others like them will be the focus of this column, "Regional Banking Outlook." This first installment suggests a few answers to the question, "Do Regional Banks Matter?" Columns during the coming year will consider, in the context of regional institutions, the changing dynamics of four pillars of banking — capital, assets and liabilities, management, and earnings. The aim is to provoke lively and useful discussion of this column's subject matter to the end that healthy regional banks may contribute to the general welfare of their regions and the nation.

DO REGIONAL BANKS MATTER?

Since the wave of bank consolidation began in the early 1980s, industry participants have questioned the need for, and the benefits of having, 7,948 banks across the United States.² Proponents of consolidation argued that economies of scale make surviving banks more efficient, more profitable, better managed and less risky. Customers too benefit from the economies of scale and the deployment of new computer technology, the cost of which can only be borne by the largest institutions. Diversification of credit risk seems a particularly salutary benefit of nationwide banking, since regional economic concentrations can be aggregated and risk thereby mitigated. Finally, the efficiency of

nationwide banking seems unassailable when one considers the ability to gather deposits in regional markets where they predominate and then make loans in other regional markets where credit fundamentals are strongest.

The 30 year cycle of bank consolidation culminated during the recent financial crisis. During the 1980s, 71 bank mergers occurred in which both the target bank and its acquirer had more than \$1 billion in assets. The next decade saw 177 such mergers. Notably only 31 of the 77 transactions in the 1980s were interstate in nature, whereas 137 of the 177 deals in the 1990s were interstate combinations.³ Large bank deals became fewer during the last decade as the largest and most acquisitive institutions reached legal limits on the quantity of deposits any one institution can hold. Thus, the number of bank holding companies having assets greater than \$10 billion remained nearly constant, ranging from 69 to 72 over the five year period ending December 31, 2009.⁴ The number of holding companies having assets of between \$3 billion and \$10 billion grew slightly, from 90 to 92, during the same period. Consolidation continued at the small end of the market however. The number of holding companies having assets under \$500 million declined 82 percent, from 537 in December 2005 to 93 in December 2009. Bank holding companies of between \$500 million and \$1 billion increased in number from 400 to 439, or 10 percent, while those between \$1 billion and \$3 billion experienced a 24 percent increase, from 239 to 296.⁵

These data suggest that the consolidation trend may have run its course in the cohort of >\$100 billion institutions while it continues apace for institutions having assets <\$500 million. The increase in the number of bank holding companies having assets >\$500 million but <\$3 billion raises the question of whether opportunities exist to fill the market space once occupied by regional and superregional franchises that have been consolidated into the group of 16 companies having assets greater than \$100 billion. Notably four of the 16 are foreign owned. And does such a regional strategy serve regional economic needs well?

Academic Research

The argument in favor of regional banks is that attenuating the relationship between banking and real economic activity weakens regional econo-

mies. Academic economists have studied this phenomenon as part of their work on monetary policy. Specifically, “monetary policy concerns itself mainly with whether or not the interest rate channel, the exchange rate channel, and the credit channel exist and function as expected during a monetary contraction.”⁶ As a conceptual matter, in so-called credit view theory, credit availability strongly influences aggregate demand. “From a regional perspective, the credit view suggests that a region’s banking sector health affects its aggregate economic performance.”⁷ Academic research in the 1980s demonstrated that “bank investment in risky projects depends on the quantity of bank capital and the return on risk-free capital and risky projects.”⁸ Further, “the distribution of bank capital across banks matters. Aggregate output declines when capital is redistributed from a state of equally capitalized banks to one where some banks are overcapitalized while others are undercapitalized.”⁹

Federal Reserve Chairman Bernanke’s academic research included a state level cross-section analysis for 1990-91, testing for the effect of the credit view. He and his colleague, C.S. Lown, demonstrated that a causal relationship exists between bank capital and the growth rate of bank loans. “Their study also indicates that the growth rate of bank loans (induced by changes in bank capital) correlates positively with employment change. In addition, they determine that capital-asset ratios and bank loans had a stronger link for small banks than for large banks.”¹⁰

