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Federal Bank Regulatory Policy: A Description and Some Observations*

In this paper, I briefly describe the development of federal bank regulatory policy and then analyze the ultimate expression of that development—present-day policy. I argue that, if having safe transactions account balances is the objective of the federal government, then that policy has to be regarded as less than adequate. After analyzing present-day policy, I consider some alternatives. I argue that, if there should be safe transactions account balances only because individuals want them, then the laissez-faire policy would serve nicely. I also argue that, if the object of the government is, say, to protect the money supply, however defined, then, of the alternatives I consider, there is only one that may be better than present-day policy, that under which banks would be split de facto or de jure into separate payments services and lending companies.

When invited by the editors of this *Journal* to contribute a paper on the regulation of banking in the United States, I was of course pleased. Perhaps too pleased: without bothering to inquire about what was involved, I simply accepted the invitation. Then I got to feeling nervous. Describing and evaluating more than half a hundred bank regulatory policies—those of the states and the District of Columbia and that of the federal government—would be no mean task. Fortunately, I was not long in hearing again from the editors, and when I did, they made clear that what they had in mind was a paper on federal regulation of banking in (as hereafter should be understood) the United States. As hardly need be added, I was much relieved.

I am again feeling nervous, although now, unlike originally, for good reason; I know what covers the pages that follow.

I do not ignore state regulation entirely in this paper. If I wanted to, I could not; federally chartered or national banks and bank holding companies are, in various ways, regulated by state

* I want, though without implicating, to thank my university colleagues Michael Dothan and Timothy Nantell for their help, and also, from the larger world, John Boyd, Carter Golembe, and David Holland. Would that even just one of them were, with me, culpable.

(*Journal of Business*, 1986, vol. 59, no. 1)

0021-9398/86/5901-0001$01.50

governments. Mostly, however, I am concerned with federal regulation: at the request of the editors, with the development of federal bank regulatory policy and, rather more interesting, with how well the policy of the present serves us.

A definition. Only a few years ago one could have used the word "bank" and the phrase "banking industry" without fear of being misunderstood. A bank was a commercial bank, an association licensed or chartered by a government to engage, presumably as a corporation, in the business of banking—to accept demand-deposit balances, that is, or provide third-party payments services. And by universal agreement "banking industry" and "all commercial banks" were synonymous. But in 1980 the Ninety-sixth Congress passed the Depository Institutions Deregulation and Monetary Control Act, mercifully referred to as DIDMCA; and in 1982 the successor Ninety-seventh Congress, doing its bit to complicate reality, passed the Garn–St Germain Depository Institutions Act. Those two statutes changed the missions of the thrift institutions, savings and loan associations (S&Ls) and savings banks, and credit unions, by, in effect, broadening their charters; and, coming to why I cited the statutes, they made that once unambiguous word "bank" ambiguous.

It is not now farfetched to think of S&Ls and savings banks as being, pure and simple, commercial banks or of the banking industry as being made up not only of commercial banks but also of S&Ls and savings banks as well. Nor are we necessarily confronted with an inconsequential matter of definition; for a proposed merger of commercial banks, it can make all the difference in the world how the banking industry is defined.

In this paper, though, just because it is convenient to be so, I am faithful to the uncomplicated past: herein, a bank is a commercial bank, and the banking industry is the aggregate of existing commercial banks. There is no implication that I am unconcerned about how, for instance, S&Ls should be regulated. That is best worked out by comparing banks and S&Ls, but only after it has been decided how, if at all, banks should be regulated.

Organization of the paper. In Section I of this paper I attempt to provide background for the truly innocent. There I give an account of the development of federal bank regulatory policy from 1863, that being when the federal government debuted as a regulator of banks. (Neither the first Bank of the United States nor the second can reasonably be regarded as, in the modern sense, a bank regulatory agency.) Perforce, my account is far indeed from being complete. To illustrate, I tell some of what a succession of Congresses did but make little of the federal bank regulatory agencies and the courts, despite their importance in the shaping of policy. I end my account of the development of federal bank regulatory policy with a summary description of what for us, in the here and now, is the ultimate expression of that development—present-day policy. But if my account is incomplete, so is my description; the adjective "summary" is all too well taken. Moreover, I describe not actual policy, which is excruciatingly broad and complex, but rather what I think of as the essential present-day policy; and that is very much a subjective thing.

In Section II of the paper I go into how banks should be regulated. There I argue—consistent with our history of bank failures, a history reaching right down to this writing—that federal bank regulatory policy is flawed, not to be counted on to keep banks sufficiently safe and sound. Of all my conclusions, that one is, I judge, the most important. It suggests a need to consider alternatives to present-day policy, one of which is the laissez-faire policy (or nonpolicy). In Section II, I also argue, if in what will strike some as a curiously oblique way, that we might be better served by it than by the present-day policy.

But, note, I said "might be." How well we would be served by the laissez-faire policy depends on what is wanted, whether only safe transactions account balances for those desiring them or, from first to last, safe and sound banks. Nowhere in this paper, though, do I get into what ought to be wanted. Thus I content myself in Section II with arguing that under the laissez-faire banking policy there would be perfectly safe banks and, in consequence, transactions account balances. But, as I note there, whether all banks would be perfectly safe is not clear, at least to me. So I do not argue that we ought to adopt the laissez-faire banking policy.

There are, however, other alternatives, and I consider several in Section III. But so that no one reads on to eventual disappointment, I must add here that I do not end up there with a strongly preferred alternative. As close as I come to advocacy is a left-handed endorsement (I am right-handed) of a variation of that most ancient of alternatives, under which banks would be required to back 100%, with marketable and perhaps appropriately dated Treasury securities, those of their balances included in the money supply.

I. From 1863

It is widely held, certainly among those favoring (more) deregulation, that present-day federal bank regulatory policy was largely fashioned during the years 1933–35 and, moreover, as has been emphasized over and over again, in response to an extremely severe economic depression and, cause or effect, an equally severe financial crisis. Supposedly, there is a clear implication: present-day policy cannot be appropriate to the present. But that is a non sequitur. A change in circumstances does not, of necessity, make a regulatory policy inappropriate. What if a policy, adopted in particular circumstances, is effective? Then those circumstances will never again be observed.

So much for the peculiar logic of some of the proponents of banking deregulation. What interests me is the assertion that present-day federal bank regulatory policy was largely fashioned during the years 1933–35 or, alternatively, by the Seventy-third and Seventy-fourth Congresses. There is no denying those Congresses a continuing presence, and yet, as it seems to me, the assertion is more wrong than right. It is not just that federal bank regulatory policy, like all other government policies, a living thing, must have changed some at least over a span of five decades. The essential present-day policy is an expression of a fear and a desire: a fear of bigness and, in a manifestly unsafe world, a desire for safety. But those federal banking statutes that express the fear of bigness do not date from 1933–35, and if some of those that express the desire for safe bank balances date from those fateful years, not all do. Recall that the Federal Reserve Act was signed into law at the end of 1913.

Later on, in appraising present-day federal bank regulatory policy, I take "a safe and sound banking industry" as the federal government's policy objective. It may therefore seem that I can ignore those federal banking statutes hatched by a fear of bigness. But they do have a certain relevance, and in my account of the development of federal bank regulatory policy I begin with them.

A. *That Abiding Fear of Bigness*

Through 1862, state governments were unrivaled as regulators of banks. Only they chartered and limited (existing) banks in what they could do. In 1863, though, the federal government became a regulator. About halfway through a tragic and costly civil war it faced a fiscal crisis. Not surprisingly, necessity having so often been the mother of invention, it hit on a plan to increase the demand for its debt and, not so incidentally, rid the United States of what for many was a maddeningly troublesome currency supply. The plan, included in the National Currency Act of 1863 (and, further refined, in the National Bank Act of 1864), involved the chartering of banks by an agency of the federal government, the Office of the Comptroller of the Currency (OCC). The newly chartered banks were to buy federal debt and, using their purchases as backing, issue notes provided by the Treasury.

When the federal government got into regulating banks, it did so with the intent of being dominant, even as a charterer of banks.[1] It is now.

1. In the National Currency Act, the Forty-third Congress imposed a 10% tax on private notes, those of state-chartered banks included. The tax was repealed, though, when a "deadwood bill," appended to the Tax Reform Act of 1976, was signed into law.

But it did not achieve anything like dominance until 1934, with the introduction of federal deposit insurance.

To limit geographic reach. Until long after 1911 the federal government was, as a regulator of banks, primarily concerned with asset quality. In 1911, however, a severe limitation on the geographic reach of federally chartered or, as hereafter, national banks was made a part of federal bank regulatory policy. It was then that the attorney general of the United States came out with a fateful decision, namely, that the National Bank Act did not give national banks the right to have branches.

In a sense, "fateful" is not an appropriate objective. Any Congress from the Sixty-second on could have rendered the attorney general's decision ineffective. Until 1927, though, no Congress did anything, save perhaps talk, about branching by national banks. The first to do something, quite something I should say, was the Seventieth; it authored the McFadden Act of 1927.[2] What that act said was that a national bank could establish branches within the community in which it was located, but only if state-chartered banks located there could too. In 1927, then, proponents of (unrestricted) branching by national banks achieved a victory, but of considerably less than momentous proportions. With the signing of the McFadden Act into law, it became generally accepted that, whatever the state in which it happened to be located, a national bank could not be freer to branch than its state-chartered competitors. Evidently, the act is best viewed as an anti-branching statute (Golembe and Holland 1983, p. 119). The meagerness of the victory achieved by those favoring branching by national banks reveals not only the political power of their opponents but also, among those not just interested in preserving local monopolies, the depth of the fear of bigness in banking.

In 1933 proponents of branching by national banks achieved a second victory, also of considerably less than momentous proportions. By amendment of the McFadden Act (the amendment was included in the Banking Act of 1933), national banks attained parity in branching with state-chartered banks. Whatever the state, national banks were to be as free to branch as their state-chartered rivals.[3] Thus national banks were made subject to a prohibition against interstate branching and, hence, banking.[4]

Since the end of 1976 there has thus been no tax on bank notes. But, for better or worse, various provisions of federal law make such notes illegal, or so the Ninety-fourth Congress was told by the OCC when it was engaged in cleaning up the federal statute books.

2. For background on the act, see U.S. Department of the Treasury (1981, particularly, app., pp. 5–6, 181–86).

3. See U.S. Department of the Treasury 1981, app., pp. 181–86.

4. To do business in state x, a state-chartered bank had to be chartered by the government of state x, so banks chartered by the government of state y could not do business there; nor, therefore, could national banks located in state y.

Mention must also be made here of a part of the Bank Holding Company Act, the so-called Douglas Amendment, the purpose of which was and is to keep (national) banks, disguised as bank holding companies, from subverting the federal government's prohibition against interstate banking.[5] When I discuss the Bank Holding Company Act, I will be precise about what, in law, "bank holding company" means. Here, "a corporation owning (in my sense) banks" suffices as a definition.

