NONDEPOSIT DEPOSITS AND THE FUTURE OF BANK REGULATION

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Banking law appears to be the preferred habitat for a peculiar genre of legal doctrine, the oxymoron. We have the nonbank bank,¹ the nonthrift thrift,² the nonbranch branch,³ even, as of 1992, the non-statute statute.⁴ In this paper we examine another oxymoron in banking law, the nondeposit deposit, by which we mean an instrument or account that fulfills the functional purposes of a checking account deposit but is not treated as a deposit for purposes of federal deposit insurance, Federal Reserve Board reserve requirements, or both. Like most of the other oxymorons in banking law, the nondeposit deposit serves a specific commercial purpose while avoiding costly regulation applicable to traditional means of serving that purpose.

We argue in this paper that the nation has already entered with a vengeance into the era of nondeposit deposit banking. The traditional bank deposit against which reserves must be held and deposit insurance paid is suffering encroachment from a wide variety of competitive instruments and arrangements, all of which, to one degree or another — often to a substantial degree — serve a function economically similar to that of the checking account at a depository institution.⁵

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1. See Board of Governors of Fed. Reserve Sys. v. Dimension Fin. Corp., 474 U.S. 361 (1986) (discussing institutions that were functionally banks but did not fall within the definition of bank in the Bank Holding Company Act of 1956).

2. See, e.g., Competitive Equality Banking Act of 1987, S. REP. NO. 100-19, 100th Cong., 1st Sess. 13-14 (1987).

3. See, e.g., Independent Bankers Assn. of N.Y. v. Marine Midland Bank, 757 F.2d 453 (2d Cir. 1985), cert. denied, 476 U.S. 1186 (1986) (holding automatic teller machine terminal not a "branch" if owned and operated by an institution other than the bank, even if customers can conduct standard banking transactions with the bank by means of the machine).

4. See Independent Ins. Agents v. Clarke, 955 F.2d 731 (D.C. Cir. 1992) (finding, *sua sponte*, that § 92 of the National Bank Act had been repealed in 1918).

5. For popular press commentary on the growth of nonbank alternatives to traditional bank-

The legal system may respond to these developments by attempting to bring nondeposit deposits under regulation, as it has done with other banking oxymorons such as the nonbank bank and the nonthrift thrift. However, the wide variety of nondeposit deposit instruments already available in the marketplace, coupled with the extraordinary ingenuity of bank lawyers at devising new ways of doing business while avoiding regulations, suggest that any attempt to close the nondeposit deposit loophole will ultimately prove unsuccessful. Nondeposit deposits are here to stay. The results of this development for the future of banking regulation are likely to be profound and long-lasting.

I. COSTS OF FEDERALLY INSURED, RESERVABLE DEPOSITS

The distinguishing feature of the nondeposit deposit is that, while it serves the essential purposes of a bank or thrift deposit, it escapes one or both of the main regulatory burdens applicable to such a deposit: deposit insurance premiums and reserve requirements. As we show in this section, these regulatory burdens are significant, have grown dramatically over the past five years, and will almost certainly become even more important in coming years. Moreover, the government has imposed these burdens at a time when banks are suffering an extraordinary outflow of depositor funds as a result of low nominal interest rates in 1991 and 1992. The fierce competition to retain (or attract) these deposits is likely to spur further the development of substitutes for traditional bank deposit accounts.

A. Reserve Requirements

Under current law, depository institutions generally must hold 10% of the amount of their transaction deposits in reserves, either in the form of vault cash or in noninterest bearing accounts at the Federal Reserve.⁶ These reserves constitute a significant tax on the operations of depository institutions because they do not generate income. The depository institution incurs all the opportunity costs of these idle funds. Thus, if an account could be structured to provide the functional equivalent of transaction services while avoiding the reserve re-

ing services, see, for example, Paul Starobin, *Bypassing Congress*, NATL. J., Dec. 14, 1991, at 3008.

6. See § 19 of the Federal Reserve Act, Pub. L. No. 89-597, 80 Stat. 823 (codified as amended at 12 U.S.C. § 461(b)(2) (1988)), and the Federal Reserve Board's Regulation D, 12 C.F.R. § 204 (1992). The Federal Reserve reduced the reserve requirement from 12% to 10% in February 1992, in an effort to spur bank lending. See David Wessel, *Fed Cuts Deposit-Reserve Requirements*, WALL ST. J., Feb. 19, 1992, at A2.

quirement, it would enjoy a distinct commercial advantage over standard transaction accounts that are subject to reserve requirements.

The cost of reserve requirements has decreased in absolute terms in recent months with the onset of extraordinarily low nominal short-term interest rates. Low interest rates have reduced the opportunity costs a depository institution must bear by maintaining reserves in noninterest bearing accounts at the Federal Reserve. At the same time, however, reserve requirements continue to influence bank profitability.

B. *Deposit Insurance Premiums*

Even more important, in today's market environment, is the potential that nondeposit deposits have for avoiding deposit insurance premiums. This concern has become significant in recent years with the dramatic increases in insurance premium rates. During most of the life of the federal deposit insurance system, premiums were set at an extraordinarily low level — 8.3¢ per \$100 of insured deposits. However, as shown in Table 1, deposit insurance premiums for banks have nearly tripled since 1989, jumping from 8.3¢ per \$100 of deposits to 23¢ per \$100 of deposits. In September 1992, the FDIC announced its intent to implement risk-based deposit insurance assessments as of January 1, 1993, under which the average assessment would increase up to 25.4¢ per \$100 of deposits.⁷

There is at least some reason to believe rates might go higher still. The FDIC's Bank Insurance Fund (BIF) is currently undercapitalized and, under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA),⁸ will be recapitalized over a fifteen-year period using assessments from BIF members.⁹ Meeting this statutory objective could require increased assessments.

Moreover, the 1991 legislation increased the FDIC's line of credit at the Treasury from \$5 billion to \$30 billion,¹⁰ to be used to support either the BIF or the Savings Association Insurance Fund (SAIF). The amount of such borrowings is required to be repaid out of assessments on insured institutions, including emergency special assessments as necessary.¹¹ The FDIC recently imposed risk-based deposit

7. See Barbara A. Rehm, *FDIC Fixes Premium At Average 25.4 Cents*, AM. BANKER, Sept. 16, 1990, at 1.

8. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (1991) (codified in scattered sections of 12 U.S.C.A. (West Supp. 1992)) [hereinafter FDICIA].

9. See FDICIA § 104 (to be codified at 12 U.S.C. § 1817(b)(1)(C)).

10. See FDICIA § 101 (amending 12 U.S.C. § 1824(a)).

11. See FDICIA § 103 (to be codified at 12 U.S.C. §§ 1824(c), 1817(b)(7)).

TABLE 1
INSURANCE ASSESSMENTS AT BANKS AND THRIFTS PER
\$100 OF DEPOSITS

Year	BIF/FDIC	SAIF/FSLIC
1935-1950	8.3¢	12.5¢
1950-1984	8.3¢	8.3¢
1985-1989	8.3¢	20.8¢
1990	12.0¢	20.8¢
1991	19.5¢-23.0¢	23.0¢
1992	23.0¢	23.0¢
1993	25.4¢ (average)	25.4¢ (average)

Source: 4 Fed. Banking L. Rep. (CCH) ¶ 47,334A (figures for 1990 and 1991); 1991-92 Fed. Banking L. Rep. (CCH) ¶ 88,542 (figures after July 1991); PHILIP F. BARTHOLOMEW, CONGRESSIONAL BUDGET OFFICE, REFORMING FEDERAL DEPOSIT INSURANCE 30 (Sheila Harty ed., 1990); Barbara A. Rehm, *FDIC Fixes Premium at Average 25.4¢*, AM. BANKER, Sept. 16, 1992, at 1.

insurance assessments ranging from 23 basis points for the strongest banks to 31 basis points for the weakest ones, with the average premium being 25.4 basis points.¹²

Striking as these figures are, they greatly understate the actual increases in premiums that banks and thrifts have experienced. Until recently, a substantial percentage of assessment premiums was rebated back to insured banks in the form of a credit for the FDIC's and FSLIC's net assessment income after deducting expenses and losses.¹³ Premium rebates were set for FDIC-insured institutions at 60% of net assessment income in 1950, increased to 66.66% of net assessment income in 1960, and reduced back to 60% of net assessment income in 1980.¹⁴ Because the losses to the FDIC and FSLIC were virtually nil prior to 1980,¹⁵ the actual cost of assessments to insured institutions was only about half of the nominal costs — i.e., only about 4¢ per \$100 of insured deposits.¹⁶ In the 1980s, however, the rebates dried up. Bank failures between 1981 and 1983 reduced premium rebates and increased the effective FDIC assessment to approximately 7¢ per \$100 of insured deposits.¹⁷ The FDIC stopped issuing rebates alto-

12. See Rehm, *supra* note 7, at 1.

13. See MILTON R. SCHROEDER, BANK OFFICER'S HANDBOOK OF COMMERCIAL BANKING LAW ¶ 11.01[3] (6th ed. 1989); Barbara A. Rehm, *FDIC's Shortfall Hit \$10 Billion in '88*, AM. BANKER, Apr. 26, 1989, at 1.

14. See PHILIP F. BARTHOLOMEW, CONGRESSIONAL BUDGET OFFICE, REFORMING FEDERAL DEPOSIT INSURANCE 34-35 (Sheila Harty ed., 1990).

15. See *id.* at 30.

16. See Stanley Silverberg, *Rising Premiums Will Cause Wave of Change in Industry*, AM. BANKER, Sept. 20, 1990, at 4.

17. See *id.*

gether in 1984,¹⁸ and there is no sign that it will be able to resume the practice any time soon.

The real economic costs of federal deposit insurance have increased in another way. Between 1933 and the present, as shown in Table 2, Congress repeatedly increased the coverage level for deposit insurance from its original figure of \$2,500 to its present level of \$100,000. Even adjusted for inflation, the level of coverage has increased significantly over the years — representing approximately twice the value in real terms over the coverage level set in 1934.¹⁹ These increases in coverage represent *de facto* reductions in deposit insurance premiums, because the government agreed to take on significantly greater risk without increasing the premiums.

TABLE 2
FEDERAL DEPOSIT INSURANCE COVERAGE 1933-1992

Year	Coverage
1933	\$ 2,500
1934	\$ 5,000
1950	\$ 10,000
1966	\$ 15,000
1969	\$ 20,000
1974	\$ 40,000
1980-92	\$100,000

Source: PHILIP F. BARTHOLOMEW, CONGRESSIONAL BUDGET OFFICE, REFORMING FEDERAL DEPOSIT INSURANCE 34-37 (Sheila Harty ed., 1990); U.S. DEPT. OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS, Figure 6, *reprinted in* Fed. Banking L. Rep. (CCH) No. 1377, Part II, at 25 (Feb. 14, 1991).

