AMERICA'S BANKING SYSTEM: THE ORIGINS AND FUTURE OF THE CURRENT CRISIS

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INTRODUCTION

Between 1945 and 1980, bank failures in the United States averaged fewer than five per year. Since 1980, however, U.S. commercial banks have failed at an average rate of over 100 per year, many of our largest and best known banks have encountered serious financial difficulties, and talk of a banking "crisis" has become increasingly prevalent. Politicians, pundits, and academics have come forward with many clever explanations for the crisis and proposals to cure it.

Blame has been variously assigned to government policy, such as the banking regulations of the 1930s or the banking deregulation of the 1970s; to economic developments such as moribund real estate markets, oil price volatility, and opportunistic third world debtors; and to business misjudgments on the part of bankers themselves. None of these explanations is entirely convincing because none satisfactorily answers the crucial question: "Why now?" Virtually all of the explanations, for example, point to federally subsidized deposit insurance as an essential cause of the current crisis. Yet the federal government has been subsidizing deposit insurance since 1933. One must ask why the adverse selection and perverse incentive problems that characterize subsidized risk taking are only now beginning to manifest themselves.

What is lacking in the current policy debate is an explanation of why U.S. commercial banks and thrift institutions, which flourished for four decades under restrictive government regulatory policies, suddenly began to fail in massive numbers in the 1980s—in the midst of the most prolonged economic expansion in modern American history. Until we understand why banks are failing now, we will not be able to evaluate the various reform proposals circulating like so many birds of prey over what was, until recently, the greatest banking system in the world.

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This Article explains why contraction of commercial banking—as defined, organized, and conducted under federal supervision since the 1930s—is inevitable over time. We show how technological innovation and improvements in the primary and secondary trading markets for financial products have led to an irreversible decline in the demand for the services commercial banks are permitted to offer. We then show why the Bush Administration's reform proposals, although dramatic, far-reaching, and, in certain important respects highly constructive, ultimately will not solve the bank failure problem resulting from these economic trends. We also explain what further changes must be made to correct the now-endemic problems that plague the U.S. banking industry.

I. THE ROLE OF BANKS IN ECONOMIC THEORY

In a world of perfect information and "zero transaction costs," there would be no banks. Capital would flow directly from perfectly informed investors to those who could put it to use at the risk-return trade-off the investors preferred. Should investors' preferences for savings and investment over current consumption change, they could sell the income stream associated with their investments directly to other investors without incurring transaction costs such as the cost of locating those investors and contracting with them. In other words, in a world in which information and market transactions were costless, there would be no need for financial intermediaries of any kind. Needless to say, we do not live in such a world.

Instead, we live in a world in which reliable information about the future cash flows associated with financial assets is quite costly to obtain and verify. In our imperfect world, assets, even valuable assets, are often highly illiquid and difficult to value. These valuation and liquidity problems create obstacles for savers and investors who want to obtain the benefits of diversification and who make consumption decisions at different times. In such a world, commercial banks and other financial intermediaries have an important role to play in the economy for several reasons.[1]

First, banks specialize in assessing credit risk. Banks, at least in theory, accumulate money from investors (depositors) on the basis of their ability to identify good, profitable uses for depositors' funds. Depositors

1. This discussion draws on material from chapter one of the authors' forthcoming book, Banking Law and Regulation: Cases and Materials (Little, Brown & Co. 1992).

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are willing to pay for the benefit of banks' financial skills because few individual investors are able to distinguish good loans from bad. By placing their money in a bank, depositors in effect hire the bank to use its know-how in identifying good investment opportunities. The beauty of a properly functioning banking system is that depositors need not—in fact almost never do—know anything about the markets in which the bank invests its assets. Because they need not gain the expertise themselves, the depositors can spend their time doing the things they enjoy.

Second, banks allow depositors to take advantage of economies of scale that otherwise would place many good investment opportunities out of the grasp of ordinary investors. Commercial bank loans often are made to borrowers who need millions of dollars in capital. Most investors are unable to extend this kind of credit, particularly if they want to retain the benefits of a diversified investment portfolio. Because banks pool funds from numerous depositors, the depositors are able to participate in the market for large-scale investments.

Third, banks convert illiquid investments into what are, from the depositors' perspective, liquid investments.[2] A liquid investment is one that the investor can convert to cash quickly in order to meet sudden demands for funds. All else being equal, of course, investors would prefer to hold liquid investments rather than illiquid ones. Consequently, borrowers forced to offer potential investors illiquid investments must offer such investors a greater return to compensate them for the additional inconvenience of illiquidity. Banks, by issuing demand deposits, "can improve on a competitive market by providing better risk sharing among people who need to consume at different random times."[3]

Thus, banks improve the operation of the economy by investing in portfolios of illiquid assets and by offering depositors liquid claims (deposits) on the banks' own assets. This conversion of illiquid investments into liquid ones provides a significant benefit for investors—and for borrowers as well. Consider a manufacturing firm with an asset that cannot be used to pay current operating expenses because it is not generating any income at present. Suppose further that the future income that will be generated by this asset is uncertain and difficult to value. This asset is

2. Diamond and Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401, 403 (1983) ("Banks are able to transform illiquid assets (into liquid assets) by offering liabilities with a different, smoother pattern of returns. . . . Illiquidity of assets provides the rationale . . . for the existence of banks . . .").

3. *Id.* at 402.

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illiquid. If, however, the firm can obtain a loan from a bank secured by the asset, it can convert a substantial portion of the asset's value into liquid form while continuing to control the plant.

Banks' ability to sell their skill at valuing assets, their ability to allow investors and borrowers to realize economies of scale in investing, and their ability to convert illiquid investments into liquid investments all explain why banks have survived and prospered even though financial intermediation is costly both to lenders (depositors) and to borrowers.

This is a succinct description of the role that banks play in the economy. Notice, however, that because the demand for banks' services arises from imperfect information and from the costliness of arranging direct investor-borrower transactions, the demand for these services will decline as markets develop—and in particular as the costs of organizing and communicating information and arranging financial transactions fall. First, as markets develop, intermediaries other than commercial banks will emerge to provide funds to particularly large borrowers, and banks will cease to be unique in this respect. Life insurance companies, for example, receive funds from purchasers of insurance that they invest in securities, loans, and other productive assets. While insurance companies can "purchase" funds on significantly different terms than banks, they amass substantial resources that allow them to make large-scale investments of the kind banks make. Pension funds can do likewise.[4] Open-end mutual funds, which accept investments from customers and invest these funds in securities, compete even more directly with banks by allowing investors to redeem their shares at any time, and by allowing investors to make redemptions by writing checks to third parties drawn on their mutual fund accounts. Thus, investors now have many mechanisms for pooling their funds with those of other investors to overcome the economies of scale problems described above. As these alternative avenues of financial intermediation emerge, it is only natural that the relative importance of banks as financial intermediaries should decline.

Similarly, the demand for bankers' skill in evaluating particular investments should be expected to decline as secondary and new issue markets

4. Pension fund assets, which now exceed two trillion dollars, include nearly a quarter of all equity securities and half of all corporate debt. The pension fund, now the dominant player in the world of institutional investing, scarcely existed a century ago, and was unimportant until the latter half of this century. In 1950, pension plans accounted for only 15.3% of the total holdings of institutional investors; by 1983 pension fund holdings had risen to 58.5% of institutional investments. R. IPPOLITO, PENSIONS, ECONOMICS, AND PUBLIC POLICY 157 (1986).

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develop. As secondary capital markets develop, business firms will find it increasingly easy to raise capital by making public offerings. The sophistication of the trading markets provides a dependable price setting mechanism that permits investors to rely on anonymous market forces rather than on the judgment of particular bankers to determine the appropriate prices for investments.[5] In addition, trading markets such as the New York Stock Exchange enable firms in search of capital to "securitize" their assets. Securitization involves unbundling the earnings stream of a firm into a large number of securities that can be sold to small investors, thus competing directly with banks' ability to transform illiquid investments into liquid investments for the benefit of depositors.

Finally, as trading markets become more developed due to the emergence of more sophisticated mechanisms for processing information, bankers must compete for business against the participants in those markets as well. Businesses in need of capital will be indifferent between borrowing from banks and selling securities in a public offering. They will make their decision on the basis of which form of investment offers them the capital they need at the lowest rate of interest. Consequently, the emergence of well developed capital markets inevitably places downward pressure on banks' rates of return. The emergence of these markets also confronts the specialists who evaluate credit risk for commercial banks (loan officers) with new competition from thousands of financial analysts and amateur investors who are attempting to ferret out information about the earnings streams of publicly traded securities. As a result, the development of securities markets will make it increasingly difficult for banks to uncover profitable investment opportunities.

The development of robust capital markets for equity and debt securities and the growth of pension plans and money market funds are a natural outgrowth of the emergence of new information technologies and the general development of the economy. As information and data processing capabilities have improved, the costs of trading have fallen. These markets developed because investors now can communicate with one another, and can obtain new information about corporate cash flows, quickly and cheaply by using computer-driven trading systems.

Likewise, as the labor force has become more skilled and productive, it has been able to command an increasing share of society's resources.

5. *See* Macey & Miller, *Good Finance, Bad Economics: An Analysis of the Fraud on the Market Theory*, 42 STAN. L. REV. 1059 (1990).

