9-1-1992

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Charles G. Roberts

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NOTE

HE WHO HESITATES IS LOST:
CONGRESSIONAL INACTION AND COMMERCIAL BANKING

INTRODUCTION

The once healthy American banking system stands on shaky ground.¹ Like the ruins of an ancient city, it is a humble memory of what it once was.

Banks are no longer the protected and steadily profitable businesses they once were. Technological advances and innovations by competing financial services providers have ended their monopoly on transaction accounts and certain types of business credit. They no longer enjoy protected access to low cost funds from interest rate controls. And old laws that once protected them from competition have become barriers that impede banks from responding to changing market conditions. The result has been declining profitability and increasing bank failures.²

¹. In recent months banks have seen a rise in profits due to the lowering of interest rates that they pay for their deposits. However, many bankers and financial analysts, recognizing that the structural problems in the banking industry are pervasive, view the current upswing as the calm within the storm. See Senate Banking Approves Clinton’s Nominee for Comptroller of the Currency, 60 Banking Report (BNA) No. 14, 452 (April 5, 1993); Bill Sheeline, Knowing When to Take Your Profits, MONEY, April, 1993, at 140; Neal St. Anthony, Stemming the CD Flow, STAR TRIBUNE, March 29, 1993, at 1D; Gordon Matthews, Slow Bleeding of Deposits Worries Bankers, THE AMERICAN BANKER, March 1, 1993, at 1; Therese Eiben & John Labate, How the Industries Stack Up, FORTUNE, Jan. 11, 1993, at 66; Kelley Holland, 2Q Scorecard: Bad Loans Eased, Spreads Widened, THE AMERICAN BANKER, July 31, 1992, at 1. While the Federal Deposit Insurance Corporation has lowered its earlier estimate for bank failures in 1993, they have also predicted that there would be an increase in bank failures in 1994 which would continue at “higher than usual levels” for the remainder of the decade. Jerry Knight, FDIC Slashes Estimate of 1993 Bank Failures, THE WASHINGTON POST, March 24, 1993, at F3.

². Deposit Insurance and Banking Reform Proposals: Hearing Before the House Comm. on the Budget, 102d Cong., 1st Sess. 91 (1991) [hereinafter Deposit Insurance and Banking Reform Proposals] (attachment of Treasury News article).
The question is, Why should we care? As long as there is a demand, financial services will continue to be provided. At least there will be foreign banks to step in and take the place of the American banks. Why does this country need to have a strong domestic banking system?

The answer is twofold. For one thing, poorly performing banks often result in bank failures, which are paid for by the Bank Insurance Fund (BIF). The BIF has been running at a deficit and borrowing from the Treasury (and ultimately the taxpayers) in order to bail out the system. However, the importance of having strong banks goes well beyond the risks to the BIF. Whether it comes from commercial banks or investment banks, capital affects our entire lives. Capital builds houses, paves roads, educates students, expands businesses, creates jobs, and funds governments.

Most of the capital borrowed by households and small businesses comes from commercial banks. This borrowing, then, is an essential part of our economic base. Therefore, it is imperative that

3. In a healthy situation, the BIF is funded completely by the insurance premiums that banks pay for their deposit insurance. See 12 U.S.C. § 1815(d) (Supp. III 1988) (premiums paid by banks are authorized to go into BIF); 12 U.S.C. § 1823(c)(1) - (c)(9) (describes what obligations of insured depository institutions are covered by BIF). However, when the BIF does not have enough capital to provide for the obligations of failed depository institutions, the Federal Deposit Insurance Corporation has the authority to borrow from the Treasury Department and the Federal Financing Bank to provide for such shortcomings. 12 U.S.C. § 1824(a). In recent years, the fund has been so depleted that Congress has had to increase the allowable amount borrowed from the Treasury Department from $5 billion to $30 billion. See 12 U.S.C. § 1824(a); see also H. Rep. No. 330, 102d Cong., 1st Sess. 95 (1991), reprinted in 1991 U.S.C.A.A.N. 1901, 1908. The BIF has already borrowed a considerable amount of money in order to meet its obligations. See Troubled Banks Still Pose Major Threat of Loss to Bank Insurance Fund, 59 Banking Report (BNA) No. 1, 10 (July 6, 1992); Bush Budget Proposes Accounting Changes In Charging for Bank and Thrift Failures, THE FDIC WATCH, February 10, 1992, at 5; BIF Will Be Insolvent At Year's End GAO Study Says, Based On Minimum Exposure, 57 Banking Report (BNA) No. 20, 793 (November 18, 1991). The main criticism of this arrangement is that the taxpayer becomes ultimately liable if these obligations are never repaid by the BIF. See Actions By Banking Agencies Next Year Will Determine Banking Bill's Results, 57 Banking Report (BNA) No. 25, 1042-43 (December 23, 1991); see also 12 U.S.C. § 1825(d) (declares that all obligations of the FDIC are backed by the full faith and credit of the United States).


5. Small businesses are responsible for producing about 37% of the gross national product ("GNP") and employ more than 57% of the private workforce. Small Business Briefs,
our government have optimum control over the direction of capital towards these entities in order to maintain a healthy economy. While it is possible that capital lending to these sectors could easily come from foreigners, it is important that our economy have sufficient domestic-based commercial banks. Allowing foreign lenders to control a substantial portion of the American capital system would give such institutions significant power over our economy.

This note will discuss the current problems in the commercial banking industry, as distinguished from the savings and loans industry. Part I discusses the history of modern banking regulation, concentrating on the development of the laws which restrict the business of banking and whose modern relevance are currently in question. Part II shall discuss the current problems with modern banking regulation, as identified by Congress, in the areas of domestic competition, interstate banking, bank affiliations, and foreign competition, both overseas and domestic; it will also discuss the potential solutions studied by Congress in recent months. Part III shall discuss the


6. Commercial banks are distinguished from thrift institutions in that they offer a full range of banking services which include "demand deposits (i.e., checking accounts) for business and personal use, savings and time deposits, investment and loan services, trust department services, and the like." MICHAEL P. MALLOY, THE REGULATION OF BANKING 41 (1992). Thrifts used to be almost completely prohibited from most of these activities until the 1980s. Id. The regulation of the thrifts has since eased, but commercial banks still rank as the leaders in providing banking services. Id.

The problems of the savings and loan (or thrift) industry are both unique and complex, and are beyond the scope of this article. However, an excellent article on the history and current problems of the savings and loan industry can be found in Carl Felsenfeld, The Savings and Loans Crisis, 59 FORDHAM L. REV. S7 (1991).

7. The most ambitious plan to restore the strength of our banking system in recent memory was instituted by the Treasury Department from a report it issued in 1991. See DEPARTMENT OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS (1991) [hereinafter MODERNIZING THE FINANCIAL SYSTEM]. The report was ordered by § 1001 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA). Pub. L. 101-73, 103 Stat. 507 (1989). This report was made in consultation with the Comptroller of the Currency, the Federal Reserve Board, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of Management and Budget. See MODERNIZING THE FINANCIAL SYSTEM, supra, at xviii. It is from this report that The Financial Institutions Safety & Consumer Choice Act of 1991 was proposed. S.713, 102d Cong., 1st Sess. (1991); H.R. 1505, 102d Cong., 1st Sess. (1991). This bill did not pass in either house. See Stephen Labaton, House Turns Down Banking Overhaul By 324-To-89 Vote, N.Y. TIMES, Nov. 5,
methods that have been suggested to Congress for countering the potential abuses that might result from any deregulation of the banking industry as well as those changes in regulation recently enacted by Congress which could counter the abuses that might coincide with deregulation.

I. 120 YEARS OF BANKING HISTORY: FROM PRESIDENT JACKSON TO THE BANK HOLDING COMPANY ACT OF 1956

It is always prudent to examine history before making proposals for the future. History gives no answers to the current problems in banking, it only shows the paths that have been taken in dealing with past problems. Yet, it is a good idea to look at the past to better understand the specific problems facing banks today.

A. The Emergence of Nationally Chartered Banks

People have not trusted banks in this country for quite some time. Andrew Jackson engaged in a “great war” against the Second Bank of the United States during his presidency. Anger over the Bank’s earlier mismanagement caused many to blame the bank for the Panics of 1819 and 1834, which resulted in the financial ruin of many. However, the disfavor of the Bank of the United States had been long-standing, manifesting itself into President Jackson’s veto of the Bank’s charter renewal in 1832. Without a federal bank, banking was left to be completely managed by the states.

Thirty years later, with the advent of the Civil War, the federal government grew desperate for funds. Treasury Secretary Salmon

9. The mismanagement of the Bank was investigated by Congress twice, in 1818 and 1834. See HOUSE REPORT ON THE BANK OF THE UNITED STATES, 15th Cong., 2d Sess. (1818), reprinted in LEGISLATIVE AND DOCUMENTARY HISTORY OF THE BANK OF THE UNITED STATES 714-732 (photo. reprint 1967) (M. St. Clair Clarke & D.A. Hall eds. 1832) (documents the mismanagement of the Bank of the United States and its branches prior to the Panic of 1819); see also REMINI, supra note 8, at 166 (discussing the investigation of 1834).
10. See REMINI, supra note 8, at 27; see also id. at 126.
11. There was controversy over the constitutionality of the First and Second Banks of the United States and whether, in their creation, too much power was placed outside of the hands of Congress. MALLOY, supra note 6, at 8-15, 23-27.
12. Id. at 23.
P. Chase was able to keep the government in business through securing short term loans and issuing long term bonds sold to the general public: basically the country's first small-denomination, publicly issued war bonds. These bonds were issued through private, state chartered banks because there were no longer any federally chartered banks. Chase then required the proceeds from these bonds to be paid in specie and kept with the Treasury rather than deposited at the banks. This brought the specie reserves of banks dangerously low since the federal government was hoarding all of the specie.

Without any federally chartered banks or federal banking laws, and without any control over the state chartered banking system, the government had absolutely no way of limiting the effects of a financial panic. The federal government was therefore dependent upon the soundness of the state controlled banking system in order to finance the Civil War. Unfortunately, that was too much power to leave outside of its hands. At the end of 1861, things looked bleak for the Union. Their army had suffered two major defeats in October and, after the seizure of two British dignitaries, it was believed that there might be war with Britain. A financial panic ensued. To curtail the run on specie, the banks stopped making specie payments. To meet its expenses for the War, the government required a steady stream of specie; with the banks halting specie payments, it would no longer be able to obtain specie for its expenses. A premature end to the war seemed imminent.

Of course the Union survived the War, but only after a last minute enactment of the controversial first issue of the Treasury's
paper money. However, it was due to the concern over the government’s lack of control over the money supply that the National Banking Act was born. Under the Act, nationally chartered banks would be the marketplace for war bonds and would help establish the newly created Treasury notes of the federal government. At the time, Treasury notes were in circulation alongside notes from various banks, subject to the banking laws of the various states. There was no national monetary policy because there was no way to control the money supply with such a system. The solution was to create a system of federally chartered banks which would purchase U.S. bonds equal to a third of their capital. These bonds were used to back up the bank’s issuance of Treasury notes, allowing them to issue such notes up to the value of ninety percent of their bond holdings. In 1865, to weaken the position of the state regulated banknotes, Congress created a ten percent tax on banknotes which brought an end to local currency and established, for the first time, exclusive federal control over the currency.

The Act also imposed many restrictions and requirements upon the new nationally chartered banks. It created the position of Comptroller of the Currency, who became the government’s overseer of the new nationally chartered banks, examining such banks and supervising their chartering. The Act also established for the first

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23. Id.
25. MCPHERSON, supra note 14, at 444-45; SUBCOMM. ON FINANCIAL INSTITUTIONS OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 94TH CONG., 2D SESS. COMPRENDIUM OF ISSUES RELATING TO BRANCHING BY FINANCIAL INSTITUTIONS 4 (Comm. Print 1976) [hereinafter COMPRENDIUM].
26. See MCPHERSON, supra note 14, at 593-94.
27. Id.
28. See id.
29. Ch. 106, § 16, 13 Stat. 99, 104 (1864) (current version at 12 U.S.C. § 101a (1988)) (requirement that national banking association deposit treasury bonds with the Treasury in an amount equal to no less than a third of their capital); see also MCPHERSON, supra note 14, at 594.
30. Ch. 106, § 21, 13 Stat. 99, 105 (repealed 1882) (allowing national banking associations to circulate Treasury notes equal to 90% of their bonds held by the Treasury); see also, MCPHERSON, supra note 14, at 594.
31. Act of March 3, 1865, ch. 78, § 6, 13 Stat. 469, 484 (1865) (repealed 1875); see also MCPHERSON, supra note 14, at 594.
time federally controlled reserve requirements for banks.\footnote{33} Additionally, it prohibited nationally chartered banks from entering into stock trading.\footnote{34} This was not much of a concern in 1863 because the stock markets were not as fully developed as they were to become after the War.\footnote{35} It is mainly because of these restrictions and extra supervision that some banks chose to keep their state charters, thereby allowing the state chartered banking system to survive the National Banking Act.\footnote{36}

B. The Road To The Federal Reserve System

The emergence of investment banking houses in the 19th century helped to establish a strong market for securities, a market which would greatly expand by the early 20th century.\footnote{37} Throughout the 19th century, these banking houses were able to provide large amounts of capital for new growing businesses in America, such as the railroad industry.\footnote{38} It was at this time that the trust companies developed.\footnote{39} The rampant speculation of the trust companies and the incredible power of the investment banks grew tremendously.\footnote{40} However, it took another financial disaster for the government to finally examine their activities.

In 1907, the country underwent a great financial panic.\footnote{41} The...
Government, having no way to control the situation, sat back and watched as Wall Street, led by J.P. Morgan, saved the country from an even larger financial disaster by maintaining liquidity in the marketplace and bailing out many financial institutions which were in near collapse.42

However, such a feat brought distrust, rather than praise, for Mr. Morgan.43 As this was the Progressive era, such concentrated power held by the private sector was despised.44 The Senate decided to investigate the matter.48

The Senate investigation led Congress to enact the Federal Reserve Act of 1913.46 This Act established the Federal Reserve System which was an attempt to give the government more control over the banking system so that it might be able to prevent such financial disasters in the future.47 The Federal Reserve was established "to furnish an elastic currency, to afford means of rediscounting commercial paper, [and] to establish a more effective supervision of banking."48 Its central duties were to regulate the money supply and assist member banks in their provision of banking services.49 State chartered banks were induced into becoming members of the Federal Reserve System by the fact that only members could enjoy the bank-


43. See CHERNOW, supra note 39, at 128.

44. See ARTHUR S. LINK, WOODROW WILSON AND THE PROGRESSIVE ERA, ch. 1-2 (1954); see also LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 4-19 (1913).

45. THE FEDERAL RESERVE BOARD, FEDERAL RESERVE SYSTEM: ITS PURPOSES AND FUNCTIONS 3 (1947). The National Monetary Commission, through its investigation of the European banking system, recommended the establishment of a central bank. Vietor, supra note 32, at 11 and 68; CHERNOW, supra note 39, at 129. In 1912, the Pujo Commission investigated the power and control the banks and trusts had over credit, which had been colloquially termed the "Money Trust." Vietor, supra note 32, at 11; CHERNOW, supra note 39, at 149-156. The committee also recognized the dangers of banks underwriting corporate issues of stocks and bonds, and urged that they be prohibited from such activities. Vietor, supra note 32, at 12.


47. Vietor, supra note 32, at 12; see also CHERNOW, supra note 39, at 130, 156.


49. FEDERAL RESERVE BOARD, FEDERAL RESERVE SYSTEM: ITS PURPOSES AND FUNCTIONS 4 (1947); see also id. chapters II, III, IV.
ing services provided by the Federal Reserve. While national banks were required to become members, state chartered banks were allowed membership without having to refrain from dealing in securities.

C. The Problems of Branch Banking

In 1864, the Comptroller of the Currency limited branch banking for nationally chartered banks. Since branch banking was not yet a concern for banks, there were no complaints about the restriction.

It was not until the turn of the century that the issue of branch banking would become a concern. At this time, bank services became widely used and competition between banks grew. States began to liberalize their bank chartering laws. The Act of March 14, 1900, lowered the capital requirements for chartering a new national bank in communities of 3,000 or less from $50,000 to $25,000. The result was a large increase in the number of banks from 13,000 to 25,000 in ten years. This increase in the number of banks made Congress less interested in liberalizing branching laws, as there were plenty of banks to serve the community. However, in response to the concerns of the banking industry, states started allowing minimal branch banking for state chartered banks, prompting nationally chartered banks to switch over to state charters.

50. Victor, supra note 32, at 12.
51. Federal Reserve Act, ch. 6, Pub. L. No. 63-43, § 9, 38 Stat. 251, 259 (1913) (current version at 12 U.S.C. §§ 321-338); see also Victor, supra note 32, at 12. In this article, such banks shall be called "state chartered member banks."
52. The Comptroller based its limitation upon two provisions in the National Bank Act that have since been interpreted by economic historians and the Federal Reserve Board's economists as having nothing to do with branching, but were simply provisions copied from state free banking acts. See Compendium, supra note 25, at 5. The provisions were originally created by states as limits on note issues, or more particularly to stop "shaving shops" where banks would set up offices remote from their main office which were the only place where their notes could be redeemed, and at a discount. See id.
53. See Modernizing the Financial System, supra note 7, at XVII-5.
55. See id. at 7. The number of banks reached a record in 1921 when they amounted to 30,500. Id.
58. See Modernizing the Financial System, supra note 7 at XVII-5; see also Department of the Treasury, Geographic Restrictions in Commercial Banking in the United States 182 (1981) [hereinafter Geographic Restrictions].
When national banks started switching their charters to gain the benefits of the liberal state branching laws, Congress decided to take action. In 1918, Congress allowed national banks to acquire state banks which had existing branching systems and allowed them to keep those existing branches under their national charter. They took this action only to prevent charter switching by national banks which could weaken the Federal Reserve System as state banks were not required to be Federal Reserve members. Congress was not happy with branch banking—they viewed it as a threat to small unit banks.