Moreover, even the \$100,000 “ceiling” underestimated the actual level of insurance coverage available to bank depositors as banks began to fail in increasing numbers during the early 1980s. During those years, the FDIC’s policy was to favor “purchase and assumption” resolution transactions in which all depositors, even uninsured depositors, were made whole.²⁰ The situations in which the FDIC used deposit payoffs — i.e., where it would pay off only the insured deposits and remit the uninsured deposits to the status of uninsured creditors — were aberrational. When the FDIC experimented with increased use of deposit payoffs in the Penn Square failure in 1983, the result

18. See Rehm, *supra* note 13, at 1.

19. See BARTHOLOMEW, *supra* note 14, at 36.

20. For a description of the purchase and assumption transaction, see Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1182-84 (1988).

was, from the agency's perspective, nearly catastrophic: the Penn Square fiasco spilled over into Chicago's giant Continental Bank and effectively contributed to the failure of that institution in 1984.²¹ The FDIC backed off from further experimentation with deposit payoffs. Moreover, the FDIC refused to expose institutions such as Continental Bank, which it deemed "too big to fail," to even the limited risk of loss that applied to other uninsured deposits. These institutions' uninsured depositors had virtually ironclad assurance of being repaid, no matter how large their deposits.

If a customer wanted to make deposits in smaller institutions that were not protected by the "too big to fail" policy, she could easily do so, while earning the highest available rates of interest, by utilizing deposit brokers to split deposits among different institutions in amounts up to \$100,000. Thus, despite the nominal policy ceiling of \$100,000, the de facto level of coverage approached infinity.

Over the past few years, however, this de facto coverage has been scaled back dramatically. Although the FDIC still shows a marked preference for purchase and assumption transactions in which all depositors are made whole, it has increasingly experimented with other resolution methods, such as insured deposit transfers, in which only insured deposits are paid off in full.²² The FDICIA legislation, which strongly signals congressional displeasure with the use of taxpayer funds to bail out uninsured depositors, should further enhance the FDIC's willingness to expose uninsured depositors to loss. After 1994, at the latest, the legislation prohibits the FDIC from taking any action that has the effect of increasing losses to the insurance fund by protecting uninsured depositors (other than as unsecured creditors).²³

The "too big to fail" policy has also come under congressional attack. The FDIC may deviate from the least-cost resolution procedure in order to save large institutions only if (1) employing the least-cost procedure would result in serious systemic effects and (2) both the FDIC and the Federal Reserve recommend the use of an exceptional procedure to the Secretary of the Treasury, who must consult with the President before acting.²⁴ Thus, a customer can no longer feel confi-

21. See JONATHAN R. MACEY & GEOFFREY P. MILLER, *BANKING LAW AND REGULATION* 260-61 (1992).

22. See FDIC Ann. Report 1991 (documenting increasing use of insured deposit transfers as failure resolution method); Michael Quint, *U.S. Shift on Deposit Insurance: More Risk for Banks' Bigger Customers*, N.Y. TIMES, Mar. 26, 1992, at D1 (reporting that 50% of bank failures in 1992 were expected to result in losses to uninsured depositors, as compared with 16.9% of bank failures in 1991).

23. FDICIA § 141 (to be codified at 12 U.S.C. § 1823(c)(4)(E)(1)(i)).

24. FDICIA § 141 (to be codified at 12 U.S.C. § 1823(c)(4)(F)).

dent that uninsured deposits at large depository institutions will be protected in the event of bank failure.

At the same time, recent legislation severely restricting the activities of deposit brokers has reduced the ease of splitting deposits among depository institutions. The FDICIA prohibits insured depository institutions that are "not well capitalized" from accepting brokered deposits.²⁵ Insured depository institutions may not, if they use the services of deposit brokers, pay rates of interest that significantly exceed normal market rates.²⁶ These provisions appear to remove most, if not all, of the economic benefits that deposit brokerage offered to insured depository institutions.

Thus, although the nominal deposit ceiling of \$100,000 has not changed since 1980, the actual extent of coverage available under the FDIC's insurance "policy" has been substantially eroded over the past few years — effectively increasing the real cost of deposit insurance.

C. Deposit Outflows

The increases, explicit and implicit, in federal deposit insurance premiums will force depository institutions either to pass these costs on to customers or to experience reduced profitability. Neither solution is particularly appealing for banks. The problems are especially severe, moreover, in light of recent extraordinarily low nominal interest rates, which have sparked an enormous exodus from the banking system. This exodus comes at the very time when banks are being forced to raise prices relative to nonbank competitors that are not subject to deposit insurance assessments.

As the Federal Reserve sought to bring the nation out of recession in 1991 and 1992, it adopted monetary policies focused on lowering interest rates. Interest rates plummeted below 4% on some bank certificates of deposit in December 1991²⁷ and continued to fall throughout 1992.²⁸ Depositors responded by abandoning ship in favor of equity and bond markets. In November 1991, depositors withdrew \$21 billion in maturing certificates of deposit; two months later, in

25. 12 U.S.C.A. § 1831f(a) (West Supp. 1992).

26. 12 U.S.C.A. § 1831f(h) (West Supp. 1992).

27. See Ellen E. Schultz, *Bad News for Savers: Some CDs Slip Below 4%*, WALL ST. J., Dec. 27, 1991, at C1.

28. As of January 1992, interest rates on NOW accounts at insured commercial banks averaged 3.37%, on personal savings deposits averaged 3.93%, and on small time deposits with maturities of between 7 and 91 days averaged 3.85%. Federal Reserve Statistical Release H.6, Feb. 20, 1992, at 11. Average yields on six-month certificates of deposit fell from over 5% in October 1991 to approximately 3% in October 1992. See Georgette Jasen, *Banks Now Bank on Alternatives to CDs*, WALL ST. J., Oct. 19, 1992, at C1.

January 1992, the outflow reached \$22 billion.²⁹ The trend continued through 1992, as assets in small-denomination (less than \$100,000) bank certificates of deposit fell by close to \$200 billion between October 1991 and September 1992.³⁰

Much of this outflow has gone to mutual funds. One source estimated that, as of December 1991, the banking industry was losing \$6 million an hour to mutual funds.³¹ The influx of money into stock and bond mutual funds approached \$16 billion in mutual funds in February alone.³² One result of this massive flow of funds was a record boom in the stock market in late 1991 and early 1992, which, however, appears to have been driven largely by disintermediation out of low-yielding bank certificates of deposit and money market mutual funds rather than fundamental strength in the equity market.

Banks have attempted to stanch the hemorrhage by competing vigorously to retain deposits. Faced with accelerating deposit outflows, they have launched advertising campaigns and touted promotions ranging from cash bonuses to enhanced services to unusual maturity periods in an attempt to persuade customers to roll over their maturing certificates of deposit.³³ Some banks offered certificates of deposit which would pay out higher interest rates in the event that rates rose during the certificate period.³⁴ Obviously, banks have been assiduously trying to compete for deposits; one anticipated impact of this increased competition is that banks will seek ways to offer nondeposit deposit accounts paying higher yields in order to compete with the other investments — such as stock market mutual funds — available in today's marketplace.

29. Richard Layne, *Deposit Runoff Picks Up Speed as CDs Mature*, AM. BANKER, Jan. 30, 1992, at 1.

30. See Jasen, *supra* note 28, at C1; Federal Reserve Statistical Release H.6, Oct. 8, 1992, at 8-9. During the same period, the banking system lost over \$75 billion in large-denomination certificates of deposit. *Id.* The outflow in time deposits was partially offset by increases in transaction account balances at banks and thrift institutions, possibly representing excess liquidity due to persistent recession. Demand deposits grew by over \$37 billion between October 1991 and October 1992, while other transaction account balances, such as NOW accounts, grew by over \$34 billion during the period. *Id.* at 6-7. The overall pattern, however, is clearly one of dramatic deposit outflows from the banking system.

31. See Ellen Braitman, *\$6 Million an Hour in Lost Business*, AM. BANKER, Dec. 11, 1991, at 6.

32. Debra Cope, *Deposit Outflow Confirms Banks' Diminished Role*, AM. BANKER, Apr. 6, 1992, at 1; Floyd Norris, *Cash Flood Still Going Toward Mutual Funds*, N.Y. TIMES, Mar. 31, 1992, at D1.

33. See Sam Zuckerman, *California Test: Getting Savers to Roll Over*, AM. BANKER, Dec. 12, 1991, at 1.

34. See *id.* at 13.

II. MODELS OF THE NONDEPOSIT DEPOSIT ACCOUNT

We now turn to an examination of different types of arrangements with payment instruments that either qualify within our definition of nondeposit deposits or that substantially contribute to the development of instruments that do qualify as nondeposit deposits. The discussion moves from the most familiar and traditional types of instruments to relatively new, arcane, and even untested arrangements.

Of all the instruments discussed below, the one with the greatest potential for destabilizing the banking industry is the use of demand debt with transaction features issued by institutions other than depository institutions. As will be seen, this remarkable instrument escapes virtually all bank-type regulatory scrutiny, yet for all intents and purposes is a bank account from the customer's perspective. This form of nondeposit deposit already exists and has been issued by at least one major firm, IBM Corporation. Whether this instrument will eventually come under regulation, or will alternatively stimulate the deregulation of bank checking accounts, remains to be seen.

A. *Traditional Payment Instruments*

We start by examining a group of traditional payment instruments that differ in various ways from the standard checking account deposit. These include electronic funds transfers, money orders, travelers checks, and official checks at banks. Each is a partial substitute for the checking account deposit at a depository institution; the degree of substitutability between these payment instruments and bank deposits depends on the characteristics and practical features of each instrument.

1. *Electronic Funds Transfers*

Consider first the use of electronic funds transfers (EFTs). These include two important arrangements in addition to the familiar automatic teller machine transaction. Wire transfers are transactions in which a customer gives a credit instruction to a bank individually and the bank effects the payment of funds electronically.³⁵ Automated clearing house (ACH) transactions occur when payment instructions are given in a batch (as when a company deposits paychecks automatically in customers' bank accounts).³⁶ Wire transfers have mainly been

35. See EDWARD L. RUBIN & ROBERT COOTER, *THE PAYMENT SYSTEM: CASES, MATERIALS AND ISSUES* 736-37 (1989).

36. See *id.* at 737.

used for corporate and interbank fund transfers.³⁷ However, consumer use of wire transfer services appears to be increasing. The consumer wire transfer industry is currently dominated by Western Union Co., which utilizes a network of 17,000 agents nationwide.³⁸ But other companies, including American Express, are making inroads into the market.³⁹

EFTs fulfill a role in the payments system similar to that of traditional checking accounts. They do not, however, serve as a particularly effective substitute for the insured deposit at a depository institution. In many cases, where the EFT occurs between two insured accounts at depository institutions, the new technology alters only the form of the payment and not the underlying substance of the accounts through which payment is made. To the extent that EFT transactions that occur outside the banking system free customers from the need to use insured deposit accounts to effect their payment obligations, they do contribute to the growth of nondeposit deposits. But the EFT transaction itself does not create a nondeposit deposit account, since the funds are transferred nearly instantaneously and are otherwise held by the customer on either end of the transaction.