Apparently, bank holding companies existed in the United States as early as the turn of the century. Until well into the 1950s, though, the public took no notice. In the late 1940s and the first few years of the 1950s, quite a few bank holding companies were formed, and as the decade wore on the belief spread that what had long been feared—behemoth-like amalgams of banking and commerce—was just over a near horizon. Revealing its fear of bigness, a fear linking it to Congresses past and future, the Eighty-fifth Congress responded with the Bank Holding Company Act of 1956, which was intended to make bank holding companies subject to federal regulation and, more specifically, to get all of them out of commerce. But when about done with the act, that Congress had an unsettling thought: the courts might not recognize bank holding companies for what they were, banks in disguise. To guard against the possibility, it appended what quickly became known as the Douglas Amendment. That amendment said, in effect, that a bank holding company headquartered (owning banks) in state x could not acquire a bank in state y unless explicitly authorized by a statute of state y to do so. Permission was not to be inferred; again, the right to acquire had to be stated explicitly. Thus, from near the beginning of the post–World War II bank holding company movement, national banks were precluded from using an obvious dodge to establish branches beyond the boundaries of their home states.

A brief digression. Although having hardly begun my account of the development of federal bank regulatory policy, I nevertheless break off here to comment on the McFadden Act and, what is to be thought of as a necessary adjunct, the Douglas Amendment. But I pause only briefly; in commenting, I confine myself to the significance of those two restrictions for bank safety and soundness.

If effective, a branching restriction limits geographic reach. Is it possible to go further, though, and add that a branching restriction, if effective, therefore limits the potential for balance sheet diversification? Almost certainly, the variety in would-be borrowers and depositors does not always increase when geographic coverage is increased.

5. For a brief but informative legislative history, see U.S. Department of the Treasury (1981, app., pp. 187–89).

Were we to assume that it always does, we still would not get the implication that limiting geographic reach necessarily limits the potential for balance sheet diversification. Think of a bank that, although constrained to have no branches, is located in a large, densely populated metropolitan area. Nor is any imagining required; even among our largest there are such banks.

We can pass over the largest of our banks, although whether the largest 25 or 50 or 100 is not clear. As lenders, those banks are not restricted in geographic reach; the branching restrictions by which they would seem to be constrained are, in a word, ineffective. The market for loans to the largest of corporate borrowers is worldwide, and all of them have access to it. Any bank lending officer can flit here and there; and there is that invention of doubtful advantage, the telephone. In the United States, there may be several (geographically distinct) markets for loans to middling corporate borrowers, but not one of our largest banks is excluded from any of them. A loan production office may not be a perfect substitute for a branch; as a place in a distant market from which to lend, it is, however, a good substitute. And whatever law and regulations may say, an Edge Corporation office is only a slightly less good substitute. Finally, making consumer loans across a broad region or, indeed, the nation is a possibility for any of our largest banks. Disguised as bank holding companies, several own regional consumer finance companies, and several own national consumer finance companies.[6]

In sum, costs and regulations are such that our largest banks all have great potential for geographic diversification in their loan portfolios. I do not say that all are geographically well diversified or, what is manifestly untrue, that all have always been so. How much geographic diversification is achieved depends not only on what is possible but also, with whatever is the constraint on geographic reach, on the loan strategy that has been chosen.

During and immediately after the rescue of Continental Illinois National Bank and Trust Company (or, more accurately, its parent, Continental Illinois Corp.), we were many times reminded of how severely restrictive the State of Illinois' branching restriction was. If Continental (the bank) had all along been freer to branch, then, as was said, it would not have become the "purchase money" bank it ended up being,

6. In 1971 the Board of Governors of the Federal Reserve System, responsible under the Bank Holding Company Act for deciding which other (nonbank) activities are permissible for bank holding companies to be engaged in and which are not, made a far-reaching decision, although by what right I do not know. As it subsequently announced, bank holding companies would not be limited geographically in their permissible other activities as national banks were in their banking businesses. If having a consumer finance company were to be judged permissible, then a bank holding company would be able to own one with, for instance, a nationwide network of offices.

and, having a much greater proportion of retail deposit balances, it would have been better able than it was to survive its bad loans. The argument must be that the Federal Deposit Insurance Corporation (FDIC) enjoys greater trust as an insurer than does the Federal Reserve; and to me that is not obviously right.

I grant that, for a bank such as Continental, achieving considerable geographic diversification in deposit balances may be more difficult (in some way more costly) than achieving similar diversification in loans. So long as Federal Reserve Banks remain willing lenders, though, a lack of diversification in deposit balances will not have anything like the significance for bank safety and soundness that diversification in loans will. But here that is by the way. The point to be made is that First National Bank of Chicago, a longtime neighbor of Continental, is still bravely carrying on as a private corporation; at least it was last time I checked.

Attributing the demise of Continental to a state branching restriction rather than, as they appear in retrospect, to unfortunate loan and funding strategies is illustrative of a long-evident willingness to make too much of the McFadden Act. But that too much has been made of the act and the companion Douglas Amendment is no justification for dismissing those federal restrictions as being of no consequence. Small banks, located in areas of extremely low population density, come inevitably to mind.

There was a time, not all that long ago, when banks generally were much more dependent on brick and mortar branches than they are now and when, I suspect, many were more exposed than, with greater freedom to branch, they would have been. Distance-lessening technological change, so dramatic as to be almost impossible for a laity to credit, has made brick and mortar far less important than they were. Why have a traditional branch now that, with the advent of new communications technologies, there are other, less expensive ways of reaching out to would-be customers? Yet there may be some banks, especially among the small and poorly located, that, without branching restrictions, would have more geographically diversified balance sheets than in fact they do.

For a small bank no less than a large one, a geographically undiversified loan portfolio may be the result of choice, not necessity, and what causes suspicion is the existence of so many nationwide asset markets. But there is no such market in small bank loans. Thus, for all the technological change that there has been, it is possible that some small banks—those located in low-density population areas of states with severe branching restrictions—are unable to achieve much geographic diversification in loans. I would go further. Not that anyone can be sure; to me, however, it would seem that state branching restrictions explain why some small banks have such geographically undiversified loan portfolios.

It would also seem that of the small banks located in states where geographic reach is severely restricted, some are unable to achieve much geographic diversification in deposit balances. But, again, as for large banks, that is of much less significance than that, as I conjectured above, there are some small banks unable to achieve much geographic diversification in loans.

Between the largest and the smallest of our banks, there are some about which I have said nothing, and for the obvious reason: I am quite unsure whether any are appreciably limited in their potential for geographic diversification. I am rather sure, though, that federal bank regulatory policy is inconsistent, although less seriously so than, for instance, 20 or even 10 years ago; that is, the McFadden Act and the Douglas Amendment cannot be squared with wanting the safest and soundest banking industry.

The fear of bigness: Another expression. A bank can establish a branch by opening a new office or by acquiring or merging with an existing bank (or bank holding company). The typical state branching restriction does not, however, distinguish between the two ways. If a bank is, for instance, constrained to have no branches, then neither can it acquire another bank and, although under a new name, keep the acquired bank in existence. Also, assuming the disguise of a bank holding company does not, in general, work. Using a multibank holding company as a substitute for a multioffice bank would be too transparent a subversion. If a bank holding company could buy and operate a bank in an area where, as a bank, it could not have a branch, then the branching restriction of the relevant state would be a bad joke. Bank acquisitions and mergers are, then, to an extent limited by state branching restrictions or, more fundamentally, by the McFadden Act. But that is not all. Under present-day federal bank regulatory policy, no bank with FDIC-insured balances can go ahead with an acquisition or merger until it has gotten the approval of the appropriate federal bank regulatory agency, whether the OCC, the FDIC, or the Federal Reserve board (FRB), all of which are, as it were, special antitrust agencies.

The 1950s was a time of extraordinary change in banking. As I noted above, disconcertingly many bank holding companies were formed during the early years of the decade, enough to provoke the Eighty-fourth Congress into passing its Bank Holding Company Act of 1956. There were as well quite a few acquisitions and mergers during the decade, some, naturally the most publicized, involving relatively large New York City banks, more than enough to cause considerable consternation. Back then, banks were regarded by most experts as being beyond the reach of the antitrust statutes and, in particular, section 7 of the Clayton Act, as amended by the Celler-Kefauver Act of 1950. But the Eighty-sixth Congress was alive to the perceived threat. It responded to the wave of joinings by passing its Bank Merger Act of 1960 and thereby made federal bank regulatory agency approval (more than casual) necessary for acquisitions by, and mergers involving, FDIC-insured banks. Under the act, jurisdiction is determined by the status of the acquiring or surviving bank. For their acquisitions and mergers, national banks must get OCC approval. State-chartered banks not belonging to the Federal Reserve System but with FDIC insurance must get FDIC approval; and state-chartered banks belonging to the system must get FRB approval.

Interestingly, there is no mention of the Department of Justice in the Bank Merger Act of 1960. But, then, it was easy for the Eighty-sixth Congress to pretend that the agency did not exist. Until 1963, it was widely believed that the antitrust statutes did not apply to banks. In 1963, however, the Supreme Court shocked antitrust lawyers, not only those in private practice but many in the Department of Justice as well (and regulators and bankers and at least one justice), by ruling in *United States v. Philadelphia National* (374 U.S. 321) that bank acquisitions and mergers were subject to section 7 of the Clayton Act.[7] Not surprisingly, there was considerable agitation for Congress to overrule the Court. The Eighty-eighth Congress did nothing. But the Eighty-ninth Congress succumbed and produced the Bank Merger Act of 1966. In so doing, it showed itself unable, though, to sustain the pretense of the Eighty-sixth Congress. In its act, it reaffirmed the right of the federal bank regulatory agencies to rule on the acquisitions and mergers of FDIC-insured banks, but it provided that, if prompt enough, the Department of Justice could challenge any bank acquisition or merger approved by the OCC, the FDIC, or the FRB.

In the Bank Merger Act of 1956, the Eighty-sixth Congress said that, in deciding on proposed acquisitions and mergers, the federal bank regulatory agencies were, surprise of surprises, to take effects on competition into account. No Congress of the 1930s would have directed the agencies to disapprove acquisitions and mergers that would result in less competitive markets for bank services. That is almost what the Eighty-sixth Congress did. But in the 1930s the dominant view was that, for banking, competitive markets were at best very mixed blessings; thinking beyond the most obvious effect of an acquisition or merger, a decrease of one in the population of banks, would have been near to impossible.

The Eighty-ninth Congress was more explicit about how proposed

7. The shocked justice was Mr. Justice Harlan. He began his dissent from the majority opinion by expressing his suspicion "that no one will be more surprised than the Government to find out that the Clayton Act has carried the day for its case in this Court." His general point, obvious enough, was that, if the antitrust statutes applied to banks (and bank holding companies), then there would be no need for a bank merger act (or a bank holding company act).

acquisitions and mergers were to be decided than the Eighty-sixth Congress had been. Under the 1966 act, any proposed acquisition or merger not found likely to result in a lessening of competition was to be approved; and any acquisition or merger found likely to result in a lessening of competition was to be disapproved, unless it could be established that the lessening of competition would be "clearly outweighed in the public interest by the probable effect of the [acquisition or merger] in meeting the convenience and needs of the community to be served." Thus, that a proposed acquisition or a merger might result even in a very substantial lessening of competition was not sufficient for a federal bank regulatory agency to disapprove it, nor was it sufficient for a court to come down in favor of the Department of Justice. (Recall that, unlike the 1956 act, the 1966 act contained a provision giving the Department of Justice the right to challenge agency-approved acquisitions and mergers.) If, for example, the court found that a proposed merger would likely lessen competition appreciably, it was bound to look to "the convenience and needs of the community to be served." Evidently, even as recently as 1966 there was still some fear of competition in banking on Capitol Hill or a suspicion, shared by sufficiently many, that unbridled competition was not best for banking.