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Favorable tax treatment has led to explosive growth in the nation's pension system. Furthermore, as technological developments have caused the nation's capital markets to price securities more efficiently, such markets have become available to smaller and smaller issuers. In 1792, the New York Stock Exchange was the nation's only public securities market.[6] Today there are ten stock exchanges operating in the United States as well as several specialized exchanges that have added trading in options and financial futures to their traditional business of trading in commodities. In addition, the over-the-counter securities market includes three thousand securities firms with six thousand branch offices that deal in securities not traded on an organized exchange.[7] There are no listing requirements for securities traded on the over-the-counter market; all registered securities are entitled to participate in this market. Brokers trade securities in this market "via a complex telephone and telex communications system, by which information is transmitted and trades are consummated."[8]

In a nutshell, as markets become more efficient, the information, evaluation and transaction services provided by commercial banks are increasingly displaced by newer and more efficient forms of financial intermediation. It is important to note, moreover, that bankers historically have specialized in servicing the most inefficient segments of the capital markets. More efficient market segments have been able to securitize themselves and thereby avoid more costly commercial loan markets. As financial markets have developed and as a wider array of assets have become capable of being securitized, bankers have been driven to focus on increasingly uncertain investments that remain incapable of being securitized. Thus, as capital markets and technology have developed, not only have commercial banks' share of investment markets declined, but the portion they have retained has become more risky; lower cost financial intermediaries have skimmed off much of the best business that commercial banks traditionally enjoyed.

The traditional bank loan involves ongoing, continuous monitoring on the part of the bank extending the credit or making the loan. The typical loan document gives banks the right to accelerate the maturity date of their outstanding loans. Banks, seeking to protect their investments,

6. Macey & Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. ILL. L. REV. 315 (describing the origins of the NYSE).

7. R. SOBEL, INSIDE WALL STREET 67 (1982).

8. Macey & Haddock, *supra* note 6, at 329-330.

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carefully monitor the firms to which they loan money on an ongoing basis. By contrast, the process of securitization involves intense monitoring by the underwriters at the time a block of securities initially is offered to the public.[9] After the securities are sold, however, it is expected that the subsequent monitoring of the issuer will be less intense because of the well-known collective action and free-rider problems facing those who invested in the issuers' securities. In particular, unlike banks, many investors who buy securities will engage in little, if any, monitoring of credit because they must incur the full costs of monitoring the issuer, while only capturing a small portion of the gains from such monitoring.[10]

Those firms that cannot obtain credit unless they subject themselves to the continual monitoring performed by banks will continue to seek bank loans. All else being equal, borrowing from a commercial bank will be more costly than raising capital by issuing securities because banks must charge more interest on loans to compensate for the continual monitoring associated with such lending. Of course, all else is not equal. The existence of federally subsidized deposit insurance enables banks to obtain funds more cheaply than securities firms because depositors demand far lower interest rates on demand deposits than they would in the absence of government-backed deposit insurance. These cheaper funds tend to offset banks' increased costs. Moreover, these cheaper, federally insured deposits were used to fund increasingly risky investments throughout the 1980s.

Firms able to obtain credit from the securities markets will do so in order to avoid the burden of bank monitoring and to avoid the concomitantly higher rates charged by banks in many cases. Of course, firms that need only occasional or episodic monitoring are likely to be better credit risks than firms that need constant monitoring. Thus, all else being equal, borrowers that are better credit risks will sell securities rather than borrow from banks because such borrowers will have no desire to pay the higher costs of obtaining the continuous monitoring available from commercial banks.

This process is highlighted by the ability of investment banks, through the underwriting of commercial paper, to capture a large portion of the

9. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 654 (1984).

10. *Id.* at 653. We wish, however, to emphasize that the reduction in bank monitoring in trading markets is replaced by market mechanisms such as the market for corporate control, incentive-based compensation packages for managers, and competition in internal labor markets.

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most basic commercial lending business of the nation's largest commercial banks. Commercial paper is the popular name for the short-term[11] unsecured debt obligations of corporations that have become a common feature in American corporate finance, particularly for large, well capitalized corporations with aggressive asset and liability management strategies. Commercial paper bears similarities to securities such as stocks and bonds, and to commercial loans made by banks.[12] Like stocks and bonds, commercial paper is sold in the secondary market, usually in negotiated underwritings with securities dealers. Like bank loans, commercial paper generally is sold in privately negotiated transactions between a single underwriting firm and a single issuing company. Issuing firms view the sale of commercial paper as a direct substitute for other forms of financing because it provides ready access to capital, does not create long term financial obligations, and does not require extensive and costly negotiations prior to issuance.[13]

Firms in need of capital can choose to issue commercial paper, obtain traditional bank financing, or sell stocks or bonds in the secondary markets. Their choice is significantly affected by federal regulation. Since 1933, the Glass-Steagall Act[14] has imposed a legal separation between commercial banking and securities dealing. With minor exceptions for such things as municipal bonds and U.S. government securities, the Glass-Steagall Act prohibits banks from underwriting, selling, or dealing in securities.[15] Firms that wish to sell securities to raise capital therefore have no choice but to do so through investment banks and securities houses. On the other hand, firms that wish to raise capital by direct borrowing can do so not only from commercial banks but also from any other person or firm willing to extend credit.

This regulatory disadvantage for many years was not a significant impediment to banks' ability to compete in the financial markets against other sorts of financial intermediaries, because of the extensive regulatory

11. Typically, commercial paper matures in 90 days or less.

12. Litt, Macey, Miller & Rubin, *Politics, Bureaucracies, and Financial Markets: Bank Entry into Commercial Paper Underwriting in the United States and Japan*, 139 U. PA. L. REV. 369, 375 (1990).

13. *Id.*

14. The Glass-Steagall Act, officially designated the Banking Act of 1933, is the popular name of ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.).

15. Section 16 is codified at 12 U.S.C. § 24 (Seventh) (1988). 12 U.S.C. § 335 (1988) makes the restrictions of § 16 of Glass-Steagall applicable to state banks that are members of the Federal Reserve System.

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costs of raising capital by selling securities. In particular, firms that wished to raise substantial amounts of money by selling securities traditionally were required to make a "public offering" of securities within the meaning of the securities laws. In 1933, Congress created something of a "level playing field" for commercial banks and securities firms by imposing significant costs on firms that wished to make public offerings of securities. These costs, which come in the form of registration and prospectus delivery requirements of the Securities Act of 1933,[16] reduced the attractiveness of securities offerings. It is in this sense that the Securities Act of 1933 mitigated the harsh effects of Glass-Steagall's regulatory restrictions by increasing the demand for commercial banks' lending services as against securities dealers' underwriting services.

During the late 1970s and early 1980s, commercial paper became the primary source of short-term financing for publicly held corporations. During this period, commercial paper accounted for one quarter of all short-term corporate debt outstanding.[17] For issuing corporations, commercial paper has distinct advantages over both commercial bank borrowing and public securities offerings. The advantage of commercial paper over a public offering of debt or equity is that commercial paper, by virtue of its short maturity, is exempt from the costly registration requirements of the Securities Act of 1933.[18] Technical improvements in the commercial paper market greatly enhanced the liquidity characteristics of that market and enabled securities firms to sell commercial paper at lower rates of interest. By passing these interest rate savings along to their clients, investment banks selling commercial paper were able to offer corporate borrowers rates of interest on commercial paper significantly below the bank prime rate.

Large corporations increasingly began to turn from commercial bank lending to the commercial paper market to fund their short-term financing needs as "[t]he spreads and placement costs on commercial paper fell low enough that a corporation could often save money by going directly

16. 15 U.S.C. § 77 et. seq. (1988).

17. Note, *A Conduct Oriented Approach to the Glass-Steagall Act*, 91 YALE L.J. 102, 115 (1981) (Jonathan R. Macey, author, citing J.P. JUDD, COMPETITION BETWEEN COMMERCIAL PAPER MARKETS AND COMMERCIAL BANKS 39, 48 (Staff Paper, Federal Reserve Bank of San Francisco, on file with the *Yale Law Journal*)).

18. The Securities Act of 1933, § 3(a)(3), 15 U.S.C. § 77c(a)(3) (1988) exempts from the registration, prospectus delivery, and anti-fraud provisions of the Act notes, drafts, bills of exchange, and bankers' acceptances arising out of a current transaction that have a maturity at the time of issuance of less than nine months.

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into the commercial paper market rather than by obtaining funds from a bank or other financial intermediary."[19] The difficulties this presented to commercial banks were acute and far-reaching:

> Once having entered the commercial paper market, many firms were reluctant to return to higher-cost bank financing, even when bank funds became readily available again. . . . Banks, to their surprise and dismay, began to see commercial paper as a threatening competitor for their core loan business.
>
> The problem was not simply a loss of loan revenues, although this was bad enough. In addition, commercial banks were deprived of key information about the activities of their loan customers. In the days when corporations returned to their banks frequently to roll over commercial loans, banks were able to maintain regular contact with their customers and thus to obtain reliable, current information about them. That source of information began to dry up as blue chip corporations increasingly turned to the commercial paper market for their short-term financing needs.[20]

Several important points can be gleaned from the commercial paper saga. First, it illustrates how commercial banks' inability to expand their product lines beyond traditional commercial lending made it difficult for them to compete in the rapidly changing financial marketplace. Second, it is a striking example of the earlier theoretical point that the business lost by commercial banks due to regulatory restrictions has not been random. Rather, commercial banks have been losing their best business and their most important customers because as participants in secondary trading markets become more sophisticated they can take advantage of technology. This technology permits them to securitize assets that previously could only be financed through traditional bank lending. Over time, investment bankers developed sophisticated trading strategies that allowed them to sell commercial paper to customers with the express or implied promise that, should the need arise, the investment bank would repurchase the securities at the market price for the remainder of their terms. Ironically, the availability of back-up lines of credit from commercial banks has further enhanced the competitiveness of commercial paper markets. Investment banks thus were able to offer investors in commercial paper meaningful liquidity over the short-term life of the loans, which in turn, enabled them to make credible financing commitments to borrowers. The emergence of commercial paper as an impor-

19. Litt, Macey, Miller & Rubin, *supra* note 12, at 378.

20. *Id.* at 379.