2. Money Orders

One instrument that has traditionally been used for transaction services and does create a form of nondeposit deposit account is the money order. This is a draft, usually made payable to the order of a third party, which a company issues to a customer in exchange for payment of the principal amount at the time of issuance (usually in cash). A company may also offer money orders as agent for an issuing company. In either case, the customer can take the money order and remit it to others in order to effect a transfer of wealth.

The traditional money order offers advantages to all parties in certain settings. From the standpoint of customers, money orders offer a means of effecting payment that is safer than cash. If the instrument is lost the customer may (with difficulty) be able to cancel it and obtain a replacement; also, the customer enjoys the protection of the Uniform Commercial Code in the event of misappropriation if the instrument is made payable to order.⁴⁰ From the standpoint of the payee, the

37. *See id.*

38. *See* Ellen Braitman & Tom Leander, *Financial Firms Fill Banks' Service Gaps*, AM. BANKER, Nov. 22, 1991, at 1.

39. *See id.*

40. *See* U.C.C. § 3-202(1) (1990) (transferee becomes a holder of an instrument payable to order only if instrument is negotiated by delivery with any necessary endorsement).

money order ensures payment by placing the issuing firm's credit behind the instrument. The issuing firm and its agents (if any), for their part, enjoy the benefit of the float between the time the instrument is issued and the time of payment, as well as any applicable fees from the customer.

The money order clearly displays significant similarities to the bank check: it is a medium for effecting wealth transfers among individuals or firms. Perhaps less evident, but equally important, is the fact that the money order is also functionally similar to a bank deposit account from the standpoint of the issuing firm. The issuing firm obtains payment up front for the money orders that it issues. The firm can use that money for all sorts of investments: it can make commercial or personal loans, invest in government or corporate securities, or use the funds to support its operations, among other things. To be sure, the issuing firm expects to pay out the funds when the payee receives the order and presents it for payment. This will not always occur immediately, however; money orders may remain outstanding for months or years. Indeed, if issued as bearer instruments, they may circulate in the economy as a form of currency. Accordingly, the firm issuing the money order is functionally similar to a depository institution: it receives funds from customers and promises to repay these funds on proper demand; and it relies on the law of large numbers to invest the funds received in various ways, keeping enough on hand at any given time to pay out the demands of customers in the ordinary course.⁴¹

Although traditional money orders functionally resemble deposit accounts,⁴² the money order business is dominated at the wholesale level by a small number of nonbank institutions.⁴³ The size of the money order business is unknown; money order companies are not regulated by the federal government and are not required to report their business to the Federal Reserve.⁴⁴ The business, however, appears to be significant: the leading firm in the industry, Travelers Express Co., is thought to have many millions or even more than a billion dollars in money orders outstanding at any given time.⁴⁵

41. The similarity between money order issuers and banks is even more pronounced when we consider that the deposit obligations of banks were once principally expressed in the form of circulating bank notes rather than checking account balances. See MACEY & MILLER, *supra* note 21, at 12.

42. See Citicorp, Order Approving Engaging in Nonbank Activity, 63 FED. RESERVE BULL. 416, 418 (1977) [hereinafter Citicorp Order]. As discussed below, banking institutions now provide services functionally similar to money orders. See *infra* text accompanying notes 52-54.

43. See Citicorp Order, *supra* note 42, at 417-18.

44. Telephone Interview with Jack Walton, Federal Reserve Board (Feb. 18, 1992).

45. *Id.*

Until recently, depository institutions did not issue money orders in quantity, although such institutions have always had some presence in the industry.⁴⁶ Several factors explain this phenomenon. A viable competitor in the money order market must have a national presence, something that until recently did not characterize banks, which were severely restricted by regulatory constraints in their ability to expand geographically. Most banking organizations, moreover, were not large enough to compete in the money order market, which is characterized by large economies of scale and high entry barriers.⁴⁷ Consumers who had accounts at banks usually did not demand money orders because they could effect payments by means of their checking accounts. To the extent that a consumer needed a payment instrument backed by the credit of a depository institution, a bank could provide alternative instruments — the teller's check, cashier's check, and certified check — which performed most of the same functions from the consumer's standpoint.

Money orders issued by institutions other than depository institutions possess significant regulatory advantages as compared with traditional checking accounts. First, if not issued by an insured depository institution, a money order is not subject to federal deposit insurance premiums. The credit of the issuing firm stands behind a money order, but not that of the federal deposit insurance system.⁴⁸ The absence of federal deposit insurance premiums has, of course, become a much more significant competitive advantage for money order firms over the past few years as the cost of these premiums for federally insured depository institutions has skyrocketed. The second advantage money orders enjoy over deposit accounts is that traditional money orders are not subject to federal reserve requirements because they were not issued by depository institutions.⁴⁹

The structural disadvantages faced by depository institutions in the consumer money order business were significantly alleviated when the

46. See Citicorp Order, *supra* note 42, at 416-17 (banks "historically have been in the business of issuing money orders and similar payment instruments. . .").

47. See *id.* at 417-18 ("[e]ntry into this business on a national scale involves overcoming significant barriers since a potential entrant must possess the capability for managing the extensive sales and servicing operation necessary for handling a low unit price, high volume product"; banking organizations may be able to compete in this market if they are of a "significant size.").

48. The security of money orders is extraordinarily high, however, for a number of reasons. Because the money order is typically outstanding only for a short period of time, the customer experiences only a brief risk exposure, unlike the checking account customer at a depository institution who maintains a balance over a sustained period. Moreover, the large size of money-order issuing firms makes default unlikely. To the best of our knowledge, there has been no default by a money-order issuing firm in recent years.

49. See Citicorp Order, *supra* note 42, at 418.

Federal Reserve, in 1977, approved the issuance of small denomination money orders as a permissible activity for a nonbanking subsidiary of a bank holding company.⁵⁰ These money orders are not subject to reserve requirements because they are issued by nonbank affiliates of depository institutions.⁵¹ Had it chosen to do so, the Federal Reserve Board could easily have conditioned its approval on the applicant's undertaking to handle the funds received in such a way as to require the holding of reserves. The Board's reason for not imposing the functional equivalent of reserve requirements on these instruments was clearly the concern for nonbank competition. The Board observed that "competitive equity" between nonfinancial institutions already in the money order business and potential bank holding company entrants could not be achieved if "some competitors are subject to reserve requirements while others are not."⁵²

The traditional money order, used to effect small-scale payments, was typically issued in denominations below \$1000. In recent years, however, customers have begun to utilize larger-denomination money orders to accomplish larger transactions. In 1984, BankAmerica received Fed approval to enter this market by issuing payment instruments with a maximum face value of \$10,000.⁵³ The Fed expressed concern, however, about the fact that these large-denomination money orders were not subject to reserve requirements, and it warned that, if the activity caused a significant reduction in the reserve base, it would likely impose reserve requirements on such instruments.⁵⁴ The following year, the Fed approved Wells Fargo's application to issue official checks (which are very similar to money orders) in denominations over \$10,000, but it did so subject to Wells Fargo's express commitment to deposit the amounts received from the customer for such checks in a demand deposit account at its subsidiary, Wells Fargo Bank.⁵⁵ The Fed thus allowed large-denomination official checks to be used as payment instruments, but it did so in a way that resulted in the

50. See *id.* at 418-19 (approving issuance of small-denomination (\$1000 or less) money orders by bank holding company's nonbank subsidiary). The permission to issue small-denomination money orders is now codified in the Federal Reserve Board's Regulation Y, 12 C.F.R. § 225.25(b)(12) (1992).

51. See Citicorp Order, *supra* note 42, at 418.

52. *Id.*

53. BankAmerica Corp., 70 FED. RESERVE BULL. 364 (1984).

54. See BankAmerica Corp., 70 FED. RESERVE BULL. 365-66 (1984); see also Chase Manhattan Corp., 71 FED. RESERVE BULL. 905 (1985); Citicorp, 71 FED. RESERVE BULL. 58-59 (1985).

55. Wells Fargo & Co., 72 FED. RESERVE BULL. 148 (1986); see also Midland Bank, PLC, 74 FED. RESERVE BULL. 252 (1988).

equivalent of reserves being held against the amount of such checks outstanding.

Despite its advantages, the money order has not become a significant competitor for the bank check in most settings. The reason is the costs associated with obtaining a money order: the customer must go to the office of the issuing firm or its agent, usually with cash in hand, and direct that a particular draft be made out to a particular payee. This is far less convenient than a checkbook for many customers. Moreover, money orders are expensive; the customer loses the value of the funds during the float period and usually must pay a fee besides. Most checking accounts, in contrast, pay interest to the customer until the check clears. For these reasons, money orders have been major competitors for checks only in specialized markets. These include, most prominently, consumers with limited funds who do not maintain checking accounts⁵⁶ and persons who wish for whatever reason to avoid having their transactions traced through the banking system.

Notwithstanding these disadvantages, money orders should be viewed as one form of nondeposit deposit. From a functional standpoint, their role is quite similar to that of bank deposits. Although they have not displaced bank deposits due to practical constraints, they do possess the valuable attribute of not being subject to deposit insurance premiums and required reserves, and to this extent they can be priced by issuing institutions at a level which results in some displacement of bank deposit accounts at the margin.

3. *Traveler's Checks*

The traveler's check is an unusual instrument that represents the obligation of the issuing firm but requires a countersignature by the person whose specimen signature appears on the instrument.⁵⁷ Traveler's checks issued by depository institutions are subject to reserve requirements,⁵⁸ and insured institutions must pay deposit insurance premiums.⁵⁹ On the other hand, traveler's checks issued by institutions other than depository institutions are not subject either to re-

56. See Wells Fargo & Co., 72 FED. RESERVE BULL. 148, 149 n.5 (1986). As of 1984, only 62% of American families with family incomes of less than \$10,000 used checks (including bank checks, automatic payments, and electronic payments); this compares with 96% of American families with incomes of \$50,000 or more who used checks. Robert B. Avery et al., *The Use of Cash and Transaction Accounts by American Families*, 72 FED. RESERVE BULL. 87, 88 (1986).

