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Understanding Bank Regulation - New Approaches to Improving the Bank Oversight System

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Lead Articles

Understanding bank regulation

New approaches to improving the Bank Oversight System

by Don Allen Resnikoff

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Introduction

In 1991 and 1992 alarms sounded about a looming bank crisis. The popular press raised the specter of commercial bank failures matching in magnitude the many failures of savings and loan institutions.[1] The 1992 book *Banking on the Brink*, by Roger Vaughn and Edward Hill, explained that "perhaps 1,200 banks are functionally insolvent."[2]

The hundreds of banks that in 1991 and 1992 were feared to be on the brink of failure have not failed.[3] The popular press no longer focuses on reports of an impending crisis for commercial banks. The debate about bank solvency has continued, but it has moved off the front pages of general circulation newspapers and into the world of bankers, interest groups, and political policy insiders.

Bankers and many policy insiders continue to argue that United States banking is in financial trouble in the sense that many banks are functionally insolvent or at risk of becoming functionally insolvent. Some also argue that Congress should address the problem of weak banks by reforming bank regulation and making it more permissive. Both arguments are summarized in a recent article stating that "the [banking] industry is within reach of real reform as leaders in Washington and the states begin to sound warnings that banks need help." The article quotes Comptroller of the Currency Eugene Ludwig as saying that the bank industry's recent profitability "lulls us into a false sense of security" that obscures "the important fact that the banking industry has been in a secular decline...." Derrick Cephas, New York's Superintendent of Banking, agrees, saying that banking is "vulnerable to periodic crisis unless certain structural issues are addressed." Mr. Cephas advocates legislation permitting banks to branch anywhere in the country, and permitting banks to sell securities and insurance. He also advocates that other regulatory burdens on banks be reduced.[4]

Alan Greenspan, chairman of the Federal Reserve Board, expressed similar views on legislative reform. Greenspan chided Congress for keeping banks "in a competitive straightjacket," and said that outdated laws, not a growing array of competitors, could be the cause of banking industry decline. The Chairman advocated legislation permitting banks to branch with fewer restrictions, and expressed the view that congressional passage of permissive branching legislation is imminent. He also advocated legislation permitting banks to deal in securities and insurance, and complained of lack of congressional action. "I am struck by the continued unwillingness of Congress to authorize banks to compete more broadly in securities underwriting and insurance sales."[5]

Whether many banks are in financial trouble, whether help is needed from Congress, and how best to structure the help, are questions of importance not only to bankers and policy insiders. The questions are important to a wide variety of people in their roles as taxpayers and consumers of bank services, as well as interested citizens. Taxpayers in particular have reason to be interested in the prospects for further taxpayer financed "bailouts" of troubled banks, which involve paying for the losses that occur when a troubled bank is either liquidated or merged into a healthier institution.

The books analyzed in this article can help the person without experience in bank regulation to understand some current issues of bank regulation policy. The books discuss the question of whether there really is a continuing problem with the financial condition of a substantial number of United States banks, and whether as a result there is potential for bank failures that can cause problems for bank consumers and taxpayers. The books also discuss whether changes in bank regulation policy would help solve the problem. The books analyze the banking industry's principal proposed solution. This solution is reduced government regulation, including relaxed restrictions on bank participation in securities and insurance sales. The rationale for the bankers' solution is that reduced regulation will permit banks additional opportunities to make profit. The thought is that the more profitable banks are, the less likely they are to fail and put a burden on taxpayers.

The bankers' recommendation of reduced regulation is rejected in the Vaughn and Hill book. Vaughn and Hill express skepticism that reduced regulation is the right way to avoid bank failures. As discussed later in this article, Vaughn and Hill recommend regulating banks more strictly to require high levels of solvency, so that banks will not fail. To some extent Congress accepted the strict approach to regulation when it increased regulatory strictures on banks.

