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"FINANCIAL SERVICES MODERNIZATION:" A CURE FOR PROBLEM BANKS?

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I. INTRODUCTION

On February 5, 1991, after consulting federal financial regulatory agencies and other interested governmental parties,[1] the Department of the Treasury transmitted to Congress its report: Modernizing the Financial System: Recommendations for Safer, More Competitive Banks."[2] The Treasury Report concludes that four major problems confront the U.S. banking system:

> (1) reduced bank *competitiveness* and financial strength, caused by outdated legal restrictions that prevent banks from responding to changing financial markets and technology; (2) the *overextension of deposit insurance*, resulting in excessive exposure for taxpayers and weakened market discipline for banks; (3) a *fragmented regulatory system* that has created duplicative rules and has often failed to produce decisive remedial action; and (4) an *undercapitalized deposit insurance fund.*[3]

To address these problems, the Treasury Report recommends four fundamental legislative reforms: (1) to increase bank competitiveness, Congress should authorize nation-wide banking, new financial activities for banks, and commercial ownership of banks; (2) to reduce taxpayer exposure and increase market discipline, Congress should reduce the scope of deposit insurance, require a link between regulatory supervision and capital strength, and require risk-based insurance premiums for deposit insurance; (3) to reduce duplicative rules and produce decisive remedial action, Congress should streamline the federal regulatory system; and (4) to recapitalize the Bank Insurance Fund, Congress should adopt a funding plan based on contributions from the banking industry, rather than from the Treasury and the taxpayers.[4]

Since its release, the Treasury Report has received substantial atten-

1. The agencies included the Comptroller of the Currency (OCC), the Federal Reserve Board (Federal Reserve), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration, the Office of Management and Budget, the Council of Economic Advisors, and the Office of Policy Development within the Executive Office of the President.

2. DEPARTMENT OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER MORE COMPETITIVE BANKS (1991) [hereinafter Treasury Report]. Congress directed the preparation of such a report in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, § 1001, 103 Stat. 183.

3. Treasury Report, *supra* note 2, at ix (emphasis in original).

4. *Id.* at x-xii.

tion from both the banking industry and Congress. While some of the report's recommendations have sparked considerable differences of opinion, representatives of the federal financial regulatory agencies have supported most of the proposals. In addition, most major financial institutions and many large nonfinancial firms have voiced support for the reforms. However, there has been significant opposition to many of the Treasury proposals from consumer organizations and from small, state, and foreign banks.

The current Treasury proposals are much like the sweeping banking industry reforms of the past in their attempt to correct the failures of past legislation. Like previous attempts at comprehensive reform, they are unlikely to accomplish all that the drafters hope. The proposed legislation should help restore bank competitiveness, reduce overextended insurance coverage, streamline the regulatory system, and recapitalize the Bank Insurance Fund with industry funding. However, many of the Treasury proposals do not go far enough, providing only minimal guidance and leaving the difficult details of implementation to the federal financial regulatory agencies. Numerous unaddressed issues may render many of the Treasury's recommendations less beneficial in practice than in theory.

Much has been written about the portions of the Treasury Report that recommend the expansion of bank powers to engage in non-banking activities. Most of the public debate has focused on the theoretical merits of the proposals to abolish restrictions on interstate banking, to repeal restrictions on securities underwriting by banks, and to allow ownership of banking institutions by industrial concerns. However, there has been little analysis of the proposals to correct past abuses and to impose new safeguards—such as increased capital requirements—as prerequisites to the use of the proposed expanded powers. After a very basic historical review of past attempts to "reform" the banking industry, this Article focuses on the less publicized portions of the Treasury recommendations in an attempt to identify some of the issues that would remain unsettled, even if the proposals are enacted into law.

II. Historical Perspective

As the Treasury Report points out, the current problems of the deposit insurance system were predictable, and in fact, were predicted by critics of the proposed deposit insurance legislation of the 1930s.[5] The Treasury Report thus raises the question of whether some of the present problems could have been avoided if Congress had listened more carefully to the critics of the 1930s. More fundamentally, it raises the question of the lasting effectiveness of any legislative solution.

The Treasury Report covers much more than just deposit insurance reform. If enacted, the recommendations would join a handful of legislative efforts that significantly changed the federal government's regulation of the banking industry. In general, Congress intended that each of these "reform" efforts correct the problems resulting from past "reforms." While the current recommendations are being promoted as "financial services modernization," it appears in large part that the Treasury proposals would dismantle legislative "reforms" of the past. The proposals would take the banking industry back to a less regulated age, removing many of the flat prohibitions of existing law and substituting less intrusive regulatory safeguards. While the Treasury Report's review of the history of the deposit insurance system is helpful, a broader view of the federal bank regulatory system's development puts the Treasury recommendations in better perspective, illustrating certain principles common in life, as well as in legislation. First, when problems are left unaddressed, they get worse. Second, no matter how comprehensive the efforts to solve past problems, it is impossible to anticipate future developments.

A. *The National Bank Act of 1864* [6]

Historians often refer to the years 1836-1863 as the "free-banking period"[7] or "the heyday of state banking."[8] While some banks operated under state control, others operated free of regulation. The widespread circulation of state currencies, counterfeit notes, and notes from non-existent banks was a significant problem,[9] ultimately resulting in an ineffi-

5. *Id.* at 5 ("Events have thus demonstrated that the criticisms leveled in the 1930s against the idea of federal deposit insurance had considerable merit").

6. National Bank Act, ch. 106, 13 Stat. 99 (1864) (codified as amended in scattered sections of 12 U.S.C. (1988)). A major source for portions of the historical overview in Parts IIA through D was an unpublished monograph entitled "Overview of Bank Regulation" dated March 1989, prepared by Mark D. Morris and William F. Stutts, Jr. with Baker & Botts, Austin, Texas.

7. J. NORTON & S. WHITLEY, BANKING LAW MANUAL § 2.03[2] (1991).

8. R. WEST, BANKING REFORM AND THE FEDERAL RESERVE 1863-1923, at 15 (1977).

9. D. LUCKETT, MONEY AND BANKING 291 (1984). *See also* R. WEST, *supra* note 8, at 17-18 ("[T]ransportation difficulties and lack of information afforded ample opportunity for unscrupulous operators to turn a quick profit by circulating unbacked currency").

cient and unreliable currency system. By 1860, approximately 10,000 different types of bank notes, with multiple values, were circulating.[10] By 1861, the value of worthless bank notes amounted to an estimated $100 million.[11]

In 1864, Congress enacted the National Bank Act to remedy the abuses of the unregulated banking industry and to correct the "near anarchy of the currency supply."[12] The National Bank Act and its amendments incorporated four major reforms. First, it established a system for chartering national banks, under the supervision of the Comptroller of the Currency.[13] Second, to increase the level of supervision of banking institutions, it established examination standards, higher capital and reserve requirements,[14] and extensive conditions on loans.[15] Third, it established a unified currency, offered only by national banks.[16] Finally, it required national banks to issue notes only to the extent that notes were guaranteed by the federal government.[17] Thus, "elaborate precautions were taken to ensure the integrity of national bank notes."[18]

B. The Federal Reserve Act of 1913 [19]

Notwithstanding the reforms enacted in the National Bank Act, the national banking system suffered from shortcomings. Because the same currency could be used to support deposits at different institutions, banks

10. T. CARGILL & G. GARCIA, FINANCIAL REFORM IN THE 1980s 29-30 (1985).

11. B. KLEBANER, AMERICAN COMMERCIAL BANKING, A HISTORY 51 (1990). The Chicago Tribune, on March 24, 1863, described the notes as follows:

> Torn, greasy, issued by nobody knows whom, payable — if payable at all — in other scraps of printed paper, like those on demand, not 1 in 5 of which is as good as the notes for an equal amount of any solvent business man; yet all clothed by custom and prescription with the attribute of money.

NATIONAL MONETARY COMMISSION, THE ORIGIN OF THE NATIONAL BANKING SYSTEM, S. DOC. No. 582, 61st Cong., 2d Sess. 18 (1910).

12. D. LUCKETT, *supra* note 9, at 291.

13. T. CARGILL & G. GARCIA, *supra* note 10, at 30.

14. D. LUCKETT, *supra* note 9, at 295.

15. The Act prohibited loans on a bank's own stock, limited loans to one borrower, and placed a ceiling on interest rates for loans. National Bank Act §§ 29, 30, 35, 12 U.S.C. §§ 83, 84, 85, 86, 94 (1988)

16. T. CARGILL & G. GARCIA, *supra* note 10, at 30. *See* National Bank Act § 22.

17. For every $100 of notes issued, $90 in federal government bonds had to be deposited with the Comptroller of the Currency. National Bank Act § 21. The upper limit on the amount of notes issuable was the bank's paid-in capital. *Id.* at § 13.

