AN ECONOMIC ANALYSIS OF BANK REGULATORY REFORM: THE FINANCIAL INSTITUTIONS SAFETY AND CONSUMER CHOICE ACT OF 1991

MICHAEL KLAUSNER*

The basic structure of the bank regulatory system has changed little in close to sixty years. The system was put in place in 1933 in response to widespread bank failures during the Great Depression. At a fundamental level, the system was designed to wall off banks from market forces. Only banks could take deposits, make loans, and pay checks. Within this preserve, banks were protected from competition from the outside. Securities firms, which in the past had engaged in banking as well, were barred from the banking business. Later, other types of firms that threatened to enter the banks' preserve were kept out by new legislation. Banks also were protected from competition from within their preserve. They were prohibited from paying interest on transaction accounts, the rates they paid on time and savings deposits were subject to a ceiling set by the Federal Reserve Board, and all deposits under a specified amount were guaranteed by the Federal Deposit Insurance Corporation (FDIC). Competition to make loans was limited by state and federal bank regulators, who rationed bank charters, and by a system of state and federal laws that forced banks to operate within narrow geographic areas. In

* Assistant Professor of Law, New York University School of Law.

Between August 1989 and January 1991, the author was a member of the staff of the Office of Policy Development in the White House. In that capacity, the author worked on the report issued by the Department of the Treasury entitled Modernizing the Financial System: Recommendations for Safer, More Competitive Banks, and on the drafting of the Financial Institutions Safety and Consumer Choice Act of 1991. In addition, since January 1991 he has also worked on financial institution reform issues as a consultant to the Office of Policy Development. The views expressed in this article, however, are the author's own and do not necessarily reflect the views of the Office of Policy Development.

I thank Alata Estreicher, Sam Estreicher, George Kaufman, Marcel Kahan, Barbara Sih Klausner, Lewis Kornhauser, Hubert Lem, Jonathan Macey, Geoffrey Miller, Clark Nielsen, Ricky Revesz, Edward Rock, Jack Slain, Al Sykes and Larry White for helpful comments on previous drafts of this article. I also thank Hubert Lem and Saul Lubetsky for their excellent research assistance. I gratefully acknowledge the generous support of the Filomen D'Agostino and Max E. Greenberg Research Fund at the New York University School of Law.

short, the model of banking contemplated was one in which a bank held some amount of monopoly or oligopoly power over a local banking market. In exchange for this power, banks were required to remain within their preserve. Their freedom to engage, either directly or through affiliates, in businesses other than the business of banking was narrowly circumscribed.

For almost fifty years, the banking industry thrived under this arrangement. Banks were profitable and, in contrast to the 1920s and early 1930s, very few failed. Although many factors contributed to the stability of the banking industry during this period—including a relatively stable economy—the protective regulatory structure was an important force in promoting stability. The price society paid for this stability was the inefficiency that generally accompanies monopoly, including wasteful spending by banks and misallocated credit.

By 1980, the legal regime originally designed to protect the banking industry by walling competitors out of the banks' profitable preserve had begun instead to trap banks within a shrinking market. The legal rules had not changed, but the market had. Through financial product innovation made possible by computer and telecommunications technologies, securities firms, mutual funds, and even commercial and industrial companies had developed products and services that competed with banks' traditional deposit and loan services. As bank customers have left the banks in favor of these new products, legal restrictions have prevented banks from following. As a result, competition for a shrinking banking market has intensified, bank profitability has declined, and bank failures have soared.

Although banks have lost their protection from competition, they retain the power to offer risk-free deposits. In reliance on federal deposit insurance, they are able to continue raising a high volume of funds. The primary restraint on their use of those funds—and on the riskiness of the investments they make with those funds—comes from a system of command and control regulation by state and federal bank regulatory bureaucracies. The result, as evidenced by a record of accelerating bank failures over the last decade, is increased risk-taking at the expense of the FDIC and potentially the taxpayer.

The savings and loan industry has gone through a similar, although much more severe dynamic, under which market forces converted a protective legal regime into a destructive regime. By the time public policy makers caught up with the S & Ls, losses estimated at about $150 billion

had been incurred. Congress responded to the savings and loan crisis by enacting the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).[1] In the long run, the most important provision of that Act may have been one that directed the Department of the Treasury to "conduct a study of the Federal deposit insurance system."[2] On February 5, 1991, in response to this congressional directive, the Department of the Treasury issued a report proposing the most comprehensive reform of the bank regulatory system since the current structure was put in place.[3] A month later, the reforms proposed in the Treasury Report were introduced in the Senate and the House of Representatives as the "Financial Institutions Safety and Consumer Choice Act of 1991 (FISCCA)."[4]

This Article analyzes the interaction between the bank regulatory system and the market for financial services and examines the ways in which bank regulation affected profitability and risk-taking both before and after 1980.[5] The Article focuses on the range of business strategies available to banks during each period and the incentives operating on bank shareholders and managers in selecting from available strategies. The Article suggests that although banks have always been subject to restrictions in the services they may provide, before 1980 those restrictions did not prevent banks from adopting profitable, low-risk business strategies. Indeed, the bank regulatory system induced banks to adopt such strategies. As a result of changes in financial services markets that began in the mid-1970s, however, the profitability of legally permissible low-risk strategies declined for many banks. The deposit insurance system's implicit subsidy of risk-taking consequently became more attractive to bank shareholders and managers than it had been in past. The Article then suggests the type of regulatory reform that is necessary in order to allow

1. FIRREA authorized the resolution of failed thrifts, reorganized the federal agencies responsible for regulating and financing the thrift industry, amended the rules governing the operation of thrifts and their holding companies, enhanced the banks' and thrift regulators' enforcement authority and increased criminal penalties.

2. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 1001(a)(b), 1989 U.S. CODE CONG. & ADMIN. NEWS 103 Stat. 183, 507-08.

3. DEPARTMENT OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS (1991) [hereinafter TREASURY REPORT].

4. S.713, 102d Cong. 1st Sess., 137 CONG. REC. S3712 (daily ed. Mar. 20, 1991); H.R. 1505, 102d Cong., 1st Sess., 137 CONG. REC. H1912 (daily ed. Mar. 20, 1991).

5. The use of 1980 as a dividing point is necessarily somewhat arbitrary. The forces that transformed the economic environment of the banks began in the mid-1970s, and the incidence of bank failures, which reflect this transformation, did not accelerate until 1982.

banks to operate effectively in the modern market for financial services. Finally, the article discusses the ways in which FISCCA would respond to the need for reform.

Part I of the Article briefly examines the central features of the current bank regulatory system and its inherent weaknesses. Part II examines the performance of the banking system prior to 1980 and offers a conceptual explanation of how shareholder and manager incentives contributed to the stability of this period. Part III then examines the instability of the post-1980 period and extends the analysis of shareholder and managerial incentives to explain the instability of this period. Part IV briefly identifies the types of fundamental regulatory reforms that are needed. Finally, Part V describes and evaluates FISCCA.

I. THE 1933 REGULATORY SYSTEM

The current bank regulatory system is largely the product of the Banking Act of 1933,[6] which was enacted in response to widespread bank failures between 1930 and 1933. The objective of the system was to require banks to operate within limited product and geographic markets and to protect banks from competitive forces in those markets. Congress reinforced this protection in 1956 with the Bank Holding Company Act and again in 1970 with an amendment to that Act. Although this approach succeeded remarkably well for over forty years, it contained the seeds of future instability.

A. Central Elements of the Regulatory System

The primary elements of the bank regulatory system include: Restrictions on the financial products that banks and their affiliates may provide;[7] restrictions on entry and geographic expansion;[8] and restrictions on protection of bank depositors' funds through federal deposit insurance.[9] An additional element, which since the early 1980s has declined

6. Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.).

7. Banking Act of 1933, §§ 16, 20, 21, 32, 12 U.S.C. §§ 24, 377, 378, 78 (1988) (often referred to as the "Glass-Steagall Act"); Bank Holding Company Act of 1956, § 4, 12 U.S.C. § 1843(c)(8) (1988).

8. McFadden Act, 12 U.S.C. § 36(c) (1988); Bank Holding Company Act of 1956, § 3(d), 12 U.S.C. § 1842(d) (1988) (often referred to as the "Douglas Amendment" because Senator Paul H. Douglas introduced this provision during floor debate. 102 CONG. REC. 5902 (1956)).

9. Banking Act of 1933, § 8; Banking Act of 1935, ch. 614, § 101, 49 Stat. 684 (codified as amended in scattered sections of 12 U.S.C.). Discount window lending by the Federal Reserve is

in significance, is the restriction of interest payments on deposits. In order to enforce this panoply of restrictions and to limit the FDIC's exposure to bank risk-taking, the system provides for extensive regulatory supervision to maintain the "safety and soundness of banks."[10]

1. Restrictions on the Financial Services Banking Organizations May Perform

Under current law, banks and their affiliates are subject to stringent restrictions on the products and services they may provide. Although the law allows banking organizations[11] to engage in certain nonbanking activities subject to strict limitation, the basic model of banking reflected in current law is one in which a bank takes deposits, makes loans, pays checks, and performs other services that support these fundamental banking functions.[12]

Prior to 1933, a segment of the commercial banking industry was heavily involved in underwriting securities, most commonly bonds.[13] In 1929, commercial banks and their affiliates underwrote 45.5 percent of all new bond issues.[14] Following the 1929 stock market crash, there was a popular sentiment, shared by members of Congress, that banks' involvement in securities markets had contributed to the crash and that banks'

---

another important element of the bank regulatory system. Regulation A, 12 C.F.R. § 201 (1991). With deposit insurance available, however, its primary function is to preserve the deposit insurance fund by preventing liquidity shortages from creating solvency problems.

10. Banking Act of 1933, ch. 89, § 11(b), 48 Stat. 162, 181-82. The Banking Act of 1935 extended the same controls to state-chartered banks that were not members of the Federal Reserve System. Banking Act of 1935, ch. 614, § 101, 49 Stat. 684, 702. Interest-rate controls on all accounts other than domestic demand deposits were phased out beginning with the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 201-210, 94 Stat. 132, 142-45 and the Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 326-327, 96 Stat. 1469, 1500-01. *See* Gilbert, *Requiem for Regulation Q: What It Did and Why It Passed Away*, 68 REVIEW, Feb. 1986, at 22 (Federal Reserve Bank of St. Louis). Today businesses are not paid interest on demand deposits. 12 U.S.C. § 371a (1988); 12 U.S.C. § 1828(g) (1988 & Supp. I 1989). Accounts not paying interest currently comprise approximately 17% of bank deposits. Brunner, Duca, McLaughlin, *Recent Developments Affecting The Profitability and Practices of Commercial Banks*, 77 FED. RESERVE BULL. 505 (1991).

11. The term "banking organization" refers to a bank and its affiliates.

12. *See* Clarke v. Securities Indus. Ass'n, 479 U.S. 388, 406 (1987) (Security Pacific) (describing these activities as "core banking functions"). *Cf.* 12 U.S.C. § 36(f) (1988) (defining a branch office of a bank as a place where "deposits are received, or checks paid, or money lent").

13. Out of approximately 27,000 commercial banks in the country, however, only 459 were underwriting securities directly and another 132 banks were doing so through affiliates. W. PEACH, THE SECURITY AFFILIATES OF NATIONAL BANKS 83, 109 (1941).

14. *Id.*

securities activities should be curtailed. The failure of forty percent of the nation's banks over the following four years fueled this sentiment.[15] Critics accused banking organizations of having conflicts of interest between their duty to maintain sufficient assets to repay depositors and their interest in supporting their securities affiliates. More generally, there was a concern that risks assumed by securities affiliates were being shifted to banks by virtue of the banks' willingness to provide financial assistance to affiliates experiencing difficulty.[16]

In response to this sentiment, Congress segregated banking organizations from most aspects of the securities underwriting and dealing business, and barred securities firms from engaging in commercial banking, which it defined as the taking of deposits and the making of loans. Thus, four sections of the Banking Act of 1933, known collectively as the "Glass-Steagall Act," severely restrict banks from underwriting or dealing in securities. Section 16 prohibits national banks[17] from underwrit-

15. Kelly, *Legislative History of the Glass-Steagall Act* in DEREGULATING WALL STREET 41, 43-45 (I. Walter ed. 1985).

16. *Id.* at 46-47 (quoting congressional subcommittee hearings). The types of transaction that created these concerns were the following: (1) bank purchases of securities from affiliates without proper regard for the price paid or the risk assumed; (2) bank loans to weak securities affiliates, presumably at rates of interest that did not reflect the risk of default; (3) bank loans to customers, on inadequate terms, for purchases of securities from affiliates; (4) manipulation of the bank's own stock through purchases and sales by its securities affiliate; (5) risk to the reputation of a bank as a result of the actions of a securities affiliate; and (6) bank purchases of securities from a securities affiliate for trust accounts. *Id.* Although the primary concern was that the existence of a securities affiliate would create a risk for a bank, some of the identified concerns actually involved risk to the securities affiliate. G. BENSTON, THE SEPARATION OF COMMERCIAL AND INVESTMENT BANKING: THE GLASS-STEAGALL ACT REVISITED AND RECONSIDERED 26 (1990). *See also* Flannery, *An Economic Evaluation of Bank Securities Activities Before 1933*, in DEREGULATING WALL STREET, *supra* note 15, at 69-71; Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L. J. 483, 497-515 (1971).

17. The bank regulatory regime divides banks into three categories: national banks, state banks that are members of the Federal Reserve System (state member banks), and state banks that are not members of the Federal Reserve System (state nonmember banks). National banks are chartered and regulated by the Comptroller of the Currency and are automatically members of the Federal Reserve System. State banks are chartered and regulated by state banking authorities. The existence of state and federal chartering and regulatory authority is referred to as the "dual banking system." State banks that choose to become members of the Federal Reserve System are regulated by the Federal Reserve Board, and state banks that are not members of the Federal Reserve System are regulated by the Federal Deposit Insurance Corporation (the FDIC) in addition to their state regulators. Finally, the Federal Reserve Board regulates the holding companies of all banks. As of June 1990, approximately thirty-three percent of insured commercial banks were national banks, eight percent were state member banks, and fifty-nine percent were state nonmember banks. Because national banks and state member banks are generally larger than state nonmember banks, however, national banks, state member banks, and state nonmember banks held approximately fifty-nine per-

ing or dealing in corporate securities.[18] Section 20 prohibits member banks from having an affiliate "engaged principally in the issue, flotation, underwriting, public sale, or distribution" of securities.[19] Section 32 prohibits any director, officer, or employee of a securities underwriting firm from holding any such position with a member bank.[20] Finally, Section 21 prohibits any firm that engages in securities underwriting and dealing from also accepting deposits.[21]

The Glass-Steagall Act, however, does not prohibit all securities activities for banks and their affiliates. Banks are still permitted to underwrite and deal in federal government debt securities and general obligation state and municipal debt, referred to as "eligible" securities. They are also permitted to execute orders for the purchase or sale of securities on behalf of customers.[22] Additionally, none of the Glass-Steagall restrictions applies to a U.S. bank's operations abroad.[23] Finally, affiliates of banks are permitted to underwrite and deal in a wide range of ineligible securities, including corporate debt and equity, as long as they are not "engaged principally" in such activities. The Federal Reserve Board has interpreted this language to allow an affiliate of a bank, referred to as a "Section 20" affiliate, to underwrite ineligible securities as long as the affiliate derives no more than ten percent of its gross revenues from this type of underwriting.[24] Only the largest banks, however, can generate a sufficiently large base of eligible securities business and other non-deposit-taking business in a Section 20 affiliate to conduct a viable business underwriting and dealing in ineligible securities without breaching the ten percent limit.

Analysis since 1933 has raised substantial doubt regarding popular claims that bank securities activities caused either the stock market crash

---

cent, seventeen percent, and twenty-four percent of bank assets, respectively. TREASURY REPORT, *supra* note 3, at XVIII-8 (fig. 1).

18. 12 U.S.C.A. § 24 (Seventh) (West Supp. 1991). Section 5(c) of the Banking Act of 1933 applied the restrictions of Section 16 to member banks. 12 U.S.C. § 335 (1988).

19. 12 U.S.C. § 377 (1988).

20. *Id.* § 78.

21. *Id.* § 378. State nonmember banks are not subject to sections 16, 20 or 32 of the Glass-Steagall Act. However, they are subject to section 21 and therefore cannot engage in underwriting or dealing in securities directly. Under the statute, they can engage in those activities through an affiliate. The FDIC, nonetheless, has prevented their affiliates from underwriting or dealing in securities. 12 C.F.R. § 337.4 (1991).

22. Banking Act of 1933, § 16, 12 U.S.C.A. § 24 (Seventh) (West Supp. 1991).

23. 12 C.F.R. §§ 211.5(d) (1991).

24. Banking Act of 1933, § 20, 12 U.S.C. § 377 (1988); *Modification to Section 20 Orders*, 75 FED. RESERVE BULL. 751 (1989).

or the bank failures of the early 1930s.[25] Moreover, careful review of the legislative history of the Banking Act of 1933 has raised questions regarding whether Congress, at the time, had any evidence supporting these claims.[26] Nonetheless, the assumption that commercial banking and securities underwriting do not mix has dominated popular thinking in this area for fifty years.

The Glass-Steagall Act referred only to the securities activities of banks and their affiliates. It thus left open the possibility that a bank could affiliate with a firm other than a securities underwriting firm. For example, the Act did not prevent a commercial firm from owning a bank, nor did it prevent common ownership of a bank and an insurance underwriting firm.[27] However, the Bank Holding Act of 1956,[28] as amended in 1970,[29] limits the activities of a bank's affiliates to those "so closely related to banking . . . as to be a proper incident thereto," and authorized the Federal Reserve Board to regulate bank holding companies. Consequently, affiliates of banks are prohibited from engaging in nonbanking activities other than those that the Federal Reserve Board determines to be consistent with this statutory standard.

Furthermore, to the extent that a banking organization may engage in nonbanking activities, it is subject to restrictions regarding the interaction of a bank and its nonbank affiliates. The primary restrictions include statutory limits on transactions involving the transfer of funds by a bank to an affiliate[30] and limits on banks' marketing of the products or

25. *See, e.g.*, M. FRIEDMAN & A. SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES 1867-1960, at 305-08, 353-37 (1963); Flannery, *supra* note 15, at 67; Huertas, *An Economic Brief Against Glass-Steagall*, 14 J. Bank Res., Autumn 1984, at 148. Senate Comm. on Banking, Housing and Urban Affairs, S. Rep. No. 305, 100th Cong., 2d Sess. 8-10 (1988); *Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, December 1, 1987*, 74 FED. RESERVE BULL. 91, 95 (1988); ECONOMIC REPORT OF THE PRESIDENT 148 (1984); FEDERAL DEPOSIT INS. CORP., MANDATE FOR CHANGE: RESTRUCTURING THE BANKING INSUDTRY 36-45 (1987).

26. G. BENTSON, *supra* note 16, at 20-42; Kelly, *supra* note 15, at 43-54.

27. Savage, *A History of the Bank Holding Company Movement* in THE BANK HOLDING COMPANY MOVEMENT TO 1978: A COMPENDIUM 21, 38 (Staff of the Board of Governors of the Federal Reserve System 1978).

28. Bank Holding Company Act of 1956, § 4(c)(6), 12 U.S.C. § 1843(c)(8) (1988).

29. Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, § 101, 84 Stat. 1760, 1760-62 (codified as amended at 12 U.S.C. § 1841 (1988)). The fact that commercial firms and banks could have become affiliates with one another until 1970 is often lost in discussions of the "long-standing" separation of banking and commerce.

30. 12 U.S.C. § 371c (1988). Section 23A of the Federal Reserve Act limits the aggregate volume of "covered transactions" between a bank and any affiliate to ten percent of the capital stock and surplus of the bank. "Covered transactions" include *inter alia* loans to an affiliate, purchases of

services of an affiliate.[31] In addition, interaction between banks and Section 20 affiliates are subject to especially stringent restrictions—referred to as "firewalls"—promulgated by the Federal Reserve Board.[32]

In sum, bank regulation severely restricts banks from providing nonbanking services. These restrictions effectively prevent most banking organizations from engaging in any nonbanking activities at all and prevent all nonbanking firms from engaging in banking activities.

2. Restrictions on Entry and Geographic Expansion

Although less severe in recent years than in the past, restrictions on entry and geographic expansion have been a central element of this country's bank regulatory system since the nineteenth century. The law currently prohibits banks from opening branches across state lines, although interstate expansion through bank holding company affiliates—on either a regional or national basis—is permitted in most states. Intrastate branching is generally unrestricted as well. New bank charters are issued by the Comptroller of the Currency for national banks and by state banking authorities for state banks, and from the 1930s until the 1970s, both were limited in order to restrain competition in local banking markets.[33]

The National Bank Act of 1864, which established the national bank system, is silent regarding the power of national banks to open branch offices, as is the legislative history of the Act. Nonetheless, the Comptroller of the Currency ruled in 1865 that national banks could not operate through branches, and the Supreme Court adopted that interpretation of the Act in 1924.[34]

In states that allowed branching by state-chartered banks, the Comp-

securities issued by an affiliate, purchases of assets, and issuance of a guarantee on the behalf of an affiliate. The volume of covered transactions with all affiliates in the aggregate is limited to twenty percent of capital stock and surplus. In addition, Section 23A requires collateral of between 100% and 130% on loans to affiliates and guarantees on behalf of affiliates. Finally, Section 23A prohibits a bank from purchasing low-quality assests from an affiliate. *Id.*

31. *Id.* § 371c-1.