57. See U.C.C. § 3-104(i) (1990) (stating that "traveler's check" means an instrument that (i) is payable on demand, (ii) is drawn on or payable at or through a bank, (iii) is designated by the term 'traveler's check' or by a substantially similar term, and (iv) requires, as a condition to payment, a countersignature by a person whose specimen signature appears on the instrument").

58. 12 C.F.R. § 204.2(b)(1)(iii) (1992).

59. See 12 C.F.R. § 330.4(b)(4) (1992).

serve requirements or deposit insurance assessments and thus have a significant cost advantage over standard checking accounts at depository institutions. That advantage, however, is offset to a greater or lesser extent by the costs of traveler's checks to the consumer, which include both any fees the customer must pay to purchase the checks and the opportunity costs of holding funds in noninterest bearing form rather than in an interest-bearing bank account. As of February 1992, the amount of nonbank traveler's checks in circulation totaled \$8.3 billion.⁶⁰

B. Credit Card Accounts

Credit cards today represent an enormously important means for consummating wealth transfers in the economy.⁶¹ Visa alone had gross annual dollar volume for domestic transactions of about \$28 billion as of 1989, involving 1.8 million merchant outlets and 12,000 participating financial institutions.⁶² By 1991, 61% of all households in the United States held Visa cards.⁶³ Consumers engaged in approximately 9.1 billion credit card transactions in 1987.⁶⁴ By 1989 there were 956.9 million — that is, nearly one billion — credit cards outstanding in the United States, on which consumers charged an annual total of \$430.3 billion.⁶⁵

Total credit card debt outstanding grew from approximately \$80 billion in 1980 to \$233.1 billion in 1990; for universal cards (such as VISA or MasterCard) credit card debt outstanding grew from \$25 billion to \$154 billion over the same period.⁶⁶ Annual spending through the use of universal credit cards grew during this period from \$52.4 billion to \$251 billion.⁶⁷ So extensive is the use of credit cards that, in

60. See Federal Reserve Statistical Release H.6, *supra* note 28, at 4. The amount of bank-issued traveler's checks is not known, since the Federal Reserve includes traveler's checks issued by depository institutions in its general statistics for demand deposits.

61. For an introduction, see Christopher C. DeMuth, *The Case Against Credit Card Interest Rate Regulation*, 3 YALE J. ON REG. 201 (1986); Robert E. Litan, Consumers, Competition and Choice: The Impact of Price Controls on the Credit Card Industry (Mar. 1992) (unpublished manuscript on file with the authors).

62. RUBIN & COOTER, *supra* note 35, at 609.

63. See Yvette D. Kantrow, *Visa Retains Top Credit Card Spot*, AM. BANKER, Sept. 11, 1991, at 1.

64. Lawrence M. Ausubel, *The Failure of Competition in the Credit Card Market*, 81 AM. ECON. REV. 50, 51 n.1 (1991).

65. U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1991, at 510 (111th ed. 1991).

66. *Id.*; Litan, *supra* note 61, at 8.

67. Litan, *supra* note 61, at 8.

the words of one recent commentator, they have become "the currency of late 20th-century America."⁶⁸

The phenomenal growth of the universal credit card, since its inception with the BankAmerica card in 1958,⁶⁹ has contributed to the growth of nondeposit deposits in two ways. First, and most importantly, the universal credit card now offers consumers the opportunity to effect most of their day-to-day economic transactions without the use of transaction accounts at a depository institution.⁷⁰ Transactions that cannot be effected by credit card are usually either very small, in which case the consumer can settle accounts with cash, or very large, in which case the consumer can pay by means outside the banking system, such as drawing a check on a mutual fund. A consumer whose credit card provides a suitably generous credit line can opt out of using bank checking accounts at all, writing only a few checks a month on a mutual fund (including the monthly check to retire the credit card balance). Thus, the credit card operates in tandem with mutual funds and other nondeposit accounts to facilitate escape from the high costs associated with deposit insurance premiums and the maintenance of required reserves.

The second means by which credit cards facilitate the creation of nondeposit deposits is through the use of credit cards issued by nonbanks. Until quite recently, banking organizations exclusively issued the major universal credit cards. However, nonbanks have demanded entrance into the lucrative credit card market and increasingly have made inroads on the depository institutions' control over this market. Thirty-seven of the top one hundred and five of the top ten issuers of merchant and universal credit cards are not banks but diversified financial services companies.⁷¹

Nonbanks have vigorously entered the universal card market. As of 1991, 20% of the public held charge cards issued by American Express, the first major nonbank entrant, while an additional 4% held the company's Optima revolving credit card.⁷² Sears, Roebuck & Co. is now a major force in the universal credit card market, offering es-

68. Ausubel, *supra* note 64, at 51.

69. See RUBIN & COOTER, *supra* note 35, at 608.

70. The increased use of credit cards for ordinary consumer transactions stems, in part, from technological improvements that allow the salesperson to "swipe" the card through a terminal and obtain authorization for the purchase within seconds. See Christine Rodrigo, *Supermarkets Respond to Demand for 'Plastic,'* PAC. BUS. NEWS, Dec. 30, 1991, at 24.

71. See Litan, *supra* note 61, at 15.

72. See Kantrow, *supra* note 63, at 13. Aside from the Optima Card, the American Express cards are not technically "credit" cards, in that the customer is expected to pay off the amount of the outstanding debt at the close of the billing period and the sanction for late payments is forfeiture of the card rather than the imposition of interest on the outstanding balance.

entially the same services through its Discover Card that would be available with a bank-issued Visa or MasterCard. As of 1990 the Discover Card had \$9.1 billion in receivables outstanding and was accepted by 1.1 million merchants worldwide.⁷³ Sears funds its credit card receivables through highly rated securitized offerings in securities markets.⁷⁴

AT&T recently entered the credit card market with its enormously successful Universal Card; over the past few years, one out of every five newly acquired credit cards was the AT&T card.⁷⁵ Approximately 12.5 million people now hold the card, with about \$3.8 billion of outstanding debt.⁷⁶ These nonbank cards are issued by specialized credit card banks, or — in the case of the AT&T card — by contractual relationship with a commercial bank that acts as the technical issuer of the card.⁷⁷ As a practical matter, however, the funding for the credit card debt comes from a nonbank source.⁷⁸

In September 1992, two major nonbank firms, GE Capital Corp. (a subsidiary of General Electric Co.) and General Motors Corp., introduced MasterCard programs that offer substantial rebates to customers on purchases from the issuing firms or their affiliates.⁷⁹ The lure of product rebates is expected to draw many customers away from their existing bank-issued universal credit cards.⁸⁰

C. Short Term Debt at Depository Institutions

Consider now a variety of capital market instruments that depository institutions can use to obtain funds and that are not treated, for regulatory purposes, as deposits subject to reserve requirements and deposit insurance assessments. The most significant of these are the use of repurchase agreements and the issuance of uninsured bank "notes."

73. See *Discover Issue is Top-Rated by Duff & Phelps*, AM. BANKER, Nov. 8, 1990, at 19.

74. See *Discover Files with SEC for Card Pass-Throughs*, AM. BANKER, Aug. 7, 1990, at 2; *Discover Issue is Top-Rated by Duff & Phelps*, *supra* note 73, at 19 (reporting that four sets of Discover pass-through certificates were issued in 1990, all rated AAA by Duff & Phelps Inc.).

75. See Kantrow, *supra* note 63, at 1.

76. See Yvette D. Kantrow, *Fed Declines to Review Legality of AT&T Card*, AM. BANKER, Feb. 24, 1992, at 1, 8.

77. See, e.g., *id.* at 1.

78. In the case of the AT&T card, for example, AT&T is believed to purchase most or all of the accounts receivable from the issuing bank, thus transferring the assets to its books. See *id.*

79. See Yvette D. Kantrow, *GM to Offer Credit Card Priced Lower than GE's*, AM. BANKER, Sept. 9, 1992, at 1; Yvette D. Kantrow, *GE Offers Credit Card with Lure of Rebates*, AM. BANKER, Sept. 3, 1992, at 1.

80. See sources cited *supra* note 79.

1. Repurchase Agreements

The repurchase agreement — or *repo* — has long been used in corporate finance as a short term credit instrument.⁸¹ A party with temporary excess liquidity agrees to “purchase” securities (usually U.S. Treasury securities) under an agreement to resell to the “seller” of the securities at a later date, usually no more than a few days later. The resale price is set at a level that reflects an implicit interest rate to compensate the purchaser for the use of the funds during the period of the agreement. Repurchase agreements are similar in economic substance to collateralized loans; the security represents the collateral for the underlying loan transaction.⁸²

In the case of the banking industry, the repurchase agreement in which a customer buys securities from a bank subject to an agreement to repurchase is treated as a sale of securities and not a deposit. The legal consequences of this characterization are significant. Funds a bank receives under a repurchase agreement are subject neither to insurance nor reserve requirements. Moreover, treating a repurchase agreement as a sale of securities permits the bank to collateralize the debt, something that national banks at least would be prohibited from doing if the funds were characterized as a deposit.⁸³

These legal consequences allow the use of repurchase agreements as nondeposit deposit accounts. Assume that a corporate treasurer has \$1 million in funds to invest but needs to have those funds available on demand, or nearly so, in order to meet the requirements of payments in the ordinary course. The treasurer could deposit the \$1 million in a bank, but doing so might well be inadvisable. The bank would have to pay deposit insurance on, and hold reserves against, the entire \$1 million, and it would necessarily pass these costs on to the depositor in the form of lower interest payments. At the same time, only \$100,000 of these funds would be insured; in today's environ-

81. For a general introduction to repurchase agreements, see MARCIA STIGUM, *THE MONEY MARKET* (3d ed. 1990).

82. There are some differences, however. For example, the holder of collateral for a loan cannot sell the collateral prior to default, whereas in theory the purchaser of securities under a repurchase agreement can sell the securities prior to resale. See *SEC v. Drysdale Sec. Corp.*, 785 F.2d 38, 41 (2d Cir. 1986). In practice this distinction is not important, for the purchaser does not resell the securities and, indeed, rarely obtains physical custody over them.

83. See, e.g., *Texas & Pac. Ry. Co. v. Pottorff*, 291 U.S. 245 (1934). There may also be liability under SEC Rule 10b-5 for fraud in connection with the transaction. See *First Natl. Bank v. Estate of Russell*, 657 F.2d 668 (5th Cir. 1981) (finding a genuine issue of material fact as to whether repurchase agreement constituted a sale of securities subject to Rule 10b-5); *The Issuance of “Retail Repurchase Agreements” by Banks and Savings and Loan Associations*, Securities Act Release No. 6351, 1 Fed. Sec. L. Rep. (CCH) ¶ 2024 (Sept. 25, 1981) (deeming retail repurchase agreements subject to antifraud provisions of federal securities laws).

ment, there would be no assurance that in the event of bank failure the depositor would be paid off in full.