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tant tool of corporate finance reveals a story about how the nation's major commercial banks lost their most important, profitable, blue-chip clients to a rival industry through a combination of regulatory impediments and technological evolution.

The final chapter in the commercial paper saga concerns the commercial banks' response to the crisis presented by the erosion of their commercial lending customer base. Led by Bankers Trust Company of New York, the commercial banks responded by re-evaluating their "long-accepted notion that the Glass-Steagall Act prohibited them from dealing in commercial paper."[21] Rather than cut their commercial lending rates to compete with the investment banks, they sought to enter the business of underwriting and dealing in commercial paper.

Two important implications can be drawn here. First, the natural response to financial market innovation is not to expand the scope of commercial banking but to diversify into investment banking. Over time, as improved markets and new technologies lead to an increase in the demand for securitized assets and a decrease in the demand for commercial loans, market forces should cause the commercial banking industry to shrink rather than to expand. Second, the legal system has placed costly obstacles in the way of banks that wish to pursue this strategy. In our example, Bankers Trust Company had only two options: (1) giving up its traditional core business of lending to large, blue chip clients, or (2) pursuing a risky and costly strategy of litigating the apparent legal restrictions on its ability to deal in commercial paper. Bankers Trust chose the latter strategy.

The commercial paper saga presents a stark example of the competitive dynamic facing the commercial banking industry. As financial markets have developed, the same process has repeated itself, albeit in a more subtle fashion and in numerous ways: bank clients gradually have reduced the portion of their external funding that comes from bank lending and increased the funding they receive from selling securities.

This process simultaneously has reduced the role that commercial banks play in the economy and caused banks to become more risky. The reduced role is a result of a decreased demand for commercial lending. Risk has increased because the assets that have become securitized are the assets for which good information is readily available, *i.e*, those that present less commercial uncertainty.

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21. *Id.*

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We wish to emphasize that the process we are describing is slow and subtle, although rapid advancements in information technology have allowed U.S. securities markets to register dramatic improvements in efficiency in the past decade. For most creditworthy borrowers, the process we are describing has not resulted in a complete shift from bank borrowing to securitization, although for large, publicly held corporations the shift from bank borrowing to commercial paper issuance has been dramatic. Rather, the process of technological evolution we are describing has manifested itself in a gradual change in the overall composition of the liability side of the corporate balance sheet, with bank borrowing assuming a smaller fraction of overall liabilities, and other forms of debt assuming a larger fraction.

Perhaps the best example of this phenomenon involves the securitization of home mortgages and other consumer financial obligations, which began in earnest in the 1980s. Historically, commercial banks carried home mortgages on the asset side of their balance sheets as loans. These mortgages were high profit, low risk assets for banks. But as computer and communications technology made it cheaper to collect and disseminate information, and as interest rates and asset prices became more volatile, it became much more efficient for banks to move these assets off their books by securitizing them. The securitization phenomenon had a profound effect on U.S. capital markets:

> by the third quarter of 1987, mortgage-backed securities outstanding exceeded $640 billion, over one-fifth of the total value of all mortgage claims. Since 1982, mortgage-backed securities have accounted for 60 percent of the growth in mortgage debt. The sale of other asset-backed obligations—debt instruments that are claims against a pool of assets such as automobiles, credit-card receivables, or leases—only began in 1985. Yet in just two years the amount of these securities outstanding had risen to almost $12 billion. By the end of 1986, GMAC (General Motors Acceptance Corporation) was the largest issuer of nonmortgage asset-backed obligations, with $8 billion outstanding.[22]

The securitization phenomenon was bad for banks in three ways. First, the fees for securitizing a loan are trivial compared to the profits involved in booking the loan as an asset. Unfortunately, the costs of keeping a loan on the books as an asset are also high, particularly when interest rates are rising and the asset has a fixed interest rate. Thus,

22. Haraf & Kushmeider, *Redefining Financial Markets*, in RESTRUCTURING BANKING AND FINANCIAL SERVICES IN AMERICA 3 (1988).

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banks that did not securitize assets that were capable of being securitized could not compete with banks that did so. Second, because commercial banks have no competitive advantage in securitization, the business of originating loans opened up to a myriad of specialized firms, thereby further eroding the market share of commercial banks. Finally, to the extent that banks attempted to continue to book commercial loans, they were forced to concentrate on increasingly risky loans, as the better credit risks came to be securitized.

In summary, during the 1980s, borrowers that traditionally looked to banks for credit began to turn to other, cheaper sources such as securitized assets and commercial paper. This phenomenon left commercial banks a shrinking and increasingly risky segment of the capital markets to service. Problems on the liability side of banks' balance sheets exacerbated the problems on the asset side. Here, the growth of pension funds, mutual funds, and new insurance products has given savers and investors a wide range of new products from which to choose. This has forced banks to pay increasingly high rates to attract depositors, despite the increasing riskiness of the banks' activities. Given such a competitive environment, it would have been surprising had commercial banks not begun to fail in record numbers during the 1980s.

II. Implications For the Treasury's Reform Proposal

The most important implication of the above analysis is that any successful proposal to reform banking policy must reflect the fact that the only healthy banking industry is going to be a significantly smaller banking industry. While the firms engaged in commercial banking need not be small, the portion of economic activity conducted by commercial banks, as opposed to other suppliers of credit, is going to continue to shrink. Accordingly, no regulatory solution premised on the assumption that the commercial banking industry can "grow its way" out of the current crisis likely will succeed. Instead, the regulatory policies concerning bank failures should be changed to encourage the liquidation, rather than the merger, of failed banks and to encourage banks to diversify, either by expanding the scope of their internal operations, or by merging with firms in industries other than banking. We hasten to add that the best outcome of all would be a regulatory regime that encouraged voluntary transfers of bank assets to willing purchasers.

Second, as explored more fully below, market forces must be allowed to exert disciplinary pressure on bank managers who are not performing

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adequately. Regulatory oversight is an insufficient constraint on bad managers. The current Treasury proposal does not contain effective measures for changing current rules and regulatory practices that undermine the incentives of market participants to impose market discipline on poorly managed banks.

III. HIGHLIGHTS OF THE TREASURY PROPOSAL

The current Treasury proposal contains five principal recommendations. Two deal with deposit insurance. The first recommendation is to "preserve deposit insurance protection for every small saver in America"[23] and at the same time to "protect taxpayers by reducing overextended deposit insurance coverage."[24] This would be done by limiting protection to two $100,000 accounts per institution, prohibiting "brokered deposits," and requiring that insurance premiums be adjusted according to the riskiness of individual banks, measured by the amount of capital on their balance sheets. Depositors could still have accounts with multiple institutions, as long as a deposit broker was not used to place the additional accounts. Finally, the Treasury proposal would not base deposit insurance premiums on market-based risk factors, *i.e.*, the riskiness of the banks whose deposits are being insured. Instead insurance premiums would be based on crude estimates of the amount of capital on the bank's balance sheet.

In addition to deposit insurance reform, the Treasury Department's remaining recommendations consist of making banks stronger and safer by strengthening the role that capital plays in bank regulation, modernizing outdated banking laws, and making the regulatory structure more efficient.

Reforming the regulatory treatment of capital has been called the "centerpiece of the Treasury proposal."[25] The Treasury proposal would assign all banks to one of five supervisory zones, based on regulators' assessment of the bank's capital levels. Zone 1 would include banks that have levels of risk-based capital "significantly above" what are considered minimum acceptable levels. Zone 2 would include banks that satisfy

23. *U.S. Department of the Treasury, Secretary Nicholas F. Brady, Remarks to the Press on Financial Services Reform, February 5, 1991*, 13 L.A. Bus. J. § 1, at 29 (1991).

24. *Id.*

25. Muckenfuss, Eager, & Nielsen, *The Treasury Department Report: Modernizing the Financial System—Recommendations for Safer, More Competitive Banks*, BANK MANAGEMENT, Apr. 1991, at 12, 13.

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minimum acceptable levels, while Zones 3, 4, and 5 would, in varying degrees, include all banks that fail to meet minimum acceptable capital levels. Banks that do not fall into the appropriate zone would be prohibited from engaging in non-banking activities through a financial services holding company, and would be subject to additional regulatory constraints such as dividend restrictions, growth constraints, and conservatorship, depending on how far capital levels deviate from acceptable levels. Finally, the Treasury proposes to use its zone allocation to determine deposit insurance premiums to be charged by the FDIC.

For well capitalized banks, the Treasury department's goal of modernizing outdated banking laws would be accomplished by allowing such banks to engage in investment banking and other activities, which historically have been out of bounds for commercial banks and bank holding companies, as well as by lifting the current restrictions on interstate branching. The Treasury proposal would permit companies that own banks to engage in a whole range of non-banking activities that currently are impermissible under the Bank Holding Company Act, including a full range of securities activities.

Finally, the Treasury proposal would create a new regulatory structure for commercial banking by abolishing the Office of Thrift Supervision and the Office of the Comptroller of the Currency and assigning their activities to a new bureau inside the Treasury Department, the Office of Depository Institutions Supervision (ODIS). The Federal Reserve Board would assume responsibility as the federal regulator and supervisor of all state banks except state savings banks. Thus the Fed would replace the FDIC as primary regulator for state-chartered banks that are not members of the FDIC, except for state savings banks, which would be regulated by the ODIS.