32. *See J.P. Morgan & Co. Inc., The Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, Security Pacific Corp.*, 75 FED. RESERVE BULL.. 192 (1989); *Modifications to Section 20 Orders*, supra note 24, at 751; *Orders Issued Under Section 4 of the Bank Holding Company Act: J.P. Morgan & Co. Inc.*, 76 FED. RESERVE BULL. 26 (1990); *Orders Issued Under Bank Holding Company Act: Canadian Imperial Bank of Commerce, The Royal Bank of Canada, Barclays PLC, Barclays Bank PLC*, 76 FED. RESERVE BULL. 158 (1990).

33. Peltzman, *Entry in Commercial Banking*, 8 J. L. & ECON. 11 (1965).

34. First Nat'l Bank v. Missouri, 263 U.S. 640 (1924). *See* R. ROBERTSON, THE COMPTROLLER AND BANK SUPERVISION: A HISTORICAL APPRAISAL 81-86, 100-05 (Office of the Comptroller of the Currency, 1968).

troller's branching restriction placed national banks at a competitive disadvantage. To reduce this disadvantage, Congress passed the McFadden Act in 1927, which granted national banks and state-member banks branching authority within a city, town, or village to the extent that their state bank competitors enjoyed such a privilege.[35] In response to the disproportionate failures of unit banks and banks with narrowly focused branches in the early 1930s, the Banking Act of 1933 extended this branching authority, allowing a national bank or a state-member bank to establish branches anywhere in its home state to the same extent that a state-chartered bank is permitted to branch under the law of that state.[36] At that time, Congress considered and rejected the option of further reducing branching restrictions for national banks.[37] Thus, although branching restrictions pre-date the Banking Act of 1933, they were deliberately retained as a central element of the regulatory regime created by that Act.

Today, only two states prohibit intrastate branching, and nine other states restrict it.[38] As a result, throughout most of the country both state and national banks are permitted to open in-state branches. However, essentially no interstate branching is permitted under state law. As a

35. McFadden Act, ch. 191, § 7, 44 Stat. 1224, 1228 (1927) (codified as amended at 12 U.S.C. §§ 36(c) (1988)). Historically, many states either prohibited branching or restricted it to locations within the city or county of a bank's head office. These restrictions originated in the nineteenth century, before which time banking was carried out primarily by single-office or "unit" banks. Shortly after the turn of the century, and largely as a result of urbanization, economic pressure for branch banking developed. As the growing middle class moved to the outskirts of major cities and the center of the cities became congested with automobiles, banks began opening branches in the areas in which their customers lived. The states' responses to branch banking varied. Some states permitted it and others prohibited or restricted it. *See* SUBCOMM. ON FINANCIAL INSTITUTIONS, SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, 94TH CONG., 2D SESS., COMPENDIUM OF ISSUES RELATING TO BRANCHING BY FINANCIAL INSTITUTIONS 1 (Fischer & Golembe, *The Branch Banking Provisions of the McFadden Act as Amended: Their Rationale and Rationality*)(1976) [hereinafter Fischer & Golembe].

36. As amended, the McFadden Act provides that a national bank "may . . . establish and operate new branches . . . at any point within the State in which [such bank] is situated, if such establishment and operation are at the time authorized to State banks by the statute law of the State in question." 12 U.S.C. § 36(c) (1988). The McFadden Act was intended to provide "competitive equality" between national banks and state banks. First Nat'l Bank v. Walker Bank & Trust, 385 U.S. 252, 261-62 (1966).

37. Fischer & Golembe, *supra* note 35, at 28-34. The measure considered would have allowed interstate branching within a single trade area.

38. TREASURY REPORT, *supra* note 3, at XVII-7-8. Colorado and Wyoming prohibit branching. The following states restrict branching: Arkansas, Illinois, Iowa, Kentucky, Louisiana, Minnesota, Missouri, New Mexico, and Tennessee. *Id.*

result, neither state nor national banks are permitted to establish branch networks across state lines.

Bank holding companies' interstate activities are governed by a combination of state and federal law similar to that created by the McFadden Act. Under a provision of the Bank Holding Company Act commonly known as the "Douglas Amendment," a bank holding company that operates a bank in one state may acquire a bank in another state only if the acquisition is expressly authorized by statute in that state.[39] Most state statutes currently allow acquisitions by out-of-state bank holding companies, although some states limit such acquisitions to holding companies from states within a specified region and some require reciprocity from other states. As a result, many banking organizations currently operate groups of affiliated banks across state lines.[40]

3. Deposit Insurance

Deposit insurance is the third pillar of the bank regulatory system. It has two purposes: to protect small depositors and to prevent bank runs. Under current law, the FDIC guarantees that if a bank becomes insolvent,[41] the FDIC will repay the bank's depositors up to a limit that is generally referred to as $100,000 per depositor per bank.[42] In fact, however, the rules governing that limit are far more complex. Moreover, the

39. 12 U.S.C. § 1842(d) (1988).

40. According to the TREASURY REPORT, forty-six states (all but Hawaii, Kansas, Montana, and North Dakota) allow out-of-state holding companies to operate banks within their borders. Twenty-one of those states allow entry from any state that offers reciprocal entry; twelve states allow entry from any state regardless of reciprocity; and thirteen states are parties to regional reciprocity pacts. TREASURY REPORT, *supra* note 3, at XVII-8. Some of those states that allow entry require holding companies to acquire an existing bank rather than organizing a new bank. *See also* Miller, *Interstate Banking in the Court*, 1985 SUP. CT. REV. 179 (discussion of regional bank expansion).

41. If a solvent bank becomes illiquid, the Federal Reserve is authorized to extend the bank a loan.

42. 12 U.S.C. § 1821(a) (Supp. I 1989). This limit was $2,500 when deposit insurance was first instituted in 1933. The history of the statutory limit of coverage is summarized in the following chart:

FDIC's current practice in "resolving"[43] failed banks usually preserves even uninsured deposits. Consequently, the present system comes very close to insuring 100% of all deposits. Banks pay premiums at a flat annual rate of 23 cents per $100 of domestic deposits for this protection.[44]

The Federal Deposit Insurance Act provides that in applying the coverage limit of $100,000, the FDIC shall combine all of a depositor's accounts in an institution "maintained in the same capacity and the same right for his benefit either in his own name or in the names of others."[45] Accordingly, the law applies separate $100,000 limits to a depositor's individual, joint, fiduciary, and business accounts.[46] In addition, the law explicitly provides that individual retirement accounts are to be insured separately up to $100,000.[47] A depositor thus can expand his or her insurance coverage within a single institution by creating separate joint trust, retirement, and business accounts. In this manner, a family of three is potentially able to obtain $1.2 million of coverage within a single bank, even without a business account. Moreover, because the limit applies on a per-institution basis, a depositor can obtain even greater insurance coverage by spreading funds among more than one bank.

The FDIC also has used the "same capacity" concept to extend insurance coverage to institutional fiduciary accounts, such as employee pen-

Year	Limit	Limit in 1990 Dollars
1933	$ 2,500	$ 29,000
1934	5,000	59,000
1950	10,000	55,000
1966	15,000	56,000
1969	20,000	66,000
1974	40,000	97,000
1980	100,000	153,000*
Present	100,000	100,000

* An additional limit of $100,000 was added for state and local government accounts in 1974 and for individual retirement accounts and Keogh accounts in 1978. THE FEDERAL DEPOSIT INSURANCE CORPORATION, FEDERAL DEPOSIT INSURANCE CORPORATION: THE FIRST FIFTY YEARS 69 (1984) [hereinafter THE FIRST FIFTY YEARS]. Figures in 1990 dollars are adjusted using the implicit price deflator for gross national product in THE ECONOMIC REPORT OF THE PRESIDENT 290 (1991) (Table B-3)

43. The term "resolve" is a term of art that refers to the FDIC's reorganization of a failed bank. The term includes all alternative means of disposing of a failed bank.

44. 12 U.S.C.A. § 1817(b)(1)(C) (West Supp. 1991); 56 FED. REG. 21,064 (1991) (to be codified at 12 C.F.R. 327.13(c)).

45. 12 U.S.C. § 1813(m)(1) (Supp. I 1989).

46. 12 C.F.R. § 330 (1991).

47. 12 U.S.C. § 1821(a)(3) (Supp. I 1989).

sion plans and accounts in which a broker holds client funds, in amounts up to $100,000 per beneficiary.[48] This "pass through" coverage allows pension plans and deposit brokers to hold millions of dollars in insured deposits on behalf of beneficiaries.

Finally, in almost all bank failures, the FDIC protects uninsured depositors along with insured depositors. This occurs most commonly when the FDIC chooses to resolve an insolvent bank by merging it with a healthy bank. In this type of transaction, termed a "purchase and assumption" transaction, the healthy bank acquires the assets of the failed bank and assumes its liabilities, including its uninsured deposits. Rather than making payments to the depositors of the failed bank, the FDIC infuses cash into the insolvent bank to the extent necessary to attract an acquiror.

The FDIC is authorized to use a purchase and assumption transaction when doing so would be cheaper than paying off the insured depositors directly and liquidating the failed bank.[49] Whether this condition applies in a particular case depends on a comparison of the amount of cash the FDIC must pay into the failed bank and the shortfall in the proceeds the FDIC would receive if it were to pay off the depositors and liquidate the bank's assets.[50] Because the transaction costs of liquidations are high, and because a failed bank often has a going concern value that can command a premium from an acquiror, this comparison usually leads the FDIC to use the purchase and assumption method of resolution rather than an insured deposit payoff followed by a liquidation.[51]

The FDIC also protects uninsured deposits when it determines that "severe financial conditions exist which threaten the stability of a significant number of insured depository institutions or of insured depository institutions possessing significant financial resources."[52] This protection could take the form of a purchase and assumption resolution or the infusion of funds into a bank that continues to operate.[53] Beginning with its

48. TREASURY REPORT, *supra* note 3, at V-3. This "pass-through" coverage extends to escrow accounts and accounts held by other financial institutions to facilitate payments processing. *Id.* at V-2.

49. 12 U.S.C. § 1823(c)(4)(A) (Supp. I 1989).

50. Indirect costs of a liquidation could be considered as well.

51. *See* Bovenzi & Muldoon, *Failure Resolution Methods and Policy Considerations*, 3 FDIC BANKING REV., Fall 1990, at 1; Bovenzi & Murton, *Resolution Costs of Bank Failures*, 1 FDIC BANKING REV., Fall 1988, at 1.

52. 12 U.S.C. § 1823(c)(2)(B)(iii) (Supp. I 1989).

53. *Id.* § 1823(c)(1).

resolution of Continental Illinois National Bank in 1984, the FDIC has announced that certain banks are "too big to fail," by which it means that if uninsured depositors of the bank were permitted to lose their deposits, the financial system would sustain severe damage. In such cases, the FDIC protects uninsured depositors.[54] The FDIC has not, however, specified how large a bank must be considered to be too big to fail.

The result of these various rules and practices is that seventy-five percent of all deposits in the banking system are explicitly insured,[55] and the remaining twenty-five percent is very likely to be protected in the event of a bank failure. Since 1985, the FDIC has protected over ninety-nine percent of uninsured deposits of banks that have failed.[56]

Three primary mechanisms control the FDIC's exposure to losses from bank failures. First, banks are subject to a wide range of regulations governing the activities in which they may engage, the loans and other investments they may make, the management personnel they may retain, and other aspects of their operations. Second, banks are subject to a set of net worth, or "capital," requirements intended to ensure that a bank's shareholders have a sufficient stake in the bank to restrain risk-taking, and to reduce the FDIC's exposure should the bank's fortunes decline. Finally, the FDIC and the other bank regulators have the power to close a bank or to terminate the insurance of a bank that is insolvent, that engages in "unsafe or unsound practices," or that is in an "unsafe or unsound condition."[57]

---

54. The potential systemic damage includes: 1) The inability of the failed bank to fulfill obligations under bank payment or securities clearing systems; 2) the inability of the failed bank to fulfill check clearance obligations; 3) the loss of the failed bank's correspondent banks' deposits; and 4) the possibility of runs being triggered at other banks. TREASURY REPORT, *supra* note 3, at III-29-35. This rationale could lead the FDIC to protect nondepositor creditors as well. *Id.*

55. FEDERAL DEPOSIT INS. CORP., 1989 ANNUAL REPORT 114 (1990).

56. *Hearings Before the Subcomm. on Economic Stabilization of the House Comm. on Banking, Finance and Urban Affairs,* 102d Cong., 1st Sess. (1991) (statement of Robert R. Glauber, Under Secretary of the Treasury) (as yet unpublished).

57. The legal authority of the banking agencies to close a bank is somewhat of a tangled web. The Comptroller of the Currency has the authority to close national banks, 12 U.S.C. § 191 (1988), and state bank regulators have the authority to close state-chartered banks. When the Comptroller closes a bank, it is required to appoint the FDIC receiver. 12 U.S.C. § 1821(c)(2)(A)(ii) (Supp. I 1989). State banking authorities are not required to appoint the FDIC receiver but they usually do, and the FDIC is authorized to accept such appointments. *Id.* § 1813(c)(3). In addition, if a state has appointed another party receiver, the FDIC may, under certain circumstances, appoint itself to replace the state-appointed receiver. *Id.* § 1821(c)(4). The FDIC also has the authority to terminate a bank's insurance if it determines that a bank has engaged in or is engaging in "unsafe or unsound practices," or that it is in an "unsafe or unsound condition." *Id.* § 1818(a). Termination of insurance would require closure in the case of a national bank or a state member bank, *Id.* § 1818(o), and

The power of the regulators to close a failing bank in part reflects the fact that the FDIC occupies a role similar to that of a creditor in addition to its role as an insurer. Like an insurer, the FDIC must make payments in respect of covered losses. The FDIC is then subrogated to the claims of the insured depositors, and assumes the role of a creditor with a claim against the estate of the bankrupt bank.[58] The power to close a failing bank allows the FDIC or other regulator to prevent the dissipation of the bank's assets, just as the power of a creditor to invoke the bankruptcy process serves to prevent dissapation of the firm's assets in the nonbanking context.

B. Seeds of Instability

Each element of the bank regulatory system described above contains both stabilizing and destabilizing potential. Deposit insurance prevents runs, but it also subsidizes socially wasteful risk-taking, which can result in unnecessary bank failures. The geographic restrictions, coupled with restraints on entry, potentially protect inefficient banks from failure, but they also prevent banks from diversifying their loan portfolios across regions and from achieving economies of scale. Similarly, the activity restrictions, coupled with restrictions on nonbanking firms providing banking services, reduce bank's exposure to interindustry competition, but they also prevent banks from diversifying their services and achieving economies of scope.

1. Subsidized Risk-Taking

Shareholders of banks, like shareholders of any corporation, enjoy limited liability. They are potentially liable to creditors only to the extent of their equity in the bank. This situation creates the possibility that a bank, like any limited liability firm, will make investments without fully taking into account the possibility that it will become insolvent and default on its liabilities. Outside the banking context, creditors attempt to prevent such behavior by demanding interest rates containing risk premiums that compensate for the possibility of default, and by placing covenants in loan agreements that limit the freedom of borrowers to take risks. By forcing corporations to pay for the risk of default, creditors

in almost all states, it would require the closure of a state nonmember bank as well. CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE-CHARTERED BANKING 147 (11th ed. 1986) (listing of states that require FDIC insurance).

58 12 U.S.C. § 1821(g) (Supp. I 1989).

ideally constrain corporations to make only those investments that carry expected returns that compensate for the risks involved.[59] This disciplinary mechanism does not exist, however, in the case of depositors placing insured funds in a bank. As long as the FDIC guarantees the repayment of a bank's deposits, depositors are indifferent to the risk that the bank will become insolvent and default on its deposits. The bank's shareholders thus enjoy both the limited liability normally accorded shareholders as well as debt financing near the risk-free interest rate regardless of the risk the bank assumes. In the absence of other restraints on risk-taking, this arrangement will lead to socially wasteful risk-taking.

The introduction of deposit insurance has displaced insured depositors as a source of discipline on bank risk-taking. The FDIC, together with the other bank regulatory agencies, must therefore provide that discipline. Deposit insurance premiums ought to be equivalent to the risk premium creditors would charge to account for the possibility of default. Unless deposit insurance is priced to take account of the risk that the FDIC will have to make good on its obligation to depositors, a bank's shareholders will not bear the full costs of the risks that the bank assumes. Consequently, one would expect banks to assume greater risk than they would if their shareholders were required to absorb the full costs of their actions. In fact, under the present system, deposit insurance is not priced to take account of risk. The FDIC charges banks a flat premium rate regardless of the risk that a bank will become insolvent and require the FDIC to make good on its commitment to depositors. Consequently, deposit insurance, in effect, subsidizes banks that take risks greater than the level of risk that happens to be reflected in the flat rate premium, and it taxes banks that take lesser risk.

The nature of the deposit insurance subsidy is most easily demonstrated with an example. Consider a bank with a market value net worth of $100 that has a choice of three alternative business strategies, each with a fifty percent probability of success: The first strategy would result in a $100 gain if successful and a $50 loss if unsuccessful; the second strategy would result in a $200 gain if successful and a $200 loss if unsuccessful; and the third strategy would result in a $200 gain if successful and a $500 loss if unsuccessful. For simplicity, assume that the period of success or failure of these investments is the same, and assume a risk-free rate of interest equal to zero.[60] The expected values of the projects are a

59. That is, a firm will only make investments that have a positive net present value.

60. The $100 net worth would include the market value of intangible assets such as franchise

gain of $25, zero gain, and a loss of $150, respectively. From a societal point of view, the bank should therefore adopt the first strategy. Its prospective gains are greater than its prospective losses.

The limited liability of the bank's shareholders, however, skews their choice of strategy. Because their liability is limited to $100 (the bank's net worth), the loss that they would incur under either the second or third strategies is at most $100 despite the fact that those strategies may in fact result in greater losses. Losses greater than $100 would be borne by the FDIC. The expected values of the three strategies to the shareholders, therefore, are gains of $25, $50, and $50, respectively.[61] Consequently, the bank's shareholders would select either the second or the third strategies.

By adopting the second or third strategy, the bank would implicitly extract $50 or $200, respectively, from the FDIC. If the flat-rate deposit insurance premium happens to be $50, the net subsidy to a bank adopting the third strategy would be $150 (the $200 expected value of the future FDIC payment minus the $50 premium.), and there would be no subsidy to a bank that adopts the second strategy. Because the deposit insurance premium does not vary with risk, however, a bank purposefully can select a strategy that is sufficiently risky to entail the extraction of a subsidy.

Another way to view deposit insurance is as a put option on the bank's assets with an exercise price equal to the value of the bank's liabilities.[62] A put option is the right to sell a specified asset to another party at a specified price referred to as the "exercise" or "strike" price on or before a specified date. If the value of the asset falls below the exercise price, the put can be exercised and the holder would receive a gain equal to the

---

value or goodwill. This type of example could be modified to take account of the duration of the strategies and interest rates, but the analysis would remain the same. This example is a simplified version of the state-preference model employed by Furlong and Keeley in analyzing the effect of capital requirements on bank risk-taking. *See* Furlong & Keeley, *Capital Regulation and Bank Risk-Taking: A Note*, 13 J. BANKING & FIN. 883 (1989).

61. In a more complicated example, the net present values of these loans would be the relevant measure of value to both the bank shareholders and to society.

62. *See* Merton, *An Analytic Derivation of the Cost of Deposit Insurance and Loan Guarantees*, 3 J. BANKING & FIN. 3, 5-11 (1977)(more complete analysis of the factors that determine the value of the put). For a recent attempt to measure the value of the put to sixty-three large banks, see SUBCOMM. ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND INSURANCE, 101ST CONG., 1ST SESS., BANKING INDUSTRY IN TURMOIL: A REPORT ON THE CONDITION OF THE U.S. BANKING INDUSTRY AND THE BANK INSURANCE FUND 36-37 (Comm. Print 1990) (Barth, Brumbaugh, & Litan). The rights of corporate shareholders are also equivalent to a put. Interest rates on corporate debt, however, ideally force the shareholders to pay for the value of the put.

difference between the value of the asset at the time the option is exercised and the exercise price. In the context of deposit insurance, bank shareholders have the right to transfer both their assets and their deposit liabilities to the FDIC if the value of the bank's assets falls below the value of its liabilities (i.e. if the bank becomes insolvent). If that occurs, the bank shareholders are absolved of further liability.[63] In effect, therefore, the bank shareholders have sold the bank's assets to the FDIC for a price equal to the value of the bank's deposits. For instance, a bank with $1,000 of assets and $900 of deposits, in effect, has the right to transfer its assets at any time to the FDIC, at which point the FDIC will, in effect, pay the bank $900 by assuming its $900 of liabilities to depositors. If the value of the bank's assets falls from $1,000 to $700, for example, the shareholders would lose only $100 rather than $300. The FDIC would incur the remaining loss of $200 when it pays off the bank's depositors. Therefore, the shareholders of the bank can take risks with their assets secure in the knowledge that, at most, they can lose $100 and that they can keep all gains if the risks pay off.

The prospective value of the put option depends upon the degree of risk that a bank assumes. The higher the potential losses beyond the value of the shareholders' equity and the greater the likelihood of such losses, the more valuable the put will be. Unless the FDIC charges a bank for the value of the put, it will implicitly subsidize the bank. In order to charge the correct price of the put, however, the FDIC would have to base its premiums on the risk that the bank will fail and on the expected magnitude of the FDIC's losses if it does fail. Again, the flat-rate premium, in effect, allows banks to assume a level of risk higher than the level represented by the prevailing premium rate and thereby to extract a subsidy from the FDIC.