Other approaches to regulation, represented by the Litan and Pierce books, attempt to fine tune regulation and focus it narrowly on well defined public interests. As discussed subsequently, the Litan and Pierce books define protection of government insured bank deposits and avoidance of taxpayer bailout of banks as important public interests, and suggest regulation narrowly focused on the goal of preventing bankers from engaging in activity that puts insured deposits at risk. These carefully tailored solutions intend to protect government insured deposits from possible risky activity by bankers while avoiding unnecessary constraint on pursuit of profit.

To put the various regulatory approaches in perspective, subsequent sections of this article provide: (1) a brief overview of the existing United States bank regulatory scheme; (2) a description of changes in the marketplace that have damaged the profitability of banks and arguably put the current regulatory scheme in jeopardy; (3) further discussion of bankers' proposals for regulatory reforms that would permit broader business activity for banks; (4) a detailed exposition of the views of authors Vaughn and Hill favoring strict regulation; (5) a detailed exposition of Litan's and Pierce's tailored approach to regulation; (6) a detailed discussion of recent Congressional response to regulation issues, the Federal Deposit Insurance Corporation Improvements Act of 1991 (FDICIA); (7) a report of some comments of participants in a conference on the FDICIA; and (8) a concluding comment.

Litan and Pierce suggest regulations narrowly focused on preventing bankers from engaging in activity that puts insured deposits at risk.

1. A Brief Overview of United States Bank Regulation

A key feature of the United States bank regulatory scheme is government–backed deposit insurance, which is perceived by many as having great public benefits, including increased stability of banks and reduction of risk for small bank depositors.[6] Because of deposit insurance, depositors have no need to withdraw deposits from troubled banks. Deposit insurance helps depositors, but it also helps banks by making the banking business less susceptible to failure. The very existence of government deposit insurance creates what is sometimes referred to as a "moral hazard," meaning that bankers will put bank assets at risk with less care than if there were no insurance. The "moral hazard" concern is essentially the same as for insurance generally, and involves the tendency of those who have the benefit of insurance to take risks that would be considered imprudent by uninsured persons.[7] The tendency of insurance to encourage risky behavior leads to a perceived need for the government to regulate the risks that banks are allowed to take. Indeed, the United States regulatory scheme may be seen as involving a balancing of, on one hand, deposit insurance and other government "safety net" protection intended to make banking stable and profitable, and, on the other hand, government imposed limits on bank activity intended to avoid the moral hazard of undue risk taking by bankers in reliance on the safety net.[8]

The government safety net includes, in addition to deposit insurance, bank access to funding from the Federal Reserve "discount window."[9] This name derives from the Fed practice of providing funding to banks by buying commercial paper at a varying discount rate. At one time the Federal Reserve did so through an actual teller's window. There has also been some legal protection against unbridled competition: entry of new competition has been controlled by statute.[10] Until the 1970s banks had a cheap source of funds in the form of legally assured low interest rate deposits.[11] Another part of the safety net has been the "too big to fail" policy of regulators which has protected large banks, but not smaller banks, from failure.[12]

The success of the United States bank regulatory scheme depends on banks having the ability to be profitable. If banks cannot be profitable, the consequence is bank failures that put stress on the government's arrangement for insuring deposits. This leads to taxpayer bailouts of insolvent banks and a series of other possible dire consequences. In addition, distressed banks cannot do well at a variety of things banks are expected to do, including facilitating the Federal Reserve Board's various policies affecting money supply and interest rates, and making loans to small businesses.

2. The Recent Deterioration of Bank Profitability

There is little doubt that the banking business and the functioning of the government safety net has changed over the years. This change has damaged the profit-making ability of United States banks, and increased the likelihood of bank failures. The significant disagreement is about how serious the damage is, and what regulatory policy approach is appropriate to repair the damage.