In the 1920s, many states began to allow more liberal branching methods for state chartered banks. In response, Comptroller Daniel R. Crissinger, wishing to further liberalize the branching abilities of national banks, urged Congress to provide national banks with the same branching privileges available to banks chartered by the state in which the national bank operated. In 1922, Mr. Crissinger went so far as to allow national banks to have limited service branching systems.

While the Comptroller wished to expand the branching abilities of national banks, much of rural America desired limits on the branching abilities of all banks. The concern was that branching systems would promote banking monopolies that would take the best and most profitable banking business in the state, leaving the smaller banks with riskier business. Rural areas were already having tough times, and did not need stronger city banks to swallow up their local capital and take away the business of local banks. The smaller rural banks were struggling as their farming and oil loans dried up due to the collapse of those industries. Rural banks failed at the rate of two a day.

The issue of branching was a hotly debated topic in both the state and federal legislatures. A concern in Congress was that the

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61. Geographic Restrictions, supra note 58, at 183.
62. Id.; see also supra note 51 and accompanying text.
63. Geographic Restrictions, supra note 58, at 183.
64. Id.
65. See Compendium, supra note 25, at 8.
68. See Chernow, supra note 39, at 302.
69. Id.
70. Id.
71. Vietor, supra note 32, at 14; Compendium, supra note 25, at 12.
current banking restriction on national banks encouraged switching to state charters. The reason for the problem of such charter switching was that, while national banks were required to be Federal Reserve System members, state chartered banks were not. Therefore, there was a serious threat that the Federal Reserve System would be based upon loose foundations.

In 1924, Comptroller of the Currency, Mr. H.M. Dawes, conducted a thorough investigation of the issues and concerns of commercial banks and prepared a bill on the matter which was introduced to Congress by Representative McFadden. After much debate in Congress, the bill became law three years later as the McFadden Act of 1927. The McFadden Act gave equal branching abilities to national banks as were enjoyed by the state chartered member banks operating in the same state, but limited the branching of both national banks and state chartered member banks to their base city. Basically, McFadden still gave the states the final say as to the branching abilities of banks within their borders.

Despite its apparent favorable effect upon national banks, McFadden was not a pro-branching statute. In the words of Rep. McFadden, this was "an anti-branch banking bill." The Act was actually the first time federal law limited the branching ability of a state chartered bank. The McFadden Act renewed the anti-branching spirit among the states, inspiring almost half the states to form anti-branching laws by 1930.

The increase in bank failures in the 1920s and 1930s started to

73. See supra note 51 and accompanying text.
74. As pointed out by Rep. McFadden, "at the rate of this defection from the national banking system it would not be many years before the [national banking] system itself would be destroyed and the Federal Reserve System thereby left with only state member banks, which could withdraw at will." 65 Cong. Rec. 11296, 11297 (1924).
75. See Compendium, supra note 25, at 14.
79. See Modernizing the Financial System, supra note 7, at XVII-2.
81. 65 Cong. Rec. 11296, 11297 (1924).
82. See Compendium, supra note 25, at 20-21.
83. See id. at 26.
change opinions about liberal branch banking. As unit banks failed, multi-bank systems grew. Of the 8,812 institutions that failed between 1930 and 1933, most were small unit banks. This fact prompted the American Bankers' Association to drop its position against branch banking. With the banking crisis of the 1930s, many states ended their campaigns to limit branch banking; by 1935, most states allowed for some form of branch banking.

It was also at this time that Congress decided to investigate the matter of branch banking. The investigation turned into a debate between liberal branching methods and deposit insurance. President Roosevelt and Senator Carter Glass both opposed banking insurance because they did not believe in federal guarantees of private enterprise. Senator Glass saw liberal branching methods as the better alternative for reducing regional economic risks. This would give banks more access to capital and, at the same time, it would help banks circumvent regional financial crises by reducing risks through diversifying their investment portfolios across the state, or even across the country.

However, at that time, liberal branch banking was viewed as too radical. There was no general consensus in Congress over how far to take branch banking. The private sector was not happy with the matter, either. The larger banks opposed such liberal banking measures fearing that the competition would hurt the strong base they had established in their existing marketplaces. Additionally, the public wanted federal bank insurance long

84. Id. at 27.
85. Geographic Restrictions, supra note 58, at 185. Unit banks are single branch banks where all of the banking services are offered at a single office. See Edward W. Reed et al., Commercial Banking 27 (3d ed. 1984). Due to inadequate transportation and communication facilities, unit banks were the most common banking form during the early stages of banking in this country. Id.
86. Compendium, supra note 25, at 27.
87. Id.
88. Id. at 28.
89. Id.
90. See Vietor, supra note 32, at 18; see also Susan Kennedy, The Banking Crisis of 1933 at 214 (1973).
91. Compendium, supra note 25, at 26-34; Vietor, supra note 32, at 19.
92. Vietor, supra note 32, at 19.
93. See Compendium, supra note 25, at 33.
94. See Geographic Restrictions, supra note 58, at 185.
95. Id.
96. Id.
before the market crash; their demands intensified afterwards.97

Because of the opposition to branch banking and the demand for deposit insurance, Senator Glass was forced to drop his idea for expanded branching powers and to support a proposal for federal deposit insurance—the only other means for a bank to insure its liquidity to the public.98 Senator Glass' concession was also the only way to pass his banking bill through Congress quickly.99 However, Senator Glass did manage to have the issue of branching addressed in the Banking Act of 1933.100 While not as broad as the original proposal, this Act expanded the branching powers of Federal Reserve System members by allowing them the branching abilities of non-member banks chartered in that state, undoing McFadden's limit to the base city of the bank.101 However, since the wording of the amended McFadden Act reads "at any point within the State in which said association is situated", branch banking is limited to the state's borders and interstate branching is prohibited.102

D. The Market Crash of 1929 and The New Deal

During the economic boom of the 1920s, business expansions and a rise in personal wealth led to the development of a tremendous securities market.103 This expansion of the securities market could not be handled by the investment banks alone.104 Banks got involved,

A correspondent is a "bank ... which regularly performs services for another in a place or market to which the other does not have direct access." BLACK'S LAW DICTIONARY 344 (6th ed. 1991). A bank uses a correspondent when it needs to make a payment to a bank in a city in which it does not have an office. In such a case, the bank would keep an account with its correspondent bank and order the correspondent to make the payment for them. See REED, supra note 85, at 33.

97. Vietor, supra note 32, at 18.
98. Id. at 19.
99. See GEOPOLITICAL RESTRICTIONS, supra note 58, at 186.
103. CAROSSO, supra note 38, at 240; KENNEDY, supra note 90, at 9.
expanding through branching and creating securities affiliates.\textsuperscript{105}

As an original sponsor of the Federal Reserve Act of 1913, Senator Carter Glass was well versed in the causes of The Panic of 1907.\textsuperscript{106} While he recognized the good qualities of the Federal Reserve, he believed that it was not properly managing the money supply.\textsuperscript{107} He felt that Federal Reserve funds were being used by banks to support speculation in the securities markets.\textsuperscript{108} As Chairman of the Senate Banking Committee, Senator Glass had proposed imposing regulations on the securities activities of banks during the controversy over McFadden,\textsuperscript{109} but at the time no one was as concerned with the matter of separating commercial banking and investment banking.\textsuperscript{110} His proposal went unheeded when the McFadden Act was passed in 1927.\textsuperscript{111} After McFadden, the securities activities of the trusts and commercial banks grew even further.\textsuperscript{112}

In the late 1920s, a speculative stock market boom arose as a result of the Federal Reserve’s lowering of the discount rate.\textsuperscript{113} Banks became very much involved in this boom by supporting margin accounts\textsuperscript{114} through loans to stock brokers and by direct investments in the securities markets.\textsuperscript{115} In the weeks following the crash, the Federal Reserve failed to provide sufficient liquidity in the mar-

\textsuperscript{105} WILLIAM PEACH, THE SECURITY AFFILIATES OF NATIONAL BANKS 37 (1941); COMPRENDIUM, supra note 25, at 11.


\textsuperscript{107} See RIXEY SMITH & NORMAN BEASLEY, CARTER GLASS 296-313 (1939).

\textsuperscript{108} Id. at 297-299; KENNEDY, supra note 90, at 51; WILSON, supra note 104, at 13 (1986).

\textsuperscript{109} Aside from addressing branching law, McFadden also confirmed the legality of a national bank being involved in both commercial and investment banking services. Vietor, supra note 32, at 14.

\textsuperscript{110} See Perkins, supra note 106, at 494-495.

\textsuperscript{111} Id. at 495.

\textsuperscript{112} See id. Banks increased their share of stock and bond issues to 40 percent of the market, up from 13 percent before McFadden. Vietor, supra note 32, at 14-15.

\textsuperscript{113} See KENNEDY, supra note 90, at 12. This action was taken by the Federal Reserve in response to demands from various interests that the discount rate be reduced. See id. Especially compelling was the request made by Mr. Monty Norman, the Central Banker of Great Britain. See CHERNOW, supra note 39, at 313. Since Britain’s switch back to the gold standard in 1925, there had been much pressure on Britain to maintain high interest rates in comparison to the United States. See id. This compelled Mr. Norman to request that the Federal Reserve reduce the interest rate in order to sustain the value of the pound. See id.

\textsuperscript{114} Margin accounts are a line of credit offered by a broker to a customer whereby the customer does not have to completely pay for the trade he has asked the broker to execute and may pay the balance in full upon the terms of the broker. See BLACK’S LAW DICTIONARY 966 (6th ed. 1990).

\textsuperscript{115} See CHERNOW, supra note 39, at 318; see also KENNEDY, supra note 90, at 20.
ketplace causing banks, which were already suffering from losses in the stock market, to cut back their lending and to sell off assets at a loss.\textsuperscript{116} This contraction of credit added fuel to the problems of the economy; it reduced economic activity, causing more business losses, and resulted in further loan losses to the banks.\textsuperscript{117} When the public became concerned with the problems of the banks, they laid the final blow by withdrawing all of their deposits ("bank runs"), which resulted in the largest amount of bank closings ever seen in this country.\textsuperscript{118}

When it became apparent that the capital markets system could not pull itself out of the disaster alone, Congress decided to take action.\textsuperscript{119} They began by investigating what practices might have contributed to the disaster.\textsuperscript{120} The Pecora Hearings were the Senate's attempt to determine what caused such a tremendous financial upheaval and what the Government could do to turn it around.\textsuperscript{121} However, the hearings were more than just a survey of the banking industry; they were a trial at which the American banking system was accused of the crime of destroying itself and the country as well.

Ferdinand Pecora presided as counsel for the Senate Banking Committee's hearings.\textsuperscript{122} With Mr. Pecora's reputation, it should have been expected that his findings would be substantial.\textsuperscript{123} The Banking Committee did a remarkable job of uncovering the


\textsuperscript{119} See Perkins, supra note 106, at 498.

\textsuperscript{120} Id. at 499; Kennedy, supra note 90, at 104.

\textsuperscript{121} See Kennedy, supra note 90, at ch. 5; see also Vietor, supra note 32, at 16.

\textsuperscript{122} Kennedy, supra note 90, at 106-108.

\textsuperscript{123} A former Progressive Democrat under Wilson's regime, and a former Anti-Tammany Hall, assistant district attorney from New York, Mr. Pecora was known to be an ambitious but honest attorney who had an excellent record of success. Chernow, supra note 39, at 360. Mr. Pecora had just been hired by the Senate committee as its chief counsel in January, 1933. Kevin Lahart, The Way We Were, Financial World, Jan. 12, 1988, at 26. Congress had originally concentrated on "Wall Street" corruption in the securities industry. Id. Mr. Pecora, in a move intended to generate publicity before Congress convened in March, expanded that investigation to include commercial banks. Id.
problems with the banking industry.\textsuperscript{124}

The types of abuses that the Senate uncovered could be divided into three areas.\textsuperscript{125} The first type, which was common to the entire banking industry, involved abuses in the dissemination of information regarding issues underwritten by banks and their affiliates. Examples included acts of underwriting and distributing extremely speculative and unsafe securities, and putting false and misleading information in the prospectuses of these new issues.\textsuperscript{126} The market was also used to support schemes where the bank would falsly bid up the price of a security to draw interest towards it in the market.\textsuperscript{127} The second type of abuse involved the use of bank affiliates for the personal profit of bank officers\textsuperscript{128} and their friends.\textsuperscript{129} This type of abuse included their using bank security affiliates to manipulate the market price of stock and bonds for their own personal

\textsuperscript{124} See Kennedy, supra note 90, at 103-128; see also, Chernow, supra note 39, at 359-377.

\textsuperscript{125} The following breakdown was given by Chairman Seidman of the FDIC. L. William Seidman, Text of FDIC Chairman’s Plan to Restructure Banking Industry, The American Banker, Aug. 26, 1987, at 4; see also Peach, supra note 105, at ch. V.

\textsuperscript{126} National City Company, the securities affiliate of National City Bank, sold Peruvian bonds even though its agents advised that Peru was “a bad moral and political risk.” See Kennedy, supra note 90, at 120. National City omitted all unfavorable information on the issue from its circulars. \textit{Id}.

National City also underwrote $8.5 million worth of bonds for Minas Geraes, a state in the Brazil Republic, which a national city official labeled as “lax, negligent, and entirely uninformed concerning the responsibilities of a long-term borrower.” Carosso, supra note 38, at 330. This info was not only kept from the investors, but the same official which gave such an opinion to National City wrote up a favorable opinion in the prospectus for the issue. \textit{Id}. The following year, Minas Geraes negotiated another $8 million bond issue through National City, half of which was to be used to pay off loans owed to National City Bank. \textit{Id}. Again, this information was kept from the investors. \textit{Id}.

\textsuperscript{127} Investment pools were created whereby the participants would falsely boom a particular issue and then sell off their interest when the security reached an optimal price; in one particular incident, a pool investment in RCA stock led to a 5 million dollar profit for the pool in one week. Carosso, supra note 38, at 325. Many times, to manipulate the market, newspapermen and radio announcers were paid to promote stocks that “were being boomed.” \textit{Id}.

\textsuperscript{128} The Senate hearings revealed how at National City Bank the sale of certain profitable issues were limited so only bank officers could buy them. Kennedy, supra note 90, at 124.

\textsuperscript{129} One amazing scheme Mr. Pecora uncovered was that J.P. Morgan’s bank engaged in the practice of selling stock for substantially less than market price to certain “preferred friends”. Chernow, supra note 39, at 370. Included on this list of “preferred friends” were the chairmen of both the Republican and Democratic National Committees, President Roosevelt’s Secretary of the Treasury William H. Woodin (who, it should be qualified, had taken the offer prior to his serving in Roosevelt’s cabinet), General John Pershing, Charles Lindbergh, former President Calvin Coolidge, and a host of other leaders from the business and political arenas. \textit{Id}. at 366-371.
The third type of abuse involved conflict of interests that were the result of combining commercial and investment banks. This type of abuse included dumping bad loans onto affiliates or using the bank and its trust department for dumping securities onto unwary bank customers. There was also the problem of the bank making loans to customers of its affiliate in order to enable these customers to purchase new issues underwritten by the affiliate. Banks also made risky loans to their affiliates. Many times, the banks would use their wealth to purchase a poorly subscribed, and poorly performing issue underwritten by its affiliate to preserve the "good name" of the affiliate. Banks would also make "special" loans to poorly performing corporations to keep them from defaulting on issues underwritten by the affiliate, which was also intended to protect its "good name".

The exposure of these abuses outraged the country. Here was tangible evidence which the country's problems could be blamed. They served as the last straw for America's faith in the free market for finance. Many people had lost their jobs and their life's savings. These hearings seemed to say that the reason for their losses was due to the rampant speculation of wealthy fat cats. Initially, the

130. When bank officers at National City Bank were overloaded with poorly performing Boeing stock, the affiliate entered into an advertising campaign for the issue for the purpose of allowing the officers to sell their interests without a loss. See Kennedy, supra note 90, at 124.

131. National City Bank created a special corporation to which it shifted its bad Cuban sugar loans, selling the shares of this corporation to the public. See id. at 119; see also Peach, supra note 105, at 131-133.

In the case of a bad loan made to Cuba, Chase Securities underwrote a bond issue for Cuba, the proceeds of which went toward paying off the loan outstanding to Chase National Bank. See Peach, supra note 105, at 133-139.

132. When copper prices began to fall, banks began unloading their interest in copper mines to the public, touting them to be good investments. See Carosso, supra note 38, at 331. National City was so pleased with the success of the campaign for these poorly performing stocks, that it actually bought more shares in the market to continue selling them onto the unassuming public. Id.

133. Edgar D. Brown of Pottsville, Pennsylvania, became a minor celebrity when he testified before the Senate Committee on how National City Bank gave him a $75,000 loan to purchase poorly performing securities. See Kennedy, supra note 90, at 116.

134. Central Republic Bank of Chicago, part of the bankrupt Insull Holding Company, which was run by former Vice President Charles C. Dawes, made loans amounting to ninety percent of its deposits to its affiliates, despite the fact that Illinois had a loan limit to any single customer of ten percent of total assets. See id. at 108. Central Republic was eventually forced to borrow $90 million from the Reconstruction Finance Corporation in order to bail itself out. Id.