Jeong *et al.* extended the work of Bernanke, Lown and others by constructing a statistical model that tested in two ways the connection between regional banking conditions and regional economic performance. The Jeong model measured the effect of bank health on investment-oriented bank loans (“IOBL”) through its effect on local bank capital. IOBL was defined as the sum of: (i) loans secured by real estate; (ii) loans for agricultural production; (iii) commercial and industrial loans; and (iv) loans to individuals. Excluded as a result were interbank loans and loans to state and political subdivisions. Jeong and his colleagues then examined the relationship between IOBL and aggregate real economic output. They used data from the U.S. Bureau of Economic Analysis (real gross state product data) and the FDIC (data for loans and bank health conditions). The data sample covered 10 years, from 1984 to 1993. Jeong and his colleagues expressed their conclusions in the understated, yet unmistakable, manner of social science writing.

State banking conditions appear to affect state investment-oriented bank loans. Overall coefficients have expected signs and appear generally [statistically] significant. The bank capital to assets ratio (K/A), the core of bank health, shows the expected positive sign in [two iterations of the model], and is [statistically] significant in [one of them]. The profit measure, net income to bank assets (ROA), produces positive effects [on the growth rate of investment-oriented bank loans in all three iterations of the model and is statistically significant in two of them]. As expected, the growth rate of loan loss reserves carries significant negative signs in [two iterations of the model]....

Growth in state investment-oriented bank loans positively and [statistically] significantly affects growth in real output in [three of four iterations of the second element of the model].... For example, [in one iteration], a 1% increase in the growth rate of loans (GIOBL) increases the growth rate of output (relative to US output) by 3.225%....

Based on evidence from a 10-year panel of state-level data, our two-equation credit view model supports the credit view theory at the state level. First, state bank health conditions affect the quantity (growth) of state-level investment-oriented bank loans. Specifically, we find that a greater capital/asset ratio, greater return on assets, and lower growth of loan-loss reserves in a state's banking sector lead to greater growth in investment-oriented bank loans. Second, the quantity (growth) of state-level investment-oriented bank loans, in turn, affects state output, with greater growth in loans associated with greater relative growth in gross state product.¹¹

Historical Antecedents

The conclusions of the academic research described above may seem obvious to bankers or lawyers steeped in the daily experience of the credit cycle and its intersection with regional economic conditions. Yet empirical validation of the proposition that an active and healthy banking sector is vital to state level economic prosperity is an important complement to historical or anecdotal evidence.

Nineteenth century railroads, along with the large quantities of steel and

financial capital needed to create and operate them, made it necessary to have banks that possessed the scale and expertise required to finance those industries. J.P. Morgan & Co.'s earliest projects included raising capital in European markets for American railroads. Only later did Morgan, Rockefeller, and others engineer the great trusts in steel, oil, and other industries. Geographic dispersion of important industries fostered regional banking centers. Examples include textiles (Philadelphia), steel, coal, oil, and gas (Cleveland and Pittsburgh), machine tools (Cincinnati), Southwestern oil and gas after Eastern fields played out (Houston), and automobiles (Detroit). More often than not, ownership and management of important banking and industrial enterprises were intertwined. At the depth of the banking crisis of 1932-33, the federal government called on General Motors and Ford to capitalize new banks that could reinvigorate industrial businesses, including their own. National Bank of Detroit (now part of JP Morgan Chase) and Manufacturers National Bank of Detroit (now Comerica) were the result.

As foreign competition and Wall Street predation undermined American manufacturing firms beginning in the 1970s, the fortunes of many regional banks followed suit. The corporate banking department of the Mellon Bank long displayed a silver platter on which were engraved the results of an annual golf match played between the treasury department of Alcoa, which the Mellon family capitalized in 1890, and Mellon bankers assigned to the Alcoa relationship. The last year the match was played was 1988, when Mellon Bank came within a hair's-breadth of failing due to soured loans made to metals, oil and gas, and real estate businesses, as well as foreign governments. By then, Alcoa and other Fortune 500 companies funded their liquidity needs through commercial paper sales rather than bank borrowings. Mellon Bank rebuilt its earnings around processing and fee income rather than net interest income. So the economic and social bonds no longer mattered enough to continue the golf match.

