The Current State of Banking Reform

by
George G. Kaufman*

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*Loyola University of Chicago

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Banking reform, or changes in banking regulations because of dissatisfaction with existing regulations, has been on the political agenda since the earliest days of the United States. This reflects a number of factors, including:

- Banking is an old industry that has existed throughout U.S. history;
- Banking has always been under some government regulation and control;
- Banks provide a large part of the country's money supply, changes in which affect economic welfare importantly and are viewed as a government responsibility;
- Banks have periodically performed poorly causing large losses to depositors, disruptions to borrowers, and societal damage;
- Banks are the single largest supplier of total credit to the economy and also the largest supplier of credit to a

number of important individual sectors and perceived to have the power to "make or break" households and business firms in need of credit; and

- Widespread fear of excessive economic power by banks.

Indeed, in some early years of U.S. history, banking was an important and emotional political issue; e.g., the chartering and subsequent termination of the First and Second Banks of the United States. The large number of bank and thrift institution failures in recent years with large losses to some large depositors, solvent institutions and, in the case of the thrift institutions, the taxpayers has brought banking reform to the front burners of the political agenda in the late 1980s and early 1990s. Because banking deals largely with intangibles and is highly technical, it is not well-understood by the general public. Except in periods of crisis, the public is generally willing to delegate the formulation of public policy towards banking to experts. As a result, banking reform frequently becomes the provence of bankers themselves and their government regulators.

Public policy towards banking, like public policy towards any other sector or issue, reflects the primary public concerns at the time. As the public's concerns change, so does public policy. Thus, in the early days of the U.S., public concern about banking focused on the fear of excessive economic power. This resulted in restrictions on the products and services banks may offer and, in many states, on their ability to branch. What easier way to restrict bank size than to restrict the number of offices and product line. In 1933, public concern focused on the large number of bank failures with losses to a large number of depositors and serious disruptions to loan customers. In response, the federal government imposed additional restrictions on bank activities perceived to be risky and introduced government insurance (guaranty) on some deposits.

In the early 1980's, the combination of high and volatile interest rates and advances in computer and telecommunications technology provided both the reason and the means for bypassing price restrictions on bank deposits and permitted nonbanks to offer traditionally exclusive banking services. The sharp increase in interest rates also drove almost the entire S & L industry, which had financed its long-term loans primarily with short-term deposits, into economic insolvency. As a result, public concern focused on the inefficiency and the threat to the viability of the banking system from excessive regulation, which was interfering with market forces. Government responded by reducing restrictive regulations, particularly on thrift institutions. In the later 1980s, the large losses associated with the large number of bank and thrift failures, a major part of which was borne by the taxpayers, shifted public concern to reducing the future cost of failure to the taxpayer. This implied deposit insurance reform.

This paper reviews bank reform in the sixty years since the Banking (Glass-Steagall) Act of 1933, and speculates on the likelihood and direction of further reform in the near future.

I

Background

With rare exception, the Banking Act of 1933 significantly increased restrictions on bank activities in an attempt to increase bank safety and soundness. Among other things, the Act:

- Prohibited interest payments on demand deposits;
- Limited interest payments on time deposits;
- Restricted bank underwriting of and trading in private and some municipal securities;
- Introduced margin requirements on bank financed security purchases;
- Restricted entry by new banks;
- Introduced federal deposit insurance; and
- Liberalized national bank branching restrictions within state boundaries.

Following its enactment, the rate of bank failures dropped to nearly zero and the banking and thrift industries recovered first slowly through the 1930s and then more rapidly in the post-World War II period. But the thrust of public policy, particularly at the federal level, continued restrictive. The Bank Holding Company Act of 1956 both increased the separation of banking and commercial by expanding it to holding companies that owned two or more banks and restricted bank holding companies from circumventing the prohibition on interstate branching by expanding across state lines through establishing full-service bank subsidiaries. The Bank Merger Act of 1960 reinforced the anti-competitiveness criteria for bank mergers. Amendments to the Bank Holding Company Act in 1970 further expanded the separation of banking and commerce to holding companies that owned only one bank.

At the same time, however, a successive series of major government and private commissions -- e.g., the Commission on Money and Credit, 1961; the Advisory Committee on Banking to the Comptroller of the Currency (Saxon Committee) 1962; the President's Committee on Financial Institutions (Heller Committee), 1963; the President's Commission on Financial Structure and Regulation (Hunt Commission), 1971; the Federal Institutions and the Nation's Economy (FINE) Study, 1975; and the Vice President's Task Group on Regulation of Financial Services Commission (Bush Commission), 1984 -- that analyzed the performance, structure, and regulation of banking and depository institutions all concluded that banks were overregulated and recommended liberalization of the restrictions on product and geographic powers, particularly for thrift institutions, and the elimination of restrictions or interest payments on, at least, time deposits. These studies laid the groundwork for the deregulation of the early 1980s.[1] But reform of regulations generally requires more dramatic causes than recommendations of a commission alone, no matter how prestigious the commission. The remainder of this paper reviews the changes in

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[1]. For a review of the contribution of these studies to financial reform see Sidney L. Jones, The Development of Economic Policy: Financial Institution Reform, Ann Arbor, MI: University of Michigan, 1979 and Thomas R. Saving et.al., "Toward a More Competitive Financial Sector" and following articles, Journal of Money, Credit and Banking, November 1972, pp. 897-1009.

bank and, to a lesser extent, thrift regulation since 1980 in three areas:

- Deposit insurance
- Powers -- product, geographic, and price, and
- Regulatory agency structure

II

Deposit Insurance Reform

Since 1933, government deposit insurance was the last banking reform to be recommended, but the first to be seriously overhauled by federal legislation. For many years, the introduction of federal deposit insurance was viewed as one of the major banking reforms in history. For example, in their seminal, A Monetary History of the United States: 1967-1960, Friedman and Schwartz, not known as great lovers of government intervention, highlight the contribution of the FDIC in achieving what had been a major objective of banking reform for at least a century, namely, the prevention of bank panics, and in reducing bank failures and depositor losses.[2] But the large losses to the insurance funds associated with the bank and thrift failures in the 1980s produced an abrupt change in opinion. By the late 1980s, the extant structure of deposit insurance was viewed as a major culprit of the debacle. The bad side of deposit insurance had surfaced.