On the other hand, the treasurer could enter into a repurchase agreement with the bank that would be functionally similar to a deposit account but would overcome most of the difficulties noted above. Under this arrangement, the treasurer would purchase \$1 million of government securities from the bank under an agreement to resell them the following day. Under the terms of the agreement, the bank would automatically roll the money over into another repurchase agreement on similar terms unless it received instructions from the treasurer to take some other action. If the treasurer wanted to make a payment, he could instruct the bank to close out some or all of the investment and remit the funds by official check or wire transfer to a designated payee. If the treasurer wanted instant liquidity, he could instruct the bank to remit the funds to a checking account maintained by the corporation at the bank, which is usually funded only at nominal levels, often with the understanding that the excess funds will be swept into the repo arrangement.

Repurchase agreements can be used to accomplish virtually all the economic substance of checking accounts, but without the costs of deposit insurance and required reserves. Moreover, because the repurchase agreement is secured by highly reliable and readily marketable collateral, it offers a good assurance against the risk of bank failure. In fact, repurchase agreements are being used today to accomplish exactly these purposes of avoiding costly regulation. Such use is only likely to increase as deposit insurance assessments continue to rise.

As yet, repurchase agreements have been used almost entirely at the wholesale level to serve the needs of corporations. Little reason appears, however, why retail repos could not be adapted to offer the equivalent of nondeposit deposit accounts to individuals. A bank, for example, could "sell" fractional interests in securities to customers, with the amount of the sale computed at the close of business on each business day, subject to an agreement to "repurchase" the securities the following day and to remit the repurchase amount to payees as directed by customers, who could provide these instructions to the bank in the form of drafts (i.e., checks); any amounts remaining at the close of the business day would be used to purchase a different fractional interest in securities.⁸⁴

84. If widely distributed, retail repos might require registration under the Securities Act of 1933, a process which would add to the costs of such instruments for the issuing bank.

2. Bank Notes

In addition to repurchase agreements, a bank can offer investment instruments that have some of the features of bank deposit account by selling "notes" on the market. These are simply short-term debt instruments that banks issue to sophisticated investors. These instruments may be either insured or noninsured, apparently at the option of the issuing bank. If the bank elects to style the instrument a "deposit note," the common understanding in the industry is that the note will be insured, and the bank must pay insurance premiums to the FDIC. If, however, an instrument with identical features is styled a "bank note," without the word "deposit" in the title, the issuing banks treat the instrument as a security rather than a deposit and do not pay deposit insurance assessments on the amounts outstanding.⁸⁵

In 1988 the FDIC, concerned about the increased issuance of non-insured notes by insured banks, proposed to bring such instruments within the ambit of deposit insurance by declaring them to be deposits by general usage.⁸⁶ The FDIC expressed concern that "[i]f the FDIC insures one liability which looks exactly like another uninsured liability except for its name and perhaps a simple statement as to whether the liability is a deposit, the consumer may be confused as to what type of liability he has purchased."⁸⁷ While acknowledging that the purchasers of bank notes might not care about deposit insurance coverage at the time of purchase, the FDIC expressed the concern that purchasers would take a different position in the event of bank failure.⁸⁸ Accordingly, the FDIC proposed to declare that all notes, bonds, acknowledgements of advance, and similar liabilities undertaken as a means of obtaining funds constitute deposits by general usage against which deposit insurance premiums must be paid.⁸⁹ The FDIC has never acted on this proposal, however, and the insurance status of bank notes remains a matter of considerable uncertainty.

D. Mutual Funds with Transaction Features

Mutual funds of the open-end investment company variety now compete prominently with banks for transaction accounts. An open-end investment company is a mutual fund continuously engaged in the issuance of its shares and ready at any time to redeem its own securi-

85. See Deposit Liabilities, 53 Fed. Reg. 47,723 (to be codified at 12 C.F.R. § 354) (proposed Nov. 25, 1988).

86. *Id.*

87. See *id.* at 47,724.

88. See *id.*

89. *Id.*

ties.⁹⁰ Today such mutual funds typically allow customers to withdraw funds by writing checks payable to third parties, which are usually cleared through the banking system.⁹¹ Customers are ordinarily restricted in their use of the mutual fund as a transaction account through limitations on the number of checks that can be drawn per month, required minimum amounts for checks, or other features. These restrictions, however, have become much less onerous over time. The mutual fund thus provides services that, from the standpoint of the investor, are similar, although not identical to, those offered by banks: it offers a highly secure investment vehicle with transaction features.⁹²

The mutual fund differs from a bank in a number of respects. Most importantly, investments in a mutual fund are not debt instruments. The fund does not promise to pay back the investor at any specified value, but rather commits to redeem investments based on the fund's net asset value at the time of redemption.⁹³ Interests in a mutual fund are thus a form of demand equity rather than demand debt. This feature means that a run on a mutual fund is unlikely. Even if a customer hears troubling news about a mutual fund in which he or she has invested, there may be little advantage to redeeming shares immediately because he or she will receive only a pro rata share of net asset value.⁹⁴ There may be a marginal advantage nonetheless for participating in a run on a mutual fund because of concern that net asset value will decrease during a run as a result of emergency liquidations of assets to meet customer demand. However, the highly liquid nature and broadly diversified asset base of most mutual funds makes

90. See 12 C.F.R. § 225.125(c) (1992).

91. Merrill Lynch apparently developed the first checkable mutual fund with its Cash Management Account (CMA). See MELANIE FEIN, *SECURITIES ACTIVITIES OF BANKS* ¶ 9.01[A] n.4 (1992).

92. The Securities and Exchange Commission recently revised its rules on money market mutual funds in order to require prominent disclosure on the cover page of the prospectus and in sales literature and advertisements that a mutual fund is not guaranteed or insured by the U.S. government and that there is no assurance that the fund will be able to maintain a stable net asset value. See Revisions to Rules Regulating Money Market Funds, 56 Fed. Reg. 8113 (1991) (to be codified at 17 C.F.R. §§ 230, 239, 270, 274).

93. See FEIN, *supra* note 91, ¶ 9.01[A].

94. This statement requires some qualification with respect to money market mutual funds, which are permitted to calculate net asset value by an amortized cost method rather than a market-to-market method. The SEC permits this more convenient calculation method because of the minimal risk that defaults in the asset portfolio will reduce net asset value at market prices significantly below the asset value as calculated by the amortized cost method. In 1989 and 1990, however, several money market funds experienced defaults in their commercial paper investments that would have adversely affected shareholders of these funds had the investment advisor or other affiliate not stepped in to purchase the defaulted securities. See Revisions to Rules Regulating Money Market Funds, *supra* note 92, at 8115. In response, the SEC tightened its rules on permissible investments for money market funds. *Id.*

this concern largely theoretical. To the best of the authors' knowledge, there has never been a significant run on a mutual fund.

The major advantage of mutual funds over bank deposits as transaction accounts is the fact that they pay no deposit insurance premiums and are not required to hold reserves at the Federal Reserve.⁹⁵ Moreover, as we have already noted,⁹⁶ the transaction limitation features seen in the typical mutual fund, while making mutual funds less attractive as a substitute for depository institutions for the conduct of day-to-day economic transactions, must be viewed in the context of the widespread use of credit cards.

Although mutual funds compete with banks for transaction accounts, banking firms today can also act as investment advisors to mutual funds.⁹⁷ Thus banks can — and do — attempt to dissuade customers from leaving the bank altogether when they withdraw funds from checking accounts. Larger banks can offer the customers an investment in "private label" mutual funds that the bank advises; banks of all sizes can place customers' funds in independent mutual funds and earn fees for doing so.⁹⁸ At least one commercial analysis has concluded that steering small savers into mutual funds is more profitable for commercial banks than selling them small-denomination certificates of deposit.⁹⁹ Some banks have attempted to regularize the process by developing sweep accounts that automatically invest excess bank account deposits in a mutual fund advised by the bank.¹⁰⁰ The connection between banks and their in-house mutual funds has recently taken a new step with the decision by NationsBank to combine

95. However, as mutual funds come increasingly to resemble banks in the transaction services they provide, there may be efforts to bring them under bank-like regulation. For example, § 151 of the FDICIA authorizes the Federal Trade Commission to impose disclosure requirements on uninsured "depository institution[s]"; the definition of *depository institution* is not limited to firms operating under bank charter but includes other firms that are in the business of receiving deposits and that might reasonably be mistaken for an insured depository institution. The FTC is now apparently considering whether to include mutual funds as depository institutions under this authority. Letter from Melanie Fein, May 7, 1992 (on file with authors). Moreover, as we observe below, the Federal Reserve has been hinting that it would like eventually to impose reserve requirements on mutual funds that offer transaction accounts. See *infra* notes 139-42 and accompanying text.

96. See *supra* notes 70-71 and accompanying text.

97. See 12 C.F.R. § 225.25(b)(4)(ii) (1992) (bank holding companies); FEIN, *supra* note 91, ¶ 6.02[E] (national banks).

98. See Paul Starobin, *Bypassing Congress*, 23 NATL. J. 3008 (1991) (reporting that banks are earning fees by steering customers into uninsured mutual funds). Even smaller banks are attempting to gain the benefits from the private label funds by establishing joint ventures to overcome diseconomies of scale. See *id.* at 3010 (reporting that approximately 70 independent banks had formed a joint venture to facilitate their offering nontraditional products and services, including mutual fund services, to customers).

99. See *id.* at 3011.

100. FEIN, *supra* note 91, ¶ 9.01[A], at 9-5.

its money market funds, with \$4.5 billion in assets, under a name very close to that of the bank: NationsFund.¹⁰¹

As indicated in Table 3, the mutual fund industry is now a formidable competitor for the banking industry's checking and other transaction account balances. As shown, total assets in open-end mutual funds at year-end 1990 exceeded \$1 trillion. Note that these figures include accounts not used for transactions, such as IRA and Keogh accounts, and that the figures include all forms of open-end investment companies, including equity funds, bond funds (taxable and tax-exempt), and money market funds. Investors tend to view money market funds as more functionally similar to bank deposits than either equity funds or bond funds, partly because under SEC rules a money market fund is permitted to calculate net asset value so as to maintain a stable price of one dollar per share.¹⁰² Statistics on total accounts typically used for transaction services are not available.

TABLE 3
ASSETS OF OPEN-END MUTUAL FUNDS

Year	Assets (billions)
1986	\$ 716.3
1987	\$ 769.9
1988	\$ 810.3
1989	\$ 982.0
1990	\$1,069.1

Source: Investment Company Institute, 1991 Mutual Fund Fact Book 74 (1991).