Any insurance arrangement entails a potential wealth transfer from the insurer to the insured similar to that described above. If the insured does not bear the full cost of the risks it assumes, it will not take full account of those costs when engaging in risk-taking behavior. If the insurer were able to monitor the insured perfectly and to determine the riskiness of the insured's behavior on a continuous basis, the insurer could charge the insured premiums that reflect the risk assumed, thereby

63. The presence of uninsured deposits or nondeposit liabilities would complicate the analysis, particularly because of the ambiguity regarding the FDIC's protection of such liabilities. It would not, however, alter its thrust or validity. For simplicity, therefore, this discussion assumes the hypothetical bank has only insured deposit liabilities.

forcing the insured to bear the full cost of its risk-taking behavior. This level of monitoring and risk assessment, however, is not possible. As a result, a problem of divergent interests between the insured and the insurer, or "moral hazard," inheres in any insurance relationship.[64]

Private insurers use several mechanisms to reduce moral hazard. One mechanism is to charge premiums based on the estimated risk assumed by the insurer, as described above. A second type of mechanism is designed to restrain risk-taking by requiring the insured to bear some of the risk of the insured-against loss. This type of mechanism includes deductibles, coinsurance, and upper limits on coverage.[65] Each of these devices forces the insured to internalize some of the cost of its risk-taking behavior. The higher the cost borne by the insured, the less risk the insured will be inclined to assume. A third type of mechanism is to include in the insurance contract a set of restrictions on the activities in which the insured may engage. By controlling the activities of the insured, the insurer can prevent certain foreseeably risky activities or situations.

The deposit insurance system relies on capital requirements, which are similar to a deductible, and on activity restrictions to restrain bank risk-taking. Insurance premiums are not related to a bank's riskiness, there is no coinsurance, and essentially all losses are covered by the FDIC.[66]

Capital requirements are intended to ensure that the shareholders of a bank have at least a minimum amount to lose if a bank fails.[67] The as-

64. K. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY 14-15 (1986).

65. Under a deductible arrangement, the insured incurs the first $X of cost arising from an insured-against event. Under a coinsurance arrangement, the insurer pays for a specified percentage (less than 100%) of the losses up to a specified limit, after which point the insured bears the remaining costs.

66. *See* White, *The Reform of Federal Deposit Insurance*, 3 J. ECON. PERSP. 11, 17-18 (1989). The FDIC can also terminate insurance, which is tantamount to closing a bank. Under current law, however, the termination of insurance or closure of a bank is subject to a set of substantive and procedural requirements that preclude the FDIC from taking action until a bank is insolvent. Therefore, the power to terminate the insurance relationship can be used to minimize FDIC losses once a bank becomes insolvent but not to prevent losses entirely.

67. Bank capital requirements consist of two components: a "leverage ratio" requirement and a system of "risk-based capital guidelines." Under the leverage ratio requirement, banks must maintain "Tier 1" capital in an amount equal to at least three percent of their assets. The three-percent requirement, however, applies only to those banks the regulators rate as being in the best financial condition. All other banks must have additional Tier 1 capital in an amount of one to two percent of their assets. "Tier 1" capital is defined to include common stockholders' equity, noncumulative perpetual preferred stock and related surplus, and minority interests in the equity accounts of consolidated subsidiaries. Under the risk-based capital guidelines, banks must, by December 31, 1992, maintain Tier 1 capital in an amount equal to at least four percent of there "risk-weighted assests."

sumption underlying capital requirements is that bank managers will take into account the potential losses of shareholders in making decisions regarding risk (or in ignoring the need to make such decisions). The more capital a bank has, the greater the losses shareholders will suffer in the event of a failure. In addition, capital serves as a cushion that absorbs losses ahead of the FDIC. Therefore, for any given level of risk, higher capital decreases FDIC losses. Capital thus performs the same role as a deductible in an ordinary insurance relationship.[68]

Under current law, however, capital is not measured by the market values of a bank's assets and liabilities. Instead, regulators rely on banks' balance sheets, which typically contain the values of a bank's assets and liabilities measured according to generally accepted accounting principles (GAAP). As a result, bank assets and liabilities are generally recorded at historical values. A loan of $1 million made at an interest rate of ten percent five years ago, for example, would be carried on the books of a bank at $1 million today, even if market interest rates are now higher than they were five years ago, and the same loan would pay twelve percent today.[69] Particularly in light of the volatility of interest rates since the late 1970s, GAAP values are often an imprecise measure of a bank's assets and liabilities. A bank with negative net worth on a market value basis may be able to meet the capital requirements on the basis of GAAP values. Conversely, a very profitable bank may have a higher net worth on a market value basis than on a GAAP basis, even if it pays out a high portion of its earnings in dividends.[70]

Activity restrictions include the restrictions on bank involvement in nonbanking activities discussed above. In addition to these categorical

---

In addition, banks' "total capital" must equal at least eight percent of their risk-weighted assets. The value of a bank's "risk-weighted assets" is determined by classifying the bank's assets according to a set of categories specified by regulation, multiplying the book value of the bank's assets in each category by a factor provided for by regulation and intended to represent the credit risk of that category of assets, and summing these products. "Total capital" is defined as Tier 1 capital plus "Tier 2" capital, which includes cummulative perpetual, long-term, and convertible preferred stock and related surplus, perpetual debt, and hybrid debt/equity instruments, intermediate-term preferred stock and term subordinated debt (up to a limit), and loan loss reserves (up to a limit). Goodwill and other intangible assets are not included in any of the capital concepts. For the period until December 31, 1991, a set of transition rules apply. 12 C.F.R. § 3, § 225, App. A and D, § 208, App. A and B, and § 325 (1991).

68. *See* White, *supra* note 66, at 20-21.

69. For a more complete discussion of the distortions that arise as a result of GAAP accounting, see White, *On Measurement of Bank Capital* (Working Paper No. Ec. 91-9, Department of Economics, Leonard N. Stern School of Business, New York University, 1991).

70. *Id. See also* White, *supra* note 66, at 19.

restrictions, the FDIC and the other bank regulators have the power to order a bank to alter its asset portfolio or its operations if the bank is engaged in an "unsafe or unsound practice."[71] Ideally, this allows the regulators to keep bank risk-taking at a level commensurate with the flat-rate premiums charged for deposit insurance. In extreme cases, the regulators can close a bank deemed to be too risky. Bureaucratic supervision as a means of controlling the risk-taking behavior of over 12,000 banks, however, is at best an imprecise means of bringing risk into line with the level of deposit insurance premiums.[72] Under current practice, for example, banks are never closed before their net worth falls substantially below zero.

Consequently, banks can take risks that are borne in part by the FDIC, which, depending on the amount paid in insurance premiums, can amount to a subsidy of risk-taking. This deposit insurance subsidy is not a direct payment to a risky bank; indeed, the bank never receives money from the FDIC. Instead, the bank receives the subsidy simply by taking sufficiently high risks that entail the possibility that it will incur losses greater than the value of its shareholders' equity. If the risks pay off, the shareholders keep the entire return. If the risks do not pay off and losses are greater than the value of shareholders' equity, the FDIC will make up the shortfall to depositors. Thus, unless insurance premiums equal the expected value of losses greater than the bank's equity, deposit insurance constitutes a subsidy. The magnitude of the deposit insurance subsidy varies depending on the degree of risk a bank assumes. The higher the potential losses beyond the value of the shareholders' equity and the greater the likelihood of such losses, the higher the subsidy will be.[73]

The existence of a deposit insurance subsidy, however, does not imply that banks can necessarily increase their risk-adjusted returns by increasing their risk. Competition among banks in a given market could lead banks to pass the subsidy on to their customers, either through lower interest rates on loans or higher rates on deposits. Once a high-risk loan

71. 12 U.S.C. §§ 1818(b), (c) (Supp. I 1989); 12 C.F.R. § 337 (1991).

72. For a discussion of the bureaucratic and political impediments to effectively controlling bank risk-taking, see E. KANE, THE GATHERING CRISIS IN FEDERAL DEPOSIT INSURANCE 7-27 (1985).

73. One way to view the subsidy is as the difference between (a) the sum of the insurance premiums paid to the FDIC and the interest rate a bank must pay on insured deposits (which will generally be close to the risk-free rate), and (b) the rate the bank would have to pay if the deposits were not insured. That difference would depend upon the likelihood that the bank will become insolvent and fail to repay the deposit.

market becomes perfectly competitive, the risk-adjusted profitability of entering that market would be no more than the competitive level. At that point, a bank would be indifferent between entering the risky market and entering a low-risk market that pays a competitive risk-adjusted return. The effect of the subsidy is to increase the relative volume of risky loans by providing an incentive for banks to enter risky loan markets up to the point at which they bid down the rate of return to the competitive level. Banks that enter a risky market early earn a return above the competitive level, but as entry continues, an equilibrium is reached at which the volume of risky loans is higher than it would be without the subsidy, but the return to the banks providing those loans is no greater than a risk-adjusted competitive return.

From a societal point of view, the deposit insurance subsidy has four negative effects. First, credit is misallocated away from lower-risk projects and toward higher-risk projects. Second, credit is misallocated to projects that on an *ex ante* basis are not socially beneficial—for instance projects being financed under the third hypothetical strategy discussed above, the expected losses of which are greater than their expected gains.[74] The "see-through" buildings that dot the Dallas landscape are examples of such projects. Third, the higher level of risk increases the frequency and extent of bank failures, thereby increasing the aggregate cost of resolving failed banks and the dislocation experienced by the clients of those banks. Finally, the deposit insurance subsidy gives the banking industry a competitive advantage over other providers of similar services—securities firms for example—thereby allowing the banking industry to grow at the expense of other types of financial institutions.[75]

2. *Lack of Diversification*

A second source of instability created by the regulatory system is insufficient diversification of risk. Because of geographic restrictions, many banks' loan portfolios are concentrated on borrowers and industries in a limited geographic region. Similarly, activity restrictions prevent banks from reducing risk by diversifying their portfolio of services. As a result, banks are more risky than they could be.

There are approximately 12,000 commercial banks currently chartered in the United States, the vast majority of which serve small geographic markets. In contrast, there are sixty-five banks in Canada, eight of which

74. *See supra* notes 60-62 and accompanying text.

75. *See* White, *supra* note 66, at 13-15.

are very large and six of which operate nationwide.[76] This geographic concentration of individual banks in the U.S. leaves banks exposed to the risk of local or regional downturns.[77] The vulnerability of small banks is reflected in their historically high failure rates compared to larger banks. During the 1920s, 1930s, and 1980s, small banks with few or no branches experienced disproportionately greater rates of failure than large banks.[78]

The uniquely American structure of small, geographically dispersed banks originated when population centers were separated by large distances and communication and transportation technologies limited the efficiency of operating through branch networks.[79] This structure has remained in place, however, largely because of the legal restrictions imposed on branching. Deposit insurance has also helped maintain this structure. Not only is the credit risk of small, poorly diversified banks generally higher than that of larger banks, but their vulnerability to runs—even when they are healthy—is greater than that of larger banks.[80] As the widespread failure of small banks during the 1920s indicates, without deposit insurance depositors are unlikely to have underwritten the unnecessary riskiness of 12,000 small banks.[81]

---

76. Canada has a population of approximately one tenth that of the United States. This population difference, however, explains only a small part of the differential between the two countries. TREASURY REPORT, *supra* note 3, at XVII-17-18. There are approximately 150 banks in Japan, 550 in the United Kingdom, and 900 in Germany. ECONOMIC REPORT OF THE PRESIDENT *supra* note 42, at 158 (1991).

77. *See* L. WHITE, THE S&L DEBACLE: PUBLIC POLICY LESSONS FOR BANK AND THRIFT SUPERVISION 109-11 (1991)(the effect of the Southwest economic downturn on thrifts in the region).

78. C. BREMER, AMERICAN BANK FAILURES 40-47 (1935); E. WHITE, THE REGULATION AND REFORM OF THE AMERICAN BANKING SYSTEM 1900-1929, 218-20 (1983); TREASURY REPORT, *supra* note 3, at XVII-8; Calomiris, *Is Deposit Insurance Necessary? A Historical Perspective*, 50 J. ECON. HISTORY 283, 291-92 (1990).

79. *See* R. ROBERTSON, *supra* note 34, at 27-29. While branch banking systems had existed in several antebellum southern and western states, these branches generally had greater autonomy and local control than those of modern branch systems.

80. Small banks would be even more vulnerable than their credit risk warrants. A rumor, whether truthful or not, regarding an industry on which the bank depends could trigger a run on a poorly diversified bank. If the bank is unable to obtain liquidity assistance, the liquidation of its assets to meet the demands of a run could lead to insolvency. Deposit insurance, however, eliminates the possibility of a run by insured depositors and allows small banks, which generally have few uninsured depositors, to hold undiversified loan portfolios without having to account to depositors. *See* Diamond & Dybvig, *Banking Theory, Deposit Insurance, and Bank Regulation*, 59 J. BUS. 55, 58-60, 62-64 (1986).

81. The relationship between deposit insurance and the structure of the U.S. banking industry was not lost on Congress in 1933. One option before Congress was to reduce branching restrictions as a means of reducing bank failures. In fact, Senator Glass actively supported legislation that would have expanded national banks' branching authority regardless of the powers granted their state-bank competitors. Senator Glass initially opposed deposit insurance. However, in a compromise that

Like the geographic restrictions, the activity restrictions of the Glass-Steagall Act and the Bank Holding Company Act impede diversification. As a result of these restrictions, banks are vulnerable to shifts in demand away from banking services to other financial services.[82]

These limits on the extent to which a bank may expand across geographic or service markets also constrain banks' efficiency. The geographic restrictions potentially prevent banks from exploiting economies of scale that may exist in the provision of certain services. Similarly, the activity restrictions prevent banks from achieving economies of scope among financial services. As long as banks were protected from competition, the loss of these potential efficiencies may not have carried a high social cost. Once banks began to face competition from financial institutions that are not subject to these restrictions, however, the social costs increased substantially.[83]

* * * * *

In sum, since 1933, the structure of the bank regulatory system has contained elements of instability. Banks have been exposed to the risks of regional or local economic downturns and of changes in the demand for banking services. Deposit insurance has prevented banks' misfortunes from being exacerbated by a run, but it has not eliminated banks' exposure to risk. Instead, it has shifted the burden of disciplining risk-taking and reorganizing insolvent banks from the private sector to the public sector. Moreover, as currently structured, deposit insurance potentially subsidizes bank risk-taking, including risk-taking that is wasteful from a societal point of view. As demonstrated during its first forty years of operation, however, the bank regulatory system's weaknesses did not lead directly to actual problems.

---

would determine the shape of the industry for the rest of the century, if not longer, he agreed with Congressman Steagall, Chairman of the House Banking and Currency Committee, to support the establishment of deposit insurance rather than interstate branching in exchange for the congressman's support for the activity restrictions that would become known as the Glass-Steagall Act. Fischer & Golembe, *supra* note 35, at 28-34 (in 1932, the Senate Banking and Currency Committee, which Senator Glass chaired, reported a bill that would have done this); Golembe, *The Deposit Insurance Legislation of 1933: An Examination of Its Antecedents and Its Purposes*, 75 POL. SCI. Q. 181, 195-99 (1960). Preston, *The Banking Act of 1933*, 23 AM. ECON. REV. 585, 597 (1933).

82. Diversification across services may have saved banking organizations involved in securities activities during the Great Depression. In many cases, their securities businesses suffered great losses, but only one bank failed as a direct result of securities affiliate losses. Flannery, *supra* note 16, at 75.

83. *See infra* notes 154-156 and 177-179 and accompanying text (extent of potential economies).

II. PERFORMANCE OF THE BANKING INDUSTRY BEFORE 1980

Despite the potential for instability, the 1933 to 1980 period was one of great stability in the banking industry. One explanation for this stability lies in the effect the regulatory system had on the financial services market during that period.

A. Record of Stability

From 1921 through 1929, bank failures averaged 524 per year, and from 1930 through 1933 they averaged approximately 2,275 per year. Following the passage of the Banking Act, the incidence of failure dropped dramatically. From 1934 through 1942, bank failures averaged approximately 43 per year, which probably reflected unresolved problems that originated before 1933. From 1943 through 1980, the failure rate fell to approximately five banks per year.[84]

This stability is attributable to several factors. First, the macroeconomic environment during this period was conducive to bank stability. Interest rates were stable and the economy was growing. Banks that did not actively seek risk were unlikely to find themselves approaching insolvency. Second, deposit insurance fulfilled its mission of preventing bank runs. Insured depositors no longer responded to either truth or rumor regarding the health of their bank by withdrawing their funds *en masse*.[85] Third, the banking industry's culture of conservatism has been identified as a factor in maintaining stability. Having lived through the personal tragedies of the Great Depression, bankers of the 1940s through 1970s are said to have been risk averse by disposition.[86] Finally, as analyzed below, the bank regulatory system contributed to this stability.

---

84. THE FIRST FIFTY YEARS, *supra* note 42, at 36, 65.

85. Between 1934 and 1980, an average of approximately 52% of the deposits in commercial banks were insured. FEDERAL DEPOSIT INS. CORP., *supra* note 55, at 114. Although uninsured depositors have more of an incentive to run than do insured depositors, the insurance of a portion of a bank's deposits reduces the incentive of even uninsured depositors to run. An uninsured depositor would know that at worst only other uninsured depositors will withdraw their funds, and that even if the bank must liquidate assets to meet the demands of those depositors, only a portion of the bank's assets would have to be sold under stress. Consequently, the bank's solvency would not be as threatened as it would be if the bank faced the possibility of liquidating its entire portfolio. The greater the percentage of deposits insured, the greater will be the protection for uninsured depositors.

86. *See, e.g.*, TREASURY REPORT, *supra* note 3, at I-17; Miller, *The Future of The Dual Banking System*, 53 BROOKLYN L. REV. 1, 7 (1987).

B. The Influence of the Regulatory System on Bank Behavior

An analysis of the incentives created by the bank regulatory system suggests a powerful explanation for the stability of the pre-1980 period—and for the instability that followed. During the pre-1980 period, the separation of banking from other types of financial services insulated the banking industry from competition with other financial institutions. No other institution was permitted to offer the savings, payment, and credit services that banks provided, and none had developed effective substitutes for those services. Moreover, banks were protected from intra-industry competition in many local markets. Branching restrictions and regulatory limits on the issuance of new bank charters restrained competition among banks. In addition, the Banking Act of 1933 prohibited banks from paying interest on demand deposits and authorized the Federal Reserve Board to regulate the rates paid on other deposits. This arrangement had the effect of an industry-wide price-fixing cartel.[87]

Protection from interindustry and intra-industry competition allowed banks to achieve a level of profitability that they could not have achieved under competitive conditions. This profitability has been documented by empirical analysis of bank costs and earnings.[88] It was also reflected in

---

87. Regulation Q, 12 C.F.R. § 217. Throughout most of the 1933 to 1980 period, the interest-rate ceilings set by the Federal Reserve were higher than the interest rates most banks paid. Consequently, they only occasionally restricted interest-rate competition among banks. *See* Gilbert, *supra* note 10, at 24-30. Beginning in the late 1970s, market rates increased to levels above the ceilings and during the early 1980s, the ceilings were removed.

Professor Kenneth Scott coined the term "cartel banking" to describe the regulatory regime during this period. Scott, *The Uncertain Course of Bank Deregulation*, REGULATION, May-June 1981, at 40.

88. *See, e.g.*, Keeley, *Deposit Insurance, Risk, and Market Power in Banking*, 80 AM. ECON. REV. 1183 (1990); Flannery, *The Social Costs of Unit Banking Restrictions*, 13 J. MONETARY ECON. 237 (1984). Banks in some markets may well have engaged in nonprice competition. One obvious example was the notorious bank practice of offering toasters, television sets, and other products in exchange for opening an account at a bank. Another, potentially more damaging, type of competition took the form of banks increasing their branch offices to improve customer convenience. White, *Price Regulation and Quality Rivalry in a Profit-Maximizing Model: The Case of Bank Branching*, 8 J. MONEY, CREDIT & BANKING 97 (1976). Through this competition (which could take place, of course, only in those states that allowed branching or free entry) banks may have expanded the capacity of the banking industry beyond that which would have existed under competitive conditions. When protection from competition ceased to exist, *see infra* Part III, this expansion may have exacerbated the problem of excess capacity and impaired the efficiency of over-expanded banks. A similar sequence of events occurred in the airline industry where prices had been fixed by regulation and were later deregulated. *See* R. POSNER, ECONOMIC ANALYSIS OF LAW 257-58 (3d ed. 1986); Posner, *The Social Costs of Monopoly and Regulation*, 83 J. POL. ECON. 807 (1975).

banks' loan-pricing procedures, which indicated a lack of competition.[89] The availability of supracompetitive profits, or rents, would be expected to offset the deposit insurance subsidy and to reduce both shareholders' and managers' incentives to incur risk.[90]

In analyzing this phenomenon, it is useful to employ the following matrix, the contents of which are discussed below.

Pre-1980 Bank Business Strategies

Risk-Adjusted Return on Assets

	Supracompetitive	Competitive	Sub-Competitive
High Risk	available to banks in protected markets but subsidy offset by threat of losing franchise value	available to banks in unprotected markets	not relevant during pre-1980 period
Low Risk	available to banks in protected markets	available to banks in unprotected markets	not relevant during pre-1980 period

The six cells of the matrix represent a simplified set of alternative business strategies for a bank. Each strategy is characterized by a level of risk—either high risk or low risk—and a level of risk-adjusted return on assets, measured in relation to the return that would be achieved under conditions of perfect competition. "High risk" is defined as a strategy that entails a significant possibility that the bank will become insolvent and thus subject to closure by the FDIC. "Low-risk" is defined as any lower level of risk. For example, the strategy represented by the top left cell involves a high level of risk and a risk-adjusted return that is greater than the level that would be achieved under conditions of perfect competition.[91]

89. *See, e.g.*, Brady, *Changes in Loan Pricing and Business Lending at Commercial Banks*, 71 FED. RESERVE BULL. 1 (1985) (loan pricing tied to a "prime" rate, which was a relatively arbitrary benchmark that facilitated parallel pricing practices).