This should not have been a surprise. Reviews of the debate

[2]. Milton Friedman and Anna J. Schwartz, A Monetary History of the United States, 1867-1960, Princeton, N.J.: Princeton University Press, 1963, pp. 11, 437, 440.

surrounding the enactment of federal deposit insurance in 1932 and 1933 clearly show that most participants, including many of the legislative sponsors, bankers, and the Roosevelt Administration, were keenly aware of the perverse incentive and moral hazard problems associated with misstructured deposit insurance.[3] The evidence both from the numerous state deposit insurance plans throughout U.S. history and from private life, casualty, and property insurance companies clearly demonstrated the importance of these potential dangers. Most supporters viewed deposit insurance as the right political solution in 1933, not necessarily the right economic solution.

History of Federal Deposit Insurance

In the Great Depression, the U.S. was traumatized by the bank failure crisis and demanded quick action by the new Roosevelt Administration and the Congress. Politically, this was not a time for emphasizing the longer-term drawbacks of proposed policies nor for calls for further study. The public only rewarded action. Numerous Congressmen had pet reform proposals that they had been unable to enact in previous sessions. These included many of the components of the Banking Act of 1933. Indeed, some 150 proposals

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[3]. Mark D. Flood, "The Great Deposit Insurance Debate," Review (Federal Reserve Bank of St. Louis), July/August 1992, pp. 51-77; James R. Barth, John J. Feid, Gabriel Riedal, and H. Hampton Tunis, "Alternative Federal Deposit Insurance Regimes" in U.S. Senate Committee on Banking, Housing and Urban Affairs, Problems of the Federal Savings and Loan Insurance Corporation: Hearings, Washington, D.C.: 101st Cong., 1st Sess., Part IV, 1989; and Charles W. Calomiris, "Getting the Incentives Right in the Current Deposit-Insurance System: Successes From the Pre-FDIC Era" in James R. Barth and R. Dan Brumbaugh, Jr., eds., The Reform of Federal Deposit Insurance, HarperBusiness, 1992, pp. 13-35.

for federal deposit insurance or guaranty had been introduced in Congress between 1886 and 1933.[4] Spurred by the public's demand for action, supporters of many of these projects were able to horsetrade sufficient votes to ensure passage of the omnibus Banking Act in the first 100 days of the new Congress.[5]

The deposit insurance program enacted for commercial banks reflected the designers' familiarity with the potential pitfalls of such plans. Two insurance plans were included in the Banking Act, a temporary plan through July 1, 1933 and a permanent plan thereafter. The temporary plan called for full insurance coverage up to $2,500 per account, which included 97 percent of all accounts and 24 percent of all deposits and flat premiums of 0.5 percent of insured deposits, with a provision for an extra assessment if necessary. The permanent plan called for graduated account coverage -- 100 percent up to $10,000, 75 percent for the next $40,000, and 50 percent for amounts in excess of $50,000. The permanent premium structure was a flat 0.5 percent of total deposits, which shifted much of the cost to larger banks, again with a provision for extra assessments if necessary. Proposals for 100 percent account coverage were defeated. However, the permanent plan was never put in operation. The temporary plan was extended in 1934 through mid-1935, with an increase in account coverage to

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[4]. Federal Deposit Insurance Corporation, The First Fifty Years, Washington, D.C., 1984, p. 29.

[5]. A similar deposit insurance plan for savings and loan associations under FSLIC was enacted in 1934, both to maintain equality between banks and S & Ls and to protect the flow of funds into home buying.

$5,000 and then enacted permanently in the Banking Act of 1935. The premiums were reduced to 1/12 of 1 percent, with a provision for rebating surpluses.

From the late 1930s through the early 1950s, the FDIC resolved almost all insolvencies through purchase and assumptions in which an acquiring bank purchased the good assets of a failed bank, assumed all of its deposits, and received cash from the FDIC for any difference. Uninsured as well as insured depositors were fully protected. In 1957, as it would again 30 years later, Congress questioned this procedure and the FDIC agreed to choose between assumption and payoff resolutions, including not protecting uninsured depositors, on the basis of lower cost.[6] Because of the widespread satisfaction with insurance in nearly eliminating bank runs and failures as well as most depositor losses, account coverage was increased to $10,000 in 1950, $15,000 in 1966, $20,000 in 1969, $40,000 in 1974, and finally $100,000 in the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980.

With the resolution of the Continental Illinois National Bank in 1984, the seventh largest bank in the country at the time, the FDIC reverted to its old policy of protecting all depositors. But the rationale was changed to protecting against systemic or spillover risk from the failure of a large money center bank, particularly if it was also an important correspondent bank or a bank considered "too big to fail." This rationale was quickly

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[6]. FDIC, pp. 86-87.

expanded to banks considered "too important to fail" and even to "too political to fail," in the protection of all depositors at the National Bank of Washington, the 250th largest bank in the country.[7] The losses to the FDIC from these policies were enlarged further by a policy of forbearance in which economically insolvent banks were not resolved for many months after they first were identified as seriously troubled institutions by examiners.[8] The FDIC did this both in the hopes that the banks would recover and because it did not have sufficient cash to pay off the depositors or an acquiring bank. Forbearance was particularly costly for the FSLIC and ultimately the taxpayers in the S & L debacle.[9]

History of Deposit Insurance Reform

Deposit insurance reform proposals effectively began with the publication in 1965 of an argument for risk-based insurance premiums over flat percent of deposit premiums by Thomas Mayer[10]

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[7]. George G. Kaufman, "Lender of Last Resort, Too Large To Fail, and Deposit Insurance Reform" in James R. Barth and R. Dan Brumbaugh, Jr., eds., The Reform of Federal Deposit Insurance, HarperBusiness, 1992, pp. 256-257.

[8]. James R. Barth, R. Dan Brumbaugh, Jr., and Robert Litan, The Future of American Banking, Armonk, NY: M. E. Sharpe, 1992, pp. 110-113.

[9]. James R. Barth and Philip F. Bartholomew, "The Thrift Industry Crisis: Revealed Weaknesses in the Federal Deposit Insurance System," in James R. Barth and R. Dan Brumbaugh Jr., eds., The Reform of Deposit Insurance, HarperBusiness, 1992, pp. 36-116 and Edward J. Kane, The S & L Insurance Mess, Washington, D.C.: Urban Institute Press, 1989.