Clearly, however, an enormous amount of funds is now held in mutual funds and used to effect economic transactions. The statistics on money market funds alone — which are viewed by many consumers as functional substitutes for checking accounts — are impressive, to say the least. As shown in Table 4, assets in money market funds increased from \$228.3 billion in 1986 to \$414.7 billion at year-end 1990. The current figures compare favorably with those for bank transaction accounts. As of January 1992, depository institutions held \$293.9 billion in demand deposits and \$339 billion in other checkable deposits (such as NOW accounts).¹⁰³

101. See Debra Cope, *NationsBank to Challenge Taboo With Like-Sounding Fund Name*, AM. BANKER, May 1, 1992, at 1.

102. See Revisions to Rules Regulating Money Market Mutual Funds, *supra* note 92, at 8113, 8114 n.3 (stable price of \$1.00 per share has "encouraged investors to view money market funds as an alternative to bank deposit and checking accounts").

103. See Federal Reserve Statistical Release H.6, *supra* note 28, at 4.

TABLE 4
ASSETS OF TAXABLE MONEY MARKET FUNDS

Year	Money Market Fund Assets
1986	\$228.3
1987	\$254.7
1988	\$272.3
1989	\$358.7
1990	\$414.7

Source: Investment Company Institute, 1991 Mutual Fund Fact Book 99 (1991). All amounts in billions of dollars.

E. *Demand Debt with Transaction Features*

A recent, potentially revolutionary development — one that promises to undermine much of the existing structure of banking regulation if it continues unchecked by regulatory intervention — is the use by major corporations of demand debt with transaction features.

The leading example of a demand debt arrangement is that offered by IBM Credit Corporation, a wholly owned subsidiary of International Business Machines Corporation (IBM). IBM Credit Corporation registered \$2 billion in Variable Denomination Floating Rate Demand Notes with the SEC in 1990. Investments in these notes, which are in pure book-entry form and not represented by a certificate, are credited to a plan account established for the investor by a commercial bank.¹⁰⁴ The principal amount of each note is equal to all investments made by the investor, including accrued and reinvested interest, less the amount of any redemptions and fees.¹⁰⁵ The notes have no stated maturity but are payable on demand in whole or in part. They earn interest at a floating rate determined by a committee of the company, but the rate always exceeds an independent measure of the most recent seven-day average yield of taxable money market funds in the United States.¹⁰⁶

104. IBM Credit Corporation Prospectus 1 (Sept. 21, 1990).

105. *Id.*

106. *Id.* Although the IBM program was apparently developed to facilitate investment by IBM employees, anyone — employee or not — may purchase these notes for a minimum investment of \$2500 and make additional investments of \$100 or more. Investors are supplied with a set of checks. They can withdraw funds by writing drafts payable to third parties or by wire transfer. Checks must be in amounts of \$500 or more. There are no account maintenance fees or charges for checks or check redemptions; a nominal fee applies for wire transfers. There is no limit on the number of checks drawn per month. Overdrafts are not honored. Investors can stop payment for a charge of \$12. Investors receive a monthly statement showing a summary of all the transactions made to their accounts during the month, including all investments and redemptions, all interest earned, and any transaction charges. Investors also receive a statement of mail or wire transfer deposits. *Id.* at 3-4, 6-7, 11-13.

The company uses funds it receives in its general financing business. The parent corporation has entered a support agreement with the subsidiary in which it commits to maintain 100% ownership of the voting stock; the agreement provides, however, that it "shall not be deemed to constitute a direct or indirect guarantee of IBM to any party of the payment of any debt of the principal of, or interest on, indebtedness, liability or obligation of the Company."¹⁰⁷

Although the prospectus states specifically that "[a] Plan account is not equivalent to a bank account,"¹⁰⁸ the difference between this arrangement and a traditional bank account is, from the consumer's point of view, somewhat attenuated. The principal disadvantage of the IBM account is that checks must be for amounts of \$500 or more. This is, to be sure, a significant shortcoming as compared with a checking account with no minimum transaction requirement. Yet the disadvantage is less than it might appear if the account holder holds a major credit card with which he or she pays most bills.

Despite the obvious similarities between the IBM Money Market Account and the traditional money market fund, there are important differences. The practical difference is that the typical money market fund invests in a highly diversified portfolio of securities — typically government securities or commercial paper issued by U.S. corporations.¹⁰⁹ Because of the broad diversification and the high level of safety in the underlying investments, the money market fund is unlikely to run into financial difficulties because of a downturn in its asset portfolio. The asset portfolio for the IBM Money Market Account, on the other hand, is neither diversified nor necessarily as safe with respect to the underlying investments as the usual money market mutual fund (although lease financings tend to be fairly secure because the financing firm retains a security interest in the underlying assets). Moreover, while the assets of a money market fund are usually invested in assets with very high liquidity, the IBM Money Market Fund's assets are tied up in relatively illiquid lease financings.¹¹⁰

The legal difference between the IBM Money Market Fund and a more traditional money market mutual fund is the fact that investments in the latter are a form of equity investment: the fund promises to pay the investor only a pro rata share of net asset value. In the case

107. *Id.* at 14.

108. *Id.* at 2.

109. See SEC Money Market Funds Rule 2a-7, 17 C.F.R. § 270.2a-7 (1992).

110. The lessor's interest in a lease financing could, in theory, be sold, but because these arrangements are often individually negotiated, especially for big-ticket items such as mainframe computers, a sale would probably be difficult.

of the IBM Money Market Fund, however, the investment is in the form of demand debt: the fund promises to pay investors the par value of their investments plus accrued interest determined with reference to an independent, objective measure of market interest rates.

These differences appear to create a risk of depositor runs in the case of the IBM Money Market Account. The chance of a downturn in the value of the IBM Money Market Account's asset portfolio is greater than for the usual mutual fund because of the lack of diversification and potentially greater credit risk for the IBM account as compared with the typical mutual fund. The relative illiquidity of the assets, moreover, implies that, in the event of a sudden unanticipated surge of withdrawals, the company might not be able to liquidate assets quickly enough to meet the demands of depositors even if the company were otherwise solvent. Difficulties in assessing the value of the underlying lease assets increase the likelihood that sudden unfavorable information might panic the market. In the event that such information (true or not) began to circulate, investors would potentially gain from getting ahead of the pack in anticipation of a downturn in the company's fortunes (although any failure within ninety days of a withdrawal could result in the withdrawal's being recaptured by a bankruptcy trustee as a preference).¹¹¹

None of this, of course, means that the IBM account is not useful as a matter of public policy; runs can be viewed as desirable forms of market discipline as long as they do not spread out into more generalized bank panics. Because IBM Credit Corporation is not a bank and probably would not be publicly identified as a bank, the danger that a failure of this firm would spill over into the banking industry appears remote.

So far, no other companies appear to have gone as far as IBM in organizing what is essentially a bank from the standpoint of the consumer. If IBM is successful in its program, however, additional industrial corporations will probably enter into the banking field through demand debt arrangements.

F. *Eurodollar Accounts*

A final form of nondeposit deposit is the Eurodollar account — a deposit in a bank or bank branch located outside the United States or

111. Whether the impact of the bankruptcy rule on preferences would be to mitigate or aggravate runs is not clear. If depositors knew that the company would surely fail within 90 days, they would have little incentive to run because of the preference rule; but if they did not know this information, they might actually run early, on the basis of less substantial information, in hopes that the company's possible failure would occur more than 90 days after their withdrawals.

in an international banking facility (IBF) within the United States.¹¹² Eurodollar deposits are often for fixed terms, but an important subsection of the market, the call market, is essentially a demand deposit account.¹¹³

Eurodollar deposits are exempt from both reserve requirements¹¹⁴ and FDIC assessments¹¹⁵ when they are payable only outside the United States.¹¹⁶ The principal practical effect of the requirement that the deposit be payable outside the United States is that the funds may be subject to the risk that the sovereign controlling the foreign depository facility may impose restrictions on repayment.¹¹⁷ This risk, however, is minimal if the deposit is made at a major Eurodollar center such as London.¹¹⁸

The exemption that Eurodollar deposits enjoy from reserve requirements and FDIC insurance assessments creates an obvious incentive for banks and depositors to arrange transactions so as to book them as Eurodollar deposits. As a practical matter, wholesale depositors — larger corporations and wealthy individuals — can take advantage of this opportunity, but smaller depositors cannot easily do so. During the early 1980s, the Bank of California devised a program to provide these benefits (as well as the benefit of avoiding the then-applicable ceiling on deposit interest rates under the Federal Reserve

112. See STIGUM, *supra* note 81, at 199. Although originally centered in Europe, the Eurodollar market now extends worldwide, making the term itself a misnomer. *Id.*

113. See *id.* at 221, 225. On a same-day value call money account, the bank commits to honor repayment instructions received from the customer before noon London time. *Id.* at 225.

114. See 12 U.S.C. § 461(b)(6) (1988) (stating that reserve requirements do not apply to "deposits payable only outside the States of the United States").

115. See 12 U.S.C. § 1813(l)(5)(A) (1988 & Supp. II 1990) (stating that federal deposit insurance does not apply to bank obligations that are "payable only at an office . . . located outside the States of the United States").

116. The deposit need not, for purposes of reserve requirements at least, be physically made outside the United States so long as repayment is to be made outside the United States. See Deposits Payable Outside the United States — CD Issued in the United States, Staff Op., Fed. Reserve Reg. Serv. 2-330.01 (Mar. 21, 1983).

117. See *Citibank, N.A. v. Wells Fargo Asia Ltd.*, 495 U.S. 660 (1990) (considering, but not deciding, whether the home office of a U.S. bank was obligated to repay a Eurodollar deposit made at a foreign branch, after the foreign government had prohibited the branch from repaying the obligation from its own assets). If the home bank guarantees repayment, the Federal Reserve insists that the home bank maintain reserves against the deposit. See Deposits Payable Outside the United States — Guarantee by U.S. Bank, Staff Op., Fed. Reserve Reg. Serv. 2-330.1 (July 29, 1983).