A core activity of banks that has suffered recently is "intermediation," where banks serve as financial intermediaries in business transactions by making loans and financing those loans by use of customer deposits or other assets. Banks hold assets representing a fraction of the value of loans outstanding as a reserve. In the past, banks were protected in the intermediation function not only by access to low interest customer deposits and the other "safety net" legal protection discussed above, but also by favorable market conditions. Only banks had access to knowledge of the customer's financial viability, the risks of the particular transaction to be financed, and the types of loans suitable to the situation.

At present, banks' unique access to credit information has been eroded by technological advances in communications, which facilitate easy transmittal of information relevant to lending decisions. Also, banks have lost much of their power to command low-cost funds provided by low interest deposits. New competitors for deposits have arisen, such as non-bank offerors of mutual funds, and legal regulations assuring low interest payments to depositors by banks have been dropped as counterproductive for banks. Once the banks had non-bank competitors offering depositors similar but higher interest paying investment alternatives, legal requirements that banks pay low interest to depositors no longer helped banks compete. The result is that banks must hustle to compete for funds in financial markets, and have no special way to get cheap funds.

Bankers and others report that another recent problem for banks is that businesses that once would have been borrowers from banks now often obtain funds elsewhere. Larger businesses obtain funds by issuing securities more frequently than in the past. Other large borrowers have moved to issuing commercial paper rather than borrowing from banks. Other new competitors to banks are specialty lenders, such as vendors that make loans for purchase of such products as cars and industrial equipment.[13] Consequently, banks feel pressured to make up for the loss of traditional lending business by taking on more risky loans and other more risky business.

If reports of marketplace changes are correct, then the financial problems of at least some banks are not likely to go away easily. If banks can no longer rely on low interest rate deposits for cheap funds, and banks face serious non-bank competition for many categories of lending, then it is not obvious how banks can do as well financially in the future as they have done in the past.

In *Banking on the Brink*, authors Vaughn and Hill argue that while market changes have affected banks' ability to find inexpensive assets and good customers for loans, bankers have greatly exaggerated the consequences of market changes. Vaughn and Hill believe that many banks survive in good condition. They explain: "America now has two banking industries. One is strong, profitable and internationally competitive. The other is dying. Of the world's 20 most profitable big banks, half are American (none is Japanese and only one is German). The average rate of return on equity for the top half of the industry is easily competitive with other sectors of the economy."[14]

In addition, Vaughn and Hill contend that many of the United States banks that are doing badly are simply suffering from poor management leading to bad loans to foreign governments, imprudent real estate investors, oil investors, and others.[15]

3. The Bankers' View of Regulatory Reform

If there have been at least some substantial market changes adverse to banks, and at least some banks are in great difficulty, what regulatory changes are likely to help avoid bank failures? Bankers often argue that the solution to the banking industry's problems is reduced regulation. Arguments for reduced regulation sometimes include proposals to eliminate government provided deposit insurance, but deregulation proposals recently urged on Congress have generally not gone that far. Deregulation arguments have focused on statutes and regulations that limit the business activities of United States banks. A particular target is a law that keeps banks away from commercial activities such as sales of securities and insurance, and which have the purpose of avoiding risky activity by banks. Another target is a law that limits geographic expansion of banks. Possible repeal of both kinds of limiting statutes has been a major focus of recent Congressional attention.[16]

A. Separation of Commercial and Investment Banks. The Glass–Steagall Act limits the business activity of banks by creating a wall of separation between commercial banking and investment banking. Securities underwriting by banks is constrained by the Act.[17] Glass–Steagall is supplemented by the Bank Holding Company Act, which prohibits bank holding companies or their non–bank subsidiaries from many non–bank activities.[18] The stated purpose of the Glass–Steagall Act is to provide for the safety and more effective use of the Federal Reserve Banks as a source of bank funds and to prevent the undue diversion of bank funds into speculative business investment. In other words, Glass–Steagall limits the scope of bank activity in order to reduce risky activity by bankers in reliance on deposit insurance and other government safety net protection.

Expansion of banking activity into securities could lead to an unwise expansion of the government safety net.