[10]. Thomas Mayer, "A Graduated Deposit Insurance Plan," Review of Economics and Statistics, February 1965, pp. 114-116. See also Thomas Mayer and Kenneth Scott, "Risk and Regulation in Banking," Stanford Law Review, May 1971, pp. 857-402.

In the 1980s, this proposal was joined first by proposals to reduce insurance coverage sharply, to replace government insurance with private insurance or a system of bank cross-guarantees, and to restrict insured deposits to "narrow banks" that would invest only in safe assets. In the late 1980s, a plan was developed that would make deposit insurance effectively redundant by requiring earlier and progressively harsher and more mandatory structured intervention by regulators in the affairs of troubled institutions as their performance declines and resolving the institutions before their capital is fully depleted. Thus, at least in theory, there would be fewer bank failures and small, if any, losses to uninsured depositors or the FDIC when banks did fail. This plan, entitled Structured Early Intervention and Resolution (SEIR) was first developed by George Benston and George Kaufman for the American Enterprise Institute in 1988 and refined by both the Shadow Financial Regulatory Committee and a Brookings Institution Task Force on Financial Institutions Restructuring in 1989.[11] Although a radical departure from other deposit insurance reform proposals, this plan did not require major changes in either deposit insurance coverage or bank operations. Deposit insurance would effectively become redundant. Because FDIC losses would be minimal, deposit insurance premiums would be low.

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[11]. For a history of the SEIR proposal, see George J. Benston and George G. Kaufman, "The Intellectual History of the Federal Deposit Insurance Corporation Improvement Act" Working Paper, Loyola University of Chicago, January 1993. A briefer version appears in Assessing Bank Reform: FDICIA One Year Later, Washington, D.C.: Brookings Institution (forthcoming).

The large losses associated with the S & L failure in the 1980s suddenly elevated consideration of deposit insurance reform ahead of other, longer discussed banking reforms. Coming on the heels of widespread public outrage over the S & L debacle and the insolvency of FSLIC, the large number of commercial bank failures and troubled banks in the early 1990s, which threatened to also bankrupt the FDIC and involve another taxpayer contribution, finally spurred Congress to undertake fundamental deposit insurance reform. The idea of possibly eliminating all losses from failures appealed greatly to it and won acceptance over the alternative proposals. In 1990, the Senate Banking Committee, chaired by Senator Donald Riegle, introduced an omnibus banking reform bill that included broader product and geographic powers, as well as deposit insurance reform in the form of SEIR. The bill did not make it through the Senate and was introduced again in the next session. Also in the 1991 session, Chairman Henry Gonzalez of the House Banking Committee introduced an approximately similar bill and the Treasury Department released a study required by the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) of 1989 that made similar recommendations.

The expanded product and geographic powers permitted by these bills drew the greatest attention and attracted the heaviest lobbying. As will be discussed later in this paper, expanded powers were not enacted. The final bill, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, included a modified and weakened version of SEIR and risk-based insurance premiums as deposit insurance reform as well as a large number of other wide-ranging provisions. SEIR is incorporated in the prompt correct action (PCA) and least cost resolution (LCR) provisions of the Act.

FDICIA is the most important banking legislation since the Banking Act of 1933. The SEIR provisions fundamentally change the incentive structure under deposit insurance for bankers to take excessive risk and for regulators to forbear taking corrective actions on troubled and even insolvent institutions. But for reasons discussed below, the Act is unlikely to either reduce the number of failures or reduce losses to the FDIC as much as possible. As a result, further deposit insurance reform is required both to correct the weaknesses in the present legislation and to provide intensified oversight of the regulatory agencies in implementing and enforcing the intent of the Act.[12]

Reform Incomplete

FDICIA provides incomplete deposit insurance reform because, among other things, it mismeasures the economic capital position of banks, particularly of troubled banks; permits overly long delays in resolving insolvent or near-insolvent banks; provides exceptions to least cost resolution for banks still considered "too big to fail;" and perhaps most importantly, delegates to the regulatory agencies both the interpretation of many of the provisions and the

[12]. George J. Benston and George G. Kaufman, "Improving the FDIC Improvement Act: What Was Done and What Still Needs to be Done to Fix the Deposit Insurance Problem," Working Paper, Loyola University of Chicago, January 1993.

drafting and implementation of the accompanying regulations.

Mismeasures Capital Position. To be most effective in implementing PCA and LCR, the capital position of banks should be measured in market or current value terms. Substantial evidence suggests that banks, particularly those in financial distress, tend to delay reserving for loan losses and to underreserve when they do.[13] In addition, book measures do not adjust for changes in values from changes in interest rates. A recent study of large banks that failed between 1986 and 1990 by the Office of Management and Budget showed that, while their capital was, on average, positive until they were closed on a book value basis, it was already negative on a market value basis 3 1/2 years before closure and substantially negative at closure (see Chart 1).[14] SEIR could work with book values, but the trigger levels for prompt corrective action and resolution would need to be increased sufficiently to compensate for the overstating of net worth.

The Act also requires that the:

> accounting principles applicable to reports or statements required to be filed with Federal banking agencies... should... result in financial statements... that accurately reflect... capital..., facilitate effective

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[13]. U.S. General Accounting Office, Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management, Washington, D.C., May 31, 1989, and U.S. General Accounting Office, Failed Banks: Accounting and Auditing Reforms Urgently Needed, Washington, D.C., April 22, 1991; and U.S. General Accounting Office, Depository Institutions: Flexible Accounting Rules Lead to Inflated Financial Reports, Washington, D.C., June 1, 1992.

[14]. Justine Farr Rodriguez, Richard L. Cooperstein, and F. Steven Redburn, "Assessing the Cost of Government Guarantees," Credit Markets in Transition, Chicago: Federal Reserve Bank of Chicago, May 1992, pp. 14-32.

> supervision... and facilitate prompt corrective action to resolve institutions at the least cost to the insurance funds.

