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# Reforming the U.S. Banking System: Lessons from Abroad

## **Cover Page Footnote**

International Law; Commercial Law; Law

# Reforming the U.S. Banking System: Lessons from Abroad

Bill Shaw†  
John R. Rowlett‡

## I. Introduction

In 1991, Congress rebuffed a Bush Administration attempt to reform the U.S. banking system. The goal of the proposal was to make the U.S. banking system more profitable, more competitive, and safer, both domestically and internationally.<sup>1</sup> The only provision that was adopted was the replenishment of the bank insurance fund, and banking "reform" was not achieved.<sup>2</sup>

This article critiques the U.S. banking system from a macro perspective and offers recommendations to make it strong, both domestically and abroad. Part II of this Article reviews the reasons behind the need for banking reform and provides an overview of the evolution of the American banking system. Part III compares the banking systems of Japan, Germany, the United Kingdom, and the banking system plan for the European Community. This Article concludes that the way to develop a superior U.S. banking system is to (1) relax restrictions on banks with respect to bank ownership and with respect to the types of businesses they can enter and who can own them; (2) impose strict controls on banks with regard to financial health; (3) privatize deposit insurance; and (4) eliminate the dual banking system and make the Federal Reserve System the one supervisory authority over banks.

## II. Why We Need Banking Reform

The banking industry in the United States is currently in terrible shape. The industry has experienced large profit fluctuations, and is

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‡ J.D., University of Texas at Austin (1992); M.B.A., Southern Methodist University (1987). I wish to thank my wife for all of the support she gave me and many of the ideas.

<sup>1</sup> See generally U.S. DEP'T OF TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER MORE COMPETITIVE BANKS (1991) [hereinafter TREASURY REPORT].

<sup>2</sup> FDIC Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (to be codified in scattered sections of 12 U.S.C.). This legislation authorized the Federal Deposit Insurance Corporation (FDIC) to borrow \$30 billion to shore up its nearly bankrupt bank deposit insurance fund and to toughen some bank regulatory rules. *Id.*

generally less profitable than in years past,<sup>3</sup> there are hundreds of bank failures each year,<sup>4</sup> and the bank insurance fund had to be replenished in 1991.<sup>5</sup> But how is it that our banking system, which was once so mighty, has become so weak?<sup>6</sup> There are a number of contributing factors.

### A. Deregulation

In the 1970s the competition among financial institutions became increasingly keen.<sup>7</sup> These increased competitive pressures led Congress to pass measures that were deregulatory in nature.<sup>8</sup> An example of such a measure was the Depository Institutions Deregulation and Monetary Control Act of 1980,<sup>9</sup> which was designed to provide greater competitive equality among financial institutions.<sup>10</sup> Important provisions of this Act included eliminating Regulation Q limits on the interest rates banks could offer on deposits; giving broader investment and service authority for federal savings and loan associations; and giving financial institutions the authority to offer NOW accounts.<sup>11</sup>

Another piece of legislation that further deregulated the financial

<sup>3</sup> Overall profits for the banking industry were \$25.3 billion, \$15.5 billion, \$15.9 billion, \$18.6 billion, and \$32.2 billion for the years 1988 through 1992, respectively. *U.S. Banks Post Record \$25.3 Billion Profit While FDIC Cooffers Dwindle in 1988*, 52 Banking Rep. (BNA) No. 12, at 676 (Mar. 20, 1989); *Bank Profits in 1990 Overshadowed by Big Bank Losses, Regional Problems*, 56 Banking Rep. (BNA) No. 15, at 692 (Apr. 15, 1991), *FDIC-Insured Banks Earned \$18.6 Billion in 1991; 4th Quarter Earnings Quadrupled*, 58 Banking Rep. (BNA) No. 11, at 442 (Mar. 16, 1992); *BIF-Insured Commercial Banks Pull in Record Profits in 1992*, 60 Banking Rep. (BNA) No. 11, at 334 (Mar. 15, 1993).

"While the banking industry appears ready to finance a sustained recovery, 'it would be a mistake not to recognize that the remnants of past mistakes will continue to plague the financial system for some time . . .'" *Bank Capital Standards Will Not Hurt Economic Expansion, Greenspan Asserts*, 59 Banking Rep. (BNA) No. 19, at 740 (Nov. 23, 1992) (quoting Alan Greenspan) [hereinafter *Bank Capital Standards*].

<sup>4</sup> From 1942 until 1980 there were a total of 198 bank failures, and the greatest number in any one year was 20. In 1983 there were 50 bank failures, and the number steadily increased each year until 1989 when there were 206 failures. TREASURY REPORT, *supra* note 1, at 18 (fig. 2). In 1991, there were only 124 bank failures, but the average size of failing banks increased, with the average total assets of failed banks standing at about \$142 million in 1989 compared with \$509 million in 1991. *GAO Confirms FDIC \$7 Billion Figure for 1991 BIF Deficit; Looks at Fund's Future*, 58 Banking Rep. (BNA) No. 24, at 1035 (June 15, 1992).

Although the assets of failing banks have decreased slightly since 1991, figures for 1992 and 1993 indicate that failures are continuing at a rate of 100-125 banks per year. *FDIC Expects 100 Bank Failures in 1992; Regulators Give Views on Banks' Future*, 59 Banking Rep. (BNA) 589 (Oct. 26, 1992).

<sup>5</sup> See *supra* note 2 and accompanying text.

<sup>6</sup> TREASURY REPORT, *supra* note 1, at XVIII-23. In 1983, three U.S. commercial banks were in the rankings of the world's top twenty banks in asset size. But by year-end 1988, no U.S. commercial bank was ranked among the world's top twenty. *Id.*

<sup>7</sup> *Id.* at XVIII-9, 10.

<sup>8</sup> *Id.*

<sup>9</sup> Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132-93 (codified as amended in scattered sections of 12 U.S.C.) [hereinafter *Monetary Control Act*].

<sup>10</sup> ERIC N. COMPTON, *PRINCIPLES OF BANKING* 16 (1988).

<sup>11</sup> *Monetary Control Act*, *supra* note 9.

institutions industry was the Garn-St. Germain Act of 1982.<sup>12</sup> This Act allowed liberalized real estate investment authority for national banks, allowed mergers between weakened savings institutions and banks, and required banks to offer money market accounts that were competitive with money market mutual funds.<sup>13</sup> This Act opened the door for the real estate lending abuses that have played a significant role in the banking system's poor health.<sup>14</sup> On a broader scale, this era of deregulation forced banks to be more competitive in terms of servicing customers.<sup>15</sup> Of course the natural result from deregulation was a shake-out of the uncompetitive companies, and the banking industry was no exception. As a result, many more banks failed during the 1980s than during the 1970s.<sup>16</sup> Deregulation, however, was not the only source of the growing banking woes.

### B. *Third World Debt*

In the 1970s, American banks began lending in force to Third World countries.<sup>17</sup> There were two rather simple reasons for this: (1) the Third World nations needed capital; and (2) the banks were willing to lend.<sup>18</sup> Instead of taking the safer and more conservative policy approach of internally generating cash flow by exporting more than they imported, Third World governments took the riskier and quicker method of borrowing the money.<sup>19</sup> Banks, in turn, were very eager to lend to developing nations because the loans produced hefty up front fees that contributed significantly to the banks' quarterly profits.<sup>20</sup> In addition, the debtor nations appeared to be good credit risks at the time the loans were made. First, repayment of the loans was generally to come from revenues generated by exports of raw materials, such as food products, metal, and oil.<sup>21</sup> During the 1970s, prices for those items were rising and there was no reason to believe they would fall in the future.<sup>22</sup> Second, inflation during the 1970s was high. High inflation counteracted high interest rates so that real interest rates were low or nonexistent.<sup>23</sup> This allowed countries to easily service debt. Finally, because these loans were made either to the sovereign nations or were

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<sup>12</sup> Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469-1548 (codified as amended in scattered sections of 12 U.S.C.).

<sup>13</sup> *Id.*

<sup>14</sup> TREASURY REPORT, *supra* note 1, at XVIII-11.

<sup>15</sup> *Id.*

<sup>16</sup> *See supra* note 4.

<sup>17</sup> TREASURY REPORT, *supra* note 1, at XVIII-11.

<sup>18</sup> Alberto Gonzalo Santos, *Beyond Baker and Brady: Deeper Debt Reductions for Latin American Sovereign Debtors*, 66 N.Y.U. L. REV. 66, 72-73 (1991).

<sup>19</sup> PEDRO-PABLO KUCZYNSKI, *LATIN AMERICAN DEBT* 38-39 (1988).

<sup>20</sup> *Id.* at 40.

<sup>21</sup> *Id.* at 35.

<sup>22</sup> ALFRED J. WATKINS, *TILL DEBT DO US PART: WHO WINS, WHO LOSES, AND WHO PAYS FOR THE INTERNATIONAL DEBT CRISIS* 51 (1986).

<sup>23</sup> *Id.*

guaranteed by them, and those nations' economies appeared to be strong, banks believed there was little risk of default.<sup>24</sup>

However, the banks miscalculated the credit worthiness of the debtor nations, and the result was the Third World Debt Crisis. Four main factors contributed to the crisis. First, restrictive monetary policy by the U.S. government in 1981 was used to curb inflation.<sup>25</sup> Simultaneously, the Federal Reserve increased interest rates.<sup>26</sup> The result was that real interest rates increased and made it more difficult for Third World debtors to service debt.<sup>27</sup> Second, these inflation curbing measures caused a recession not only in the United States, but also worldwide.<sup>28</sup> This resulted in lower prices for Third World countries' exports.<sup>29</sup> Consequently, there was less revenue with which Third World nations could service debt. Next, banks were not diligent in analyzing the credit worthiness of the debtors.<sup>30</sup> Many times, the banks were not familiar with the projects to which the proceeds of the loans were going.<sup>31</sup> Many of those projects were unsuccessful.<sup>32</sup> If banks had been more inquisitive and had analyzed those projects, they would have been less reluctant to lend money for them. Finally, the U.S. dollar was relatively cheap compared to other currencies during the 1970s. Consequently, many wealthy investors in Third World nations transferred their money to the United States. These transfers adversely affected those Third World economies.<sup>33</sup>

In August of 1982, Mexico announced that it was unable to make its scheduled principal and interest payment on nearly \$100 million of debt owed to foreign governments and commercial banks.<sup>34</sup> Other debtor nations soon followed. Most new lending was stopped. Creditors did provide some gap financing, however, to allow the debtor nations to make interest payments.<sup>35</sup>

Since 1982, commercial banks have worked feverishly to reduce their exposure to Third World debt.<sup>36</sup> The nine largest U.S. banks managed to decrease their exposure to the fifteen largest Third World debtors from \$61 billion in 1982 to \$40.1 billion in 1990.<sup>37</sup> Likewise, these banks increased their primary aggregate capital from \$32 billion

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<sup>24</sup> *Id.* at 24.