18. D. LUCKETT, *supra* note 9, at 292.

19. Federal Reserve Act, ch. 6, 38 Stat. 25 (1913) (codified as amended in scattered sections of 12 U.S.C. (1988)).

were able to inflate, or "pyramid," the value of their reserves artificially.[20] Also, because the National Bank Act did not provide for a nation-wide check-clearing system, checks had to pass through a complex system of correspondent banks.[21] The National Bank Act also failed to provide a system to vary the amount of notes in circulation based on cyclical and seasonal fluctuations in need.[22] Finally, because the system afforded no method for expanding total bank reserves during periods of crisis, the availability of funds was severely limited and subject to stringent credit policies.[23]

A series of financial panics after 1864 illustrated the inadequacies of the original national bank system.[24] After major panics in 1873 and 1893, depositors, increasingly skeptical that banks could satisfy demands for payment during emergencies, came to expect that many banks would fail or suspend operations during such periods. The succession of financial panics was attributed to the lack of a centralized reserve and policy making authority.[25] Depositors' growing distrust of the system led to calls for a new national currency, secured by the assets of issuing banks.[26] During the panic of 1907, as a result of pressure from J.P. Morgan, New York banks voluntarily pooled their reserves.[27] Although the measure demonstrated the benefits of pooling reserves, it also showed the extreme reluctance of banks to engage in such efforts voluntarily, and demonstrated the growing need for a federal regulatory authority. Some critics, however, still opposed the creation of a central bank, arguing that government involvement either would bring politics to banking—leading ultimately to complete governmental control—or would bring banking to politics through "Wall Street domination."[28]

Congress established a National Monetary Commission to study the deficiencies in the banking system and to make suggestions on how best

20. D. LUCKETT, *supra* note 9, at 291.

21. T. CARGILL & G. GARCIA, *supra* note 10, at 31.

22. D. LUCKETT, *supra* note 9, at 296.

23. *Id.*

24. The inability of the banking system to satisfy increased customer demand during holiday and crop-moving seasons contributed to the more notable panics. In New York, for example, panics broke out after currency had been sent west to pay farmers for their crops. H. BARGER, MONEY, BANKING AND PUBLIC POLICY 142-43 (1962).

25. T. CARGILL & G. GARCIA, *supra* note 10, at 31.

26. R. WEST, *supra* note 8, at 27-28, 36.

27. *Id.* at 32.

28. B. KLEBANER, *supra* note 11, at 111.

to achieve a more stable financial and monetary framework.[29] The Commission, comprised of seven House members and seven Senate members, hired experts and conducted hearings.[30] After comparing American and foreign banking systems, the commission cited the "concentration of surplus money and available funds" in New York City as one of the major defects in the existing system[31] and recommended that the United States create a central bank similar to the Bank of England.[32]

The Commission's recommendations largely were adopted in the Federal Reserve Act of 1913. The Act established a centralized banking system designed:

> to give stability to U.S. commerce and industry;
> to prevent financial panics or stringencies;
> to make available effective commercial credits recommended for individuals engaged in manufacturing, commerce, finance, and business; and
> to put an end to the pyramiding of bank reserves and the use of such reserves for gambling purposes on the stock exchange.[33]

To allay fears that the federal government was seizing control of the banking industry, Congress decentralized the system, establishing twelve separate districts, each with its own reserve bank.[34] The Federal Reserve Board was created to serve as the administrative head of the system. The Act provided that private member banks would own the central bank through the purchase of Federal Reserve stock.[35] National banks were required to join the Federal Reserve System or forego their national charters. State bank membership was optional.

The federal reserve banks also were expected to serve as "lenders of last resort," allowing member banks to borrow reserves during a panic if they had appropriate short-term collateral.[36] This function was viewed

29. T. CARGILL & G. GARCIA, *supra* note 10, at 31.

30. H. BARGER, *supra* note 24, at 149.

31. B. KLEBANER, *supra* note 11, at 81-82.

32. H. BARGER, *supra* note 24, at 149.

33. B. KLEBANER, *supra* note 11, at 111. The creation of a central monetary authority also marked the recognition of the relationship between the structure of the financial system and monetary control, accomplishing monetary control functions in a more automatic fashion through the rules of the gold standard and eligibility requirements for discounting commercial paper. T. CARGILL & G. GARCIA, *supra* note 10, at 32-33. *See* Federal Reserve Act, ch. 6, § 13, 38 Stat. 251, 264 (1913), *repealed by* Garn-St. Germain Depository Institutions Act of 1982, 96 Stat. 1510 (codified at 12 U.S.C.A. § 82 (West 1989)).

34. Federal Reserve Act, ch 6, § 2, 38 Stat. 251, 251 (1913) (codified as amended at 12 U S.C.A. § 222 (West 1989)).

35. *Id.* at §§ 2, 9, 12 U.S.C.A. §§ 222, 321-336, 338 (West 1989).

36. *Id.* at § 16, 12 U.S.C.A. §§ 248, 360, 411-416, 418-421, 467 (West 1989).

as important in achieving stability during times of financial crisis.[37]

C. *The Banking Acts of 1933 and 1935*[38]

The Federal Reserve Act did not result in the financial stability for which its supporters had hoped. Bank failures continued at a high level, averaging 600 per year.[39] One of the major flaws of the Federal Reserve Act was its failure to regulate the state banking system.[40] Because state banks were subject only to state regulations, the Act encouraged banks to seek state charters and thus avoid federal regulation by the Federal Reserve Board.[41]

More than 5,700 banks failed between 1921 and 1929.[42] In December 1930, the Comptroller of the Currency found that those failures had tied up deposits of nearly $2 billion.[43] Critics blamed the Federal Reserve System for failing to check speculative bank investments during the 1920s. Banks were willing to pay high interest rates to attract deposits to invest in high-risk loans and securities ventures. The system also had structural defects. In 1931, the Secretary of the Treasury stated:

> Our dual system and the divided control which exists have tended to relaxation in banking laws and regulations, and to the development of unsound practices in the management of the banks. Moreover, recent events have disclosed as never before the extent to which many banks with deposits payable on demand have allowed too large a proportion of their assets to become tied up directly or indirectly in capital commitments. . . . The banking structure of the United States needs modification.[44]

Despite general recognition of the need for reforms, the banking community resisted any increase in federal control. State banking authorities also opposed further infringement on their powers.[45] Substantial reform from within the banking industry was itself difficult due to the varying

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37. D. FISHER, MONEY, BANKING, AND MONETARY POLICY 44-45 (1980).

38. Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C. (1987)); Banking Act of 1935, ch. 614, 49 Stat. 684 (codified as amended in scattered sections of 12 U.S.C. (1987)) [hereinafter Banking Acts].

39. D. LUCKETT, *supra* note 9, at 298.

40. K. COOPER & D. FRASER, BANKING DEREGULATION AND THE NEW COMPETITION IN FINANCIAL SERVICES 49 (1984).

41. *Id.*

42. *Id.* at 50. The majority of the failed institutions were state banks in rural areas.

43. H. BURNS, THE AMERICAN BANKING COMMUNITY AND NEW DEAL BANKING REFORMS 1933-1935, at 10 (1974).

44. *Id.* (citing U.S. SECRETARY OF THE TREASURY, ANNUAL REPORT 32 (1931)).

45. *Id.* at 6.

interests of national and state banks, urban and rural banks, East Coast and inland banks, and large and small banks. Legislation was necessary, not only to restore public confidence, but also to reconcile competing interests.[46]

The Banking Acts, adopted to address the major defects of prior law, established an extensive network of regulation to be implemented by new federal agencies.[47] To limit competition for deposits and, indirectly, to curb speculative lending and investment, the Banking Acts prohibited interest payments on demand deposits and gave the Federal Reserve authority to regulate interest paid on time deposits.[48] In addition, the Banking Acts limited competition by establishing regulatory barriers to entry into the industry. Before allowing a new bank to enter the market, regulatory agencies were required to review the need for additional banking services and to determine whether the existing banks and new banks could both earn adequate rates of return. In stark contrast to the days of "free banking," banking became a protected industry. A primary goal of federal law was to ensure the survival of existing banks.

The most significant reform, in terms of restoring public confidence, was the creation of the Federal Deposit Insurance Corporation (FDIC).[49] Congress created the FDIC to provide federal insurance for banks and mutual savings banks.[50] Additional functions included the purchase, holding, and liquidation of the assets of closed national and member state banks.[51] Deposit insurance substantially reduced the likelihood that one institution's failure would generate runs on banks and panics that historically had been a major problem.[52]

46. *Id.* at 7.

47. After adoption of the legislation, the federal regulatory apparatus consisted of the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation, the Federal Home Loan Bank Board, the Federal Bureau of Credit Unions, the Comptroller of the Currency, and the Federal Reserve.