The agencies are to review their accounting principles and modify them if they do not comply with the above objectives. In addition, the agencies should develop methods for insured banks to provide supplementary market value reports "to the extent feasible and practicable." The agencies were given until one year after enactment (December 19, 1992) to review their procedures for conformity with these objectives and to make appropriate changes. To date, the agencies have not released any reports that they have done so. Nor have any research studies been published. Indeed, for years, the agencies have been dragging their feet with respect to introducing market value accounting or reporting and do not appear ready to make meaningful changes in their position.[15]

The reluctance of the agencies to move towards market value reporting quicker is particularly disturbing in light of their ongoing attacks on the supplementary noncapital tripwires included in the Act. In large measure, these tripwires were included

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[15]. The General Accounting Office has recently concluded that:

> Because neither FASB nor the regulators appear willing to address the serious deficiencies in existing accounting standards for nonperforming loans, we have suggested that the Congress consider legislating regulatory accounting principles for nonperforming loans and financial reporting to the regulators.... If the regulators do not adequately address our recommendations to correct the serious weaknesses, the Congress may wish to enact legislation to mandate such improvements

General Accounting Office, <u>Bank Insurance Fund</u>, Washington, D.C., December 1992, pp. 37-38. The agencies are currently working on revising and clarifying standards for loan loss allowances.

because the agencies themselves had testified that book value capital is a lagging indicator of the financial condition of a bank and, therefore, is an inappropriate trigger to use in delineating the prompt corrective action zones. The supplementary tripwires were an attempt to compensate for the failings of book value measures.

Exceptions to Least-Cost Resolution. The Act permits two exceptions to prompt resolution at least cost to the insurance fund. One, institutions viewed as too big to fail (TBTF) without causing "serious adverse effects on economic conditions and financial stability." Two, critically undercapitalized institutions with less than 2 percent tangible equity capital need not be placed in receivership to conservatorship for 90 days after being classified so and may be accorded two additional 90-day extensions or even an indefinite period of time, if the agency views the institutions as recovering and viable.

The first exception does appear to make it more difficult for the agencies to invoke TBTF. To do so, the FDIC must obtain in writing the consent of a majority of the Board of Governors of the Federal Reserve System and of the Secretary of the Treasury after consultation with the President. All must certify that making uninsured depositors whole is necessary to avoid serious economic harm. Any loss the FDIC suffers in making all depositors whole under the exception must be recaptured by a special assessment on all banks based on their total assets. This may be expected to evoke increased opposition to such rescues by the larger banks, who would pay the greater share of the cost. The provision for delays in resolving critically undercapitalized banks, however, has no self-limiting or restraining aspects other than that the agencies have to restrict the institution's activities, file periodic reports or certifications of its viability, and need to explain in writing, disclose publicly, and have reviewed by the General Accounting Office any material losses incurred. Through mid-February 1993, two months after the so-called "December 19, 1992 surprise," only one of the 25-odd banks caught with less than 2 percent equity capital at that time had been resolved by the FDIC.

Foot-Dragging by Regulators. During the legislative process, the regulators vigorously opposed the enactment of a strong SEIR and have been dragging their feet since in adopting regulations that would effectively carry out the spirit of the Act. They fear that the reductions in their discretionary powers and flexibility in disciplining troubled banks and resolving insolvent banks might, among other things, reduce their visibility and importance. This may adversely impact both their current career advancement and their post-career opportunities. The revolving door between bank regulators and the industry revolves at least as fast as does the better-publicized door in the Defense Department. In advancing their personal careers, bank crises may be said to be to regulators what wars are to generals. They put them in the spotlight.

Thus, as has already been noted, regulators have moved slowly in introducing market value accounting. They have also adopted definitions of adequate-capitalization for prompt corrective action on a book value basis that are far too low for ensuring safety and considerably lower than at the banks' uninsured "unregulated" competitors.[16] The agencies' definition encompasses 98 percent of all banks, holding 97 percent of all bank assets as of mid-1992. At the same time, however, some 8 percent of all banks with 14 percent of all banking assets were on the FDIC's problem bank list, nearly 25 percent of the so-called adequately-capitalized banks had received CAMEL ratings of 3 or less on their examinations, and some 5 percent had ratings of 4 or 5. Since then, the substantial improvement in bank earnings has depleted the lower capitalization categories even further. In light of the low values for capital ratios that were established by the agencies as qualifying a bank as well-capitalized, it is apparent that the regulators' definitions may be generating a false sense of security if macroeconomic shocks have not diminished greatly.

The adequately-capitalized category in mid-1992 also encompassed all 46 banks with assets in excess of $10 billion. This is particularly important because it is the largest banks that provide most of the correspondent bank services to smaller banks and thereby are the counterparty to the interbank exposure of smaller banks. The critical role of interbank exposure in transmitting bank shocks was repeatedly cited as particular worrisome in the Congressional testimony of the regulators. In

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[16]. George G. Kaufman, "Capital in Banking: Past, Present and Future," Journal of Financial Services Research, April 1992, pp. 385-402. Because the uninsured competitors of banks have higher capital ratios, it follows that the market has been a stronger regulator than the regulators.

response, the Act requires the agencies to draft regulations to reduce the probability of systemic risk occurring through interbank exposure. It is thus ironic that after Congress accepted their argument, the regulators failed to take the opportunity to follow through and limit the exposure of smaller banks to large correspondent banks by requiring the large banks, who with to maintain the correspondent business, to be more than adequately-capitalized. This would have provided strong incentive for large banks that were not better than adequately-capitalized, i.e., well-capitalized, to become so. It would also have been consistent with the carrot-stick approach of the Act, which provides greater freedoms and less supervision to better-capitalized banks.

It is even more ironic that the regulators had proposed this in their draft regulation, but then modified it in their final regulation to permit unlimited exposure by smaller banks to only adequately-capitalized larger banks. This represents another major weakening of the Act. The final irony is that if the regulators had not been so attached to systemic risk and had not successfully argued for a TBTF exception, the interbank exposure section of the Act may not have been included, and an interbank exposure regulation would not have been necessary. Banks would have monitored each other automatically. And who is better qualified to monitor banks than other banks?

The Act also requires the regulators to expand the risk-based capital standards to incorporate interest rate and asset concentration risks. This had been a glaring failure in the existing capital requirements. Particularly in 1992, when the yield curve was exceptionally steeply upward-sloping, banks increased their relative holdings of longer-term securities sharply. This has greatly increased their exposure to interest rate risk. Yet, the regulators' draft interest rate risk regulation is badly deficient in four areas. One, the measurement of exposure is inadequate. Because the regulators wanted to impose a minimum reporting burden on the banks, the exposure computation requires minimum information in. As a result, it also generates nearly useless information out. Indeed, most fair-sized banks already collected more information in measuring their exposure internally.