<sup>25</sup> U.N. CONFERENCE ON TRADE AND DEVELOPMENT, TRADE AND DEVELOPMENT REPORT, at 92-93, U.N. Doc. ST/ESA/82, U.N. Sales No. E.88.II.D.8. (1988).

<sup>26</sup> *Id.* at 92.

<sup>27</sup> *Id.*

<sup>28</sup> WATKINS, *supra* note 22, at 49.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at 29.

<sup>31</sup> *Id.* at 22.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.* at 23.

<sup>34</sup> Clyde H. Farnsworth, *Debt Crisis for Banks Said to End*, N.Y. TIMES, Jan. 6, 1989, at D1.

<sup>35</sup> Santos, *supra* note 18, at 75.

<sup>36</sup> *Id.* at 83.

<sup>37</sup> *Id.*

to \$54.7 billion.<sup>38</sup> This means that these banks reduced their debt exposure from 191% of capital to 73.3% of capital in this period and increased their average loan loss reserves for Third World debtors from 5% of book value for Third World loans to 50% of book value for these loans for the same period.<sup>39</sup>

As can be seen, Third World debt poses much less of a threat to the health of U.S. banks now than it did at the outset of the crisis. In fact, in 1989 leading bank regulators told Congress that Third World debts no longer posed a threat to the U.S. banking system.<sup>40</sup>

### C. Real Estate Lending

As much harm as Third World lending has done to the U.S. banking system, real estate lending has probably done more, because it permeates a much greater number of institutions, and there is much greater exposure.<sup>41</sup>

This problem also originated in the 1970s. Banks' profitability was being squeezed on several fronts. For instance, depositors substituted higher interest money market funds and other investments for traditional bank accounts,<sup>42</sup> and large corporations stopped using bank credit lines and started issuing their own commercial paper.<sup>43</sup> To counter the squeeze on profit margins, banks began making more profitable and more risky loans to such entities as real estate developers. In the eleven years from 1979 to 1990, U.S. bank real estate lending increased by 316%.<sup>44</sup>

This strategy, of course, did not fare well for American banks. As of March 31, 1992, non-current real estate loans, which are those that are either 90 days past due or on non-accrual status, were 5.38% of total real estate loans.<sup>45</sup> This is a modest improvement compared to June 1991 when the figure was 5.67%, which was the highest level in six years.<sup>46</sup> Moreover, the commercial real estate market shows no signs of improvement, which suggests that the current situation with real estate lending could last several more years.<sup>47</sup>

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<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> Farnsworth, *supra* note 34, at D1.

<sup>41</sup> Susan Dentzer, *As the Banks Crumble*, U.S. NEWS AND WORLD REPORT, Jan. 21, 1991, at 55. As of November 13, 1990, the risk exposure for real estate among commercial banks was \$791 million. TREASURY REPORT, *supra* note 1, at XVIII-11 (fig. 3).

<sup>42</sup> TREASURY REPORT, *supra* note 1, at XVIII-9, 10.

<sup>43</sup> *Id.* at XVIII-11.

<sup>44</sup> *Id.* fig. 2.

<sup>45</sup> FDIC Insured Commercial Banks Earned Record Quarterly Profits of \$7.6 Billion, 58 Banking Rep. (BNA) No. 1032, at 1032 (June 15, 1992) [hereinafter *Record Quarterly Profits*].

<sup>46</sup> National Bank Earnings Fall by \$1 Billion and Loans Drop by \$23 Billion, OCC Says, Banking Daily (BNA) (Sept. 11, 1991).

<sup>47</sup> See *Record Quarterly Profits*, *supra* note 45.

#### D. Corporate Debt

Starting in about 1984, there was a relaxation of credit standards by banks.<sup>48</sup> Corporate raiders intent on acquiring undervalued stock and management intent on taking companies private used this opportunity to borrow money to carry out their plans.<sup>49</sup> Banks, believing that the economic expansion would last forever, accepted the companies' overly optimistic projections in analyzing their credit worthiness.<sup>50</sup> Traditional debt-to-capitalization standards and debt-coverage ratios that banks had used to determine credit worthiness were largely loosened or ignored.<sup>51</sup> Banks reasoned that even if the debtors defaulted, the assets that secured the loans could always be sold at rising prices to pay off the debt.<sup>52</sup> Moreover, tax treatment of interest payments has long favored capitalizing corporations through debt rather than equity: interest payments are tax deductible,<sup>53</sup> while dividends on stock are not.<sup>54</sup> Finally, banks earned lucrative fees for engaging in highly leveraged transactions.<sup>55</sup>

Against this backdrop, banks had \$190 billion of exposure to highly leveraged transactions by November 1990.<sup>56</sup> Recessions in industries that were particularly debt laden caused many companies to collapse under these mountains of debt.<sup>57</sup> The result is that by mid-1991, there were approximately \$50 billion in losses.<sup>58</sup>

#### E. Antiquated Legislation

A final contributing factor to the current troubles of the banking system lies in antiquated legislation that continues to play a significant and fundamental role in preventing the banks from being profitable. The two most problematic acts were passed in an era when foreign competition was nonexistent. They responded to concerns which, while important at the time, are less important today.

##### 1. McFadden Act of 1927

The McFadden Act<sup>59</sup> prohibits national banks from establishing

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<sup>48</sup> Robert F. Black, *No Easy Cure for Red Ink*, U.S. NEWS AND WORLD REPORT, May 6, 1991, at 62.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> See 26 U.S.C. § 163 (1988).

<sup>54</sup> MICHAEL J. GRAETZ, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 465 (1988).

<sup>55</sup> WARREN F. COOKE, TOMORROW'S BANKS: DEVELOPMENTS SHAPING THE 90'S 173 (1990).

<sup>56</sup> TREASURY REPORT, *supra* note 1, at XVIII-11 (fig. 3).

<sup>57</sup> Black, *supra* note 48, at 62.

<sup>58</sup> *Id.*

<sup>59</sup> National Bank (McFadden) Act of 1927, Pub. L. No. 91-90, § 2, 44 Stat. 1224, 1228 (1927), as amended by Banking (Glass-Steagall) Act of 1933, Pub. L. No. 91-90, § 23, 48 Stat. 162, 189 (codified as amended at 12 U.S.C. § 36 (1988)).



branches outside of the state where the bank is headquartered.<sup>60</sup> The McFadden Act also limits intrastate branching by national banks to that which is permitted of state banks.<sup>61</sup> National banks can only establish branches in a particular state if state banks are so permitted according to state law.<sup>62</sup> However, this intrastate branching restriction has been relaxed somewhat in recent years by the work of the Comptroller of Currency, Robert Clarke. The Comptroller took the position that the definition of a "state bank" included a state-chartered savings and loan, because state savings and loans have had bank-like powers since the early 1980s. The Comptroller argued successfully that those states that allowed intrastate branching by state-chartered savings and loans must also allow branching by national banks, even if the states did not allow intrastate branching by state banks.<sup>63</sup>

The problem with the McFadden Act is that by restricting banks' abilities to establish branches, it imposes more costs on them and causes them to be less competitive.<sup>64</sup> The original purpose of the Act was to preserve the dual banking system by promoting competitive equality between national and state banks.<sup>65</sup> The theory was that competition between state and national banking systems would lead to the development of more efficient banking regulations.<sup>66</sup> In practice, the result is a less efficient banking system for two reasons. First, the McFadden Act places restrictions on interstate branching. These restrictions increase the costs of expanding a bank's presence outside of its home state because the bank must set up a separate subsidiary bank in the other state instead of just opening up a branch office. This scheme precludes American banks from realizing significant economies of scale.<sup>67</sup> Second, if a state wishes to restrict competition and maintain cartel banking, it can easily do so by prohibiting branch banking in any form.<sup>68</sup> The ultimate result of this act is that it makes American banks less efficient and less competitive.

## 2. *The Glass-Steagall Act of 1933*

The Glass-Steagall Act<sup>69</sup> generally prohibits commercial banks

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> See Dep't of Banking and Consumer Fin. v. Clarke, 809 F.2d 266 (5th Cir.), *cert. denied*, 483 U.S. 1010 (1987).

<sup>64</sup> TREASURY REPORT, *supra* note 1, at 52.

<sup>65</sup> Henry N. Butler, *The Competitive Equality Doctrine and the Demise of Intrastate Bank Branching Restrictions*, 55 TENN. L. REV. 703, 707 (1988).

<sup>66</sup> *Id.* at 709.

<sup>67</sup> *Id.* at 710.

<sup>68</sup> Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 693, 702-03 (1988).