Southern banks, meanwhile, engaged in a concerted effort to boost their regional economy by joining forces to create a handful of Southern banking powerhouses. In 1960, University of North Carolina sociologist Rupert Vance articulated the social basis for what became the Southern regionalist economic movement.

In economic development, industrialization and all that goes with it, regional forces and leaders have pushed toward integration with the national economy. As they succeed, regional differences blur, but regional identity remains. Regionalism, like individualism, claims a right to maintain identity—to defend and to cherish certain autonomy in cultural values, a style of life, certain attitudes regarded as Southern.¹²

Southern academic, political, business and banking leaders recognized that their regional economy lagged the Northeast and the Midwest due to a dearth of investment capital. So they set out to pool their resources and exert greater economic influence as a unified region. In 1980, Thomas Storrs, CEO of what was then North Carolina National Bank, framed the issue for a task force called the Commission for the Future of the South:

[T]he capital currency before the Civil War was cotton. After the Civil War, it was poverty.... [I]f we were ever to come out of that, and to control our own destiny and not have it controlled by Northeastern bankers or Midwestern bankers, we had to create some system to allow the collective capital in the Southeast to be assimilated and to grow large enough to compete. It was really the genesis of the interstate banking compact.¹³

Storrs and other leaders of the Southern business and legal establishment created the Southeastern Regional Banking Compact (the “Compact”), using as a model a compact enacted in Massachusetts and Connecticut in 1982 and 1983, and validated by the United States Supreme Court in 1985. The Compact permitted cross border bank acquisitions, but only within a “Southern Region” consisting of Alabama, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina, Tennessee, and Virginia. Texas was excluded because the Southern Region bankers feared Texas banks would seek to acquire Southern Region banks. Under the Georgia version of the legislation implementing the Compact, to acquire banks in Georgia, a qualifying Southern Region bank holding company had to be headquartered in a Southern Region state and have total deposits in the Southern Region greater than 80 percent of the holding company’s total deposits. Storrs’ successor, the flamboyant Hugh McColl, called the Compact “the Berlin Wall of Bank-

ing.”¹⁴ His arch rival, Ed Crutchfield of First Union, said the Compact was developed specifically to prevent acquisitions of Southern Region institutions by New York banks. “If you want a healthy pond,” he said, “you don’t turn a six pound trout loose on fingerlings.”¹⁵

By 1985, most states in the Southern Region had passed legislation to implement the Compact. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 trumped the Compact; but by then, sufficient consolidation within the Southern Region had occurred, and growth of the region’s economy outstripped growth in the Northeast and Midwest, giving the Southern banks earnings momentum and buoyant stock prices with which to do out-of-region acquisitions. So the surviving Southern banks like NationsBank, First Union, BB&T, Regions, and SunTrust became six pound trout and First Fidelity, CoreStates, Boatmen’s, and Fleet were the fingerlings. Southern defensiveness gave way to Southern swagger. McColl made the point in relation to his capstone acquisition of California-based Bank of America.

We carried on negotiations with their CFO.... He came to talk to me on a Saturday morning. He said we can get a deal, but they don’t want to be a southern company. I said, “Tough...! That’s what we are.” I really did say that. We are a southern company, so we are not going anywhere with this conversation. They blinked, and the rest is history. The California press attacked us unbelievably.... They thought we were bumptious barbarians.... We aren’t ashamed of being from the South.¹⁶

As recently as December 2009, Robert Kelly of The Bank of New York Mellon interviewed to be CEO of Bank of America. His qualifications for the position included a stint as chief financial officer of Wachovia, which gave him sufficient Southern bona fides to earn consideration. Kelly reportedly suggested that the bank’s headquarters be moved to New York City.¹⁷ Negotiations ended abruptly.