118. Eurodollar deposits can also be made within the United States at international banking facilities, and be exempt from reserve requirements, provided that the funds received are used only to support the non-U.S. operations of the depositor. See International Banking Facilities — Policy Statement on Use of IBF Deposits and Loans, Fed. Reserve Reg. Serv. 2-261 (June 18, 1981). Foreign banks located in the United States can operate without federal deposit insurance so long as they limit themselves to accepting only wholesale deposits (over \$100,000). See 12 U.S.C.A. § 3104(c) (West Supp. 1992). If a foreign bank doing business in the United States wishes to accept retail deposits (below \$100,000), it must obtain FDIC insurance. *Id.*

Board's Regulation Q¹¹⁹) to retail customers. The bank's Money Market Plus program proposed to allow retail depositors to transfer funds from a NOW or checking account into a separate account at the bank's London branch, where the deposits would earn market interest rates and would not be subject to reserve requirements or deposit insurance assessments. On the consumer's order, the amounts deposited in the London branch (which were expressly made payable only outside the United States) could be transferred back to the domestic account.¹²⁰ The Federal Reserve quickly clamped down on the program by amending its Regulation D, without notice or hearing, and subjecting deposits of less than \$100,000 maintained at foreign branches of U.S. banks to interest rate ceilings and reserve requirements.¹²¹ This ruling was questionable when made, since the BankCal program appeared to comply with the literal terms of the Federal Reserve Act. It is even more questionable now, given that one of the principal premises upon which the ruling was based — that domestic deposit accounts were subject to Regulation Q interest rate ceilings at the time — is no longer operative. Moreover, the Fed's ruling does not appear dispositive of the legality of such a program. No bank has since sought to revive the idea of offering uninsured deposit accounts at foreign branches to retail customers. If deposit insurance premiums continue to rise, the appeal of such a program might spark new attempts to offer such nondeposit deposit accounts.

III. NONDEPOSIT DEPOSITS' IMPLICATIONS FOR BANKING LAW

We now consider some of the implications of the growth in nondeposit deposits described above. We look first at the impact of nondeposit deposits on the antitrust analysis of bank mergers. We next consider the implications of these market developments for federal deposit insurance and the Fed's reserve requirements. We close with some thoughts about how the growth of nondeposit deposits is likely to affect the future of the American banking industry.

119. 12 C.F.R. § 217 (1992).

120. See Laura Gross, *BankCal Says Fed Edict on Account Is Biased Against Small Depositor*, AM. BANKER, May 15, 1981, at 3, 10.

121. See 12 C.F.R. § 204.2(t) (1992) (defining *deposits payable only at an office outside the United States* to include, in the case of deposits by U.S. residents, only deposits in denominations of more than \$100,000 and as to which the depositor is entitled, under the agreement with the institution, to demand payment only outside the United States); 12 C.F.R. § 217.1(c)(2) (1992) (utilizing the same definition of *payable only at an office outside the United States* for interest rate restrictions as found in 12 C.F.R. § 204(t)(2) (1992) for reserve requirements).

A. Antitrust Considerations

The burgeoning of the nondeposit deposit has important implications for bank antitrust policy. Considering the full extent of the nondeposit deposit phenomenon, any market definition that looks only at bank deposits is grossly inadequate.

Unfortunately, the Supreme Court's failure to revisit and reform its approach to product market definition as outlined in the 1963 *Philadelphia Bank* case¹²² has severely retarded the growth of the law in this area. The Court ruled in *Philadelphia Bank* that the relevant product market in which to evaluate the competitive effect of bank mergers was the "cluster of products (various kinds of credit) and services (such as checking accounts and trust administration) denoted by the term 'commercial banking.'"¹²³ The Court reaffirmed the *Philadelphia Bank* "cluster" approach to bank mergers in the *Connecticut Bank* case.¹²⁴ Although these cases were decided against the backdrop of a banking industry that has long since been transformed by market-place forces,¹²⁵ the Supreme Court has never revisited the question of product market definition in the banking industry.¹²⁶

Left without adequate Supreme Court guidance on the issue, the administrative agencies charged with bank merger policy have jerry-built a doctrinal structure that takes into consideration, albeit imprecisely, the existence of nonbank competition in evaluating competition in bank merger cases. The Department of Justice has announced that it will use higher-than-normal thresholds of concentration for evaluating bank mergers as a way of implicitly recognizing the competitive effect of limited-purpose lenders and other nondepository financial entities.¹²⁷ In a creative exercise of double counting, the Federal Reserve typically evaluates bank mergers by including half the deposits held by thrift institutions in the calculation of concentration in a relevant market.¹²⁸ The result can be regulatory approval of bank mergers that would clearly be subject to challenge based on concentration measures alone if they occurred in an industry other than banking.¹²⁹

122. *United States v. Philadelphia Natl. Bank*, 374 U.S. 321 (1963).

123. 374 U.S. at 356.

124. *United States v. Connecticut Natl. Bank*, 418 U.S. 656 (1974).

125. See generally MACEY & MILLER, *supra* note 21, at 462-63 (questioning the continuing validity of the model of the banking industry used by the Court in *Philadelphia Bank*).

126. For a critique of the Court's approach, see Note, *The Line of Commerce for Commercial Bank Mergers: A Product-Oriented Redefinition*, 96 HARV. L. REV. 907 (1983).

127. See, e.g., *Trustmark National Bank*, 5 OFF. OF THE COMPTROLLER OF THE CURRENCY Q.J., Mar. 1986, at 145, 148 n.9.

128. See, e.g., *AmSouth Bancorp.*, 73 FED. RESERVE BULL. 351, 352 n.5 (1987).

129. See, e.g., *Banc One Corp.*, 77 FED. RESERVE BULL. 741, 742 (1991); *Key Centurion*

Although this regulatory response to the *Philadelphia Bank* case has been *ad hoc* and uncertain, it reflects an accurate assessment of the degree of competition that nonbank institutions — thrift institutions offering the functional equivalent of checking accounts as well as other institutions that offer nondeposit deposits of various sorts — presently offer in banking markets. Unfortunately, the Department of Justice appears recently to have retrenched on its commitment to liberalizing bank merger policy, indicating that it may well challenge mergers that the Federal Reserve has approved¹³⁰ and attempting to define the market for small business loans as a separate product market for bank merger analysis.¹³¹ The trend toward more restrictive antitrust analysis of bank mergers is not yet clear cut. However, given the growth of nondeposit deposits outlined above, it would be unfortunate if regulators began to return to an outdated market definition at a time when the banking industry is experiencing unparalleled competition in its core markets — especially the market for transaction account balances — from strong nonbank financial institutions.

B. *Regulatory Responses to the Growth of Nondeposit Deposits*

We now turn to an analysis of the likely regulatory responses to the growth of nondeposit deposits documented above. These responses are likely to take the form, in the short run, of attempts to cast the net of regulation more widely to sweep the presently unregulated nondeposit deposits within the scope of the existing system. We doubt, however, that this attempt to capture nondeposit deposits within the existing regulatory structure will be fully effective. Ultimately, the nondeposit deposit is likely to have the effect of *deregulating* traditional bank deposits. Such deregulation promises consumer benefits in a political environment where fundamental and beneficial changes are unlikely to be forthcoming from the Congress or the Executive Branch.

Bancshares, Inc., 77 FED. RESERVE BULL. 323, 326 (1991); South Carolina Natl. Corp., 76 FED. RESERVE BULL. 1045, 1060 (1990); AmSouth Bancorp., 73 FED. RESERVE BULL. 351, 351 (1987).

130. See, e.g., First Hawaiian, Inc., 77 FED. RESERVE BULL. 52, 56 (1991); Fleet/Norstar Fin. Group, Inc., 77 FED. RESERVE BULL. 750, 752 (1991).

131. See Letter from Charles F. Rule, Acting Assistant Attorney General, to Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System (Aug. 7, 1985), cited in Rodgin Cohen, *The New Phase of Bank Consolidation: Regulatory Issues and Considerations*, 27 WAKE FOREST L. REV. 63, 78 & n.71 (1992).

1. *Deposit Insurance Premiums*

We have already noted the extraordinary increase in deposit insurance assessments over the past few years. There is little prospect, in the short run at least, that deposit insurance premiums will be reduced to their old levels. Even though by the summer of 1992 many commercial banks were returning to profitability, and the worst of the bank and thrift failure problems were over, the need to refund the deposit insurance funds and the continued exposure of the banking industry to significant risks — including activities risk, competitive risk, and interest rate risk — makes the industry's quick return to the stable and profitable (and inefficient) pattern of years past unlikely. Depository institutions will continue to pay a significant — and, for some at least, unwanted — tax for the privilege of obtaining coverage of deposits against the risk of business failure. The FDIC may attempt to spread the net of its insurance assessments more broadly, but it probably will not be able to assess all institutions offering arrangements that serve the practical purposes of insured bank deposits. Mutual funds will probably never be brought within the scope of the FDIC's insurance program; in any event, the FDIC will not be able to check the flow of capital into uninsured bank accounts abroad.

Under such conditions, we expect to see further growth of uninsured deposit facilities in the future. Such facilities can offer consumers the transaction services traditionally offered by commercial banks — and more recently by thrift institutions — free of the tax for deposit insurance. If consumers are fully informed of the fact that accounts at such institutions are not insured, then we see little reason why they should not be given the opportunity to do their banking through uninsured facilities rather than through insured banks or thrifts.¹³² Indeed, consumers are already making this choice, although the ability to opt out of the deposit insurance system has been limited to date to larger corporate customers and relatively wealthy individuals.¹³³ In the future, the growth of nondeposit deposits suggests that such choice may be expanded to a broader class of depository institution customers.

If uninsured transaction accounts continue to grow outside the banking system, depository institutions will probably press for — and eventually receive — the right to offer explicit uninsured accounts in place of the de facto uninsured accounts that they presently offer with

132. See Jonathan R. Macey & Geoffrey P. Miller, *Toward Enhanced Consumer Choice in Banking: Uninsured Depository Facilities as Financial Intermediaries for the 1990s*, 1991 ANN. SURV. AM. L. 501.

133. See *id.*

the repurchase agreement and other accounts described above. Congress, in FDICIA, hinted strongly that it would be willing to consider such arrangements by mandating a study of "two window" banking (i.e., permitting depository institutions to offer explicit uninsured deposits).¹³⁴ The Bush administration has also implied that it would consider supporting two-window banking; the 1991 *Economic Report of the President* stated, obliquely but portentously, that "[i]f banks and thrifts are given time to develop sources of funding other than insured deposits, they may continue to compete effectively with a less comprehensive safety net."¹³⁵ The *Report* went on with the equally intriguing observation that, if depository institutions do eventually develop such uninsured sources of funding, "then reducing the scope of deposit insurance coverage may have little effect on aggregate bank and thrift lending."¹³⁶ Beneath the carefully guarded bureaucratic rhetoric, this document appears to suggest that the development of uninsured accounts at depository institutions might eventually obviate one of the principal justifications for deposit insurance itself, namely the fear that bank panics would lead to a "sudden, sharp reduction in lending" that would then impose severe recessionary costs on the economy.¹³⁷

Thus, the nondeposit deposit may eventually provide an avenue for weaning the nation's financial system from its dependence on federally insured deposits as a source of funding. Events of the past few years have strongly suggested that, however flawed it may be as a regulatory system,¹³⁸ deposit insurance cannot be easily phased out by legislative fiat. There are too many political impediments to the frontal accomplishment of this objective. However, the growth of nondeposit deposits may undermine the political support base for deposit insurance by providing alternative, uninsured instruments preferred by customers who now utilize insured deposit accounts. Eventually, if the process continues, deposit insurance may be relegated to a vestigial — and therefore relatively benign — status, while the financial system evolves in the direction of more efficient, and more competitive, uninsured products.