90. Keeley, *supra* note 88, at 1190-98 (providing empirical support for this effect).

91. Each of these "strategies" could represent a wide range of actual business strategies, which would include specific mixes of customer targeting, marketing and financing. The reduction of each strategy to two variables—risk and return—is a simplification, but these variables are all that is needed for the analysis that follows.

This analysis, which is repeated in Part III for the post-1980 period, proceeds as follows. The first step is to determine the availability of each of the six strategies. The next step is to analyze how rational bank shareholders and managers would select from among the available strategies. The final step of the analysis is to draw inferences regarding the effect of the regulatory system on the performance of the banking industry. Inferences regarding the pre-1980 period will be compared below to inferences regarding the post-1980 period and will be used as a basis for analyzing bank regulatory reform.[92]

Protection from competition during the pre-1980 period would be expected to afford banks the opportunity to earn supracompetitive returns on assets, and indeed there is empirical evidence that banks in fact earned such returns. Because this protection depended on local market conditions and on state branching laws and chartering practices, however, not all banks could earn supracompetitive returns.[93] Thus one can think of banks during this period as being divided into two groups, one of which operated in protected markets and one of which operated in competitive markets.[94]

Protection from competition had two effects on banks. First, it allowed them to earn supracompetitive returns. Thus, banks could pay below-market interest rates for deposits, or charge above-market rates for loans, or both.[95] Consequently, the Low-Risk Supracompetitive-Return Strategy was available to banks that enjoyed this protection. This strategy could have involved, for example, providing traditional banking services in a market in which branching and entry were restricted.

Second, banks that enjoyed protection from competition would have

92. The analysis that follows draws inferences regarding bank behavior—specifically the selection of a business strategy—based on market structure, which in this industry is heavily influenced by the regulatory regime. This form of analysis necessarily involves generalization. Individual banks have unique sets of strengths and weaknesses, which influence their behavior. As a result, a particular bank that operates in a protected market, for example, may not be able to earn a supracompetitive return, and, in the short run at least, it may not be taken over by a group of managers or shareholders that can. This possibility, however, does not invalidate the inference that banks in protected markets will generally adopt strategies that achieve supracompetitive returns.

93. Keeley, *supra* note 88, at 1190-98 (empirical analysis demonstrating that some banks earned rents as a result of regulatory protection in local markets and that those that did took less risk). The capitalized value of the rents were embedded in the rates a bank paid on deposits or earned on loans.

94. The interest-rate ceilings alone did not eliminate competition because they were set above the prevailing rates through most of the 1933 to 1980 period, and because banks could compete on the basis of factors other than price. *See supra* notes 87-88.

95. *See* Keeley, *supra* note 88, at 1192.

been penalized for adopting high-risk strategies. In addition to losing their net worth in the event of a failure, in all likelihood they would have lost an additional value known as "franchise value," which represents a bank's ability to earn profits in the future and which would be reflected in the market value of a bank's equity.[96] The more profitable a bank is, the greater will be its franchise value. Thus, a bank that operated in a protected market risked forfeiting a high franchise value to the FDIC if it were to allow its net worth to fall to zero.[97]

The penalty of forfeiting franchise value would have offset the deposit insurance subsidy for banks in protected markets up to a certain level of risk.[98] In order to extract a subsidy greater than the penalty, a bank would have had to adopt a strategy that carried such a high risk that potential losses exceeded the sum of the bank's net worth and its

96. To avoid double counting, franchise value should be measured by taking the net present value of the bank's future profits and subtracting an amount equal to its net worth.

97. When the FDIC enters into a purchase and assumption transaction, it in effect sells the failed bank's franchise to the acquiring bank. If the franchise value were greater than the negative net worth of the failed bank, the FDIC would be required to pay the shareholders of the failed bank an amount equal to the difference. That is, the FDIC has no authority to make a profit when closing a failed bank. In such a case, the bank would not lose its franchise value. In fact, however, the shareholders of a failed bank never receive such a payment. This may be due to: (1) a delay prior to closing a failed bank during which time negative net worth may increase to a magnitude greater than franchise value; (2) inefficiency in the FDIC's auction process for purchase and assumption transactions; (3) inefficiency in the FDIC's sale of the assets that an acquiror may choose to leave with the FDIC; or (4) the administrative costs of the FDIC's resolution. To the extent that a bank continues to take risk and to incur losses that exceed its going concern value, the loss of its franchise value is not a penalty. Loss of franchise value attributable to causes (2) through (4), however, is a penalty. This distinction is not made in Keeley, *supra* note 88. His empirical results imply, however, that banks at least expect some penalty in the event of a failure.

98. Keeley, *supra* note 88, at 1185-86; Marcus, *Deregulation and Bank Financial Policy*, 8 J. BANKING & FIN. 557 (1984) (formal model of relationship between franchise value and risk-taking).

This effect can be illustrated using the hypothetical strategies described in Section I-A. Recall that the three alternative strategies offered expected values of $25, $50, and $50 to the bank shareholders. If a bank had a franchise value of $100, which it would lose in the event of a failure, the expected values of the second and third strategies would change. (The expected value of the first strategy would not change because that strategy did not entail a possibility of failure.) Each of the second and third strategies involved a fifty percent chance of failure. Therefore, the expected value of these strategies would decline by $50 (.5 x $100) to $0, leaving the first, low-risk strategy the most attractive.

Because banks are closed or otherwise resolved when their net worth falls to zero on a book value basis, a going concern value greater than book value net worth does not effect the time of the closing. A bank with going concern value above its book value net worth would be closed when its book value net worth falls to zero. The bank's shareholders would lose the residual going concern value of the bank when the bank is resolved, and the FDIC would theoretically realize that value when it, in effect, sells the going concern value to an acquiror of the failed bank. *See supra* notes 49-51 and accompanying text (purchase and assumption transactions).

franchise value.[99] Depending on a bank's level of profitability, this may well have required such a high level of risk-taking that the regulators would have been able to prevent it.[100] Thus, one can infer that the availability and the magnitude of the deposit insurance subsidy were not limited for a major segment of the banking industry during this period. Moreover, depending on the level of a bank's profitability, the cost of the prospective forfeiture of its franchise value could have offset the deposit insurance subsidy entirely, and could have been even greater than the value of the deposit insurance subsidy for any feasible range of risk-taking. Consequently, for banks that enjoyed protection from competition, the High-Risk Supracompetitive-Return Strategy could well have been subject to a net tax.[101]

The effect of a bank's forfeiture of its franchise value is similar to the effect of a deductible on risk-taking by an insured. A higher deductible requires the insured to bear more of the cost of the insured-against event. Accordingly, the insured can be expected to take greater care in avoiding that event.[102] For shareholders of banks in protected markets, therefore, the Low-Risk Supracompetitive-Return Strategy may well have been more attractive than the High-Risk Supracompetitive-Return Strategy. Moreover, bank managers' preferences would have led them to adopt the Low-Risk Supracompetitive-Return Strategy. Because they are disproportionately invested in their jobs, managers generally prefer low-risk strategies over high-risk strategies. Consequently, one would expect the protected segment of the banking industry to adopt the Low-Risk Supracompetitive-Return Strategy.

For banks that did not enjoy protection from competition, a supracompetitive return was not generally available. These banks would

99. *See supra* note 96 (the relationship between net worth and franchise value).

100. The bank regulators' job was easier when most banks provided a similar set of services and served similar markets. In addition, because brokered deposits were not available during most of this period, a bank could not very easily raise new funds and irrevocably alter its risk profile in between examinations. Regulators, therefore, may have been able to detect increases in risk-taking earlier in the process.

101. The tax would have been equal to the difference between the expected value of the deposit insurance subsidy and the (greater) expected value of the forfeiture of the franchise.

102. The shareholders' loss of franchise value could also be viewed as analogous to coinsurance. Because a bank is deemed insolvent, and the FDIC's contingent liability becomes payable, when a bank becomes insolvent on a book value basis, one could characterize the resolution of a bank with residual franchise value as one in which the FDIC makes a payment to the insured depositors and the bank's shareholders make a payment to the FDIC equal to the amount of the bank's franchise value.

have had available either the High-Risk Competitive-Return Strategy or the Low-Risk Competitive-Return Strategy. Some banks that adopted the former would have extracted the deposit insurance subsidy but then passed it on to either depositors or borrowers as a result of competition, retaining only enough of the subsidy to provide a risk-adjusted normal return to shareholders.[103] Banks that adopted the Low-Risk Competitive-Return Strategy would have earned unsubsidized competitive profits by conservatively providing traditional banking services.[104]

Assuming that shareholders of unprotected banks hold perfectly diversified portfolios, they would have been indifferent between the two competitive-return strategies.[105] Bank managers, however, would have preferred the Low-Risk Competitive-Return Strategy,[106] particularly because there would have been no sacrifice of shareholder interests entailed in adopting this strategy.

In sum, the stability of the banking system between 1933 and 1980 seems to be attributable at least in part to the incentives created by the regulatory system. The protection from competition that a segment of the banking industry enjoyed created a penalty for risk-taking that offset the deposit insurance subsidy and that, for banks with very high franchise values, could have created a net tax for risk-taking.[107] As a result, one would expect a low level of risk-taking within this part of the industry. For banks that operated in competitive markets, managerial preferences for low levels of risk, along with shareholder indifference to risk, would also be expected to lead to a low level of risk-taking, although

103. *See supra* notes 73-74 and accompanying text (effect of competition on the subsidy).

104. The Sub-Competitive-Return Strategies were also available. However, the availability of more competitive options rendered these strategies unnecessary. They are therefore not considered in this stage of the analysis.

105. The assumption that shareholders hold a diversified portfolio of investments is reasonable in the context of a publicly held bank. In the context of a privately held bank, where at least some large shareholders may be managers as well, shareholders may not have diversified portfolios. Presumably they would be risk averse. To the extent they are, their incentives would be similar to those of managers. For a theoretical analysis of the incentives of both shareholders and managers of a bank to take risk, see Furlong & Keeley, *Bank Capital Regulation and Asset Risk*, ECONOMIC REVIEW, Spring 1987, at 20 (Federal Reserve Bank of San Francisco).

106. The expectation that bank managers would avoid risk is consistent with the popular image of bankers at the time, who were sometimes referred to as leading the "3-6-3 life"—borrow at 3%, lend at 6%, and be on the golf course by 3:00 p.m.

107. To the extent this was true, there would have been a socially undesirable *underinvestment* in risky projects during this period. This may have been reflected in the low bank failure rate during this period. In addition, the inefficiencies that generally occur in the absence of competition were another cost society paid for this period of stability.

one would have expected to find some high risk-taking within this segment of the industry.

III. PERFORMANCE OF THE BANKING INDUSTRY AFTER 1980

The period of stability in the banking industry ended in the late 1970s.[108] Although the regulatory system had remained largely unchanged, the market for financial services had changed dramatically. Incentives that had previously promoted stability dissipated, and the inherent destabilizing elements of the regulatory system appear to have had a dominant effect on the industry's performance.

A. Record of Instability

In 1980, there were 10 bank failures involving approximately $236 million in bank assets. In 1985 there were 120 failures involving approximately $9 billion in assets. And in 1988 and 1989 there were 200 and 206 failures respectively, involving a total of approximately $65 billion in assets.[109] From 1980 to the end of 1989, the FDIC's insurance fund fell from a level of 1.16% to .7% of insured deposits, its lowest level ever.[110] Furthermore, the savings and loan industry, which had unique problems but operated in a regulatory and economic environment somewhat similar to that of the banking industry, experienced failures that, at current government estimates, will cost the taxpayer between $130 billion and $176 billion in deposit insurance payments.[111]

B. The Modern Market For Financial Services

The market for bank services has changed dramatically in the last 15 years. Until the mid-1970s, banks were the primary repository of savings, and the primary providers of short-term credit for a substantial segment of American business. In addition, banks had become major providers of home mortgage and consumer financing. In short, the regu-

108. Recall that the use of 1980 as a transition year is necessarily artificial. *See supra* note 5.

109. FEDERAL DEPOSIT INS. CORP., *supra* note 55, at 101.

110. *Id.* at 114.

111. ECONOMIC REPORT OF THE PRESIDENT, *supra* note 42, at 167 (1991). Unlike banks, savings and loan associations were legally required to hold a high proportion of thirty-year fixed-rate loans in their portfolios, which were financed by short-term deposits. Consequently, savings and loans were much more vulnerable to interest rate risk. For a discussion of the causes of the savings and loan failures and the similarities between the regulatory environment of the savings and loan and the banking industries, see L. WHITE, *supra* note 77; E. KANE, THE S & L INSURANCE MESS: HOW DID IT HAPPEN (1989).

latory system was effective in holding back market forces to maintain the banking industry's protected preserve. Beginning in the mid-1970s, however, technological and market forces began to erode the industry's privileged position.

As other authors have demonstrated, by the early 1980s, the banking industry had lost its captive markets.[112] Banks now compete for deposits with mutual funds, securities firms, and thrifts, all of which provide accounts that to many holders offer most of the services that bank accounts offer, plus, in some cases, additional services such as convenient means of making securities purchases and sales.[113]

Furthermore, many of banks' traditional borrowers, including essentially all blue chip corporations, now obtain short-term credit directly from anonymous lenders in the commercial paper market at rates that cannot support the banks' overhead. Other businesses as well as individuals borrow from finance companies, which fund themselves with commercial paper. Among these finance companies are affiliates of major commercial and industrial firms, including, for example, General Motors, General Electric, AT&T, and Sears, Roebuck. In 1980, the ratio of bank loans to commercial paper outstanding was over two to one. In 1989, that ratio had fallen to 1.2 to one.[114] Banks also have lost lending business to the markets for securitized mortgage loans, car loans, consumer loans, and other loans that can be repackaged into securities and traded on securities markets.[115] Although banks earn fees for providing stand-by letters of credit for commercial paper and for originating loans that are later securitized, the returns available for holding these loans has fallen.[116]

In addition, intra-industry competition among banks has increased.

---

112. Eisenbeis, *Regulation and Financial Innovation: Implications for Financial Structure and Competition Among Depository and Non-Depository Institutions*, 4 ISSUES IN BANK REG., Winter 1981, at 15; R. LITAN, WHAT SHOULD BANKS DO? 41-49 (1987); TREASURY REPORT, *supra* note 3, XVIII-9-12; Macey & Miller, *America's Banking System: The Origins and Future of the Current Crisis*, 69 WASH. U.L.Q. 769 (1991); Rosenblum & Siegel, *Competition in Financial Services: the Impact of Nonbank Entry*, in PROCEEDINGS OF A CONFERENCE IN BANK STRUCTURE AND COMPETITION 1 (Federal Reserve Bank of Chicago, 1983); Swire, *The Good Old Days Disappear in Banking Regulation*, VA. L. REP., Summer 1991, at 21.

113. TREASURY REPORT, *supra* note 3, at XVIII-9-10.

114. *Id.* at I-26 (fig. 10). In 1960 the ratio was close to ten to one. *Id.*

115. *Id.* at I-26 (fig. 12).

116. For a discussion of bank strategies in the face of shrinking margins on securitized debt, see Kantrow, *As U.S. Consumers Change, So, Too, Must Banks' Tactics*, Am. Banker, April 23, 1991, at 1, col. 1.

Large deposits are now placed in banks by brokers with nationwide access to funds and a nationwide clientele of banks that accept those deposits. Much of the deposit market has thus become national in scope. States have also eased their restrictions on geographic expansion. Intrastate branching is permitted in many states, as is interstate expansion through holding company affiliates. Finally, the Federal Reserve Board has allowed banks to open "loan production offices" outside the state in which they are headquartered. Thus many local loan markets have been opened to increased competition among banks.[117]

Finally, the macro-economic environment in which banks operated also changed between the 1970s and 1980s. Interest rates rose sharply in 1979 and have been volatile since then.[118] The initial increase in interest rates caught some banks with mismatched asset and liability maturities. These banks were forced to pay higher interest rates to retain their deposits, but they continued earning low interest rates on their existing loans. On a market-value basis, those banks suffered a decline in their net worth as a result of the devaluation of the fixed-rate loans they made before 1979.[119] Moreover, after the initial rise, interest rate volatility had two effects on banks. It challenged bank managers, who had little experience in managing interest-rate risk, to adopt methods of protecting banks from swings in interest rates; and it offered banks ready opportunities to take risk if they chose to do so.

As a result of these changes in the financial services markets, bank profitability has declined substantially since the late 1970s. Banks' average return on equity during the period 1975 to 1979 was 12.38%. For the periods 1980 to 1984 and 1985 to 1989, return on equity fell to 12.13% and 8.88%, respectively. Behind these figures, however, there is a wide variation in the profitability of different segments of the banking industry. Most notably, the money center banks, which were directly affected by the expansion of the commercial paper market, experienced a decline in their return on equity from 13.06% during the first half of the 1980s to 3.37% during the second half.[120] Moreover, the riskiness of

117. TREASURY REPORT, *supra* note 3, at I-26 (fig. 11). For a more complete discussion of the ways in which interstate competition among banks has increased, see Miller, *supra* note 40, at 183-87.

118. TREASURY REPORT, *supra* note 3, at I-25 (fig. 8).

119. This effect was devastating for savings and loan institutions, which had been legally required to hold long-term home mortgage loans financed by short-term deposits. *See* L. WHITE, *supra* note 77, at 61-65.

120. Danker & McLaughlin, *Profitability of Insured Commercial Banks in 1984*, 71 FED. RE-

banks increased during this period. This increased risk is reflected not only in the bank failure statistics cited above, but also in the increasing rate of loan chargeoffs. During the 1970s, net loan chargeoffs were .39% of loans and leases. That figure increased to .57% during the first half of the 1980s, and to .99% during the second half of the 1980s.[121] This increase in bank riskiness is similarly reflected in the interest rates banks pay on their nondeposit liabilities. The risk premiums embedded in these rates rose substantially in 1979 and have remained high since then.[122]

The decline in bank profitability and the increase in bank risk have been reflected in declining values of publicly traded bank stocks. In 1975, the Salomon Brothers 35 Bank Index was fifty-five percent of the Standard and Poor's 500 Stock Index. By 1980, it had declined to approximately fifty percent, and by 1989, it had fallen to thirty-eight percent.[123]

A portion of the decline in risk-adjusted bank profitability can be attributed to the loss of supracompetitive returns that banks suffered due to increased competition. The loss of protection from competition would be expected to cause returns to bank shareholders to fall to competitive risk-adjusted levels. The returns of many banks, however, may well have fallen below those levels.

The recent entry of nonbank financial institutions into markets previously reserved for banks appears to have created a situation in which banks have become relatively inefficient producers in markets with excess capacity.[124] Generally, when excess capacity exists in an industry, com-

SERVE BULL. 836, 842 (1985) (charting return on equity for 1980-1985); Duca & McLaughlin, *Developments Affecting the Profitability of Commercial Banks*, 76 FED. RESERVE BULL. 477, 483 (1990) (same for 1985-1989); Opper, *Profitability of Insured Commercial Banks, 1979*, 66 FED. RESERVE BULL. 691, 699 (1980) (same for 1973-1979). *See also* TREASURY REPORT, *supra* note 3, at I-25 (fig. 7) (downward trend in return on assets).

121. TREASURY REPORT, *supra* note 3, at I-25 (Table 6).

122. Carroll & Rolnick, *After Penn Square: The Insurance Dilemma* in PROCEEDINGS OF A CONFERENCE ON BANK STRUCTURE AND COMPETITION 243, 250-53 (Federal Reserve Bank of Chicago, 1983). Furlong, *Changes in Bank Risk Taking*, ECON. REV., Spring 1988, at 45.

123. TREASURY REPORT, *supra* note 3, at I-25 (fig. 9).

124. Excess capacity in this context refers to the quantity of assets devoted to the banking business, which is not necessarily related to the quantity of banks in the industry. I am not aware of any empirical studies of bank capacity and its use. The pattern of declining profitability and increasing failure, along with new entry by nonbank firms into banking markets, are consistent with the presence of excess capacity. In addition, observations of bankers that they must change their business strategies to rely less on traditional lending, and predictions of a shrinkage of the banking industry, support this view. *See, e.g.*, Roosevelt, *What's Ahead? Fewer Banks, Fewer Bankers, Fatter Profits*, Am. Banker, April 16, 1991, at 1, col. 1; Lipin, *As Loans Slip, Banks Push New Products and Strategy*, Am. Banker, April 30, 1991, at 1, col. 1.

petition drives prices below the competitive level. The least efficient firms fail, and other firms redeploy their resources to new markets through internal expansion or merger and acquisition. In such a situation, prices are set below the average cost of the industry until the excess capacity is withdrawn. The most efficient firms may be able to set prices equal to their average cost[125] and thereby earn a risk-adjusted market rate of return on their assets under these conditions.[126] Other firms, however, cannot cover their fixed costs. Those that can sell at prices above their average variable costs continue to operate until they can no longer maintain their fixed assets. Those that cannot cover their variable costs should cease operation. Depending on the value of its assets to other firms, a firm forced to set prices below average total cost might be better off selling assets or merging with another firm that can use its assets more efficiently either within the same industry or in another industry. A firm that cannot set prices above average variable cost would necessarily be better off selling its assets or merging.

To the extent that excess capacity exists in segments of the banking industry, one would expect lower profits, failures, and reorganizations of banks and their affiliates. Although additional empirical work would be enlightening, there is reason to believe that the bank regulatory system has distorted this adjustment process in a way that has increased bank failures, reduced profitability, and impeded the redeployment of bank resources to more efficient uses.