A. The False Promise of Deposit Insurance Reform

There are a number of flaws with the Treasury approach to deposit insurance reform. First, the Treasury proposal does not reflect fully the relationship between deposit insurance protection and bank failure policy, as reflected in the determination that some banks simply are too big to be allowed to fail. No deposit insurance reform proposal will be successful in reducing the pressure on the deposit insurance funds until it changes the FDIC's bank failure policy, which results in *de facto* deposit insurance protection for virtually all depositors in commercial banks, re-

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gardless of how many accounts they have or even how large their deposits are.

There are four basic regulatory options currently available for dealing with insolvent and nearly insolvent banks.[26] First, the FDIC can employ the deposit-payout approach and liquidate the insolvent bank. When an insolvent bank is liquidated, the FDIC, in its capacity as insurer, pays off the insured depositors in the bank. The other depositors stand in line with other creditors to receive their pro rata share of the assets of the liquidated bank. Where the deposit-payout option is invoked by regulators, uninsured depositors face a realistic risk of losing a substantial portion of their investment. Similarly, in an insured deposit transfer, rather than liquidating the bank, the FDIC funds an acquiror who pays a premium for the "core insured deposits" of the failed bank, and, in addition, purchases some or all of the assets of the failed bank.

Second, the FDIC may employ open-bank assistance to keep a troubled bank afloat by providing direct financial assistance to enable the bank to continue to meet its creditors' demands. Where open-bank assistance is employed, the FDIC provides capital to the troubled bank by purchasing its bad loans or buying its newly issued preferred stock or other securities. Unlike the deposit-payout approach, open-bank assistance protects all creditors of the bank against loss—including all depositors of any size—because the bank continues to be able to meet all of its obligations as a result of the infusion of cash.

The FDIC's third option when confronted with an insolvent bank is the purchase and assumption transaction. Under this approach, the deposit liabilities of the failed bank are assumed by another bank, which purchases some of the failed bank's assets. The important feature of the purchase and assumption transaction is that, as with open bank assistance, all of the depositors in the failed bank—including uninsured depositors—are completely protected against loss.

Although the FDIC is obligated by law to select the mechanism for resolving bank failures that involves the least cost to the FDIC, the agency uses the purchase and assumption transaction, except where there is no interest by other banks in acquiring the failed bank.[27]

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26. For a more extended discussion of the regulatory options available to dispose of the assets of failed banks, *see* Macey & Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153 (1988).

27. Gilbert, *Recent Changes in Handling Bank Failures and Their Effects on the Banking Industry*, ECON. REV., June-July 1985, at 17 (Federal Reserve Bank of St. Louis).

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New powers granted to the FDIC under the Financial Institutions Reform Recovery and Enforcement Act of 1989 (FIRREA)[28] enhance its ability to arrange bank mergers and thus to avoid liquidation, even when a suitable merger partner cannot be found immediately. The FDIC may do this by transferring some or all of the failed bank's assets and liabilities to a "bridge bank" that agrees to manage them until the agency finds a permanent acquiror. Under FIRREA, the FDIC may organize a bridge bank whenever one or more insured banks are in default, or when it anticipates that one or more insured banks may default on their obligations.[29]

The FDIC's final option is to execute a "modified payout" transaction.[30] The modified payout approach combines attributes of a straight liquidation (deposit payout), and the bank merger (purchase and assumption transaction).[31] In particular, the modified payout approach, unlike open-bank assistance, and unlike a straight purchase and assumption transaction, inserts some sorely needed elements of market discipline.[32]

Under a modified payout, the FDIC pays off the failed bank's obligations to insured depositors in full. In contrast to open-bank assistance and deposit payouts, however, only partial payments are made to uninsured depositors. These partial payments are based on the FDIC's estimate of what these depositors would receive in the event of a liquidation of the failed bank. If it turns out that actual recoveries exceed this initial estimate, the uninsured depositors receive additional payments.[33] The modified payout has been described as follows:

> Like a P&A (purchase and assumption) transaction, a modified payout does not disrupt the insured depositor's activities because these bank liabilities are transferred to another bank. As with P&A, the FDIC arranges the merger of the failed bank with a healthy bank and provides cash to cover any shortfall between the value of the assets purchased and the value of the liabilities assumed by the healthy bank. The major difference between the two types of transactions is that the modified payout provides uninsured

28. Pub. L. No. 101-73, 103 Stat. 183.

29. FIRREA § 214, 12 U.S.C. § 1821(n) (Supp. I 1989).

30. Macey & Garrett, *Market Discipline by Depositors: A Summary of the Theoretical and Empirical Arguments*, 5 YALE J. ON REG. 215, 237 (1988).

31. Note, *The Modified Payoff of Failed Banks: A Settlement Practice To Inject Market Discipline into the Commercial Banking System*, 73 VA. L. REV. 1349, 1378-81 (1987).

32. Macey & Miller, *supra* note 26, at 1184.

33. Gilbert, *supra* note 27, at 22. While the uninsured depositors receive extra payments if the FDIC initially underestimates the proceeds of a liquidation or merger, if the FDIC overestimates the proceeds of such a transaction, the FDIC will absorb the losses associated with its mistake. *Id.*

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depositors with a significant incentive for monitoring the banks where their funds are held and for imposing disciplining on excessive risk taking.[34]

The FDIC developed the modified payout in 1983 and used it in twenty-one bank failures between 1983 and 1985.[35] For a variety of reasons, the modified payout system is superior both to the purchase and assumption transaction and to open-bank assistance as a method of dealing with failed banks. In particular, the banking system would benefit enormously from the market discipline that large uninsured depositors exert. Many of these depositors are themselves banks, and hence are uniquely suited to serve as monitors.

The FDIC never has explained officially why it abandoned the modified-payout approach,[36] which many commentators heralded as a great innovation.[37] The FDIC claims that it uses purchase and assumption transactions rather than straight liquidations as its strategy of choice in handling bank failures because purchase and assumption transactions are less costly. This is false. The mergers that take place under purchase and assumption transactions generally require the repurchase of assets "purchased" by the bank making the acquisition if such assets later go into default. For other assets, the FDIC guarantees a certain rate of return to the acquiring bank under what are known as "yield maintenance agreements." These agreements insure acquirors a substantial rate of return on assets not resold to the FDIC. Hence, when bank failures are resolved as purchase and assumption transactions, not only is the banking system deprived of the benefits of depositor discipline, but the FDIC

34. Macey & Miller, *supra* note 26, at 1185. On average, uninsured depositors received over 40% of their claims in the modified payouts used during this period. *Id.*

35. Note, *supra* note 30, at 1378 n.174, 1380.

36. *Id.* at 1382-84; Macey & Miller, *supra* note 26, at 1185.

37. One commentator has noted that the FDIC experiment with modified payoffs "ended abruptly when the Continental Bank crisis began." Bank regulators did not think that a modified payoff of Continental would work due to the size of the bank and the large number of uninsured depositors. Rather than liquidate Continental (no other bank was willing to participate in a purchase and assumption transaction with the FDIC and Continental), the FDIC provided Continental with direct assistance. *See* Cagane, *Maintaining Financial Stability: Financial Strains and Public Policy*, in DEFICITS, TAXES AND ECONOMIC ADJUSTMENTS 181, 194 (1989). The rescue of Continental Bank "subjected bank regulators to criticism for treating large and small banks differently." Their policies, it was said, were encouraging a "flight to size," rather than a "flight to quality," and excessive concentration of deposits in the very largest banks. In response to these pressures, William Seidman, the chairman of the FDIC, announced in March 1986 that to maintain equality of treatment for banks of all sizes, the FDIC would undertake P&As whenever feasible. In other words, "Seidman instituted a policy of *de facto* 100 percent coverage for all depositors when feasible." *Id.* (citations omitted).

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assumes significant future contingent liabilities on the deals it makes with acquiring banks.

The Treasury Department's proposed reforms of the deposit insurance system will be futile unless there also is an overhaul of the administrative procedures for disposing of failed banks. Under current procedures, sophisticated depositors can direct their deposits to those banks that are likely to merge with another bank in case of insolvency or otherwise are considered "too big to fail" and thus likely to be bailed out. The odds of a sophisticated depositor (uninsured depositors are virtually always institutions) finding itself with deposits in a bank being liquidated are relatively small. Thus, the Treasury Department's proposed reforms would remove the *de jure* deposit insurance protection for some large depositors, but would have no practical effect since large depositors would still, in all likelihood, enjoy the *de facto* protection of the liberal deposit liability assumption policies currently in place.

While the Treasury proposal seems to acknowledge implicitly many of the arguments made here, it does not go nearly far enough. First and foremost, the proposal does not eliminate the "too big to fail" regulatory policy employed most notoriously in 1984 when Chicago's Continental Illinois Bank became insolvent. Under this policy, certain banks simply are deemed too big to fail because the failure of such banks would cause undue disruption to the financial system as a whole.[38] This policy creates opportunities for strategic behavior and unfairness because large depositors shift their assets out of smaller banks that are not considered too big to fail and into the nation's largest banks.