48. Banking Act of 1933, ch. 89, § 8, 48 Stat. 162, 181, 182 (codified as amended at 12 U.S.C.A. §§ 371a, 371b (West 1989)).

49. T. CARGILL & G. GARCIA, *supra* note 10, at 35. *See* Banking Act of 1933 § 8 (amending the Federal Reserve Act by inserting §§ 12A and 12B).

50. Banking Act of 1933, ch. 89, § 8, 48 Stat. 162, 168 (*replaced by* the Federal Deposit Insurance Act, ch. 967, § 2[1], 64 Stat. 873 (1950) (codified as amended at 12 U.S.C.A. § 1811 (West 1989)).

51. *Id.*

52. T. CARGILL & G. GARCIA, *supra* note 10, at 35.

D. *The Bank Holding Company Act of 1956*[53]

During the early 1900s, the practice of forming a bank holding company to control the stock of one or more banks along with other types of businesses became popular.[54] The Federal Reserve reported that, by 1930, holding companies controlled 2,103 banks, with the value of loans and investments totalling $11 billion, or 19 percent of the assets of all United States banks.[55] The state and federal governments criticized the "uncontrolled growth" of bank holding companies. At least one bill to restrict holding companies was introduced in each session of Congress between 1933 and 1955.[56] A subcommittee of the Senate Banking and Currency Committee that investigated the non-banking activities of holding companies in connection with the stock market crash of 1929, found that the involvement of bank holding companies in the securities business played a major role in the uncontrolled speculation of the 1920s.[57]

With the Banking Act of 1933, Congress took an important first step toward controlling bank holding companies by prohibiting them from engaging in the securities business and by authorizing limited regulation by the Federal Reserve Board.[58] However, holding companies continued to escape regulation of their non-banking, non-securities activities.[59] In 1956, William M. Martin, Jr., Chairman of the Federal Reserve, explained that the Banking Act of 1933 had "proved entirely inadequate to deal with the special problems presented by bank holding companies."[60] Bank holding companies that combined banking and non-banking activities presented one of the main areas of potential abuse. Chairman Martin emphasized that a bank holding company's use of depositors' money to invest in its affiliated enterprises jeopardized the fiduciary relationship between a bank and its depositors.[61]

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53. Bank Holding Company Act of 1956, ch. 240, 70 Stat. 133 (codified as amended at 12 U.S.C. §§ 1841-48 (1988)).

54. T. CARGILL & G. GARCIA, *supra* note 10, at 36-37.

55. *See* M. JESSE & S. SEELIG, BANK HOLDING COMPANIES AND THE PUBLIC INTERESTS (1977). Other data indicated that, at this time, 28 large holding companies, although controlling only 2% of commercial banks, controlled almost 10% of total bank assets.

56. *Id.* at 8.

57. *Id.* at 7.

58. Banking Act of 1933, ch. 89, § 19, 48 Stat. 162 (current version at 12 U.S.C.A. § 1843 (West 1989)).

59. M. JESSE & S. SEELIG, *supra* note 55, at 8.

60. S. Rep. No. 1095, 84th Cong., 2d Sess., *reprinted in* 1956 U.S. CODE CONG. & ADMIN. NEWS 2482, 2483.

61. *Id.* at 2483, 2486.

In response to these problems, Congress enacted the Bank Holding Company Act of 1956. The Act served to:

> define bank holding companies;
> control expansion;
> require divestment of bank holding companies' non-banking interests; and
> establish the Federal Reserve Board's administrative responsibilities and enforcement powers.[62]

Under the Bank Holding Company Act, a company becomes a bank holding company when it directly or indirectly acquires control of a bank or bank holding company.[63]

Each holding company is required to register with the Federal Reserve.[64] The Bank Holding Company Act also requires that bank holding companies obtain approval from the Federal Reserve Board before acquiring more than five percent of the voting shares of another bank, forming a new holding company, acquiring all or substantially all of the assets of a bank (if the holding company was not a bank), or merging or consolidating with another bank holding company.[65] The Bank Holding Company Act requires that, before approving any acquisition, merger, or consolidation, the Federal Reserve Board consider several factors:

> the financial and managerial history and conditions;
> the future prospects of the company and the banks;
> the convenience, needs, and welfare of the affected community; and
> whether the effect of an acquisition, consolidation or merger would . . . expand the size or extent of the bank holding company system involved beyond limits consistent with adequate and sound banking, the public interest, and the preservation of competition in the field of banking.[66]

Thus, in general, the Bank Holding Company Act filled a major gap in prior legislation by preventing the holding company structure from being used to undermine the safety and soundness of federally insured banks.

E. Summary

Over the past 130 years, the role of the federal government in the regu-

62. *See* 12 U.S.C. §§ 1841-49 (1988).

63. A company gains "control" if it controls or has the power to vote 25% or more of another's voting securities, or if the Federal Reserve Board finds that the company exercises a controlling influence over another bank or bank holding company's management and policy. Bank Holding Company Act of 1956, ch. 240, § 2, 70 Stat. 133 (codified as amended at 12 U.S.C.A. § 1841(a)(2)(4), (c) (West 1989)).

64. *Id.* at § 5(a), 12 U.S.C.A. § 1844 (West 1989).

65. *Id.*

66. *See id.* at § 3(c), 12 U.S.C.A. § 1842 (West 1989).

lation of banking steadily has increased. Congress has adopted successive reform measures to correct the abuses and structural defects that arose after the prior round of reform because the reforms were unable completely to cure the problems they were intended to fix. In each case, although Congress intended the legislation as a comprehensive reform program, the new laws ultimately proved inadequate. The history of legislative attempts to regulate the banking industry indicates that legislative "fixes" are, at best, temporary. Ultimately, Congress' best laid plans are rendered obsolete by economic changes or by the ingenuity of bankers and their advisors in finding loopholes in the law.

The current Treasury recommendations include significant measures aimed at curbing abuses of the past. In addition, they revise, and actually dismantle, parts of the regulatory system that developed from the Banking Acts. In particular, the "financial services modernization" recommendations directly reverse many earlier reforms, by repealing restrictions on securities activities, allowing acquisition of banks by industrial concerns, and reducing federal scrutiny of well-capitalized banks. Further, the Treasury's recommendation that banks be supervised by a single federal regulator (within the Treasury Department), rescinds the powers granted to other bank regulatory agencies by the Banking Acts. Thus, many of the Treasury's major proposals to modernize the industry simply restore powers taken away by the Banking Acts in the 1930s. The banking industry's record concerning self-regulation seems to indicate that any grant of new bank powers should be supplemented by carefully considered regulatory boundaries.

III. THE TREASURY RECOMMENDATIONS

A. Proposals Relating To "Deposit Insurance"

While the Treasury proposals to grant new powers to banks have drawn the most attention, the Treasury recommendations for "deposit insurance reform" ultimately could have a more significant impact on a larger segment of the banking industry. These proposals would do much more than simply change the rules regarding deposit insurance coverage; they also include a number of provisions aimed directly at correcting recent abuses of the system.

A major theoretical foundation for the Treasury's deposit insurance proposals is that the existing system reduces "market discipline" by eliminating insured depositors' need to worry about the financial health of the institution in which they place their money.[67] As the Treasury Report explains:

> Events have thus demonstrated that some of the criticisms leveled in the 1930s against the idea of federal deposit insurance had considerable merit. The system has subsidized highly risky, poorly managed institutions. These institutions have exploited the federal safety net by funding speculative projects with insured deposits. The resulting costs have been borne by well-run institutions and by the taxpayers.[68]

To some extent, however, the "market discipline" problem inheres in the concept of deposit insurance. One of the primary purposes of the insurance system, to promote confidence in the safety of insured deposits,[69] necessarily will conflict with the goal of instilling "market discipline" on financial institution management. The "market discipline" problem either can be reduced or aggravated by particular policy choices, but it can never be eliminated.[70] The Treasury Report, in an attempt to find an appropriate middle ground, combines increased market-based incentives with new regulatory prohibitions and requirements.

The deposit insurance debate has focused primarily on the issues of who should be insured, and for how much. The Treasury proposal would maintain the current $100,000 limit on deposit insurance coverage, but impose that limit on the aggregate accounts held per institution by each depositor.[71] The implicit assumption of that limitation is that large uninsured depositors will impose the necessary "market discipline" because of their strong incentive to inquire as to the financial health of an institution before depositing their money. However, this same basic presumption has provided the theoretical foundation for the deposit insurance system since 1933. Experience has shown that the theory does not work perfectly because, as a matter of policy, the FDIC often protects even uninsured depositors in a failed institution.[72] Thus, tightening the dollar limitations on insurance coverage alone will not solve the deposit insurance problems.