136. See Vietor, supra note 32, at 16.
concern of Congress was to instill security in the banking industry; but something more was necessary. American banks were now seen as a business that could not be trusted, and the only way to prevent the evil from acting again was to put limits on the business of banking.\textsuperscript{137}

Senator Glass's earlier proposal for the separation of commercial and investment banking, finally received attention in Congress, and grew more support with each day of the Pecora hearings.\textsuperscript{138} Soon, the separation became inevitable.\textsuperscript{139} Initially, Glass proposed that bank involvement in the securities business be federally regulated, but the public response after the Pecora hearings demanded that the two be completely separated.\textsuperscript{140}

So was born The Banking Act of 1933;\textsuperscript{141} its sections pertinent to this note are known as the Glass-Steagall Act, which separated commercial and investment banking.\textsuperscript{142} The Banking Act also pro-

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  \item \textsuperscript{137} See Chernow, supra note 39, at 375. On March 4, 1933, the day of Roosevelt's inauguration, the Governors of New York and Illinois, the two states which dominated American finance, suspended bank activity. Thirty-eight other states had done the same thing already. See Leuchtenburg, supra note 135, at 39. Both the New York Stock Exchange and the Chicago Board of Trade suspended activity. \textit{Id.} At his inauguration, Roosevelt made a strong condemnation of the bankers:
  
  "We are stricken by no plague of locusts. . . . Plenty is at our doorstep, but a generous use of it languishes in the very sight of the supply. Primarily this is because rulers of the exchange of mankind's goods have failed through their own stubbornness and their own incompetence, have admitted their failures, and have abdicated. . . . The money changers have fled from their high seats in the temple of our civilization. We may now restore that temple to the ancient truths."
  
  \textit{Id.} at 41.
  
  \textsuperscript{138} Vietor, supra note 32, at 18.
  
  \textsuperscript{139} \textit{Id.} Even the large banks were recognizing some conflict of interest that they had never noticed before—that a bank's short-term commitments prevented it from taking speculative, high risks, as the profits cannot cumulate fast enough to meet the banks short term obligations. \textit{Id.} Chase and National City Bank both voluntarily severed their ties to their non-banking affiliates. Helen M. Burns, The American Banking Community and New Deal Banking Reforms: 1933-35 85 (1974). This action was the final blow to the resistance of the remainder of the banking community against the separation. \textit{Id.}
  
  \textsuperscript{140} Vietor, supra note 32, at 17.
  
  

  Section 16: This section prohibits national banks from dealing in, underwriting or purchasing securities, with certain government obligations being the only exceptions. 12 U.S.C. Section 24. This § is also applicable to state-chartered banks that are Federal Reserve members. 12 U.S.C. § 335. FDIC insured banks which are not federal reserve members are subject to this section as well, but the prohibition may be excepted with the FDIC's approval. 12 U.S.C. § 1831a.
hibited payment of interest on demand deposit accounts and authorized the Federal Reserve to regulate interest rates on time deposits. With the creation of federal deposit insurance, the Federal Deposit Insurance Corporation was established. It had the power to regulate all of its members, whether they were nationally or state chartered; this new agency would become the primary regulator of insured, state chartered, non-member banks.

E. The Bank Holding Company

After McFadden, restrictions on branching were substantive enough to prevent banks from expanding sufficiently to serve their customer base. Also, during the 1920s, with the massive failures of rural banks, unit banking began to be seen as a dangerous business and branch banking was viewed more favorably as a means of geographic risk diversification. Banks circumvented bank branching restrictions through holding company scenarios, whereby one bank would own another bank by holding its stock or a holding company would own several banks.

Regulators did not particularly care for bank holding relationships. There was a general fear that they could not be effectively supervised and that this would result in "an excessive concentration of banking resources." Despite the general disfavor by regulators, bank holding com-

Section 21: This section prohibits any individual or entity engaged in the business of issuing, underwriting, selling or distributing securities from engaging in the business of receiving deposits. Id. § 378.

Section 20: This section prohibits Federal Reserve member banks from affiliating with any organization 'engaged principally' in the issue, floatation, underwriting, public sale, or distribution of securities. Id. § 377.

Section 32: This section prohibits director, officer, and employee interlocks between Federal Reserve member banks and firms 'primarily engaged' in securities activities. Id. § 78.

143. Pub. L. No. 73-66, § 10, 48 Stat. 162, 181 (1933) (current version at 12 U.S.C. §§ 371a, 371b). See also Victor, supra note 32, at 20. While there was no finding that competition for deposits had been a contributing factor in the bank failures, Senator Glass claimed that the problem existed anyway. Id. at 6.


146. Id. at 26; MODERNIZING THE FINANCIAL SYSTEM, supra note 7, at XVIII-6.

147. BANK HOLDING COMPANY, supra note 145, at 24. A bank holding company is "any company which has control over any bank or over any company that is or becomes a bank holding company." BLACK'S LAW DICTIONARY 146 (6th ed. 1990).

148. BANK HOLDING COMPANY, supra note 145, at 28.

149. Id.
pany subsidiaries survived the Depression at a far better rate than non-holding company banks.\textsuperscript{150} The reason seems to be that the larger bank holding company set up allowed for risks to be spread out among the entire holding company, with capital flowing between banks through the holding company.\textsuperscript{151}

However, along with the Federal banking laws of the 1930s, came some regulation of the bank holding companies.\textsuperscript{152} Under the Banking Act of 1933, for the first time bank holding relationships were to be regulated by the Federal Reserve, regardless of their charter.\textsuperscript{153} However, this regulation was limited to holding companies which owned a Federal Reserve member bank.\textsuperscript{154} The Banking Act of 1935 exempted from regulation holding companies which only owned one federal reserve member bank.\textsuperscript{155} Those that owned multiple member banks were covered by the statute and were required to apply for a permit from the Federal Reserve in order to use their stock to vote in the elections of their subsidiaries.\textsuperscript{156} The Federal Reserve was then required to consider the financial condition and the management of the holding company before it allowed for the holding company to vote.\textsuperscript{157} There were also rules set by the 1933 Act which limited loans between affiliates.\textsuperscript{158}

By the 1950s, the growth of bank holding companies created an incentive for more regulation.\textsuperscript{159} The concern over holding company relationships grew after *Transamerica Corp. v. Board of Governors of the Federal Reserve System*.\textsuperscript{160} In *Transamerica*, the Third Circuit held that the Federal Reserve Board had no authority to apply the anti-trust limitations of the Clayton Act to prevent the large Trans-America Holding Company from expanding statewide and

\textsuperscript{150.} Id. at 30.
\textsuperscript{151.} See Compendium, supra note 25, at 27. This is very much the same concept behind Glass's idea of expanding branching powers. See supra notes 91-92 and accompanying text.
\textsuperscript{152.} Bank Holding Company, supra note 145, at 34.
\textsuperscript{153.} Pub. L. No. 73-66, § 5(e), 48 Stat. 162, 166 (1933) (repealed 1966) (replaced by 12 U.S.C. § 1841-1842); see also Geographic Restrictions, supra note 58, at 187; Bank Holding Company, supra note 145, at 34.
\textsuperscript{154.} Bank Holding Company, supra note 145, at 34.
\textsuperscript{156.} Bank Holding Company, supra note 145, at 35.
\textsuperscript{157.} Id. at 36.
\textsuperscript{159.} Bank Holding Company, supra note 145, at 39.
\textsuperscript{160.} 206 F.2d 163 (3d. Cir. 1953); cert. denied, 346 U.S. 901.
across state borders.¹⁶¹

In 1956, Congress came up with the Bank Holding Company Act of 1956 ("BHCA").¹⁶² The Act required prior approval by the Federal Reserve for any entity to become a bank holding company regardless of whether a Federal Reserve member bank was involved.¹⁶³ The Act also restricted interstate bank holding company relationships unless there was approval by the state whose borders were being crossed.¹⁶⁴

The Act also addressed the concern over the expansive power of large bank holding companies. Congress feared that problems might arise from the affiliated relationships between banking and commercial affiliates, similar to those that had existed between banks and securities firms, with the services of the bank used to support the commercial affiliate at a risk to the bank.¹⁶⁵ There was also a fear that affiliations with commercial entities could lead to commerce and banking conglomerations too powerful to control.¹⁶⁶ The Bank Holding Company Act of 1956 eliminated this fear by prohibiting affiliated relationships between banks and enterprises unrelated to banking.¹⁶⁷ There were certain specific activities that the Act mentioned as clearly related to banking, but it was up to the Federal Reserve to decide if the activity of the affiliate was "so closely related to the business of banking or managing or controlling banks as to be a proper incident thereto."¹⁶⁸ This restriction, enacted almost twenty five years after the Pecora Hearings, demonstrated how much fear those hearings had instilled in the nation as to the potential abuses of the banking industry.

¹⁶¹ Id.; see also Bank Holding Company, supra note 145, at 41.
¹⁶⁵ See Modernizing the Financial System, supra note 7, at XVIII-8.
¹⁶⁶ Id.
II. The Business of Banking: Problems and Solutions

A. Competition With Non-Banks

1. The Problems

Banks traditionally play many roles in our financial system. They provide a safe place for people and businesses to keep their money, and also offer a safe payments system for checking and other transaction accounts. More importantly, banks serve an intermediation function whereby they take deposits from people with excess capital and turn them into loans, many times to borrowers who would not have access to the securities market.

From these activities, banks make their profit through fees and spreads on interest rates. The fees are charged for usage of services, while the spreads are earned on the loans that are made. Since the bank is participating in a competitive market, its income from the services it performs and the loans it makes is constrained by the supply and demand for such services and loans in the marketplace. Banks also earn income through investment in certain securities. Bank profits are then determined through the difference between its income and its costs. Costs may include operating expenses, taxes, and the rates that the bank must pay to obtain deposits and other forms of capital.

This section shall analyze the marketplace of financial services during the past twenty years, and how recent changes have cost banks in fees and interest spreads.

a. Loss of Deposits

In the 1970's, investment opportunities for the average investor grew, making it possible for him or her to invest funds in relatively safe and accessible instruments offered outside of the confines of banks. Changes and reinterpretations of both state and federal regulation had “broken down many of the traditional barriers that

170. Id.
171. See Reed, supra note 85, at ch. 8.
172. Id.
173. Id.
174. Id.; see also id. at ch. 17.
175. Id.
176. Id.
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[had] separated banking and other industries. The availability of alternative investment forms have proven to be tough competition for banks in attracting deposits. Previously, capital costs were not always an issue in banking because banks were in a protected position. Rates were set; depositors and lenders were forced to take what they got as there were no other choices. There was no competition for banks. Once deregulation arrived and alternative investments became available, this all changed. Depositors began switching over to the capital markets as those markets became more readily accessible to the average investor and offered rates more competitive than the banks.

Competition with banks has come in many different forms and from many different places. States began to allow state-chartered savings and loans to offer Negotiable Order of Withdrawal ("NOW") accounts, which effectively acted like interest bearing checking accounts, an activity previously forbidden for insured depository institutions. Non-banks also became fierce competitors of banks. Money market funds were established by brokerage houses to allow depositors to earn interest rates higher than those the banks were allowed to pay under Regulation Q of the Banking Act of 1933. Insurance companies offer a variety of tax-deferred savings products which compete with bank certificate of deposits. In recent years, mutual funds have proven to be a growing competitor for bank deposits. Such a change demonstrates the shift in the aver-


179. See The Framework of History, supra note 177, at 22.

180. Id.

181. Felsenfeld, supra note 6, at S7, S14. Congress was quick to validate the states' actions in such area so as to avoid the appearance of the states undermining federal law. Id.

182. Money market accounts operate like checking accounts, thereby effectively creating interest bearing checking accounts that are not subject to the regulation of the Banking Act. Id. After other deregulation, banks were allowed to offer such products themselves, but the accounts of the brokerage houses have been much more popular due to their better rates. See Yvette D. Kantrow, As U.S. Consumers Change, So, Too, Must Banks' Tactics, AMERICAN BANKER, April 23, 1991, at 1. The reason for these better rates is that brokerage houses have "much lower costs than typical bank accounts due to lower overhead and the absence of costs associated with deposit insurance premiums, required reserves, or bank-capital adequacy requirements." Deposit Insurance Reform, supra note 178, at 244 (statement of Richard L. Fogel, Assistant Comptroller General, Government Programs, General Accounting Office).

183. Deposit Insurance Reform, supra note 178, at 244-45 (statement of Richard L. Fogel, General Accounting Office).

184. Recent surveys have indicated that mutual funds are becoming the investment vehi-
age American's tastes as to where he chooses to place his savings.

The competition between banks and the capital markets drove up the cost of capital for banks, thereby dwindling bank profits. In 1990, the General Accounting Office examined 100 of the country's largest banks and 200 of the largest problem banks, and reported that 35 banks required serious recapitalization within the following year or else they would require assistance to prevent their failure.

In the 1980's, Congress tried to protect banks from further loss of their customer base. The Depository Institutions Deregulation and Monetary Control Act of 1980 got rid of Regulation Q, the regu-

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185. Zimmerman, supra note 184, at 53.
186. Deposit Insurance Reform, supra note 178, at 56 (statement of Rep. Gonzalez, Texas, Chairman of the Committee).
lation which created interest rate ceilings for deposits and loans.\textsuperscript{188} This removed the limitations on competitive interest rates for banks.\textsuperscript{189} It also allowed banks to exceed the interest rate ceilings that were placed upon them, thereby removing any regulatory structural barriers that prevented them from actively competing with the capital markets. However, this did not solve the problems of the banks. The cost of capital was still high because the rates being offered in the capital markets were much higher than those rates traditionally offered by banks. Furthermore, banks were burdened by extra costs in the form of deposit insurance, and other costs associated with the intensive regulation of the banking industry.\textsuperscript{190}

In order to compete with the rates of the capital markets, banks were drawn to riskier investments which offered them higher returns.\textsuperscript{191} This way they would be able to offer higher rates to depositors in order to attract deposits. While Glass-Steagall restricts the investments a bank can make, it does not restrict them to only the safest investments. Banks may still take interests in risky, high yielding investments. Such investments during the '80s included loans to lesser developed countries (LDC debt), speculative commercial real estate lending, energy and agricultural loans, and loans in highly leveraged transactions.\textsuperscript{192} These loans soon became "problem" loans.\textsuperscript{193} Aside from being poorly performing loans, these loans cost

\begin{footnotesize}
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190. It has been estimated that compliance with regulation cost banks $10.7 billion in 1991; that amounts to nearly 60% of their profits. \textit{Banks Spent $10.7 Billion In Compliance Costs In 1991, An ABA Survey Estimates,} 58 Banking Report (BNA) No. 25, at 1086 (June 22, 1992).
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banks in the capital markets when they tried to raise capital; their cost of capital increased due to the extra risks they had taken on.\textsuperscript{194}

With the decrease in interest rates in the current economy, banks have been further losing deposits.\textsuperscript{195} However, the demand for loans has gone down and therefore the concern over maintaining deposits has also gone down.\textsuperscript{196} There is a concern that it will become very costly for banks to reattract those deposits once the demand for loans increases again.\textsuperscript{197} The lower interest rates have forced bank customers to become "more sophisticated" by searching for alternative investments such as mutual funds.\textsuperscript{198} Once these former bank customers have become accustomed to their expanded "investment environment" it is expected that banks shall be forced to enter into significant rate competition and advertising in order to reattract those customers to the bank.\textsuperscript{199}

\section*{b. Loss of Borrowers}

Another problem for banks has been the securitization of financial products. In the past decade, widespread securitization of financial assets has occurred in the form of new instruments such as interest rate swaps, mortgage related securities, and other asset backed securities which have been introduced into the capital markets.\textsuperscript{200} Securitization effectively allowed borrowers to obtain financing at more competitive rates through the capital markets rather than through banks.\textsuperscript{201} This method of financing has provided non-banks with many in-roads into the banking business, most notably in the area of mortgages and commercial loans.\textsuperscript{202}

The increase in the popularity and usage of commercial paper is

\begin{thebibliography}{99}


\bibitem{194} Id.

\bibitem{195} Matthews, supra note 1, at 1.

\bibitem{196} Id.; see also supra notes 169-176 and accompanying text.

\bibitem{197} Matthews, supra note 1, at 1.

\bibitem{198} Id.

\bibitem{199} Id.


\bibitem{201} \textit{Modernizing the Financial System}, supra note 7, at XVIII-12.

\bibitem{202} \textit{Vol. I, Deposit Insurance Reform and Financial Modernization}, supra note 184, at 67 (written statement of Thomas G. LaBrecque, President, Chase Manhattan Bank).

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HE WHO HESITATES

a prime example of the problems with securitization. In 1970, commercial lending from large banks accounted for about eighty percent of the short term credit received by corporations for their business financing. From holding eighty percent of the market for short term credit in 1974, the market share for banks dropped to forty-three percent in 1988.

There are other examples of the tremendous overlaps in the business of banking and non-banking firms which cause banks to lose market share. A large number of non-banking firms are now very active in consumer credit and mortgage lending. Insurance companies now offer an array of products which are effectively the same as many banking products. With the benefits of lower costs due to not having to pay deposit insurance premiums, and much less limitation in how they may receive and invest their capital, these non-banks can afford to offer loans at much more competitive rates.

At the same time, though, banks have been attempting to invade the turf of non-banks by creating new products to compete with them. However, for both banks and non-banks, such competition is many times attained only with the researched advice of legal counsel on how to remain within the constraints of current regulation, the costs of which are passed on to their customers. Therefore, by competing in the global investment market, American banks and securities firms are at a competitive disadvantage due to costs that their


204. Vol. I, Deposit Insurance Reform and Financial Modernization, supra note 184, at 67 (written statement of Thomas G. LaBrecque, President, Chase Manhattan Corp.).

205. Id. Commercial paper was originally an alternative only available to big named corporations whose names were strong in the capital markets. See id. However, smaller corporations started using this means of financing in the 1970's. Id. This resulted in the steady loss of short term lending business by banks.

206. Deposit Insurance Reform, supra note 178, at 244 (written statement of Richard L. Fogel, General Accounting Office).

207. Vol. I, Deposit Insurance Reform and Financial Modernization, supra note 184, at 68 (written statement of Thomas G. LaBrecque, President, Chase Manhattan Corp.). An example of this are financial guarantees, which are the equivalent to a bank's standby letter of credit. Id.