The basic response of the Eighty-ninth Congress to the Supreme Court's Philadelphia National decision was the Bank Merger Act of 1966. In a laudable attempt to achieve consistency, that Congress also amended the Bank Holding Company Act, passed, it will be remembered, in 1956. In the 1956 act, the FRB had been given the responsibility of deciding on proposed acquisitions and mergers of bank holding companies. What the Eighty-ninth Congress did in amending that act was to direct the FRB to decide proposed acquisitions and mergers of bank holding companies as it and the other federal bank regulatory agencies were to decide proposed acquisitions and mergers of FDIC-insured banks. More particularly, the FRB was to approve any proposed bank holding company acquisition or merger that, in its judgment, would not result in a substantial lessening of competition; and in deciding on any proposed acquisition or merger that seemed likely to lessen competition, it was to look beyond, to the "convenience and needs of the community to be served."

Another brief digression. For bank acquisitions and mergers, the Bank Merger Act of 1966 is as much the ruling statute now as it was in 1966; for bank holding company acquisitions and mergers, the Bank Holding Company Act, as amended in 1966, is as much the ruling statute now as it was then. That tells us something, but, alas, not too much. It certainly matters how a proposed acquisition or merger is to be approached; and that is what the Eighty-ninth Congress made clear to the federal bank regulatory agencies in its Bank Merger Act. Inevitably, though, the guidance provided by that Congress was most vague. The essence of any acquisition and merger policy is how free banking organizations are to acquire and merge, and the Bank Merger Act of 1966 and the amended Bank Holding Company Act do not tell us that.

The implication could not be clearer. I should be going on to what the federal bank regulatory agencies and the courts have made of the Eighty-ninth Congress's guidance. I do not, however, have "world enough and time." In this second brief digression, I therefore limit myself to commenting on the guidance, the not quite hopelessly vague policy, of the Eighty-ninth Congress.[8]

An obvious question is whether structure significantly influences the safety and soundness of a banking industry. United States financial history may provide an answer. That so many small unit or one-office banks failed in the years before 1934 would seem to be suggestive. That federal deposit insurance was introduced would too; and it does not matter that the structure of the U.S. banking industry of the period 1900–33, although not constant, was always more the expression of the policy of the federal government than of bank technology.

Something is perhaps to be made of the English banking industry having fared so well in the early 1930s. Back then, that industry was pretty nearly just a few large banks, each possessed of a branch network of broad geographic reach. So was the Canadian banking industry, and it too fared well. Above, I argued that branching restrictions, never imposed in either England or Canada, are inconsistent with the desire for bank safety and soundness; and it can be argued, by appealing to historical experience as well as to economic theory, that the (proximate) objective of acquisition and merger policy ought to be a banking industry closely resembling that of the England or the Canada of the interwar years.

Of course, historical experience could well turn out on careful examination to be revealing of nothing. How often has the past been found stonely mute? It is, however, extremely important whether the naturally safest and soundest banking industry is that made up of only a few banks, each with a branch network of broad geographic spread. I do not deny that, even though I do not take a stand. For me it is enough that, for better or worse, the Eighty-ninth Congress rejected an extremely concentrated banking industry as the objective of its acquisition and merger policy. My point is only that, having done so, it might have abandoned all thought of a special policy for banking organizations.

If persuaded of the desirability of competition in banking, the

8. But for accounts of bank merger policy as developed by the courts and the bank regulatory agencies, see Austin (1981, 1982) and Eisenbeis (1982).

Eighty-ninth Congress cannot have been entirely so. Had it been, it would not have come out where it did, nor, more particularly, would it have provided that a bank acquisition or merger might threaten a lessening of competition and still be approved. The language of the Bank Merger Act of 1966 is mind-boggling. What are we to make of a federal bank regulatory agency finding "that the anticompetitive effects of the proposed transaction are clearly outweighed in the public interest by the probable effect of the transaction in meeting the conveniences and needs of the community to be served?" A naive economist might think that competition is what satisfies the conveniences and needs of communities. It is not, however, that the language of the Eighty-ninth Congress is nonsensical but rather that, if competition in banking is generally desirable, then, whatever grander objective beyond a competitive banking industry a federal bank regulatory agency may believe it is honoring, it should not have the authority to decide, whenever so disposed, that there should be less competition. In sum, there is too much potential for mischief in the acquisition and merger policy of the Eighty-ninth Congress.

I can put what I believe another way. If it is right, as some economists have argued, that our antitrust statutes are just so much clutter, then the Eighty-ninth Congress ought to have put bank and bank holding company acquisitions and mergers beyond the public reach. And if it is right, as other economists have argued, that the Sherman and Clayton acts provide essential protection, then the Department of Justice might have been made responsible, by itself, for watching over the acquisitions and mergers of banking organizations.

It will perhaps be objected that, because banking organizations are regulated, the objective being to keep them safe and sound, the federal bank regulatory agencies had to be made primarily responsible for deciding on their proposed acquisitions and mergers. To illustrate, an acquisition could result in the acquiring bank having too little capital; and the Department of Justice would not be sufficiently sensitive to that possibility.

Clearly, though, that the Department of Justice could not be counted on to be sufficiently sensitive does not justify the Eighty-ninth Congress having given the federal bank regulatory agencies the authority to approve proposed acquisitions and mergers found to threaten competition. At most, that Congress would have been justified in providing for agency participation in acquisition and merger decisions and, further, in allowing the agencies to give weight to "banking factors."[9]

There is, however, something more to be said. Imagine a proposed

9. The following passage is from the Bank Merger Act of 1966, 12 U.S.C. § 1828(c): "In every instance, the responsible agency shall take into consideration the financial and managerial resources and future prospects of the existing and proposed institutions."

acquisition that, in the judgment of the relevant federal bank regulatory agency, would result in a new bank with too little capital. But if too little capital is a satisfactory basis for refusing approval of an acquisition, then, apparently, the agencies could not all deal with banking organizations as they were. The Eighty-ninth Congress would seem to have made rather a damaging admission. In making it possible for the federal bank regulatory agencies to ring in "banking factors" in deciding on proposed acquisitions and mergers, it at least hinted that, as of 1966, the agencies were less than entirely in command. Seemingly, enforcing regulations intended to ensure the safety and soundness of banking organizations was not all that easily managed.

B. A Quest for Safety

I remarked earlier that the essential present-day federal bank regulatory policy is an expression of a fear of bigness and, hardly surprising, a desire for safe bank balances. So far, I have been concerned with those federal banking statutes that express the fear of bigness. But I have now said all that I am going to say about them, and here I turn to the others, those that express a desire for safety.

The federal government as an insurer. To continue my account of the development of federal bank regulatory policy, I go back to the end of 1913, when the Federal Reserve Act was signed into law and the Federal Reserve System, made up of a Federal Reserve Board (later the Board of Governors) and twelve regional Federal Reserve Banks, was created. The act was a somewhat belated response to the financial crisis of 1907. But, then, midwifing a central bank is not always easy. One of the stated purposes of the act was to make "supervision" of banks more effective. Apparently, regulation of state-chartered banks by state agencies had not been entirely adequate, nor, presumably, had OCC regulation of federally chartered or national banks. But that did not trouble the Sixty-third Congress. Of course, federal regulation, although not entirely adequate, may nevertheless have been better than state regulation. In any event, the Sixty-third Congress hoped that state-chartered banks would become members of the Federal Reserve System and, hence, by provision of the Federal Reserve Act, subject to federal regulation. That Congress was, however, destined to be disappointed. Possibly because the Federal Reserve Act made holding reserve balances mandatory for member banks, state-chartered banks did not flock to the system, either in 1914 or subsequently. In 1980, before DIDMCA was passed, the Federal Reserve System was still complaining about its membership problem, real or imagined.

The Sixty-third Congress wanted not only to make state-chartered banks subject to federal regulation but also to create a lender of last resort. In providing Federal Reserve Banks with discount windows, the Sixty-third Congress must, however, have had in mind that those windows could be used by member banks with "liquidity" problems. If it did not, it could hardly have expected, as surely it did, that state-chartered banks would rush to become members of the Federal Reserve System.

That the Federal Reserve Act of 1913 was in part intended as a deposit insurance statute is thus not absurd. But for anyone disposed, as I am, to accept that it was, there is an exceedingly awkward question. If one of the purposes of the Sixty-third Congress was to provide (a kind of) federal deposit insurance, why did the Federal Reserve allow so many banks to fail during the years 1914–33? Why was there an epidemic of failures immediately after World War I and another, even more severe, in the early 1930s? As the author of the Federal Reserve Act, the Sixty-third Congress was ever so much vaguer than it had to be, and that may be the explanation. We do have to accept, though, that federally insured bank balances became a reality only in 1934, when the FDIC appeared on the scene. Yet, a bungling or half-hearted attempt is an attempt, and I do credit the Sixty-third Congress with an attempt at providing federal insurance for bank balances. The attempt reveals a willingness, expressed as well by other Congresses, to do what was thought necessary to make bank balances safe. Below, I make much of that willingness.

Of all the banking legislation of the years 1933–35, and there was much, pride of place must, it seems to me, be given to a 1933 amendment to the Federal Reserve Act, included in the Banking Act of 1933, which gave the United States a full-blown federal deposit insurance policy and a new federal agency, the FDIC, to implement the policy. Here, two of the policy decisions embodied in the amendment are of special significance. The decision to make FDIC insurance available to banks not belonging to the Federal Reserve System is one. That is because the Seventy-third Congress insisted on a quid pro quo; any nonmember bank wanting FDIC insurance would have to submit to FDIC regulation. In the circumstances of 1934, most nonmember banks were more than willing. By means, then, of the 1933 amendment the federal government about realized its longtime objective of having all banks subject to its regulation. And, much more likely than not, it saved thousands of small banks and an industry structure that in early 1933 seemed doomed to drastic change.

The other decision of special significance is well-known but worth recalling here. I refer to the decision to have identical premiums for all banks with FDIC-insured balances. More than any other, that decision of the Seventy-third Congress explains why it has a continuing presence. Of course, any one of the subsequent Congresses might have overturned the decision. Even in 1933 there were some around, economists and others, arguing for risk-based insurance premiums.[10] But from the beginning we have had identical premiums and, hence, a moral hazard problem for which, of necessity, a solution has been sought in regulation.

Note must be taken of a second amendment to the Federal Reserve Act, authored by the Seventy-fourth Congress and included in the Banking Act of 1935. It authorized the FDIC to assist in merging failing banks into ongoing banks or, in the jargon of the trade, to engage in purchase and assumption transactions. (Thereafter the FDIC would in effect be able to pay an ongoing bank to acquire the assets and assume the liabilities of a failing bank.) There is yet another way of putting what the FDIC was authorized to do: namely, if it wanted, to provide 100% insurance coverage for nearly all depositors. In its 1935 amendment to the Federal Reserve Act, the Seventy-fourth Congress increased the FDIC's maximum liability per depositor from \$2,500 to \$5,000. But having been authorized to assist in mergers, the FDIC could insure virtually every depositor in full. And for a stretch of years after World War II it did precisely that.