FDIC policy aside, many of the recently apparent flaws in the theory of deposit insurance are also attributable to the ingenuity of large depositors who have found ways around the system. The Treasury Report

67. *See, e.g.*, Treasury Report, *supra* note 2, at I-11 to I-13.
68. *Id.* at I-11.
69. *Id.* at I-4 to I-11.
70. *See id.* at III-2 to III-10.
71. *Id.* at 20.
72. *Id.* at I-12, III-2 to III-10.

therefore recommends ending or limiting some of the means by which large depositors have obtained deposit insurance protection in the past.[73] These recommendations bring to mind the military adage about making war plans for the future based on the tactics and strategy of the last war. While the Treasury Report addresses the current "abuses" of the system, innovative investors and money managers undoubtedly will devise new and different means of taking advantage of the government's safety net without imposing the desired "market discipline" on financial institutions.

Whether or not the Treasury recommendations have a lasting effect, they will have a significant impact on the way many banks do business. Some of the major proposals, and their potential effects, are outlined below.

1. *Brokered Deposits*

One of the more controversial proposals, which would have a substantial impact on money managers and large investors, is the Treasury's recommendation to eliminate insurance coverage for "brokered deposits."[74] As the name implies, "brokered deposits" are deposits placed with a financial institution by a third party, or broker. Brokered deposits became popular after the deregulation of deposit interest rates in 1980. Through a broker, large depositors could get the benefit of the highest interest rates offered by financial institutions located throughout the country. The inherent problem, however, is that the financial institutions paying the highest interest rates are often those in the worst financial condition. Additionally, deposit brokers typically "package" the deposits in amounts of $100,000 or less to take advantage of federal deposit insurance.[75] While the results of empirical studies of the relationship between brokered deposits and institutional failures are debatable, there is no question that many savings and loan associations that failed during the 1980s fueled explosive growth with brokered deposits.[76]

The Treasury Report suggests removing brokered deposits from the definition of insured deposits.[77] In addition to the Treasury's goal of reducing the potential liabilities of the insurance funds, the Treasury rec-

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73. *See id.*, Conclusions and Recommendations, at 22-29.
74. *See id.*, Conclusions and Recommendations, at 24.
75. *See generally id.* at IV-1 to IV-2.
76. *Id.* at IV-4.
77. *Id.*

ommendation would have other significant effects. First, it would substantially decrease the business of deposit brokers. Second, it could also affect the behavior of financial institutions, limiting their deposit-gathering abilities and making rapid growth much more difficult. In addition, by reducing the attractiveness of brokered deposits, the Treasury recommendation might reduce the incentive for significant regional differences in interest rates. Finally, by slowing the flow of funds into financial institutions that pay higher rates, the Treasury proposal would reduce the funds available for highly speculative investments. While none of these consequences is stated in the Treasury Report, they all appear to be among the unspoken objectives of the brokered deposit recommendations.

2. *Interest Rate Limitations*

As a supplement to the proposals relating to brokered deposits, the Treasury Report discusses limitations on allowable interest rates.[78] Although the Treasury Report did not include such limitations as a specific recommendation, the Treasury's proposed legislation to implement the Report does provide for interest rate limitations.[79] Section 102 of FISCCA, introduced as H.R. 1505[80] and S. 713,[81] would preclude institutions that do not meet minimum capital requirements from soliciting deposits "by offering rates of interest . . . which are significantly higher than the prevailing rates of interest on deposits offered by other insured depository institutions in such institution's normal market area."[82] The provision is intended to limit the ability of an institution to "grow out" of its problems by inflating its deposit base through high rates of interest. This pattern of explosive growth through above-market interest rates was common to many of the most spectacular savings and loan failures of the 1980s.[83] The legislative language, however, is silent on when the rates being offered are "significantly higher" than those offered by other institutions in the same area. While it is certainly possible to calculate aver-

78. *See id.* at IV-9.

79. The proposed legislation drafted by the Treasury is entitled the "Financial Institutions Safety and Consumer Choice Act of 1991" (FISCCA).

80. H.R. 1505, 102d Cong., 1st Sess. (1991).

81. S. 713, 102d Cong., 1st Sess. (1991).

82. FISCCA § 102(a).

83. *See* U.S. GENERAL ACCOUNTING OFFICE, REPORT TO CONGRESS, THRIFT FAILURES: COSTLY FAILURES RESULTED FROM REGULATORY VIOLATIONS AND UNSAFE PRACTICES 25-26 (1989).

age rates and to issue regulations defining what will be considered a "significant" difference, the proposed legislation leaves unanswered some interesting questions.

If enacted, FISCCA could result in even more uniformity in interest rates than currently exists because insured institutions will have a statutory justification for keeping interest rates on deposits low. The new provision could solve the problem of competition for funds that results in the federal government insuring accounts that pay rates of interest significantly above what the government pays for borrowing.[84] However, it would also impose a new form of indirect federal regulation of interest rates, thereby swinging the pendulum back from the deregulation of interest rates that occurred in 1980.[85] Instead of statutorily setting deposit interest rates, the new law effectively would allow depository institutions to establish such rates by tacit agreement, thus raising questions about the interplay between the proposed statute and the federal antitrust laws.

Theoretically, it is possible that the proposed statute could force a downward movement in deposit interest rates. For example, when an institution wants to decrease its deposit base to meet statutory capital requirements, it may post lower interest rates to discourage deposits. These lower rates could cause average rates to drop, and could thereby force other institutions paying higher than average rates to come into line. These decreases in rates could, in turn, lower the average, again forcing more institutions to lower their rates. Ultimately, the downward spiral would end only when all institutions were clustered around the average rate for the particular market area. Thus, while the deposit solicitation provision is a useful attempt to deal with one of the significant problems of the 1980s, there may be a number of consequences that need to be thoroughly investigated before specific language is adopted.

3. *"Too Big To Fail"*

The Treasury Report also addresses the problems associated with the FDIC's "too big to fail" policy.[86] The proposed solution simply removes the "too big to fail" determination from the FDIC's jurisdiction and provides that the Federal Reserve and the Treasury will make the determination whether the proposed resolution of a failed financial institution

84. Treasury Report, *supra* note 2, at IV-9.

85. *See generally* Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 204, 94 Stat. 143 (codified at 12 U.S.C. § 3503 (1987)).

86. Treasury Report, *supra* note 2, at 26-28, 29, III-29 to III-31.

would have a severe adverse impact upon the financial system.[87]

Interestingly, the relatively modest jurisdictional change recommended in the Treasury Report would not take effect until three years after the date of enactment. Presumably, this three year time delay indicates that the Treasury and the Federal Reserve are likely to take a fundamentally different approach to the "too big to fail" question; large depositors should no longer assume they will be protected. The time delay would thus allow large depositors and bank creditors to evaluate the strength of their depository institutions and to move funds from weak institutions to strong institutions. While the reaction of large depositors and creditors is uncertain, the prospect of a loss upon the failure of a weak institution might impose the kind of "market discipline" that the Treasury favors.

Another issue, of course, is the effect a substantial dose of "market discipline" will have on the FDIC insurance funds. Significant growth of strong institutions could result from the increased market discipline due to an inflow of new deposits. Similarly, weak institutions could shrink substantially as a result of the corresponding outflow of deposits. This result certainly would benefit the insurance funds, since it reduces the potential exposure of the funds upon failure of the weaker institution. An additional consideration, however, is the effect on trade creditors and others who do business with weak financial institutions. Faced with the failure of a weak institution and the prospect of substantial losses, creditors may demand security before providing goods and services, or may refuse to do business with weak institutions altogether. Such effects could further hasten the decline of a weak institution and eliminate any possibile recovery, thus exacerbating the burden on the insurance funds.

Finally, a more stringent application of the "too big to fail" policy will have little effect on "market discipline" unless large depositors and creditors can obtain accurate information about the health of the financial institutions with which they deal. Presently, even where the financial institution is a publicly traded company, the book value of its assets differs from the market value of those assets. An accurate picture of the institution's financial health is therefore difficult to obtain. Unless accurate disclosure of complete financial information is required, the "market discipline" goal of the "too big to fail" recommendations will be difficult to achieve.

87. *Id.*, Conclusions and Recommendations, at 27-28.

4. *Risk-Based Assessments*

The Treasury Report also recommends that the FDIC develop a system of risk-based premiums for deposit insurance.[88] The Treasury proposal would allow the FDIC broad discretion in determining the factors that should be considered in evaluating a particular institution's risk and in setting the corresponding premium. However, the current law regarding the assessment of insurance premiums contains detailed provisions and includes maximum premium levels.[89] FISCCA would not change these maximum premium levels.[90] It thus appears that the Treasury's proposed "risk-based" system would give the FDIC the authority to adjust premiums downward for low-risk institutions, but would not provide corresponding authority to increase premiums above the current ceilings for high-risk institutions. Unless the FDIC is authorized to raise the premium ceiling for risky institutions, the Treasury proposal could be the equivalent of a reduction in taxes without a corresponding reduction in spending.