<sup>69</sup> Banking Act of 1933, Pub. L. No. 91-190, § 16, 20, 21, 32, 48 Stat. 162, 184-194 (1933) (codified at 12 U.S.C. §§ 24, 78, 377, and 378 (1988)). The Glass-Steagall Act is the name commonly used to refer to the above provisions.

from entering the securities field and other non-banking activities.<sup>70</sup> Also, the Act prohibits entities that issue, underwrite, sell, or distribute securities from engaging in the banking business.<sup>71</sup> Members of the Federal Reserve System (the "Fed") are precluded from being affiliated with securities firms.<sup>72</sup> The purpose of this Act was to protect bank depositors against a repeat of the era of widespread bank closings of the Great Depression.<sup>73</sup> Congress believed that the rash of bank failures was attributable in part to speculative activities by banks made possible by the connections between commercial banking and investment banking.<sup>74</sup>

In fact, there is no evidence that the 1929 Stock Market Crash was caused by the collapse of the banking system. Nor is there any evidence to suggest that commercial bank securities activities caused the failure of a single bank.<sup>75</sup> It has been shown that the causes of the bank failures during the Great Depression were general economic conditions, restrictive monetary policy, and protectionistic trade measures.<sup>76</sup> Alan Greenspan, the Chairman of the Board of Governors of the Federal Reserve System stated: "Research over the last 50 years concludes, contrary to Congress' view at the time, that bank securities activities were not a cause of the Great Depression and that banks with securities affiliates did not fail in proportionately greater numbers than banks more generally."<sup>77</sup> On the contrary, most banks that had securities affiliates survived the Great Depression.<sup>78</sup> The health of and confidence in the U.S. banking system was restored via the Banking Act of 1933.<sup>79</sup> The Banking Act created deposit insurance and the Federal Deposit Insurance Corporation. It introduced badly needed regulatory reforms, such as control over the capital requirements of national banks, restrictions on interbank transfers, and greater authority in bank regulators.<sup>80</sup>

The Glass-Steagall Act precludes commercial banks from fully entering the securities business and effectively eliminates this means for

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<sup>70</sup> 12 U.S.C. § 24 (1988).

<sup>71</sup> 12 U.S.C. § 378 (a)(1) (1988).

<sup>72</sup> 12 U.S.C. § 377 (1988).

<sup>73</sup> Walter Henry Goodwin, Comment, *Fifty-Two Years After the Glass-Steagall Act: Do Commercial Bank Securities Activities Merit a Second Look?*, 4 DET. C.L. REV. 933, 936 (1984).

<sup>74</sup> *Id.* at 936-37.

<sup>75</sup> William M. Isaac & Melanie L. Fein, *Facing the Future—Life Without Glass-Steagall*, 37 CATH. U. L. REV. 281, 286 (1988).

<sup>76</sup> *Id.* at 286.

<sup>77</sup> *Legislative Proposals to Restructure our Financial System: Hearings on § 1886, § 1891, and § 1905 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. 92 (1987) (statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System).

<sup>78</sup> *Modernization of the Glass-Steagall Act: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. 56-57 (1987) (statement of Edward J. Kelly, III).

<sup>79</sup> Isaac & Fein, *supra* note 75, at 288.

<sup>80</sup> *Id.*

banks to diversify and supplement their earnings. In this respect it has made the U.S. banking system less competitive.

### III. Comparison with Other Leading Banking Systems

In reforming our own banking system, it is useful to study other banking systems that have operated quite effectively. There are some significant differences between the U.S. banking systems and those of Japan, Great Britain, Germany, and the European Community.

#### A. *United States*

##### 1. *In General*

The United States has a dual banking system, i.e., banks can be chartered at either the state or federal level.<sup>81</sup> This system has resulted in four different authorities overseeing American banks, with an individual bank's chief regulatory authority depending on several factors. The four regulatory sources are the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC), and the various state banking agencies.<sup>82</sup>

National banks are chartered by the OCC, and the OCC is the chief regulatory agency for national banks.<sup>83</sup> These banks also are required to be members of the Federal Reserve System (FRS), and they must carry FDIC insurance.<sup>84</sup> As a result, national banks must also be supervised by the FRB, and the FDIC.<sup>85</sup>

State banks must all be chartered by a state banking agency and must be regulated by that agency. However, they have a choice of whether to be members of the FRS and whether to carry FDIC insurance.<sup>86</sup> This flexibility allows for three different possible scenarios regarding the regulation of state banks:

(1) State Banks, Not Members of the FRB (Non-Member), and Not FDIC Insured (Non-Insured). These types of banks are regulated and supervised only by the state banking agency.<sup>87</sup>

(2) State Banks, Non-Member, FDIC Insured (Insured). These banks are regulated and supervised by the state banking agency and supervised by the FDIC.<sup>88</sup>

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<sup>81</sup> ERIC N. COMPTON, *PRINCIPLES OF BANKING* 8 (1988).

<sup>82</sup> TREASURY REPORT, *supra* note 1, at XIX-1.

<sup>83</sup> 12 U.S.C. § 11 (1988); TREASURY REPORT, *supra* note 1, at XIX-1.

<sup>84</sup> 12 C.F.R. §§ 1-35, 303-353 (1992).

<sup>85</sup> TREASURY REPORT, *supra* note 1, at XIX-1.

<sup>86</sup> 12 C.F.R. § 208.3 (1992).

<sup>87</sup> EDWARD L. SYMMS, JR. & JAMES J. WHITE, *BANKING LAW* 64-69 (1991). Only one section of Glass-Steagall, 12 U.S.C. § 378, is applicable to state-chartered, nonmember banks; organizations engaged in securities transactions are criminally liable if, at the same time, they engage in the business of receiving deposits. *Id.* at 68.

<sup>88</sup> 12 C.F.R. § 303.1 (1992).

(3) State Banks, Members of the FRB (Member), Insured.

These banks are regulated and supervised by the state banking agency and the FRB, and supervised by the FDIC.<sup>89</sup> The FRB regulates and supervises bank holding companies, though it does not regulate or supervise their subsidiary banks.<sup>90</sup>

American banks, unlike their counterparts in Europe and Japan, are not allowed unlimited branching. The McFadden Act of 1927 and subsequent amendments prohibit national banks from establishing branches outside of the state where the bank is headquartered.<sup>91</sup> The McFadden Act also limits intrastate branching by national banks to that which is permitted of state banks.<sup>92</sup> National banks can only establish branches in a particular state if state banks are so permitted according to state law.<sup>93</sup>

## 2. The Major Banking Acts

### a. Federal Reserve Act of 1913

The Federal Reserve System was established in 1913 by the Federal Reserve Act.<sup>94</sup> The main reason behind the establishment of this system was to stop banking panics attributable to the inability of banks to convert demand deposits into cash.<sup>95</sup> The Act provides, *inter alia*, that (1) every national bank shall have to be a member of the Federal Reserve System;<sup>96</sup> (2) member banks shall maintain a specified amount of reserves against their demand and time deposits;<sup>97</sup> and (3) members can get loans from the Fed by discounting commercial paper that could be used to ease liquidity crunches.<sup>98</sup>

### b. Banking Act of 1933

In the midst of all the bank failures of the Great Depression, the Roosevelt administration and Congress responded by passing the Glass-Steagall Act and the Banking Act of 1933.<sup>99</sup> These acts of legislation were generally successful in restoring the public confidence in the U.S. banking system. The Glass-Steagall Act legally separates invest-

<sup>89</sup> 12 C.F.R. § 208.3 (1992).

<sup>90</sup> TREASURY REPORT, *supra* note 1, at XIX-2.

<sup>91</sup> See 12 U.S.C. § 36 (1988). There is speculation that Congress will be considering interstate branching legislation in the near future, despite failed attempts in 1991 and 1992. Anne C. Bryan et al., *Bankers Await Clinton Regulatory Picks, Action Might Come on Community Development Bank*, 60 Banking Rep. (BNA) No. 3, at 67 (Jan. 18, 1993).

<sup>92</sup> 12 U.S.C. § 36(c) (1988).

<sup>93</sup> *Id.*

<sup>94</sup> Federal Reserve Act of 1913, Pub. L. No. 91-190, § 38, 38 Stat. 251 (1913) (current version at 12 U.S.C. §§ 221-226 (1988)).

<sup>95</sup> TREASURY REPORT, *supra* note 1, at XVIII-3.

<sup>96</sup> 12 U.S.C. § 222 (1988).

<sup>97</sup> 12 U.S.C. §§ 461(b)(2)(A),(B) (1988).

<sup>98</sup> 12 U.S.C. § 461(b)(7) (1988).

<sup>99</sup> Banking Act of 1933, Pub. L. No. 91-90, § 89, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C.).

ment banking and commercial banking.<sup>100</sup> Major provisions of the Banking Act of 1933 include the prohibition of payment of interest on demand deposits<sup>101</sup> and the creation of deposit insurance and the Federal Deposit Insurance Corporation.<sup>102</sup>

*c. Bank Holding Company Act of 1956*

The Bank Holding Company Act of 1956 restricts the activities of a bank holding company to those closely related to banking.<sup>103</sup> The goals and effects of this legislation were to prevent bank holding companies from circumventing the Glass-Steagall Act through ownership of investment banking subsidiaries,<sup>104</sup> and to prohibit bank holding companies from avoiding interstate branching laws established by the McFadden Act.<sup>105</sup>

*3. Permissible Business Activities*

Since the passage of the Glass-Steagall Act in 1933, American banks have been permitted to engage only in traditional banking activities, i.e., making loans and taking deposits.<sup>106</sup> American banks are expressly prohibited from engaging in investment banking activities, such as underwriting corporate securities<sup>107</sup> or dealing in securities.<sup>108</sup> Moreover, American banks cannot have officers, directors, or employees who are affiliated with investment banks.<sup>109</sup>

However, in recent years, banks have found ways around the Glass-Steagall Act to engage in activities that seem to have investment banking characteristics. The most significant of these activities is asset securitization, which is the pooling together of many of a bank's loan assets and then selling off interests in these pools to investors. The majority of the pooled loans are mortgage loans, but the other popular pools include motor vehicle installment loans and credit card receivables.<sup>110</sup> In addition, banks have been able to circumvent the laws to enter into the insurance field in a limited manner.<sup>111</sup>

<sup>100</sup> See *supra* notes 69-80 and accompanying text.

<sup>101</sup> 12 U.S.C. § 371a (1988).

<sup>102</sup> 12 U.S.C. § 1811 (1988).

<sup>103</sup> 12 U.S.C. § 1843(a) (1988).

<sup>104</sup> 12 U.S.C. § 1843(b) (1988).

<sup>105</sup> 12 U.S.C. § 36 (1988).

<sup>106</sup> Traditional or commercial banking is in reality much more complicated than making loans and taking deposits. It also includes many activities which are arguably investment banking and insurance activities.

<sup>107</sup> 12 U.S.C. § 24 (1988).

<sup>108</sup> 12 U.S.C. § 378 (1988).

<sup>109</sup> 12 U.S.C. § 78 (1988).

<sup>110</sup> *Securitization of Bank Assets: An Outline of Current Legal and Regulatory Issues*, PRACTICING LAW INSTITUTE, ORDER NO. A4-4251, 1989.

