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THE DEPOSIT INSURANCE CONNECTION

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*** The views expressed in this article are solely those of the author, and should not be attributed to the Federal Reserve Bank of Dallas or the Federal Reserve System.**

Depository Institution Failures:
The Deposit Insurance Connection

Gerald P. O'Driscoll, Jr.*

Until comparatively recently, even economists generally favorable to unregulated markets have tended to accept the existing regulatory and safety-net systems for depository institutions. They did so on the theory that, in some relevant sense, banking is "special." And even those ill-disposed toward banking regulation endorsed federal insurance of deposits. For instance, in their monetary history of the United States, Friedman and Schwartz (1963, p.434) concluded that: "Federal insurance of bank deposits was the most important structural change in the banking system to result from the 1933 panic, and, indeed in our view, the structural change most conducive to monetary stability since state bank notes were taxed out of existence immediately after the Civil War."¹ Deposit insurance was, as it were, the government intervention that worked.

Endorsement of the existing deposit-insurance system invites, however, what I call the sophisticated argument supporting banking regulation. The argument begins with the standard moral hazard argument against charging a flat-rate premium for deposit insurance: it encourages bank managers to incur more risk in order to secure greater returns. As Kareken (1983, p. 198) phrases it, "unless insured banks are to be as risky as profit maximization dictates, they must, one way or another, be effectively regulated; they must, that is, be limited by regulation to appropriately risky balance sheets."²

The sophisticated argument for regulating banks is widely accepted: the incentives established by the deposit insurance system need

to be offset by regulation.³ Though the argument is widely accepted, I believe it is flawed both conceptually and historically. In what follows, I first examine why the argument seems so plausible. Next, I argue that, regardless of deposit-insurance reform, further deregulation would be stabilizing not destabilizing. Then I consider the case of the savings and loan industry, which seems to be an instance of deregulation gone bad. I conclude by examining some recent public policy proposals.

Banking: Structure and Stability

The Glass-Steagall Act

The same act that established federal deposit insurance also enacted a system of binding regulations on commercial banks. If they wanted to avail themselves of deposit insurance, banks would be required to adhere to the new rules. For member banks in the Federal Reserve System (a set comprising all national banks) there was no choice: all were required to join the FDIC. Certainly a superficial analysis of the Banking Act of 1933 supports the sophisticated argument for regulation. Moreover, on its own terms, the system worked well for three or four decades. Annual bank failures declined from triple-digit to double-digit to single-digit figures (Friedman and Schwartz [1963], p. 437.) During this period, Friedman and Schwartz's encomium seems merited.

It appears, then, that, during the period of low bank failures, regulation offset the incentives for risk taking generated by

single-premium deposit insurance. The Banking Act of 1933 can be viewed in an alternative light, however. The alternative approach views the legislation as having enacted a cartel-like arrangement in the financial services industry. The Banking Act artificially created three industries out of one emerging financial services industry: commercial banking, investment banking and savings (i.e., nonbank depository institutions).⁴ For quite a time, competition among the the three sets of players was largely intramural; for instance, commercial banks and investment banks did not play on a common field.

Each set of institutions gained something important in this market-segmenting scheme. Investment banks and brokers were big gainers because the major commercial bankers had become formidable competitors through the use of securities affiliates. Eugene Nelson White (1986, p.35) reports that national banks' securities business grew rapidly in the 1920s, so that in the peak year of 1931 there were 114 national bank affiliates and 123 conducting securities business in their bond departments. Additionally, many more traded securities and provided investment advice "on an occasional basis." According to White (1986, p.36), commercial banks widened the market for securities by heavily discounting standard brokerage fees. Commercial banks' fees were about one-fourth those of the New York brokerage commission, making them "the contemporary equivalents of 'discount brokers.'" In this competitive environment, the potential rents for investment bankers from excluding commercial banks are obvious.

The modal bank also stood to gain in the aftermath of the bloodbath in commercial banking. Deposit insurance offered the promise of

stabilizing the deposit base. Moreover, the modal bank was not deeply involved in the securities business. Most small bankers were probably happy to see the national banks lose their securities business. One would surmise that larger national banks would have viewed the Act with mixed feelings at best.⁵ They had the most to lose and they needed the deposit guaranty less than did the average bank. Still, the national banks were outnumbered.