5. *Restrictions On Federally Insured State Bank Activities*

In its recommendations regarding limitations on the activities of state-chartered banks, the Treasury Report attempts to address another significant problem that has existed since the days of the National Bank Act. Under the "dual banking system" in the United States, a financial institution may be chartered under either federal or state law and regulated by either federal or state regulators, or by both. During the 1980s, some states, competing with one another to attract new financial institutions, allowed state-chartered institutions to engage in a much broader range of activities than those permissible for federally chartered institutions.[91]

While the dual banking system and the right of the states to set standards for state-chartered institutions are deeply entrenched, federally insured, state-chartered institutions pose a risk to the federal treasury. The Treasury Report, therefore, recommends that the risk to the federal insurance funds be lessened by limiting the range of permissible activities for state-chartered, federally insured institutions to the same activities authorized for federally chartered institutions, notwithstanding any more

88. *Id.*, Conclusions and Recommendation, at 32-36.
89. *See* 12 U.S.C. § 1817 (1988).
90. FISCCA § 104.
91. *See* Treasury Report, *supra* note 2, at 47.

liberal provisions of state law.[92]

The thrust of the proposal, as set forth in the Treasury's proposed legislation, is that state banks, and their subsidiaries, would be prohibited from engaging in any activity not permissible for national banks or their subsidiaries. Only after an express finding that the activity "would pose no significant risk to the affected deposit insurance fund" would the FDIC permit the activity.[93] In addition, the state bank would be required to comply with the minimum capital standards imposed by the bank regulatory agencies.[94]

While paying lip service to the concept of the dual banking system, the proposed legislation would make it very difficult for state regulators to allow state-chartered institutions to make investments or to engage in activities beyond those available to federally chartered institutions. Any incentive for an institution to subject itself to dual regulation by choosing to be state-chartered rather than federally chartered thus would be greatly reduced. Long-term effects of the proposal may be the gradual disappearance of state-chartered institutions, and the concurrent withering of the dual banking system.

6. *Market Value And Other Disclosure*

To provide a means for investors, depositors, creditors, and others to obtain a more accurate picture of the strength or weakness of a financial institution, the Treasury Report recommends that a means be developed for reporting the fair market value of assets and liabilities in financial statements and reports filed with the bank regulatory agencies and the SEC.[95] The Treasury's proposed legislation would require insured institutions to provide copies of their financial reports to the bank regulatory agencies, to notify the regulators within fifteen days of the resignation or dismissal of their accountants, and to provide a statement of reasons for the change.[96] Although the proposed legislation would not change the accounting standards by which the capital of an insured institution is formally determined, it ultimately would require a uniform system of market value reporting useful not only to investors, depositors, and creditors, but also to the bank regulators.

92. *Id.* at 48.
93. FISCCA § 105.
94. *Id.*
95. Treasury Report, *supra* note 2, at 43-44.
96. FISCCA § 107.

The general subject of market value accounting and disclosure, debated in considerable detail, is a primary concern of the SEC.[97] By focusing only on market value *disclosure* as a supplement to existing accounting disclosure requirements, the Treasury Report does not attempt to resolve the theoretical debate on market value *accounting*. This approach may be sufficient to accomplish the goal of improving market discipline, but it is unclear whether it will satisfy the needs of the financial institution regulatory agencies.

B. Proposals Relating To Financial Services Modernization

The Treasury recommendations for "modernizing" the financial services industry contain four key components. First, the current bank holding company structure and the separation of banking and commerce would be replaced with a structure under which a non-financial commercial firm, a "diversified holding company," could own, in addition to any other subsidiaries, a "financial services holding company." In turn, the financial services holding company could own banks, securities firms, and insurance companies.[98] Second, national banks would be authorized to engage directly in certain financial activities that are currently prohibited and, under some circumstances, would be prohibited from engaging in certain activities that are currently authorized.[99] Third, national banks would be allowed to branch into all states within three years, and to branch within each state to the extent the state's law allows intrastate branching for state-chartered banks.[100] Finally, the ability of diversified commercial companies to own a financial services holding company that in turn owns banks, the ability of national banks to engage in newly-authorized non-banking activities, and the regulatory supervision of banks in general, would be determined based upon the capital level of the regulated bank.[101] These four recommendations are discussed below.

97. *See RTC Assets Disposition: Hearings Before the Subcomm. on Banking, Housing and Urban Affairs,* 101st Cong., 2nd Sess. (1990); Testimony of Richard C. Breeden, Chairman, Securities and Exchange Commission, before Senate Comm. on Banking, Housing, and Urban Affairs (September 10, 1990).

98. Treasury Report, *supra* note 2, at 56-61.

99. *Id.*

100. *Id.* at 49-53.

101. *Id.* at 57-58.

1. *Financial Services Holding Companies and Diversified Holding Companies*

The key structural component of financial modernization in the Treasury Report is the replacement of bank holding companies with financial services holding companies ("FSHCs"). FSHCs would be authorized to engage, through separate subsidiaries, in securities, insurance, and other approved activities of a financial nature, provided that the bank maintains a minimum capital level. Rewarding well-capitalized banks with the authority to engage in new financial activities through the FSHC structure is designed to make the banking franchise more competitive and profitable in order to attract needed capital. This in turn would minimize the exposure of the federal deposit insurance system and improve the stability of the banking industry.[102] The insured bank would be regulated by its primary bank regulator.[103] Any securities affiliate would be regulated by the SEC, and any insurance affiliate would be regulated by the relevant state insurance commission.

In addition to authorizing bank affiliation with financial services companies, the Treasury Report would allow indirect ownership of banks by commercial firms engaged in nonbanking businesses through such a firm's ownership of a FSHC. Designated as "diversified holding companies" ("DHCs"), such firms are seen as a vital source of capital for the banking industry. As the Treasury Report notes, "[b]anks need capital, and commercial companies constitute almost 80 percent of the capital of U.S. businesses."[104]

The Treasury's proposal regarding FSHCs and DHCs is generally supported by regulators and industry as a way to make banks more competitive through improved efficiency, and safer through diversification. There are, however, four basic issues that the Treasury proposal has not

102. *Id.* at 55 ("This blending of banking, finance and commerce will a create stronger, more diversified financial system that will provide important benefits to the consumer and important protections for the taxpayer").

103. *Id.* at 68. National banks and their holding companies would be regulated by the newly created Federal Banking Agency within the Treasury Department. The Federal Reserve would regulate all state-chartered banks.

104. *Id.* at 57. This may be particularly true when the FDIC attempts to sell a failed institution, leading to a substantial reduction in resolution costs. *See Restructuring of the Banking Industry: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 102nd Cong., 1st Sess. (1991) [hereinafter *Hearings on Restructuring of the Banking Industry*] (testimony of Philip J. Purcell, chairman and Chief Executive Officer, Dean Witter Financial Services Group, Inc. on behalf of the Financial Services Council at 21-22).

addressed with certainty and that have raised objections.[105] First, no matter how they are designed, "firewalls"[106] will be either too high and wide to allow synergies between entities, or so opaque that they will not work when needed to balance properly the desire to obtain increased efficiency through application of financial expertise and the conflicts of interest that may lead to excessive risk-taking or self-dealing. Even though the Treasury proposals would allow some "cross-selling" of bank, securities, and insurance products, capital flows and inter-affiliate financial arrangements such as loans and guarantees would be heavily restricted. For instance, a DHC would be able to own a securities affiliate within or outside of a FSHC. If owned within, however, firewalls would apply. Moreover, from three years after the enactment of FISCCA all securities activities would be required to be conducted through an FSHC securities subsidiary, or a subsidiary of the bank if no separate FSHC securities subsidiary exists.

Enforcement of these firewalls would require substantial regulatory oversight. For this reason, the American Bankers Association "opposes firewalls that would impose heavy new regulatory burdens on the industry and undermine the very purpose of allowing diversification through the offering of additional financial services."[107] Without such new regulatory standards, however, the Treasury's proposed safeguards against conflicts of interest would be ineffective. The Independent Banking Association of America ("IBAA") has testified:

> If the massive financial conglomerates that would be created are not permitted to take advantage of the 'synergies' among their affiliates, why should they be created in the first place? Either the firewalls will not work, and consumers and businesses will be subject to abuses, or, they will work, and the economic efficiency sought will not be attained.[108]

105. *Oversight of the Financial Services Industry: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 102nd Cong., 1st Sess. 3-4 (1991) (Testimony of E. Gerald Corrigan, President, Federal Reserve Bank of New York).

106. The term "firewalls," as used in the context of regulation of financial services, describes various regulatory provisions designed to keep problems in one subsidiary or affiliate from affecting the parent or affiliated company. For instance, the Treasury Report recommends that transfer of funds between a federally insured bank and its holding company be prohibited to keep taxpayer funds from going to the non-banking activity. Treasury Report, *supra* note 2, at 59.