<sup>111</sup> Bank holding companies are allowed to provide: (1) credit life insurance; (2) insurance activities in cities that have populations of 5,000 or less; and (3) any insurance activity (except life, health, or annuities) if the bank holding company has total assets of \$50 million

#### 4. Disclosure Requirements

American banks are subject to extensive accounting and disclosure requirements. Banks must periodically prepare and submit call reports which contain extensive information on important financial measures, such as capital adequacy, asset quality, management quality, earnings, and liquidity. Regulators use these call reports to determine a bank's rating. This rating indicates a bank's relative financial health and determines how much regulatory attention the bank warrants.<sup>112</sup>

Regulatory agencies conduct scheduled,<sup>113</sup> on-site examinations of banks. The policies regarding examinations of institutions vary according to which regulator is the primary regulatory authority. The OCC maintains resident examiner teams in each national bank that is the lead bank of a multinational banking company. Also, it assigns each regional bank an examiner whose primary responsibility is to supervise that bank. Additional examiners are assigned to multinational and regional banks as needed to conduct specialized examinations and asset quality reviews.<sup>114</sup> The FDIC, on the other hand, assigns an examiner to each bank and a team of examiners visits each bank on a periodic basis, depending on the size and condition of the institution.<sup>115</sup> Finally, the Federal Reserve conducts on-site, full-scope examinations of large, state member-banks on an annual basis.<sup>116</sup>

Federally insured financial institutions are not uniformly required to be audited by a certified public accountant.<sup>117</sup> Requirements vary by regulatory agency. The OCC requires audits of newly chartered national banks.<sup>118</sup> The FDIC requires audits of institutions for the first three years after they receive federal deposit insurance<sup>119</sup> and the Federal Reserve System requires audits of bank holding companies with \$150 million or more in total assets.<sup>120</sup> The Securities and Exchange

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or less. 12 U.S.C. § 1843(c)(8) (1988). National banks are allowed to sell insurance in towns with populations of 5,000 or less. 12 U.S.C. § 92 (1988). The OCC has also ruled that national banks can provide title insurance and annuities. OCC Interpretive Letter No. 377 (Mar. 1987); OCC Interpretive Letter No. 499 (Feb. 1990). The OCC has the power to decide in which activities a subsidiary of a national bank may engage. It has been very liberal in allowing various insurance products which it determines to be "incidental" to the business of banking. *Id.*

<sup>112</sup> ROBERT DALE, *BANK SUPERVISION AROUND THE WORLD* 66 (1966); see also Connie M. Friesen, *The Regulation and Supervision of International Lending: Part I*, 19 INT'L LAW. 1059, 1073 (1985).

<sup>113</sup> All regulatory agencies conduct bank examinations at least once per year.

<sup>114</sup> TREASURY REPORT, *supra* note 1, at IX-9.

<sup>115</sup> *Id.*

<sup>116</sup> *Id.* at IX-10.

<sup>117</sup> *Id.* at XII-3. In practice, almost all of the larger institutions receive external audits by CPAs. As of March 31, 1990, approximately two-thirds of all federally insured banks with 95% of the industry's assets received external audits from CPAs. The audit rate of banks with over \$1 billion in assets was 99.9%. *Id.* at XII-4.

<sup>118</sup> *Id.* at XII-3.

<sup>119</sup> *Id.*

<sup>120</sup> *Id.* at XII-4.

Commission, on the other hand, requires external audits of all publicly held banking companies.<sup>121</sup>

### 5. *Loans to Single Borrowers*

National banks are limited in the amount of loans or other extensions of credit that can be extended to any single borrower to fifteen percent of total unimpaired capital and surplus of the bank.<sup>122</sup>

### 6. *Capital Adequacy*

Bank regulators require that banks maintain a system of risk-based capital requirements. Currently, the minimum risk-based capital ratio is 7.25%.<sup>123</sup>

There are two types of qualifying capital in computing this ratio: Tier 1, or core capital, and Tier 2, or supplementary capital. Tier 1 capital must represent at least fifteen percent of a bank's total capital. It consists of common stockholders' equity, certain types of perpetual preferred stock, and the minority interest in the equity accounts of consolidated subsidiaries, less goodwill. It is really the tangible equity that is available to absorb unexpected losses.<sup>124</sup> Tier 2 capital consists of a limited amount of loan loss reserves, certain types of perpetual preferred stock not included in Tier 1 capital, intermediate-term preferred stock, and term subordinated debt. Tier 2 capital is limited to the amount of a bank's Tier 1 capital.<sup>125</sup>

Risk-weighted assets are assets that are placed in one of four risk categories. Each category is given a risk weight of either zero, twenty, fifty, or one hundred percent according to the credit risk of the asset. The risk-weighted assets are multiplied by their category's risk weight and summed to derive the total risk-weighted asset amount. This figure is the denominator in the risk-based capital ratio.<sup>126</sup>

In addition to the minimum risk-based capital requirements, the federal bank regulatory agencies require banks' Tier 1 capital to be at least three percent of adjusted total assets. This is a distinct requirement from the risk-adjusted capital requirement. Any bank having a ratio at or near the three percent minimum must have well-diversified risk (including no undue interest rate risk exposure), excellent asset quality, high liquidity, good earnings, and a strong organization with the highest possible supervisory rating. If a bank does not have the highest supervisory rating, it is expected to have Tier 1 capital/total adjusted assets ratio of at least four percent.<sup>127</sup>

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<sup>121</sup> 15 U.S.C. § 80a-29(e) (1988).

<sup>122</sup> 12 U.S.C. § 84(a)(1) (1988).

<sup>123</sup> *Final Rule—Amendment to Regulations H and Y*, 6 FED. RES. BULL. 84 (1990).

<sup>124</sup> TREASURY REPORT, *supra* note 1, at II-6

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

These risk-based capital guidelines were endorsed in the Basle Accord by the central bank governors of the G-10 countries in July 1988.<sup>128</sup> These guidelines were fully phased in by December 31, 1992.<sup>129</sup> The Accord requires that all countries party to the agreement have regulations requiring banks to have risk-based capital equal to at least eight percent of risk-based assets.<sup>130</sup>

### 7. *Liquidity Control*

There are no standard liquidity ratios that banks must satisfy. However, regulators do generally evaluate the individual banks' liquidity position with respect to deposit volatility, ability to convert assets into cash, reliance on interest-sensitive funds, and access to money markets.<sup>131</sup>

### 8. *Liquidity Support*

The Federal Reserve System can provide liquidity support to any bank that maintains reserves with the appropriate Federal Reserve Bank. These banks can borrow funds by discounting eligible paper or by securing the borrowings with satisfactory collateral.<sup>132</sup>

### 9. *Deposit Insurance*

The Federal Deposit Insurance Corporation provides deposit insurance of up to \$100,000 per account in the event of a bank failure.<sup>133</sup> The FDIC was established in 1933 in response to the Great Depression.<sup>134</sup> The scope of deposit insurance has increased significantly since 1933. The dollar amount covered by deposit insurance in 1933 was \$2,500, compared to the current amount of \$100,000.<sup>135</sup> The FDIC provides deposit insurance to all national banks, Federal Reserve member banks, and to state chartered, non-Federal Reserve member banks that qualify for coverage.<sup>136</sup> All insured banks pay a flat rate

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<sup>128</sup> *Bank Capital Standards*, *supra* note 3. G-10 countries are: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. The Basle Accord has also been adopted by the European Community and was implemented on December 31, 1992.

<sup>129</sup> See *Fed Cuts Loan Risk Weights in Half for Some Residential Construction Loans*, 60 *Banking Rep.* (BNA) No. 1, at 4 (Jan. 4, 1993). The Fed has been considering revision proposals for the standards set out in the Basle Accord. *Fed Releases Consultive Papers on Banking Issues from Basle Committee*, 60 *Banking Rep.* (BNA) No. 19, at 682 (May 10, 1993).

<sup>130</sup> TREASURY REPORT, *supra* note 1, at II-5, 6, 7. See also, *Basle Accord, U.S. Capital Standards Compared in Joint Treasury-Fed Report*, 58 *Banking Rep.* (BNA) No. 26, at 1151 (June 29, 1992).

<sup>131</sup> Marilyn B. Cane & David A. Barclay, *Competitive Inequality: American Banking in the International Arena*, 13 *B.C. INT'L. & COMP. L. REV.* 273, 281 (1990).

<sup>132</sup> 12 U.S.C. §§ 461(b)(2)-(7) (1988).

<sup>133</sup> 12 U.S.C. § 1821(a)(3) (1988).

<sup>134</sup> See *supra* notes 79-80 and accompanying text.

<sup>135</sup> TREASURY REPORT, *supra* note 1, at III-1.

<sup>136</sup> 12 U.S.C. § 1814(b) (1988).



premium for deposit insurance, computed at a rate of 0.195% of total domestic deposits.<sup>137</sup>

## B. Japan

### 1. In General

The Japanese banking system, like the British banking system, is based on tradition and custom rather than strict rules.<sup>138</sup> This regulatory style is called *gyosei-shido* or administrative guidance.<sup>139</sup> There is much cooperation between government and industry. Regulators often tailor regulations and policies to individual banks rather than applying strict rules to all banks. The banks in turn voluntarily cooperate with the directives given to them.<sup>140</sup>

The four types of banks in Japan are the commercial city banks, commercial regional banks, long term credit banks, and trust banks.<sup>141</sup> The city banks are based in thirteen large cities and have many branches nationwide.<sup>142</sup> They also play a large role in international lending.<sup>143</sup> There are sixty-three commercial regional banks modeled on city banks but on a smaller scale.<sup>144</sup> The three long-term credit banks provide long term funds.<sup>145</sup> They also play a significant role in the international banking arena.<sup>146</sup> The seven trust banks provide little in the way of banking services; they deal largely in trust activities.<sup>147</sup>

The city banks usually have a close relationship with major industrial companies in Japan. This relationship is called *keiretsu*, which is an informal affiliation between commercial banks and their industrial customers.<sup>148</sup> In these *keiretsu*, officers of the banks are on the board of directors of the client industrial company, and the bank owns significant blocks of the industrial company's stock.<sup>149</sup>

### 2. The Banking Law of 1927

The Japanese banking system is based on the Banking Law of 1927

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<sup>137</sup> TREASURY REPORT, *supra* note 1, at VIII-21.