Two, additional capital is to be required only of the outlying 20 percent of the banks with the greatest interest rate risk exposures. In the example presented in the draft proposal, this would include only banks whose capital has a duration of more than 12 years. At this exposure, a 200 basis point adverse change in interest rates would reduce the bank's capital by 25 percent. Three, the additional capital required is greatly insufficient for the risk assumed.

Lastly, the requirement is static. There is no provision for the replenishment of capital if interest rate change adversely to reduce the market value of the bank's capital, although not its book value. Unlike losses from credit defaults, losses from adverse interest-rate changes are not recognized.

The regulators are also weakening FDICIA by specifying risk-based insurance premiums required by the Act that, on the one hand, have too narrow a spread between healthy and sick banks in comparison to the differences in deposit rates imposed by the market and, on the other hand, are too high on healthy banks in relationship to the current value they receive from the insurance coverage. As a result, sick banks are not sufficiently discouraged from taking excessive risk at the expense of healthy banks and healthy banks and their customers are encouraged to search for less costly alternatives.

In sum, enacted in response to the high cost of the extant structure of government deposit insurance to the taxpayer, FDICIA represents the first major step forward in reforming federal deposit insurance since its inception in 1933. Nevertheless, the reforms are only potentially effective for, among other reasons, those discussed above. To make the Act more effective and prevent back-sliding requires strong Congressional and public oversight to see that the regulators are not sabotaging the Act and some strengthening of the Act itself.

III

Powers Reform

Although, because of the rush of events, deposit insurance reform was the most urgently required reform in recent years, powers reform has been discussed for much longer and had received the majority of attention in most of the earlier commissions, committees, and studies on financial reform.[17] But the costs of regulatory failure in this area were much smaller and less directly visible. Thus, reform was not perceived as urgent. If deposit insurance reform is perceived to be effective, attention is likely to refocus on powers reform.

Product and Service Powers

Little, if any, reform has occurred to date in expanding the product and service lines for commercial banks. The Depository Institutions and Monetary Control Act of 1980 and the Garn-St Germain Act of 1982 greatly broadened the product powers of S&Ls to more closely resemble those permitted banks. Once deposit insurance is reformed to discourage banks from shifting excessive risk on to the FDIC, many reformers would permit banks to offer a nearly unlimited range of financial services generally within the bank and also some nonfinancial services but generally outside the bank itself through holding company affiliates. FDICIA makes permitting additional powers more rational both by potentially repairing deposit insurance and by permitting regulators to award new powers only to better-capitalized institutions. Arguments for

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[17]. For a discussion of the state of bank powers reform in the early 1980s see George G. Kaufman, Larry R. Mote, and Harvey Rosenblum, "Consequences of Deregulation for Commercial Banking Reform," Journal of Finance, July 1984, pp. 789-803. See also Franklin R. Edwards, "The Future Financial Structure: Fears and Policies," in William S. Haraf and Rose Marie Kushmeider, eds., Restructuring Banking and Financial Services in America, Washington, D.C.: American Enterprise Institute, 1988, pp. 113-155 and Anthony Saunders, "Bank Holding Companies: Structure, Performance and Reform," in William S. Haraf and Rose Marie Kushmeider, eds., Restructuring Banking and Financial Services in America, Washington, D.C.: American Enterprise Institute, 1988, pp. 156-202.

permitting commercial banks a broad range of financial powers, i.e., universal banking, include greater efficiencies of scale and scope, reduced risk through diversification, and more intensive competition with the benefits passed through to consumers in the form of lower prices and higher quality. Arguments against focus on small, if any, economies, the potential for increased risk through permitting new riskier powers, unfair competition from access to underpriced federal deposit insurance, and excessive economic concentration.[18]

The new financial powers most often discussed are insurance and securities. Most studies suggest that insurance brokerage is relatively riskless, amenable to meaningful scope economies, and quite inefficient in its present form of delivery. Insurance underwriting involves greater risks, smaller synergies, and probably small returns. In most states, insurance was separated from commercial banking relatively early in banking. This separation was reinforced by the Board of Governors in its determination of permissible bank holding company powers and periodically broadened by federal legislation. The insurance agency lobby is one of the more powerful lobbies in the country. It has lost few battles to keep banks out of insurance brokerage. Indeed, the latest in a series of challenges to general insurance offerings by banks is a challenge to the legal ability of national

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[18]. A thorough review of all issues related to universal banking appears in Thomas A. Pugel, Anthony Saunders, and Ingo Walter, Universal Banking in the United States, New York: Oxford University Press, forthcoming.

banks to offer such services in cities under 5,000 in population. This authority appeared to be on the books almost since the National Banking Act in 1864, but may have been inadvertently erased by Congress in amendments to the Act in the early 1900s.

Securities Activities. Banks have always been involved in some aspect of securities activities -- as investors, underwriters, and/or dealers. Until the enactment of the Glass-Steagall Act in 1933, most states permitted their banks to engage in all three activities for a wide range of securities, including both debt and equity. National bank regulations were vaguer, until the enactment of the McFadden Act in 1927. Many national banks engaged in all three activities in their bond departments. At the time, equity issues were relatively minor to debt issues and most banks could not hold equities in their portfolios. Other national banks conducted these activities in holding company affiliates or separate entities under common ownership. The McFadden Act codified these activities to explicitly give national banks the same in-bank powers as state banks, subject to approval by the Comptroller of the Currency. The latter denied national banks the power to underwrite or trade equities.

The Glass-Steagall Act prohibited institutions that accepted deposits (commercial banks) and belonged to the Federal Reserve System from underwriting and trading all private securities and municipal revenue bonds, and vice versa for investment banks. But banks could continue to invest, underwrite, and trade federal and general obligation municipal securities. Congress liberalized the

Glass-Steagall restrictions only once, in 1968, when some municipal revenue bonds were added to the list of bank-eligible securities.