107. *Hearings on Restructuring of the Banking Industry*, *supra* note 104 (testimony of Richard A. Kirk, Chairman of the Board and Chief Executive Officer, United Bank of Denver, and President of the American Bankers Association at 5).

108. *Hearings on Restructuring of the Banking Industry*, *supra* note 104 (testimony of David Ballweg, President, Community State Bank, Union Grove, Wisconsin, and President of the Independent Bankers Association of America at 4-5).

Moreover, the IBAA opposes the Treasury's plan to allow bank affiliates to engage in underwriting and retail sales:

> Rather than being independent agents, banks would likely sell products created by their affiliates. They wouldn't ask themselves, what's best for my customer, but what is our affiliate trying to sell today. Extensive consumer protection firewalls would be needed to avoid conflicts of interest and prevent abuses that the Treasury's new ownership structure could lead to. . . . We are deeply skeptical that any sort of workable firewalls could effectively protect consumers.[109]

Allowing affiliation of banks with nonbanking entities is also opposed because at least parts of the banking supervisory system, and perhaps the insurance fund as well, inevitably will be extended to such entities. As a bank decreases its capital and descends into lower capital zones, its FSHC and DHC, and their other subsidiaries, would become subject to greater supervision and examination.

In addition, there is concern that the affiliation of banks with securities or commercial firms will result in a harmful concentration of economic resources and power. For instance, purchases of banks by industrial companies are opposed by many who argue that such measures would threaten independent banks and the smaller businesses and farmers who depend on such institutions.[110] Under this view, the Treasury's plan would hurt the average consumer by increasing concentration, by making the financial marketplace less competitive, and by posing severe risks for the taxpayer by extending the federal safety net. Finally, the plan simply would lead to corporate reshuffling, not to new marketplace entries.[111]

To the extent that they are right about industry consolidation, the critics may prove too much. Allowing the affiliation of banks with nonbanks may be important not because it creates new and efficient business arrangements that benefit consumers and industry, but because the resulting mergers, acquisitions, and asset sales would replace what might otherwise be bank failures, securities firm bankruptcies, and insurance company seizures. Thus, what is hailed as a long-term solution may in fact be most beneficial as a "quick fix" for an ailing financial services

109. *Id.* at 25.

110. *Small Banks Intensify Assault On Reform Plan*, AMERICAN BANKER, Mar. 6, 1991, at 1. Thus, the IBAA has labeled the Treasury proposal "a blueprint for massive economic concentration." *Hearings on Restructuring of the Banking Industry, supra* note 104 (testimony of David Ballweg, at 4-5).

111. *Id.* at 21-22.

industry. Securities and insurance firms will buy banks for their profit potential and for their market penetration with financial services consumers—both business and personal—that will then allow the nonbank firms to recover some of the market they have lost.[112]

Finally, the Treasury proposal is criticized because the potential benefits that might grow out of combining banking and nonbanking entities are seen as remote at best and illusory at worst. Yet the potential detriments are immediate. The synergies of any conglomerate structure, while theoretically obtainable, often prove elusive. This problem can only grow worse when combined with regulatory firewalls.

2. *Financial Activities of Banks*

Even though current law prohibites banks from affiliating with securities firms and from otherwise engaging in activities such as underwriting and dealing in securities, a number of securities-related activities are allowed. The Treasury recommendations regarding securities activities of banks change the rules such that, with the exception of nine specified activities, currently allowed activities may be continued, but outside the bank.[113] Banks would be required to establish separate affiliates or subsidiaries to perform these nine excepted activities.[114] Under the FSHC structure, these activities could be conducted through a subsidiary of the bank, through an affiliated securities subsidiary of the FSHC, or through a nonbank affiliate of the DHC. Certain securities, including shares or debt issued by the bank or by any affiliate, would not be allowed to be sold or offered for sale to the general public in any part of the bank commonly accessible to the general public for the purpose of accepting deposits.[115]

In addition, FISCCA would amend the Securities Act of 1933 to require registration of all public offerings of bank-issued or bank-guaranteed securities.[116] Disclosure with respect to such securities therefore

112. Various bankers have praised the Treasury's proposed reforms because they would lead to banking mergers and shrink the industry to a safer size. Continental Bank Corp. Vice Chairman Richard Huber stated that "[p]recipitating mergers is the intent of the plan," and that "[a]nything that hastens the consolidation of our industry will help it." John Rau, Chief Executive Officer of LaSalle National Bank, observed that "[t]he new securities powers would help the big New York banks more.... For the top 50 U.S. banks, this is very important for their evolution." Reuters, Feb. 6, 1991 (LEXIS, Nexis library, Wires file).

113. FISCCA § 242(a)-(c).

114. *Id.* § 242(d).

115. *Id.* § 242(e).

116. *Id.* § 241. Thrift securities are treated in the same manner.

would be regulated by the SEC instead of the banking regulatory agencies. This type of "functional regulation" is intended to be more efficient and effective than a system in which multiple agencies each regulate essentially the same activity.[117]

FISCCA provisions related to insurance activities of banks are minimal and generally clarify rather than reform existing law. Essentially, FISCCA would allow banks to (i) sell insurance from the bank's offices in towns with populations of fewer than 5,000, to residents of and persons employed in the state in which such towns are located, and (ii) engage in insurance brokerage in any state in which the bank has its headquarters or a branch, to the extent the insurance brokerage activities are permitted in that state for state-chartered banks.[118]

3. *Nationwide Banking and Branching*

There are three basic parts to the Treasury Proposal regarding nationwide banking and branching.[119] First, national banks immediately would be allowed to branch into any state that currently allows interstate banking (i.e., that allows bank holding companies from other states to acquire banks within its borders). Second, each state would decide whether to grant interstate branching authority to its state-chartered banks, but could not limit the ability of an out-of-state bank to branch inside its borders to the same extent its own banks can branch, unless it currently prohibits interstate banking absolutely. Third, in three years, FSHCs or DHCs could acquire banks in any state, including those states that currently prohibit interstate banking (states would then be required to allow interstate branching as discussed above).

By amending Section 3(d) of the Bank Holding Company Act,[120] FISCCA would authorize the appropriate federal banking regulator to approve the application of any DHC, FSHC, or foreign bank to acquire, directly or indirectly, any voting shares of, interest in, or all or substantially all of the assets of, any additional insured depositary institution or FSHC located in any state.[121] The amendment effectively repeals the Douglas Amendment, which prohibits a bank holding company from ac-

117. Treasury Report, *supra* note 2, at 59.

118. FISCCA § 222.

119. Nationwide banking would allow a FSHC to have separate banks in every state; interstate or nationwide branching would allow a single bank to operate branches in every state.

120. Redesignated as § 3(f) of the proposed Financial Services Holding Company Act, set forth in FISCCA, Title IV.

121. FISCCA § 261.

quiring a bank in a state other than the company's principal state of business, unless the acquisition is specifically authorized by the laws of the state in which the bank is located.[122]

Unlike several other provisions in FISCCA that would dramatically change existing banking law,[123] the authorization of nationwide banking through a holding company structure merely would bring to a conclusion the ever-increasing trend by states to allow interstate banking within their borders.[124] By 1991, thirty-three states permitted acquisitions of banks within their states by bank holding companies from other states. Thirteen others and the District of Columbia allow interstate banking based on reciprocity. Only Hawaii, Kansas, Montana, and North Dakota prohibit all interstate banking.

Nonetheless, opposition to the Treasury proposal generally follows two lines. First, nation-wide banking, when combined with interstate branching, would "lead to massive consolidation of the banking industry to the detriment of the consumer, small businesses, farmers, and ultimately the taxpayer."[125] Second, while nation-wide banking in principle may produce some efficiency and safety benefits, the "laboratory of the states" is still in the process of developing an interstate banking system that strikes a good balance between the local interests and the need for greater economies of scale and efficiency through diversification.[126]

The Treasury Report makes a fair assesment of the effects of nationwide banking on the industry, consumers, and taxpayers. Equally important may be the limited nature of these effects. Well-run, locally supported banks will not suddenly branch nationwide, nor will they be run out of business by interstate conglomerates.

> The evidence clearly shows that both big and small, diversified and specialized financial firms compete side-by-side in markets where they are permitted to do so. Community banks in New York, California and Washington have prospered by competing with big banks such as Citibank, Chemical, Security Pacific and Bank of America. There are shopping malls in virtually every city and town in this country where small shops and boutiques

122. Treasury Report, *supra* note 2, at XVII-2.

123. *See, e.g.*, FISCCA § 251 (establishing a new "zone" system for regulating a bank's activities and for determining the corrective action to be ordered by regulators); FISCCA § 101 (eliminating insurance coverage for brokered deposits). *See also supra* notes 74-77 and accompanying text and *infra* notes 129-31 and accompanying text.