The Glass–Steagall "firewall" concept has been weakened over the years. Federal Reserve regulations have been modified to permit, for example, limited stock selling by special bank subsidiaries.[19] Also, the Comptroller of the Currency has given permission for some bank "self–underwriting" of securities.[20] Federal Reserve Board Regulation K permits United States banks to engage in some securities transactions overseas that are not permitted in the United States.[21] Nevertheless, to a substantial extent the firewall separation of banking and securities underwriting has remained intact.

Opponents of the firewall concept argue that it needlessly damages banks' opportunities for profit, possibly leading to financial problems for many banks and even failure for some. These problems cause stress on deposit insurance and other elements of the regulatory structure. Separating banking and commerce decreases bank safety and soundness because banks have fewer sources of capital than if banking and commerce were allowed to coexist. Opponents also argue that firewalls prevent synergies that would result from combining commercial banking and investment banking within one entity. However, other major capitalist economies, such as Germany and Japan, permit greater intertwining of commercial banking and industrial investment than is permitted in the United States. But for some people in this country the expansion of banks into industrial business raises the specter of excessive concentrations of economic power.

Not everyone agrees that Glass–Steagall firewalls are bad. Some argue that repeal of Glass–Steagall would impair bank safety and soundness by permitting highly risky activity. The argument is that expansion of banking activity to securities could lead to unwise expansion of the government safety net and create a moral hazard that bankers will take great risks over an expanded range of financial activities. In effect, the federal government would guarantee not only traditional banking activities, but also the additional types of financial activity allowable to banks after repeal of the Glass–Steagall restrictions. In the event of a severe economic downturn, the federal guarantee of expanded bank activities would require a bailout of tremendous proportions.

B. Limits on Bank Branches. The McFadden Act of 1927[22] initiated another kind of limit on the business activity of banks, a restriction against free branching. National banks may establish branches only within the home state and only as extensively as state law permits state–chartered banks to branch. State banks may establish interstate branches only if a specific interstate agreement permits it. Bank holding companies may not acquire a bank in another state unless the laws of the second state specifically authorize the acquisition.[23]

Some recent liberalization of geographic restrictions on banks has occurred. For instance, some states have eased restrictions on branching and interstate banking. Federal regulatory authorities have offered interstate branching opportunities as an incentive to banks acquiring failing thrift institutions. To a great extent, however, the old prohibitions on branching remain in effect.

Bankers, particularly those from large banks, argue against the geographic constraints of the McFadden Act and Douglas Amendment. They argue that geographic constraints cause the American banking business to be less efficient and more fragmented than would otherwise be the case. Defenders of geographic restraints, including small regional banks, fear that repeal of the McFadden Act would cause industry consolidation into fewer but larger banks, and that small businesses and community institutions would be less well served.

4. Vaughn and Hill: A Strict Approach to Regulation

Vaughn and Hill find relatively little value in the previously discussed regulatory reform proposals that would permit an expanded scope of activity to banks. Vaughn and Hill are cynical about the claimed benefits of repeal of the McFadden, Glass–Steagall, and the Bank Holding Acts. "On balance, repealing these three laws appears to offer modest gains for both banks and consumers, though such benefits would remain mainly a sideshow to the main issues facing American banking.... The banking debate is not about how to save the banking industry. American banks are among the best in the world: well capitalized, well run, and highly profitable. The banking debate is what to do about the 1,179 dead and dying banks, and the 1,492 crippled banks, that together manage more than a third of all banking assets."[24]

Vaughn and Hill focus on new regulatory steps to force banks to high levels of solvency. Their attention is on the moral hazard problem of bankers engaging in risky investment behavior in reliance on the government safety net as a means for avoiding failure. They recommend steps that would close insolvent banks and limit bank access to deposit insurance. The regulatory steps Vaughn and Hill advocate would avoid putting great stress on government–provided deposit insurance, and would make the Federal Deposit Insurance Corporation successful without recourse to taxpayer bailouts. "If commercial bank losses are to be stopped, reform of the deposit insurance system is essential. While drastic reforms would be best...more modest reforms—such as adjusting premiums to reflect risk better or boosting capital requirements—are the only game in town."[25]