209. Id. at 18.
foreign competitors do not have.210

c. The Securities Business

Glass-Steagall limits banks as to the business they may enter and what types of affiliations they might have. However, in the 1980's, the regulatory agencies greatly expanded the breadth of these activities. Banks are now allowed to own brokerage houses, as long as those brokerage houses do not engage in underwriting activities.211 Banks are also allowed to offer investment advice.212 Non-member banks were given even broader powers in 1984, when the FDIC allowed insured, state-chartered, non-member banks to affiliate with businesses that engage in a "broad range of securities activities", the rationale being that most of Glass-Steagall did not apply to the subsidiary and affiliate relationships of non-member banks.213 However, Glass-Steagall still prohibits all insured banks from underwriting and dealing in corporate securities.214

The Federal Reserve has recently been expanding upon a bank's allowable affiliations.215 Bank-holding companies may now establish non-bank subsidiaries, known as Section 20 Affiliates (named for §20 of Glass-Steagall) that may earn ten percent of their revenue from a range of otherwise prohibited securities activities, such as the

210. Id.
211. In 1984, the Supreme Court upheld the Federal Reserve Board's decision allowing BankAmerica Corporation, a bank holding company regulated by the Federal Reserve, to acquire Charles Schwab Corporation, as a non-banking, brokerage affiliate. Securities Indus. Assoc. v. Board of Governors of the Fed. Reserve Sys., 468 U.S. 207 (1984). While § 20 of Glass-Steagall strictly prohibits bank holding companies from owning a firm that principally engaged in the "issue, flotation, underwriting, or distribution of securities", the Court found that Charles Schwab only provided brokerage services and Glass-Steagall was more concerned with investment banking activities. Id. at 215-221.
212. In Securities Indus. Assoc. v. Board of Governors of the Fed. Reserve Sys., 821 F.2d 810 (D.C. Cir. 1987), cert. denied, 484 U.S. 1005 (1988), the Circuit Court upheld a Federal Reserve decision whereby Westminster Bank, PLC and its subsidiary Natwest Holdings, Inc. were allowed to provide both brokerage services and investment advice.
215. Id. at 464.
underwriting of corporate bonds, and possibly even corporate equities. However, Section 20 Affiliates are only feasible to very large banks which can afford to establish a separately capitalized affiliate with strict "firewalls" separating it from the bank. By mid-1990, there were about thirty bank holding companies that had Section 20 subsidiaries.

d. Insurance Activities

Insurance is considered a financial activity very close to banking. Even so, all insured banks are almost completely restricted from engaging in insurance activities. The Bank Holding Company Act is held to generally restrict the insurance activities of subsidiaries and affiliates of banks.

Insurance products are often very much like bank products. The General Accounting Office has determined that by allowing banks to offer insurance products as an agent of those products, the costs of insurance would be reduced due to lower marketing costs achieved through economies of scale. These costs would be spread among the products that a bank has to offer. Similarly, there would be an increase in convenience for consumers in obtaining insurance through the banking systems current distribution system of branch

216. Id. at 259 (written statement of Nicholas F. Brady, Secretary of the Treasury). In 1987, the Federal Reserve Board approved the applications of several bank holding companies to have businesses that underwrite and trade limited amounts of commercial paper, municipal revenue bonds, and securitized mortgage debt issued by others. See Kaufman & Mote, supra note 184, at 401-02; Citicorp, 73 Fed. Res. Bull. 473 (1987). However, the banks were limited in these new activities to "5 percent of the gross revenues of their securities subsidiaries and to 5 percent market share limitation". Kaufman & Mote, supra note 184, at 403. The Board also allowed bank holding company subsidiaries to underwrite and deal in corporate debt and contingently approved dealings in corporate equity to receive full approval within a year, subject to the same limits established for such affiliates as before. Id. at 405; J.P. Morgan & Co., Inc., 75 Fed. Res. Bull. 192 (1989). This was upheld by the D.C. Circuit in 1990. Securities Indus. Assoc. v. Board of Governors of the Fed. Reserve Sys., 900 F.2d 360 (D.C. Cir. 1990). In 1989, the Board expanded the limit on approved securities business to ten percent of gross revenue. Modifications to Section 20 Orders, 75 Fed. Res. Bull. 751 (Nov. 1989).


219. Id. at XVIII-16. The insurance company takes premiums instead of deposits, invests them in assets and loans and then repays the proceeds to the policyholder rather than the depositor. Id.

220. Id. at XVIII-17.


222. Modernizing the Financial System, supra note 7, at XVIII-17.
banking.\textsuperscript{223} The potential conflict of interest problems, such as pressure sales, can be combated through regulatory oversight rather than a complete ban on banks provision of such services.\textsuperscript{224}

Currently, however, banks and bank holding companies are only allowed limited access to the insurance market.\textsuperscript{225} National banks may only underwrite and broker credit insurance, title insurance, and property insurance related to loan collateral.\textsuperscript{226} They are allowed to broker fixed-rate annuities and to perform general insurance brokerage in towns of less than 5,000 people.\textsuperscript{227} While originally the Bank Holding Company Act was interpreted to prohibit bank holding companies from acquiring insurance companies, the Federal Reserve began allowing for such alliances.\textsuperscript{228} However, the Garn-St. Germain Act of 1982\textsuperscript{229} strictly prohibited bank holding companies from acquiring interests in insurance companies.\textsuperscript{230}

For state chartered banks, it is a different story. Banks chartered in Delaware and California used to be permitted to engage in insurance activities.\textsuperscript{231} However, with the enactment of FDICIA\textsuperscript{232}, insured, state chartered, non-member banks are now restricted to those insurance activities allowed for national banks.\textsuperscript{233}

Nevertheless, a number of bankholding companies have interests in insurance companies that were "grandfathered" under the Garn-St.Germain Act.\textsuperscript{234} Basically, these holding companies had owned insurance companies upon the permission of the Federal Re-

\begin{itemize}
\item \textsuperscript{223} Id.
\item \textsuperscript{224} Id.
\item \textsuperscript{225} Id.
\item \textsuperscript{226} Id.
\item \textsuperscript{227} Id. at XVIII-17 to 18. Currently, there is a question as to whether national banks are allowed to engage in insurance activities in towns of less than 5,000. This issue has been addressed in two cases: Independent Insur. Agents of America, Inc. v. Clarke, 955 F.2d 731 (D.C. Cir. 1992) (stating that such activities were not permitted to national banks); and American Land Title Assoc. v. Clarke, 968 F.2d 150 (2d Cir. 1992) (stating that national banks were permitted to perform such activities). Currently, a motion for certiorari has been filed with Supreme Court on this matter.
\item \textsuperscript{228} Modernizing the Financial System, supra note 7, at XVIII-18.
\item \textsuperscript{230} 12 U.S.C. § 1843(c)(8) (1992); Modernizing the Financial System, supra note 7, at XVIII-18.
\item \textsuperscript{231} See Vol. III, Deposit Insurance Reform and Financial Modernization, supra note 191, at 259 (written statement of Nicholas F. Brady, Secretary of the Treasury).
\item \textsuperscript{234} Modernizing the Financial System, supra note 7, at XVIII-18.
\end{itemize}
serve prior to the enactment of the Garn-St. Germain Act. Instead of requiring divestment of these affiliations, the Act decided to permit the holding company to maintain their interests.

e. A Result of the Problems

The effect of deregulation on the banking industry can be seen more clearly through statistics. The banking industry's control over the financial sector assets has fallen from 33% in 1980 to 27% in 1989. Over a period of forty-five years, from the time the FDIC was created up until 1979, less than 600 FDIC insured banks had failed; after deregulation, in less than ten years, from 1980 to 1989, 1,085 such banks failed.

2. The Solutions

One solution is something the banks are already attempting—adapting themselves to the changing market through cost cutting, wherever necessary, and learning how to expand into new areas. Banks used to allow four-fifths of their costs to be shared among the entire bank while industrial companies would only allow one-fifth. Now banks are very concerned with the profitability of each department, and costs are being managed more efficiently. Banks now cut those parts of the business that are not proving profitable; ten years ago, such actions would be considered quite unusual. There has also been an expansion of fee generating businesses such as mortgage banking and financial advisory work. In six years, non-interest income for banks has grown from 10% of their business to 16%. Recent reinterpretations of banking regulation by various regulatory authorities have given banks great access to the securities business. A recent survey of large banks shows that seventy-four percent currently offer some form of investment product, mostly in the form of annuities or mutual funds.

235. Deposit Insurance Reform, supra note 178, at 278 (written statement of L. William Seidman, Chairman of the Federal Deposit Insurance Corporation).
236. Id. at 108 (statement of Rep. Frank Annunzio, Illinois).
238. Id.
239. Id.
240. Id.
242. Id.
243. See discussion supra notes 211-218 and accompanying text.
244. Duffy, supra note 184, at 42.
Moreover, banks have been very creative in their development of new investment products. Market Index CDs ("MIDs") were first offered by Chase Manhattan Bank in 1987. MIDs are CDs whose rates follow the Standard & Poor 500 index's return, but have benefits over an index fund. They have guaranteed floors in case the market drops below a certain amount and, at the same time, they are FDIC insured. Banks also now offer CDs whose returns reflect the price of gold. These products, which resemble commodity option contracts, have been approved by the Commodity Futures Trading Commission. Bankers Trust originated the short-term securitized loan, which serves as a substitute for commercial paper. Interests in this loan are sold to participants, while the originating bank is able to retain a portion for itself; the transaction is structured more like a loan participation rather than a security. This type of transaction is permissible as the loan is not considered a security and, therefore, not subject to Glass-Steagall.

Aside from adapting to their new environment, many changes have been occurring in banking law without the action of Congress. In Board of Governors of the Federal Reserve System v. Investment Co. Institute, the Supreme Court "set a standard of great deference" to the administrative agencies, thereby opening the door for the agencies to expand banking powers. Furthermore, at the Bush Administration's direction, the regulators officially announced their intention to actively coordinate amongst themselves a program of de-

245. Kaufman & Mote, supra note 184, at 416.
246. Id. The banks reduce their risk in offering such returns through investing in S&P Index future contracts, which a bank is permitted to invest in because these contracts are settled in cash and not in stocks. Id. at 417.
247. Id.
248. Id.
250. Id.

The extent of bank deregulation has gone so far, that according to an estimate made by Citicorp "of about $5.7 trillion of securities issued in 1985, including federal government securities, U.S. commercial banks were excluded from underwriting only 265 billion dollars, or 4 percent of the total." See Kaufman & Mote, supra note 184, at 410-11. Bankers Trust, J.P. Morgan, and Citicorp all ranked as among the top twenty-five domestic underwriters in corporate securities. Id. at 411.
regulation of the banks.\textsuperscript{253}

However, it is improper for the regulators to make such substantive changes in the law when they are only meant to interpret and execute it. There would not be sufficient checks on the actions of the agencies, as the courts tend to overlook many of the real concerns underlying Glass-Steagall.\textsuperscript{254} Under the current system of expanding bank powers there is confusion for banks as to the business in which they may lawfully engage, and with the associated legal costs. Worse yet, the changes in the banking activities allowed by the regulators might require further expansion of the regulator's supervisory powers. This would be something only Congress could cure. Solutions are necessary. Whether implemented to save the banking industry or to give power back to the government over the money supply, a change in the law is in order. As Mr. Richard Fogel of the GAO testified to Congress, "the piecemeal, ad hoc redefinition of the financial landscape that has been occurring over the last two decades is, in our view, dangerous because our regulatory system is neither equipped nor organized to deal with the changes."\textsuperscript{256} While Congress has introduced a number of bills on the matter, none have become law.\textsuperscript{257}

Likewise, the actions taken by the regulators and the courts are not always adequate. The regulators can only go so far in their reinterpretations of banking regulation. An example is underwriting. While the underwriting of securities is strictly prohibited under Glass-Steagall, it has been determined to have less risks than the risks involved with commercial loans.\textsuperscript{258} There is also the issue of

\textsuperscript{253} See Regulators Announce Set of Regulation Reform Moves; OTS To Adopt Branching Plan, 58 Banking Report (BNA) No. 14, at 579 (April 6, 1992); Bush Streamlines Banking Regulations, Clarifies Lender Liability Under CERCLA, 58 Banking Report (BNA) No. 18, at 760 (May 4, 1992).

\textsuperscript{254} LeGraw & Davison, supra note 252, at 267.

\textsuperscript{255} Deposit Insurance Reform, supra note 178, at 59 (written statement of Richard Fogel, General Accounting Office).


commercial paper. Disallowing banks to directly underwrite commercial paper is a constraint which only exists to keep banks within the boundaries set by Glass-Steagall, rather than to protect against any real dangers. While it is true that a bank is able to privately place commercial paper as long as it does not make loans on that paper, such a limitation places a bank at a serious competitive disadvantage against non-banks. Underwriting commercial paper is no more riskier than making a loan. Furthermore, the allowance of banks to underwrite through Section 20 affiliates is effectively discriminatory since the strict “firewalls” make it too costly for smaller banks to have such affiliations. The limits of the ten percent cap for affiliates is also too restrictive. Such a revenue limitation reduces the benefits of having such an affiliate and makes it worthwhile only to the largest banks.

The evolution occurring in the financial marketplace over the last twenty years has brought calls from many for Congress to

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258. In Securities Indus. Assoc. v. Board of Governors of the Fed. Reserve Sys., 468 U.S. 137 (1984), the Supreme Court addressed some Glass-Steagall policy concerns in allowing banks to underwrite commercial paper, such as underwriting the paper to pay off loans owed to the bank. Id. at 149. However, most of the case seemed more concerned with defining whether commercial paper is a “note” or “other security” for the purposes of Glass-Steagall. Id. The question of whether commercial paper was actually a “hazard” under Glass-Steagall was ignored by the Court due to it being a “post hoc rationalization” by the Agency’s counsel. Id. at 145.

259. Litt, supra note 243, at 389.


Commercial paper is a short term debt instrument, usually with a maturity of 30 days or less. Paul Lowenstein, The Commercial Paper Market and the Federal Securities Laws, 4 CORP. L. REV. 128, 147 (1981); Evelyn M. Hurley, The Commercial Paper Market, 63 FED. RES. BULL. 525, 530 (1977). The proceeds from commercial paper are used for generally the same purposes that the proceeds from short term loans are used, since they both have short term maturities and therefore can only be used for temporary purposes. Id. at 527. Corporations issue commercial paper as a substitute to receiving a bank loan. Id.; Lowenstein, supra, at 130. See also John P. Forde, Commercial Paper May Yet Top Bank Loans, Study Says, AMERICAN BANKER, Sept. 27, 1983, at 3.

The risk to the lender in commercial paper market is equivalent to the risk of an unsecured creditor. Lowenstein, supra, at 133. However, those who issue commercial paper are subject to the scrutiny of the rating services, which affect the availability to successfully sell commercial paper to the public; the poorer the rating, the higher the interest the issuer must pay. Hurley, supra, at 528-29. Therefore, the public is well informed as to the risks of the borrower.


262. MODERNIZING THE FINANCIAL SYSTEM, supra note 7, at XVIII-19.
change Glass-Steagall and the other regulations that prevent banks from being more competitive. Alan Greenspan, Chairman of the Federal Reserve, recently testified to the House Banking Committee:

As you know, the Federal Reserve Board has long supported repeal of the provisions of the Glass-Steagall Act that separate commercial and investment banking. We still strongly advocate such repeal because we believe that technology and globalization have continued to blur the distinctions among credit markets and have eroded the franchise value of the classic bank intermediation process. A banking system that cannot adapt to the changing technical and technological environment will no longer be able to attract and maintain the higher capital level that some of our institutions need to operate without excessive reliance on the safety net [deposit insurance].

There are three basic ways that American banks could be allowed to offer a diversified product line. The most radical solution would be to implement a "universal" banking system. The major concern with "universal" banks would be with deposit insurance coverage as the risks of the banks would be much higher. Additionally, regulation would require examiners who were experts in both banking and securities. The countries with the two largest equity markets, Japan and the United States, do not permit universal banking, while in Germany, where it is permitted, the equity market pales by comparison.

263. Deposit Insurance Reform, supra note 178, at 12 (written statement of Alan Greenspan, Chairman, Federal Reserve).

264. Such a system would allow banks to engage directly in a broad range of financial activities and to hold interests in commercial enterprises. Financial Services Industry, supra note 200, at 23 (statement of Richard C. Breeden, Chairman, Securities and Exchange Commission). This system is currently employed in Germany and other nations in Europe. Id.

265. Id. at 24 (written statement of Richard C. Breeden, Chairman, Securities and Exchange Commission).

The risks for all investments might not be as high as one would think. The risks of allowing banks to underwrite issues of securities can be much less than those risks for loans. In such situations the bank would merely serve as a middleman issuing securities to the public, its obligation extending only to the point of sale; this risk is far less than that of a commercial loan which the bank extends credit and subjects itself to risks over a period of years. Oversight Hearing on Foreign Competition In the Banking Industry: Field Hearing before the Subcomm. on Financial Institutions Supervision, Regulation, and Insurance of the House Comm. on Banking, Finance, and Urban Affairs, 101st Cong., 2d Sess. 148 (1990) [hereinafter Oversight Hearing on Foreign Competition In the Banking Industry] (written statement of Robert L. Clarke, Comptroller of the Currency).


267. Id.
Another problem seen in diversifying the banks’ product line is that the banks will have unfair advantages over other providers of financial services. Banks will have greater access to cheap funds because a risk premium is not needed on those insured deposits, and because banks have access to the Federal Reserve discount window. However, this concern is overstated, as banks do not receive their insurance for free; they have to pay premiums for it to the FDIC. Also, the discount window is not cheap, and use of such for “last resort lending” is at a premium above the market and above “the borrower’s alternative cost of funds.”

Another method of allowing banks to offer non-banking products is through the direct subsidiaries of the bank, as done in Canada and Britain. The third manner is through a holding company structure, where the holding company would own both the bank and the non-bank. Supervision of affiliations or subsidiary relationships with non-banks is preferable to that of a bank providing the additional financial services. Affiliates can be examined individually by separate examiners instead of requiring an examiner who is a “jack of all trades”, with knowledge in banking, insurance, securities, and whatever else the bank might engage. Moreover, the separation by affiliations would make it easier for a regulator to determine if “a particular activity is being conducted prudently and profitably.” An affiliation structure would also permit for firewalls or “chinese walls” to be created which would prevent insured deposits from being placed in risky investments.