<sup>138</sup> Friesen, *supra* note 112, at 1108.

<sup>139</sup> Cane & Barclay, *supra* note 131, at 289.

<sup>140</sup> *Id.*

<sup>141</sup> Friesen, *supra* note 112, at 1110.

<sup>142</sup> *Id.*

<sup>143</sup> *Id.*

<sup>144</sup> Cane & Barclay, *supra* note 131, at 290.

<sup>145</sup> *Id.*

<sup>146</sup> Friesen, *supra* note 112, at 1110.

<sup>147</sup> Cane & Barclay, *supra* note 131, at 290.

<sup>148</sup> Friesen, *supra* note 112, at 1110.

<sup>149</sup> Cane & Barclay, *supra* note 131, at 290. For recent limitations on relationships between parent companies and subsidiaries in the financial arena, see *Japanese Agency Unveils Rules to Achieve Transparency in Bank/Broker Relationships*, 60 Banking Rep. (BNA) No. 15, at 519 (Apr. 12, 1993) [hereinafter *Japanese Rules in Bank/Broker Relationship*].

(Banking Law), as amended in 1981.<sup>150</sup> It provides for two regulatory authorities, the Bank of Japan (BOJ),<sup>151</sup> and the Ministry of Finance (MOF).<sup>152</sup> Of the two, the MOF is relatively more important.<sup>153</sup> The BOJ is primarily responsible for developing monetary policy. It does this by using its influence on banks that borrow from it through BOJ's discount window.<sup>154</sup> The MOF, on the other hand, has been said to have such broad powers that they approximate "those of the Treasury, Internal Revenue Service, Securities and Exchange Commission, state banking commissions, and policy-making responsibilities of the Federal Reserve Board."<sup>155</sup> Using these broad powers, the MOF exercises "administrative guidance" to achieve its objectives.<sup>156</sup>

### 3. *Permissible Business Activities*

The Japanese banking system prohibits banks from underwriting most securities in a manner similar to Glass-Steagall.<sup>157</sup> The one exception is that banks are permitted to underwrite and offer government bonds and government guaranteed debentures to subscribers.<sup>158</sup> Banks are permitted to engage in businesses that are incidental to the banking business. These businesses include real estate development, leasing, bank equipment maintenance, and owning corporate stock of companies that are debtors.<sup>159</sup>

### 4. *Disclosure Requirements*

Japanese Banking Law requires that banks submit interim and final business reports to the MOF.<sup>160</sup> Also, banks must make public financial statements with explanatory notes within three months of the end of the fiscal year.<sup>161</sup>

The banks have stringent auditing requirements. A bank must appoint a minimum of two auditors and one certified public account-

<sup>150</sup> Friesen, *supra* note 112, at 1108 (citing Japanese Banking Law of 1927 (Law No. 21), revised in 1981 (Law No. 59), effective Apr. 1, 1982 [hereinafter Japanese Banking Law]).

<sup>151</sup> Cane & Barclay, *supra* note 131, at 289 (citing Bank of Japan Law 1942 (Law No. 67), as amended Sept. 1, 1971 [hereinafter Bank of Japan Law]).

<sup>152</sup> *Id.* at 12.

<sup>153</sup> Friesen, *supra* note 112, at 1109.

<sup>154</sup> Friesen, *supra* note 112, at 1108-09 (citing Japanese Banking Law, art. 13, para. 2).

<sup>155</sup> Stephen Bronte, *Inside the Tokyo Ministry of Finance: The Most Powerful Men in Japan*, EUROMONEY, June 1979, at 24.

<sup>156</sup> FEDERAL RESERVE BOARD REPORT TO CONGRESS ON BANK SUPERVISION IN THE GROUP OF TEN NATIONS AND SWITZERLAND 57 (1984) [hereinafter GROUP OF TEN NATIONS AND SWITZERLAND].

<sup>157</sup> Cane & Barclay, *supra* note 131, at 298. These restrictions on securities activities were somewhat eased by the Japanese Fair Trade Commission on April 1, 1993. See *Japanese Rules in Bank/Broker Relationships*, *supra* note 149.

<sup>158</sup> Friesen, *supra* note 112, at 1109 (citing Japanese Banking Law, art. 10(2), 11).

<sup>159</sup> GROUP OF TEN NATIONS AND SWITZERLAND, *supra* note 156, at 59.

<sup>160</sup> Friesen, *supra* note 112, at 1109 (citing Japanese Banking Law, art. 19(1)).

<sup>161</sup> *Id.* arts. 20, 21.

ant.<sup>162</sup> The auditors are responsible for bank management, and the CPA is responsible to the bank's shareholders.<sup>163</sup>

Banks are also subject to stringent examinations by regulatory agencies. The MOF conducts surprise on-site micro inspections at least every three years to ensure individual bank safety.<sup>164</sup> The BOJ conducts scheduled macro bank examinations at the same intervals to check for industry stability.<sup>165</sup> Also, the MOF International Finance Bureau performs on-site inspections to check the banks' foreign exchange operations.<sup>166</sup>

### 5. Loans to Single Borrowers

Before 1982, there were no statutory limits on the amount that banks could lend to a single borrower. The MOF used administrative guidance to effect limits on exposure to single borrowers.<sup>167</sup> However, an amendment to the Banking Law in 1981, coupled with an MOF administrative order, now mandates the limits on loans to single borrowers to twenty percent of capital for city banks and regional banks, and thirty percent of capital for long term credit banks.<sup>168</sup>

### 6. Capital Adequacy

There are no statutory capital adequacy requirements.<sup>169</sup> However, the MOF does exercise great influence in persuading banks to meet certain capital adequacy ratios. For example, the MOF mandates that a bank's capital should equal at least ten percent of total deposits;<sup>170</sup> total loans should be less than eighty percent of deposits;<sup>171</sup> and dividends paid out should be less than fifteen percent of equity capital and forty percent of after-tax net income.<sup>172</sup>

### 7. Liquidity Control

The MOF is less concerned about liquidity than other indicators of financial health.<sup>173</sup> However, the MOF has spoken on the subject of a bank's liquidity. A bank's average of liquid assets must exceed thirty percent of its total deposits.<sup>174</sup> The MOF has set forth specific guide-

<sup>162</sup> GROUP OF TEN NATIONS AND SWITZERLAND, *supra* note 156, at 62.

<sup>163</sup> *Id.*

<sup>164</sup> *Id.* at 61-62.

<sup>165</sup> *Id.* at 61.

<sup>166</sup> Cane & Barclay, *supra* note 131, at 295-296.

<sup>167</sup> Friesen, *supra* note 112, at 1112.

<sup>168</sup> GROUP OF TEN NATIONS AND SWITZERLAND, *supra* note 156, at 6.

<sup>169</sup> Friesen, *supra* note 112, at 1113.

<sup>170</sup> GROUP OF TEN NATIONS AND SWITZERLAND, *supra* note 156, at 59. *See also supra* note 128 and accompanying text.

<sup>171</sup> *Id.*

<sup>172</sup> *Id.* at 60.

<sup>173</sup> Cane & Barclay, *supra* note 131, at 292.

<sup>174</sup> GROUP OF TEN NATIONS AND SWITZERLAND, *supra* note 156, at 57.

lines in regard to Japanese banks' Eurocurrency operations. Banks must fund term Eurocurrency loans exceeding one year with forty-five percent Eurocurrency debt maturing in over one year.<sup>175</sup> Also, banks must fund Eurocurrency loans with maturities of more than three years with more than fifteen percent Eurocurrency debt having maturities of at least three years.<sup>176</sup>

### 8. *Liquidity Support*

Banks can borrow from the BOJ on a short-term basis at the "Bank Rate."<sup>177</sup> The Bank Rate is determined by the amount of the bank's yen assets.<sup>178</sup> In addition, banks can borrow from the BOJ on a longer term basis if they secure the loan with adequate collateral.<sup>179</sup>

### 9. *Deposit Insurance*

Deposit insurance has existed in Japan since 1971 when the Deposit Insurance Corporation (DIC) was founded by the government and the BOJ.<sup>180</sup> Banks finance the DIC by paying premiums of 0.008% of their total insured deposits.<sup>181</sup> The DIC insures against losses up to three million yen per account.<sup>182</sup>

## C. *United Kingdom*

### 1. *In General*

Bank supervision in the United Kingdom can best be described as cooperation between government and industry.<sup>183</sup> There is much informal communication and direction between the banks and the Bank of England (BOE), the central bank. Her Majesty's Treasury assumes the role of supervisory agency over the industry, but it exercises this control in a relatively restrained manner.<sup>184</sup> There is a general system of guidelines and reporting requirements but relatively few hard and fast rules that the banks must follow.<sup>185</sup> The system is codified, but the supervisory aspect is still effected largely by moral suasion.<sup>186</sup> The policy behind this loose system is the British belief that whenever possible, government should accommodate rather than restrict different kinds

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<sup>175</sup> Friesen, *supra* note 112, at 1113.

<sup>176</sup> *Id.*

<sup>177</sup> Cane & Barclay, *supra* note 131, at 296.

<sup>178</sup> *Id.*

<sup>179</sup> *Id.*

<sup>180</sup> GROUP OF TEN NATIONS AND SWITZERLAND, *supra* note 156, at 63.

<sup>181</sup> *Id.* at 63-64.

<sup>182</sup> *Id.* at 63.

<sup>183</sup> Friesen, *supra* note 112, at 1085.