5. Litan's and Pierce's Tailored Approaches to Regulation

This article has discussed proposals to eliminate Glass–Steagall firewalls and McFadden geographic constraints, as well as proposals for stricter regulation to assure bank solvency. Another kind of proposal involves tailored bank reform, as discussed in Litan's *What Should Banks Do?*[26] and Pierce's *The Future of Banking*.[27] The premise of the tailored regulatory proposals is that government regulation should be narrowly applied only where needed to address a serious problem not solvable by ordinary free market mechanisms. Application of that premise depends on one's point of view. A socialist skeptical of free market solutions will be quicker to find a need for a governmental solution than a strong free market advocate.

Both Litan and Pierce accept government provided insurance as a desirable goal, and the idea that government regulation is needed to deal with the moral hazard problem of bankers taking great risk in reliance on government–provided safety net arrangements that make failure unlikely. Litan and Pierce suggest regulations narrowly drawn to meet those goals, so that bankers' freedom to take business risks is not unnecessarily interfered with.

Litan advocates a regulatory reform approach that would continue the concept of government insured deposits, yet permit bankers the expanded field of activity they want "[F]inancial conglomerates that choose to offer banking services would be required to organize...by separating deposit taking from lending activities. Specifically, this approach would authorize the creation of new 'financial holding companies' (FHCs), which would be free to engage through separate subsidiaries in *any* activity, financial or non–financial," subject to certain restrictions.[28] The restrictions are that the "banks" in FHCs would be required to operate as insured money market funds, accepting deposits and investing only in highly liquid safe securities. Financial holding companies could extend loans, but only through separately incorporated subsidiaries wholly funded by uninsured liabilities and equity. Only the "narrow banks" would have access to the Federal Reserve payment system as a source of funding.[29]

Pierce endorses a similar narrow bank concept. Under Pierce's plan, monetary services such as federally insured accounts payable on demand, checking accounts, electronic fund transfer, payment, and similar services, are provided by separately capitalized monetary service companies within the bank structure. Monetary companies are limited to holding only safe assets. These specialized companies cannot make loans. Thus, monetary activities are isolated from all others within banks. All activities other than those of monetary service companies would be placed in financial service companies, which would be separate entities that could exist within a bank's conglomerate corporate structure. The financial service companies would operate essentially without federal firewall, geographic limit, or any other regulation of the nature and scope of business.[30]

6. Congress' Solution: The Federal Deposit Insurance Corporation Improvements Act of 1991

By the time the Vaughn and Hill book was published, the Federal Deposit Insurance Corporation Improvements Act of 1991 (FDICIA)[31] went into effect. The FDICIA to some extent matches the strict regulation approach suggested by Vaughn and Hill. As explained by Kaufman and Litan in the introduction to their 1993 work *Assessing Bank Reform*,[32] with the FDICIA Congress enacted a "new capital–based system of early regulatory intervention to reduce the cost of failures to the FDIC, together with $30 billion in borrowing authority for the FDIC, while adding a variety of additional regulatory provisions [intended] to protect consumers and to better ensure the safety and soundness of banks."[33] However, it seems unlikely that the high degree of regulatory action advocated by Vaughn and Hill is met by the level of current enforcement of the FDICIA.

7. Comments of Participants in the Conference on the FDICIA

Assessing Bank Reform reports on a conference of scholars, policymakers, and private sector people who discussed the 1991 FDICIA and the future of the United States banking industry.