There have been proposals to Congress from the various regulatory authorities that banks be allowed to affiliate with financial ser-

269. Id.
270. Id. at 463. Also, a system of risk based premiums could account for the associated problems of risks to the insurance fund. See Deposit Insurance Reform, supra note 178, at 189 (written statement of Alan Greenspan, Chairman, Federal Reserve). Such a system would both properly insure a bank based upon its risks and at the same time serve as a discouragement to banks from taking on excessive risks.
271. Id.
273. Id.
274. Id. at 26
275. Id.
276. Id.
277. Id. at 27.
vice companies which offer a broad range of services. One suggestion for the structure of such affiliations is to limit banks to short term or medium term loans that do not have the attributes of equity instruments, and having the affiliates handle the riskier, longer-term investments. The affiliates would be required to be separately capitalized and would not be insured. Banks under this system have been called "insured narrow banks". These institutions would only be allowed to invest in "high quality, short-maturity, liquid investments, while recovering the costs for checking accounts and wire transfers from user fees." However, it has been suggested that small banks be treated differently under such a scheme, due to the "difficulties in setting up holding companies or separate subsidiaries, and the lesser danger they pose to the deposit insurance system." Such smaller institutions would be under less restrictions.

The problem with the insured narrow bank is that, in the short term, such a transition from the modern banking structure to such a "narrow bank" structure would be "difficult and costly", putting American banks at a disadvantage against foreign competitors. Also, without insurance, the affiliates or subsidiaries of these banks, in taking uninsured deposits and investing them in riskier investments, would now be subject to the bad times of the capital markets. They would suffer from the same types of risks which closed down banks during the Depression when mere rumors of bad investments sent lines of people outside their doors to withdraw all of their uninsured deposits.

The Treasury Department has proposed an alternative system, whereby only the better run and safer banks would be able to engage in a broader range of activities. Such a supervised system for banks would be based on their level of capital, dividing banks into five

278. Deposit Insurance Reform, supra note 178, at 103 (written statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation).
279. Id.
280. Id. at 51 (statement of Alan Greenspan, Chairman, Federal Reserve); see also id. at 285 (written statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation).
281. Id. at 189 (written statement of Alan Greenspan, Chairman, Federal Reserve).
282. Id.
283. Id. at 103 (statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation).
284. Id.
285. Id. at 190 (written statement of Alan Greenspan, Chairman, Federal Reserve).
286. Id.
287. Id.
zones. Zone 1 banks would have capital ratios higher than that required by law, and would receive the highest regulatory freedom and would be allowed to engage in a broad range of financial activities through a holding company. Zone 2 banks would be banks capitalized at their minimum requirements and would not be allowed to engage in any other activities through a holding company. Zone 3, 4, and 5 would consist of banks below their minimum capital requirements and would be subject to penalties. This system would only allow the higher capitalized, healthy banks to have affiliations in non-banking activities. The General Accounting Office also supports this concept of a case-by-case basis for broadened powers. However, they have also promoted the idea that non-banks should reciprocally be allowed to engage in more banking activities.

The Treasury Department had also suggested that banks be allowed to do the administrative work in managing their mutual funds. Mutual funds are an investment that banks could offer without risk to itself. The risk is assumed by the investor who is rewarded with a risk premium that the capital market, and not the bank, provides. The bank profits through fees regardless of how the mutual fund performs; of course, the banks would want the mutual fund to perform decently, since high performance is what attracts investors to the product. Current restrictions on banks in managing mutual funds are overly burdensome because the manager of a mutual fund is an agent, not an owner, underwriter, or guarantor of the assets on the fund. The bank would never guaranty the sale of mutual fund shares or the performance of the fund.

The Treasury Department has also proposed to allow banks to affiliate with insurance companies. The House Banking Committee created a firewall for bank affiliations with insurance companies,
by limiting such affiliations through a diversified holding company.²⁹⁸

Both banks and their customers stand to gain a lot from allowing banks to offer a more diversified product line.²⁹⁹ Banks will be able to compete on a level playing field, while customers will reap the benefits of competition between financial services providers.³⁰⁰ Better yet, it would encourage financial service providers to seek out a specialized niche, resulting in individualized service.³⁰¹

B. Interstate Branching

1. The Problems

One of the purposes of the McFadden Act was to prevent large powerful banks from taking over the territory of smaller, rural banks who were, at the time, suffering from bad loans.³⁰² Today, however, the restrictions on interstate banking have effectively diluted the power of American banks. In Germany, eight banks control half of the country's bank assets while in Japan, where the top banks are much larger than American banks in asset size, thirteen national-commercial banks carry half of the country's bank assets.³⁰³ In the United States, it takes thirty-five banks to carry that amount of assets.³⁰⁴

Almost all interstate banking has occurred by way of bankholding company affiliations in states where such holding company relationships are permitted.³⁰⁵ Therefore, member banks can only operate across state borders through bank holding company affiliations.³⁰⁶ At the same time, banks must compete with non-bank financial companies that are not subject to such limitations in cross-border expansion.³⁰⁷ America has seriously fallen behind the times. While European banks in the Economic Community now have the

²⁹⁸. *Id.* A diversified holding company would be the holding company of a bank-holding company (or basically, the insurance company could be the affiliate of a bank holding company).


³⁰⁰. *Id.*

³⁰¹. *Id.*

³⁰². *See discussion supra* notes 61-63 and accompanying text; *see also The Framework of History, supra* note 177, at 22.


³⁰⁴. *Id.*


³⁰⁶. *Deposit Insurance Reform, supra* note 178, at 206 (written statement of Alan Greenspan, Chairman, Federal Reserve).

³⁰⁷. *Id.* at 64 (statement of Richard Fogel, Government Accounting Office).
ability to branch all over the Community, American banks cannot extend branches beyond state lines.\footnote{308} It is estimated that due to duplicative costs, the banking industry would save $10 billion a year if nationwide banking was permitted; this should be compared to a pre-tax profit of $25 billion for the entire industry.\footnote{309} Ultimately, these savings could be passed to the average bank customer through fees and interest rate premiums and allow banks to compete more effectively with the capital markets.

2. The Solutions

In the ideal world, if there was only one bank who never had to deal with any other financial institution, there would never be any bank failures because money withdrawn from one branch would be deposited into another.\footnote{310} It would seem to follow, then, that the risks related to deposit insurance would be lessened if there were fewer banks. Historically, branch-network banks have had a considerably lower failure rate than unit banks.\footnote{311} Texas and Oklahoma, two states with among the most restrictive banking laws in the country, are also among the states with the largest amount of bank failures.\footnote{312} The removal of the artificial constraints created by the McFadden Act would allow for consolidations that would help reduce risks to the bank insurance fund by allowing banks to expand their capital base through deposits.\footnote{313}

The advantages of removing border barriers to branch banking would be twofold. First, the benefit to consumers would be that, on average, they would have access to a wider variety of financial services.\footnote{314} Second, the advantage to the banks, recognized in the 1930s by Senator Carter Glass, would be the banks ability to diversify their

\footnote{308. \textit{Financial Services Industry}, supra note 200, at 18 (written statement of Robert C. Breeden, Chairman, Securities and Exchange Commission).}
\footnote{310. \textit{Id.} at 36.}
\footnote{311. \textit{Modernizing the Financial System}, supra note 7, at XVII-8. Unit banking is a system whereby all of the banking services are provided by one office. \textit{Reed}, supra note 85, at 27. This type of system was popular in the 19th century, due to poor transportation and communication facilities, as branch banking could not easily be supported. \textit{Id.}}
\footnote{312. \textit{Strengthening the Supervision and Regulation of the Depository Institution}, supra note 102, at 450 (written statement of Robert Carswell, Partner, Shearman and Sterling).}
\footnote{313. \textit{Deposit Insurance Reform}, supra note 178, at 36.}
\footnote{314. \textit{Oversight Hearing on Foreign Competition in the Banking Industry}, supra note 265, at 150 (written statement of Robert L. Clarke, Comptroller of the Currency).}
investments to become more immune to regional economic downturns.\textsuperscript{315} A bank would not become dependent upon a local economy or industry.\textsuperscript{316} This would allow regional downturns to be absorbed by the prosperity of branches in other regions, helping the bank insurance fund by avoiding bailouts.\textsuperscript{317} Also, such a system of interstate branching would remove the inequity in competition with non-bank financial service companies which are not bound by state borders.\textsuperscript{318} At the same time, this system would help optimize the use of bank capital, allowing regions with excess deposits to extend credit to regions with an excess demand for loans.\textsuperscript{319}

There are three possible forms of regulatory structures for interstate branching. One form would be to only allow interstate branching for national banks, which would only be subject to federal regulation. Another form would be to have host-state regulation, subjecting state chartered banks to the regulation of the state in which it is doing business. Still another form would be to have home-state regulation designed after the plan established by the European Economic Community for branch banking whereby the home state of the state chartered banks shall establish the laws by which the branches shall exist.\textsuperscript{320}

In its report to Congress, the Treasury Department proposed full nation-wide banking for bank holding companies after a three year delay.\textsuperscript{321} Interstate branching would be allowed immediately in those states where an out-of-state bank holding company could currently acquire a bank under state law; in three years interstate branching would be allowed everywhere.\textsuperscript{322} This proposal allows the states to retain their power in establishing activity standards and consumer protection laws for banks that branch into their states.\textsuperscript{323}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{315} See supra notes 91-92 and accompanying text.
\item \textsuperscript{316} Id.
\item \textsuperscript{317} Modernizing the Financial System, \textit{supra} note 7, at XVII-9.
\item \textsuperscript{318} Oversight Hearing on Foreign Competition in the Banking Industry, \textit{supra} note 265, at 150 (written statement of Robert L. Clarke, Comptroller of the Currency).
\item \textsuperscript{319} Id.
\item \textsuperscript{320} Modernizing the Financial System, \textit{supra} note 7, at XVII-15.
\item \textsuperscript{321} Deposit Insurance and Banking Reform Proposals, \textit{supra} note 2, at 91 (attachment of Treasury News article).
\item \textsuperscript{322} Id.
\end{itemize}
\end{footnotesize}
Also, in recognizing a potential loss in taxing revenues due to bank main offices being located out of state, the proposal allows states to tax interstate branches.\footnote{324}

The biggest problem in implementing a system of interstate branching is that many states oppose such a system. One way to create an interstate banking system is to allow the states to regulate their own banking laws. A number of states have done exactly this and have formed regional compacts allowing interstate banking, mostly on a reciprocal basis.\footnote{325} Interstate banking “exploded” in the last decade.\footnote{326} However, even though most states have some form of interstate banking, interstate branching remains virtually prohibited.\footnote{327} Until Congress amends the McFadden Act, federally regulated banks will be prohibited from branching across state borders.

While Congress has still failed to enact legislation which would permit interstate branching,\footnote{328} there has been some action towards that direction by other sources. New York recently passed a law which permits state chartered, non-member banks to branch interstate, and reciprocates branching abilities for banks of other states that allow New York banks to branch in their states.\footnote{329} Partially to benefit from this law, Key Bank, in New York, switched itself from a federal to state charter.\footnote{330} The Office of Thrift Supervision (“OTS”) adopted regulations which permit interstate branching of savings associations.\footnote{331} This regulation was authorized under section 5(r) of the Home Owner’s Loan Act (“HOLA”).\footnote{332} In July, 1992,
TCF Savings Bank of Minnesota became the first thrift to be approved to operate an interstate branch under this regulation.\textsuperscript{333} Unfortunately, there is no law that would permit banking regulators to take the same action as the OTS.

Congress has many concerns over interstate branching.\textsuperscript{334} These apprehensions stem from the longstanding fear that big-town banks will devour the capital of small-town America and give little in return.\textsuperscript{335} For many residents of smaller towns, getting a loan is becoming inconvenient as bank systems grow larger within the state and the banks, now based in big cities, refer customers to main offices located miles away.\textsuperscript{336} This problem is feared to only get worse when the main offices of the banks are located in another state.

Despite these problems, there are other means of countering the longstanding fears that have surrounded interstate branching without prohibiting interstate branching altogether. The House Agricultural Committee has made a proposal whereby, in allowing interstate branching, rural branch offices of out-of-state banks should be closed if they did not service the credit needs of the local community.\textsuperscript{337} While this proposal directly addresses the fear over big-town banks, that fear is greatly exaggerated. In actuality, if there are profitable investments to be made in a rural community a bank will make such an investment, regardless of where its main office is located.\textsuperscript{338} If Congress should place such a requirement on banks that expand into other states, it should take into account other factors, such as whether a local bank would be able to service those needs of the community.

There is an additional concern with interstate branching that Congress has hardly addressed at all. This problem is that lending

\begin{itemize}
\item \textsuperscript{333} \textit{OTS Approves First Interstate Branching Request In Minnesota, Considers 4 More}, 59 Banking Report (BNA) No. 3, at 108 (July 20, 1992).
\item \textsuperscript{334} See, \textit{e.g.}, \textit{Deposit Insurance Reform-1991}, supra note 309, at 28 (written statement of Rep. Peter Hoagland, Nebraska).
\item \textsuperscript{335} See supra notes 67-70 and accompanying text.
\item \textsuperscript{338} \textit{Deposit Insurance Reform-1991}, supra note 309, at 29 (written statement of Nicholas F. Brady, Secretary of the Treasury).
\end{itemize}
decisions might be made in far away cities by bank officers who cannot properly evaluate the risks of making a loan due to their remote contact with the particular community.\textsuperscript{339} Normally, such credit decisions would be made by bank officers who lived in the community. Local banks have a more intimate relationship with the community and therefore a better understanding of the real risks involved in local investments. Should such banks be taken over by larger banks, or replaced by branches of out-of-state banks, lending decisions, especially for large projects, might be more conservative than they would be if made by local banks. The only way to combat such a problem would be to require banks with interstate branches to have their lending decisions made by regional divisions. Such divisions would be expected to be in tune to the community, and would, therefore, be able to make better decisions as to lending risks than an officer at a far away city. Such lending departmentalization is already conducted by many of the larger banks, but the mid-size and smaller banks might skip out on such divisions in their interstate lending. Unfortunately, Congress has made no attempt to address this situation at all.

C. Affiliations

1. The Problems

Banks need capital before they can lend capital. One of the greatest sources of capital in this country is the corporation.\textsuperscript{340} However, the Glass-Steagall Act and the Bank Holding Company Act restrict banking and commerce from forming affiliations.\textsuperscript{341} Glass-Steagall prevents banks from affiliating with non-banks while the Bank Holding Company Act prevents banks from affiliating with commercial firms.\textsuperscript{342}

However, this practice does not apply to all banks which operate in this country. Regulation K of the Federal Reserve holds that the Bank Holding Company Act of 1956 does not apply to foreign banks who have affiliations with non-banks overseas.\textsuperscript{343} A foreign based

\begin{itemize}
  \item \textsuperscript{339} Id. at 41 (testimony of Rep. James P. Moran, Virginia).
  \item \textsuperscript{340} Vol. III, Deposit Insurance Reform and Financial Modernization, supra note 191, at 169 (written statement of Richard C. Breeden, Chairman of the Securities and Exchange Commission).
  \item \textsuperscript{341} See discussion supra notes 142 and 165-168 and accompanying text; see also Vol. III, Deposit Insurance Reform and Financial Modernization, supra note 191, at 168 (written statement of Richard C. Breeden, Chairman of the Securities and Exchange Commission).
  \item \textsuperscript{342} Id.; see also supra note 142 and 165-168 and accompanying text.
  \item \textsuperscript{343} See infra note 435-436 and accompanying text; see also Financial Services Indus-
bank with commercial affiliations at its home base may operate branches and subsidiaries in the U.S., and can, therefore, enjoy the competitive advantage of having an alternative access to capital that American banks are denied.

Allowing affiliations between commerce and depositary institutions is not a novel idea. Commercial firms are already allowed to acquire thrift institutions. Ford Motor Company, Westinghouse Incorporated, Sears Roebuck, and General Electric have all been owners of thrift institutions.\textsuperscript{344} Such affiliations have been going on for quite some time with no indications of any improprieties. The benefit of such affiliations is the ability and willingness of the holding companies to provide needed capital to its financial subsidiaries.\textsuperscript{345} As a matter of fact, no thrift institutions owned by a commercial enterprise has failed during the S&L crisis.\textsuperscript{346}

Aside from affiliations with thrifts, in recent years there has also been the advent of the limited service banks, more commonly known as the “nonbank” banks.\textsuperscript{347} Such institutions were formed through a legal loophole in the Bank Holding Company Act, whereby a bank was defined as an institution that both accepted demand deposits and made commercial loans.\textsuperscript{348} This definition allowed for a commercial firm to simply eliminate one of the elements which defined a bank, thereby circumventing the restrictions of the Bank Holding Company Act upon affiliations between banking institutions and commercial enterprises and allowing for a commercial enterprise to own a bank-like organization which would be insured by the FDIC.\textsuperscript{349} In

\textit{try, supra} note 200, at 20 (written statement of Richard C. Breeden, Chairman, Securities and Exchange Commission).

\textsuperscript{344} \textit{Modernizing the Financial System, supra} note 7, at XVIII-21; \textit{see also The Impact of Banking Restructuring Proposals on Small Businesses’ Access To Credit, supra} note 336, at 57. (written statement of Edward Yingling, American Bankers Association). In 1990, Westinghouse acquired a thrift institution which had twenty branches and assets worth over $800 million. \textit{Modernizing The Financial System, supra} note 7, at XVIII-21.

\textsuperscript{345} Ford provides capital for its thrift operations, and American Express and Prudential do so for their securities firms. \textit{Modernizing the Financial System, supra} note 7, at XVIII-23.


\textsuperscript{347} \textit{Modernizing the Financial System, supra} note 7, at XVIII-21.

\textsuperscript{348} Id.