Currently, however, there is little incentive for depositors to shift their funds to big banks because even large, uninsured depositors in small and medium-sized banks are protected under standing regulatory practices. The Treasury proposal possibly may make it somewhat more difficult for the bank regulators to structure purchase and assumption transactions, because, under the proposal, the FDIC could not consummate a purchase and assumption transaction unless such a transaction is cheaper than all regulatory options. Under current regulations, the FDIC can consummate a purchase and assumption transaction as long as it decides that such a transaction is cheaper than a liquidation. But since a liquidation is often the cheapest method for disposing of the assets of a

38. I. SPRAGUE, BAILOUT: AN INSIDER'S ACCOUNT OF BANK FAILURES AND RESCUES 183 (1986).

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failed bank, it is not entirely clear that the Treasury proposal will change existing regulatory practice. Indeed, John D. Hawke, one of the nation's foremost banking attorneys, has astutely observed that the administration's proposal to protect uninsured depositors only if the FDIC determines it to be the least costly means of resolving the bank failure is virtually indistinguishable from the current practice.[39]

The greatest prospect for improving current practice lies in the Treasury proposal's apparent revival of the ability of bank regulators to engage in transactions similar to the modified payout transactions described above. In particular, the Treasury proposal appears to contemplate that the FDIC will use insured deposit payouts or insured deposit transfers for resolving bank failures.[40] In an insured deposit payout, as in the modified payout system described above, the FDIC pays insured depositors the amount of their insured deposits, liquidates the failed institution, and distributes the proceeds to creditors, including uninsured depositors.

Unfortunately, the Treasury proposal still leaves regulators with far too much discretion as to the method for disposing of failed banks. In particular, the FDIC still would be given an undesirably large amount of discretion to resolve bank failures by means of purchase and assumption transactions in which all uninsured depositors are protected. Moreover, it is not clear that uninsured depositors will be affected, even if the Treasury proposal results in more bank failures being handled by liquidations and insured deposit transfers rather than by purchase and assumption transactions. This is because the Treasury proposal envisions that bank regulators will continue to keep large insolvent banks operational through federal bailouts in the form of open-bank assistance transactions. Thus, at best, the Treasury proposal will result in a massive disparity in regulatory treatment between big banks and smaller banks, with uninsured depositors in small and medium-sized banks facing a realistic prospect of losing money in the event of a bank failure, and depositors in large banks enjoying complete protection.

The Treasury proposal, in fact, exacerbates the problems associated with the availability of open-bank assistance as a regulatory option because the proposal shifts authority to decide whether to give open-bank assistance from the FDIC to the Department of the Treasury and the

39. *Banking Reform Plan Faces Major Hurdles on Capital Hill: Industry Reaction Mixed* BANKING REP. (BNA) No.6, at 229 (Feb. 11, 1991).

40. GIBSON, DUNN & CRUTCHER, FINANCIAL INSTITUTIONS GROUP, ANALYSIS OF THE FINANCIAL INSTITUTIONS SAFETY AND CONSUMER CHOICE ACT OF 1991, at 8 (1991).

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Federal Reserve Board. This re-allocation of regulatory authority will create a bizarre state of affairs in which the Treasury and the Fed decide whether to employ open-bank assistance, while the FDIC retains the responsibility for providing the direct financial assistance required under such assistance plans. This inevitably will lead to a decline in accountability and an increase in the use of open-bank assistance, since the regulators at the Treasury and the Fed can enjoy all of the political benefits associated with keeping large insolvent banks in operation, but can shift all of the costs of pursuing such a policy to the FDIC.

Allocating regulatory authority to the Fed to determine whether insolvent banks should be given open-bank assistance is particularly bizarre in light of the fact that the Fed can and does use the discount window as a vehicle for giving distressed banks access to cheap credit. Thus the Fed can make loans available to an insolvent bank through the discount window and later "decide" that it should be reimbursed by the FDIC by requiring the FDIC to extend open-bank assistance to the insolvent bank. This allocation of regulatory authority appears even more bizarre once one recognizes the fact that uninsured depositors frequently remove their deposits from banks that avail themselves of the discount window as a means of obtaining liquidity. Not only should the Fed not be permitted to decide when open-bank assistance should be used, but the central bank also should not be permitted to make the discount window available to insolvent banks. The discount window should be used to provide liquidity only to solvent banks, and occasionally, as a tool of monetary policy.

Thus, the Treasury proposal may result in little, if any, change in current regulatory practices. Indeed, the Treasury's plan could result in a massive inequality in the way problems of large banks and smaller banks are resolved. This inequality, in turn, will cause large depositors to shift their funds from small and medium-sized banks to large banks in order to enjoy the benefits of the government's policy of treating some banks as "too big to fail."

Another problem with the Treasury proposal's response to failed banks stems from the assumptions being made about which form of resolution will involve the "least cost to the deposit insurance fund."[41] Regulators appear to be taking the position that insured deposit transfers are cheaper than insured deposit payouts because, in the insured deposit

41. Financial Institutions Safety and Consumer Choice Act of 1991 (FISCCA), H.R. 1505, S. 713, 102d Cong., 1st Sess., § 103(a)(1)c (1991).

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transfer, the FDIC saves the cost of a liquidation and also obtains a premium for the core insured deposits.[42] This assumption is flawed for two reasons. First, the costs of liquidating the failed bank must be compared to the costs associated with the substantial discounts the acquiring bank applies to the value of the failed banks' assets in order to induce it to do the deal. Second, regulators often give acquirors yield maintenance guarantees and buy-back options, which add costs that must be factored into the value of the merger.

Finally, and most importantly, we wish to observe that, regardless of whether the FDIC disposes of failed bank assets through merger or liquidation, the significant costs of delay should be factored into its calculus. Not only does the market value of these assets decline rapidly when they are transferred to the Resolution Trust Corporation, but the cost of maintenance and up-keep for the assets is a staggering twenty percent of the value of the property.[43] Thus, all else being equal, the FDIC should be required to select the asset disposition strategy that returns the assets of failed banks to the private sector as quickly as possible.

B. Strengthening Capital Requirements

At the heart of the Treasury's proposal is its plan to provide banks with incentives to improve their capital positions by permitting only well-capitalized banks to engage in new activities, including securities underwriting. The theory behind rewarding banks for maintaining strong capital positions is both sound and straightforward. Capital serves as a cushion to protect creditors such as the FDIC from risk of loss. As a bank's capital ratio goes up, risks to the insurance fund should decline because this increased capital will cushion against future unforeseen shocks to the bank's financial condition. In order for capital adequacy regulation to work, therefore, the capital requirements imposed on banks must vary with the riskiness of the bank's assets. It would be wildly inappropriate, for example, to require a bank whose assets are 100 percent invested in U.S. government bonds to maintain the same level of capital as banks whose assets are invested in junk bonds and undeveloped real estate.

One of the major flaws in the Treasury proposal is that it fails to distin-

42. GIBSON, DUNN & CRUTCHER, *supra* note 39, at 8.

43. Macey, *While Politicians Fiddle Banking Crises Explode*, L.A. Times, Sept. 23, 1990, at M4, col.3.

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guish adequately among bank assets on the basis of the quality of those assets. The Treasury proposal adopts the definition of "capital" contained in the report of the Basle Committee on Banking Regulations and Supervisory Practices. This definition is deeply flawed because it lumps assets together in a manner that is too crude to be of real value in distinguishing well-capitalized from poorly capitalized banks. For example, all commercial loans, residential loans, and standby letters of credit to municipalities that back their general obligations are treated identically, despite the fact that the actual risks associated with each may vary widely.

Not only are these capital requirements an inappropriate means of determining whether a bank is well capitalized, the incentives contained in the Treasury proposal will cause banks inefficiently to shift their lending strategies to improve their apparent capital position. For example, under the Treasury's capital guidelines, a bank could improve its capital position by calling in loans to private corporations and using the funds to finance residential properties, since the capitalization rules treat loans on such residential properties more favorably than loans to corporations. Even though loans to solid corporations are far better credit risks than many bank loans made to finance residential properties, particularly under current market conditions, banks have an incentive to make more real estate loans and fewer corporate loans. Thus, the Treasury proposal will exacerbate the distortions of the capital adequacy guidelines which already encourage banks to adopt inefficient lending strategies to improve their apparent capital positions.

The second problem with the Treasury proposal as it relates to capital requirements is that its "carrot and stick" approach, which gives holding companies with well-capitalized banks new powers while holding companies with poorly capitalized banks get those banks closed down, fails to appreciate that poorly capitalized banks may benefit more from enhanced powers than well-capitalized banks. Well-capitalized banks, by definition, are able to find lucrative avenues for their investment dollars, while poorly capitalized banks may be unable to survive unless the scope of their activities can be expanded. In other words, new powers should not be viewed simply as political "carrots" that regulators can distribute to well-financed banks in exchange for past performance. Instead, these powers should be looked at as opportunities whose benefits may be of particular value to poorly capitalized banks. The administration, however, is properly concerned that new powers will be abused to increase the volatility of a poorly capitalized bank's overall portfolio. However,

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banks can acquire plenty of volatile investments using only traditional bank powers, so it is not clear how much is gained by the current Treasury proposal.

Put another way, suppose you have two banks, one on the verge of insolvency, the other in excellent financial shape. Obviously, the bank on the verge of insolvency is the one whose capital position will be the weakest. It is also the one most in need of new profit-making opportunities. But the Treasury proposal would not make any of these opportunities available to the weak bank. Ironically, under the Treasury proposal it is the strong bank that will be able to avail itself of the ability to extend its operations to other areas. Quite clearly, not *all* poorly capitalized banks should be permitted to expand into new areas. Where a bank is in trouble because of bad management, for example, no new powers should be given until management has changed. But new managers will be more willing to assume control of a weak bank if they can take advantage of new powers.

C. New Powers

Perhaps the most widely publicized aspects of the Treasury proposal are the recommendations to repeal antiquated laws that separate commercial banking from investment banking and impede nation-wide branching and banking. The proposal would permit well-capitalized banks to affiliate with securities firms and mutual funds through a newly created corporate entity known as the "financial services holding company." In addition, the Treasury proposal would permit non-financial firms to own banks. Specifically, the Treasury plan would permit commercial firms to own financial services holding companies, which in turn could own banks. Finally, the Treasury proposes that full nationwide banking be permitted after three years, and that national banks immediately be given the authority to engage in interstate branching in any state in which the bank's holding company can acquire a bank.