With regard to financial soundness of banks, a number of participants in the

FDICIA conference reinforce the notion that not too much comfort should be taken from the small number of recent bank failures. William Haraf of Citicorp argues that recent strong bank industry profits are largely the result of a favorable interest rate and improvement in the economy. Haraf believes that the continuing decline in bank intermediation functions and the regulatory burdens of FDICIA and other statutes will further shrink the banking industry.[34] David Mullins, of the Board of Governors of the Federal Reserve System, suggested that "all is not well when roughly 15 percent of the [banking] industry's assets—half a trillion dollars—is in troubled institutions."[35] Edward Kane, of Boston College, ominously points out that many banks are "deeply economically insolvent, even though their accounting ratios are not yet desperate enough to force federal regulators to demand recapitalization or to impose other mandatory disciplines." Kane explains: "The electorate must understand that there could only have been a surprise [involving many bank failures] this December [1992] if it came from the policies of the new President and the new Congress. It could not come from the tangible capital trigger set by the FDICIA. Scheduling a life–and–death exam one year ahead and making the right answer to the test question known in advance gave zombie [banking] firms ample opportunity to cram effectively for the test."[36]

The 1993 Litan–Kaufman book contains many references to the real politics of bank reform. Robert Glauber, former undersecretary of the treasury, explains that "powerful forces" were arrayed when Congress considered broad bank reform legislation supported by the Bush administration. That legislation would have permitted expanded bank powers and branching. "First and foremost, the [proposed] structural changes were viewed as deregulation, which many saw as having caused the S&L debacle.... Second, the chairmen of both Senate and House banking committees wanted a 'narrow' bill.... And finally there were the industry lobbies: the powerful securities and insurance lobbies opposed to reform.... [T]he strongest industry group supporting the administration [reform] legislation was the Financial Services Council..., (Ford, Citicorp, American Express, Sears, Bankers Trust, John Hancock, among others)."[37]

Conclusion

Consumers of bank services, taxpayers, and citizens are capable of intelligently considering regulation issues raised by the reported financial difficulties of banks, even without prior background in bank regulation. A goal of this article has been to demonstrate that the issues are comprehensible. The books discussed provide accessible discussions of the issues. They teach that it is quite plausible that many banks are having financial difficulties, and that the range of possible responsive regulatory reforms runs from broad deregulation to rigorous new regulation of banks.

In evaluating which regulatory solutions are best, it is important to keep in mind that the current United States regulatory scheme involves government deposit insurance and other "safety net" protections of bank stability. They are balanced by government restrictions that limit risky activity by bankers in reliance on the government safety net. Each of the regulatory proposals advocated in the books respect that regulatory balance.

The Litan–Pierce proposals are not panaceas. The proposals do not purport to address all the regulatory issues of banking, including such issues as how the Federal Reserve Board should deal with its monetary duties in a period of banking decline, and how the government should deal with possible credit problems of small and medium sized businesses. In addition, it is likely that the need for regulation cannot be entirely contained within the "narrow" banks Litan and Pierce propose: the less regulated "broad" banks will remain capable of mischief requiring government intervention to protect the consuming public. Nevertheless, the proposals are instructive in suggesting how to focus bank regulation so that it is efficient and addresses well defined problems.

It is hard to avoid the conclusion that the regulatory solutions that are best are those most likely to achieve well–defined and important public policy goals with minimum burden on bank consumers, taxpayers, and the banks. Applying this standard, the tailored approaches of Litan and Pierce have much to recommend them. They provide strong protection of the security of the deposits of bank customers, but put little burden on government deposit insurance and few constraints on banks. Both government support of important banking functions and government limitation of banking endeavors is achieved at relatively low cost.

ENDNOTES

[1] *See, e.g.*, Michael Arndt, *Bank Crisis Could Greet New Administration*, Chicago Tribune, October 18, 1992 at 1.

[2] Roger Vaughn and Edward Hill, Banking on the Brink at vii (1992).

[3] In the months following December of 1992 the number of bank closures was not greater than in prior months. Martha L. Ellett, *1993 Agenda Reflects Concern Over Laws Passed Last Year*, The Magazine of Bank Management, February 1993 at 8.