Nevertheless, thorough reinterpretation of the Act by the courts and the regulatory agencies one activity at a time, banks have slowly been permitted to engage in underwriting and trading through holding company affiliates effectively all securities, including equities, but mutual funds that they also manage.[19] Indeed, a major regional bank in Michigan recently purchased a full-service investment bank. But the restrictions imposed by the agencies on how some of these activities can be conducted, both increase the cost of the activities and limit them primarily to large banks. For example, underwriting and dealing in newly-permitted so-called "ineligible" securities must be conducted in a separately capitalized holding company affiliate and is restricted to a maximum percentage of the affiliate's activity in "eligible" securities. Because smaller banks underwrite and trade only small amounts of eligible securities, most would be permitted to deal in ineligible securities in amounts too small to be economic. Ironically, it could be that few large banks will be able to compete successfully with large investment banks, while some smaller regional banks, which generally have been slower at

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[19]. Thomas G. Fischer, William H. Gram, George G. Kaufman, and Larry R. Mote, "The Securities Activities of Commercial Banks: A Legal and Economic Analysis," Tennessee Law Review, Spring 1984, pp. 467-578; George G. Kaufman, "Securities Activities of Commercial Banks: Recent Changes in the Economic and Legal Environments," Journal of Financial Services Research, January 1988, pp. 183-199; and George G. Kaufman and Larry R. Mote, "Glass-Steagall: Repeal by Regulatory and Judicial Reinterpretation," Banking Law Journal, September-October 1990, pp. 388-421.

entering into securities activities other than brokerage, may be more successful in competing with large investment banks headquartered elsewhere in underwriting securities of local private and government entities.

Opposition to expanded bank securities powers from the securities industry association has weakened considerably in recent years. Indeed, the major opposition appears to come from smaller banks, which are more afraid of Citicorp and BankAmerica than of Merrill Lynch and Salomon. Repeal of Glass-Steagall has passed the Senate twice, but has been stalled in the House.

Banking and Commerce. Combining full-service banking with commerce (nonfinancial products), which was effectively stopped by the Bank Holding Company Acts of 1956 and 1970, is even more controversial. Some opponents fear excessive bank concentration, a fear that was basic throughout much of U.S. history until recently. Moreover, studies show few scope economies in such combinations, although risk reduction may be possible through diversification. Studies of combinations of banking and commerce in other countries report little evidence of adverse impact. On the other hand, the benefits include not only intensified competition for many services but improved corporate governance, longer investment time horizons, and lower failure rates for affiliated nonbank firms. Permitting the combination of banking and commerce through holding company affiliation was recommended in the 1991 Treasury study and included in the 1991 Bush Administration's draft bank reform bill, but did not make it through Congress.

Although most studies conclude the new product powers would permit banks to reduce their risk exposure through diversification, recent evidence from the S&L industry also suggests some institutions may misuse the new powers to increase their risk. As a result, some oppose granting banks additional powers, at least, until they are financially stronger and the public cost of potential misuse is smaller.

The chances appear poor for little immediate legislative relief for new financial or nonfinancial powers, but good for greater use of securities activities through the door opened by the courts and the regulators. Because the fastest growing assets in the financial sector are those generally owned by individuals and managed by institutions, e.g., pension and mutual funds, rather than those owned by institutions, it is unlikely that even if banks receive new product powers that they would be able to reverse greatly the reported secular decline in their market share of all financial assets since the end of World War II. The assets of mutual funds managed by banks, for example, are classified as mutual funds not as banks in the flow of funds data. Moreover, except for insurance brokerage, it is also unlikely that any new financial services by themselves would add greatly to the industry's aggregate profitability, although it might boost that of a number of individual banks. Indeed, competitive forces may insure that much if not all of any potential gains in profitability would be passed through to consumers in the form of lower prices.

Geographic Powers

The drive to expand geographic powers through branching and holding company acquisitions began in earnest in the early 1900s with the development of the automobile and suburbia. A number of states liberalized their branching laws but, by the late 1920s, branching opponents succeeded in stalling further liberalization. In 1930, branching was still permitted in only 19 of the 48 states. National banks, which effectively were not permitted to branch, were first given city-wide branching authority in states permitting branching by the McFadden Act of 1927 and then full equity with state banks by the Banking Act of 1933. No state permitted branching across state lines and the McFadden Act specifically prohibited it for national banks.

That is where matters stood until the 1950s, when the drive to expand geographically was renewed. Some bank holding companies began aggressively to expand across state lines into states that did not prohibit such acquisitions. But Congress viewed this as a circumvention of the prohibition against full-service interstate branching and effectively prohibited further such expansion in the Douglas Amendment to the Bank Holding Company Act of 1956. The Amendment permitted interstate holding company expansion only if the host state specifically permitted it. At the time, no state did. However, holding companies continued to expand rapidly across state lines on a limited service basis, such as loan production and consumer credit offices. At the same time, states began to liberalize their intrastate branching laws. By the mid-1960s, about two-thirds of the states permitted some form of branching, about one-half statewide (primarily on the West Coast) and the other half more limited (primarily on the East Coast). The Midwest remained predominantly unit banking. By 1992, all states permitted some branch banking, and only a handful permitted less than statewide branching.

Interstate Holding Company Expansion. In the early 1980s, in response to the large number of interstate limited-service offices, advances in telecommunications and computer technology (some as simple as the 800 telephone number) that permit quick and low-cost interstate transfers of funds, and the need to attract buyers for troubled institutions, states began to enact legislation specifically permitting acquisition of full-service domestic banks by out-of-state holding companies, generally on a reciprocal and, at first, regional basis. By 1992, all states but one (Montana) permitted some form of full-service interstate holding company banking, most on a national basis. It appears likely that full nationwide interstate holding company banking will be a reality in the next few years.

It is of interest to note that, despite the national ramifications of this change, interstate holding company banking has occurred without any changes in federal legislation. Indeed, the states were forced to enact enabling legislation to remove restrictions imposed by federal legislation. More recently, a small number of relatively small states and New York have enacted some form of interstate branching, generally on a reciprocal basis.

This does not affect national banks. Little such branching has, however, occurred to date. In 1991, the Treasury Banking Study recommended and the Bush Administration introduced legislation phasing in interstate branching for national banks. The proposal was opposed primarily by smaller banks, who feared intensified competition. The opponents carried that day. But it appears likely that they will not carry all future days and that interstate branching is not far away.