<sup>184</sup> *Id.*

<sup>185</sup> *Id.*

<sup>186</sup> *Id.* at 1086. This method of oversight has been a source of criticism of the U.K. banking system in recent years. See *BCCI Liquidator Sues Bank of England for Failing to "Properly" Regulate BCCI*, 60 Banking Rep. (BNA) No. 22, at 812 (May 31, 1993).

of banking business.<sup>187</sup>

## 2. *The United Kingdom Banking Acts of 1979 and 1987*

Prior to the passage of the U.K. Banking Act of 1979,<sup>188</sup> the British banking system was supervised largely by custom and tradition.<sup>189</sup> The Banking Act of 1979 provided the first statutory basis for supervision in the United Kingdom.<sup>190</sup>

The 1979 Act gives the Bank of England responsibility for supervising recognized banks and licensed deposit takers.<sup>191</sup> The Act treats these two types of entities differently.<sup>192</sup> The main forms of supervision practiced by the BOE are requesting information such as financial statements from banks, making recommendations, and issuing directives to the banks to effect compliance with the recommendations.<sup>193</sup>

The 1987 Act<sup>194</sup> superseded the 1979 Act. The primary difference between the two, however, is that the 1987 Act eliminates the distinction between banks and deposit takers. The term which now encompasses is "authorized institution."<sup>195</sup>

## 3. *Permissible Business Activities*

No formal restrictions are placed on business activities in which banks can engage.<sup>196</sup> However, the Bank of England will generally only permit banks to invest in non-banking activities if the activities are financial in nature.<sup>197</sup>

## 4. *Disclosure Requirements*

Banks must furnish monthly reports to the Bank of England.<sup>198</sup> The BOE uses these reports as a basis for discussion with senior officials in the banks.<sup>199</sup> Banks are also required to submit annual financial statements to the Registrar of Companies in accordance with the Companies Act of 1948.<sup>200</sup> The BOE does not conduct examinations of the banks, however.<sup>201</sup>

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<sup>187</sup> *Id.* at 1085-1086.

<sup>188</sup> J. MORISON ET AL., *THE BANKING ACT OF 1979 (1979)* (citing *The U.K. Banking Act of 1979*).

<sup>189</sup> Friesen, *supra* note 112, at 1087.

<sup>190</sup> *Id.*

<sup>191</sup> DALE, *supra* note 112, at 58.

<sup>192</sup> *Id.*

<sup>193</sup> Friesen, *supra* note 112, at 1088 (citing *Bank of England Act of 1946*).

<sup>194</sup> *The United Kingdom Banking Act of 1987*, reprinted in *Halsbury's Laws of England* (vol. 4, 1987 re-issue).

<sup>195</sup> *The United Kingdom Banking Act of 1987*, *supra* note 194, § 106(1).

<sup>196</sup> GROUP OF TEN NATIONS AND SWITZERLAND, *supra* note 156, at 94.

<sup>197</sup> DALE, *supra* note 112, at 128.

<sup>198</sup> GROUP OF TEN NATIONS AND SWITZERLAND, *supra* note 156, at 99.

<sup>199</sup> *Id.* at 98-99.

<sup>200</sup> *Id.* at 100.

<sup>201</sup> *Id.* at 98-99.

### 5. *Loans to Single Borrowers*

There are no statutory limits on the amount of loans that a bank may provide to a single borrower.<sup>202</sup> However, the BOE has recommended that the aggregate of such loans should not exceed ten percent of a bank's capital. If the ten percent guideline is exceeded, the BOE expects the bank to raise its capital base to maintain a stronger capital adequacy ratio.<sup>203</sup>

### 6. *Capital Adequacy*

The BOE does not prescribe a precise figure for capital adequacy of banks because it feels to do so would be too inflexible.<sup>204</sup> However, the BOE uses two ratios in order to determine the capital adequacy in light of the particular circumstances of the banks.<sup>205</sup> The "gearing ratio" relates the capital base to its current liabilities. The "risk-assets ratio" relates the banks' capital to its potential losses. The risk-assets ratio is the more traditional of the two.<sup>206</sup>

### 7. *Liquidity Control*

The BOE does not impose any specific rules with regard to a bank's liquidity.<sup>207</sup> It does, however, monitor liquidity so as to ensure against funding risk, the risk that a bank will not have sufficient cash on hand to satisfy all obligations falling due on a certain day; and interest rate mismatch risk, the risk that a bank will post losses due to adverse fluctuations in interest rates.<sup>208</sup> The BOE analyzes banks' liquidity by placing banks' assets and liabilities into a maturity ladder. The maturity ladder measures accumulated net mismatch positions.<sup>209</sup>

### 8. *Liquidity Support*

The BOE regularly provides short term liquidity to banks. It also provides long-term support to large, financially stressed banks whose failure could undermine the public confidence in the banking system.<sup>210</sup>

### 9. *Deposit Insurance*

The Deposit Protection Board (Board), created in 1979, administers the Deposit Protection Fund (Fund), which insures bank depos-

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<sup>202</sup> Friesen, *supra* note 112, at 1091.

<sup>203</sup> GROUP OF TEN NATIONS AND SWITZERLAND, *supra* note 156, at 97.

<sup>204</sup> Friesen, *supra* note 112, at 1092. See *supra* note 128 and accompanying text.

<sup>205</sup> *Id.*

<sup>206</sup> DALE, *supra* note 112, at 59.

<sup>207</sup> Cane & Barclay, *supra* note 131, at 302.

<sup>208</sup> Friesen, *supra* note 112, at 1093.

<sup>209</sup> DALE, *supra* note 112, at 59-60.

<sup>210</sup> GROUP OF TEN NATIONS AND SWITZERLAND, *supra* note 156, at 100.

its.<sup>211</sup> The Board's scheme provides that seventy-five percent of a deposit up to 20,000 pounds per institution<sup>212</sup> is insured against loss in the case of a bank failure.<sup>213</sup> The Fund is financed by mandatory fees from banks.<sup>214</sup>

#### D. Germany

##### 1. In General

There are two general types of banks in Germany: full service banks and specialized banks.<sup>215</sup> The full service banks predominate.<sup>216</sup> Within the full service bank segment, there are three types of German banks: (1) private commercial banks—full service banks that engage not only in lending, deposit-taking, and payment transactions, but also in underwriting securities and securities trading; (2) cooperative banks—commercial and agricultural credit cooperatives; and (3) public sector banks—savings banks and their central institutions.<sup>217</sup> The specialized banks focus on specific areas of business.<sup>218</sup> Examples are mortgage banks and other real estate institutions, installment credit institutions, postal savings offices, and banks with other special functions.<sup>219</sup> This article will consider only the supervision of the commercial banks.

The German banking supervisory system is similar to that of the United States in that it is rule based, rather than less formally directed as in the United Kingdom or Japan.<sup>220</sup> Those rules are closely and carefully read and narrowly interpreted, which encourages the discovery of "loopholes."<sup>221</sup>

The German system is, however, similar to the Japanese and British banking systems in that there is much cooperation between government and industry. A study of the system stated that "the prevalent pattern of interaction between large German banks and their government on matters of mutual international concern has been one of quiet consensus, enhanced by official sensitivity to the banks' financial interests and the banks' responsiveness to government incentives and suasion."<sup>222</sup> The supervising agencies regularly consult with senior officials of banks when formulating and refining rules and regula-

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<sup>211</sup> J. MORISON ET AL., *supra* note 188 (citing U.K. Banking Act of 1979 at §§ 21-33).

<sup>212</sup> *Id.* (citing § 29 of the U.K. Banking Act of 1979).

<sup>213</sup> *Id.* (citing U.K. Banking Act of 1979, §§ 58(1), 60(1)).

<sup>214</sup> *Id.* (citing U.K. Banking Act of 1979, § 52(1)).

<sup>215</sup> JUERGEN STEIN, *BANKING SYSTEM IN GERMANY* 5 (1982).

<sup>216</sup> *Id.*

<sup>217</sup> *Id.*

<sup>218</sup> *Id.*

<sup>219</sup> *Id.*

<sup>220</sup> Friesen, *supra* note 112, at 1098.

<sup>221</sup> *Id.*

<sup>222</sup> ARTHUR SPINDLER, *THE POLITICS OF INTERNATIONAL CREDIT: PRIVATE FINANCE AND FOREIGN POLICY IN GERMANY AND JAPAN* 181 (1984).

tions.<sup>223</sup> Also, banks tend to work through the Federal Association of German Banks in proposing those rules.<sup>224</sup>

## 2. *The Banking Act of the Federal Republic of Germany*

The Banking Act of July 10, 1961<sup>225</sup> is the backdrop for bank supervision in Germany. It established the Federal Banking Supervisory Office (FBSO) as the main supervisory authority over banks.<sup>226</sup> The Bundesbank Act of 1957 established the Bundesbank.<sup>227</sup> Its role is to control monetary policy and to collect and evaluate commercial bank reports.<sup>228</sup> Once the Bundesbank has evaluated the reports, it forwards them to the FBSO so that it can take supervisory action on the banks if necessary.<sup>229</sup>

## 3. *Permissible Business Activities*

German banks engage in "universal banking", i.e., there are no limits on the types of businesses in which they can engage.<sup>230</sup> Banks can and do engage not only in deposit taking and lending, but also underwriting, selling securities, and participating in nonfinancial activities such as ownership of nonfinancial companies.<sup>231</sup>

## 4. *Disclosure Requirements*

Banks must submit annual financial statements to the FBSO and the Bundesbank.<sup>232</sup> They must submit preliminary financial statements within three months of the fiscal year-end and audited statements within five months of year-end.<sup>233</sup> These statements are made available to the public.<sup>234</sup> Banks are subject to on-site inspections by the FBSO or auditors appointed by the FBSO.<sup>235</sup>

## 5. *Loans to Single Borrowers*

The Banking Act specifies how much a bank can lend to any one customer in some detail.<sup>236</sup> The Act distinguishes between *Grosskredite*

<sup>223</sup> Friesen, *supra* note 112, at 1100.

<sup>224</sup> *Id.*

<sup>225</sup> GESETZ UEBER DAS KREDITWESEN (1961), translated in HANNES SCHNEIDER ET AL., THE GERMAN BANKING SYSTEM 65 (1978) [hereinafter SCHNEIDER].

<sup>226</sup> *Id.* at 69 (citing The German Banking Act of 1961 § 6(1)).

<sup>227</sup> Friesen, *supra* note 112, at 1098 (citing Gesetz Ueber die Deutsche Bundesbank, July 26, 1957, as amended May 23, 1975).

<sup>228</sup> *Id.*

<sup>229</sup> SCHNEIDER, *supra* note 225, at 69 (citing The German Banking Act of 1961 § 7(1)).

<sup>230</sup> GROUP OF TEN NATIONS AND SWITZERLAND, *supra* note 156, at 39.