C. *Influence of the Bank Regulatory System on Bank Behavior*

The influence of the bank regulatory system on the banking industry has changed dramatically since 1980. In response to the entry of other financial institutions into banks' traditional markets, some banks have experienced pressure to redeploy their resources to other markets. The bank regulatory system, however, has impeded this process by restricting the parties that may purchase bank assets or merge with banks. As a result, pressure created by excess capacity has been concentrated in those markets in which banks are permitted to operate. If this were the only

125. This would include fixed and variable costs.

126. F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 112-14 (2d ed. 1980). Rigidities that impede the reallocation of capital create this type of situation. In the case of the banking industry, one rigidity discussed below is the regulatory system. Another well known example of a market with excess capacity is the textile manufacturing market. Many low-cost producers from less developed countries have entered this market. *Id.*

effect of the regulatory system, one would expect to find a greater than optimal level of bank failure. By subsidizing banks that take high levels of risk, however, the regulatory system compounds the distortion. The deposit insurance subsidy creates an outlet for banks needing to escape markets in which nonbanking firms have become the most efficient producers. The availability of the subsidy allows banks to redeploy their resources into high-risk loan markets. This section analyzes the effect of bank regulation on banks' responses to the post-1980 market conditions and suggests that regulation may at least partially explain the poor performance of the banking industry during the post-1980 period.

Banking organizations operating in markets in which nonbanks have entered have a choice in the long run between moving to new markets that do not have excess capacity or remaining in their current markets and achieving a sufficiently high level of efficiency to compete with other banks and with nonbank entrants. Otherwise, they will eventually fail. Regulatory restrictions, however, limit the ability of banking oganizations to respond in either of these ways. By constraining the services banking organizations may provide, the regulatory system impedes their ability to redeploy resources from banking markets with excess capacity to other financial services markets. In addition, the system impedes banking organizations from achieving economies of scope by expanding across product and service markets.

Deposit insurance has also influenced banks' ability to respond to the influx of nonbank financial institutions into their traditional markets. Although deposit insurance has always subsidized risk-taking, regulatory protection from competition during the pre-1980 period offset the subsidy by creating enhanced bank franchise values for many banks. The erosion of bank profitability in the 1980s, however, reduced bank franchise values and thereby unharnessed the deposit insurance subsidy of risk-taking. The increased availability of the deposit insurance subsidy had the effect of increasing the attractiveness of high-risk business strategies even in the absence of nonbanking competition. Because the subsidy is available only to banks, however, the deposit insurance subsidy gives banks an advantage over other financial institutions in providing high-risk loans. In competing to provide a high-risk loan, if all other factors are equal, a bank would be able to out-bid a nonbank as a result of the deposit insurance subsidy. Moreover, the arithmetic of the subsidy offers

the greatest advantage to the least profitable banks.[127] Banks whose profitability has declined as a result of excess capacity, therefore, have a particularly strong incentive to adopt higher-risk strategies.

The same matrix used above is helpful in analyzing this dynamic.

Post-1980 Bank Business Strategies

Risk-Adjusted Return on Assets

	Supracompetitive	Competitive	Sub-Competitive
High Risk	unavailable during post-1980 period	subsidized — available to the most efficient banks in markets with excess capacity	subsidized— pursued by less efficient banks in markets with excess capacity
Low Risk	unavailable during post-1980 period	available to banks in markets with no excess capacity	precluded by shareholders

The changes that have occurred in the financial services market since 1980 eliminated the possibility that banks can earn supracompetitive returns on a sustained basis.[128] Either interindustry or intra-industry competition would preclude such profitability. Even banks that avail themselves of the deposit insurance subsidy are forced by competitive pressure from other banks to pass the subsidy on to borrowers and depositors, leaving banks at best with competitive returns. Consequently, neither Supracompetitive-Return Strategy is generally available to banks.

At best, the Competitive-Return Strategies are available. These strategies are available to banks that operate in markets without excess capacity. An example of this type of market is a community bank market in which banks have not lost their loan clientele.[129] Both the High-Risk and the Low-Risk Competitive-Return Strategies are available in this

127. When a bank's going concern value (market value net worth plus any additional franchise value) increases, its subsidy decreases. *See supra* notes 96-97 and accompanying text.

128. Some banks may have unique attributes that allow them to earn supracompetitive profits. The point here is that with competition, this should occur rarely.

129. *See, e.g.*, Klinkerman, *Small Banks, Stars of the '80s, Gird for Tough Fight Ahead*, Am. Banker, May 7, 1991, at 1, col. 1 (describing small bank success in "[s]ticking to their home markets").

type of market. Managerial incentives, however, would create a bias toward the Low-Risk Competitive-Return Strategy.

Banks that operate in markets with excess capacity could also adopt a Competitive-Return Strategy if they are, or can become, efficient relative to competing banks and other financial institutions. Because deposit insurance gives banks a competitive advantage over other financial institutions in pricing high-risk loans, however, one would expect these banks to tend to adopt the High-Risk Competitive-Return Strategy rather than the Low-Risk Competitive-Return Strategy.[130]

The remaining banks—the less efficient banks in excess capacity markets—do not have a Competitive-Return Strategy available. Among those banks, a conflict between management and shareholders could arise. If such a bank had the opportunity to merge with another firm that could use the bank's assets more efficiently, the shareholders would prefer to merge rather than to earn returns on the bank's assets that are lower than the risk-adjusted market rate.[131] If a merger partner is not available, the shareholders would prefer to liquidate so long as the expected proceeds of the liquidation are greater than the present value of the bank's future earnings. Managers of these less efficient banks, on the other hand, would seek to avoid the loss of autonomy and the loss of jobs that would accompany either a merger or a liquidation. One would expect managers, therefore, to attempt to disguise the fact that their shareholders would be better off with a merger or liquidation. Empirical analyses have shown that shareholders can indeed be misled in this way when banks assume high levels of risk. This can occur because the riskiness of a bank's loan portfolio is inherently difficult to assess.[132] High current returns may appear satisfactory to shareholders if they cannot

130. To the extent that a bank has both strategies available, however, managerial incentives would create a bias toward the adoption of the Low-Risk Strategy with no sacrifice of shareholder interests.

131. The issue here is whether the present value of the expected profits of the bank are greater than or less than the expected proceeds of a merger.

132. Randall, *Can the Market Evaluate Asset Quality Exposure in Banks*, NEW ENG. ECON. REV., July-Aug. 1989, at 3 (Federal Reserve Bank of Boston); Gilbert, *Market Discipline of Bank Risk: Theory and Evidence*, 72 ECONOMIC REVIEW, Jan.-Feb., 1990, at 3 (Federal Reserve Bank of St. Louis)(reviewing empirical studies of market discipline and criticizing Randall's study). The theoretical explanation of this phenomenon is that banks specialize in holding assets that are costly to evaluate. Their comparative advantage over the securities markets in providing credit lies in their ability to assess the idiosyncratic risk of a project or enterprise. Bank portfolios thus consist of a large number of loans, the riskiness of which is difficult to ascertain. One would therefore expect shareholders to be less than perfect in assessing bank profitability. Diamond & Dybvig, *supra* note 80, at 58-60.

accurately assess the underlying riskiness of the bank's portfolio. Thus managers of banks that cannot earn a competitive profit can be expected to adopt the High-Risk Sub-Competitive-Return Strategy in an attempt to avoid shareholder pressure to merge or liquidate.[133]

In addition, a special scenario of bank risk-taking occurs when a bank is close to insolvency and faces the immediate threat of regulatory closure. The closure of a bank exacts a penalty from management in lost jobs and damaged reputations, and from shareholders in the loss of equity remaining in the bank.[134] As the threat of regulatory closure increases, managers have a particularly strong incentive to adopt a high-risk strategy, regardless of the prospective risk-adjusted return from the gamble. If they take risks that pay off quickly, they may be able to restore the bank's capital to a level that prevents closure, and buy time in which to reassess their long-term strategy. The managers of a bank that is about to be closed have nothing to lose by adopting such a strategy. Depending upon the expected proceeds of voluntary liquidation and the availability of merger partners, bank shareholders may have an incentive to take this gamble as well. Moreover, even if a voluntary liquidation or merger would be more attractive to shareholders than risking their remaining equity in a gamble that carries a below-market rate of return, managers may be able to prevent shareholders from evaluating the gamble in time to prevent them from taking it. Consequently, as regulatory closure approaches, banks are likely to adopt very high-risk strategies.

The incentives of banks earning below-market profits, including those facing immediate closure, would exist with or without the deposit insurance subsidy. The subsidy, however, increases a bank's expected return from risk-taking and thereby expands the volume of high-risk business available to banks at a given rate of risk-adjusted return. In addition, by

133. Ordinarily, one would expect management of a corporation to be biased in favor of assuming a low level of risk. Overinvestment in their jobs tends to make managers averse to the risk of failure, which normally leads them to manage in a manner that avoids risk. In the context of an unprofitable bank, however, managers' most pressing concern is either closure by the regulator or shareholder pressure to merge or liquidate. To the extent that managers can deceive the regulator and shareholders by increasing risk, their interest in keeping their jobs would lead them to do so.

134. When the FDIC resolves a bank, even in a purchase and assumption transaction, it almost always forces management to resign. In addition, if a bank regulator determines that a bank is operating in an unsafe or unsound manner or that it is in an unsafe or unsound condition, it often forces management resignations. *See* Bovenzi & Muldoon, *supra* note 51, at 5-6. Because regulatory closure decisions are based on findings of insolvency made on the basis of historical cost accounting, even a bank that operates in a competitive market may have positive equity at the point of closure.

eliminating the need for depositors to assess the riskiness of a bank before making a deposit, deposit insurance allows a bank to raise funds very quickly. This in turn allows a bank to make new loans or other investments and thereby increase its risk quickly. The services of deposit brokers further facilitate this process. The result is that with deposit insurance bank managers are more likely to be able to adopt a high-risk strategy without the regulator's or their shareholders' knowledge than if deposit insurance were not available.[135]

In sum, the combination of excess bank capacity and deposit insurance has created two sources of bias toward risk-taking. First, efficient banks can compete most effectively against nonbank competitors by increasing their risk and thereby extracting the deposit insurance subsidy. Second, the best opportunity for managers of inefficient banks to avoid liquidation, merger, or forced closure is to increase risk.[136]

There remains a question regarding the extent to which the increased risk observed in the banking industry since 1980 is attributable to deliberate decisions to take risk in response to the incentives discussed above. Environmental factors, including regional and sectoral recessions, surely have been at work as well. Although it is difficult to attribute riskiness to one or the other cause, and although additional empirical work would be useful, there is empirical support for the hypothesis that a major portion of bank riskiness during this period was the result of bank managers' deliberate decisions.

---

135. This problem could exist even if deposit insurance were priced correctly. To eliminate the problem, the deposit insurer would have to reprice insurance continuously, or at least at any point at which a bank proposes to make a large volume of new investments. Alternatively, growth restrictions could be imposed on banks, or the ability to raise deposits rapidly could be restricted by, for instance, limiting the use of brokered deposits. *See infra* notes 215, 218-219 and accompanying text.

Constraints on the market for control of banks—including the limitations on bank affiliates and regulatory control over the bank acquisitions—also reduce the pressure on bank managers to act in the interest of shareholders. *See* Macey & Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1212-25 (1988).

136. In addition, a secondary effect of increased risk-taking in the banking industry is to create pressure on banks that have the option of pursuing low-risk strategies. Consider, for example, a low-risk bank that competes with a bank that has just decided to pursue a high-risk strategy. In order to pursue that strategy, the latter bank would have to raise a high volume of funds in order to finance new risky investments. Consequently, the bank would have to raise the interest rates it pays on deposits. In order to keep its deposits, the low-risk bank might have to raise its rates as well. The low-risk bank would find it difficult, however, to pay high interest rates to depositors and yet continue to earn low returns on its loan portfolio, even if the portfolio carries a very low level of risk. The low-risk bank, therefore, may be forced to seek higher-risk loans that pay an interest rate commensurate with the rate it is paying depositors. The practice of deposit brokerage, which creates a nationwide market for deposits, exacerbates this problem.

In 1988, the Office of the Comptroller of the Currency released a study of bank failures that concluded that eighty percent of the banks that failed between 1979 and 1987 had "overly aggressive" management. The study found that banks that failed during this period had disproportionately pursued high-growth strategies. Although a high rate of growth does not necessarily imply a high level of risk, these observations are consistent with the hypothesis that bank managers actively sought to increase risk by making substantial changes in their portfolios. The Comptroller's study further found that the boards of directors of banks that failed were disproportionately uninformed regarding the bank's business, which supports the hypothesis that bank management can prevent shareholders from becoming aware of the fact that they have adopted a high-risk strategy.[137] Another study of bank failures, the findings of which are consistent with the Comptroller's study, revealed that many failed banks had pursued strategies of rapid loan growth fueled by lending outside their normal area of business. Again, this implies that a deliberate change of strategy had occurred. That study found that those banks charged rates of interest substantially above regional averages, which further supports the hypothesis that bank risk-taking was part of a deliberate business strategy.[138]

IV. OBJECTIVES OF BANK REGULATORY REFORM

The overarching goal of bank regulatory reform should be to allow banks and their affiliates to respond to evolving market forces, both in determining the services to provide and the level of risk to assume. Under an ideal regulatory regime, banks would pursue business strategies that offer a market rate of return to their shareholders with no subsidy. Bank resources would thus be put to their most productive uses and socially wasteful projects and enterprises would not be financed.

To achieve this ideal, regulatory reform should eliminate barriers that

137. COMPTROLLER OF THE CURRENCY, BANK FAILURE: AN EVALUATION OF THE FACTORS CONTRIBUTING TO THE FAILURE OF NATIONAL BANKS (1988). Among this study's findings were the following: Among banks that failed, 51% had excessive loan growth in relation to management capability and funding sources, 73% had made loans that were high relative to the borrower's ability to service its debt, and 37% had unwarranted concentrations of credit to one industry. *Id.* at 5-7. In addition, the study found that incompetence was a major source of bank failure.

138. Booker, *Management Errors Litter the Steps to the Closed Doors of '82*, ABA BANKING J., July 1983, at 31. *See also* Keeton & Morris, *Why Do Banks' Loan Losses Differ?* 72 ECONOMIC REVIEW, May 1987, at 3 (Federal Reserve Bank of Kansas City)(concluding on the basis of statistical analysis that deliberate risk-taking does occur).

impede banks from increasing their efficiency within banking markets and from redeploying resources into other financial services markets in which they may be put to more productive use. Thus, the restrictions on service and geographic expansion ideally should be eliminated to allow banks the opportunity to diversify risk, to achieve economies of scale and scope, and to facilitate the transfer of resources out of banking markets with excess capacity. In addition, the deposit insurance subsidy should be eliminated to the extent feasible.

Under such a regime, banks currently in markets with excess capacity would have the opportunity either to increase their efficiency and remain in those markets or to redeploy their resources into other markets. Banks could no longer gain an advantage over nonbank competitors by increasing risk. Furthermore, under this type of regime the market for bank control would have a wider range of potential acquirors, including banks in other geographic areas and nonbanking firms. The increased threat of takeovers, coupled with reduced profitability of risk-taking, would reduce the ability of bank managers to continue operating a bank that fails to earn a market rate of return for shareholders.

Under the ideal regulatory system, the matrix of potential strategies for banks would be as follows:

Bank Business Strategies Under Reform

	Risk-Adjusted Return on Assets		
	Supracompetitive	Competitive	Sub-Competitive
High Risk	unavailable	available and unsubsidized	bank to be reorganized
Low Risk	unavailable	available	bank to be reorganized

Because banks would be subject to competition, they would generally not be able to earn risk-adjusted returns above the competitive level, and if a bank is unable to earn a competitive return, it would be merged, liquidated, or otherwise reorganized. The two strategies that would be available to the typical bank in this ideal regulatory environment would be the High-Risk Competitive-Return Strategy and the Low-Risk Competitive-Return Strategy (and everything in between once one leaves the confines of this simplified typology). To the extent possible within an insurance arrangement, banks would internalize the costs of the risks they assume.

The deposit insurance subsidy would be reduced to the minimum amount feasible. The profitability of the High-Risk Competitive-Return Strategy, therefore, would reflect the range of returns available in competitive financial services markets. There would be no distortionary preference in the funding of risky projects and enterprises, and there would be no competitive advantage accorded the banking industry in relation to other financial institutions.

In response to the availability of these alternative strategies, one would expect banks to pursue both high-risk and low-risk strategies. In selecting a strategy, a bank would respond to the opportunities presented in its particular markets. Managers would prefer the latter, and diversified shareholders would be indifferent between the two.

Despite the objective of allowing banks to be exposed to and to respond to market signals, the elimination of government involvement in the banking industry does not appear to be an appropriate solution. Moreover, radical deregulation is politically untenable at least at this time. A complete rendition of the need for bank regulation is beyond the scope of this article.[139] A few points of explanation, however, should serve present purposes.

First, in the absence of governmental involvement, banks would be inherently susceptible to wasteful runs, even if they are financially sound. Although it is unclear how often runs have occurred on solvent banks, such runs are socially costly. By forcing hasty liquidation of assets, a run can cause a bank to become insolvent and to fail. Such a failure not only represents the loss of a valuable economic entity, it also can entail economic dislocation in the community the bank serves and transaction costs of reorganizating the failed bank. In addition, if a run occurs on the banking system as a whole—an event that has rarely occurred in U.S. history—severe macro-economic effects would result. Deposit insurance, along with liquidity assistance available from the Federal Reserve System, reduces the threat of a run by guaranteeing that covered depositis will be protected.[140] It may be that governmentally provided deposit in-

139. *See, e.g.*, Black, Miller & Posner, *An Approach to the Regulation of Bank Holding Companies*, 51 J. BUS. 379 (1978); Clark, *The Soundness of Financial Intermediaries*, 86 YALE L. J. 1 (1976); Fischel, Rosenfield, & Stillman, *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301 (1987); Scott & Mayer, *Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform*, 23 STAN. L. REV. 857 (1971); Stiglitz & Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393 (1981) (in the presence of imperfect information, regulation is likely to be needed).

140. *See* Diamond & Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON.

surance eventually can be replaced with another mechanism to control the problem of runs. The record of the last ten years demonstrates that deposit insurance certainly exacts a high price from society in exchange for preventing runs.[141] At this point, however, the elimination of deposit insurance seems politically untenable. Nonetheless, academics and banking experts should continue to develop technically supportable alternatives.

Second, even if deposit insurance is eliminated, a failure or set of failures that causes widespread losses would give rise to substantial political, if not economic, pressure on the federal government to bail out depositors. Past bail-outs of large corporations such as Chrysler provide examples of this type of situation. Moreover, since large banks would be the most likely beneficiaries of such an ad hoc bail-out, they would gain a competitive advantage over other banks. To the extent this occurs, the current problems of deposit insurance would be recreated.

Third, as discussed above, deposit insurance can provide a subsidy to banks. Although a goal of regulatory reform should be to eliminate that subsidy, in practice it may not be possible to do so entirely. Because insurance relationships always entail some amount of moral hazard, some level of subsidization to some banks may be part of the price society pays in order to prevent bank runs. The distortionary effect of that sub-

401, 401-04. Because a bank finances its portfolio of illiquid loans with liquid deposits, there is always a threat that a large number of depositors will demand repayment of their funds at the same time. Although the law of large numbers prevents this from occurring in the normal course of events, massive withdrawals can be triggered by reports, whether correct or not, that the bank is in financial trouble. In order to comply with its depositors' withdrawal requests, the bank would have to sell illiquid loans at "firesale" prices, thereby reducing the value of its assets and bringing it closer to insolvency. Once this process begins, each depositor has an interest in withdrawing his or her funds early enough in the process to ensure that the bank's remaining assets will cover his or her withdrawals. When a run occurs on an insolvent bank, the run could be viewed as a satisfactory means of ensuring the closure of an inefficient bank, although this form of closure could entail substantial externalities. When a run occurs on a solvent bank, the liquidation of assets and the failure that could follow is socially undesirable. Theoretically, a run on a solvent bank could be averted by the Federal Reserve's provision of immediate liquidity assistance. Because the Federal Reserve would have difficulty determining the solvency of a bank experiencing a run, however, it could in effect become a deposit insurer in addition to a provider of liquidity.

141. Private deposit insurance is one possibility. *See, e.g.*, P. WALLISON, BACK FROM THE BRINK: A PRACTICAL PLAN FOR PRIVATIZING DEPOSIT INSURANCE AND STRENGTHENING OUR BANKS AND THRIFTS (1990); Ely, *Yes - Private Sector Depositor Protection Is a Viable Alternative to Federal Deposit Insurance* in PROCEEDINGS OF A CONFERENCE ON BANK STRUCTURE AND COMPETITION 338 (Federal Reserve Bank of Chicago, 1985). A system of liquidity assistance could theoretically reduce the need for deposit insurance, but only if the Federal Reserve can easily distinguish an insolvent bank from an illiquid bank. *See supra* note 140.

sidy, however, can be limited by preventing banks from using the subsidy to finance nonbanking services, particularly those services that unsubsidized firms provide. Therefore, banks should be restricted in their ability to use depositors' funds to finance nonbanking activities. One means of restricting the incidence of the subsidy, other than disallowing a banking organization to engage in a nonbanking activity, is to require banking organizations to use separately incorporated affiliates to provide nonbanking services, and to restrict the transactions between a bank and its nonbank affiliates. To some extent, this approach is used under current law.