Does it matter whether interstate banking is provided through branching or holding companies? Efficiency arguments suggest that organizations be permitted to choose the form they consider optimum for them. In states where both forms of geographic expansion are permitted, banks have generally preferred the branching route. Some analysts also argue that, as a result of the more intense competition, improved management, and economies of scale, interstate banking would generate annual savings as large as $15 billion. Although these claims appear high, savings from an expanded reduction in the number of independent small banks should occur.[20] Perhaps more importantly, interstate branching will permit even greater geographic and product diversification than interstate holding company banking and improve bank safety. It appears reasonable that if interstate banking had been permissible a number of years earlier, the number of bank and thrift failures in the 1980s would have been considerably smaller and possibly less

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[20]. Robert E. Litan, "Interstate Banking and Product-Line Freedom: Would Broader Powers Have Helped the Banks," Yale Journal of Regulation, Summer 1992, pp. 521-542.

costly.

Prices

As noted earlier, the Banking Act of 1933 restricted interest rates banks could pay on time deposits (Regulation Q) and prohibited interest payments on demand deposits primarily to reduce interbank competition and thus enhance bank safety and soundness. But in time markets developed to permit depositors to circumvent these ceilings when binding. In the early 1960s, banks innovated large negotiated certificates of deposits (CDs) to permit them to compete for funds on the national money market. CDs were first subject to higher Q ceilings than consumer deposits and then exempted from ceilings altogether in the early 1970s. As market interest rates increased sharply in the late 1970s, many depositors disintermediated out of banks and particularly thrifts into short-term Treasury securities and newly-developed money market funds. To permit the depository institutions to compete, the ceilings were progressively removed off consumer deposits. The process was accelerated first by DIDMCA of 1980, which called for a six-year orderly phaseout of all ceilings, and then by the Garn-St Germain Act of 1982, which permitted banks to offer money market deposit accounts (MMDAs) without any ceilings. Moreover, starting in the mid-1970s, checks were permitted to be written on some interest bearing consumer deposits (NOW accounts), so that consumers could effectively avoid the restrictions of interest payments on demand deposits.

But the prohibition on interest payments on nonconsumer demand deposits remained in effect. However, technology has often permitted it to be effectively avoided through such means as sweep accounts, which automatically invest a large depositor's excess day-end balances overnight every night. As a result, there appears to be little if any groundswell for an early renewal of the prohibition on interest payments on demand deposits.

IV

Regulatory Agencies

Probably no banking area has received as much attention with respect to reform through the years than has restructuring the bank regulatory agencies and no area has seen as little change. In part, according to Kenneth Scott, this may reflect the failure to have a

> comprehensive and powerful theory of the political process and regulation. A large body of rather elegant theory and accumulated date can be brought to bear on the functioning of economic markets, but not on the working of political markets.[21]

Is one regulatory agency per industry better than a number of competing agencies? History also is of little guide. Industries

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[21]. Kenneth E. Scott, "The Patchwork Quilt: State and Federal Roles in Bank Regulation," Stanford Law Review, April 1980, p. 742. Good reviews of the arguments for and against restructuring appear in Bernard Shull, "How Should Bank Regulatory Agencies Be Organized", Contemporary Policy Issues, January 1993, pp. 99-107; George J. Benston, Robert A. Eisenbeis, Paul M. Horvitz, Edward J. Kane, and George G. Kaufman, "Perspectives on Safe and Sound Banking", Cambridge, MA.: MIT Press, 1986, Chapt. II, "Centralization or Decentralization of Regulation, Supervision and Examination", and U. S. Treasury Department, Modernizing the Financial System, Washington, D.C., February 1991, Chapter 19, "Reform of the Regulatory Structure."

regulated by a single agency, e.g., ground transportation by the Interstate Commerce Commission, air transportation by the Civil Aeronautics Board, and S & Ls by the Federal Home Loan Bank Board, have not had a better performance rating than multiagency regulated commercial banks, particularly in introducing innovations. If competition is good for private firms, is it less good for government entities?

Every banking commission since World War II has recommended consolidation in their reorganization plan. None have recommended maintaining the status quo. Yet, until 1989, no reorganization has occurred. And when the Federal Home Loan Bank Board was eliminated in 1989 by FIRREA and its powers divided among the newly created Office of Thrift Supervision (OTS) within the Treasury Department (supervisory authority), the newly created Savings Association Insurance Fund (SAIF) within the FDIC (insurance protection), and the Federal Home Loan Banks under the newly created Federal Housing Finance Board (thrift liquidity), it was basically done to punish the Board for permitting the S & L debacle to grow to the extent that it severely embarrassed Congress. The winning agencies were those that were less tainted at the time and had lobbied the hardest for the additional powers. A number of commissions recommended consolidating the deposit insurance and regulatory functions in a single agency so that the insurer could better protect the insurance fund. That structure existed in the S & L industry. The FSLIC was a division of the Federal Home Loan Bank Board. But the Board not only failed to protect the fund, but acted to endanger it. As a result, this experience led to recommendations that the two functions are better served separated. Likewise, most regulators prefer "independent" banking agencies. Yet, the supervisory powers of the old independent Board were shifted to the OTS in the "political" Treasury Department.

Most commissions also recommended diminishing the role of the Federal Reserve System in bank supervision and regulation. That would permit it to concentrate its full attention to monetary policy, over which it has sole responsibility. Separation would also remove any potential conflicts between its monetary policy and regulatory responsibilities. But to date, the Fed has fought this reduction in authority long, hard, and successfully. When a late draft of the Bush Commission Report in 1984 recommended transferring much of the Fed regulatory power to the FDIC and the Comptroller of the Currency, the Chairman of the Federal Reserve, Paul Volcker, personally went before the Commission to lobby against this change. He successfully argued that, without the ability to directly monitor large banks, the Fed could not be held responsible for any monetary or financial crisis that might ensue. No commission can be expected to be willing to shoulder the burden of such a possibility and be charged as acting irresponsibly. Indeed, from a relatively minor bank regulatory agency in the early 1950s, with primary responsibility for a relatively small number of state chartered member banks, the Federal Reserve has grown rapidly until FDICIA into the premier bank regulatory agency. Its regulatory responsibilities were enhanced greatly by being delegated primary responsibility over all bank holding companies by the Bank Holding Company Acts of 1956 and 1970 and by subjecting all depository institutions to Federal Reserve reserve requirements by DIDMCA in 1980, all of which the Fed lobbied for vigorously. By granting it broad powers to resolve undercapitalized banks, FDICIA, however, is likely to elevate the FDIC to equal regulatory, although not overall, importance.