The Present Era

In an era when the threat of economic domination comes from Asia rather than those who won the American Civil War, regional banking is a bulwark

very much needed to sustain American jobs and create new ones. Economic development professionals universally recognize that small and medium-sized businesses account for most new job creation. For super-sized banks, these businesses and their banking relationships simply do not justify the marketing effort required to establish and sustain banking relationships. As a Bank of America executive explained this reality, “B of A is an elephant. It takes bales of hay to feed it; peanuts won’t do.” Yet for all the reasons commerce and banking have always enjoyed a symbiotic relationship, the nation needs regional banks to serve companies whose revenues are less than \$100 million and whose success is vital to the cities and regions they inhabit. Nowhere is this needed more than in the manufacturing economy, which has suffered most at the hands of Asian competitors.

The importance of manufacturing is threefold. On average, workers who lose their manufacturing jobs and take other work earn 11-13 percent less in their new positions.¹⁸ Many of these workers are not able or willing to perform higher level, knowledge-based jobs. And a healthy manufacturing sector is necessary to the nation’s economic and military security.

It is vitally important to preserve (or recreate, where needed) and protect a cohort of regional banks as a means to sustain regional economies. Three examples illustrate the point.

Graphite Electrodes

Electric arc furnaces, used to recycle scrap steel into newly useable steel products, conduct electricity through the steel charge via graphite electrodes that stand upright in the furnace amid the scrap steel. The process consumes the electrodes, which must be replaced. During the 2000-03 economic recession, the only American owned manufacturer of graphite electrodes was one of many American steel and steel-dependent companies to go into bankruptcy. A middle market management buyout firm structured a buyout that would put the company back into production. Reasons for the buyout to go forward included substantial price increases for electrodes imposed by the European owners of the other two U.S. electrode manufacturing facilities, the history of U.S. antitrust price fixing convictions of these European competitors, and the opportunity to save 165 manufacturing jobs in rural Pennsylva-

nia and the indirect benefits that flowed from that payroll in the communities where the hourly workers lived.

Impediments to completion of the buyout included reluctance of the bank group that had financed the debtor to sell the electrodes business assets at the price the market would support paying, eagerness of the European competitors to eliminate a competitor, and the reluctance of regional banks to lend to companies whose business was steel or steel-related due to recession conditions. The buyout firm overcame these impediments by enlisting federal and state political support. Office holders of both political parties, and bankers from four regional and community banks, rallied behind the transaction to aid the hourly workers, the economy of rural Pennsylvania where the manufacturing plant is located, and the revival of the steel industry. The bankers made prudent loans that were paid as agreed. And the political office holders were able to advertise on television their support for hourly workers in the next election cycle.

Powdered Metal Products

Elk County, Pennsylvania is as rural as its name implies; its population includes a sizeable herd of elk. The county is the capital of the powdered metal business in the United States. Powdered metal machinery parts are an economical alternative to forged or cast metal parts. To manufacture these parts, powdered metal is poured into molds, hydraulic presses form the parts in the molds, and the finished parts are heat-treated to harden the resulting metal products. One of the powdered metal businesses located in Elk County had been purchased by a Chicago private equity fund. A Midwest regional bank now part of Bank of America financed the acquisition and the company's working capital requirements. The fund planned to double the parts company's volume by adding automotive business. Quick sale of the now much larger company was the Chicago fund's intended exit strategy.

The company entered Chapter 11 when it ran out of cash. Company workers said they believed the non-automotive business was profitable, but the automotive business was not. A cost accounting was done for every product the company made and a business plan that focused on manufacturing the profitable industrial parts was written. Local investors, customers of a re-

gional bank in rural Pennsylvania, purchased the business. Smaller, but profitable, the company again makes a meaningful contribution to the economy of Elk County and the region.