In 1950, when the insurance amendments to the Federal Reserve Act of 1933 and 1935 were made into the Federal Deposit Insurance Act, the FDIC was authorized to provide direct assistance to troubled and closed banks; it was empowered to assist a failing bank or reopen a bank that had been closed whenever, in its judgment, doing so was necessary to ensure an adequate supply of banking services. In the Garn–St Germain Act of 1982, authority to provide direct assistance was extended to instances in which conditions in financial markets threatened a significant number of banks, a few banks with a significant combined total of assets or liabilities, or, most generally, the FDIC's insurance fund.

At this moment, then, the FDIC can pay off the insured depositors of a bank that has been declared insolvent; when necessary to get an ongoing bank to make an acquisition, it can buy bad assets of a failing or a failed bank; it can provide the assistance required to get a closed bank reopened if doing so is the only way of assuring adequate banking services for a community; and, finally, the FDIC can provide direct assistance to a bank in trouble if that is the only way of assuring adequate banking facilities for a community or if, in unusual market conditions, its insurance fund is threatened.

The activities of banking organizations. The Seventy-third Congress may have done nothing more important than make the federal govern-

10. For a brief account of the argument ca. 1933 about the pricing of federal deposit insurance and many references to the literature of the period, see Wells and Scruggs (1984). And for an account of pre-1933 attempts by states to insure bank balances, see Golembe (1960).

ment an insurer of bank balances. At present, however, it is perhaps less well remembered for its insurance amendment than for the Glass-Steagall Act, also a part of the Banking Act of 1933. The Glass-Steagall Act can be traced to Congressional hearings of 1932–33, during which enough members of the Senate and the House of Representatives were persuaded of the reality of various allegations, among them that capital losses on inventories of underwritten securities had gotten more than a few banks into trouble.[11] As it seemed, then, there was nothing to do but separate commercial banking from investment banking, and, by common understanding, that is what the Glass-Steagall Act did (or for many years did). It prohibited companies engaged in the underwriting (distribution) of corporate securities from having any balances subject, whether de jure or de facto, to call. More to the point here, it limited Federal Reserve System member banks to underwriting Treasury debt securities and the general or full-faith-and-credit obligations of states and their subdivisions.

That the Glass-Steagall Act is currently being honored in full in the real world can reasonably be doubted. How to square what it says, or seems to say, with the existence of companies that underwrite corporate securities and offer transactions (interest-bearing checking) accounts? That there is something wrong has not escaped the notice of banks. Many are keen to get back into the underwriting of corporate securities, and those that want to may well succeed, if not tomorrow. How the act will be read in the future by the federal bank regulatory agencies and the courts, how it will be interpreted as limiting (Federal Reserve System member) banks, is far from apparent.

The interest in investment banking may go back quite a way. Early in the post–World War II period, it seems, many banks began to dream of being more than what they had become. As I observed above, a significant number of bank holding companies were formed in the late 1940s and the first few years of the 1950s, and a certain restlessness must be a part of the explanation. In the Bank Holding Company Act of 1956, to which I have already referred, provision was made for regulating the nonbanking or other activities of bank holding companies.

Actually, regulation of bank holding companies dates back not to 1956 but to 1933. By amendment to the Federal Reserve Act, the Seventy-third Congress made corporations controlling Federal Reserve

11. There was much about conflicts of interest in those hearings. For instance, it was alleged that banks engaged in securities underwriting had been putting unsold portions of badly priced issues into trust accounts or, more generally, that trust affiliates and departments had been used to support securities issues being underwritten. Abusing trust beneficiaries does not, however, make a bank more likely to fail. Quite the opposite; a government interested only in bank balances being safe would encourage banks to use trust beneficiaries' wealth to protect depositors. So the allegations of conflict of interest are not relevant here. Only those that linked securities underwriting to failure are.

System member banks subject to FRB regulation—but, by and large, to ineffective regulation. What interests us is that the FRB was chosen by the Seventy-third Congress to regulate bank holding companies. The Eighty-fourth Congress may well have been influenced by the Seventy-third Congress's choice. In its Bank Holding Company Act, the Eighty-fourth Congress designated the FRB, not the OCC, to regulate bank holding companies and, more specifically, to decide within vague statutory limits the other activities in which those companies could and could not engage.

As the author of the 1956 act, the Eighty-fourth Congress was obliged to define "bank holding company." In the act, it said that any association accepting demand deposits was to be considered a bank and, further, that any corporation controlling at least two such associations was to be considered a bank holding company and, hence, subject to the act. Ownership of 25% of the equity of a bank would be presumed to constitute control. But owning even as small a proportion as 5% could be judged to imply control.

Looking back, it is clear that the Eighty-fourth Congress slipped up in making only corporations controlling at least two banks subject to its act. As might have been guessed, "two" turned out to be a loophole. By 1965 or thereabouts, forming one-bank holding companies had become the favorite indoor sport of bankers, and, what is not at all surprising, the belief spread that such companies should be regulated. The Ninety-first Congress responded with the Bank Holding Company Act Amendments of 1970. In the event, making one-bank holding companies subject to the Bank Holding Company Act was easy.

The Ninety-first Congress also changed the Bank Holding Company Act definition of "bank." Again, in the 1956 act a bank was an association (corporation) accepting demand deposits. In the Bank Holding Company Act Amendments of 1970, though, a bank is an association accepting demand deposits and making commercial loans.

When contemplating a change of definition, the Ninety-first Congress was assured by experts, those of the FRB included, that the more restrictive definition proposed would be better than the one in the 1956 act. I do not know why a new definition was thought to be needed. But it could not be more evident that the FRB deeply regrets its advice and that senators and representatives of the present, especially those most influential in banking matters, deeply regret the credulity of the Ninety-first Congress. What the FRB regards as a most serious problem, what on Capitol Hill is thought of as a maddeningly vexing problem, namely, the existence of loophole or nonbank banks and unregulated bank holding companies (corporations that under the 1956 act would be bank holding companies but by the 1970 definition are not), is to be traced back to the change of definition effected in 1970. The drive now, being spearheaded by the FRB, is for a definition not unlike that in the 1956 act: any company with FDIC-insured balances or eligible for FDIC insurance is a bank. The desire to have the phrase "eligible for FDIC insurance" in the definition bears witness that an age-old presumption still holds: it is not for banks to decide whether their demand deposits should be safe.

Back in 1956 there were different views of how far ranging bank holding companies should be allowed to become. The Bank Holding Company Act of 1956 was a compromise. Not that the statute is therefore unique. But if the Eighty-fourth Congress went beyond all precedent in authorizing the FRB, under section 4(c)(8) of its act, to decide the activities in which regulated bank holding companies might and might not engage, it also put the agency in an awkward position. The FRB would not be able to please all. It may have pleased some. Even on Capitol Hill, though, individuals persisted in their differing views. That is why in 1969–70 the Ninety-first Congress was occupied with the Bank Holding Company Act and, I suspect, why it changed the basic section 4(c)(8), the source of the board's authority, but little.

In its section 4(c)(8), the Eighty-fourth Congress had said that the FRB might approve those nonbank activities that it determined "to be so closely related to banking . . . as to be a proper incident thereto." And in amending that section, the Ninety-first Congress did not do much more than append some guidance for the FRB. If an activity, when engaged in by a (particular) bank holding company, would likely produce "benefits to the public, such as greater convenience, increased competition, or gains in efficiency" outweighing "possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices," then it could be judged properly incidental to banking.[12]

But such guidance! It takes no effort to think of the Ninety-first Congress as in effect telling the FRB to go its own way. In administering the amended Bank Holding Company Act, the FRB has, however, insisted all along that a bank holding company can engage in other activities only if the result is a stronger, not a weaker, banking subsidiary. (Or is it that a bank holding company should venture beyond banking and get involved in other activities only to the extent that it can without putting its banking subsidiary or subsidiaries in jeopardy?) That principle can, I believe, be squared with the Ninety-first Con-

12. I may be all alone in my bewilderment that the FRB may approve an activity for a regulated bank holding company if the activity is "closely related to banking" or if it is "a proper incident thereto." See, e.g., Golembe and Holland 1983, pp. 154–55. I go back to that passage from section 4(c)(8): an activity may be deemed permissible if the board has determined that it is "so closely related to banking . . . as to be a proper incident thereto." As it seems to me, a naive soul, someone tutored only in elementary (not policy) logic, could read that passage as saying that an activity is a proper incident to banking only if it is closely related to banking.

gress's section 4(c)(8). Imagine the board having decided that there is no public benefit sufficient to outweigh a decrease in bank soundness (or the spread of unsound banking practices).

Whether the principle I have ascribed to the FRB is consistent with the intent of the Ninety-first Congress matters little. It would seem a natural one for a central bank doubling as a federal bank regulatory agency, and, whatever its source, it is a part of present-day federal bank regulatory policy.

1980: A watershed? There are several more federal banking statutes of the post–World War II period to be discussed. In chronological order they are the Financial Institutions Supervision Act of 1966, the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (among the knowing referred to as FIRIRCA), DIDMCA, and, finally, the Garn–St Germain Depository Institutions Act of 1982.[13] (It will have occurred to others too that there is desperate need for a working congressional statute laureate, an individual of taste with a talent for felicitous phrases and uncontestable authority for titling all federal statutes.) But I put off discussing the Financial Institution Act and FIRIRCA, a potpourri second only to the Banking Act of 1933, until I consider how banks should be regulated. In this section, I discuss only DIDMCA and the Garn–St Germain Act.[14]

In its posture, a regulatory agency can change over time; and it need not become ever more firm or ever more permissive. Among our federal bank regulatory agencies there is, I suspect, not one that has. But, then, insofar as posture is determining, policy can change gradually over time and, more particularly, cycle between extremes of firmness and permissiveness. If we keep, though, to what Congresses have done, then the years from 1863 on appear as a period of more and more federal restrictions applying to more and more banks—the years, that is, through 1979, for 1980 borders at least on being a watershed. In passing DIDMCA, the Ninety-sixth Congress made it, if nothing more,

13. There is one other statute that could well be discussed, namely, the International Banking Act of 1978. I ignore it, except in this footnote, but only because it can be viewed as in essence providing the "level playing field" that spokesmen for U.S. banking organizations, supposedly outraged by the privileged positions of so-called foreign banks, had been demanding. Under that act, many of the restrictions applying to national banks were extended to the agencies and branches of those foreign banks. And foreign banks with agencies and branches in the United States were made subject (most particularly, in their choices of activities) to the Bank Holding Company Act. From 1956 until the International Banking Act was signed into law, only foreign banks (corporations) with U.S. banking subsidiaries were regarded as bank holding companies and subject to regulation by the FRB.

14. And, indeed, only the provisions of those acts pertaining directly to banks. But for a summary of DIDMCA in its entirety, see Federal Reserve Bank of Chicago 1980; and for a summary of the entire Garn–St Germain Act, see Holland (1982) or Garcia et al. (1983).

a memorable year, and, in a way, the Ninety-seventh Congress, author of the Garn–St Germain Act, made it more memorable.