In the unstable environment of the 1930s, a cartel-like scheme arguably stabilized demand for most firms in each sub-market. The Act abated competitive pressures and, most importantly, stanching deposit outflows. That the new law appeared attractive at the time does not seem surprising. In retrospect, it remains somewhat of a conundrum why it took so long to unravel. The stable, low interest-rate environment of the war and early postwar years surely played a role, as did the concomitant conservative behavior of commercial banks. On this issue, however, more work clearly needs to be done.

To recapitulate, in this subsection I have suggested that the Banking Act provided immediate stability through its guaranty of deposits and long-term stability through its abatement of competitive forces in the financial services industry. This explanation depends in no way on the contention that those activities prohibited to banks are categorically riskier than the provision of commercial loans. Indeed, I rebut that argument directly below. Before moving on, however, I analyze in more depth who gained among commercial banks. Answering this question also further illuminates the risk issue.

The Road Not Taken

Even in the midst of the 1933 banking crisis, some policymakers were acutely aware that market solutions existed. In the debate over the creation of the FDIC, the Comptroller of the Currency, John Pole, commented on the Banking Act of 1933: "I am in agreement with the ultimate purpose of this bill, namely, greater safety to the depositor. The method proposed by the bill and the principles which I advocate stand at opposite poles. A general guaranty of deposits is the very antithesis of branch banking."⁶ In other words, a competitive system of branched and diversified banks was proffered as a substitute for the restricted branching system found in most states at that time.

There was an historical model to support the Comptroller's position. In the aftermath of the 1907 panic, the California State legislature reacted by passing the most liberal branching law ever enacted in the United States (White [1983], p.196). The law led to a substantial increase in branching within the state, sparked by the rapid growth of A. P. Giannini's Bank of Italy (White [1983], p.160).

Most states did not follow California but many instead flirted with state deposit-guaranty systems. The two models -- branching freedom and deposit guaranty -- were alternative responses to achieving banking stability. White (1983, p.196) found that "branch banking and deposit insurance were incompatible. No state that permitted branch banking seriously entertained the idea of deposit insurance."

As successful as branch banking was, state guaranty funds -- then, as now -- were abject failures. The decline in agricultural prices in the 1920s led to bank failures in the West and the South. In 1923 a wave of bank failures in these regions crippled the voluntary systems (White [1983] p.217). By the end of the decade, even the compulsory systems were falling by the wayside. White (1983, p.218) concluded that "the agricultural depression wrecked the rest of the systems as liabilities of the guarantee funds greatly exceeded their assets."

On the eve of Glass-Steagall, "banking reformers were thus divided into two hostile camps, one bent on preserving, the other on eliminating unit banking" (White [1983], p. 197). The Comptroller backed branching. Representative Henry Steagall suffered no illusions about the purpose of the bill arguing that: "This bill will preserve independent dual banking in the United States...that is what the bill is intended to do".⁷ Then, as now, "independent dual banking" is a code-phrase for "unit banking." It rhetorically wraps a policy restricting competition in the garb of competition and decentralization.

The importance of understanding the origins of the Banking Act of 1933 is not merely historical but also analytical. An understanding reveals first what is being protected: the unit-banking system. Moreover, it clarifies the reasons why the era in which the Banking Act was effective was one of low bank failure. So long as the Act successfully held competitive financial forces in check, then so long could deposit insurance protect unit banks. It was not, then, that bank failures were reduced through having increased bank safety. Rather, by reducing competition

among financial institutions, the Banking Act held in check the restructuring of the financial services industry that has only now begun once again.

Unit bankers needed protection, of course, not only from nonbanks but from larger commercial banks. Had national banks been able to continue to exploit the complementarities of commercial and investment banking, the financial services industry would surely have been transformed.⁸ Diversified national banks would have grown at the expense of both investment banks and undiversified unit banks.

The restrictions on commercial banks' powers do not so much offset incentives for risk taking provided by deposit insurance as they reinforce the protection afforded to unit banks by deposit insurance. This interpretation turns the sophisticated argument for regulation on its head. If the interpretation is correct, then the existence of deposit insurance is not a reason to forgo deregulation of the asset side of banks' balance sheets. Indeed, given that competitive forces have upset the delicately crafted balance of the regulatory and safety-net systems, the case for deregulation is stronger than ever. In the next section, I develop the case in more depth by focusing on the benefits of asset diversification.