Hardwood Furniture

Another rural Pennsylvania town's two largest employers were a Top 50 liberal arts college and a company that manufactured furniture from hardwood species harvested in New York and Pennsylvania. These hardwoods, principally oak and cherry, are considered the finest of their type. The furniture was a staple of upper middle class American households. In 2004, the U.S. corporate owner of the furniture manufacturer announced it would shift production to China. Pennsylvania's governor sought to save the 425 manufacturing jobs. Negotiations with the U.S. corporate owner stalled when the owner refused to sell either the registered trademark, a well-known brand in the industry, or the distribution and sales network. Without these assets, industry experts said the business had no value. So the Pennsylvania operation closed. Now, anecdotal evidence suggests that the brand no longer enjoys its reputation for producing high-quality goods.

CONCLUSION

Regional banks *do* matter. They enable capital formation by entrepreneurs and investors who do not warrant the attention of JP Morgan Chase or Goldman Sachs. To succeed, however, regional banks must more keenly focus their business strategies on the niche opportunities that exist within their markets and be disciplined in the execution of those strategies. Ten years ago, a \$3 billion asset Mid-Atlantic regional bank bought two thrift institutions in California in the belief it could originate residential mortgage loans in that market and sell them on Wall Street. After the strategy failed, the bank's human resources director confided, she had no idea that laws governing employment were different in California. The bank spent a fortune educating her by hiring California counsel, she said. Fortunately, the bank's core loan and deposit franchise was sound. With a new business plan, the bank sold the California operations and focused on its home markets. Losses declined,

profits rose and the institution regained its leadership position in a regional market it never should have considered leaving.

A clergywoman friend is fond of saying, “The main thing is to keep the main thing the main thing.” This column’s main thing will be the fundamentals of regional banking. The author looks forward to exploring this important topic with you, our readers.

NOTES

¹ See Bank Holding Company Performance Reports: Peer Group Average Reports 2005-2009, available at www.ffiec.gov/nicpubweb/content/bhcrprt (“BHC Performance Reports”). Data given are as of December 31, 2009.

² *Id.* Number of banks is as of April 8, 2010.

³ S. Rhodes, Bank Mergers and Banking Structure in the United States, 1980-98, Federal Reserve Staff Study 174 (August 2000).

⁴ To this number, the financial crisis added five nonbank financial companies. American Express, CIT Financial, GMAC, Goldman Sachs and Morgan Stanley applied for and were granted bank holding company charters by the Federal Reserve Board of Governors to assure their liquidity through the crisis. See BHC Performance Reports.

⁵ *Id.*

⁶ W. Jeong, K. Kymn, C. Kymn, B. Cushing, Testing the Credit View with Pooled Data: Dynamic Links Among State Bank Health, Investment-oriented Bank Loans, and Economic Performance, 40 *Annals of Regional Science* 133, 134 (2006). Prior to his appointment to chair the Board of Governors of the Federal Reserve System, Prof. Ben Bernanke contributed significantly to economists’ and policy makers’ understanding of monetary policy.

⁷ *Id.*

⁸ *Id.* at 135.

⁹ *Id.*

¹⁰ *Id.* at 136.

¹¹ *Id.* at 142-144.

¹² T. Hills, The Rise of Southern Banking and the Disparities Among the States following the Southeastern Regional Banking Compact, 11 *North Carolina Banking Institute* 57, 60 (2007), also available at studentorgs.law.unc.edu/documents/ncbank/volume11/hills.pdf. *Id.* at 60.

¹³ *Id.* at 66, quoting Roy Barnes, then a Georgia state senator and later Governor of Georgia.

¹⁴ *Id.* at 103.

¹⁵ *Id.* at 69.

¹⁶ *Id.* at 94.

¹⁷ See www.thestreet.com/story/10645677/1/bank-of-america-loses-top-choice-for-ceo.html.

¹⁸ R. Scott, Unfair China Trade Costs Local Jobs, Economic Policy Institute Briefing Paper #260, March 23, 2010, available at www.epi.org/publications/entry/bp260/.