\textsuperscript{349} Id. “These so-called ‘non-bank banks’ were attractive to a wide range of business organizations seeking to capitalize on the efficiencies and synergies that come with offering largely complementary services.” \textit{Id. General Electric, Textron, ITT, Gulf & Western, John Hancock, Prudential Bache, American Express, Merrill Lynch, Dreyfus, Household, Beneficial, Sears Corporation, Bank of Boston Corporation, J.C. Penney, McMahan Valley Stores
1987, the Competitive Equality Banking Act\(^5\) ("CEBA") closed the loophole for non-bank banks, although creating some minor exceptions and grandfathering those existing non-bank banks.\(^6\) The result is that now a number of bank-like institutions exist which can have capital allocated to them by their commercial affiliates through their holding companies.

Commercial firms desire such relationships with financial companies for more than just the affiliation with another institution. The financial institution allows the customers to purchase from the commercial enterprise and, at the same time, the commercial enterprise provides customers to the financial institution.\(^7\)

2. The Solutions

The Treasury Department has suggested that commerce and banking be linked, but only through allowing commercial enterprises to obtain interests in banks.\(^8\) Such a distinction makes sure that insured deposits are not invested into the corporation, but yet allows the corporation to invest capital into the bank.\(^9\)

Should this alliance be allowed, the Bank Holding Act's reporting requirements might leave many potential commercial investors avoiding such affiliations. The Act holds the entire holding company to the regulatory process of the Federal Reserve, subjecting the affiliates to "regulatory approvals by the Federal Reserve before new businesses could be commenced or acquired."\(^10\) Such regulation would probably be a burden that few would consider undertaking to gain such affiliations.

Legislation has been proposed to allow any company to affiliate with depositary institutions.\(^11\) This proposal has set specified ar-
rangements, whereby a depository institution holding company\textsuperscript{357} would not be subject to holding company regulation and capital requirements.\textsuperscript{358} This proposal also called for the elimination of most regulation at the holding company level, leaving management to the holding company itself, while leaving regulators to regulate the banking activities of its subsidiary.\textsuperscript{358}

A perceived problem of allowing affiliations between commerce and banking is that it might result in an “overconcentration in banking assets, conflicts of interest and unfair competition.”\textsuperscript{380} It should be noted that in the securities industry, corporate ownership of securities firms is allowed, and there are many examples of such relationships.\textsuperscript{361} There have been no instances of abuses in these relationships. Instead, there has been quite the opposite. “These parent firms have provided capital for needed restructuring and liquidity in times of financial adversity, calming the market during difficult periods.”\textsuperscript{382} Overseas, where such relationships are commonplace, there is also “little evidence of any bank safety-and-soundness concerns, conflict-of-interest abuse or undue concentrations of resources from the interaction of banking and non-banking activities . . . .”\textsuperscript{383}

There should not be any fear that the commercial/financial conglomerate would focus itself on servicing primarily the commercial enterprise. This fear entirely overlooks the “tying relationships” restrictions for bank holding companies.\textsuperscript{384} However, these provisions

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\textsuperscript{357}. A depository institution holding company is defined as a holding company that owns a depository institution and has elected to be treated as a depository institution holding company. \textit{Id.} at 140.

\textsuperscript{358}. \textit{Id.} (written statement of Richard C. Breeden, Chairman, Securities and Exchange Commission).

\textsuperscript{359}. \textit{Id.} at 77 (written statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation).


\textsuperscript{361}. Such relationships as Kidder, Peabody owned by General Electric; Shearson Lehman owned by American Express; Dean Witter owned by Sears. \textit{Financial Services Industry, supra} note 200, at 21 (written statement of Richard C. Breeden, Chairman, Securities and Exchange Commission).

\textsuperscript{362}. \textit{Id.}

\textsuperscript{363}. \textit{Oversight Hearing on Foreign Competition in the Banking Industry, supra} note 265, at 161 (written statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation).

\textsuperscript{364}. \textit{See} 12 U.S.C. §§ 1971-1978 (1988). Tying is defined as “a condition imposed by a seller or lessor that a buyer or lessee may obtain a desired product (the ‘tying’ product) only if it also agrees to take an additional product (the ‘tied’ product), which it may or may not desire.” \textit{Black's Law Dictionary} at 1519 (6th ed. 1990).
should not be overused as they could end up taking away the benefit of affiliation. 366

D. Foreign Competition: Overseas

1. The Problems

During the past twenty years, American banks have all but disappeared from the international arena. In 1970, seven of the top twenty-five banks in the world, ranked by assets were American; in 1990, there was only one. 366 While Japanese banks have been increasing their market share of international banking assets, the market share of American banks has been dwindling. 367 U.S. banks have been reducing their foreign presence in order to strengthen their domestic positions. 366 An example of this can be seen in London where two-thirds of the banks leaving London are American and are being replaced by Asian banks. 368 In 1985, U.S. banks controlled an average of 22% of the overseas' market for banking assets, while in 1988, their share decreased to 15%. 370

It is recognized that size is not necessarily an indicator of performance. 371 However, such a dwindling market share at such a rapid rate may be a signal that American banks are unable to compete because of unfair regulatory burdens. 372 At the same time, it should be noted that of the fifty most profitable banks in the world, based on return on assets, U.S. banks held twenty-six of the spots. 373

365. Competitive Implications of the Financial Institutions Safety and Consumer Choice Act Hearings, supra note 257, at 571 (written statement of Arnold Heggestad, Professor, Univ. of Florida). For a more in-depth discussion on suggestions how bank affiliations might be separated, see the discussion on firewalls, infra section III.B.2.


369. Id.


371. Id. at 141 (written statement of Robert L. Clarke, Comptroller of the Currency).

372. Id. at 163 (written statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation).

An analysis by the Federal Reserve has shown that profits of these American international banks, however, were not quite at the top, and instead, were somewhere in the middle of their competitors. Even so, it is well recognized that the Japanese are willing to sacrifice profits for long-term market share.

These changes do not mean a disinterest of foreign investments by American investors, or a decrease in cross-border transactions. While gross cross-border equity investments outside of the U.S. borders have reached $1.6 trillion in 1990, American purchases and sales of foreign securities increased from $198 billion to $4.7 trillion dollars in the last ten years.

For one thing, it is recognized that American banks as a whole have never taken a strong international perspective. Very few American banks are active internationally. Four banks in the U.S. account for nearly half of the American banking system's international assets; ten account for about 80%. However, the current problems facing American banks today do not encourage them to expand internationally.

The problems of American banks competing internationally can be traced to several factors, almost all of which can be traced to issues involved with current banking regulation. One of the most basic problems is cost of capital. Currently, capital costs for American banks are too high and hinder their competitiveness abroad. Such high capital costs discourage banks from making many investments overseas. At the same time, Japan, which has some of the

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This analysis was based on 1958-1988 averages on: real asset growth, real revenue growth, R.O.A., R.O.E., capitalization, and productivity. Id.


378. Id. at 103.

379. Cost of capital is defined as "the real pre-tax rate of return [a bank] must pay in order to attract debt and equity funds to finance its portfolio of assets." Id. at 107 (written statement of Alan Greenspan, Chairman, Federal Reserve).

380. Id. at 141 (written statement of Robert L. Clarke, Comptroller of the Currency).
largest banks in the world, ranked by asset size, has the cheapest capital costs in the world due to interest rate controls and high deposits.381

Another problem that American banks have in competing internationally is the costs that are the result of intense regulation in this country.382 The corporate structure which is required in order to be in compliance with Glass-Steagall, being more complex than that required of banks in other countries, is a competitive benefit to foreign banks and, therefore, a burden that is unique to American banks.383 This problem is demonstrated when American banks are prevented from engaging in certain activities on their own and must instead do so through subsidiaries. Such a system requires a bank to undergo the costly process of creating a separately capitalized affiliate through a holding company in order to start up such operations.384

While banking regulation limits what types of investments a bank may make, those limitations are not based upon risk alone. There are many risky financial transactions in which a bank may still engage that are permissible under the American banking laws.


Japan has a protected market, just like American banks used to have. Sixty percent of deposits in Japan were subject to interest rate ceilings in 1990, and as such they provided a cheap source of funds for Japanese banks. Oversight Hearing on Foreign Competition in the Banking Industry, supra note 265, at 165 (written statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation). Aside from this, Japan has a very high savings rate coupled with large trade and current account surpluses which are the products of strategy and government led economic management. Examine Japanese Financial System and Its Affect on Ability of U.S. Firms to Compete, supra, at 118 (written statement of Daniel Burstein, journalist and author).

However, as of late, Japanese depositors have retaliated against their controlled banking system much the same way as American depositors retaliated in the '70s by taking their deposits and investing them in the capital markets. Oversight Hearing on Foreign Competition in the Banking Industry, supra, note 265, at 165 (Statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation). This stopped growth in deposits to such a degree that Japanese banks stopped adding new branches. Id. This domestic pressure put on the Japanese government by Japanese depositors, as well as those players in the international markets who have been complaining that such a system was unfair, have been pushing Japan towards deregulating interest rates. Id. at 166.


383. Id. at 144 (written statement of Robert L. Clarke, Comptroller of the Currency).

384. Id. at 145.
However, with higher risks come higher risk premiums and, therefore, higher returns. Therefore, enticed by the higher returns, many banks have made very risky loans to third world nations. Due largely to the third world debt losses, the top twenty-five U.S. banks' net income for foreign operations was a negative $13 billion in 1987.385 Such poor returns on foreign investments has soured the attitude of many banks in increasing their portfolio of overseas assets.386

There have also been external problems afflicting banks, which are really no fault of banking regulation at all. The devaluation of the dollar in recent years has made foreign investments expensive for American banks.387 This also creates an incentive for American banks to sell off their foreign assets, which have increased in value due to the change in exchange rates. It is only natural that when a business is going through tough times they might react by selling off valuable assets and avoiding costly investments.

The cumulative affect of these circumstances has led banks to retrench their foreign activities in recent years, while the foreign activities of other nations have expanded. While American banks are leaving because of insufficient profit margins, the Japanese, although their profit margins are even lower, are expanding.388 The reasons that the Japanese can afford the lower profit margin include low inflation and low costs of capital at home, the yen's strength making overseas investments cheap, as well as the cultural acceptance of lower rates of return in Japan.389 Also, the Japanese Parliament recently passed legislation designed to encourage the expansion of their financial sector and mergers between banks and brokerage houses.390 The Europeans have also been reorganizing themselves due to the changes occurring within the European Economic Community.391


386. *Id.*


389. *Id.* at 126.


391. In 1993, the Second Banking Directive of the EEC took effect, whereby all banks in Europe are allowed to engage in both commercial and investment banking, further promoting larger financial services available from a single institution. See *Modernizing the Financial System*, supra note 7, at XVIII-26.
With the opening of borders in Europe, there is pressure on both the European financial companies and the local European governments to keep their banks and financial service companies as competitive as possible and, therefore, to limit restrictions on them.\(^{392}\)

This is not to say that American banks have disappeared from the international scene. They are still very much present. However, they have now become the invisible players overseas. They are involved in activities and take positions in areas that industry analysts are not prepared to analyze, as such activities produce no tangible assets. With hard assets becoming too expensive, and with dramatic technological advances in the areas of financial research and international telecommunications, American banks have refocused themselves to meet the rising demand in banking services that assist in cross-border transactions.\(^{393}\) Such transaction assistance does not result in assets, and has created an incentive for banks to cut back on activities that would only produce price volatile assets.\(^{394}\) In this area of transaction services, the U.S. is still among the world leaders.\(^{395}\) FDIC figures have shown that non-asset producing activities for American banks have grown from 58% of actual assets to 116% in less than ten years.\(^{396}\) American banks are still strong in "capital

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393. Banque Nationale de Paris, France’s largest bank, and Union des Assurances de Paris, France’s largest insurance company, announced an alliance in cross marketing each other’s financial services. Financial Services Industry, supra note 200, at 62 (written statement of Mr. Baptista, President of the Financial Services Council). Deutsche Bank, Germany’s largest bank, recently announced it was going to enter into the life insurance business through a subsidiary. Id. In Britain, Lloyd’s Bank purchased Abbey Life, a large British insurance company. Europe’s largest insurance company, Allianz, announced a new cross marketing arrangement with Germany’s Dresdner Bank. Id.


395. Id. For example, in the area of international loan syndications American banks occupied nine of the top ten spots worldwide for the first half of 1990, the only other competitor being National Westminster of Britain. Competitiveness of U.S. Insurance Companies, Financial Service System and Nonbank Financial Firms, Hearings before the House Subcomm. on Financial Institutions Supervision, Regulation and Insurance Task Force on International Competitiveness of U.S. Financial Institutions of the Comm. on Banking, Finance and Urban Affairs, 101st Cong., 2nd Sess. 93 (1990) [hereinafter Competitiveness of U.S. Insurance Companies, Financial Service System and Nonbank Financial Firms] (Statement of Stephen J. Friedman, for the American Council of Life Insurance). Other types of non-asset producing business are also standby letters of credit, commercial letters of credit, loan commitments, foreign exchange obligations, and interest rate swaps. Modernizing the Financial System, supra note 7, at XVIII-12.

396. Modernizing the Financial System, supra note 7, at XVIII-12.
strength, profitability, skill of management, and innovativeness."}\textsuperscript{397} However, with the availability of "department store" banking in Europe by 1993, and the knowledge that the Japanese have consistently improved their position in the past, the fact that American banks are doing well in transactional services is of little consolation. If a foreign institution requires several banking services, why go to the American bank if the European bank can do it all under one roof. Services are only secondary in the end. And while the Europeans are expanding their services, American banks have been stifled with the limits set by American banking regulation.

One area where this problem exists is with underwriting. Prior to 1991, the Federal Reserve's Regulation K specified that the foreign affiliates of American banks could underwrite securities in Europe, but "that [any] single underwriting commitment [could] not exceed 2 million dollars or represent 20 percent or more of the issuer's capital and surplus or voting shares."\textsuperscript{398} The limit for the investment of the entire bank holding group was $15 million.\textsuperscript{399} These restrictions changed a bit in 1991, when the Federal Reserve amended Regulation K.\textsuperscript{400} Now, foreign affiliates of American banks can

underwrite, on a consolidated basis, the lesser of 60 million dollars or 25 percent of the investor's Tier 1 capital\textsuperscript{401}, and hold equity securities of any one issuer in trading or dealing accounts equivalent to the lesser of 30 million dollars or 10 percent of the investor's Tier 1 capital.\textsuperscript{402}

With Board permission, the banking organization may exceed its $60 million limit on underwriting.\textsuperscript{403} If a bank follows these procedures, it is allowed to be the principal underwriter in a deal.\textsuperscript{404} However,

\begin{itemize}
  \item \textsuperscript{397}Competitiveness of U.S. Insurance Companies, Financial Service System and Non-bank Financial Firms, supra note 395, at 158 (written statement of Robert Glaube, Under-Secretary for Finance, Treasury Department).
  \item \textsuperscript{398}12 C.F.R. § 211.5(d)(13) (1991); see also Oversight Hearing on Foreign Competition in the Banking Industry, supra note 265, at 146 (written statement of Robert L. Clarke, Comptroller of the Currency).
  \item \textsuperscript{399}12 C.F.R. § 211.5(c)(1) (1991); see also Modernizing the Financial System, supra note 7, at XVIII-19.
  \item \textsuperscript{400}See 56 Fed. Reg. 19549-50 (1991).
  \item \textsuperscript{401}Tier 1 Capital is comprised of common stockholder's equity, noncumulative perpetual preferred stock and related surplus, and minority interests in the equity accounts of consolidated subsidiaries. 12 C.F.R. § 12 app. A (1992).
\end{itemize}
Glass-Steagall still manages to limit American banks in such underwritings by prohibiting them from marketing the securities in the United States, where they possess their strongest market.406 The United States is the world’s major market for equities, yet the American banks are unable to offer the equities that they underwrite overseas.407 This is a limit that foreign competitors note to potential customers when they are competing against American banks for underwriting business.407 Such a burden has proved to be a major competitive disadvantage for American banks.408 In the 1980's, Great Britain, Canada and Australia all let their banks enter into the securities business for the first time.409 Soon, the U.S. will be the only major industrial power in the world which does not allow its banks to underwrite equities.410

The problem with all American banks goes much deeper than the fact that American banks are losing their position overseas. The problem of American banks becomes a problem for American industry, which will find itself more and more dependent upon foreign banks in order to be involved in international transactions.411 One need only imagine Japan as the banker of American corporations to consider if such a dependency is good for the U.S.. The problems to American industry and commerce are discussed further in the next section dealing with international competition in our domestic market.

1. The Solutions

The best way for the government to help banks compete internationally is to assist them in lowering the cost of capital for banks.412 One major problem, claims Mr. Greenspan, is the low sav-

407. Id.
408. Id.
410. Id. at 25.
ings rate in this country which results in banks paying higher interest rates in order to attract savings. Another problem is the U.S. fiscal deficit, for which the U.S. Treasury buys up capital in its bond issues to finance. There is also the problem of the government's economic policy, because if the economy appears to be in poor shape, it reflects upon domestic investments by adding risk to them. In such an environment, investors of uninsured deposits, which are deposits over the $100,000 guaranteed by the FDIC, will require a premium from banks in order to counter such risk.

The solution to helping banks raise capital is allow them to diversify their product offerings and expand geographically which would help the bank raise its rate of return and lower its risks. Glass-Steagall has become a burden on banks competing internationally. It is necessary that there be proper structuring of the regulatory system to allow banks to offer a diverse selection of products, while not creating undue risks to the bank insurance fund, and therefore, to the taxpayer. While the Federal Reserve has been expanding the powers that banks may engage in, the existing fire walls for such new activities have proven too costly for many banks.

It might also be helpful for this country to arrange international banking regulation agreements as was done in the Basle capital agreement. Such agreements could help put pressure on Japan to get rid of the unfair capital benefits it has with its interest rate

413. Id. at 108.
414. Id. at 109.
415. Id.
416. Id. (written statement of Alan Greenspan, Chairman, Federal Reserve.)
417. Id.
418. Id.
419. Id. at 142 (written statement of Robert L. Clarke, Comptroller of Currency).
421. The Basle Committee has members in the U.S., Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, and the United Kingdom. See Oversight Hearing on Foreign Competition in the Banking Industry, supra note 265, at 152 (written statement of Robert L. Clarke, Comptroller of the Currency). The capital agreement, entitled "International Convergence of Capital Measurement and Capital Standards", was adopted by the committee in 1988 and has established "a common risk-based capital framework, and minimum standards for all banks." Id. This agreement has also been adopted by countries who are not members of the committee; and European countries who are not members will be bound to standards established by the EEC in accordance with the Basle agreement. Id. at 153. The Office of the Comptroller of the Currency has been pursuing with the Basle Committee to coordinate supervisory standards for banks "in order to achieve a level international playing field in this area." Id. at 152.
ceilings.