<sup>231</sup> *Id.* at 39-40.

<sup>232</sup> SCHNEIDER, *supra* note 225, at 109 (citing The German Banking Act of 1961 § 26(1)).

<sup>233</sup> *Id.* at 109, 112 (citing The German Banking Act of 1961 § 26(1), 27(1)).

<sup>234</sup> Friesen, *supra* note 112, at 1100.

<sup>235</sup> SCHNEIDER, *supra* note 225, at 135 (citing The German Banking Act of 1961 § 44).

<sup>236</sup> *Id.* at 77-97 (citing The German Banking Act of 1961 §§ 13-20).



(large loans) and *Organkredite* (loans to insiders).<sup>237</sup>

*Grosskredite* are loans to a single borrower that exceed fifteen percent of the bank's equity capital.<sup>238</sup> They must be reported to the Bundesbank.<sup>239</sup> However, no *Grosskredite* is allowed to exceed fifty percent of a bank's capital,<sup>240</sup> and the total of all a bank's *Grosskredite* must not exceed eight times a bank's equity capital.<sup>241</sup>

*Organkredite* are loans made to any company related to the bank, any employee of a related company, or an employee of the bank.<sup>242</sup> In order to make an *Organkredite*, the bank's board of directors and managers must approve the loan by a unanimous vote.<sup>243</sup> Also the bank must report to the FBSO and the Bundesbank any *Organkredite* exceeding DM250,000.<sup>244</sup>

## 6. Capital Adequacy

The Banking Act does not specify any criteria for capital adequacy for banks. A bank must maintain "adequate equity capital."<sup>245</sup> However, the FBSO has stated in Principle I<sup>246</sup> of its regulations that loans and equity participation, exclusive of loan loss provisions, may not exceed eighteen times a bank's capital.<sup>247</sup> According to FBSO regulations, in calculating the capital adequacy equation, the loans and equity participation are risk weighted with the following factors:

ASSET	RISK-WEIGHTING
Fully Secured/Guaranteed Loans	50%
Loans to Foreign Banks	50%
Loans to Domestic Banks	20%
Public Sector Loans	0%
Various International Loans	100% <sup>248</sup>

## 7. Liquidity Control

There is no statutory criteria for determining a bank's liquidity, but the Banking Act mandates that banks must maintain sufficient liquidity at all times.<sup>249</sup> FBSO regulations in the form of Principles II

<sup>237</sup> *Id.*

<sup>238</sup> *Id.* at 77-78 (citing The German Banking Act of 1961 § 13(1)).

<sup>239</sup> *Id.*

<sup>240</sup> *Id.* at 81 (citing The German Banking Act of 1961 § 13(4)).

<sup>241</sup> *Id.* at 79, 80 (citing The German Banking Act of 1961 § 13(3)).

<sup>242</sup> *Id.* at 83 (citing The German Banking Act of 1961 § 15(1), (2)).

<sup>243</sup> *Id.* (citing The German Banking Act of 1961 § 15(1)).

<sup>244</sup> *Id.* at 89, 90 (citing The German Banking Act of 1961 § 16).

<sup>245</sup> *Id.* at 76 (citing The German Banking Act of 1961 § 10(1)). See *supra* note 128 and accompanying text.

<sup>246</sup> Grundsätze Ueber das Eigenkapital und die Liquidat der Kreditinstitute, Jan. 20, 1969, as amended Jan. 16, 1980 [hereinafter Principles Concerning Capital].

<sup>247</sup> GROUP OF TEN NATIONS AND SWITZERLAND, *supra* note 156, at 40.

<sup>248</sup> DALE, *supra* note 112, at 135.

<sup>249</sup> SCHNEIDER, *supra* note 225, at 77 (citing The German Banking Act of 1961 § 11).

and III<sup>250</sup> establish complex ratios for matching assets and liabilities based upon their respective maturities. Principle II provides that certain long-term and fixed assets must be matched by certain long-term liabilities.<sup>251</sup> Principle III provides standards for a proper relationship between medium-term assets and various short-term and medium-term liabilities.<sup>252</sup> If these standards are not followed, the FBSO may require corrective action.<sup>253</sup>

#### 8. *Liquidity Support*

Banks have two options for receiving liquidity support, the Bundesbank and the Liko Bank.<sup>254</sup> The Bundesbank is the primary source of liquidity for the banks.<sup>255</sup> It sets limits as to how much each bank can borrow from it for liquidity support.<sup>256</sup> Thereafter, banks must borrow from the Liko Bank.<sup>257</sup> The Liko Bank was formed in 1974 by the Bundesbank and the banking industry.<sup>258</sup> Its role is to assist solvent banks that are experiencing temporary liquidity difficulties.<sup>259</sup> The Liko Bank has not been used much to date. Also, it has a relatively small capital base, which allows it to aid smaller banks only.<sup>260</sup>

#### 9. *Deposit Insurance*

The Banking Act does not prescribe deposit insurance.<sup>261</sup> However, the Federal Association of German Banks created the Deposit Guarantee Fund (Fund), which protects deposits up to a limit of thirty percent of the bank's equity capital or the size of the Fund, whichever is smaller.<sup>262</sup> Banks finance the Fund by paying fees of 0.003% of insurable deposits.<sup>263</sup> Membership in the fund is voluntary.<sup>264</sup>

#### E. *European Community*

The European Community (EC) passed the Second Banking Directive on December 15, 1989.<sup>265</sup> It has been implemented and is the

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<sup>250</sup> Principles Concerning Capital, *supra* note 246.

<sup>251</sup> *Id.*

<sup>252</sup> *Id.*

<sup>253</sup> Friesen, *supra* note 112, at 1103.

<sup>254</sup> *Id.* at 1105.

<sup>255</sup> *Id.*

<sup>256</sup> GROUP OF TEN NATIONS AND SWITZERLAND, *supra* note 156, at 45.

<sup>257</sup> *Id.*

<sup>258</sup> *Id.*

<sup>259</sup> *Id.*

<sup>260</sup> *Id.*

<sup>261</sup> *Id.*

<sup>262</sup> *Id.*

<sup>263</sup> *Id.*

<sup>264</sup> *Id.*

<sup>265</sup> 1989 O.J. (L 386) 1. The Second Banking Directive continues the liberalization of EC banking begun under the First Banking Directive. *Banking and Securities*, EC Commenta-

law on banking in the European Community.<sup>266</sup> The general provisions of the Directive are set out below.

### 1. *Single License*

Under the single license system, banks need only obtain a charter in one member country of the EC in order to establish additional operations in any member state without having to go through further registration procedures.<sup>267</sup> However, the scope of activities that the bank provides in any member state is dictated by the laws of the country that granted the charter (home country), rather than the other member countries in which the bank may be operating.<sup>268</sup> Banks from EC states with more restrictive banking systems will be at a disadvantage when operating in states with more liberal banking laws because they will still have to operate under restrictive laws. The single license/home state law should create pressure on member states that have restrictive banking laws to liberalize them so that banks from those states can remain competitive, both in the restrictive home state and in the other states.<sup>269</sup>

### 2. *Relations with Countries Outside the EC*

The Second Banking Directive also has rules regarding non-EC banks establishing subsidiaries within the Community. Basically, the goal is to permit a non-member country to operate more banks within the EC if the non-member country allows EC banks more access to the non-member country's market.<sup>270</sup> Another goal is to allow EC banks to engage in the same activities in the non-member country as it does in the EC.<sup>271</sup> However, the mechanism used to achieve this end is more subtle. Article 9 of the Directive provides that if the EC Commission finds that a non-member country is denying EC banks "effective market access comparable to that granted by the Community," then the EC Commission can mandate that negotiations with the non-mem-

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ries (Coopers & Lybrand) sec. 1 (Sept. 23, 1993), available in LEXIS, Intlaw Library, Eurscp File.

<sup>266</sup> Michael Dynes, *Home Loans May Come From Abroad-European Single Market*, TIMES (London), Jan. 2, 1993 at 1.

<sup>267</sup> Second Council Directive of 15 December 1989 on the coordination of laws, regulations, and administrative provisions relating to the taking up and pursuit of the business of credit institutions, amending Directive 77/780/EEC, 1989 O.J. (L 386) 1, art. 6 (1) [hereinafter Second Banking Directive].

<sup>268</sup> OFFICE OF INTERNATIONAL BANKING AND PORTFOLIO INVESTMENT, U.S. DEP'T OF TREASURY, E.C. SINGLE MARKET: BANKING AND SECURITIES (Aug. 1, 1989); see also *Banking and Securities*, supra note 265, para. 14.

<sup>269</sup> *Oversight Hearings on European Community's 1992 Program: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation, and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 1st Sess. 75 (1989) (testimony of Manuel H. Johnson, Vice Chairman, Federal Reserve System). See also *EC Financial Market Regulation Analyzed at London Conference*, 58 Banking Rep. at (BNA) 970 (June 1, 1992).

<sup>270</sup> Second Banking Directive, supra note 267, at art. 9.

<sup>271</sup> *Id.* art. 9(3).

ber country be initiated to obtain "comparable competitive opportunities for Community credit institutions" in the non-member countries.<sup>272</sup> This provision should encourage non-member countries with restrictive banking laws to liberalize them so that they can compete in the lucrative EC market.

#### IV. What Should Be Done to Reform the U.S. Banking System?

##### A. Repeal Antiquated Legislation

##### 1. Glass-Steagall Act

Repeal of the Glass-Steagall Act would permit banks to enter, without restrictions, the securities industry and other financial industries such as insurance. It would also permit banks to enter non-financial industries as well.

The Glass-Steagall Act was passed in 1933 in response to a crisis. It has been determined that securities activities by banks were not the cause of the widespread bank failures which occurred during that time and that banks which had securities affiliates did not fail more often than banks without them.<sup>273</sup> However, banks of today are no longer the protected and steadily profitable businesses they were from the 1940s until the 1970s. The laws passed during the regulatory period designed to insulate banks from competition are now barriers which prevented them from adapting to changed market conditions. Banks "are losing market share to GE Capital, Merrill Lynch, and even your corner pawn shop."<sup>274</sup>

Allowing banks to enter other financial industries would give banks opportunities to earn incremental profits by applying their expertise in related financial activities without increasing their costs materially. It would also allow banks to attract more capital by merging with securities and other financial and non-financial firms. In short, this move would allow banks to regain the competitive edge they lost when banking became so heavily regulated.<sup>275</sup>

Also, the banks of Germany and the United Kingdom which are allowed to engage in businesses other than traditional "banking" business have shown that combining investment banking and other activities with commercial banking can be achieved successfully and without undue risk to the bank or its customers. The implications of the Second Banking Directive in the EC suggest that only the banking activities which are allowed in the United States will be allowed for American banks operating in the EC. Thus, even though securities

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<sup>272</sup> *Id.*

<sup>273</sup> See *supra* notes 74-77 and accompanying text.