[4] Barbara A. Rehm, *Policymakers Renewing the Call for Overhaul of Bank Regulations*, American Banker, February 17, 1994 at 2.

[5] Susan Stangenes, *"Set Banks Free" Greenspan Says*, Chicago Tribune, May 13, 1994, Business Section at 1.

[6] *See* 12 U.S.C.A. §§ 1811–1834b (West 1990) (providing "[t]here is created a Federal Deposit Insurance Corporation...which shall insure...the deposits of all banks and savings associations which are entitled to the benefits of insurance under this chapter [Chapter 16]."). The Federal Deposit Insurance

Corporation was originally created in 1933.

[7]Moral hazard concepts explain why, for example, a property owner with building insurance might consider building on ocean front property while an uninsured person would decline the risk.

[8]This article focuses on the perceived need to maintain a stable and profitable banking industry in order to avoid the stress on the government system of deposit insurance and possible drain of U.S. Treasury assets. Additional reasons often suggested for special "safety net" regulatory support to banking involve preservation of important banking functions such as (1) service to bank depositors, (2) aid to the government as it carries out monetary policies that affect cost of funds to borrowers, and (3) loans to businesses that would otherwise have greater difficulty obtaining loans.

[9]The statutes concerning the Federal Reserve System are found at 12 U.S.C.A. §§ 221-531 (West 1990 & Supp. 1994). The board of directors of the Federal Reserve Board may "extend to each member bank such discounts, advancements, and accommodations as may be safely and reasonably made with due regard for the claims and demands of other member banks, the maintenance of sound credit conditions, and the accommodation of commerce, industry, and agriculture." 12 U.S.C.A. § 301 (West 1990).

[10]Charter requirements for new banks may be set by both State and United States government authorities. Until at least the 1960s the U.S. Comptroller of the Currency frequently used statutory authority to refuse bank charters on the grounds of resulting excessive competition that would disserve "convenience and needs of the community." The statute concerning charter granting is found at 12 U.S.C.A. § 27 (West 1990). Although the language of that section does not directly address problems of "excessive" competition, the Comptroller's authority to deny bank charters because of perceived excessive competition was upheld in cases interpreting 12 U.S.C.A. § 27. *E.g.*, City National Bank v. Smith, 513 F.2d 479 (2d Cir. 1975).

[11]Until the 1970s the banks had a practical monopoly on demand deposits, and the benefit of legal requirements that prohibited payment of substantial interest amounts to depositors by banks to prevent excessive competition. These requirements were dropped in 1980 after competition against banks had arisen for deposits. In recent years banks have needed to compete for funds by paying more interest on deposits and by obtaining funds on the open market.

[12]The "too big to fail policy" refers to regulators' tendency to avoid widespread financial disruption from the failure of a large bank by arranging for its sale to solvent banks, or, sometimes, recapitalization of the failing bank. In contrast, regulators more frequently simply close small failing banks and pay off their depositors, since less financial disruption is at stake. The 1991 FDICIA calls for early government intervention in the affairs of struggling banks, and is intended to reduce application of a "too big to fail" policy. Most observers believe the "too big to fail" policy will continue to some extent.

[13]"Only 30 percent of all bank loans are to commercial and industrial borrowers. Of the more than $3 trillion of assets held by banks, only $609 billion, or 18 percent, is devoted to the kind of business lending that historically made banks special." JAMES PIERCE, THE FUTURE OF BANKING 80 (1991).

[14]ROGER VAUGHN AND EDWARD HILL, BANKING ON THE BRINK 5 (1992).

[15]*Id.* at 9. *See also id.* at 99.

[16]Expanded bank powers in both the securities area and free bank branching area were rejected by Congress in 1991. At this time, Congress is considering legislation to liberalize bank branching restrictions. Passage is considered likely by many. Robert M. Garsson, *Clinton May Get Branching Legislation by Memorial Day*, AMERICAN BANKER, May 2, 1994 at 1. Similar consideration for expanded bank powers concerning securities is unlikely.