1. Relaxing Geographic Restrictions

The Treasury proposals to relax current restrictions on interstate banking are the most important and salutary changes contained in the statute. They will do much to improve the delivery of banking services in the United States. Section 262 of the Financial Institutions Safety and Consumer Choice Act (FISCCA) would amend the McFadden Act. The McFadden Act currently limits branching by national banks to the state

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in which the bank is located, and then only to the extent the statutory law of the state expressly allows branching by state banks.[44] The amendments would permit interstate branching by national banks within three years, or whenever the state of the proposed branch permits interstate banking by bank holding companies (whichever is sooner). Thirty-three states, however, already permit nationwide banking by bank holding companies. Twenty-one of these states permit entry on a reciprocal basis, and twelve have no restrictions. Another thirteen states permit regional banking. Only four states (Hawaii, Kansas, Montana and North Dakota) still prohibit all interstate banking.[45] The important change included in the Treasury proposal is that under the new law, financial services holding companies would be able to expand interstate by *branching* rather than by acquiring out-of-state banks as separate subsidiaries under the bank holding company. Moreover, the Treasury proposal would permit existing bank holding companies with networks of separate interstate banks to convert those separate banks into branch networks.

Even under FISCCA there would be some significant restrictions on banks' ability to expand. The Treasury proposal would not permit bank holding companies that have acquired Savings & Loan Associations in distant states to convert those S & Ls into branches. This seems odd since these S & Ls often are acquired when they are insolvent, and financial services companies should be given every incentive to make such acquisitions. In addition, a national bank that establishes a single branch in another state could not establish additional branches in places where state banks could not branch. For example, if a national bank established a single branch in a state that permitted only county-wide branching, the bank could not establish additional branches outside of the county in which its first branch was located. In addition, national banks located in states that have regional banking restrictions could not branch in states that are not party to the interstate compact establishing the restrictions.

After three years, FISCCA would repeal the Douglas Amendment to the Bank Holding Company Act.[46] The amendment restricts interstate acquisitions of banks by bank holding companies by allowing state law to control interstate banking. At the end of the three year period, FISCCA

44. 12 U.S.C. § 36(c) (1989).

45. DEPARTMENT OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS (1991).

46. 12 U.S.C. § 1842(d) (1988).

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would preempt state laws that restrict out-of-state financial services holding companies' entry into the state. FISCCA, however, still would permit states to limit branching internally.

We applaud FISCCA's liberalization of the ability of depository institutions to expand interstate, because it would permit the realization of some efficiency gains in bank organization due to the ability of financial services corporations to establish nation-wide firms to branch networks. It is doubtful, however, that these changes will result in a major change in the way banking business is conducted in the United States. Even if they do, the banking crisis will not be resolved. One reason the law will not result in major change is that, even after FISCCA, the states still would control banks' ability to expand internally. Second, as noted above, because most states already permit significant geographic expansion, the effects of the proposal will be marginal. The major change effected by the Treasury proposal is that banks will be able to engage in interstate expansion through branching rather than through holding company acquisitions of other banks. The ability to expand through branching rather than through holding company acquisitions may result in significant efficiency gains and cost savings for some banks.[47] However, as we have explained elsewhere in detail, if the Treasury wanted to obtain the greatest possible efficiency gains from interstate banking, it would relax the massive impediments to hostile acquisitions contained in the Bank Merger Act,[48] the Change in Bank Control Act,[49] and the anti-takeover provisions of the Bank Holding Company Act,[50] which, taken together, disable outside bidders from gaining control of poorly managed banks in hostile acquisitions without regulatory delays that make such acquisitions all but impossible.[51]

Third, as technology and communications capabilities have expanded, geography has become somewhat less important. Banks can attract deposits on a national basis by electronic funds transfer. Banks can make and service loans nationwide by establishing loan production offices, which are not prohibited under current law, and by having loan officers travel the country to monitor outstanding loan commitments. Indeed,

47. *See* Miller, *The Future of the Dual Banking System*, 53 BROOKLYN L. REV. 1, 16 (1987); Miller, *Interstate Branching and the Constitution*, 41 BUS. LAW 337 (1986).

48. 12 U.S.C. § 1828(c) (1988).

49. 12 U.S.C. § 1817(j) (1988).

50. 12 U.S.C. § 1842 (1988).

51. Macey & Miller, *supra* note 26, at 1215-1223.

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the increasingly international character of most major corporations has required modern loan officers to travel extensively in order to keep abreast of their clients' far-flung empires. Thus, while brick and mortar branches continue to serve important functions, it seems likely that these functions will become less central over time as bank customers come to rely on new technologies.

It is noteworthy that FISCCA would eliminate deposit insurance for so-called "brokered deposits" by amending the legal definition of the term "insured deposit" to exclude "funds obtained or accepted, directly or indirectly, by or through any deposit broker."[52] Elimination of deposit insurance for brokered deposits is designed to prevent insolvent and nearly insolvent banks from rapidly expanding their deposit base. Insured institutions on the brink of insolvency have every incentive to take imprudent risks with funds rapidly obtained from deposit brokers on the eve of insolvency; they have nothing to lose if such risks turn out badly and everything to gain in the unlikely event that the imprudent risks turn out well *ex post*. The deposit insurance system bears all of the costs associated with the use of brokered deposits by insolvent, federally insured banks. However, this moral hazard problem is not a result of brokered deposits. Brokered deposits are merely a minor symptom of the disease, which is the lack of risk-based deposit insurance, and a de facto policy of resolving bank failures that extends the benefits of unlimited deposit insurance to all depositors in certain banks.

Eliminating brokered deposits will not impair the ability of large, sophisticated depositors to locate high-risk banks paying excessively high rates of return on short-term certificates of deposit. Similarly, banks offering high rates on CDs still could advertise their rates, and stock brokers and other intermediaries still could provide information about high rates on certificates of deposit to their customers. Depositors in search of the highest available returns still will be able to shift their money from bank to bank via wire transfer almost instantaneously. To solve the moral hazard problems associated with the current regulatory scheme, Congress will have to impose a truly risk-based pricing system for deposit insurance. Eliminating deposit insurance simply will result in a trivial increase in the transaction costs associated with locating banks

52. FISCCA § 101(A)(1)B. FISCCA defines "deposit broker" as any person "engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions, or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties."

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willing to pay high rates of return to depositors. And, since deposit brokers are a valuable source of information for both depositors and regulators about the financial condition of troubled banks, it is not clear that the Treasury's proposal to restrict their activities will improve the safety of the banking system even marginally. Instead, the most likely result of the elimination of deposit brokers will be to increase the costs of expansion for all banks. With the elimination of deposit brokers, banks that want to compete for deposits nationally will have to advertise more and incur the costs of obtaining national name recognition. Thus, absent deposit brokers, the costs of bank expansion will go up.

Finally, FISCCA does not repeal or even alter the provisions of the Community Reinvestment Act which, as Walter Wriston has thoughtfully observed,[53] actually *mandates* concentration in the banking industry by insisting that banks allocate a disproportionate share of their resources to their local community. Under the Community Reinvestment Act, banks receive one of four ratings ("outstanding," "satisfactory," "needs to improve," or "in substantial noncompliance") based on how well they serve their local communities. Ironically, one consequence of the Community Reinvestment Act is that a bank that locates its offices exclusively in wealthy areas can obtain an outstanding rating while doing little, if anything, to assist in the attainment of the Act's ostensible purpose, which is to provide credit to low and moderate-income neighborhoods. By contrast, banks that are located in poor areas, and that attempt to diversify their loan portfolios by combining (risky) loans within the community with (less risky) loans in other areas, may find themselves in substantial noncompliance, particularly when local community groups choose to challenge the lending decisions of the local bank.

Thus, the Community Reinvestment Act penalizes banks that choose to locate in poor areas. Even banks with outstanding Community Reinvestment Act ratings find it difficult to expand, either by merger or by establishing new branches, because of opportunistic objections by interest groups attempting to extract concessions from the expanding bank. Incredibly, even banks that attempt to purchase *insolvent* banks may find themselves subjected to challenges by special interest groups attempting to wrangle promises of favorable action in exchange for agreements to

53. Wriston, *No Wonder Banks Fail*, Wall St. J., Dec. 19, 1990, at 16, col. 3.

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withdraw Community Reinvestment Act challenges.[54] The opportunistic protests launched by community interest groups are likely to stifle banks' lending patterns in poor areas because banks will wait until they need regulatory approval for a merger or similar transaction before making commitments to poor areas. By waiting, the banks will appear to be making concessions to such groups.

To reduce the regulatory burden on banks that wish to expand, the Treasury should propose that the Community Reinvestment Act be rethought to remove perverse incentives so that banks no longer would be punished when they expanded from wealthy areas to poor ones or from poor areas to wealthy ones.

2. Reforming Financial Services: Securities Powers

Title II of FISCCA would create two new sorts of holding companies, Financial Services Holding Companies (FSHCs) and Diversified Holding Companies (DHCs). A Financial Services Holding Company is any company (other than a DHC) that controls a bank. Thus, existing bank holding companies would, under the Treasury proposal, become FSHCs on January 1, 1993. FISCCA prohibits banks from becoming FSHCs.[55] Any bank that is currently a bank holding company by virtue of its control of another bank would be required to divest itself of its controlling interest in the other bank or reorganize into a FSHC. In order to reorganize into an FSHC, the bank would have to limit its activities to owning and controlling banks.