One thing the Ninety-sixth Congress did by means of DIDMCA was to solve the membership problem, real or imagined, of the Federal Reserve System, and in the most obvious of ways; it made insured nonmember banks subject to the FRB's reserves requirement. Indeed, it went further; it made all depository institutions with either transactions account or time deposit account balances (other than personal) subject to the FRB's requirement. In a gesture of evenhandedness, it also opened the Federal Reserve Bank discount windows to all depository institutions having to keep balances with those banks.

But the Ninety-sixth Congress is known for its attempt at deregulation, and that attempt, although recent enough to be familiar to many, is what has to be described. It is necessary to begin, though, by going back to 1933, when many were convinced that the just-witnessed collapse of the banking industry was due in no small part to an excess of interest rate competition for deposit balances, especially in the years immediately prior to the collapse. Understandably, the Seventy-third Congress, a repository of conventional wisdom, wrote a prohibition against paying explicit interest on demand deposit balances, applicable to all FDIC-insured banks, into its Banking Act of 1933. By that act it granted the FRB and the FDIC authority to limit rates paid by FDIC-insured banks to owners of time and savings account balances. The FRB's authority to limit rates paid by Federal Reserve System member banks was not challenged. The FDIC's authority to limit rates paid by state-chartered insured banks was, but in 1935 the Seventy-fourth Congress, author of the Banking Act of 1935, came to the rescue and made further challenge a waste.

When the Ninety-sixth Congress came to power in January 1979, FDIC-insured banks were, as borrowers, fixed about as they had been at the end of 1935. They were still not permitted to pay explicit interest to owners of demand deposit account balances; and they were still subject to FRB- and FDIC-imposed limits or restrictions on rates paid to owners of time and savings account balances. What the Ninety-sixth Congress did in passing DIDMCA was to make negotiable order of withdrawal (NOW) accounts of individuals (roughly, interest-bearing demand or checking accounts) permissible for depository institutions all across the United States. So in part it repealed the prohibitions against paying explicit interest to owners of demand deposit account balances that had been written into the Banking Act of 1933, although in such a way that made a new phrase, "transactions account," necessary. (If explicit interest was to be paid on a checking account, that checking account could not be a demand deposit account.)

For S&Ls located beyond the borders of New England, permission to have individuals' NOW accounts was of great importance (and under the Garn–St Germain Act all S&Ls would be given permission to have some business NOW accounts). All banks got was permission to pay interest up to some nonzero maximum on demand deposit or checking account balances of individuals; and they had long had authorization to offer checking accounts. That permission was worth something, for in 1980 banks were doing battle with money market mutual funds that, being subject to no interest rate restrictions, were paying rather impressive rates on their checking accounts. The point is, though, that NOW (the new checking) accounts, as authorized in DIDMCA, were subject to interest rate restrictions. So more important than the authorization of NOW accounts was the creation of the Depository Institutions Deregulation Committee (DIDC). For the Ninety-sixth Congress charged that committee with eliminating all restrictions on rates paid depositors (other, that is, than owners of demand deposit balances) by end of March 1986.

The membership of DIDC was spelled out in DIDMCA: the secretary of the Treasury, the chairman of the FRB, the chairmen of the FDIC and the Federal Home Loan Bank Board (FHLBB), the chairman of the National Credit Union Administration Board, and, as a nonvoting member, the comptroller of the currency. That the chairman of the FHLBB was a member of the committee may explain why it hit the ground limping. In fact, it did not get to running until well into 1982, after the Garn–St Germain Act had been passed. In that act, the Ninety-seventh Congress instructed DIDC to fashion and authorize a deposit account for depository institutions that would be fully competitive with the checking accounts being offered by the money market mutual funds. The committee responded by authorizing the money market deposit account and, almost immediately thereafter, the super NOW account. What is much more important, it established a schedule for eliminating interest rate restrictions that would result, by the end of October 1983, in depository institutions being almost entirely free to decide what rates to offer depositors.

Nor was there any backsliding, whatever the pressures may have been. At the end of October 1983 depository institutions did become free to decide their own offering rates, and Senator Garn and Representative St Germain are deserving of much credit or, as I believe, blame. I may be paying too little heed to the force of circumstances. My sense is, though, that if Senator Garn and Representative St Germain had not been so insistent, the Ninety-seventh or the Ninety-eighth Congress might well have altered the charge to DIDC contained in DIDMCA. There was also the possibility of the Ninety-ninth Congress altering the charge; it would have had more than a year in which to manage. Sufficient resolve aside, there has never been any bar to imposing interest rate restrictions on money market mutual funds.

Much of the Garn–St Germain Act was shaped by an understandable desire to make S&Ls and savings banks viable. To that end, those depository institutions were given scope to become ever so much more like banks than they could have been before the act was passed. There is no need here to go into what, specifically, S&Ls and savings banks were authorized to do, although it is worth noting that, having opened the way for S&Ls and savings banks to become banks, the Ninety-seventh Congress took the precaution of explicitly exempting those thrift institutions from FRB regulation.[15] Whatever they might get involved in doing, federally insured S&Ls and savings banks were not to be considered banks or made subject to the Bank Holding Company Act. But some provisions of the Garn–St Germain Act pertained to banks, and they do have to be mentioned.

As is generally believed, the Ninety-seventh Congress restricted the insurance activities of bank holding companies; or, as might be said, it restricted the authority of the FRB to decide the permissible and impermissible activities of those companies. Roughly, what the Ninety-seventh Congress did in its Garn–St Germain Act was to confine bank holding companies to underwriting (and of course marketing) insurance that would protect the loans of their bank and consumer finance subsidiaries. On the other hand, in its 1982 act the Ninety-seventh Congress also made service corporations more attractive vehicles for banks.

C. *Present-Day Policy*

In the next part of this paper, I appraise present-day federal bank regulatory policy. Anticipating, I now briefly describe that policy and thus, in a way, summarize what I have had to say about the development of federal policy over the years since 1863. Although I am not concerned in Section II with policies of the past, it may nevertheless be of some interest how the policy of the present contrasts with the policy of the end of 1935. (Recall the often-repeated claim, mentioned above, that the policy of the present was fashioned mostly in the years 1933–35, when thinking was dominated by wildly extreme economic circumstances.) In what follows, I stress that contrast.

Just as they were at the end of 1935, national banks are currently obliged to have FDIC insurance.[16] For state-chartered banks there is still free choice. But there has been no souring on FDIC insurance. The proportion of state-chartered banks with such insurance has, if anything, increased since the mid-1930s. The essential point, though, is that, just as nearly all the state-chartered banks of the mid-1930s, having opted for FDIC insurance, were subject to regulation by the FDIC, so too are nearly all those of the present.

15. Again, see Holland (1982) or Garcia et al. (1983).

16. And since 1978, when the International Banking Act was signed into law, deposit-taking subsidiaries of foreign banks have also been obliged to have FDIC insurance.

The FDIC was but a fledgling at the end of 1935, and how it would deal with failing and failed banks, the deposit balances of which it was insuring, had not yet been firmly established. Now the agency is well into (some would say way beyond) middle age; yet, mostly because it has of late been so awkwardly placed, its policy for dealing with insured banks in deep trouble, and those that have been declared insolvent, cannot be described with confidence. Over the decade or so ending with the failure of Penn Square Bank, the FDIC had a policy of, whenever possible, finding an acquiring bank and doing a purchase and assumption transaction. In effect, then, the agency was, whenever possible, insuring depositors in full. And my guess is that it has gone back to that policy. One day soon, the FDIC's policy may, however, again be different. Lately, the agency has been making noises about adopting a policy like that of the period from the failure of Penn Square to the failure of Continental, under which losses were imposed on some depositors with deposit balances in excess of $100,000.

Just as they were at the end of 1935, FDIC-insured banks are limited in their asset choices. They are subject to statutory restrictions, many of which applied at the end of 1935, and to agency restrictions, many of which also applied back then. Of the agency restrictions that still apply, essentially unchanged from what they were at the end of 1935, there is one, so far not noted, of which I will be making much in Section II; applicable to all insured banks and necessarily vague, it is that loans and investments must be of good or sufficient quality.

But insured banks are not now limited in their asset choices exactly as they were at the end of 1935. For example, at the end of 1935 only member banks had to satisfy the FRB's reserves requirement, and at present all insured banks must. At the end of 1935 there was a reserves requirement for personal time deposit balances, and at present there is not. Finally, at the end of 1935 agency capital-asset ratios were much less clearly specified than they are now.

Just as they were at the end of 1935, insured banks are prohibited by statute from paying explicit interest on demand deposit account balances. Now, however, the prohibition is largely without effect, for insured banks can offer interest-bearing money market deposit, NOW, and super NOW accounts. More generally, insured banks are essentially unrestricted in their choices of what rates to offer their depositors, and at the end of 1935 they were subject to FRB and FDIC-imposed restrictions.

Turning now to the present-day federal restrictions on the geographic reach and other activities of banks and bank holding companies, I feel myself getting ill. It is easy to describe how national banks were limited in geographic reach at the end of 1935. By and large, they were effectively constrained by the McFadden Act. That act has not been repealed, and yet, thanks mostly to the FRB, geographic and, in particular, state boundaries are much less significant than they were, particularly for (national) banks disguised as bank holding companies.[17]

But in their acquisitions and mergers insured banks are much more tightly regulated than they were. At the end of 1935 it was relatively easy for a bank needing federal bank regulatory agency approval for, say, an acquisition to get it. After the acquisition, would the acquiring bank have adequate capital? Or for a merger, would the resulting bank have adequate capital? (Nor did it hurt that "adequate capital" had no settled meaning.) Now, however, agency approval cannot be taken for granted. That is in part because, unlike at the end of 1935, attention is paid to how competition (market structure and, hence, performance) will be affected.

In 1963 it was determined that all banks, national included, are subject to our antitrust statutes and, more particularly, to section 7 of the Clayton Act; and, consistent with the Bank Merger Act of 1966, the Department of Justice serves as a watchdog, more or less vigilant, depending on the mood of the moment. All bank holding companies operating in the United States are also subject to our antitrust statutes. That notwithstanding, they are also regulated in their acquisitions and mergers by the FRB.

Describing how banks were limited in their other activities at the end of 1935 is easy too. For one thing, what the Glass-Steagall Act said seemed clear then. In their other activities, insured banks are subject to a regulatory procedure little, if any, different from that of the end of 1935, and yet, thanks to the federal bank regulatory agencies, they are much more broadly engaged than they were; nor, apparently, is the Glass-Steagall Act as restrictive as it was once held to be.[18] All statutes have to be interpreted; but before long that act may well have been interpreted out of existence.[19]

At the end of 1935 bank holding companies operating in the United States were all essentially unregulated, even in their choices of activities. And at present there are corporations that, although controlling

17. Recall that in 1971 the FRB announced an extremely important policy principle: in their other activities bank holding companies would not be limited by state boundaries.

18. As was observed above, the present-day financial scene is black with corporations that do general underwriting and offer transactions of checking accounts (see, e.g., Gross 1985, p. 1).