Fourth, because deposit insurance leaves bank regulators responsible for monitoring and restraining bank risk-taking, regulation is necessary to ensure that the activities of a banking organization which impose risks on the bank, and therefore the FDIC, lie within the supervisory expertise of the bank regulators. Again, one means of achieving this objective is to separate nonbanking activities and banking activities into separately incorporated entities.[142]

The segregation of banking activities from other activities performed by a bank under an ideal reform regime, however, cannot be complete. Just as segregation can theoretically wall off the insured bank from nonbanking risks, it also can reduce and potentially eliminate the benefits of economies of scope. Therefore, a balance must be struck between segregation and integration of a reformed banking organization.[143]

V. THE FINANCIAL INSTITUTIONS SAFETY AND CONSUMER CHOICE ACT

FISCCA represents a significant step in the direction of achieving the regulatory ideal set out above. If enacted, it would bring the most sweeping changes to the legal landscape that the banking industry has experienced since 1933. Among those changes would be the repeal or amendment of the Glass-Steagall Act, the Bank Holding Company Act (including the Douglas Amendment), the McFadden Act, and the Federal Deposit Insurance Act, which now contains the insurance provisions of the Banking Act of 1933 as they have been amended. From an economic perspective, however, most of the 361-page bill is devoted to the establishment of regulatory constraints that reduce the deposit insurance

142. *See* U.S. GENERAL ACCOUNTING OFFICE, BANK POWERS: INSULATING BANKS FROM THE POTENTIAL RISKS OF EXPANDED ACTIVITIES (1987).

143. *See id.* at 24-25.

subsidy, and the elimination of regulatory constraints that narrow the set of profitable business strategies available to banks and their affiliates.[144]

FISCCA would eliminate most restrictions on the services a banking organization may perform and on the locations from which it may operate. Banks or their affiliates would be permitted, for instance, to engage in securities and insurance activities and, within limits, to integrate those businesses into regional or national financial services firms. FISCCA would thus increase the range of business strategies available to banking organizations. Moreover, there is reason to believe that FISCCA would make available strategies that are not only more profitable, but also less risky, than those currently available.

This Part analyzes the ways in which FISCCA would respond to the weaknesses in the bank regulatory system identified above. A systematic comparison of FISCCA's reforms with alternative reforms is beyond the scope of this Article. This Article, therefore, is not intended to take a position regarding the merit of the particular measures included in FISCCA compared to the many variants of these measures that have been proposed and that will continue to surface as Congress addresses bank regulatory reform.

A. Expansion of Business Strategies Available to Banking Organizations

As discussed in Part III, the profitability of traditional banking services has declined as a result of competition from other types of financial institutions. Regulatory restrictions on the services a banking organization may perform, and the locations in which a bank may operate, limit the nontraditional business strategies available to banking organizations,

144. In addition to reforming deposit insurance and allowing banking organizations to offer nonbanking financial services, FISCCA would: Allow commercial and industrial firms to own banks, FISCCA §§ 203, 204; reorganize regulatory responsibilities among the FDIC and other bank, savings and loan, and credit union regulatory agencies, *id.* §§ 301-361; and provide for additional financing of the FDIC, *id.* §§ 401-412. This article does not address those reforms.

I have been asked by the editors of this symposium to include in this part a fairly detailed description of FISCCA. Readers with only a general interest in bank reform may want to skim this part, focusing on the first part of each subsection, in which I attempt to relate provisions of FISCCA to the preceding theoretical discussion. For a more detailed description of FISCCA, see Muckenfuss, Eager, & Nielsen, *The Treasury Department Report: Modernizing the Financial System — Recommendations for Safer, More Competitive Banks*, BANK MANAGEMENT, Apr. 1991, at 12 or GIBSON, DUNN & CRUTCHER, ANALYSIS OF THE FINANCIAL INSTITUTIONS SAFETY AND CONSUMER CHOICE ACT OF 1991 (Report by the Gibson, Dunn & Crutcher Financial Institutions Group, Washington, D.C., 1991).

and impair the efficiency with which banks provide traditional banking services. As a result, banking organizations are unable to compete effectively in traditional banking markets, and they are impeded from expanding beyond those markets.

1. Expansion of Services Banking Organizations May Provide

Many banking organizations have responded to the erosion of banks' traditional loan markets by mounting aggressive business and litigation strategies to test the limits of the Glass-Steagall Act and the Bank Holding Company Act and to expand their activities as far as those limits permit. In the last ten years, banking organizations have obtained regulatory approval for a wide range of nonbanking services, including, for example, the securitization of loans,[145] securities brokerage,[146] commercial paper sales,[147] merger and acquisition advice,[148] and, subject to volume limits, corporate equity and debt underwriting.[149] Legal restrictions, however, continue to constrain banks' performance of these services.[150] The saga of Bankers Trust obtaining approval to underwrite commercial paper, its innovation to minimize the competitive disadvantage created by Glass-Steagall Act and Bank Holding Company Act restrictions, and the remaining competitive disadvantage that Bankers Trust and other banks continue to suffer in the commercial paper market, provides an example of this process.[151]

Legal restrictions on banks' ability to expand into nonbanking finan-

145. Securities Indus. Ass'n v. Clarke, 885 F.2d 1034 (2d Cir. 1989) *cert. den.* 110 S. Ct. 1113 (1990) (Security Pacific).

146. Securities Indus. Ass'n v. Board of Governors, 468 U.S. 207 (1984) (Charles Schwab & Co.) (discount brokerage in affiliate); Securities Indus. Assn v. Comptroller of the Currency, 758 F.2d 739 (D.C. Cir. 1987), *aff'd in part and rev'd in part sub nom.* Clarke v. Securities Indus. Ass'n, 479 U.S. 388 (1987) (Security Pacific) (discount brokerage in bank); Securities Indus. Ass'n v. Board of Governors, 821 F.2d 810 (D.C. Cir. 1987) *cert. den.* 484 U.S. 1005 (NatWest) (full service brokerage).

147. Securities Indus. Ass'n v. Board of Governors, 807 F.2d 1052 (D.C. Cir. 1986), *cert. den.*, 483 U.S. 1005 (1987) (Bankers Trust).

148. *See, e.g., The Fuji Bank Limited*, 75 FED. RESERVE BULL. 577 (1989); *Signet Banking Corporation*, 73 FED. RESERVE BULL. 59 (1987); *Security Pacific Corp.*, 71 FED. RESERVE BULL. 118 (1985).

149. *J.P. Morgan & Co. Inc., The Chase Manhattan Corp., Bankers Trust New York Corp, Citicorp and Security Pacific Corp.*, 75 FED. RESERVE BULL. 192 (1989). These services may be provided in a "Section 20" affiliate of a bank. *See supra* note 24 and accompanying text.

150. *See supra* notes 27-29 and accompanying text.

151. *See* Litt, Macey, Miller & Rubin, *Politics, Bureaucracies, and Financial Markets: Bank Entry into Commercial Paper Underwriting in the United States and Japan*, 139 U. PA. L. REV. 369, 383-94 (1990) (recounting Bankers Trust's efforts and the current status of banks' involvement in the commercial paper market).

cial services have constrained banks from adopting business strategies that banks appear well positioned to pursue.[152] There is substantial reason to expect that economies of scope exist among banking services and other financial services, such as securities underwriting and insurance underwriting and sales. These potential economies include the multiple use of computer systems, marketing programs, and customer relationships, plus economies of convenience to bank customers.[153]

Furthermore, activity restrictions constrain banking organizations from adopting business strategies that could reduce their risk.[154] One study has estimated that, on average, if banks had provided a diversified set of financial services during the 1965 to 1982 period, they could have reduced their risk by twenty-seven percent without affecting their profitability.[155] Earlier studies similarly found that diversification of services could reduce bank risk without sacrificing profitability. These studies specifically found that fire and casualty insurance underwriting, investment banking, and insurance agency services, among other activities, are elements of an efficient portfolio of financial services that a bank unconstrained by regulation would provide.[156]

---

152. R. LITAN, *supra* note 112, at 74-81 (economies of scope).

153. *See id.* (analyzing potential economies); Kane, *Technological and Regulatory Forces in the Developing Fusion of Financial-Services Competition*, 39 J. FIN. 759 (1984) (analyzing the interaction between economies of scope and mispriced deposit insurance); Benston, Berger, Hanweck & Humphrey, *Economies of Scale and Scope in Banking*, in PROCEEDINGS OF A CONFERENCE ON BANK STRUCTURE AND COMPETITION 432 (Federal Reserve Bank of Chicago, 1983).

Many of the services that banks perform involve the same skills and organization that securities underwriters perform. Most fundamentally, both banking and securities underwriting involve credit assessment. In addition, syndicated bank loans involve the use of distribution channels that are similar in structure to those used by underwriting syndicates. And to the extent that some banks are already involved in limited underwriting and other securities activities permissible under current law, there are even greater economies. TREASURY REPORT, *supra* note 3, at XVIII-14.

Similarly, banking services employ some of the same resources as insurance services. Whereas a bank takes in deposits, invests them, and makes payments to depositors and their payees, an insurer takes in premiums, invests them, and makes payments to insureds and their beneficiaries.

154. Ordinarily, shareholders' ability to diversify their own portfolios eliminates any need for concern over diversification within a firm. The assessment of risk-related premiums that do not distinguish between systematic and unsystematic risk, however, would make diversification at the firm level a substantial concern. If banking organizations could not diversify and their nonbank competitors could, banking organizations would suffer a competitive disadvantage. Furthermore, to the extent that the deposit insurance system fails to internalize risk, there would be social benefits from diversification. None of this is to say that banking organizations should be forced to diversify or that they necessarily would do so if permitted. Some may choose instead to specialize and forgo the benefits of diversification in favor of the efficiency they perceive in specialization.

155. R. LITAN, *supra* note 112, at 91.

156. Eisemann, *Diversification and the Congeneric Bank Holding Company*, 7 J. BANK RES. 68 (1976); Wall & Eisenbeis, *Bank Holding Company Non-Banking Activities and Risk*, in PROCEED-

FISCCA would allow banking organizations that meet a specified set of heightened capital standards to engage in an expanded range of financial and nonfinancial services. In order to limit the incidence of any deposit insurance subsidy that may remain despite the deposit-insurance reforms discussed below, and in order to shield the FDIC from nonbanking risk, FISCCA provides for a new holding company structure under which most nonbanking activities would be carried out in affiliates of the bank. The proposed structure involves two separate holding companies: a "financial services holding company" (FSHC) and a "diversified holding company" (DHC), which would replace the current bank holding company structure.[157] The FSHC, which would hold the bank and the affiliates engaged in nonbanking financial service activities, would be permitted to engage in any activity that its federal regulator[158] determines to

---

INGS OF A CONFERENCE ON BANK STRUCTURE AND COMPETITION 340 (Federal Reserve Bank of Chicago, 1984); Heggestad, *Riskiness of Investments in Nonbank Activities by Bank Holding Companies*, 27 J. ECON. & BUS. 219 (1975); Johnson & Meinster, *Bank Holding Company Diversification and the Risk of Capital Impairment*, 1 EAST. ECON. J. 316 (1974). *See also* Saunders, *Bank Safety and Soundness and the Risks of Corporate Securities Activities* in DEREGULATING WALL STREET, *supra* note 15, at 171, 175-78 (summarizing these studies).

It is often suggested that securities underwriting and other financial service businesses are riskier than banking and that bank involvement in those activities would result in increased risk. In fact, however, the studies cited above indicate that banking is among the riskier financial services businesses. Moreover, if a banker wants to take high risk, there are ample opportunities within the areas of activity permitted for banks. *See* Scott, *Deposit Insurance and Bank Regulation: The Policy Choices*, 44 BUS. LAW. 907, 912 (1989) ("a bank can establish approximately the asset risk level that it desires").

157. Under FISCCA, the expanded financial services — referred to as "new financial activities" in the bill — could be provided only by a "Zone 1 FSHC" or an FSHC each of whose banks has capital above the mean of the range of capital prescribed for "Zone 2" banks and that is making "substantial progress" toward Zone 1 status. A Zone 1 FSHC is defined as an FSHC with 80% of its insured depository institutions' assets held by banks within Zone 1 and the balance of its depository institutions in Zone 2. A Zone 1 bank is a bank that (a) maintains risk-based capital significantly in excess of the required minimum and Tier 1 capital significantly in excess of the required minimum, or (b) meets the required minimum risk-based capital ratio and maintains a Tier 1 capital leverage ratio that is substantially above the minimum. In addition, a Zone 1 bank must at least meet any other applicable capital requirement that its regulator may establish. A Zone 2 bank must meet or exceed all applicable capital requirements. FISCCA §§ 201-203, 251(a). *See supra* note 67 (current capital requirements).

A bank holding company that, prior to January 1, 1993, engages in nonbanking activities permitted by the Federal Reserve Board under current law could continue to engage in those activities even if it is not a Zone 1 FSHC. *Id.* § 203(a)(3)(A).

158. The FSHC's regulator would be the agency with jurisdiction over its bank. FISCCA would reallocate regulatory authority between the Federal Reserve Board and a newly created Office of Depository Institutions Supervision (ODIS). The Federal Reserve Board would be responsible for regulating state banks and their holding companies, and the ODIS would be responsible for regulat-

be "of a financial nature,"[159] including all those activities that the Federal Reserve Board has previously determined to be permissible for bank holding companies under the current "closely related to banking" standard.[160] The DHC could be any commercial or industrial firm and could own a bank only through an FSHC.[161]

FISCCA authorizes FSHCs to engage in a broad range of securities activities through securities affiliates. These activities include underwriting, distributing, brokering, and dealing in securities, operating mutual funds, and any other activity permitted for registered securities brokers, dealers, or investment advisors.[162] Within periods of time specified in FISCCA, a bank that is part of an FSHC would have to shift many of its current securities activities out of the bank itself and into a securities affiliate.[163]

In addition, FISCCA provides that an FSHC subsidiary would be permitted to serve as an insurance underwriter, broker, or agent. All insurance underwriting would have to be performed in a subsidiary of the FSHC and not in either the bank or a subsidiary of the bank. Insurance

---

ing national banks and savings associations as well as their holding companies. The ODIS would also regulate credit unions. FISCCA, Title III.

159. FISCCA § 203(a)(3)(A). Real estate investment, management and development, and the purchase and sale of real estate as principal or broker are explicitly deemed not to be "of a financial nature." FSHCs, therefore, would not be permitted to engage in such activities. *Id.*

160. The "financial nature" standard would replace the familiar provision of the Bank Holding Company Act that allows bank holding companies to engage in activities that are "so closely related to banking . . . as to be a proper incident thereto." 12 U.S.C. § 1843(c)(8) (1988).

161. FISCCA §§ 202, 204. By allowing DHCs to engage in any type of business, including commercial and industrial businesses, FISCCA would eliminate the separation between banking and commerce, which has existed by law since the Bank Holding Company Act was enacted in 1956. FISCCA would allow a commercial or industrial firm to acquire an FSHC and thereby become a DHC only if its FSHC would be a Zone 1 FSHC following the proposed transaction. *See supra* note 157. In addition, FISCCA would give each banking agency the authority to disapprove an acquisition of an FSHC by a DHC if the agency determines that the depository institution involved in the acquisition is engaged in unsafe or unsound practices or would be in an unsafe or unsound condition following the acquisition. FISCCA § 202.

162. FISCCA § 203(a)(3)(C).

163. FISCCA would require the conversion of section 20 subsidiaries into FSHC securities affiliates within three years of enactment of FISCCA. If an FSHC does not meet the capital standards for new activities, it would be required to divest the section 20 subsidiary. In order to continue to engage in those activities, a holding company would have to become a Zone 1 FSHC. *Id.* § 203(a)(3)(A). In addition, beginning one year after enactment, any bank that acquires a securities affiliate would have to transfer all securities activities out of the bank and any other affiliate into the securities affiliate. Securities activities "specifically authorized" for national banks by statute, regulation, order, or interpretation promulgated prior to the enactment of FISCCA would not be subject to this mandatory transfer. *Id.* § 203(a)(3)(C).

agency and brokerage activities, which are considered essentially riskless, could be performed by national banks themselves only if the law of the state in which the bank is located permits state-chartered banks to engage in such activities.[164]

A bank's federal regulator would have the authority to prescribe record-keeping requirements, to request reports from, and to examine the bank's FSHC, DHC, and any financial services affiliate. This authority would be circumscribed, however, by a set of constraints intended to limit the bank regulators' review to matters affecting the risk imposed on the bank. Regarding all other aspects of its operation, a bank's affiliate would be subject to the primary regulatory jurisdiction of the agency with responsibility for the activities in which the affiliate is engaged. For instance, a bank's securities affiliate would be regulated by the Securities and Exchange Commission and an insurance affiliate would be regulated by state insurance regulators.

In an attempt to strike an efficient balance between the integration of a bank with its financial services affiliates and the insulation of the bank from the risks assumed by its affiliates, FISCCA would tighten the rules regarding bank transactions with affiliates and loosen the rules on the joint marketing of banking and other financial services. FISCCA would allow the services of a bank and those of an FSHC affiliate to be packaged and sold together at a combined price that is lower than the sum of the prices of each service, so long as each service is available separately.[165] In addition, FSHC affiliates would be permitted to market services of the bank.[166] In order to prevent confusion regarding the status of an FSHC affiliate, FISCCA would require prominent disclosure to customers that the affiliate is not an insured depository and that its securities or insurance products are not insured.[167]

In order to protect an insured bank from the risks of its FSHC affiliates and to prevent FSHCs from transferring any deposit insurance sub-

164. *Id.* § 203(a)(3)(C). Otherwise, only national banks located in towns with populations under 5,000 would be permitted to sell insurance and they would be limited to selling to residents and employees in the state in which the bank is located. Under current law, the Comptroller allows such banks to sell insurance to customers anywhere. 12 C.F.R. § 7.7100 (1991). For banks that are not subsidiaries of FSHCs, FISCCA would not disturb the limited insurance agency powers available under current law.

165. FISCCA § 212(b).

166. FISCCA would preempt any state law that would have the "purpose or effect of preventing or impeding" such joint marketing. *Id.* § 206.

167. *Id.* § 203(a)(4).

sidy that may exist to nonbank affiliates, FISCCA would retain and strengthen sections 23A and 23B of the Federal Reserve Act, which are the principal "firewalls" between a bank and its affiliates.[168] These provisions apply collateral requirements and volume limitations to transactions between a bank and its affiliates[169] and require that such transactions be on arm's length terms.[170] FISCCA would extend the application of these provisions to investment companies and commodity pools for which an FSHC affiliate is an advisor.[171] It would also require a bank to provide five days advance notice to its regulator for transactions with affiliates above a specified size.[172] Additionally, it would apply the restrictions to transactions with customers of FSHC affiliates, unless such transactions are made on the same terms and according to the same procedures that apply to true third-party transactions and so long as the transaction is not intended to evade any of the affiliate transaction provisions.[173]

Without more, the expansion of activities in which a banking organization may engage would not reduce the likelihood that the bank would fail. In order to have the risk-reducing effects of diversification accrue to the benefit of the bank—and therefore the FDIC—there must be a mechanism by which losses in the bank can be recouped from the gains of nonbank affiliates. One such mechanism is the self-interest of the shareholders and managers of the FSHC or DHC of a bank that becomes weak. Because the failure of an affiliated bank could well damage the reputation of the bank's affiliates, a holding company may come to the rescue of its failing bank.

FISCCA would supplement this incentive by requiring that an FSHC and a DHC replenish the capital of a subsidiary bank when its capital falls below a specified level.[174] When such a drop occurs, the FSHC

168. *See supra* notes 30-31 and accompanying text.

169. *Id.* § 371c.

170. *Id.* § 371c-1.

171. FISCCA § 223(a)(2).

172. *Id.* § 223(a)(1)(ii). This requirement would apply to transactions "exceed[ing] 5 per centum of the capital stock and surplus of the insured depository institution." *Id.*

FISCCA would also expand the range of transactions to which these restrictions apply. The transactions added would include the following: (a) a bank's assumption of a liability of an affiliate; (b) any transaction to enhance the marketability of securities underwritten or distributed by an affiliate; and (c) any transaction that the Federal Reserve Board determines to be "substantially equivalent" to a covered transaction. *Id.* § 223(a)(5).

173. *Id.* §§ 223(b)(1) and (3).

174. That level would be the ZONE 1 level. *See supra* note 157.

would be required either to restore the bank's capital or to post a bond sufficient to bring the bank back to that level. That bond would be payable to the FDIC in the event of a failure. If the bank's capital is not restored, the FSHC would be required either to divest the bank or to terminate any new financial activity provided for under FISCCA. If the FSHC fails to comply with these requirements, its DHC (if it has one) would be required to divest its interest in the FSHC or terminate its nonfinancial activities.[175] Consequently, a bank would either reap the benefits of the diversification provided for by FISCCA, or it would be divested ideally in time for it to be reorganized or otherwise put on a safe and sound footing.

2. *Geographic Expansion*

Banks have responded to the changes in the financial services market by expanding geographically within the limits established by current law. This expansion has taken the form of intrastate branching and interstate holding company acquisition. Interstate branching, however, is not permitted under current law.

Interstate operation through holding company subsidiaries is generally considered less efficient than the operation of an interstate branch network within a single bank.[176] Under an interstate branch structure, the bank would have a single board of directors, management structure, and computer system. It would also undergo integrated supervisory examinations and audits and file integrated regulatory reports. Finally, it would be subject to a single set of capital requirements for its entire operation.[177] With separate bank affiliates in different states, each affiliate must have a separate board of directors and management structure, and each must comply with regulatory requirements separately. This multiplication of effort increases costs.[178]

---

175. FISCCA § 251(a). These obligations would be triggered by a drop in bank capital below the Zone 1 level and the obligation would be to restore capital to the Zone 1 level. *See supra* note 157.