If anything, changes in the law are necessary. The current limits on the underwriting capabilities of foreign subsidiaries and branches of American banks is by far too cautious and restrictive. They only serve to further discourage American expansion into the overseas markets. While caution is necessary, it should not be the only factor when considering bank regulation, as being overly cautious can do tremendous harm to the banking industry even when its intention is to protect it.

E. Foreign Competition: Domestic

1. The Problems

The presence of foreign banks on our shores has become very noticeable in recent years. With NatWest, Barclays, Marine Midland, European American Bank, Fuji Trust, Bank Leumi, Algemene Bank, as well as many others, foreign owned banks and branches are becoming commonplace. In 1989, 281 foreign banks operated in the U.S. with 697 branches. With these branches, subsidiaries and holding interests, foreign banks have been increasing their ownership of America. In 1984, the average number of foreign banks used by American companies was 3.2, while American banks used were 15.5; in 1988, the number of foreign banks used rose to 5.3, while American banks dropped to 9.7. Foreign ownership of American banks and banking assets has increased by 600% since 1972. In 1989, foreign banks controlled $530 billion of American banking assets, up from $120 billion in 1980. In 1982, foreign banks held 11.2% of all deposits in the U.S.; in 1990, they held 17.3%.

422. Id. at 163 (written statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation).


425. Id. at 63 (written statement of Mr. Baptista, President, Financial Services Council).

made by branches on U.S. shores and loans made by offshore branches to American interests overseas, it is estimated that foreign banks account for about forty-two percent of all business loans to American industry.\footnote{427. \textit{Oversight Hearing on Foreign Competition in the Banking Industry}, supra note 265, at 226 (written statement of Robert Z. Aliber, Professor of International Finance at the University of Chicago).} In most other industrial nations, foreign capital accounts for no more than 6\% of business loans.\footnote{428. \textit{Id.}} Much of this growth in foreign banks on U.S. shores is attributed to Japanese banks, who, it is estimated, account for about 53\% of foreign bank holdings of U.S. bank assets.\footnote{429. \textit{Id.} at 163 (written statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation).} This amounts to a total of 14\% of all U.S. banking assets.\footnote{430. \textit{Id.} at 166.} This increase in Japanese interests in U.S. banking has been occurring while foreign assets of American banks have been decreasing.\footnote{431. See discussion \textit{supra} notes 366-370 and accompanying text; see also \textit{Oversight Hearing on Foreign Competition in the Banking Industry}, supra note 265, at 163 (written statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation).}

The preference for foreign banks is becoming more widespread amongst American businesses. In recent months, American banks have been losing corporate accounts to foreign institutions due to corporate treasurers feeling safer with keeping their large deposits, which are well above the $100,000 limit guaranteed by the FDIC, with foreign institutions and away from what is now viewed as the overly risky American banking industry.\footnote{432. \textit{Id.}} Such "silent" runs can be deadly, as seen in the Continental Illinois bank run of 1984.\footnote{433. \textit{Id.} at 1.} Rumors of the instability of that bank led corporate treasurers not to renew their CDs at maturity and pull out $8 billion of Continental's deposits in a few days and $20 billion within a couple of months.\footnote{434. \textit{Id.}}

While all is fair in business competition, it should be recognized that American banks and their foreign based competitors are not playing on a level playing field. Under the Bank Holding Company Act and the Federal Reserve's Regulation K, the Bank Holding Act Company of 1956 does not apply in the same manner to foreign banks as to American banks.\footnote{435. \textit{Layne}, \textit{supra} note 184, at 1.} Therefore, a foreign bank which has
affiliations with a non-bank at its home base is still allowed to take over a bank in this country.\textsuperscript{436} Such a system creates an unfair advantage for foreign banks, as the greatest concentrations of wealth is in large corporations and foreign banks can receive tremendous capital input from their commercial affiliations.

There are many other reasons for the surge in bank acquisitions in the U.S.. One reason has been the devaluation of the dollar during the ‘80s.\textsuperscript{437} In the mid ‘80s, the Reagan Administration decided to actively cut the value of the dollar to stimulate the export of American products and to discourage the import of foreign products, particularly Japanese and German.\textsuperscript{438} This has been viewed as a great mistake, because the Administration did not recognize that, to the consumer, price was secondary to “quality, deliverability, brand-name recognition, advanced technology, [and] after-market service.”\textsuperscript{439} Japanese and German industry made up for the devaluation of the dollar by becoming more cost efficient and putting more effort into making a superior product, which proved to be their saving grace against such a change in the currency rates.\textsuperscript{440} While lower prices may have stimulated purchases of American products to a degree, in the long run they caused foreigners to become more competitive, upgrading their output and cutting back costs making an even better product.\textsuperscript{441} In the end, the devaluation caused the U.S. to become cheap in its most sensitive area, its banking assets.\textsuperscript{442} The one thing that was learned by all, except the United States, is that a strong currency is important to keep capital costs low, reduce inflationary pressures, and to help domestic businesses take strong equity positions in foreign markets.\textsuperscript{443}

The resulting problem of the devaluation of the dollar is that as more foreign banks made loans in the U.S., more of our industry has become dependent upon foreign banks. In 1989 and 1990, Japanese banks cut back on their lending in the U.S.. These cuts in lending by


\textsuperscript{436} 12 C.F.R. § 211.23(f)(3) (1992).

\textsuperscript{437} \textit{Examine Japanese Financial System and Its Affect on Ability of U.S. Firms to Compete, supra}, note 381, at 120 (written statement of Daniel Burstein, journalist and author).

\textsuperscript{438} Id.

\textsuperscript{439} Id.

\textsuperscript{440} Id. at 121.

\textsuperscript{441} Id.

\textsuperscript{442} Id.

\textsuperscript{443} Id.
the Japanese has been blamed in part as causing the "credit crunch" whereby there is less money being lent by banks which encourages an economic downturn.444

The problems could get worse. A commercial enterprise in this country of moderate size might find itself one day dependent on foreign lenders for most of its capital. Imagine the economic catastrophe that could result if the foreign lender, under the guidance of its government, should constrict its lending for its own economic, or even political, reasons.448 Such a scenario recently happened when Mr. Makoto Utsumi, Vice Minister of Finance for International Affairs in Japan, threatened to curb credit to the United States if Congress passed the Fair Trade in Financial Services Act.446 This type of problem had been expected from Japan.447 In truth, this type of "credit cutting" punishment to other nations has been an action taken by the United States in the past.448 Also, imagine the more routine and typical problems where an American manufacturer, in attempting to persuade a foreign bank to lend it substantial capital, might find itself forced to reveal many intimate details of its business to a foreign based bank with an affiliation back at home to a competitor of that American manufacturer. Is this dangerous? We'll soon find out. By the year 2000, it is expected that Japan will control 25% of U.S. banking assets; they already control this much of the

444. Deposit Insurance and Banking Reform Proposals, supra note 2, at 11 (written statement of Nicholas F. Brady, Secretary of the Treasury).


446. Clyde H. Farnsworth, Japan's Stern Warning on Trade Sanctions, N.Y. TIMES, Jan. 29, 1991, at D18. The Fair Trade in Financial Services Act, S. 47, Title IV, 102d Cong., 1st. Sess. (1991), was a bill introduced into Congress which was to put pressure on foreign nations to treat American financial institutions abroad as equal with their own institutions. For more on this bill, see discussion infra notes 453-459 and accompanying text.

447. Farnsworth, supra note 446, at D18.

448. See, e.g., Clyde Haberman, Israel Threads the Maze Toward U.S. Loan Pact, N.Y. TIMES, August 5, 1992, at A-2 (discussing the political actions Israel had to undertake regarding the settlement of Russian emigrees before it could receive a loan from the United States); U.S. Influence: Who Trades With Burma?, THE WASHINGTON TIMES, January 9, 1992, at 62 (discussing how the United States had imposed trade sanctions against Burma and denied them loans because of human rights violations); Support For de Klerk, THE DAILY TELEGRAPH, February 22, 1992, at 12 (discussing the Gramm Amendment which blocked loans to South Africa through the International Monetary Fund and the World Bank because of their policy of apartheid); Brahma Chellaney, India To Seek French Assistance In Beating U.S. Sanctions, UNITED PRESS INTERNATIONAL, September 26, 1992 (discussing how Russia felt pressured by the fear of losing credit from the West to not enter into an agreement with India to develop cryogenic rocket engines).
banking assets in California.\textsuperscript{449}

2. The Solutions

The Treasury Department's bill\textsuperscript{450} supported the idea of putting limits upon the acquisitions of American banks by foreign banks. If the branch, agency or commercial lending company of a foreign bank rather than a subsidiary sought to acquire more than a 5% interest in an American depository institution, it would have to be approved by the appropriate federal regulator.\textsuperscript{451} Currently, a foreign bank may acquire up to 25% of an American bank before it is required to get regulatory approval.\textsuperscript{452}

The Fair Trade in Financial Services Act\textsuperscript{453} addressed another problem; it proposed creating a standard for treatment of foreign based banks based upon their treatment of American banks on their soil.\textsuperscript{454} With evidence of mistreatment of American financial firms overseas, the Treasury Department would be required to attempt to "negotiate an end to it."\textsuperscript{455} The regulators are permitted, after consultation with the Treasury Department, to deny any new applications for regulatory approval filed by foreign based banking and securities firms whose country of origin discriminated against U.S. firms.\textsuperscript{456} A denial would not mean that the foreign firm must in any way shrink its existing operations but would rather limit their opportunities for future expansion.\textsuperscript{457} Such a standard would take into consideration special protection measures taken by third world countries to protect their fragile markets from foreign exploitation.\textsuperscript{458}

\textsuperscript{449} Fair Trade In Financial Services: Hearing before the Subcomm. on Economic Stabilization of the House Comm. on Banking, Finance and Urban Affairs, 102d Cong., 1st Sess. (1991) at 69 [hereinafter Fair Trade In Financial Services] (statement of Senator Donald Riegle, Michigan, Chairman of the Committee.)
\textsuperscript{450} See supra note 7.
\textsuperscript{452} Id.
\textsuperscript{453} S. 347, Title IV, 102d Cong., 1st Sess. (1991). This bill was attached to the Defense Production Act Amendment. Unfortunately, it failed to become law. 138 CONG. REC. S 17943.
\textsuperscript{455} Fair Trade In Financial Services, supra note 449, at 63 (written statement Senator Donald Riegle, Michigan, Chairman of the Committee).
\textsuperscript{456} Id.
\textsuperscript{457} Id.
Unfortunately, the Fair Trade bill was not passed due to the lobbying efforts of the State Department in its belief that it would excessively hinder free trade.459

It has also been suggested that foreign investments in American financial institutions be limited so as to allow U.S. banks regain their market share.460 Anticipated retaliatory measures would not be very severe as U.S. banks have actually been retracting their position overseas.461 The goal of this action is to give American banks the time necessary to improve their condition domestically. However, such an anticipated improvement would also require new regulatory reforms which would help the American banks to improve their positions.

III. REREGULATION, NOT DEREGULATION: COUNTERING THE DANGERS OF DEREGULATION

A. Deregulation, the S&Ls, and the Ghost of Ferdinand Pecora

The mere suggestion of regulatory changes in the banking industry creates a feeling of *deja vú*. There is a real fear that the same problems that occurred in the savings and loans industry might also occur in the banking industry.

However, in truth the situation of the thrift industry was entirely different from that of the banking industry. The problem of the S&L crisis was not as much the allowance of S&Ls to expand their investments and services, but rather the desupervision of them. The deregulation that Congress enacted allowed the thrifts effectively to become undercapitalized and unsupervised.462

Mr. Robert L. Clarke, Comptroller of the Currency, recently explained the distinctions between the two industries:

First, a principal underlying cause of the thrift crisis was the gross mismatch in the maturities of thrift assets and liabilities, brought on by government policies that encouraged — indeed, required — thrifts to specialize in long-term mortgage loans funded with short-

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460. *Fair Trade In Financial Services, supra* note 449, at 137 (written statement of Anthony T. Cluff, Executive Director, Association of Reserve City Bankers).
461. *Id.*
term deposits. When interest rates soared in the early 1980's, this mismatch resulted in massive losses that effectively wiped out the industry's capital. Banks have always had much better diversified balance sheets and are therefore far less exposed to interest rate risk, and they have significant capital positions — $214 billion in equity as of the third quarter of 1990.

Second, the insolvency of the Federal Savings and Loan Insurance Fund prevented the Federal Home Loan Bank Board (FHLBB) from closing insolvent thrifts promptly. Instead, the FHLBB granted capital forbearance, which allowed insolvent thrifts to run up larger losses. In contrast, bank supervisory agencies have increased their supervisory oversight, and close banks promptly when their capital is exhausted. (The Treasury report recommends that banks having virtually no prospects for recovery be placed promptly into conservatorship for subsequent sale or liquidation.) Moreover, the Bank Insurance Fund administered by the FDIC is solvent, though it is under serious strain. Action will be taken to make sure the fund will continue to have sufficient money to take whatever measures are needed to resolve problem banks.

And third, thrifts were authorized to make investments in real estate and junk bonds with insured deposits. A combination of improper asset management and inadequate supervision resulted in excessive risk taking and, eventually, massive losses. Many thrifts that undertook those activities had little capital. In contrast, increased business opportunities for banking companies would be conducted in separately capitalized affiliates with strict limits on funding with insured deposits.\textsuperscript{463}

Of course these distinctions do not satisfy all fears. There is always the general fear of the return to the mismanagement and improprieties that Mr. Pecora exposed sixty years ago. However, things have changed in the past sixty years. There are more regulatory controls over the banking and security business than there were in the 1920s. Still, the mere possibility of danger should be danger enough. We should learn from history and we should not allow ourselves to be fooled twice.

B. Protection Against Old Fears

1. Souped Up Supervision

The Federal Reserve, the FDIC, and the Treasury Department have all recognized that it is necessary to extend the current level of supervision of banks. During better times, between 1863-1965, banks were audited on site twice a year. Since that time, on site audits have been reduced. In 1980, the Depository Institutions Deregulation and Monetary Control Act of 1980 ("DIDMA") was passed whereby national banks were only to be audited at the discretion of the Comptroller of the Currency, which sometimes ended up being once every five years. In between audits, the various agencies were relying on the reports given to the agencies by the banks themselves. Such reports have been found by the Government Accounting Office to be unreliable, as are reports issued by outside auditors on behalf of the bank. The only reliable way to audit a bank is to have the regulators do the audits.

The larger national banks account for nearly half of the assets of all national banks, and about a third of all banking assets. The FDIC proposed a system whereby resident examiners of the agency are kept at all of the major banks. Currently, resident examiners only exist for the top twenty banks, but Mr. Seidman suggested that there should be more on-site examiners, and that the government should keep on-site examiners at all 350 to 400 banks with over $1 billion in assets.

464. Deposit Insurance Reform, supra note 178, at 16 (statement of Alan Greenspan, Chairman, Federal Reserve); see also id. at 108 (written statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation); Modernizing the Financial System, supra note 7, at 42.
469. Id. at 16.
470. Id.
472. Deposit Insurance Reform, supra note 178, at 102 (statement of Mr. Seidman, Chairman, Federal Deposit Insurance Corporation).
473. Id.
The Treasury Department recommended that on-site examinations be conducted for all banks on at least a yearly basis. This is the best way to keep track of the bank's capital level, which is the best indicator of current and potential problems. The examiners can examine files to find problems that might be covered up in reports prepared by the bank.

The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") set a requirement, effective December 19, 1992, of annual, full, on-site examinations for every insured bank by their primary regulator. The examination by the federal regulator may be conducted every two years if the appropriate federal agency determines that a state examination of the bank during the intervening year carries out the purpose of the provision.

FDICIA also gives power to the FDIC to "remove, suspend, or bar" an independent public accountant from auditing bank financials "upon a showing of good cause." This power would allow the FDIC to actually decide who may audit banks, and therefore, create an incentive for auditors to work with the regulators instead of against them.

2. Thick Firewalls

"Firewalls" are mechanisms that restrict the flow of funds and transactions between affiliates and subsidiaries within the holding company structure to avoid improprieties that might add extensive risks to the bank and the bank insurance fund. Firewalls might not be able to prevent failure altogether, but they may help regulators better manage failures and prevent them from occurring due to improprieties or illegal transactions. There is also the benefit to the bank insurance fund of separating the bank's assets from that of its affiliate or subsidiary. This separation helps to keep creditors of

475. Id.
476. Macey & Miller, supra note 164, at 577.
478. Id. § 111 (codified as amended at 12 U.S.C. § 1820(d)).
479. Id.
482. Id. at 187.
483. Id.
the different entities separate in the event of bankruptcy or liquidation.\textsuperscript{484} Such a system, if left unchecked, would effectively have the taxpayers subsidizing loans made to bank affiliates and subsidiaries through the taxpayer's support of the bank insurance fund.

There are also fairness reasons for limiting the flow of funds between banks and an affiliated entity. A bank could make a loan to this entity at a rate lower than the market rate, or a rate not adequately commensurate with the risk of the loan, putting non-affiliated competitors at a disadvantage.