Deregulation: Assets or Liabilities?

The saga of the deregulation of banks' liabilities is by now well-known: inflationary forces, technological advances and financial

innovation combined to render obsolete the system of interest-rate controls on the liabilities of depository institutions.⁹ Liability deregulation was largely market-driven with regulatory changes reflecting lagged political responses to economic realities. More recently, barriers to interstate banking having been falling. This reflects a kind of geographical deregulation, one largely wrought at the state legislative level.

The system of regulations on bank powers, or, broadly speaking, on the composition of their portfolios, has proved more durable than regulations on either banks' liabilities or their branching powers. Fundamental change here must come in Congress. Accordingly, the prognosis for asset deregulation is not good. As the recent banking bill illustrates, competing interests in the financial services industry can block meaningful reform. Indeed, what begins as a deregulation bill can end as a bill to reregulate (England [1987], p. 7).

Correctly identifying what kind of deregulation has taken place is crucial for assessing the likely effects of further deregulation. The popular press is full of accounts that associate the new powers that banks have been given with recent problems in the industry. But commercial banks have been given no new asset powers. Banks experiencing earnings difficulties and capital shortfalls have arrived at this situation the old fashioned way -- by making bad loans. To the best of my knowledge, no commercial bank has failed in recent years other than by making bad loans.¹⁰

Far from being part of the current problem, asset deregulation is surely part of the future solution. Any asset would improve a bank's risk

standing, so long as the newly acquired asset represented portfolio diversification. Assume, hypothetically, that both the risk and returns from owning and operating a gaming casino were higher on average than for other bank assets, but the higher risk were uncorrelated with that of the other assets in the typical bank portfolio. In this case, informed public policy ought to permit banks to enter this line of activity. This conclusion is so far removed from conventional wisdom that I will defend it briefly.

Virtually the entire regulatory and supervisory system for banks is predicated on a categorical view of risk. Some activities, like equity investment in real estate or underwriting corporate securities, are inherently risky and must be denied banks. Other activities, like making commercial loans, are less risky and banks may be permitted to engage in these activities "prudently." Finally, some activities, like purchasing government bonds, are characterized by little risk and are to be encouraged.

The categorical view of risk is inconsistent with modern finance and economic theory, which focuses on portfolio risk. As in my casino example, an individual asset may experience a high variance in returns but the variance be uncorrelated with that of the remaining assets in the portfolio. If the asset also yields an above-average return, this makes it a candidate for inclusion in a bank's portfolio. While regulators look at the average risk of assets, portfolio managers correctly assess the marginal risk of adding an asset to their portfolios. Additions to portfolios of apparently risky assets can, in principle, reduce overall risk.

Granted that deposit insurance leads banks to incur greater risk than they would otherwise, it would still be beneficial to permit these depository institutions maximal freedom to diversify their investments.¹¹ The argument gains more empirical force when one examines some of the obvious candidates for expanded bank powers. I consider two: selling insurance and underwriting securities.

Permitting banks to sell insurance would generate fee income with little additional equity commitment from banks. In many cases, the activity could be conducted on existing bank premises. Earnings from selling (as opposed to underwriting) insurance are relatively stable (that is, they have a low beta relative to that of other assets in banks' portfolios). Texas savings and loans, who are permitted to engage in this activity, are using such fees as a safe income source in an era of loan losses and retrenchment in their traditional lines of business. Commercial banks would be well-served if they had such an option. The economic case for permitting banks to engage in this line of activity is fairly straightforward.

Underwriting securities is only a slightly more complex issue. Banks must commit equity capital to the activity. To the degree that they borrow capital, they are leveraged and incur additional risk. Once again, however, it is not the riskiness of underwriting securities but what engaging in this activity does to the overall probability of losses for a bank. Using a logit model, White (1986, p. 41) found that, historically, "the presence of a [security] affiliate seems to have reduced the probability of bank failure." Whereas 26.3 percent of all national banks

failed between 1930-33, only 6.5 percent of the 62 banks with affiliates in 1929 and 7.6 percent of the 145 banks with large securities operations conducted through their bond departments failed during this period (White [1986], p. 40). As the probability-of-failure results suggest, entering investment banking in the 1920s represented safe diversification for commercial banks. White (1986, pp. 44-45) found that adding a securities affiliate raised a commercial bank's rate of return substantially but increased the standard deviation of income only slightly.