176. TREASURY REPORT, *supra* note 3, at XVII-12 (possible efficiencies to holding company expansion).

177. TREASURY REPORT, *supra* note 3, at XVII-10-11.

178. Recent studies estimate substantial savings from integrating holding company affiliates into branch networks. *See Core Bank Proposal: Hearings on H.R. 6 Before the House Comm. on Banking, Finance, and Urban Affairs*, 102d Cong., 1st Sess. (statement of Lowell L. Bryan, McKinsey & Co., Inc.) (1991); L. Bryan, J. Linder & D. Crane, Bank Mergers: Integration and Profitability (Harvard Business School Working Paper No. 91-038, 1991). *See also* C. Glassman, INTERSTATE BRANCHING - THE ECONOMIC ENVIRONMENT 2-3 (concluding with no new empirical work that interstate

By increasing the cost of geographic expansion, branching restrictions, like product restrictions, limit the range of profitable business strategies available to banks. Strategies that involve the exploitation of economies of scale by expanding regionally or nationally are less attractive as a result of these restrictions.[179] Moreover, geographic restrictions increase the riskiness of a bank. Under the current regulatory regime, a portion of the extra risk is borne by the FDIC. Under a reformed deposit insurance system in which banks internalize the cost of their own risk, these restrictions would increase banks' cost and hence decrease the profitability of a poorly diversified bank.

FISCCA would substantially reduce the legal impediments to geographic expansion. It would repeal the Douglas Amendment, thereby allowing bank holding companies to acquire banks across all state lines, beginning three years after enactment.[180] In addition, FISCCA would amend the McFadden Act to allow national banks and out-of-state state-chartered banks to branch into any state in which a bank holding company could acquire a bank.[181] Subject to the limits on intrastate branching discussed below, existing holding companies would be permitted to consolidate their banks into branch networks.[182]

---

branching would increase efficiency). *But see* Klinkerman, *Wider Branching Welcomed but Seen as No Quick Fix*, Am. Banker, March 8, 1991, at 1, col. 3 (although most bankers view branching as more efficient, Banc One Corp. (Columbus, Ohio) believes the use of separate banks improves employee performance and community acceptance).

179. Economists have attempted to measure economies of scale in banking. *See, e.g.*, Benston, Hanweck & Humphrey, *Scale Economies in Banking: A Restructuring and Reassessment*, 14 J. MONEY, CREDIT & BANKING 435 (1982). These studies generally find minimal economies of scale. Nonetheless, large banks flourish in a variety of banking markets. *See* Miller, *supra* note 40, at 196-98. Economies of scale could be dependent on the type of business in which a banking organization engages. Some banks may adopt strategies that offer economies of scale while others adopt strategies that do not. In addition, whatever economies may have existed in the past, technological developments could alter those economies in either direction. The objective of reform is to allow a bank to determine for itself the extent to which economies of scale can be achieved in the areas in which it does business.

180. FISCCA § 261(a). Under this provision, state law would be preempted to the extent that it restricts an acquisition by an out-of-state bank holding company (under the new FISCCA nomenclature, an FSHC or a DHC) based on the location or size of the holding company, its subsidiaries, or any factor that would have a discriminatory effect on out-of-state holding companies. A parallel provision, which would achieve the same effect for savings and loan holding companies, would go into effect immediately upon enactment. *Id.* § 266. Under current law, savings and loan holding companies are subject to a restriction generally similar to the Douglas Amendment, except that acquisitions of weak or failed savings associations may be made regardless of state law restrictions. 12 U.S.C. § 1467a(e)(3) (Supp. I 1989); *id.* § 1823(k).

181. FISCCA §§ 262, 264.

182. *Id.* § 263.

These provisions would allow immediate branching among states that currently allow out-of-state holding company acquisitions, and unlimited interstate branching in three years following enactment, when the repeal of the Douglas Amendment would become effective. Although FISCCA would still allow a state to prohibit its own state-chartered banks from engaging in interstate branching, competitive pressure from national banks and out-of-state state-chartered banks would probably prevent states from retaining or enacting this type of restriction.

In deference to traditional federalism concerns in this area of the law, FISCCA would leave the McFadden Act untouched to the extent that it relates to intrastate branching. Thus, intrastate branching by national banks still would be governed by the rules each state applies to its own state-chartered banks, which, as stated above, have become generally permissive in recent years.[183]

* * * * *

In sum, consistent with the regulatory ideal discussed in Part IV, FISCCA's reforms in the areas of activity and geographic restrictions are designed to expand the range of business strategies available to banks and their affiliates. By allowing banking organizations to exploit economies of scale and scope, these reforms would improve efficiency and enhance the ability of banking organizations to compete with other financial institutions in traditional banking markets. Moreover, they would allow banks to redeploy resources out of banking markets with excess capacity and into other financial services markets. Finally, the business strategies that would be made available by FISCCA include strategies that involve the diversification of assets and services, which should allow banks that pursue these strategies to reduce their risk below current levels. FISCCA falls short of the ideal in these areas, however, by allowing states to restrict intrastate branching and banks' insurance agency activities. In addition, there is no way of knowing in advance how well FISCCA's holding company structure strikes the balance between integrating banks with their affiliates to achieve efficiencies while segregating them to avoid the transfer of risk and the deposit insurance subsidy.

B. Reduction of the Deposit Insurance Subsidy

FISCCA would establish several mechanisms that would reduce the

183. The *Treasury Report* recognizes, however, that "state laws restricting intrastate branching are inefficient and anticompetitive." TREASURY REPORT, *supra* note 3, at 52.

subsidy that deposit insurance provides to risky banks. It would do so by forcing banks to internalize a greater portion of the cost of their own risk-taking behavior. In insurance terms, these mechanisms include a higher deductible, more coinsurance, stricter limits on FDIC liability, risk-based premiums, stricter conditions of coverage, and better FDIC access to information regarding bank riskiness. In addition, FISCCA enhances the bank regulator's ability to conserve the assets of a failing bank by allowing the regulator to intervene and potentially close a bank before the bank becomes insolvent.

1. Higher Deductible—Higher Going Concern Value

Commentators have blamed low capital for the excessive riskiness of banks in the 1980s, and have suggested that capital requirements be increased in order to reduce risk-taking.[184] As discussed in Part I, a bank's capital serves as a restraint on moral hazard and a cushion for FDIC losses in the same way that a deductible performs these functions in a typical insurance relationship. When a bank fails, the shareholders lose the value of their equity, just as an insured in any other context loses his or her deductible if an insured-against event occurs. Higher capital thus increases a bank's cost of failure. The argument in favor of higher capital requirements is based on the plausible assumption that the more a bank's shareholders have to lose in the event of a failure, the less they will take risks that could lead to failure.[185]

Consistent with that analysis, FISCCA would raise banks' deductibles, but not by increasing bank capital requirements.[186] Instead, the reduction of the geographic and service restrictions would have the effect of increasing the aggregate profitability of banking organizations. As discussed in the context of the pre-1980 banking market, increased profitability increases a bank's franchise value, which in turn increases the loss a bank will suffer if it fails. The forfeiture of a bank's franchise value upon failure, like the loss of capital, is analogous to the loss of a deducti-

184. *See, e.g.*, Benston & Kaufman, *Regulating Bank Safety and Performance* in RESTRUCTURING BANKING & FINANCIAL SERVICES IN AMERICA 63, 85-89 (W. Harat & R. Kushmeider, eds. 1988)

185. *See* Furlong & Keeley, *supra* note 105 (modeling this effect).

186. As a reason for refraining from increasing capital requirements, the *Treasury Report* cites the possibility that increased capital requirements would lead to the shrinkage of bank lending, which could leave certain borrowers without properly priced credit. The *Treasury Report* rejects other arguments against increasing capital requirements. TREASURY REPORT, *supra* note 3, at II-11-17.

ble in the ordinary insurance context.[187] The possibility of losing franchise value, therefore, would increase the prospective cost of high-risk strategies.

Because FISCCA would not accord banks protection from competition, there is no reason to expect (or to desire) that banks would generally earn supracompetitive returns under the proposed regulatory regime. Therefore, banks that are currently earning returns below the competitive level[188] would be the ones that experience the increased deductible as a result of FISCCA.

Although most of FISCCA's reforms of activity restrictions would apply only to the holding companies of banks whose capital meets or exceeds current capital requirements, the increase in franchise value attributable to the opportunity to provide additional services would theoretically accrue not only to banking organizations that can expand their services immediately, but also to any banking organization with a foreseeable prospect of doing so. Such a prospect would include the possibility of increasing capital by retaining earnings, raising equity from current shareholders, raising equity from new investors, merging with another bank, or being acquired by a new holding company (either an FSHC or a DHC). A bank with insufficient capital to allow an affiliate immediately to avail itself of the expanded powers would theoretically experience an increase in its franchise value in an amount equal to the present value of the additional profits to be earned by virtue of the expanded powers multiplied by the probability that the bank will meet those capital requirements.[189]

2. *Risk-Related Premiums*

Typically, an insurer charges premiums based on an estimate of the expected value of the insurance payments that an insured's activity entails. A car driver who has a history of reckless driving, for example, will

187. The loss of franchise value could also be characterized as a form of coinsurance. Its effect on incentives, of course, does not depend on the characterization.

188. *See supra* notes 131-133 and accompanying text.

189. FISCCA includes other benefits dependent upon a bank's capital level. These include the right to open new branches and to engage in new activities without regulatory approval, and the right to acquire or merge with another bank subject to an approval process that is more circumscribed than the process for banks with lower capital. FISCCA § 251(a). This freedom from regulatory approval processes would theoretically be reflected in a bank's franchise value as well.

FISCCA also provides for regulatory sanctions for banks whose capital is below certain thresholds. *See infra* notes 220-237 and accompanying text.

pay more for insurance than a driver with a perfect safety record. By paying premiums based on expected losses, the insured internalizes at least a portion of the prospective cost of his or her activities. Accordingly, the insurer receives adequate funding of future losses, and insureds are induced to take the potential losses into account when evaluating risky activities.

FISCCA would replace the current flat-rate premium with a system of risk-related premiums. Premiums would be based on a bank's level of capital, plus any other factors that the FDIC deems appropriate, including the activities in which a bank is engaged and the nature of a bank's assets and liabilities.[190] In recognition of the limitations facing the FDIC in attempting to price risk,[191] FISCCA also directs the FDIC to study the possibility of having private entities insure a portion of the risk of bank failure. Under this proposal, private insurers would insure a pro rata share of the risk of bank failure along with the FDIC.[192] They would price their insurance at market rates, and the FDIC would take into account their premiums in setting its own premiums.[193]

3. *Coinsurance—Reduced Scope of Deposit Insurance*

In a typical insurance relationship, the insurer pays for less than 100% of the insured's marginal losses. For instance, after subtracting a deductible, the insurer might pay for eighty percent of the insured's losses up to a maximum limit. The twenty percent of the losses that the insured bears is referred to as coinsurance. Like deductibles and risk-related premiums, coinsurance is designed to reduce moral hazard by forcing the insured to pay for increases in risk. In making decisions regarding risk, the insured will take into account the possibility of bearing a fixed fraction of the cost of his or her actions.

The risk-restraining effect of coinsurance exists only to the extent that

190. FISCCA § 104(b).

191. In testimony before the Senate Committee on Banking, Housing and Urban Affairs, William R. Watson, Director of the Division of Research and Statistics of the FDIC, cited the lack of competition in the FDIC's pricing of risk and the inherent difficulty of assessing the riskiness of bank loans as impediments to the development of a risk-related premium system that relies entirely on FDIC pricing. *Risk-Based Deposit Insurance Premiums, 1991: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 102d Cong., 1st Sess. (1991)(statement of William R. Watson)(as yet unpublished).

192. Such a system has been proposed in a bill introduced in the Senate by Senator Dixon. Deposit Insurance Reform Act of 1991, S. 261, 102d Cong., 1st Sess., 137 CONG. REC. S1160-70 (daily ed. Jan. 24, 1991).

193. FISCCA § 116.

the insured does not expect to be insolvent at the time of an insured-against event. If the insured knows he or she will be insolvent, and therefore unable to bear a share of the loss, the deterrent effect of coinsurance is lost. Because deposit insurance is paid only when the insured bank is insolvent, the bank cannot be made to pay a portion of the insured depositors' losses.[194]

The limits of deposit insurance coverage, however, may function in a manner similar to coinsurance. By leaving some depositors uninsured, banks may be forced to pay for the risk their activities impose on those depositors left unprotected. If, as some studies suggest,[195] these depositors demand higher interest rates to reflect the risk that they will lose their deposits in a bank failure, those risk premiums would function in a manner similar to coinsurance. Instead of the bank, however, the uninsured depositors are the coinsurers, and they charge the bank risk-related premiums for the risk they bear.[196]

In recognition of this principle, FISCCA would reduce the scope of deposit insurance, potentially increasing the percentage of uninsured deposits in the banking system. FISCCA would thus eliminate pass-through coverage for most pension plans.[197] In addition, rather than allowing a depositor to gain multiple $100,000 coverage limits by holding several accounts in different "capacities" within a single institution, FISCCA would combine a depositor's individual, joint and trust accounts in applying the $100,000 limit.[198] However, FISCCA would continue to allow depositors to gain multiple coverage by opening accounts

194. One can imagine, however, a system in which the bank's shareholders pay the amount of the coinsurance out of their personal funds. Along these lines, prior to the 1930s, some states held bank shareholders liable for losses to depositors to the extent of twice the value of their equity in the bank.

195. *See* Gilbert, *supra* note 132, at 12-17 (reviewing empirical studies of market discipline); Macey & Garrett, *Market Discipline by Depositors: A Summary of the Theoretical and Empirical Arguments*, 5 YALE J. ON REG. 215, 233-36 (1988) (arguing that empirical evidence supports the effectiveness of depositor discipline).

196. The payment of risk-related interest rates on uninsured deposits may also be viewed as analogous to a risk-related insurance premium.

197. FISCCA would eliminate pass-through coverage for the accounts of defined-benefit plans (which are insured by the Pension Benefit Guarantee Corporation), for defined-contribution plans that are professionally managed, and for Bank Investment Contracts, or "BICs." FISCCA § 101(a).

198. *Id.* § 101(b). This provision would become effective two years following enactment. FISCCA would continue to allow an additional $100,000 of coverage for a retirement account. In addition, the FDIC would have the authority to allow separate coverage for specific types of accounts that it deems to warrant such coverage consistent with the objectives of protecting small depositors and limiting expansion of deposit insurance coverage.

in different banks. Thus, the revised $100,000 limit would reduce the scope of coverage only by increasing a depositor's transaction cost of making and maintaining multiple accounts of under $100,000. This reduction may well be minimal. The Treasury Report described a $100,000 system-wide limit as an "appropriate long-term goal" but cited administrative difficulties that prevent its immediate attainment. FISCCA therefore directs the FDIC to spend eighteen months studying the administrative feasibility of a system-wide $100,000 limit.[199]

In addition, FISCCA would restrict the FDIC's authority to provide de facto insurance by using failure resolution methods that protect uninsured depositors along with insured depositors. As discussed above, the FDIC has protected uninsured depositors under two circumstances: when it determines that a purchase and assumption transaction is less costly than paying off insured depositors and liquidating a bank,[200] and when it determines that systemic financial damage would occur as a result of uninsured depositors suffering losses.[201] Under FISCCA, the FDIC would be permitted to protect uninsured depositors through a purchase and assumption transaction or any other resolution method only when such a method is the least costly of all possible methods.[202] The Treasury Department expects that failed banks often can be resolved at least cost by transferring insured deposits to an acquiring bank, leaving uninsured depositors with claims against the failed bank's assets along with those of other creditors, including the FDIC. To the extent this is true, the requirement that the FDIC use the least-cost resolution method would reduce, though not eliminate, the de facto protection that uninsured depositors currently enjoy.

Under this type of transaction, termed an "insured-deposit transfer," only insured deposits are transferred to the acquiring bank along with the failed bank's physical facilities and perhaps some of its other assets. The FDIC contributes an amount of cash necessary to attract an acquiror. Just as in a purchase and assumption transaction, however, the acquiror typically pays an implicit premium for the failed bank's franchise value.[203]

FISCCA further provides that the Federal Reserve Board and the

199. *Id.*

200. *See supra* notes 49-51 and accompanying text.

201. *See supra* notes 52-54 and accompanying text.

202. FISCCA § 103.

203. TREASURY REPORT, *supra* note 3, at 27.

Treasury Department, rather than the FDIC, would have discretion to protect uninsured depositors in a too-big-to-fail situation. They could provide such protection based on a joint finding that, in the absence of protection, there would be a "severe adverse impact on the financial system."[204] The cost of the protection, however, would be borne by the FDIC with loans available to the FDIC to cover the cost of this protection.[205]

In order to maintain the liquidity of uninsured deposits in either a payoff and liquidation or an insured-deposit transfer, FISCCA would authorize the FDIC to pay uninsured depositors an amount equal to the face value of their deposits times a fraction equal the mean fraction of bank liabilities that the FDIC has recovered in prior liquidations of failed banks.[206] That payment would be final, regardless of the recovery actually achieved in a particular liquidation. Thus, over time, uninsured depositors as a class would receive the amount they are due following the liquidation of failed banks, but any particular depositor may receive either more or less than the amount that would be received following the liquidation of that depositor's own bank. Rather than waiting for a liquidation to be complete, however, the uninsured depositors would immediately receive an amount equal to the statistically determined expected value of their deposits.

The assumption underlying FISCCA's reduction in the scope of deposit insurance is that depositors can effectively discipline bank risk-taking. Substantial questions have been raised by commentators regarding the effectiveness of depositor discipline, and the empirical evidence regarding this issue is ambiguous.[207] The riskiness of a bank is difficult to ascertain and the incentive for any single depositor to monitor bank risk-taking is plagued by collective action problems. The existence of a large number of sophisticated depositors that are uninsured in name and in

204. FISCCA § 103(a). The Treasury Department and the Federal Reserve Board would be required to consult with the FDIC and the OMB in making this determination.

In addition, FISCCA would alter banks' payment system obligations in a manner that would reduce the likelihood that the failure of one bank would cause a chain reaction of failures as a result of the failed bank's inability to fulfill payment obligations. *Id.* §§ 501-505.

205. *Id.* § 103.

206. *Id.* § 541.

207. *See, e.g.*, Gilbert, *supra* note 132, at 12-17 (concluding that empirical studies of market discipline show mixed results); Garten, *Still Banking on the Market: A Comment on the Failure of Market Discipline*, 5 YALE J. ON REG. 241 (1988) (questioning the effectiveness of depositor discipline); Garten, *Banking on the Market: Relying on Depositors to Control Bank Risks*, 4 YALE J. ON REG. 129 (1986) (same).

fact, however, could lead to expanded availability of private bank rating entities that could reduce the likelihood of a run and facilitate depositors' assessment of and response to bank risk-taking. Alternatively, markets for private insurance could develop to cover uninsured deposits. It remains to be seen whether these forms of market discipline can effectively restrain risk-taking and whether scaled back insurance will reintroduce the problem of bank runs.[208]

Even without an improvement in market discipline, however, the reduction in the scope of deposit insurance could have a socially beneficial effect on the allocation of credit. Rather than bear the risk of bank failure, some large depositors might shift funds out of the banking system and into any of the various substitutes that now exist for bank accounts. Although that would reduce the volume of credit that banks can provide, current bank clients may well have other sources of credit available that would replace bank credit once the deposit insurance subsidy is removed. Furthermore, as a result of the deposit insurance subsidy, some bank credit is currently being provided to projects that should not be financed in the first place. One would therefore expect, and indeed desire, that the removal of the deposit insurance subsidy would result in some shrinkage of the banking industry as a proportion of the credit market.[209] For those banks that expand their services into the mutual fund and securi-

208. Some commentators have proposed the use of subordinated debt as a means of internalizing the cost of bank risk-taking. *See, e.g.*, G. BENSTON, R. EISENBEIS, P. HORVITZ, E. KANE & G. KAUFMAN, PERSPECTIVES ON SAFE & SOUND BANKING: PAST, PRESENT, AND FUTURE 315-16 (1986) [hereinafter SAFE & SOUND BANKING]; Scott, *supra* note 156, at 916; Wall, *A Plan for Reducing Future Deposit Insurance Losses: Puttable Subordinated Debt*, 74 ECONOMIC REVIEW, July-Aug. 1989, at 2 (Federal Reserve Bank of Atlanta). These proposals are based on the same principle of market discipline and are intended to avoid the collective action problems that depositor discipline entails. *See* TREASURY REPORT, *supra* note 3, at II-19-24 (discussing advantages and disadvantages of subordinated debt).

209. It is difficult to predict accurately the extent to which uninsured deposits, which now constitute approximately 25% of total deposits, would be shifted out of the banking system. The possibility and effect of a run by uninsured depositors contributes to this difficulty. In addition, it is difficult to determine the extent to which credit markets now served by banks could be served efficiently by other types of financial institutions. Since the late 1970s, banks have provided a decreasing share of commercial credit, with the shares of commercial paper and finance company loans increasing. ECONOMIC REPORT OF THE PRESIDENT, *supra* note 42, at 164-65 (Chart S-2) (1991). I am not aware of any research regarding how much more credit might be provided efficiently outside the banking system or regarding the size of the markets that remain dependent on banks for credit. This should be a high priority for future research. The riskiness of a bank is difficult to ascertain and the incentive for any single depositor to monitor bank risk-taking is plagued by collective action problems. Moreover, depositor discipline could take the form of a run, even on a solvent bank, which would be an efficient form of discipline.

ties areas, the transfer of funds out of the banking system would not necessarily mean a transfer out of a given banking organization. It may only mean a transfer of business to a securities or mutual fund affiliate.

4. Conditions of Coverage—Activity Limits

The insurance devices discussed above are designed to provide insureds with monetary incentives to consider the downside potential of activities that involve risk. The other general type of restraint on risk-taking that commercial insurers employ is to restrict the activities in which the insured may engage in order to obtain and retain insurance. For instance, many life insurers do not sell insurance to people engaged in certain high-risk occupations or hobbies. The current regulatory system relies heavily on this type of curb on risk-taking. The restrictions on the securities services a bank and its affiliates may provide, for example, fall into this category of restraint. More generally, the bank regulatory agencies' authority to supervise bank operations and to order banks to cease and desist from engaging in any "unsafe or unsound practice" or from maintaining any "unsafe or unsound condition" is intended to allow regulators to constrain bank risk-taking.