The Federal Reserve and the Government Accounting Office have claimed that the firewalls in sections 23A and 23B of the Federal Reserve Act\textsuperscript{485} are adequate "to create insulation" so that the insurance fund does not end up covering failures due to non-banking activities.\textsuperscript{486} However, sections 23A and 23B in their current form would only apply to transactions between affiliates of member banks and either member banks themselves or subsidiaries of member banks; therefore, these sections should be amended to apply to transactions between member banks and their subsidiaries, too.\textsuperscript{487} The Financial Institutions Safety and Consumer Choice Act of 1991 ("FISCCA")\textsuperscript{488} proposed to revise the Federal Reserve's sections 23A and 23B to make them stronger.\textsuperscript{489} The provisions of FISCCA covered subsidiaries, and went even further by covering subsidiaries where less than 80\% of its common stock is owned by the bank.\textsuperscript{490} Also, under FISCCA, a revised version of section 23B would require "bank loans to customers of affiliates" to be conducted with caution and without undue favoritism.\textsuperscript{491} While allowing affiliations with commercial enterprises, FISCCA forbid any loans to be made from the bank to any of the bank's affiliates.\textsuperscript{492}

\textsuperscript{484} Id.
\textsuperscript{486} Deposit Insurance Reform-1991, supra note 309, at 65 (statement of Richard Fogel, Government Accounting Office).
\textsuperscript{487} Vol. III, Deposit Insurance Reform and Financial Modernization, supra note 191, at 328 (written statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation).
\textsuperscript{489} Id. § 223.
\textsuperscript{490} Id.; see also Financial Institutions Safety and Consumer Choice Act Hearings, supra note 323, at 49 (written statement of Robert R. Glauber, Undersecretary of Finance, Department of the Treasury).
\textsuperscript{491} Id.
The House proposed a bill which would allow banks to affiliate with non-banks to make loans to the customers of affiliates in order to allow them to purchase the affiliate's products and services "without regard to the quantitative and collateral limits of section 23A." This bill proposed applying some of the provisions of sections 23A and 23B to protect the deposit insurance fund.

The Senate proposed some firewalls a few years earlier that would set limits on transactions between banks and their security affiliates. The proposal had prohibited banks from:

- extending credit or purchasing the financial assets of the security affiliate;
- enhancing the marketability of securities underwritten by the security affiliate;
- knowingly extending any credit that will be used to purchase securities underwritten by the security affiliate;
- extending any credit that will be used to pay the principal or interest on securities underwritten by the security affiliate;
- having officer and director interlocks with the security affiliate;
- giving investment advice to the security affiliate.

In its 1987 study, the General Accounting Office suggested a method of insulating the bank's deposits from the risks of the business of its affiliates or subsidiaries. Depending upon how the business was divided, whether by subsidiaries, affiliates or bank departments, the banking unit responsible for holding bank deposits and receiving the benefits of the banking safety net should be insulated from the other banking units. Insulation was achieved through legal, economic and "market perception" separation of the insured part of the bank from those parts offering expanded activities.

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495. In 1988, the Senate passed the Financial Modernization Act, S. 1886, 100th Cong., 2d Sess. (1988). This act had proposed the elimination of §§ 20 and 32 of the Glass-Steagall Act and to "allow bank holding companies to acquire non-bank security affiliates." William J. Shafer, Note, Glass-Steagall Reform: It's Time to Replace the Crumbling Wall, THE JOURNAL OF CORPORATION LAW Summer 1989 at 973, 989. While this act never passed in the House, it did provide some suggestions for firewalls.

496. Shafer, supra note 495, at 990.

497. MODERNIZING THE FINANCIAL SYSTEM, supra note 7, at XVIII-29.

498. Id.

499. Id.
Legal separation requires courts to recognize the independence of the entities involved. This is achieved through sufficient and separate financing of each unit; keeping and maintaining separate business records; implementing formal barriers between the management structures of the units; and providing that the units are not “publicly represented or advertised as being one entity.” Economic separation is achieved by keeping the insured and uninsured units of the holding company separately and adequately funded, keeping the assets of the two units from being commingled, and keeping all transactions between the two parts at arms-length without any undue favoritism. A separate relationship must be clearly relayed to the public. The Government Accounting Office (“GAO”) found bank departments the least likely way to effectively insulate bank operations; the bank subsidiary and affiliate methods were the best. Unfortunately, subsidiary and affiliation separation are more costly than bank department separation and the GAO determined that such costs may keep some banks from expanding their financial services.

Firewalls do not always work in times of crisis. Capital can easily be moved when it is urgently needed. The rules established must make certain to take into account the entire holding company scheme, scrutinizing every transaction between the bank and its affiliates. The GAO has also suggested making bank managers and directors more accountable “for reporting on the effectiveness of their internal control structures and for their compliance with laws and regulations related to safety and soundness.” Such accountability would presumably reduce the risk that managers would cover up the banks faults and failures through fraudulent transactions and, at the same time, encourage them to actively control and supervise the actions of their employees.

However, it should be recognized that firewalls are not always

500. Id. at XVIII-30.
501. Id.
502. Id.
503. Id.
504. Id.
505. When Drexel Burnham was experiencing financial difficulties, the regulators found out that funds were being transferred between the subsidiaries and between Drexel and its subsidiaries; however, they felt as though they should have found out sooner and that the system of regulation did not permit an earlier discovery. Deposit Insurance Reform, supra note 178, at 76 (written statement of Richard Fogel, Government Accounting Office).
506. Id. at 61.
the best thing for an organization. They can prevent the benefits of synergy and economies of scope and scale from taking effect. It has been suggested that a way to keep firewalls from being too broad and overprotective is by allowing each regulatory agency to implement and control firewalls to the level necessary for each bank under its control.\textsuperscript{607} This method would allow for flexibility. The FDIC has agreed with this line of thinking and suggested that bank regulators should decide what activities a bank can perform directly, and what activities it can perform only through subsidiaries or affiliates.\textsuperscript{608} The House bill, Financial Industry Reform and Capital Enforcement Act\textsuperscript{609}, proposed allowing affiliations between banks and non-banks.\textsuperscript{610} Yet called for sections 23A and 23B of the Federal Reserve Act to be applied in a manner that allowed the proper regulators would be given “the authority to adopt [their] own rules and interpretations and to exempt institutions or transactions from section 23A and section 23B limits.”\textsuperscript{611} However, the Federal Reserve found this weakening of strict firewalls inappropriate when initially mixing banking and commerce, as the house bill proposed.\textsuperscript{612}

3. Capital Requirements

If one lesson was learned from the S&L crisis it was that banks require a strong capital base.\textsuperscript{613} A strong capital base helps absorb losses and keeps the bank insurance fund from becoming overly burdened by the bank’s losses in the event of a failure.\textsuperscript{614} Additionally, a bank with low capital which then suffers from extensive loan losses must write off those losses from its capital base.\textsuperscript{615} Such a write off will cause the bank to contract its lending and therefore contribute to a “credit crunch”, a problem during this current recession.\textsuperscript{616}

\begin{itemize}
\item \textsuperscript{608} Id. at 328 (statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation).
\item \textsuperscript{609} H.R. 192, 102d Cong., 1st Sess (1991).
\item \textsuperscript{610} Financial Industry Reform and Capital Enforcement Act Hearings, supra note 191, at 124 (written statement of John P. LaWare, Member, Board of Governors of the Federal Reserve System).
\item \textsuperscript{611} Id.
\item \textsuperscript{612} Id.
\item \textsuperscript{613} Vol. III, Deposit Insurance Reform and Financial Modernization, supra note 191, at 274 (written statement of Nicholas F. Brady, Secretary of the Treasury).
\item \textsuperscript{614} Id.
\item \textsuperscript{615} Modernizing the Financial System, supra note 7, at II-3.
\item \textsuperscript{616} Id.
\end{itemize}
bank with a strong capital base would be better able to withstand a downturn in the economic cycle, and such a bank would not be forced to cut back on its extensions of credit during economic downturns because of loan write-offs.

There have been proposals to either raise or strengthen the existing minimum capital requirements for banks. The Federal Reserve Board, Comptroller of the Currency, and the Federal Deposit Insurance Corporation have adopted a uniform system of capital standards for banks based upon the risk level of the individual banks, rather than a uniform standard.\textsuperscript{517} Such a standard would make banks more sensitive to the credit risks in their portfolios so that they will have to be more careful with risks or else face the problem of raising more capital.\textsuperscript{518}

However, raising capital requirements can be costly for a bank and therefore, have to be phased in over a period of time.\textsuperscript{519} Since capital ratios are based upon equity compared to assets, higher capital standards might encourage purposefully slower asset growth.\textsuperscript{520} If banks become too concerned with maintaining a certain capital level, they may end up cutting back on credit.\textsuperscript{521}

The Treasury Department has opposed raising capital standards, but believes that the role of capital should be strengthened.\textsuperscript{522} The Treasury believes that “regulation should be redesigned to provide more incentives for banks to maintain strong levels of capital.”\textsuperscript{523} They have approached the problem through a reward system


This legislation is the product of the Basle Accord, discussed, supra at note 414 and accompanying text. The Basle Accord created an international standard for G-10 countries. The system of risk based capital guidelines is scheduled to be fully effective by December 31, 1992. Modernizing the Financial System, supra note 7, at II-5.

\textsuperscript{518} Vol. III, Deposit Insurance Reform and Financial Modernization, supra note 191, at 466 (written statement of Robert L. Clarke, Comptroller of the Currency); see also Financial Industry Reform and Capital Enforcement Act Hearings, supra note 191, at 114 (written statement of Robert L. Clarke, Comptroller of the Currency).

\textsuperscript{519} Modernizing the Financial System, supra note 7, at II-11.

\textsuperscript{520} Id. at II-15.


\textsuperscript{522} Hearing on the Credit Crunch, supra note 521, at 12.

\textsuperscript{523} Id.
under a system of capital supervision, whereby a bank would receive benefits for keeping higher levels of capital.\textsuperscript{524} The highest group would have the capital levels above the minimum requirements and would be allowed to engage in a broader range of services.\textsuperscript{526} The lowest group would have a capital level below the minimum requirement and would suffer consequences such as not being allowed to issue dividend payments to its shareholders.\textsuperscript{526} Such a system of rewards would encourage a higher capital base without having to force banks to cut back in lending in order to maintain an adequate capital base.

Whether it is by reward or punishment, the goal of higher capital levels is to improve the status of the banking system. For management to keep to a goal of higher capital ratios helps prevent them from taking excessive risks with the bank’s funds. Losses from risky investments would mean more than a write off; under a revamped system such a loss could reduce capital to a dangerous level and subject the bank to being punished by the regulators.\textsuperscript{527}

4. Risk Based Insurance

The old system of flat-rate premiums treated all banks the same and therefore did not discourage banks from taking risks.\textsuperscript{528} Risk based premiums determine premiums based upon the risk taken by the insured bank much the same way insurance premiums are priced in the real world. The basic idea is that these premiums would help discourage unnecessary risk among bankers in the types of investments they make. Also, it would prevent cautious banks from having to pay higher premiums due to the acts of uncautious, poorly managed banks.\textsuperscript{529}

While such a system sounds ideal, its implementation is what makes it a bit tricky. The problem here is that it is not always easy to price risk on a bank before its problems have fully manifested.\textsuperscript{530}

\textsuperscript{524} Deposit Insurance and Banking Reform Proposals, supra note 2, at 90 (attachment from Treasury News).
\textsuperscript{525} Id.
\textsuperscript{526} Id.
\textsuperscript{527} Id.
\textsuperscript{528} Vol. III, Deposit Insurance Reform and Financial Modernization, supra note 191, at 340 (statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation).
\textsuperscript{529} Deposit Insurance and Banking Reform Proposals, supra note 2, at 90 (attachment from Treasury News).
\textsuperscript{530} Id.
All banks take risks; it is part of their business.\textsuperscript{531} However, there are no existing standards to evaluate the risks a bank undertakes to such a level so as to create a premium system for bank deposit insurance.\textsuperscript{532} While it is recognized that some loans are riskier than others, no one has ever truly attempted to determine the cost differentials of insuring different types of loans.\textsuperscript{533} Defining the risk factors to develop such a "bracket" system of insurance will be difficult, based mostly on the subjective experience of the agencies, even though they have been unable to develop a "formula" for statisticating such insurance.\textsuperscript{534} One response to these problems is to approach private insurers with whom it could be arranged to insure the banks together through "an integration of primarily government insurance and just enough private insurance to serve as an overall price-indicator."\textsuperscript{535} The Treasury Department has also suggested that capital levels could be used as the primary measure for risk, but that the FDIC be given the power to use its discretion "to adjust and refine the risk-based premium standard."\textsuperscript{536}

A problem with this system is that it would create a penalty on a bank who engages in riskier lending, and could therefore discourage banks from making any loan which might jeopardize their current premium status. Such an attitude by banks could encourage them to become overly conservative. Also, risk premiums have been viewed by many as being impractical, if not impossible, to develop.\textsuperscript{537}

Under the Federal Deposit Insurance Corporation Improvement Act of 1991,\textsuperscript{538} Congress required that the FDIC, by regulation, establish a risk-based premium system for deposit insurance.\textsuperscript{539} However, Congress did not offer much by way of guidance as to how the FDIC is to develop such a risk based premium system.\textsuperscript{540} The risk

\textsuperscript{531} Id. at XVIII-4.
\textsuperscript{532} MACEY & MILLER, supra note 164, 276.
\textsuperscript{533} See Modernizing The Financial Institutions, supra note 6, at XVIII-20; see also S. MAISEL, RISK AND CAPITAL ADEQUACY IN COMMERCIAL BANKS (1981).
\textsuperscript{534} Deposit Insurance Reform-1991, supra note 309, at 135 (statement of L.W. Seidman, Chairman, Federal Deposit Insurance Corporation).
\textsuperscript{535} Modernizing The Financial System, supra note 7, at 34; see also Deposit Insurance Reform-1991, supra note 309, at 136 (statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation).
\textsuperscript{536} Modernizing The Financial System, supra note 7, at 33.
\textsuperscript{537} Id. at VIII-20.
\textsuperscript{540} MACEY & MILLER, supra note 164, at 276.
based assessment system is scheduled to be fully effective by Jan. 1, 1994.541

The FDIC has recently proposed regulation for such a risk based system.542 This system of classification for premiums is planned to be an interim rule until the final rule is adopted by January 1, 1994.543 The system proposed by the FDIC would establish nine classifications for premiums which would be based upon capital and supervisory factors.544 There are three capital classifications, which would be based upon capital-ratio standards.545 From these capital classifications, the banks would be sub-classified into three supervisory risk classifications, based upon the consideration of a supervisory evaluation provided by the institution's primary regulator as well as other information the FDIC feels is relevant to the risk posed to the Bank Insurance Fund.546 The banks would have the ability to appeal the premium classification that the FDIC chooses for it.547 The FDIC has made it very clear in its proposal that the entire system is subject to change based upon future experiences with it.548

**Conclusion**

Outdated laws which restrict bank activities and impose extra costs on banks are the basic problems facing banks today. These problems manifest themselves in two areas: competition with other financial service institutions and competition with foreign lenders.549 While immediately the problem belongs to the banking industry, it shall prove itself to be a problem of the welfare of this country in the long run.

As non-bank financial institutions have entered into the traditional banker's market, the money supply is being held by more than just banks.550 The problem with this is that since most of the laws which give our government the power to control the money supply

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543. Id.
544. Id.
545. Id.
546. Id.
547. Id.
548. Id.
549. See supra section II.
550. See supra notes 170-187 and accompanying text.
are directed at banks, the government will end up with less control over the economy. Such a situation would return this country to the problems it faced before it started regulating banks. A clear example of this could occur if the stock market should crash and cause investors to form a “run” on mutual funds in which they would sell their shares for heavily deflated prices which could have a catastrophic effect on the money supply. Another example would be if a major insurance company should go into bankruptcy, its policy holders losing all of their premiums paid. The federal government would have little control over either of these problems. Our government is losing its control over the economy as money leaves the American banking system and enters the hands of other financial institutions. As a matter of fact, the regulatory tool of lowering interest rates now serves equally as poison as it does medicine for the banking system as it entices depositors to move their investments into the capital markets to gain the higher returns.

Also there is the problem of foreign competition. As banks lose their share of the American financial markets and financial markets abroad to foreign competition, this country shall find many of its loan decisions being made in Tokyo, London, Geneva, Milan, and Frankfurt. American businesses depend heavily on a healthy financial system for their day to day financing of operations. It would be quite dangerous to the welfare of this country to allow for a substantial portion of its credit decisions to be based in foreign nations whose primary regulators will be foreign governments whose primary concerns will be their own country.

Another significant change which is becoming more and more evident each year is the globalization of the economy. Just like the end of the nineteenth century when the railroads brought the states more closely together which helped to develop the national economy, now the advances in technology and communication are allowing the modern world to become a global economy. It was during the nationalization of the American economy 100 years ago that

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552. See Matthews, supra note 1, at 1.
553. See supra note 3 and accompanying text.
554. See CUOMO COMMISSION ON COMPETITIVENESS, AMERICA’S AGENDA: REBUILDING ECONOMIC STRENGTH 56 (1992) [hereinafter CUOMO COMMISSION].
556. See CUOMO COMMISSION, supra note 554, at 56.
the trust banks arose to provide a wide variety of financial services and to raise large amounts of capital for new growth businesses.\textsuperscript{557} Now, as we approach the next century, the bankers of the world are helping to usher in this new global economy. Shall American banks be excluded from this? If American industry is to continue participating in this global expansion as the Europeans and the Asians are, can they do so without the assistance of strong American banks?

The problems with the banking industry should not have to reach catastrophic proportions before Congress acts. This note does not attempt to come up with solutions, it is merely a mandate for action; it is not meant to solve problems, it is only meant to address them.

The recognition in this note of the problems of the banking industry comes from the hearings and reports which were undertaken by Congress. While Congress is very aware of the problems, they still find themselves deadlocked. They hesitate for all the reasons mentioned in this note. In truth, they are lost as to what solutions are necessary. However, since it is the welfare of the country which is at stake, a strong attempt should be made to make the changes in the banking laws that are required.

Charles G. Roberts

\textsuperscript{557} Carosso, supra note 38, ch. 2. See also Competitive Problems Confronting U.S. Banks Active In International Markets, supra note 193, at 26.