[17]For example, banks can only trade stock and securities on its customers' order and account. 12 U.S.C.A. § 24 (West 1990). No director, officer, or employee of a securities business may be a director, officer, or employee of a bank. 12 U.S.C.A. § 78 (West 1990). Participants in the securities industry are ineligible to participate in banking. 12 U.S.C.A. § 378(a) (West 1990). State banks are subject to the stock and securities restrictions of 12 U.S.C.A. § 24. 12 U.S.C.A. § 377 (West 1990).

[18]The Bank Holding Company Act was amended to close a loophole in the Act that seemed to permit a special one–bank category of holding companies the power to engage in securities dealings. Congress closed this apparent loophole by means of the Bank Holding Company Amendments Act of 1970, 12 U.S.C.A. § 1843(c)(8) (West 1990), which instructed the Federal Reserve Board to limit bank holding companies to certain "proper" banking activities.

[19]Separately capitalized subsidiaries have been permitted to offer discount stock and bond brokerage services and engage in private placement of commercial paper. *See* Securities Indus. Ass'n v. Board of Governors of the Federal Reserve System, 468 U.S. 207, 216–21 (1984)(brokerage services); Securities Indus. Ass'n v. Board of Governors of the Federal Reserve System, 807 F.2d 1052, 1062 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987) (commercial paper).

[20]The permission extends to self underwriting by banks of interests in packages of loans originated by the bank and the "securitization" of other bank paper. *See* Securities Industry Ass'n v. Clarke, 885 F. 2d 1034 (2d Cir. 1989), *cert. denied*, 493 U.S. 1113 (1990).

[21]The Federal Reserve Board's Regulation K governs the foreign operations of U.S. banks. Generally, U.S. banks can engage in a broader array of securities activities abroad than at home. 12 C.F.R. § 211 (1994).

[22]12 U.S.C.A. §§ 36, 332 (West 1990) (limitations on state banks that are Federal Reserve Board members).

[23]12 U.S.C.A. § 1843(d) (West 1990).

[24]ROGER VAUGHN AND EDWARD HILL, BANKING ON THE BRINK 106 (1992).

[25]*Id.* at 75.

[26]ROBERT LITAN, WHAT SHOULD BANKS DO? (1987).

[27]JAMES PIERCE, THE FUTURE OF BANKING (1991).

[28]*Id.* at 164–65.

[29]*Id.* at 165–66.

[30]*See id.* at 131–148.

[31]The FDICIA implements many refinements to banking regulation laws. Insurance assistance to a troubled institution is to be carried out in the way that is least costly to the insurance fund. 12 U.S.C.A. § 1823(c)(4)(A) (West Supp. 1994). The "too big to fail" policy is tailored so that suspension of "least cost resolution" policies is permitted only when "systemic risk" of harm to the banking industry is found. 12 U.S.C.A. § 1823(c)(4)(G) (West Supp. 1994). Protection of uninsured depositors is prohibited. 12 U.S.C.A. § 1823(c) (West Supp. 1994). Federal Reserve discount window ad-

vances are restricted for undercapitalized institutions. 12 U.S.C.A. § 347b (West Supp. 1994). The federal banking agencies are each required to prescribe capital requirements for financial institutions, effective December 19, 1992. 12 U.S.C.A. § 1831o(c). Undercapitalized institutions are required to submit capital restoration plans. 12 U.S.C.A. § 1831o(e)(2)(A) (West Supp. 1994). The activities of undercapitalized institutions are restricted. 12 U.S.C.A. § 1831o(f)–(h) (West Supp. 1994).

[32] ASSESSING BANK REFORM (George G. Kaufman and Robert E. Litan eds., 1993).

[33] *Id.* at 2.

[34] *Id.* at 42–52.

[35] *Id.* at 91.

[36] *Id.* at 75.

[37] *Id.* at 36–38.