19. On November 19 the FDIC put out a long-awaited rule, a clarification, it said, of its interpretation of the Glass-Steagall Act. Under the rule, it is legal for a state-chartered nonmember bank to underwrite investment quality corporate bonds and equities through a sufficiently well-capitalized subsidiary (see Trigaux 1984, p. 7); and on December 27, 1984, Citicorp announced that it had filed an application with the FRB for permission to do general underwriting through a subsidiary (see Berg 1984, p. 23). A decade ago it would not have troubled (see Fraust 1985, p. 1). Note too that although the FRB has found Bankers Trust Co. to be in violation of the Glass-Steagall Act, it so far has not ordered the bank to close down its commercial paper operation (see Langley 1984, p. 7).

what might easily be regarded as banks (and, indeed, before 1970 would have been), are not subject to federal regulation as bank holding companies. But those corporations controlling associations defined in law as banks are subject to federal regulation as bank holding companies. Most important, they are constrained in their choices of activities by the FRB.[20]

I end my description of the federal bank regulatory policy of the present, and how it contrasts with the policy at the end of 1935, with the observation that national and other banks (actual and, as bank holding companies, in disguise) would seem to be less tightly restricted in geographic reach and their choices of other activities than they were 50 or so years ago. With no obvious metric available, one cannot be certain; but that is my sense. To be sure, in saying that I may be attributing too little significance to the failure of Continental.

II. A Critique

I have been many pages in telling of the development of federal bank regulatory policy. Now, however, I can turn critic, and in analyzing present-day policy, I take "a safe and sound banking industry" as being the objective of bank regulation. In the grand tradition, the objective is having risk-free or safe bank balances. With deposit insurance a possibility, it might seem that a safe and sound banking industry is not necessary. There is a problem, though, when bank balances are insured and banks are bankruptcy prone. And, as I argue below, risk-based insurance premiums are for a far distant future.

It has long been argued that because even the relatively poor and financially unsophisticated must have demand deposit or transactions account balances, all such balances should be free of default risk. (Presumably, there is no practical way of making only the balances of the relatively poor and financially unsophisticated safe.) For economists, however, "must have" is a tricky phrase, or a meaningless one. There is also a less subtle rebuttal to the social justice argument. At one time, there may have been many who, except for their demand deposit account balances, had no financial assets; but at present there must be relatively few.

The other traditional argument for regulating banks is that they are, in a way, special. Allegedly, when a company not engaged in banking fails, there are no third-party effects; but there are such effects when a bank fails. And banks will fail if unregulated. History shows that. So

20. Again, under the Bank Holding Company Act of 1956, only foreign banks (corporations) with U.S. bank subsidiaries were regarded as bank holding companies; and now, as provided in the International Banking Act of 1978, foreign banks with U.S. agencies and branches are also subject in their choices of activities to regulation by the FRB.

the government, protector of third-party interests, must regulate banks.

That second argument obviously needs filling out. As phrased, it invites questions (for some of which, by the way, there may be no convincing answers). Why are there third-party effects when a bank fails? Because bank liabilities are "money"? Arguably, a decrease in wealth is a decrease in wealth, no matter how (in the accounting sense) caused. So is it that the failure of a bank can be likened to a loss of specie, a means of payment? If not, then, independent of what sort of company fails, a failure is a failure.

Does history show what has so often been claimed? That if unregulated, banks will fail? In what past, recent enough to be relevant, were banks not regulated by government?

My purpose here is not, however, to challenge the traditional arguments for safe demand deposit or, in the language of the present, transactions account balances. I want only to indicate why, even among economists, a safe and sound banking industry has had, and continues to have, appeal. Fearful of being misunderstood, but so that I can get on, I simply accept that having safe transactions account balances is socially desirable and that regulation of banks is too or, until the bright new day of risk-based insurance premiums has dawned, will be.

That marvelous phrase "safe and sound," so often used, is more than a little vague, which may explain our addiction. The objective of bank regulation could be to have no bank failures. Indeed, having none may from time to time have been the federal government's objective. It may currently be the objective. There have been bank failures in the United States, but to start off by assuming a perfectly effective federal bank regulatory policy would be bizarre. But an occasional small bank failure may be judged inconsequential. The objective of bank regulatory policy could be to have no epidemic of failures and, for the largest of banks, no failures at all.

Fortunately, there is no need to rid "a safe and sound banking industry" of all vagueness. If nothing more than an interest in limiting bank failures is attributed to the federal government, rather much can be said about its bank regulatory policy.

A. Policy Effectiveness

I begin here with an observation about the effectiveness of federal bank regulatory policy, one that may well reveal me as being shockingly naive or, less kindly, simpleminded. The observation is not original with me, though; it has been made many times, if more often than not implicitly, and mostly by those who have advocated reserves ratios of unity for banks. As for the observation, it is in two parts: there is no period of the past during which federal bank regulatory policy was completely effective; nor should the policy of the present be counted on to keep bank failures down to the appropriate number.

The financial history of the United States from 1863 does not contradict the first part of my observation. If there are years unmarked by bank failures, they are, by a wide margin, the exceptional years. Before 1935, Congress after Congress had to deal with financial crisis. Most revealing, however, is that federal deposit insurance was introduced in 1935; that is, the safety of bank deposits was made independent of how safe and sound the banking industry might be. Had more members of the Seventy-third Congress been supremely confident of the ability of the federal government to keep banks from failing, bank balances would have remained uninsured. Recall what considerable effort was expended. There were influential opponents of federal deposit insurance in the banking industry, on Capitol Hill, and in the Roosevelt administration. But the cascade of banking failures of 1930–33 was not well calculated to inspire supreme confidence.

There is no time in the past when banks were prohibited from making and holding (commercial) loans, nor are they prohibited now. In the most relevant respect, then, present-day federal bank regulatory policy is identical to policies of the past. So the financial history of the United States from 1863 on does not contradict the second part of my observation, that present-day policy cannot be counted on to make us quite forget about banks failing.

Bank supervision. There is more to bank regulation than restrictions that limit banks in their choices. Compliance cannot simply be hoped for or, despite the much appreciated probity of bankers, expected. A bank regulatory agency must always be checking and doing what it can to stop such violations of statutes and regulations as it uncovers.

So far, I have made no mention of the compliance procedure followed in the United States. Now, though, having gotten into the effectiveness of federal bank regulatory policy, I am obliged to indicate how the federal bank regulatory agencies go about trying to enforce compliance with one particular restriction, referred to above, to which banks are subject: that their loan and investment portfolios should not be such as to put them in jeopardy. And I must take notice of two federal banking statutes, the Financial Institutions Supervisory Act of 1966 and FIRIRCA.

An obvious essential of any effort to ensure compliance is information about what has been going on. A federal bank regulatory agency gets what it feels it has to know about the banks it is responsible for supervising from reports required of those banks and from on-site examinations. (In the information they gather and how, the three federal agencies are now very much alike, much more so than they were even a decade ago.) Over the years, reports have become relatively more important. We may one day wake up to discover that bank examiners have gone the way of the plow horse. At this moment, however, there are some examiners examining banks and, what is of special relevance here, valuing banks' loans portfolios. How those portfolios are valued need not be gone into; it suffices to say that many bankers think of examiners as practicing a most black art. It is only important what, in part, examiners do. By rating loans, they in effect get estimates of the market values of banks' portfolios and, hence, estimates of shareholders' interests in banks, which are to be contrasted with book values.

When an examiner has found a bank with "too many" bad and suspect loans, a bank in jeopardy or trouble, his (or her) agency decides what that bank must do and, one way or another, tells it. Very often such a bank will be told to increase its shareholders' interest or, say, its capital-asset ratio and, as must be hoped, to adopt a new and less risky loan policy. (If it does not always seem so, all the agencies must be aware that only requiring more "capital" does no real good; independent of the initial shareholders' interest, if a bank in trouble does not change its loan policy, then, unless it was entirely the victim of a bad draw, it must in time be in trouble again.)[21] In the International Lending Supervision Act, a part of the International Monetary Fund (IMF) Quota Act of 1982, the federal bank regulatory agencies were directed, if not in so many words, to get banks to increase capital ratios. And it must therefore be assumed that a capital ratio specified by one of the agencies is now more nearly legally binding than it was; banks cannot be as casual about satisfying the agencies as some were. Even so, an agency that has told a bank in jeopardy or trouble to get more capital must follow up. Indeed, whatever it has told the bank, it must; the agency has to be sure that its prescribed medicine, doubtless bitter, is actually being swallowed.

Until 1966, the federal bank regulatory agencies were not especially well equipped to force their prescriptions on banks in trouble or, more generally, to force compliance with federal statutes and regulations. As has often been observed, a government possessed only of nuclear weapons must, by its own perception, find itself powerless to deal with any of a host of transgressions. Just so. The agencies of the period to

21. The following passage from McComas (1985, p. 79) must, however, give us pause: "When bankers and regulators are in an upbeat mood, they like to speak of expanded capital as a base that would allow banks to diversify into new fields. But the regulators are chiefly interested in the downbeat case—protecting the banking system against loan losses. Comptroller of the Currency C. Todd Conover is eloquently textbookish in his observation that while banks may first write off bad loans against reserves set aside expressly for that purpose, ultimately they can 'charge off loans against shareholders' equity.' Adds the Comptroller: 'Banks become insolvent when they incur losses that exceed their capital. So, the more capital you have, the better your ability to withstand potential losses in your loan portfolio.' " Independent of the choice of assets, capital is protection!

1966 must often have felt themselves powerless. Possessed only of the ultimate power, the power to revoke charters, they must often have been, by their own perceptions, powerless.

When the OCC was created, it was given authority not only to grant charters but also, with due regard for rights of private property, to revoke charters. When the FDIC was created, it was given authority to declare sufficiently wayward banks ineligible for insurance or, in effect, to revoke charters. When the Federal Reserve System was created, the FRB was given authority to declare sufficiently wayward banks ineligible for system membership; and early on it was established that loss of system membership would result in loss of FDIC insurance. Again, though, being able only to revoke charters is like having only nuclear arms.

But the agencies of the period since 1966 can be likened to a government possessed of conventional as well as nuclear arms. In its Financial Institutions Supervisory Act of 1966, the Eighty-ninth Congress granted the OCC, the FRB, and the FDIC authority to confront noncomplying banks in their respective jurisdictions with cease-and-desist orders and to remove bank officers and directors from office. In FIRIRCA, the Ninety-fifth Congress made individuals, bank officers and directors, and others involved in banks' affairs legitimate targets for cease-and-desist orders; and it authorized civil money penalties for wayward banks and individuals. Also, recognizing a changed reality, the Ninety-fifth Congress provided that, in seeking compliance from bank holding companies and nonbank affiliates thereof, the FRB could proceed as any agency could against a wayward bank.

There can be no real doubt; the federal banking agencies are all better able now to get compliance than they were before 1966 and, indeed, before 1978. With probability very near to unity, any one of them can force its prescription on, for example, a bank with what has been determined to be too many bad and suspect loans. The threat of a cease-and-desist order being issued can suffice. Note, though, what I claim: no agency is wanting power to force its demands (or, more appropriate for the gentle world of banking, wishes) on a bank in danger of failing; any one of the agencies may be able to put things right. But there is such a difference between "may" and "can." History is clear; there have been instances when things could not be put right.

There can be an unwillingness to see what, if others (outsiders) could look, would be apparent to them; or, as I prefer to say, there can be a failure of will. Admittedly, it is often extremely difficult to distinguish a failure of will from what in retrospect appears to have been an error in judgment. What is evident after a bank has failed may not have been so a year or two before. In the instance of the United States National Bank of San Diego, though, a failure of will, an unwillingness to see or to blow the whistle, would seem to be the better explanation for why, in the end, the bank collapsed under the weight of bad (mostly insider) loans. It is not credible that, whether a year or two before the collapse, the actual outcome was unpredictable.