Under FISCCA, a Diversified Holding Company is any company that has control of a bank through an FSHC and that also engages in activities or controls companies engaged in activities that, under FISCCA, FSHCs are forbidden to perform.

FISCCA would amend the Bank Holding Company Act so that FSHCs can engage in any activity that is determined to be "of a financial

54. For example, a California community group known as the Greenlining Coalition lodged a protest against Bank of America's proposed acquisition of Bank of New England until Bank of America agreed to devote $5 billion to community lending over the next 10 years. Bank of America has an "outstanding" CRA rating from the Office of the Comptroller of the Currency. In a similar protest, the Bank of Boston's bid for Bank of New England has been challenged by the Massachusetts Urban Reinvestment Advisory Group, Inc. *See* Corman, *Bank America's Huge CRA Pledge Squelches New England Protest*, Am. Banker, April 12, 1991, at 1, 10.

55. A statutory exception is made for foreign banks with FDIC insured branches. FISCCA § 202(a)(1)(B).

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nature."[56] Under present law, companies that control banks may only engage in activities that are "so closely related to banking as to be a proper incident thereto."[57]

FISCCA would amend the Glass-Steagall Act to allow any FSHC to engage in a full range of securities activities, but such securities activities could only be conducted through a separate subsidiary authorized by FISCCA.[58] These securities affiliates would be able to: (1) underwrite, distribute, and deal in securities; (2) organize, control, and distribute shares in investment companies registered under the Investment Company Act of 1940; (3) engage in securities brokerage, private placement, and investment advisory activities; and (4) engage in any other securities activities permitted for brokers or dealers registered under the Securities Exchange Act of 1934 or permitted for investment advisers under the Investment Advisers Act of 1940.[59]

Significantly, FISCCA would require any FSHC that acquires a securities affiliate to transfer all securities underwriting and securities dealing activities from its bank's subsidiaries to its securities affiliate. The key to understanding FISCCA's grant of new securities powers to financial services firms is that the Act *reduces* rather than enlarges the ability of banks to profit from dealing in securities and other non-traditional banking products. FISCCA permits new securities activities, to be sure, but only through FSHCs, not through the banks themselves.

The Treasury proposal would amend section 16 of the Glass-Steagall Act to provide that a national bank "may not engage in the United States in any securities activity except to the extent such activity is specifically authorized by statute or authorized by regulation, order or interpretation."[60] Existing bank securities activities would be channeled to non-banking affiliates. A number of activities currently permitted to banks under existing law, including the purchase and sale of certain securities, the purchase and sale of securities for customers in agency transactions, the maintenance of collective investment funds, and the provision of investment advice and management for customers, would be removed from

56. FISCCA § 203(a)(3)A).

57. Bank Holding Company Act § 4(c)(8), 12 U.S.C. § 1843(c)(8) (1988); National Courier Ass'n v. Board of Governors, 516 F.2d 1229 (D.C. Cir. 1975).

58. FISCCA § 203(a)(3)(C).

59. *Id.*

60. *Id.* § 221.

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banks to the auspices of those banks' securities affiliates under the proposed law.

The restrictions on banks' securities activities are bolstered by the establishment of stringent "firewalls" between FSHCs and DHCs. FISCCA would prohibit any extension of credit "in any manner" by a financial firm within an FSHC to a member of an affiliated FSHC group. Thus, no bank or securities firm within an FSHC could extend credit to a non-financial firm within the DHC.[61]

Our point here is that the provisions of FISCCA do nothing to promote bank safety. In all likelihood, they actually make banks more risky by preventing them from attaining low-cost means to diversify their loan portfolios through expansion into securities activities. FISCCA fails to acknowledge that combining commercial banking and investment banking actually will *reduce* the riskiness associated with commercial banking as long as the two activities can be combined in such a way that the returns from each activity negatively correlate with one another. In other words, a basic implication of portfolio theory is that the effect of an activity (like dealing in securities) on the riskiness of a firm (like a commercial bank) cannot be evaluated in the abstract, but rather must be measured by looking at that activity along with the other activities conducted by the firm.[62] For example, "options are clearly riskier than their underlying securities, but no one would suggest that purchasing a security and its underlying put option increases the risk faced by the investor. Rather, such a combination of investments, one risky and the other less risky can clearly decrease or even eliminate risk."[63] Thus, despite the fact that investment banking is, in all probability, riskier than commer-

61. *Id.* § 204. These restrictions bolster the already strict restrictions on transactions between banks and their affiliates contained in §§ 23A and 23B of the Federal Reserve Act, ch. 6, 38 Stat. 251 (1913) (codified as amended at 12 U.S.C. §§ 371c, 371c-1 (1988)). Section 23A regulates transactions between banks and their affiliates, including other firms owned or controlled by the same holding company as the bank. Section 23B requires that transactions between banks and their affiliates be on terms that resemble an arm's length transaction, *i.e.*, on terms that are at least as favorable to the bank as those prevailing at the time for comparable corporate transactions. FISCCA would expand the scope of §§ 23A and 23B (*see* § 223), and would require that bank regulators be given five days notice before extending credit to an affiliate, buying or investing in securities of the affiliate, or purchasing any asset from the affiliate. Section 23A imposes strict limitations on these extensions of credit. FISCCA also would expand the restriction of § 23A to include a bank's assumption of a liability of an affiliate and any transaction to enhance the marketability of securities distributed by the affiliate (unless there is substantial participation by other lenders in the transaction).

62. Macey, Marr & Young, The Glass-Steagall Act and the Riskiness of Financial Intermediaries, forthcoming in J. OF RES. LAW & ECON. (1991) (copy on file with author).

63. *Id.* at 6-7.

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cial banking, the *combination* of investment banking and commercial banking is likely to be less risky than commercial banking. The argument that permitting banks to engage in risky activities like selling insurance or dealing in securities would increase bank risk ignores the fact that the combination of these activities may enable banks to enjoy the benefits of a portfolio effect. Portfolio effect is the reduction in total risk from combining into a single portfolio a group of assets whose returns are imperfectly correlated with each other.

Thus, by only granting new powers to Financial Service Holding Companies, rather than to the banks controlled by such holding companies, FISCCA prevents banks from obtaining the benefits associated with diversification into these other activities. All of the benefits of diversification flow up from the bank to the FSHC. FISCCA should be amended to permit banks themselves to take advantage of new powers, particularly securities powers.

The potential benefits of granting banks new securities powers can be explained as follows. One of the reasons commercial banks are in trouble is because of the risks associated with the mismatch between the term structure of their assets and liabilities. Specifically, banks' liabilities are in the form of short-term obligations to depositors, while their assets consist primarily of medium-term commercial loans. One reason for this mismatch, of course, is customers' preferences. Depositors want ready access to their cash, while borrowers need time to repay their obligations to the bank.

One of the primary risks associated with this mismatch, between the maturity structure of banks' assets and liabilities, concerns fluctuations in the relationship between time to maturity and yield. The term "yield curve" describes this relationship. On a yield curve, times to maturity are arrayed along the x-axis, and yields themselves are arrayed along the y-axis. Sometimes the yield curve will be ascending. When this is the case, long-term assets such as bonds will yield more than short-term assets. At other times, the yield curve will be descending, and short-term assets (like commercial paper and certificates of deposit) will yield more than long-term assets. When there is only a negligible difference between the yield on long-term assets and the yield on short-term assets, the yield curve is said to be flat. The yield curve will change in shape to reflect changes in the market's estimation about inflation, long-term risk and other macro-economic factors. Obviously, a commercial bank that must rent capital on a short-term basis from depositors, while lending it on a

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relatively long-term basis, is quite vulnerable when the yield curve is descending. A bank that can buy and sell a wide range of different types of securities to the public can hedge the riskiness posed by fluctuations in the yield curve. Thus, FISCCA, by forbidding banks to take advantage of new powers, deprives banks of the ability to diversify the risks it faces from fluctuations in the yield curve.

D. Risk-Based Deposit Insurance Premiums

FISCCA requires the FDIC to impose a system of risk-based deposit insurance assessments for all insured depository institutions.[64] While a system of risk-based deposit insurance is essential to any plan to reform the banking industry, FISCCA's plan is fundamentally flawed. The flaw lies in FISCCA's requirement that the FDIC use risk-based capital ratios as a "fundamental basis" for establishing the categories of risk upon which insurance premiums would be based. As noted above, risk-based capital ratios do not provide a coherent basis for separating safe banks from unsafe banks because of the crude distinctions made under such capital ratios among various types of assets.

Instead of basing deposit insurance premiums on capital, the FDIC should use market-based standards for setting deposit insurance premiums. For example, as Stanford professor Kenneth Scott has suggested, banks could be required to sell unsecured, uninsured subordinated debentures in the capital markets.[65] A bank's deposit insurance premium could be set with reference to the interest rate set by the capital markets on these debentures. Alternatively, premiums could be set by having banks obtain co-insurance from private insurance companies. The rates set by these private insurers could be used as a guide for the regulators.

Another option would require banks to obtain private insurance on a portion of their deposits and federally funded insurance on the rest. Again, the rates charged in the private sector could serve as a guide for the rates charged by the FDIC.

Senator Alan Dixon has offered a proposal that contains a plan similar to the one suggested here. Senator Dixon's proposed law would create a re-insurance scheme for banks that are part of bank holding companies with over $1 billion in assets, banks not part of bank holding companies

64. FISCCA § 104.

65. Scott, *Deposit Insurance—The Appropriate Roles for State and Federal Governments*, 53 BROOKLYN L. REV. 27, 35 (1987).