124. Treasury Report, *supra* note 2, at XVII-8.

125. *Hearings on Restructuring of the Banking Industry*, *supra* note 104 (testimony of David Ballweg, at 20).

126. *Id.*

compete side-by-side with major department stores. This is likely to be the case in financial services as well.[127]

4. Capital-Based Ownership, Activities, and Supervision

Under the Treasury proposal, capital would play a central role in determining whether a bank could take advantage of financial services modernization. The level of a bank's capital would determine whether it could become and remain part of a FSHC, and thus engage in securities, insurance, and other activities of a financial nature. In addition, as a bank's capital declined, the bank, its FSHC, and its DHC would be subject to increasingly heightened supervisory action including, in some instances, forced divesture. In this way, the "proposal would make bank supervision more effective by creating incentives for banks to build and maintain high levels of capital, and providing swifter and more certain regulatory intervention against banks with too little capital."[128]

a. Capital Measurement and the Zone System

In general, the relevant capital measures for purposes of FISCCA include a risk-based capital ratio and a leverage limit, the numerical content of which is to be determined by the appropriate federal banking agency, and any other capital measure established as relevant by such agency.[129] In addition, the appropriate federal banking agency is to determine what constitutes "Tier 1" or core capital. Based upon their capital levels, banks would then be classified in one of five "Zones:"

> (i) Zone 1 would include any insured bank that (A) maintains a risk-based capital ratio and Tier 1 capital that are both significantly in excess of the required minimum, or (B) maintains a risk-based capital ratio that meets the minimum and Tier 1 capital that is substantially in excess of the minimum. A Zone 1 bank also would be required to maintain capital that meets or exceeds the minimum ratio for each other relevant capital measure established by the appropriate federal banking agency.
>
> (ii) Zone 2 would include any bank with capital that meets or

127. *Hearings on Restructuring of the Banking Industry, supra* note 104 (testimony of Philip J. Purcell, at 20).

128. *Restructuring of the Financial Services Insustry: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 102nd Cong., 1st Sess. (1991) [hereinafter *Hearings on Restructuring the Financial Services Industry*] (testimony of Nicholas Brady, Secretary of the Treasury, at 12).

129. FISCCA § 251.

exceeds the required minimum ratio for each relevant capital measure but that is not within Zone 1.

(iii) Zone 3 would include any bank that maintains capital that is below the required minimum ratio for any relevant capital measure, but that is not within Zone 4 or Zone 5.

(iv) Zone 4 would include any bank that maintains capital that is significantly below the required minimum for any relevant capital measure, but is not within Zone 5, or that is reclassified to Zone 4 upon the determination by the appropriate federal banking agency that the bank is in an unsafe and unsound condition.[130]

(v) Zone 5 would include any bank that maintains capital at or below the applicable "critical capital level," which is to be "a level of capital that will, as a general matter, permit resolution of an insured bank's problems without significant financial loss" to the bank insurance fund, but must at least equal or exceed a ratio of Tier 1 capital to total assets of one and one-half percent.[131]

b. Rewards for Well-Capitalized Banks

The primary rewards for well-capitalized banks are that the bank itself could engage in certain newly authorized financial activities and take advantage of an expedited approval process for opening new branches and acquiring bank affiliates. Additionally, the bank could be owned by a FSHC. The premise of the entire structure of allowing banks to be owned by FSHCs that also own insurance companies, securities firms, and other entities engaged in financial activities and FSHCs to be owned by commercial firms is that banks maintain or make significant progress toward obtaining Zone 1 status.[132] Under FISCCA, if eighty percent of the assets of the banks that an FSHC owns are in Zone 1 and the remaining twenty percent are in Zone 2, the FSHC would be deemed a Zone 1 FSHC and therefore would be authorized to engage, through non-bank subsidiaries, in securities, insurance and other activities—"new financial

130. The term "significantly" is not defined with respect to Zone 4 or Zone 1, but "is not intended to suggest symmetry with Zone 1 . . ." FISCCA, Section by Section Analysis, as prepared by the Treasury, at 58.

131. FISCCA § 251, amending Federal Deposit Insurance Act, ch. 967, § 2[1], 64 Stat. 873 (1950) by adding new § 35(b)(6).

132. *Reform of the Federal Deposit Insurance System: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 102nd Cong., 1st Sess. — (1991) [hereinafter *Hearings on Reform of the Federal Deposit Insurance System*] (testimony of Alan Greenspan, Chariman, Board of Governors of the Federal Reserve System, at 21).

activities"—deemed by the appropriate federal agency to be of a financial nature.

In addition, a FSHC that makes substantial progress (as determined by the relevant federal regulator) toward Zone 1 status also may engage in new financial activities. In this regard, a DHC could acquire a Zone 2 FSHC, but only if, as a result of the acquisition, the FSHC would be reclassified in Zone 1 due to an increase in capital. Approval for acquisitions of banks and for commencement of new financial activities by Zone 1 FSHCs would be expedited as well, and an agency could only disapprove an application by a Zone 1 FSHC or its DHC to engage in new financial activities if the holding company were in an unsafe and unsound condition or were engaging in any unsafe and unsound practice.

c. *Prompt Corrective Action*

Section 251 of FISCCA would add a new Section 35 to the Federal Deposit Insurance Act, authorizing certain mandatory and discretionary supervisory actions by the appropriate federal banking agency with respect to an insured bank. Banks with capital in Zones 2 through 5, and, in certain instances, their FSHCs and DHCs, would be covered by the additional regulations.[133] These new "prompt corrective actions" depend primarily, but not entirely, on capital levels. The appropriate federal agency also would have explicit authority to reclassify institutions into lower Zones, and thereby to force additional capital contributions or divestiture of affiliates, based solely on the "safety and soundness" of a bank, apart from its capital level.

Supervisory powers with respect to Zone 1 banks and their FSHCs and DHCs are generally limited. They include: (i) Receiving notice after the commencement of certain permitted activities, the opening of other than the first branch in a state, or the merger or consolidation with another bank; (ii) disapproving transactions when the condition of the bank or its activities are unsafe and unsound or when, as a result of the transaction, the bank would be reclassified to a lower Zone; and (iii) requiring either capital restoration or divestiture of the bank or the non-bank affiliates.

Supervisory powers over Zone 2 institutions generally include, in addition to the Zone 1 powers, (i) mandatory disapproval of any investment, expansion, acquisition, or other proposal if the condition of a bank or its holding company, or their activities, are unsafe and sound; and (ii)

133. FISCCA § 251.

mandatory restriction of capital distributions that would cause a reclassification to a lower Zone.

More extensive mandatory supervision would be required over Zone 3 banks, including: (i) Mandatory submission and implementation of a capital restoration plan; (ii) restrictions on capital distributions and payments to affiliates; (iii) disapproval of any investment, expansion, acquisition, or similar action by a bank, its FSHC or its subsidiaries; (iv) retention of consolidated capital of the bank, the FSHC, and the DHC at least equal to the minimum required for the bank, and dissallowance of any capital distribution; and (v) mandatory supervision of the FSHC, the DHC, and each subsidiary of the FSHC as if each individually were a Zone 3 bank. In addition, the appropriate federal banking agency would have discretionary authority to: (i) restrict or eliminate the growth of, or order the reduction of, bank assets or liabilities; (ii) terminate, reduce, or alter any activity if it creates excessive risk to the bank; (ii) require dismissal of certain officers and employees and reduce or eliminate some forms of compensation; (iv) order election of a new board of directors designated by the agency; and (v) require divestiture of any affiliate in danger of default that poses significant risk to the liquidity or solvency of the bank or is likely to cause significant dissipation of the bank' assets or earnings.

Required supervisory actions with respect to Zone 4 banks and their FSHCs and DHCs, include: (i) Manadatory submission of a capital restoration plan; (ii) supervision of the FSHC and the DHC on the same terms and by the same means as the bank, including examination; and (iii) restriction of compensation to certain executive officers. Discretionary supervisory actions include: (i) Zone 3 actions; (ii) restriction of any transaction between the bank and any other affiliate; (iii) divestiture, liquidation, or closing of any nonbank affiliate in danger of default; (iv) divestiture of the bank; (v) dismissal of certain officers and employees and restriction of compensation; and (vi) appointment of a conservator for the bank.