<sup>274</sup> Former FDIC Chairman Seidman Sees Need to Overturn Some Banking Regulations, 61 Banking Rep. (BNA) No. 1, at 17 (July 5, 1993) (quoting former FDIC Chairman L. William Seidman).

<sup>275</sup> TREASURY REPORT, *supra* note 1, at 55.

activities by German banks will be permitted in the EC, American banks will not be allowed to participate in such activities in the EC even though the German banks can.<sup>276</sup> In addition, because the United States does not permit the EC banks to engage in securities activities, the EC could conceivably not allow the American banks any access at all to the EC.<sup>277</sup>

Therefore, besides the fact that allowing American banks to engage in investment banking activities would make them more competitive in the global arena, it seems that if we want to compete at all in the global arena we must expand the number of activities in which banks can engage.

## 2. *The McFadden Act*

Repeal of this Act would allow banks to establish branches nationwide without having to set up separate subsidiary banks within a state. Geographic expansion of large banks is a clear historical trend. Currently thirty-three states allow ownership of banks by out-of-state holding companies; there is no branching across state lines, however.<sup>278</sup>

By allowing nationwide branch banking, banks that expand geographically could realize huge cost savings. Instead of having to set up entire subsidiary banks in other states and incurring the sizable costs associated with such a move, banks could set up branch offices with numerous types of cost savings. Fewer employees would be needed to staff the out-of-state branches as compared to entire subsidiary banks.<sup>279</sup> Reporting requirements and computer systems could be consolidated at the headquarters of the main bank rather than maintaining separate reporting requirements at each out-of-state subsidiary bank.<sup>280</sup> In addition, disclosure requirements to bank regulators could be simplified so that regulators would only have one bank to examine (albeit with many branches) compared to several (or more) subsidiary banks in different states all examined independently.<sup>281</sup> The board of directors at the main bank could be consolidated to alleviate the current need to separate boards at each out-of-state subsidiary bank.<sup>282</sup> Finally, auditing functions,<sup>283</sup> and capital requirements<sup>284</sup> also could be simplified as applied to one bank rather than numerous subsidiary banks.

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<sup>276</sup> See *supra* notes 267-69 and accompanying text.

<sup>277</sup> See *supra* notes 270-72 and accompanying text.

<sup>278</sup> TREASURY REPORT, *supra* note 1, at 50. "New House Banking financial institutions subcommittee chairman Neal will continue to support passage of interstate banking and branching legislation. . . ." Bryan, *supra* note 91, at 71.

<sup>279</sup> TREASURY REPORT, *supra* note 1, at 50.

<sup>280</sup> *Id.*

<sup>281</sup> *Id.*

<sup>282</sup> *Id.*

<sup>283</sup> *Id.*

<sup>284</sup> *Id.*

The banks would not be the only parties to benefit from nationwide branching; consumers will also benefit. Under a more competitive system, banks could be expected to pass their savings on to their customers in the form of lower fees on checking accounts and other services. Also, business and personal travelers will have better access to their banking services when they are out of state.<sup>285</sup> For example, customers of Chemical Bank in New York, cannot obtain Chemical Bank services in Texas from Texas Commerce Bank, even though Texas Commerce Bank is a wholly-owned subsidiary of Chemical. But if nationwide branch banking were in effect, a customer of Chemical in New York could get the same services in Texas as in New York.

Finally, the American banking system is the only one of the four leading banking systems in the world (Japan, Germany and the United Kingdom are the others) that does not allow nationwide branch banking. Nationwide branching works to the advantage of those countries, and there are no unique economic circumstances in the United States that would prevent branch banking from operating efficiently here as well. Also, with the cost savings achieved by branch banking, U.S. banks could be more competitive in the global arena against the other banking powers.

#### *B. Encourage Cooperation Between Industry and Government*

Encouraging cooperation between industry and government is a rather nebulous idea, yet it is a key factor in the success of the Japanese, German, and British banking systems. In the United States, however, the relationship is virtually adversarial. Bank officials tend to think that regulators do not know much about lending and can only analyze loan portfolios superficially, i.e., by limiting their review to financial statements and other written documents. Bankers think that regulators cannot understand that a loan may still be good even though the borrower posted a loss the year before. They also think that bank regulators want to classify as bad as many loans as possible. Therefore when regulators examine banks, bank officials become very guarded and defensive about their portfolio and tend to put problems in the best light possible instead of talking openly and honestly. This leads to distrust between the parties. We believe that the adversarial relationship it fosters is an affront to many conscientious examiners and contributes to overzealous behavior by some. Both parties are, in varying degrees, responsible for this lack of trust, and in the long term it is inefficient, debilitating, and counterproductive.

Unlike our major competitors, in the United States there is no government ministry or cabinet official making general policy about the direction of banking, either on a macro or micro basis. For in-

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<sup>285</sup> *Id.* at 51.

stance, if the Treasury had the power to persuade banks to curb real estate or leveraged buyout lending from the beginning, losses in those areas may have been curtailed. There is a much closer and better working relationship between government and industry in the United Kingdom, Germany, and Japan. In Japan, when the Ministry of Finance tells banks to curb lending in a certain market, such as American real estate, the banks listen and comply. Cooperation of this nature is an important factor contributing to the success of our global competitors.

### *C. Revise the Deposit Insurance Scheme*

Obviously, deposit insurance is overly broad and in need of reform. Currently, all bank accounts in banks which are members of the Federal Deposit Insurance Corporation (FDIC) are insured up to \$100,000 in the event of bank failure. This has caused tremendous losses to the FDIC when banks failed and the FDIC liquidated their assets. Insuring every account has removed the incentive for customers to bank with strong institutions because customers know that, even if the bank fails, their accounts will still be covered up to \$100,000.

There are a number of alternatives which have been proposed for reforming the deposit insurance system. In our view, the deposit insurance system should charge higher premiums for higher risks, i.e., banks which are greater risks should pay higher premiums. The risk factor of a particular bank could be calculated by a formula that would take into account the bank's capital adequacy, its liquidity, and the riskiness of its assets. In addition, deposit insurance should not reimburse customers for the total amount of deposits in the account, but rather only for a specified percentage. This will force customers to use due diligence in order to determine whether the bank is financially healthy.

A good way to achieve the above ideals would be to combine FDIC coverage with the private insurance industry to insure bank deposits. The reason for involving private insurance companies is that the private sector could better assess and price bank risk than a government agency.<sup>286</sup> Also, the private companies would take a small portion of the insurance risk, say twenty percent, with the FDIC taking the rest. Ownership by non-government entities would promote efficiency, better pricing for insurance premiums, and earlier detection of problem assets at banks.<sup>287</sup>

### *D. Eliminate the Dual Banking System*

The Dual Banking System is based on the concept of federalism

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<sup>286</sup> *Id.* at 34.

<sup>287</sup> See *supra* notes 270-72 and accompanying text.

that protects the right of states to regulate banking activities within their borders. Also the choice of being regulated by either state or federal law is supposed to promote competition between the state banking system and the national banking system. However, as we have already seen, the two systems do not compete against each other and society is not extracting the benefits of such competition. Therefore, the major aim of the dual banking system, increased efficiency through competition, fails.

By eliminating the dual banking system and regulating banking solely through federal law, social benefits will likely ensue. Banks will be subject to federal regulators only and not state regulators. Often times, state banks which are members of the Fed are subject to regulation by both state and federal governments. These two types of regulation often contradict each other. The federal government can regulate the banking industry nationwide without conflicting regulation by states and ensure the overall health and competitiveness of the industry.

Opponents of the elimination of the dual banking system cite the states' longstanding ability to regulate local matters and the tradition of the dual banking system. However, the system is inefficient because it requires increased expenditures to operate the state banking systems. Also, as noted earlier, the state systems sometimes conflict with the federal system. Opponents further argue that since state banks are usually members of the Federal Reserve System and the FDIC, the banks consent to being regulated by the Federal government and the state government. Given the consequences of not "consenting," however, the notion of consent-freely-given is extremely problematic. It seems simply the essence of common sense that a bank would prefer regulation by one authority rather than by two.<sup>288</sup>

Unlike the framers of the Constitution, the framers of the U.S. Banking System were not able to produce a "living, breathing" system which would be readily adaptable to the dramatic changes in our society which have occurred over the past two hundred years. Over time, lawmakers have kept the same system in place and modified it slightly whenever the need arose. The result is a system which no one would consider if given the opportunity to develop from scratch. Like the U.S. government, the U.S. Banking System needs to be reinvented.

By taking four steps, our banking system can once again become the envy of the world. Repealing antiquated legislation, like the Glass-Steagall Act and the McFadden Act will allow banks to earn incremental income, diversify their risk, allow American banks to compete on an even basis with European and Japanese banks, and allow banks to cut

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<sup>288</sup> In a letter to President Clinton, various professional associations of bankers expressed the desire to see the elimination of "unnecessary regulatory burdens and paperwork that impede economic growth." Bryan, *supra* note 91.



costs and streamline their operations. Encouraging cooperation between government regulators and bankers will contribute to fewer bank failures because good relationships foster better resolutions of problems. The semi-privatization of deposit insurance will lead to less expensive premiums for strong banks and fewer losses for the Bank Insurance Fund. Finally, the elimination of the Dual Banking System will lead to more efficiency by both regulators and banks and more effective regulation.

Maintaining a strong Banking System is essential to the health of our economy. Our system cannot afford to be burdened with outdated laws which hinder its competitiveness and needlessly increase the costs of doing business if we are to compete effectively in the global economy. Congress and the Clinton Administration should act swiftly to reform our Banking System.