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with $1 billion in assets, and smaller banks that exercise insurance, securities, real estate, or investment powers either directly or through a holding company. The Dixon plan calls for the FDIC to sell between three and ten percent of the risk associated with the failure of an insured bank to private re-insurers or to a re-insurance subsidiary of a financial services holding company. Under Senator Dixon's plan, covered banks would negotiate with eligible re-insurers over rates, and the FDIC would adjust the premium charged to the insured bank on the basis of the premiums charged to the FDIC by the re-insurer. Senator Dixon's plan has much to recommend it. It is not clear, however, why the proposal should be limited to large banks, or why the additional options suggested here for market-based pricing of deposit insurance should not be made available to covered banks.

Still another possibility would be to allow consortiums of banks to enter into co-insurance schemes both as a way of reducing their own insurance rates, and as a way of providing regulators with a market-based bench-mark for fixing federal insurance premiums. News that a particular bank could not gain entrance to a consortium, or was being charged an unusually high premium or fee for entry into a co-insurance group, would provide regulators with important new information.

For years the FDIC has been claiming that risk-based deposit insurance is an impractical idea because bank regulators, including themselves, simply are incapable of segregating banks on the basis of risk. We believe them. Their inability to predict reliably that a bank is going to fail provides substantial support for their claim that they lack expertise. That regulators have been unsuccessful at pricing deposit insurance on the basis of risk does not mean that market-based pricing will not work. Indeed the long-time failure of the regulatory system to impose market-based pricing is a strong additional reason to move to a market-oriented system.

Each of the specific proposals for risk-based deposit insurance suggested above has advantages and disadvantages over the others. Some would favor small banks over large banks. For example, a small bank might find it easier to find private deposit insurance or willing co-insurers than a large bank. Others would favor large banks over small banks. In particular, small banks would be at a distinct disadvantage in trying to create a market for its unsecured, subordinated debentures. Because of the disparate impact these various proposals would have on different banks, we propose that banks be given the *option* of selecting the insur-

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ance method they want most. Large banks might prefer to sell debentures, while small banks might prefer to enter into co-insurance schemes. Any of these alternatives would be preferable to the proposal contained in FISCCA, since all of them are market-based, and none of them is based on such unreliable indicators of risk as capital ratios.

IV. A Final Word on Deposit Insurance

There has never been a convincing argument for federally sponsored deposit insurance. The three most cogent arguments are: (1) deposit insurance is efficient because it solves a collective action problem that exists among depositors; (2) deposit insurance is necessary to provide a "transparent" payments system, one in which those accepting checks need only worry about the credit-worthiness of the check writer, rather than about financial institutions interposed between the check writer and the person accepting the check as payment; and (3) society needs an institution in which unsophisticated individuals can keep funds for safekeeping. We will consider each of these arguments in turn.

A. Deposit Insurance and the Collective Action Problem Facing Depositors

Commentators have argued that depositors face a collective action problem, specifically a prisoner's dilemma, because all depositors realize that the banks that maintain their deposits keep only a fraction of these deposits on reserve at any given time. The rest of these funds are transformed into relatively illiquid assets such as loans to home owners and commercial clients. As a consequence of this mismatch between assets and liabilities, all depositors cannot demand repayment of their deposits simultaneously because the bank will not have sufficient funds on hand at any given time to satisfy the demands of all depositors.[66] Thus, if any substantial portion of the bank's depositors withdraw their funds at the same time, the bank will be forced to liquidate its assets "at distress prices," rendering the bank insolvent and jeopardizing the interests of those depositors who refrain from attempting to obtain immediate repayment of their deposits from the bank. Thus, the argument goes:

> [I]f some class of depositors does decide, for whatever reason, to withdraw assets from the bank, other depositors will rationally conclude that they

66. Fischel, Rosenfield & Stillman, *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 307 (1987).

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> must do the same to avoid being left with nothing. The result of such a "run" on the bank's assets may be the failure of a previously solvent bank to the detriment of depositors as a group.[67] The problem with this analysis is that it ignores the ability of markets to solve this problem, at low cost, through private contracts between banks and their depositors: The reason the collective action problem is so acute in banking . . . is because of the asymmetry between the maturity structure of banking assets and the maturity structure of banking liabilities. But there is nothing preventing banks from designing their asset portfolios to match their liabilities by purchasing highly liquid short-term assets. This would eliminate the collective action problem facing depositors in ways similar to deposit insurance. Thus, the design of deposit insurance makes it possible for banks to have a disparity between the maturity structure of their assets and liabilities. Absent such a design, rational depositors would prefer to place their deposits at banks that matched the maturity structure of bank assets with those of bank liabilities.[68]

In particular, in a world without deposit insurance, banks, in order to attract depositors and stay in business, would have an incentive to design contractual solutions to this perceived collective action problem. On the asset side of the balance sheet, banks could agree to keep their assets in short-term money market instruments or in other highly liquid, short-term assets. Banks willing to make this commitment would be able to attract deposits at lower interest rates than other banks.

On the liability side of the balance sheet, banks could mitigate the collective action problem by issuing certificates of deposit with longer maturities. Those depositors willing to accept certificates of deposit with longer maturities would be able to command higher interest payments from their banks. Similarly, in exchange for higher interest on their deposit accounts, depositors might agree to forego the right to repayment on demand, and to give the banks holding their funds the option of delaying payment for a few days or weeks where necessary. This would eliminate the necessity of a bank having to liquidate assets under duress to meet unexpected liquidity demands by depositors. Thus, it seems clear that existing contractual devices provide sufficient means for depositors to protect themselves from the prisoner's dilemma posed by a fractional reserve banking system.

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67. *Id.* at 308.

68. Macey, *The Political Science of Regulating Bank Risk*, 49 OHIO ST. L. REV. 1277, 1281 (1989).

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B. Deposit Insurance and the Payments System

The second argument in favor of governmentally supplied deposit insurance is that such insurance is necessary to provide a payments system that allows those accepting checks to worry only about the credit-worthiness of the check-writer and to ignore the credit-worthiness of the financial institutions between the check writer and the person accepting the check as payment. This argument has merit. In a complex economy with many financial institutions, the transaction costs of doing business would be prohibitive if there were a realistic danger that the payments system would collapse at any moment. But this is not an argument for deposit insurance, it is an argument for a central bank that can monitor and guarantee the integrity of the banks within the payments system.

The existence of deposit insurance is wholly superfluous to a properly functioning payments system. Clear evidence of this is the proliferation of uninsured money-market funds with check-writing privileges. Investors who keep funds in these accounts have absolutely no trouble having their drafts accepted for payment in the same way that checks are accepted. The Federal Reserve Board's ability to supervise, monitor, and, if necessary, guarantee the payments system provide all of the safeguards necessary to protect the financial integrity of the payments system. Deposit insurance adds nothing to the functions performed by the central bank.

C. Deposit Insurance and the Need to Protect Small Savers

The final argument in favor of deposit insurance is that small savers need deposit insurance because they have neither the resources nor the sophistication to evaluate the riskiness of the financial intermediaries that they entrust with their savings. This argument is also flawed. In a world without federal deposit insurance, small depositors desiring extra protection of their funds would be able to purchase such protection from private insurers. Moreover, the small depositor argument ignores banks' strong incentive to attract such small depositors and to make credible (bonded) promises that such depositors' funds will be kept safe. In addition to private insurance, banks could promise to keep depositor funds in U.S. government guaranteed securities, or to back the bank's financial obligations to depositors on the basis of the personal liability of the bank's shareholders.

Obviously, depositors would have to pay for the extraordinary levels of

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protection described above. But it is important to remember that the argument in favor of federal deposit insurance is that small depositors demand absolute safety. If this is not true, the last argument in favor of federal deposit insurance disappears.

In fact, the general public does not benefit very much, if at all, from deposit insurance:

> Contrary to popular belief, the primary beneficiary of deposit insurance appears to be the insured banks themselves rather than the depositors. This argument becomes almost self-evident when one observes that even during the incredible four-year period from 1930-1933 when 9000 banks failed or suspended operation, losses to depositors came to only 1.3 billion dollars as compared to losses of 85 billion dollars suffered by holders of common and preferred stock.[69]

Thus, none of the public-interest justifications for deposit insurance appear valid. Nonetheless, while FISCCA retains federally backed deposit insurance, it also makes no meaningful reforms to the way in which the insurance system is administered. We would recommend privatizing deposit insurance along the lines described above, or, at the very least, linking the price of federally backed insurance to market-based criteria.

CONCLUSION

Observing the traumatic shocks that have been felt by the banking industry in the U.S. should help Americans understand the problems associated with deregulating industries that previously enjoyed the solicitous protections of government regulators. The shocks to the banking industry provide a glimpse of what citizens in eastern Europe and the Soviet Union are seeing on an economy-wide basis.

While the deregulation of the U.S. airline industry came about as the result of governmental policies aimed at helping consumers, the deregulation of banking is occurring in spite of the best efforts of regulators, governmental officials, and industry participants. Deregulation of banking, like the deregulation and privatization in eastern Europe, is being brought about by the inability of a hopelessly inefficient, highly bureaucratized industry to survive in global and domestic markets against more agile, less regulated competition.

The Treasury Department is entirely correct in its observation that the problems faced by American banks are a result of the antiquated regula-

69. *Id.* at 1283.

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tory structure that simultaneously rewards recklessly managed banks for excessive risk-taking, while punishing well-run banks for prudence. Unfortunately, the reforms contained in the Treasury's plan do not go nearly far enough to relieve the banking system of the regulatory constraints that precipitated the current crisis.

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