Although FISCCA would substantially reduce restrictions on the financial services activities of banks' affiliates, it would enhance the authority of federal bank regulators to prevent banks themselves from engaging in risky activities. As discussed further below, any bank that does not meet the capital requirements would be potentially subject to growth limits, restrictions on distributions to shareholders, termination of activities that create "excessive risk to the bank," dismissal of management, and other measures.[210] In addition, even if a bank meets the capital requirements, its federal regulator would be required to withhold approval for any investment, expansion, or acquisition if the bank or any affiliated bank is "engaged in an unsafe or unsound practice or is in an unsafe or unsound condition."[211]

FISCCA would also restrict the freedom of state bank regulators to allow state-chartered banks to engage in activities that are not permissible for national banks. First, unless it meets the capital requirements and receives approval from the FDIC, a state bank would not be permitted to engage as a principal in any activity that is impermissible for a national

210. FISCCA § 251(a). *See infra* notes 220-237 and accompanying text.
211. FISCCA § 251.

bank.[212] Second, a state bank could not make any equity investment that is impermissible for a national bank.[213] Third, any state or national bank that fails to meet the capital requirements could be ordered to stop engaging in any activity that, in the view of the federal bank regulator, poses excessive risk to the bank.

FISCCA would also improve the regulators' ability to control bank risk-taking by curtailing the use of insured deposit brokerage. Under current law, a bank can obtain a high volume of insured funds in a short amount of time through a deposit broker and invest those funds in risky investments, thereby altering the bank's risk profile well before its next examination. In order to remedy this situation, FISCCA would deny insurance to deposits obtained through a broker. Without insured brokered deposits, a bank could not as easily effect a rapid change in the riskiness of its portfolio. Consequently, periodic bank examinations would be more likely to uncover increases in risk while there is still time for examiners to impose restraints.[214]

5. *Limits of Liability—Growth Restrictions*

A typical insurance contract provides that the insurer will cover insured-against losses for a single insured up to a limit — often $300,000 or $500,000 on automobile insurance, for example. Such provisions limit the insurer's exposure and reduce moral hazard. The FDIC's obligation is to provide full protection for all insured deposits that are lost in a bank failure. Even if the $100,000 limit (or any other per-depositor limit) on depositor protection were adhered to strictly, the addition of new deposits from existing customers whose account balances are below the limit would increase the FDIC's potential loss in the event of a failure, as would the addition of new depositors.[215] Direct limits on the extent to which the FDIC will cover a bank's losses are therefore inconsistent with

212. To approve an activity, the FDIC would have to find that the activity "poses no significant risk" to the deposit insurance fund. *Id.* § 105(a).

213. *Id.*

214. *Id.* § 101. Brokered deposits are deposits that a bank receives through a broker, often a securities firm, which can rapidly communicate the availability of an attractive interest rate to large depositors nationwide. With a sufficiently attractive interest rate, a deposit broker can attract tens of millions of dollars in deposits in a very short time. Although FISCCA would eliminate the brokerage of insured deposits, it would not prevent a bank from soliciting its own deposits by nationally advertising an attractive interest rate.

215. The conceptual limit on the FDIC's exposure discussed here should not be confused with the $100,000 limit on the coverage of a depositor's funds. The concept discussed here is a limit on the FDIC's liability in the event of a particular bank's failure.

the concept of deposit insurance.[216]

A practice has developed, however, that has the same effect on FDIC exposure and bank incentives as do coverage limits in other insurance contexts. Under current law, the FDIC and the other bank regulatory agencies have discretion to restrict the rate at which a weak bank may accept additional deposits. This limitation fixes the FDIC's maximum exposure at the bank's current level of deposits plus a permitted rate of growth.[217]

As discussed further below, FISCCA would increase the bank regulators' use of this type of mechanism. If a bank's capital is below the minimum requirements, the FDIC would have the authority to restrict the rate at which the bank could increase its deposits. As part of a system of calibrated regulatory responses to banks with low capital, a bank whose capital is below a regulatory minimum could be prohibited from allowing its deposits to grow or even be ordered to have them contract. Banks with capital "significantly" below the minimums would be subject to mandatory deposit-growth restrictions.[218]

6. The End-Game of the Insured Bank—Prompt Corrective Action

Deposit insurance differs from other types of insurance in that the FDIC, in combination with the other bank regulators, has the power to influence directly the magnitude of its own losses if an insured-against event occurs. The source of this power lies in the role of the FDIC and other bank regulators in timing the point at which a failing bank is closed.[219] If, for example, a bank were closed at a point at which its net worth—measured by market value—were exactly zero, rather than negative, the FDIC would incur no losses (other than the administrative cost of the closure). The FDIC would pay off depositors and recoup the cost of those payments from the proceeds of the sale of the bank's assets. Alternatively, the FDIC might find an acquiror that is willing to take over the failed bank and assume all obligations to insured depositors with no financial assistance from the FDIC. In a sense, one could thus view deposit insurance as insurance, not against bank failure, but rather

216. One can imagine, however, a system in which a bank is allocated, or perhaps purchases, a specified quantity of insurance—say, $500 million—to be allocated among depositors in whatever manner the bank chooses. That would be a radical departure from the current system and, without substantial refinement, would not meet the needs of the banking system.

217. *See* White, *supra* note 66, at 24.

218. FISCCA § 251(a). *See infra* note 232 and accompanying text.

219. *See supra* note 57 (authority to close a bank or to terminate its insurance).

against the possibility that the regulators will fail to close a bank before its net worth, measured at market value, becomes negative.

In this respect, the position of the FDIC is similar to that of a creditor. The FDIC has an obligation to insured depositors, but once a bank is closed and the FDIC has fulfilled that obligation, it assumes the rights of the depositors against the assets of the insolvent bank.[220] Therefore, the ability of the regulator to close a bank in a timely fashion is a significant determinant of the FDIC's ultimate losses.

The timely closure of a bank is difficult because it requires accurate information regarding not only the current solvency of a bank, but also the rate at which its net worth may decline. It also requires decisive action by the bank regulator. Timely closure is made particularly difficult because, as a bank approaches the point of insolvency, its incentive to take risks increases, and increased risk-taking can cause the bank's rate of decline to accelerate.[221] It is therefore important for the FDIC and the other bank regulators to have regulatory tools at their disposal that allow them to restrict the risk-taking behavior of banks as they approach the insolvency point.

Under current law, regulators have a wide range of discretion to order banks to cease and desist from engaging in unsafe or unsound practices.[222] The procedures required for the exercise of this discretion, however, can be lengthy. In addition, the regulators may, at times, be more lenient than they should be in exercising this discretion.[223]

FISCCA provides for increasingly stringent regulatory control as a bank's capital falls below the regulatory minimum, coupled with expedited administrative and judicial review procedures. Although the regulatory agencies would retain some discretion in applying sanctions, their discretion would be constrained. FISCCA's system of controls, termed "prompt corrective action," is structured around a set of five "zones"

220. As some commentators have observed, deposit insurance in this respect is structured like a loan "guarantee." *See* Kane, *Appearance and Reality in Deposit Insurance: The Case for Reform*, 10 J. BANKING & FIN. 175 (1986). Deposit insurance differs from a typical loan guarantee in that it applies to a constantly changing set of obligations (deposits) backed by a constantly changing set of assets (bank loans and other assets).

221. That is, its deductible declines to zero.

222. 12 U.S.C. §§ 1818(b),(c)(Supp. I 1989)(cease-and-desist actions for unsafe and unsound practices).

223. *See* TREASURY REPORT, *supra* note 3, at 41, X-6-10; SAFE & SOUND BANKING, *supra* note 209, at 260-71, 309-10 (concluding that regulators fail to respond quickly to failing banks and suggesting closure while bank capital is still positive).

defined with reference to bank capital levels.[224] Banks in Zone 1 and Zone 2 have capital equal to or above the currently prescribed minimum,[225] and banks in Zones 3 through 5 have capital below the minimum.[226]

Under the prompt corrective action scheme, a Zone 3 bank is defined as a bank with capital below the regulatory minimums, but not "significantly" below any either minimum. A Zone 4 bank is a bank with capital "significantly" below a regulatory minimum. Finally, a Zone 5 bank is a bank with capital at or below a "critical" level, which is defined as "a level of capital that will, as a general matter, permit resolution of an insured bank's problems without significant financial loss to the [FDIC]." The "critical" capital level is to be set by each bank regulator, at a level at least equal to 1.5% of assets.[227] In addition, each bank regulator is given the authority to define a bank to be in Zone 3 or Zone 4 regardless of its capital level if it determines that the bank is in an unsafe or unsound condition.[228]

A bank within Zone 3—that is, a bank with capital below a regulatory minimum, but not "significantly" so—would be subject to a set of "mandatory" sanctions. These sanctions include a requirement that the bank submit to its regulator a feasible plan providing for the restoration of its capital to a level sufficient to meet the regulatory minimums. In addition, the bank would be prohibited from making any distribution to shareholders that would cause the bank to fall below Zone 3, or to make any other distribution without first obtaining a determination from its federal regulator that the distribution furthers the bank's capital restora-

224. Capital levels are to be determined with reference to a bank's risk-based capital ratio and its leverage ratio in relation to the required risk-based capital and leverage ratios provided for under current law. *See supra* note 67. In addition, however, the regulatory agencies are given the authority to "establish any additional relevant capital measure or measures that are consistent with the purposes of [the prompt corrective action system]." FISCCA § 251(a).

225. The difference in treatment between Zone 1 banks and Zone 2 banks primarily involves the availability of regulatory privileges rather than constraints. *See supra* note 157. Depending on one's point of view, the withholding of a privilege can look very much like the imposition of a sanction. Nonetheless the distinction is useful in describing regulatory control over banks approaching the insolvency point.

226. *See supra* notes 69-70 and accompanying text (describing capital requirements).

227. For purposes of this measure, only Tier 1 or "core" capital is to be included in the numerator of the calculation. Tier 1 capital, which would continue to be defined as it is under current law, includes common stockholders' equity, certain types of preferred stock, and minority interests in the equity accounts of consolidated subsidiaries, but excludes goodwill. *See supra* note 70 and accompanying text (describing capital requirements).

228. FISCCA § 251(a).

tion plan. Furthermore, if a Zone 3 bank is part of an FSHC or a DHC,[229] those holding companies would be required to maintain a net worth equal to the shortfall of the bank's capital, and they would be permitted to make distributions to shareholders only with the approval of the bank's federal regulator. A regulator would be authorized to refrain from imposing any of these sanctions if it makes a determination in writing that doing so is "in the public interest." Finally, a Zone 3 bank would be subject to the following discretionary sanctions: limits on the growth or mandated reduction of its assets or liabilities; requirements that new equity be issued; restrictions on activities, including the termination of activities; dismissal of bank board members and executive officers; requirements that new directors be elected, including directors specified by the regulator; and required divestiture or liquidation of affiliates.[230]

A bank within Zone 4—one with capital "significantly" below a regulatory minimum—would be subject to the same mandatory and discretionary actions to which a Zone 3 bank is subject, plus additional sanctions. Mandatory sanctions for a Zone 4 bank would include the following: Prohibition on distributions to shareholders; prohibition on the acquisition or establishment of an affiliated bank or a branch, or the initiation of a new activity; asset growth restrictions; and prohibition on any increase in executive officers' compensation. Again, a regulator could refrain from imposing these sanctions only based upon a written determination that doing so is "in the public interest." In addition, a regulator would have the discretion to order a bank's holding company to divest the bank if it determines that such divestiture would improve the bank's financial condition or future prospects. Alternatively, it could appoint a conservator for the bank.[231]

Finally, a bank within Zone 5 would be subject to a forced merger or to the appointment of a receiver or conservator, which would generally be the FDIC. The FDIC, as receiver or conservator, would have the authority to take any action against the bank that can be taken against a Zone 3 or Zone 4 bank. A Zone 5 bank could escape such a fate only if its federal regulator and the FDIC agree that the public interest requires leniency.[232]

---

229. *See supra* note 157 and accompanying text.

230. FISCCA § 251(a). This list of mandatory and discretionary sanctions is not exhaustive.

231. *Id.* This list of mandatory and discretionary sanctions is not exhaustive.

232. *Id.*

In order to allow the regulatory agencies to institute these "prompt corrective action" measures in a timely fashion, FISCCA would limit and expedite judicial review of agency actions.[233] Suits to set aside agency actions would be subject to an arbitrary-and-capricious standard of review and could be brought either in the United States Court of Appeals for the District of Columbia Circuit or the United States Court of Appeals for the circuit in which the aggrieved bank maintains its home office.[234] The United States Claims Court would have exclusive jurisdiction to award damages to parties that have succeeded in having an agency action set aside.[235] No court would have the authority to enjoin an agency action pending judicial review, and the filing of a suit challenging an agency action would not operate as a stay of any such action.[236]

7. *Access to Information—Market Value Reporting, Annual Examinations, Access to Audit Reports*

The ability of the bank regulators to monitor bank safety and to implement the measures described above depends upon the availability of accurate and timely information regarding a bank's operations and financial condition. Although there is evidence that the information regulators currently receive often allows them to identify troubled banks between one and three years prior to their failure, better information would allow them to do so more frequently and to close failing banks earlier.[237]

One type of information that can be very useful to a bank regulator is the market value of a bank's assets and liabilities. As discussed in Part I, this information is not provided to regulators under current law. Regulators instead rely on banks' balance sheets, which generally reflect the historical values of assets and liabilities. FISCCA, therefore, would require banks to report to the bank regulatory agencies the estimated fair market value of their assets and liabilities, to the extent feasible. Banks

233. Suits challenging agency actions would have to be filed within ten days after the plaintiff receives notice of the action, and the Courts of Appeals would be directed to give these actions expedited review.

234. Suits could be brought by any of the following parties: a company ordered to make a divestiture or to terminate activities; a bank or bank affiliate that is subject to mandatory or discretionary sanctions or any company that controls such a bank or bank affiliate; and a director or officer who has been dismissed or whose compensation has been limited by agency action.

235. Damages would be limited to "actual damages." FISCCA § 251(a).

236. *Id.*

237. TREASURY REPORT, *supra* note 3, at X-2-5.

would not be required to restate their balance sheets in market value terms. Capital—upon which premium levels, the scope of permissible activities, and other regulatory privileges would depend—would still be measured by valuing assets and liabilities according to historical values.[238] Hence, this reform would not go as far as the ideal suggested by some commentators.[239] Nonetheless, with market value information in hand, the bank regulators could employ their discretionary authority to prevent unsafe or unsound practices or conditions and potentially to achieve the same objectives that proponents of full-fledged market value accounting seek.[240]

In addition, FISCCA would require all banks to provide their regulator with copies of any audit report, management letter, or other report produced by an independent auditor. In order to discourage opinion shopping, banks would also be required to notify their regulator of any change in auditor.[241]

Finally, FISCCA would improve the regulators' and the FDIC's access to information by requiring annual on-site examinations for banks with assets above $1 billion and allowing additional examinations if necessary. Examinations could also be extended to bank affiliates to determine the effect they have on the bank.[242] As is true under current law, a bank examiner would have the authority to mark down loan values on a bank's balance sheet depending on his or her judgment regarding the likelihood of repayment. With more frequent examinations, such revaluations would improve the accuracy of a bank's reported capital and

238. FISCCA § 107(a).

239. *See e.g.* White, *supra* note 66, at 19-20 (suggesting complete market value accounting).

240. Because most bank assets are not traded on an active market, their market values cannot be obtained with any objectivity. According to the *Treasury Report*, the Treasury Department declined to require complete market value accounting because the inherent subjectivity of this information could lead to inaccuracy and would make comparisons among banks difficult. In addition, the Treasury stated that the development of a comprehensive market value accounting system would be expensive and would disproportionately burden small banks. Finally a system in which some assets are measured at market value and others are measured at GAAP values could lead to biases in the investment decisions of banks, including a bias against using certain techniques to hedge against interest rate volatility. The Treasury Department suggested that, in the future, techniques may be developed that allow more complete market value accounting. TREASURY REPORT, *supra* note 3, at 43-4.

241. FISCCA § 107.

242. *Id.* §§ 106, 323. Banks with under $1 billion in assets and that are in compliance with the capital requirements would be examined every eighteen months. There is now no statutory requirement regarding the frequency of examinations. *See* 12 U.S.C. § 481 (1988 & Supp. I 1989). The median frequency with which banks are currently examined is approximately one year. TREASURY REPORT, *supra* note 3, at X-5 (fig. 3).

thereby increase the effectiveness of the capital-based regulatory measures.

Although these measures would improve the ability of bank regulators to react to excessive risk-taking and to reduce the FDIC's losses from bank failures, failures will surely occur nonetheless, and mistakes will be made. Some banks will be able to conceal their true condition from the regulators. Moreover, even a bank that has had an accurate examination can fail before its next examination. Once banks begin to fail, their capital can fall very quickly. The better the information available to the regulators, however, the less frequently this will occur.[243]

8. *Summary of Deposit Insurance Subsidy Reforms*

Although there is no way of knowing the extent to which FISCCA would eliminate the deposit insurance subsidy, there is reason to believe that it would reduce it substantially. The increased profitability expected to occur as a result of FISCCA's liberalized activity restrictions would have the effect of an increased deductible for a segment of the banking industry. Risk-related premiums and the reduced availability of insured deposits would force all banks, to some extent, to pay higher costs for increases in risk (and to reduce their costs for reductions in risk).[244] Furthermore, banks whose capital declines below the regulatory minimum would become subject to strict regulatory control. In order to extract a subsidy from the deposit insurance system, a bank would have to increase its risk to a level high enough to offset the expected loss of its capital plus its franchise value; it would have to do so in a manner that does not trigger offsetting increases in either its deposit insurance premiums or the interest rates it pays on uninsured deposits; and such an increase in risk would have to escape the heightened attention of the bank's regulator, whose discretion to refrain from imposing sanctions would be more narrow than in the past.

FISCCA thus appears well designed to respond to the problems this article has identified in the current regulatory system. The potentially weak link in the system is continued reliance on governmental entities—the FDIC and the other bank regulatory agencies—to monitor bank operations, to assess risk, and to take actions based on those assessments.

243. *See* TREASURY REPORT, *supra* note 3, at X-2-5 (inherent difficulty of preventing failures consistently).

244. For banks that experience an increased franchise value, the prospect of losing that value will also represent a cost of increasing risk at the margin.

FISCCA's risk-related premiums, the sanctions for FSHCs with inadequate bank capital, and the prompt corrective action system are only as good as the regulators that administer them. In light of recent history, concern on this score is not unwarranted. Nonetheless, other than radical proposals to deregulate or restructure the financial services sector, which are politically infeasible and technically uncertain at this time, alternative regulatory systems would be similarly reliant on bureaucratic decisionmaking.

CONCLUSION

The ultimate irony of the current bank regulatory system is that a set of rules designed to protect banks from what was perceived as unhealthy competition now forces banks to compete in a clearly unhealthly environment. As economic forces have moved lending activity from the banking markets to securities markets, regulation has generally prevented banking organizations from responding effectively. Banks therefore have remained largely trapped in a shrinking market.

As a result of changes that have occured in the financial markets, bank failures have accelerated, reaching a level in recent years that far exceeds that of any period since the establishment of the current regulatory regime in 1933. One would expect, however, that banks would fail as a result of increased competition. In a system of competitive markets, when demand for the products of an industry declines, the industry's resources are reallocated to markets in which they are in greater demand. This occurs through the failure and liquidation of some firms, and through mergers, acquisitions, and internal expansion of others. The disturbing aspects of the last decade of bank failures are, first, that they appear to be the only means by which resources are reallocated out of the banking markets, and second, that they have been the crowning conclusion to bank risk-taking sprees that have been financed by the FDIC. The result is that these losses are greater than they would have been if the regulatory system had allowed market forces a freer rein.

Both the failure of excess resources to be withdrawn from the banking market and the excessive risk-taking that seems to be occurring among banks are attributable to a poorly conceived bank regulatory system. Restrictions on the services banking organizations may perform and the locations in which they may operate have impeded banks from achieving efficiencies in providing banking services and from reallocating resources to nonbanking markets through either internal expansion or mergers

with nonbanking firms. At the same time, the deposit insurance system has created an undesirable outlet for the competitive pressure created by the entry of other financial institutions into banks' traditional markets. By adopting high-risk business strategies that take advantage of a subsidy available only to banks through the deposit insurance system, banking organizations can continue to employ resources in banking markets that would be better employed in other sections of the economy and can extend their presence in the banking business.

Bank regulatory reform must include three elements: It must allow banking organizations to expand the services they provide; it must allow banks to expand and merge across state lines; and it must eliminate the deposit insurance subsidy. FISCCA achieves the first two objectives directly. Although the proposed holding company structure may require further refinement, the general outlines of the proposal would allow adequately capitalized banks to provide a full range of financial services and thereby respond to market forces in allocating their resources among banking and nonbanking markets. FISCCA would retain deposit insurance, but it would introduce a set of measures designed to reduce the deposit insurance subsidy by forcing banks to internalize the risks they assume and by enhancing the ability of the FDIC and the other federal regulators to control bank risk-taking. Only experience will tell whether these measures will be effective. If they are not, the ultimate solution may require significantly more radical changes to the banking system, including the elimination of deposit insurance or the narrowing of its scope to a small fraction of bank deposits.[245]

245. *See, e.g.*, R. LITAN, *supra* note 112; L. BRYAN, RESTORING HEALTH AND PROFITABILITY TO THE U.S. BANKING STSTEM (McKinsey & Co., 1990).