There are many issues involved in establishing public policy with respect to banks' asset powers generally and with respect to the two specific activities cited here. I have not attempted an exhaustive analysis of all factors, economic and political.¹² Rather, my major purpose in this section was twofold. First, I countered the perception that commercial banks have gained significant new asset powers and that these have contributed to current banking problems. Second, I focused on the conceptual error in the existing regulatory system, which tries to categorize risk instead of to assess overall portfolio risk.

What I am suggesting is a reorientation of public policy toward bank powers. If, ceteris paribus, diversification is stabilizing, then policy ought to be encouraging it rather than denying banks the means of diversifying. Instead of worrying so much about what banks put into their portfolios, regulators should be more concerned with what banks are not putting in their portfolios (e.g., those assets tending to diversify risk).

The argument suggests a tentative, practical conclusion. If any part of the regulatory system has the capability, in principle, to assess

portfolio risk, it is the supervisory function. Properly trained, auditors could apply techniques to measure diversification and portfolio risk relative to some standard. From an economic perspective, this approach certainly seems preferable to assessing risk by category. Yet, as discussed in the final section, public policy is moving toward formalizing the categorizing of risk.

The next section examines the current basket case among depository institutions -- the "brain dead" savings and loans. This is an area in which expanded asset powers seem to have led to greater financial difficulties. As is so often the case, however, appearances can be deceptive.

The Thrift Crisis

The savings and loan industry is often pictured as an example of the perils of expanding asset powers for depository institutions. The suggestion is made that we cannot allow the banking industry to get into the predicament in which S&Ls now find themselves. And, certainly, an examination of industry balance sheets makes it appear that S&Ls, if not already given the powers to operate casinos, have certainly been at the gaming tables and lost heavily. Conditions have deteriorated even since the recent analysis by Kane (1987). Yet the conventional wisdom begs all the important questions.

First, expanded thrift powers cannot explain the thrift crisis as presently constituted. As Kane (1987) emphasizes, the critical problems

all derive from the existence of the living-dead S&Ls -- "zombies," in his colorful terminology. Betting the S&L on a high-risk strategy can certainly lead to failure. The unique problem in the thrift industry, however, stems from the continued activities of already failed institutions. Here the deposit-insurance connection is doubly relevant. First, the existence of deposit insurance provides incentives to S&L managers to take on added risk. Second, the guaranty insulates the managers from the unfortunate consequences of having acquired an excessively risky asset portfolio. Insolvent institutions can continue to bid for deposits and their equity shares command positive prices. As Kane (1985) asked: "How long could an underwater MSB [mutual savings bank] or S&L stay open for business if its deposit insurance were rendered inoperative?"

Second, concentration on the expansion of asset powers granted by the Garn-St Germain Depository Institutions Act of 1982 is beside the point for the single most affected segment of the S&L industry: Texas institutions. Texas S&Ls are in the vanguard of the industry's problems. Yet Garn-St Germain did nothing to enhance the powers of most Texas thrifts. In fact, the portion of Garn-St Germain dealing with S&Ls' asset powers was modelled after the statute that had governed state-chartered S&Ls since 1974. Indeed, investment powers of these state-chartered institutions still exceeded those of their federal counterparts after passage of Garn-St Germain (Brock 1983).¹³

As of the end of 1986, 59 out of 281 Texas S&Ls (representing 20.7 percent of total assets) had negative net worth, as measured by regulatory

accounting principles (RAP). Another 54 S&Ls (with 17.2 percent of total assets had positive net worth but capital below the 3 percent minimum.¹⁴ Regulatory accounting is extremely liberal, of course, and includes a good deal of fictitious value on the asset side. This is a lower-bound estimate of insolvency in the thrift industry. Moreover, conditions probably deteriorated significantly in the first quarter of 1987.¹⁵ Additionally, as this is being written, the capital-insolvency problem is evolving into one of possible cash-flow insolvency at some institutions.