As a flaw in the federal compliance procedure, failure of will may be endemic. Saying that is not to suggest that, beyond the exceptional few, bank examiners are lacking in (or that examiners of the past lacked) integrity. It is widely accepted that a $30,000-a-year examiner is no match for a $300,000-a-year chief executive officer, especially one who has the firm backing of his board of directors. Being overmatched is different from lacking integrity, though, and saying that examiners' seniors are often slow to weigh in is not to suggest that, beyond the exceptional few, they lack (or that any have ever lacked) integrity. Nor have the federal bank regulatory agencies been co-opted in the way, for instance, that the Tennessee Valley Authority was. But there is an inevitable closeness between the agencies and banks, a closeness that nurtures tolerance or a sympathetic appreciation of bankers' problems—too sympathetic an appreciation.

At the present time, our federal agencies are being tough. For sure the OCC is, having been stung by congressional criticism of how it dealt with Continental. But how will the OCC (and the other agencies) behave when, if ever it does, the memory of the Continental affair has dimmed? As the OCC did before there was a Continental to remember?

What strikes me, though, as a more important flaw in the federal compliance procedure than the failure of will is an inability to quarrel with success. Imagine that there are two loan policies (strategies), A and B, and further that policy B is confidently held to be riskier than policy A. An examiner observes a bank following policy B, a bank that, however, has for some time enjoyed an exceptional rate of return. If there can be *n* heads in *n* tosses of a fair coin, then an exceptional rate of return, persisting for several years, is not an impossibility. In the face of the record, will the examiner doubt his judgment about the riskiness of policy B? Doubt, prompted by a bank's success, is perhaps only a failure of will. But we can imagine the agency responsible for supervising the bank following policy B having decided to be tough. A while back, doing that would have taken some effort; now, with Penn Square, First National Bank of Seattle, and Continental having failed, hardly any is required. So the responsible agency issues a cease-and-desist order. What can hardly be imagined is a court being persuaded that an exceptional rate of return, sustained over some time, can be attributed to bad management—or that strategy B must produce a disaster, having so far produced only an exceptional rate of return.

I can make my point more concretely. If the OCC (or the FDIC) had gone to court in, say, early 1981 or before in an attempt to get Penn Square to change its loan policy, the agency would not have been successful. Nor would it have been if, in 1981 or 1982, it had gone to court in an attempt to get Continental to change its loan policy. Even as recently as then, that bank was still being held up as an industry model.

Those are my guesses; and guesses they surely are. I also have to concede that, if, ex ante, any loan policy is as likely to produce failure as any other, then I have no real concern. What will not be surprising, I do believe, though, that by appeal to experience it is possible to rank at least some loan policies.

B. A Lost Opportunity?

As it seems to me, then, the federal government is not likely to be sufficiently effective as a regulator of banks until banks have been barred from lending or, because bad investments can also produce bank failures, from holding risky assets. (Above, I stressed the difficulties in trying to prevent bad loans from resulting in failures; but I might have considered bad investments instead of bad loans.) If loans are made, then, lending being risky, there will be some bad loans, and the federal bank regulatory agencies cannot be counted on to make sure that no unacceptable failures result. Something less than complete effectiveness may not be a logical necessity. Nor am I confident of having got straight why the federal agencies have not done better; being unable to quarrel with success is but one of several possible explanations. But our history is compelling. It reveals less than complete effectiveness, and, until policy has been changed, there will be no reason to expect the future to be other than a replay.

It would be most remarkable if effectiveness in keeping bad loans from producing bank failures did not depend on the choice of compliance technology or, with a given technology, on the amount of resources used in the effort. So there are obvious questions. How well do the technologies actually being used by the federal bank regulatory agencies approximate the best of those that currently exist? What amount of resources ought to be devoted to attempting to contain threats posed by bad loans? I am not the one to provide answers, however, and instead of trying I turn to another question, one that may by comparison seem frivolous. Does regulation of banks, not only by the federal government but by state governments as well, explain what may be thought of as a failure of competition?

If we accept that often-told tale of how banking English style arose out of goldsmithing, then the very first banks were engaged in lending; that is to say, goldsmithing became banking when goldsmiths started lending specie entrusted to them for safekeeping. And from the transformation, which occurred more than three centuries ago, until recently, virtually all the companies of the English-speaking world engaged in supplying third-party payments services were also engaged in lending. At any rate, that is my impression. In the second half of the 1970s, a group of companies, all with transactions account balances among their liabilities, came to prominence in the United States. The money market mutual funds enjoyed a moment in the sun. But before 1977, or thereabouts, the companies in the United States with transactions account balances were all lending too; and since then nearly all have been. That is what surprises me and is the evidence of what I have referred to as a failure of competition.

It seems that until 1934, and perhaps for a long while thereafter (well into the post–World War II period), banks differed in how risky they were. Differences, I suspect, were most pronounced among the smaller (owner-operated) banks, and no doubt banks still do differ, although because federal deposit insurance has been available to all banks since 1934, and because premiums have been identical for all insured banks, it is very likely that they differ much less than they did in, for instance, the 1920s. Perhaps that is all we should ever have expected to observe, banks differing in risk. Another impression of mine, though, is that at no time before 1934 was there an appreciable supply of safe transactions or, as at the time, demand deposit account balances. (Note how heavily I lean on my assumption of there being no such thing as a safe loan.) Yet, I would have expected a supply to appear and, indeed, if only through 1933, to increase with the passing years.

To me, it seems reasonable that from the beginning there has been a demand for safe transactions account balances. There is an argument that owning such a balance amounts to being insured against uncertainty in desired consumption.[22] Wanting safe insurance, a balance in a safe bank, is easily imagined; and since 1827, if not before, governments have been trying to make transactions account and other bank balances safe. If all along governments have been responsive, that reveals something.

To be more definite, what I would have expected to observe is some banks, perhaps a great many, lured by prospects of profit, coming to supply safe transactions account and perhaps time and savings account balances. There may have been a time before which safe balances could not be supplied. But that time cannot be of the immediate past. There is also the possibility of rivals of banks appearing, companies supplying transactions account balances or payments services but not loans. Except maybe for an odd few, though, banks do not seem ever to have been suppliers of safe balances; and, again, until the second half of the 1970s, no important rivals, suppliers of safe balances, appeared.

Even assuming a considerable demand for safe bank balances, there is no problem with banks supplying transactions account balances and lending in the post-1934 period. Once again, federal deposit insurance, with identical premiums for all banks with insured deposits, became

22. See, e.g., Diamond and Dybvig 1983.

the reality in 1934. It is most interesting, though, that in the second half of the 1970s, during their moment in the sun, the money market mutual funds were supplying uninsured yet safe or near-safe transactions account balances. For the most part, those funds held only extremely shortdated Treasury securities. That is suggestive of a considerable demand by individuals for safe balances. It cannot plausibly be argued that, with bank balances federally insured, the money market mutual funds were in some sense forced to hold the portfolios they did. They were free to pay whatever interest rates they wanted.

Government regulation can be worked harder as an explanation. I see the continuing attempt by government to make bank balances safe as explaining, although perhaps only in part, why a supply of safe balances did not emerge and increase, a supply offered by banks or rival companies or both. Not that I have anything deep in mind. It is just that with enough faith in the effectiveness of government regulation of banks, individuals can believe that their demands for safety are being satisfied, and if there is enough faith, then there is less incentive than there otherwise would be for rival companies to become suppliers of safe balances.

The financial history of the United States being so crowded with bank failures and financial crises, any faith in government as a regulator of banks may appear silly. A few widely scattered failures need not be thought of, though, as much affecting individuals at some remove. Then, too, although the United States experienced several financial crises in the years to 1935, there is no need to think of individuals as having been "born again" and again and again. It may on occasion be convenient to assume that individuals have infinitely long lives. But that assumption cannot be used in confronting an actual history. In fact, individuals have finite lives. The years 1800–1935 were occupied by a succession of generations, and we know that, even though technical knowledge is readily transmitted from one generation to the next, there is a wisdom that every generation must acquire for itself.

I note finally that our governments, those of the states and of the federal government, might even be credited with some imagination. Thus the federal government did not respond as if by rote to the crises of the years 1863–1933. To illustrate, it responded very differently to the crisis of 1930–33 than it had to the crisis of 1907. In a way, it had to. Why have two lenders of last resort? But a different response makes a faith in government, dashed in a previous generation, easier to accept.

I have been implicitly assuming a particular argument for government regulation of banks: as a matter of social justice, the transactions account balances of banks should be safe; or, as I translate, individuals want safe balances and so should have them. As will be recalled, though, there is another argument: that the failure of a bank, unlike the failure of any company not engaged in banking, has third-party effects. I have always had difficulty with that argument; I have never been able to understand as well as I would have liked why there are third-party effects. But if there are such effects when a bank fails, then my argument, even if more convincing than I would have guessed, may not establish the laissez-faire posture as being better than regulation by government. There is the possibility of not all individuals holding safe transactions account or bank balances.

The third-party effects of a bank failure may be real or imagined. Whichever, there is reason enough for me to go on to how banks ought to be regulated. It could be quite wrong that, with no attempt by governments to make bank balances safe, banks or rival companies or both would have supplied those balances.

III. Alternative Policies

In Section II, I argued that present-day federal bank regulatory policy cannot be counted on to keep banks sufficiently safe and sound. So long as banks lend, there will be bad loans and, in consequence, more bank failures than are wanted. Furthermore, although quite without any hard evidence, I suspect that the present-day policy cannot be made into a completely effective policy just by increasing the resources used in trying to insure compliance. There may be no increase sufficient to produce a completely effective policy. And if there is, then, at a guess, the required increase is greater than any Congress would seriously contemplate.

For those who accept my argument and my suspicion, there are implications: among them, that present-day FDIC policy cannot be shrugged off as inconsequential. We would be able to if present-day federal bank regulatory policy kept banks perfectly safe and sound. Then, of course, there would be no need for federal deposit insurance. But we might think of collecting what are called insurance premiums as a way of defraying the cost of trying to ensure compliance. Having the total insurance premium of a bank depend on its total domestic balances would seem reasonable. Again, though, present-day policy does not keep all banks perfectly safe and sound. So taxpayers are at risk, and, depending on how the Ninety-ninth and subsequent Congresses deal with federal restrictions on banks' choices, they could be at greater risk in future.

Eliminating maximum deposit interest rates prior to changing deposit insurance policy was, I believe, a mistake. The banking industry must, as a result, become riskier. With identical insurance premiums for all insured banks and no restrictions on rates paid depositors, those banks most inclined to risk lead the way. If there are some less inclined, they must follow along or see their balances bid away.[23]

23. Smith (1984) argues that, even with safe banks, binding restrictions on rates paid to depositors may be necessary to prevent a bank run.