In part, because there appears to be no widely agreed upon underlying logical rhyme or reason for a particular bank regulatory structure, the arguments come down to which agencies are sufficiently strong and sufficiently acute at lobbying to absorb the powers of the weaker and less efficient lobbiers; e.g., the FDIC and Treasury Department over the FHLBB in 1989. Moreover, because banking is generally viewed as technical and beyond the ability and interest of much of the public, even the most educated members, the public makes little attempt to understand the issues. Other than at major financial crises, there is thus little, if any, public sentiment or emotion for change. Outside the industry and its regulators, basically no one cares about regulatory agency restructuring. It is primarily an inside the beltway issue. Thus, the outlook for restructuring the regulatory agencies for good or for bad is not bright. Nevertheless, both the Senate and House Banking Committees have announced that they will take another try at it this session. Most likely, as they are now both housed in the Treasury Department, there may be an attempt to consolidate the OCC and the OTS. If the Clinton Administration wishes to do so, it delegated primary responsibility over all bank holding companies by the Bank Holding Company Acts of 1956 and 1970 and by subjecting all depository institutions to Federal Reserve reserve requirements by DIDMCA in 1980, all of which the Fed lobbied for vigorously. By granting it broad powers to resolve undercapitalized banks, FDICIA, however, is likely to elevate the FDIC to equal regulatory, although not overall, importance.

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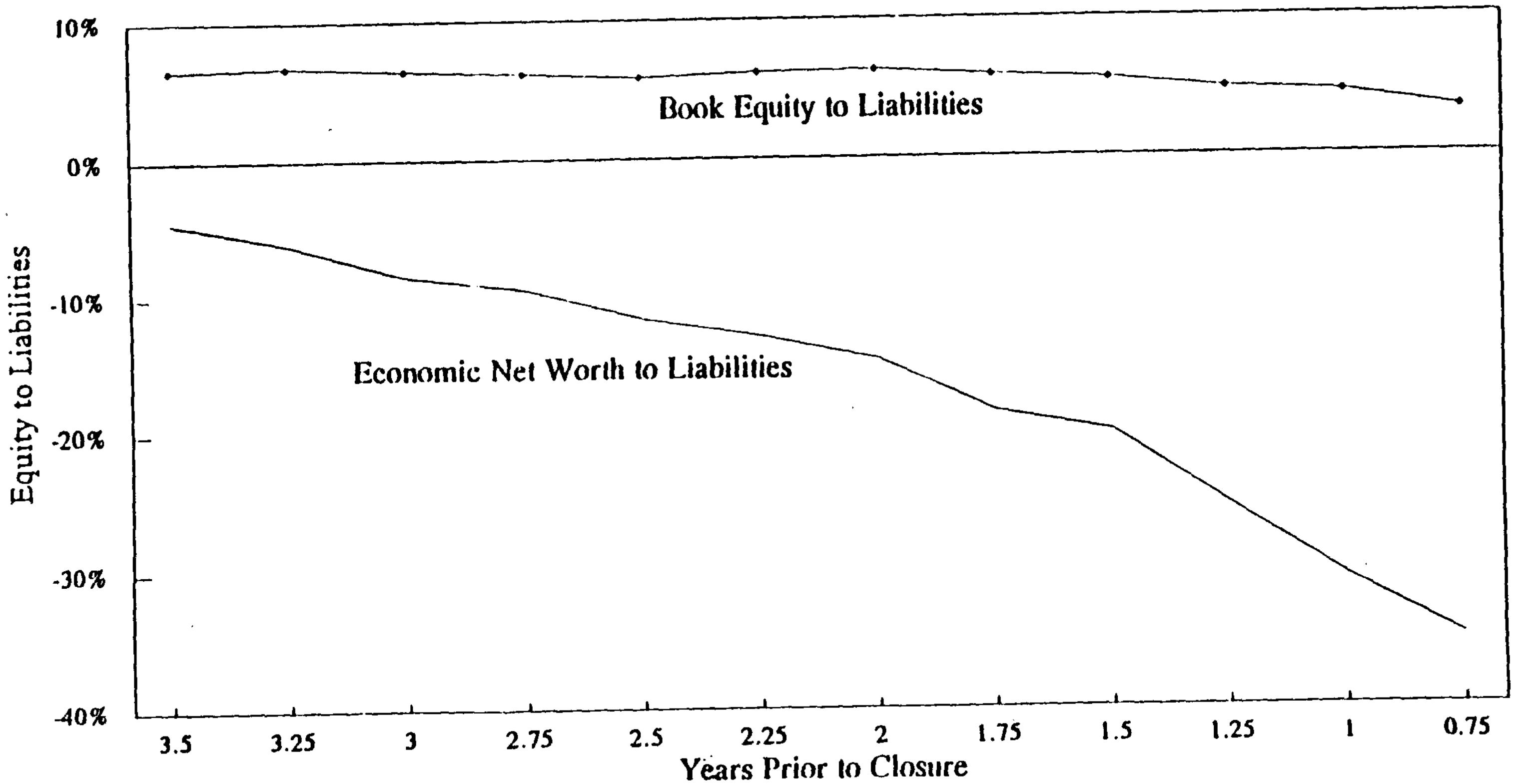
Significant legislative action to expand product powers in the near-term is unlikely, at least until the banking industry is healthier and less likely to require taxpayer support. Broadened product powers would add only marginally to aggregate bank market share and profitability and does not have the unanimous approval of the banking industry itself. It is caught between the opposition of many smaller banks and the support of fewer but more influential larger banks. Expanded geographic power in the form of interstate branching is more likely, although it also is caught in the middle of the two warring bank factions. But because nationwide bank holding company banking is now almost a reality and is eroding local banking monopolies and because it not only does not appear to increase risk but should actually promote safety through improved diversification, nationwide branching is probably more inevitable than are greatly expanded product powers. Because it permits regulators to limit expanded powers only to better capitalized banks, thereby providing an incentive for banks to improve their capital ratios, FDICIA is a good vehicle for introducing additional powers. Regulatory agency reform is probably least needed, least likely to reach agreement on, furthest away for major changes, and least likely to resemble "reform" if and when it does occur.

CHART 1

Book Equity vs Economic Net Worth
Averages For Large Failed Banks: 1986 - 1990



SOURCE: Justine Farr Rodriguez, Richard L. Cooperstein and F. Stevens Redburn, "Assessing the Cost of Government Guarantees," Credit Markets in Transition, Chicago: Federal Reserve Bank of Chicago, May 1992, p.32.

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