If not expanded asset powers, then what explains the timing and magnitude of the problems experienced by Texas S&Ls? It appears to be a combination of three factors: (1) the historical evolution of the thrift industry; (2) the regulatory climate; and (3) the energy crisis.

It was only in the post Garn-St Germain era that most S&Ls were able to diversify away from their traditional business of issuing fixed-rate mortgages and garnering insured deposits to fund the mortgages. Though the nation's S&Ls gained significant new asset powers almost overnight, they did not instantly acquire the expertise or human capital to utilize the powers. In the short run, competence of existing management was a constraint. Indeed, many thrifts moved slowly to exploit their new powers and, in retrospect, those exhibiting caution may have been the best managed.

It is unfortunately true some that institutions moved all too quickly into the unfamiliar territory of making commercial and real-estate loans. This was especially true at large institutions adopting the strategy of "growing out" of their previous problem, which was

characterized by excessive exposure to interest-rate risk. This part of the story is particularly applicable to Texas' zombies. If Garn-St Germain affected Texas thrifts, it was through the enhancement of their liability powers (Brock 1983). It enabled them to fuel their rapid growth strategy that has culminated in the bust phase of the current boom-bust cycle.

The new managers at Texas thrifts had learned a lesson: never fill up an investment portfolio with fixed-rate mortgages. Unfortunately, the managers learned the wrong lesson. It is not writing fixed-rate mortgages that constituted S&Ls' former problem. Rather, the problem consisted in overconcentrating their portfolios in one asset category and failing to match assets and liability maturities. Instead of using the new liability powers to build a diversified asset portfolio, the new breed of S&L manager went headlong into funding real-estate development. And it was dubious real-estate development at that, including, perhaps, questionable transactions.¹⁶

Adaptation to change, be it environmental or economic, is an evolutionary process (Nelson and Winter 1982). Some species never learn to adapt. The approximately thirty percent of the S&L industry that is now in deep water appears to fit the description of an economic dinosaur. Having lived only in an environment of concentrated asset portfolios, it knew no other. Faced with a changed environment, these S&Ls gravitated to a habitat much like the old one: an undiversified asset portfolio. In the process, their portfolios grew rapidly and, beginning in 1983, negative interest-rate spreads had been transformed into asset-quality problems (Barth, et al. 1985).

Kane (1987) emphasizes the regulatory climate, especially the fact that the FSLIC exercised too much discretion in forbearing on capital standards. I have little to add to his account. Forbearance not only sanctions previous conduct but invites more of the same. Deposit insurance, which represents an implicit federal guaranty to underwrite losses, funds the continued operation of zombies. It does so, moreover, at the expense of solvent and conservatively managed institutions, who are compelled to bid for funds in competition with zombies. The latter bid up the cost of funds in a never-ending quest to grow out of ever-increasing losses.

Finally, there is the energy crisis about which so much has been made. The U.S. League of Savings Institutions maintains that external economic conditions, not fraud or mismanagement, are responsible for most S&L problems. Certainly there has been another supply shock in energy and one would expect that this would have affected the portion of S&L portfolios particularly exposed to this sector. And the shock constitutes a possible explanation of why the crisis hit Texas institutions earlier and with more force.¹⁷ It does not explain, however, how the portfolios of Texas thrifts (much less California institutions) came to be so concentrated in speculative real-estate that their existence would be threatened by the shock. And, more to the point, it does not explain how zombie institutions continue operating. Once again, the deposit-insurance connection provides the answer.

Public Policy: Prospects and Pitfalls

The financial services industry has shown a remarkable capacity to circumvent regulatory straightjackets. This includes innovating new products, like money-market funds; inventing new institutional forms, like the nonbank bank; and finding ways -- including lobbying state legislatures -- to break down geographical barriers. Restrictions on banking activity remain the last clear obstacle to developing a competitive and sound banking system in the U.S. These restrictions are likely to prove less amenable to circumvention (O'Driscoll 1987).