134. Section 321 of FDICIA mandates a study by the FDIC of the "feasibility of authorizing insured depository institutions to offer both insured and uninsured deposit accounts to customers." FDICIA § 321(a).

135. 1991 ECONOMIC REPORT OF THE PRESIDENT 182.

136. *Id.*

137. *See id.*

138. Most of the flaws in the existing deposit insurance system are already well-known and will not be explored here.

2. *Reserve Requirements*

The Federal Reserve's inability to pay interest on reserves, as we have seen, significantly distorts banking markets by imposing an implicit tax on some deposit accounts while not taxing other accounts that appear functionally similar to those accounts against which reserves must be held.

In the short run, the Fed has made quite clear that it intends to impose the reserve requirement on all instruments or accounts at depository institutions, however denominated, that serve the functional purpose of transaction accounts. In a recent proposed rulemaking on the subject, for example, the Board stated:

The ability to structure transactions and account relationships to avoid or reduce transaction account reserve requirements reduces the reserve base available for the conduct of monetary policy, and often does so in a manner that results in inequitable treatment of similar transactions among depository institutions. Permitting reductions in the reserve base in this manner favors depository institutions with the resources to develop reserve avoidance practices, and that are willing to implement such practices, over depository institutions that cannot afford the legal or automation resources necessary to implement these [practices, or are reluctant to do so for other reasons].¹³⁹

The Fed's efforts to pursue reserve-avoidance techniques among depository institutions may ultimately prove futile, however. As we have seen, the functional equivalent of banking services can now be provided by a variety of institutions — including ordinary industrial firms — that are neither subject to the Federal Reserve's jurisdiction at present nor likely to be brought within its jurisdiction in the future. Thus, even if the Fed is successful at enforcing competitive equality among depository institutions, it will probably encourage the shift of business away from depository institutions altogether, thereby creating even greater market distortions than exist at present.

In the long run, the Fed is likely to adopt a different strategy — not attempting to impose broader reserve requirements on depository institutions, but rather paying interest on required reserves — thus eliminating, or at least substantially mitigating, the burden of the existing regulatory tax. Indeed, the Fed would like to pay interest on required reserves already but cannot presently do so, both because the law appears to prohibit it and because the amount of interest would

139. Federal Reserve System, Regulation D — Reserve Requirements of Depository Institutions, Notice of Proposed Rulemaking, 56 Fed. Reg. 15,522 (Apr. 17, 1991). The Fed issued its final rule in August, 1992. See Reserve Requirements of Depository Institutions, 57 Fed. Reg. 38,417 (Aug. 25, 1992) (to be codified at 12 C.F.R. § 204).

represent a significant revenue loss to the federal government.¹⁴⁰ The FDICIA mandated a study (apparently backed by the Fed) on the feasibility of assessing Federal Reserve banks an amount equal to the imputed earnings on reserves held at such banks by insured depository institutions.¹⁴¹ Since such assessments would reduce the assessment liability of insured depository institutions, the functional effect of such a program would be to pay insured depository institutions an implicit interest on reserves held at the Fed.

The Fed's long-run strategy in paying interest on reserves is probably to obtain regulatory control over various forms of nondeposit deposits outside the banking system — most importantly, money market mutual fund balances, which function as part of the money supply but which the Fed cannot presently control with reserve requirements. The Fed has used a similar strategy before. In 1980, during a period of extraordinarily high nominal interest rates that greatly increased the opportunity costs to banks of holding idle reserves, the Fed announced that it would start paying interest on reserves as a matter of administrative discretion.¹⁴² Congress responded — as the Fed may well have hoped it would — by authorizing the Fed to impose reserve requirements (which had formerly been limited to commercial banks that were members of the Federal Reserve System) on all insured depository institutions. The Fed's current strategy may be similar — to begin paying interest on reserves, or at least to indicate an intention to pay such interest, as a means of inducing Congress to expand the Fed's regulatory authority to money market mutual funds and perhaps other forms of nondeposit deposit accounts presently beyond the reach of the Fed's writ.

If Congress ends up changing the law to provide for the payment of interest on reserves, the consequences would be significant. First, the abolition of the implicit tax on depository institutions represented by the reserve requirement could represent a loss to the Treasury of relatively significant proportions, and a gain to the banking industry. How the politics of this tradeoff would play out in practice remains unclear, but if past experience is a guide the matter is likely to be controversial. The banks are likely to be asked to give up something in the political process in exchange for receiving interest on reserves, and

140. See Debra Cope, *Fed Closes Loopholes in Its Rules on Reserves*, AM. BANKER, Aug. 13, 1992, at 1; Wessel, *supra* note 6, at A2. Fed Chairman Alan Greenspan is on record as supporting the payment of interest on reserves. See *Greenspan: Fed Should Pay Interest on Reserves*, AM. BANKER, Mar. 11, 1992, at 7.

141. See FDICIA § 421.

142. See WILLIAM GREIDER, *SECRETS OF THE TEMPLE: HOW THE FEDERAL RESERVE RUNS THE COUNTRY* 154-56 (1987).

whether the gain will be worth the candle to the banks in the long run remains uncertain.

Payment of interest on required reserves would also have a relatively significant impact on the political position of the Federal Reserve. The Fed has traditionally operated virtually free of congressional oversight through the budget process, since it funds its operations largely with interest on its holding of reserve balances, which are invested in U.S. government securities.¹⁴³ The Fed has been zealous in guarding its budgetary independence, resisting even integration of a statement of its expenditures and receipts into the overall federal budget.¹⁴⁴ If the Fed begins to pay interest on required reserves, however, an important source of its income will dry up. How the loss of this income would impact the Fed's independence from the political process is unclear, but the consequences could be far-reaching.

C. Implications for the Future of the Banking Industry

The dramatic growth of nondeposit deposits chronicled in this article represents a development of profound importance for the future of the U.S. banking industry. Because these instruments can function as partial, or, in some cases, nearly complete substitutes for the traditional checking account balance, they are likely to grow relative to bank deposits to the extent that the latter will operate under costly regulatory constraints not applicable to insured depository institutions.

In the long run, the traditional banking function of matching checking account deposits against portfolios of commercial loans will probably become significantly less important. Banks — especially big banks — are already in the process of altering their balance sheets on the liability side to include a greater percentage of nondeposit deposits relative to traditional checking accounts. This process will probably accelerate.

At the same time, nonbanks will increasingly intrude on the core banking business of offering transaction services. The regulatory and cost advantages enjoyed by many of the nondeposit deposit instruments that nonbanks can presently offer, and those that will likely be developed in the future, are nearly certain to induce further nonbank

143. *See id.* at 160.

144. *See* Statement by Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, before the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, Jan. 29, 1986, *reprinted in* 72 FED. RESERVE BULL. 184 (1986).

expansion into this service market. The result will be further blurring of the distinctive characteristics that through the years have allegedly made banks "special" institutions deserving unique regulatory treatment.¹⁴⁵

Perhaps the most important consequence of the growth of nondeposit deposits for the long-range prospects and stability of the banking system is that they promise to convert federal deposit insurance from an essentially mandatory form of social insurance, which persons wishing to consummate economic transactions are forced to accept without any real choice as to whether the benefits of the insurance are worth the costs, into an optional system that consumers can utilize if they wish or can avoid if they are willing to incur the risks of conducting their affairs through higher yielding, but uninsured, transaction accounts.

We believe that real reform of our system of deposit insurance can only come by means of such marketplace evolution, rather than social engineering through the political process. If deposit insurance can be made essentially a voluntary program, the costs of such insurance can then be better imposed on those wishing to obtain its benefits. In such a world, deposit insurance will survive if its benefits exceed its costs; but if the costs of deposit insurance — in terms of the moral hazard and subsidization of risk-taking that it creates, and the elaborate regulatory restraints that must be instituted to correct for these problems — turn out to exceed the benefits, then deposit insurance will wither away to a largely vestigial — and therefore socially unproblematic — program.

The fact that the restructuring is likely to occur by means of exploitation of lacunae in the regulatory structure — or, to use a term with less favorable connotations, loopholes — is not a new phenomenon in the world of banking. Change in the banking industry typically takes the form of marketplace innovations that upset existing regulatory structures. This has been true from early on in the American banking industry, from Aaron Burr's notorious exploitation of a bridge and canal company charter as a means of entering the commercial banking business¹⁴⁶ to the state banks' development of checking accounts as means of avoiding the federal government's attempt to

145. The classic defense of banks as "special" is E. Gerald Corrigan, *Are Banks Special?*, 1982 FED. RESERVE BANK OF MINNEAPOLIS ANN. REP. 5. For a caustic reply from an economist affiliated with a large commercial bank, see Richard Aspinwall, *On the "Specialness" of Banking*, ISSUES IN BANK REG., Autumn 1983, at 16.

146. See BRAY HAMMOND, *BANKS AND POLITICS IN AMERICA FROM THE REVOLUTION TO THE CIVIL WAR* 149-58 (1957).

eradicate them by means of a punitive tax on their circulating notes.¹⁴⁷ More recently, it has taken the form of aggressive exploitation of loopholes as a means of avoiding regulatory restrictions on geographic expansion,¹⁴⁸ the prohibition of paying interest on checking accounts,¹⁴⁹ and the Glass-Steagall Act's¹⁵⁰ barrier against the commingling of investment and commercial banking.¹⁵¹ Aggressive "loophole lawyering" has often proved to be the most effective remedy for the paralysis that so often afflicts the political system's approach to banking regulation.¹⁵² If the nondeposit deposit moves the financial services industry forward into more competitive and efficient forms, the result will benefit consumers of banking services and the American economy as a whole.¹⁵³

147. See MACEY & MILLER, *supra* note 21, at 12.

148. See Geoffrey P. Miller, *Interstate Banking in the Court*, 1985 SUP. CT. REV. 179.

149. See MACEY & MILLER, *supra* note 21, at 31.

150. Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.) (1933).

151. See David G. Litt et al., *Politics, Bureaucracies, and Financial Markets: Bank Entry Into Commercial Paper Underwriting in the United States and Japan*, 139 U. PA. L. REV. 369 (1990).

152. See Jonathan R. Macey & Geoffrey P. Miller, *Bank Failure: The Politicization of a Social Problem*, 45 STAN. L. REV. (forthcoming 1992).

153. For a suggestion that the banking and economic system can be improved through the creation of uninsured state-chartered banks that would operate free of nearly all federal regulation under existing law, see Macey & Miller, *supra* note 132.