With respect to Zone 5 banks and their FSHCs and DHCs, the appropriate federal banking agency must require sale or merger of the bank or appoint a receiver or conservator within thirty days of the date on which the bank's capital reaches the "critical capital level" and the bank is classified in Zone 5.

d. Effect of the Treasury Proposal

By allowing only well-capitalized banks to engage in new financial activities through FSHCs, the Treasury proposal attempts to provide incentives for new capital to flow to the banking industry, while at the same time providing a cushion for any added risks not adequately isolated from the bank by firewalls.[134] "Not only does such an approach create additional inducements for these organizations to build and maintain the banks' capital, it also addresses one of the most significant causes of weaknesses in the banking system by widening the scope of activities for holding companies with well capitalized bank subsidiaries."[135]

Moreover, establishing a supervisory system around capital-based prompt corrective action has won praise because it "would permit a systematic program of progressive restraint based on the capital of the institution, instead of requiring the regulator to determine on a case-by-case basis, as a precondition for remedial action, that an unsafe and unsound practice exists."[136] Thus, while there is much opposition to the proposal that banks be allowed to expand into new financial activities, requiring such banks to have higher capital as a prerequisite is generally well-supported.

There remain, however, a number of concerns regarding the role of capital in the Treasury proposal. Primary among these is the fear that, although regulators can take action against any unsafe and unsound activity or condition, capital alone will become an exclusive measure, at least with regard to well-capitalized banks. Despite the Treasury Report's claim that the "single most powerful tool to make banks safer is capital," it is generally recognized that capital levels are a lagging indicator of financial strength.[137] It may be difficult to take prompt corrective action against an apparently well-capitalized bank. "If depletion of capital is to be avoided, instead of merely corrected, supervisors must have

134. Frederick L. Webber, President and Chief Executive Officer of the U.S. League of Savings Institutions, supports this measure. "Rewarding well-capitalized institutions clearly makes sense. Foremost among its virtues is the incentive it provides to build capital. That certainly merits the support of all savings institutions." *Savings Institutions Have Much at Stake in the Debate Over Treasury's Reform Plan*, AMERICAN BANKER, Mar. 22, 1991, at 4.

135. *Hearings on Reform of the Federal Deposit Insurance System*, *supra* note 132 (testimony of Alan Greenspan, at 19).

136. *Id*. (testimony of Alan Greenspan, at 6).

137. *Id.* (testimony of L. William Seidman, Chariman, Federal Deposit Insurance Corporation, at 32). *See also Hearings on Restructuring the Financial Services Industry*, *supra* note 128 (testimony of Charles A. Bowsher, Comptroller General, General Accounting Office, at 8).

the ability to take early action to correct poor loan and investment policies, poor internal controls, vulnerable earnings, excessive interest-rate risk, unqualified management, etc."[138] The General Accounting Office has proposed that the critical capital concept be replaced with a "trip wire" system, which would require prompt regulatory action tied to specific unsafe banking practices. "Under this approach to supervision and enforcement, regulatory discretion in dealing with identified problems would be limited, and owners and managers of insured banking institutions would know in advance the consequences of actions that could potentially weaken the financial strength of their institutions."[139]

The U.S. League of Savings Institutions also has raised questions about the Treasury's plan to set in stone a critical capital threshold below which the regulators would be required to seize an institution, arguing that one of the problems with such an inflexible approach is that the definition of capital constantly evolves. What is an appropriate threshold at one time might not be so at a later time, when legislative relief may not be possible in a timely manner.

> [W]hile early intervention is intended to minimize taxpayer exposure and expense, it could have the opposite consequence in some cases. In short, there can be instances (and we have some actual cases in mind) where, although an institution has fallen to low net worth levels, it could be more beneficial to the taxpayer to allow it to work its way back into compliance.[140]

The American Bankers Association (ABA) has expressed a similar concern over the "critical" capital level concept used in the Treasury proposal. The ABA is concerned that for the "critical" capital level to be high enough to assure that the FDIC will experience only insignificant losses, it would have to be almost as high as the FDIC's loss rate on case resolutions. For example, if the FDIC's loss rate is approximately twelve percent on average, the critical capital would have to be approximately nine percent.[141] Chairman Greenspan has voiced similar concerns and has suggested that the basis for early intervention should be to "minimize" resolution costs rather than resolution "without significant finan-

138. *Hearngs on Restructuring of the Financial Services Industry, supra* note 128, (testimony of L. William Seidman, at 32).

139. *Id.* (testimony of Charles A. Bowsher, at 10).

140. *Hearings on Restructuring of the Banking Industry, supra* note 104 (testimony of Donald B. Shackelford, Chairman and Chief Executive Officer, State Savings Bank, Columbus, Ohio, and Chairman, U.S. League of Savings Institutions, at 19).

141. *Id.* (testimony of Richard A. Kirk, at 27-28).

cial loss to the FDIC."[142]

With respect to basing supervisory action primarily on a bank's capital, the Treasury proposal leaves the determination of capital standards entirely to the regulators. While proper in many respects, this could lead to a constantly changing regulatory environment. "The definition of the zones will change from time to time as regulatory attitudes change. Institutions will change zones as the economy changes and as the regulators change their rules. When an institution changes zones, its whole regulatory environment will change."[143]

In addition, there is some concern that the discretionary authority of regulators under FISCCA may be too powerful and "that the regulatory actions that are described as discretionary will soon become mandatory, as regulators competing to see who can be the toughest will quickly be compelled to impose as many of the discretionary sanctions as possible."[144] The discretionary approach, however, is strongly supported by the regulators. For instance, Chairman Greenspan has forcefully argued for even greater regulatory authority to intervene than that recommended by the Treasury proposal.[145]

Another concern is that FISCCA would subject Zone 3 FSHCs to consolidated capital requirements unless they recapitalize or divest the low-capital bank. However, "[f]orced divestiture may not be a very effective way to police capital, particularly during economic downturns when it may be hard to sell assets."[146] Similarly, requiring a holding company to be a "source of strength" for the capital needs of a bank, even though the

142. *Hearings on Reform of the Federal Deposit Insurance System, supra* note 132 (testimony of Alan Greenspan, at 8). He cautions, however, that "prompt corrective action will tend to reduce losses to the insurance fund, but a genuine fail-safe, no-losses-to-the-FDIC policy would require unrealistically high capital levels." *Id.* at 8-9.

143. *Hearings on Restructuring of the Banking Industry, supra* note 104 (testimony on Donald B. Shackelford, at 9).

144. *Id.* (testimony of Edward P. Lorenson, Chairman and President, Bristol Savings Bank, on behalf of the National Council of Savings Institutions, at 12-14).

145. *Hearings on Reform of the Federal Deposit Insurance System, supra* note 132 (testimony of Alan Greenspan, at 5-6) ("We believe more general language—such as 'other supervisory criteria' [rather than just "unsafe and unsound"]—would be more useful. Operationally, this would mean that supervisors would be able also to consider asset quality, liquidity, earnings, risk concentrations, and judgmental information based on recent examinations, such as classified assets data").

146. *Id.* (testimony of L. William Seidman, at 10). "[W]e do not want to handicap the banks that are moving 'in the middle of the pack' in terms of their competitive position when compared with better capitalized competitors. If the products and services allowed to better-capitalized institutions give them a competitive advantage, the less well-capitalized institutions may be pushed into weaker and weaker positions. Banks that are further behind in capital levels will never catch up if they are not allowed to compete." *Id.* at 34.

holding company is not engaged in new financial activities, may make investments in "traditional" banks unattractive.[147] On an operating level, banks may raise their capital ratios not by increasing equity but by reducing assets, that is, by restricting loans.[148]

Moreover, banks with Zone 3 capital on the effective date of the requirement could not be acquired by an FSHC unless the acquiror provided enough capital to move the bank to Zone 1, likely a very large capital infusion. The very banks that could benefit the most from additional capital would be competing with better-capitalized FSHCs and DHCs that are able to offer much more diversified and (presumably) profitable investment. A better approach may be to allow a Zone 3 FSHC a period of time to reach an increased capital level while phasing in the authority to engage in new financial activities.

IV. Conclusions

The recommendations set forth in the Treasury Report and in FISCCA would affect all major segments of the financial services industry. The Treasury Report is a detailed, scholarly analysis of the issues. However, as any observer of Congress knows, major legislation is enacted for a variety of reasons, the merits of the proposals representing only one consideration. Therefore, the Treasury's theoretical analysis may not be as important a factor as local political concerns in determining whether the recommendations become law. Whether or not its far-reaching proposals are ultimately adopted, or, if adopted, whether they would be a cure for problem banks, the Treasury Report has at least served to focus debate and force serious consideration of legislative measures to address the major problems facing the banking industry today.

147. "Many bank stocks prior to the mid-1930s were subject to additional assessments if a bank experienced financial difficulties. Congress and the state legislatures removed these requirements because of their negative effect on the ability of banks to raise new capital." *Id.* at 10.

148. Thomas Hawly, of Salomon Brothers, Inc., has criticized the Treasury Report's emphasis on the need for banks to be strongly capitalized. "That part of the Treasury plan will immediately affect the mind sets of bank managements and be passed on rather quickly to borrowers in the form of no loans. As the proposal is written now, it definitely intensifies the credit crunch." Reuters, Money Report, Feb. 6, 1991 (LEXIS, Nexis library, Wires file).