The intellectual climate has never been so favorable to arguments both for deregulating depository institutions and for implementing deposit-insurance reform. In some ways, however, the public policy environment is becoming less hospitable. Instead of further deregulating depository institutions, Congress tightened loopholes. Among other actions, it closed the nonbank-bank loophole without addressing the reasons why this institution had emerged (England 1987). The Board of Governors, in cooperation with the Bank of England, is proposing a system of risk-based capital standards that would formalize categorical assessment of risk. And Congress appears intent on privatizing the FSLIC's deficit by requiring solvent S&Ls to bail out the insolvent ones. Whatever the merits of relying on the industry as much as possible in fashioning a solution, the deficit as a whole cannot be privatized. The income and assets of the solvent part of the industry are insufficient to resolve the zombie problem. To insist on a purely private solution is to insure that there

will continue to be insufficient resources devoted to the FSLIC. And so long as that is the case, the zombie problem will be with us. And if the zombies flourish, they will eventually suck the life from the remainder of the industry (Kane 1987). We need to a fashion a public policy that allows the expeditious closing of economically insolvent institutions in order to preserve the sound ones. Then, but only then, we will have a safe and sound financial system.

Notes

*Assistant vice president and senior economist at the Federal Reserve Bank of Dallas. The views expressed in this paper are mine alone and should not be construed as representing the official position of any part of the Federal Reserve system. The paper was presented at the 62nd Annual Western Economic Association International Conference, Vancouver, B.C., July 1987. I would like to acknowledge the helpful comments of Edward J. Kane and Robert T. Clair.

¹Schwartz (1984, pp.205, 209) reassesses her earlier position.

²He does not endorse the present regulatory system in its entirety; he specifically questions geographical restrictions imposed by the McFadden Act and the Douglas Amendment to the Bank Holding Company Act.

³I have lent credence to the argument in my own work. For example, see Garrison, Short and O'Driscoll (1987); but also see the caveats in O'Driscoll (1987).

⁴I have included traditional brokerage services under investment banking.

⁵White (1986, p. 39) says that the 1932 draft of the Act "met with strong opposition from the banks, the Federal Reserve Board, the Treasury Department and the White House." He does not amplify on the grounds of opposition from each group.

⁶Cited in White (1983, p. 197).

⁷Cited in White (1983, p. 197); emphasis added.

⁸I discuss these complementarities in the next section.

⁹See O'Driscoll (1985, p. 5) for a conventional chronicle of deposit deregulation. Merris and Wood (1985, p. 69) question the account, pointing out that recent financial innovations "almost entirely ... represent returns to practices that were well-established by the 1920s or the resumption of trends that were underway in that decade but were interrupted by the Great Depression and World War II." The decade of the 1920s was one of price stability not inflation and, obviously, differed radically in its available technology. The story of financial innovation in the last quarter century does need to be reexamined.

¹⁰In the 1970s, First Pennsylvania Corp. required FDIC assistance because of losses experienced on its bond portfolio. First Pennsy bet the bank on declining interest rates but rates rose. The story is unusual, but purchasing bonds is, once again, an example of approved, old fashioned banking activity.

- 11 One obvious caveat is relevant. A depository institution may become riskier by concentrating its portfolio. In other words, the institution may adopt a "shoot the moon" strategy. When permitted to branch freely, however, commercial banks do not appear to find this an attractive strategy. (For evidence on this point with respect to agricultural lending, see Smith [1987].) A segment of the savings and loan industry does appear to have adopted the strategy. But see the text, below, for a discussion of problems in the thrift industry. In any case, observing that a bank may not use its freedom to diversify does not constitute a reason to deny them the ability to do so.
- 12 White (1986) considers a number of other factors, including alleged abuses by securities affiliates of commercial banks.
- 13 In mid-1983, 231 of the 284 Texas S&Ls were state chartered and these institutions had 80 percent of industry assets (Brock 1983).
- 14 Bert Ely supplied both the data and the calculations.
- 15 This assessment reflects the losses that accrued in the first quarter of 1987. Losses, of course, erode capital.
- 16 The role of alleged fraud and abuse in current S&L problems is receiving increased attention. See, for instance, "Extensive Misconduct Seen in Calif. S&Ls," Washington Post, June 13, 1987; and "FBI Bolsters Effort Against Fraud in Texas Banks," Wall Street Journal, June 18, 1987.
- 17 Whatever the plausibility of the League's position on problems at Texas thrifts, it is incomprehensible as an explanation of problems at California S&Ls. The California economy, the envy of the rest of the nation, is booming and has been throughout the recovery.

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