For nearly a year now, the FDIC has been upset about deposit brokers providing balances (at relatively handsome rates) not only to banks in trouble but also to banks with decidedly risky loan policies. The agency has the problem of getting backing on Capitol Hill for, in effect, doing away with deposit brokers, that being what it believes it can manage. Almost certainly, though, it knows that making scapegoats of the brokers is wrong. The brokers are only facilitating what was bound to happen when, with no change in FDIC policy, maximum deposit rates were eliminated. The FDIC should be complaining about past Congresses. But, then, having supported elimination of those rates, it cannot.

At this writing, there is considerable sentiment for allowing banks and bank holding companies to engage in heretofore prohibited activities. Some state legislatures have already revised their banking statutes and thereby given their state-chartered banks greater freedom in their choices of activities. A few have authorized their banks to get into, of all things, real estate development, and as principals, not lenders. Now, however, our federal bank regulatory agencies, having become alarmed, are moving to regain control.[24] We may take it as read: the Ninety-ninth Congress may intervene; but if it does not, then no state legislature is going to be permitted to subvert federal restrictions on bank and bank holding company choices.

Even within the federal bank regulatory agencies, though, and certainly on Capitol Hill, there is much support for doing away with the Glass-Steagall restriction and some for making insurance underwriting a permissible activity for banks and bank holding companies. Yet, at least for some kinds of insurance, underwriting would seem to be relatively risky. Underwriting corporate bonds and equities would too. If banks or new bank affiliates of holding companies are allowed to bring out issues of, say, corporate equities, then, presumably, they will also be allowed to make markets in those equities and, more particularly, be involved as principles in block trades. But, as indexed by risk, doing block trades is very different from being engaged in a retail brokerage business.

The prospect of banks and bank holding companies venturing farther and farther afield may not be cause for concern. Currently, the disposition is to make banks that want to engage in certain relatively risky activities (those to be made permissible) do so through subsidiaries.[25]

24. See Noble 1984, p. 33; and Trigaux 1985, p. 1. The California Assembly is among those state legislatures that have authorized their banks to get in real estate (see Hooper 1984, p. 38). California-chartered S&Ls have been similarly authorized. But the FHLBB, less timid than the FDIC, perhaps because it is more worried about its insurance fund, has made clear that, to be eligible for Federal Savings and Loan Insurance Corporation insurance, state-chartered S&Ls will have to abide by its restrictions (see Wynter 1985*a*, p. 5). On the attitude of the FHLBB, see McCue (1984, p. 2).

25. See, e.g., Noble 1984, p. 33.

So the question is whether the fates of banks can be made independent of how their subsidiaries fare. I am doubtful that they can be. But I should perhaps be optimistic that the fates of bank subsidiaries of holding companies can be made independent of how nonbank subsidiaries do. We might think of a relatively risky activity being impermissible for banks but permissible for bank holding companies willing to establish subsidiaries and engage in the activity through them. Among the cognoscenti, there are some who believe that sealing banks off, making their fates independent of how nonbank affiliates do, is practical. One point made is that insurance business regulators have managed to keep life insurance affiliates sealed off.[26]

I have, however, wandered. It is not necessary to argue that in the near future banks or bank holding companies or both will (with probability worrisomely close to unity) be authorized to engage in new, relatively risky activities. If no newly authorized activities were a certainty, or if we could be sure that, whatever new activities are authorized, banks will not become potentially riskier, there would still be need to find a substitute for the bank regulatory policy of the present.

A. *One Hundred Percent Reserves*

Of the various alternatives to present-day federal bank regulatory policy, only one, hoary and of most distinguished parentage, can fittingly be considered first. It has most often been offered as a policy for protecting the money supply and is made up of a single restriction, which can be put as follows: transactions account balances must all be backed 100% by (marketable) Treasury debt. In its simplicity, that policy contrasts very favorably with the federal policy of the present and, in fact, save for the laissez-faire policy, necessarily the simplest, with all the other alternatives. Enforcing compliance would cost little even if, as seems reasonable, banks were required to value their holdings of Treasury debt at market prices. If adopted, though, would the policy be effective? As I believe, there are grounds for doubt.

I go back to when, before the turn of the decade, banks were contending with money market mutual funds and getting little help from the federal bank regulatory agencies or from Capitol Hill. At the time, they were bound by restrictions on rates paid depositors, but many banks increased the effective rates they were paying on demand deposit account balances by making the switching of funds between demand and time accounts easier or, by the standard of the past, relatively inexpensive. (Even in the late 1970s, "demand deposit" was still the appropriate label.) As will be remembered, some banks began "sweeping" demand deposit accounts daily. What the innovations of the period of struggle suggest is that quite a few banks had already

26. See Clark 1979; and also Chase and Waage 1983.

mastered computer-based bookkeeping to the extent that they were able to accommodate switches of funds at unit costs much below what they had been several years before. And of those banks not technologically up to scratch or not possessed of needed equipment, quite a few had discovered that they could purchase such bookkeeping. Now, though, banks generally are more the masters of modern bookkeeping than were the technologically advanced of six or so years ago. Unit switching costs are lower than they were. My judgment is that virtually any bank that wanted to could maintain zero balances in all its transactions accounts and without much affecting check writing.

By itself, then, the restriction requiring 100% backing in Treasury debt would be ineffective. If imposed, it would not guarantee all transactions account balances being safe. A bank disposed to offering risky balances could; it would only have to make the balances in its possession invisible.

A second restriction is needed. Any company with transactions balances can have only such balances. With that restriction, transactions balances could not be made invisible, and, with the restriction requiring 100% backing in Treasury debt, all transactions balances would of necessity be safe.[27]

If the two restrictions were imposed, providing payment services would be separated from lending; alternatively, loans could not be offset by (funded with) transactions account balances. Every present-day bank would become, whether in fact or only in effect, two companies. Thus, a company, once a bank, might have one subsidiary providing payment services and holding only Treasury debt and another engaged in lending and having liabilities (other than transactions account balances) of its choice. Or we might imagine there being two industries, one made up of payments services companies and the other, part of a broader or more inclusive industry, made up of lending companies. There can, however, be no wonder why, with the two restrictions applying, all transactions account balances would be safe.

Note, though, that the two restrictions would not protect against disruptions in loan markets. With the two restrictions applying, companies engaged in lending could still fail. That will not trouble those who worry only about protecting the money supply. Yet there are some who, rightly or wrongly, worry about maintaining continuously well functioning loan markets. For them the two restrictions together will not appear as a completely effective regulatory policy.

27. If Treasury securities are valued more or less continuously at market prices, then, as it appears to me, there is no term structure risk. Unless a bank is perfectly hedged, the owners may at any time find themselves having to provide more capital, and they cannot be permitted to refuse. Some might prefer that the owners of banks not be allowed to speculate.

B. Marking to Market

There is nothing strange in a bank promising to pay what it may not be able to pay. Save only for the Treasury, all issuers of fixed-coupon obligations do that; and lenders are willing to accept the gambles implicit in such obligations, perhaps because determining actual outcomes in any state of the world is too expensive, even though in the event of bankruptcy some of the saving in monitoring cost must be lost in court proceedings. It is worth pausing here, though, if only briefly, to consider the possibility of not allowing banks to have the fixed-coupon obligations, the transactions (or demand deposit) account balances that for so long have been their staple. The more specific question is whether they ought to be made to mark their assets to market more or less continuously and revalue their transactions account balances accordingly.

If the owner of a transactions account balance can never get more than a proportionate share of his bank's assets, then he (or she) has no incentive to ever be, as it were, first in line. Whether the owner of such a balance converts to currency is thus independent of what he expects other owners will do. So the probability of a bank run is zero. That is what commends making banks mark their assets and transactions account balances to market.

The appeal is to how mutual funds operate. But the typical mutual fund does not (in the generally accepted sense) have capital, and making banks operate as mutual funds do would be to eliminate a long-standing subordination rule. Thus if banks were forced to mark their assets to market and adjust the values of their transactions account balances, they would have to have separate businesses (or, more likely, be split into separate companies). Every bank would have to be, in part, an identifiable mutual fund with transactions account balances as liabilities. And with what assets? I will presently come back to that question.

With banks revaluing their transactions account balances more or less continuously, the narrowly defined money supply would not be protected as it is with federal deposit insurance. But, then, neither would taxpayers ever be at risk. Juxtaposing those two observations is my way of indicating that there would seem to be nothing in a forced continuing revaluation of transactions account balances to offend those who believe protecting the money supply to be fundamental. If there is, in some sense, a change in wealth when transactions account balances are revalued, then there is an identical change when they are not.

It will perhaps be objected that requiring revaluation of transactions account balances would be to deny banks their raison d'être. They would not be able to provide insurance against uncertainty in desired consumption. Again, though, if banks lend, then insuring against such uncertainty by means of a transactions account balance is like having a life insurance contract with a company that could fail. I may simply not understand the modern banking literature, but it is beyond me why having a contract for a known dollar sum, which, however, may not be honored, is necessarily better than having an account balance the future value of which is uncertain.

If the mutual fund businesses of banks (or the subsidiaries of what once were, in my sense, banks) were not allowed to hold loans, then requiring banks to mark their assets to market and revalue their transactions account balances would be very much like making them back those balances 100% with Treasury debt. If, however, they were allowed to hold loans, then requiring them to mark their assets to market would be, without a great deal of arbitrariness, making them do the impossible. There is evidence of a rapidly developing market in old loans.[28] At present, though, only the loans of well-known borrowers are being traded; trading in middle-market loans is still largely unknown. Nor have I yet been able to come up with a scheme that would force banks to use their best estimates of loan values. Finally, there would seem to be little to recommend the compromise policy of requiring banks to hold only easily traded (minimum bid-ask spread) assets in their mutual fund portfolios.

C. *How to Insure Bank Deposits?*

Of all the officials in our nation's capital, those of the FHLBB must be among the most worried. The insurance fund of the Federal Savings and Loan Insurance Corporation (FSLIC) could very quickly vanish. Such is the potential for failure of S&Ls and savings banks insured by the FSLIC. Banks are, by and large, less precariously perched than S&Ls. Yet officials of the FDIC (and no doubt the other federal bank regulatory agencies) are themselves more than a little worried. The FDIC insurance fund could be spent down to practically nothing in all too brief a period, and beyond the federal agencies responsible for regulating depository institutions there is worry. That is why a while ago, under Treasury leadership, experts began poking about among alternatives to the present-day insurance policies of the FDIC and the FHLBB. As must be supposed, they were looking for some that would be politically acceptable and would make the insurance funds less vulnerable, although not necessarily by making depository institutions safer.

The Treasury task force seriously considered many possible changes in the insurance policies of the FDIC and the FHLBB, so many in fact that I can confine myself to them and still deal adequately (as ade-

28. See Cohen and Hill 1984, p. 27; and also Sandler 1984, p. 33.

quately as I am able) with the question of how bank balances should be insured.[29] The FDIC and the FHLBB would seem to face problems that are, except perhaps in severity, identical. But I persist in focusing narrowly on (in my sense) banks and so explicitly consider only how the FDIC's insurance policy might be changed.

What the Treasury task force would seem to want to do is to shift responsibility for policing banks from the federal bank regulatory agencies to private-sector depositors and perhaps even to state and local governments, although many of them are protected by earmarked holdings of Treasury debt. Of the changes it seriously considered, one was intended to make private-sector depositors more effective than, supposedly, they would otherwise be. I refer to the proposal for increased disclosure of banks' circumstances. Other of the changes, though, are intended to shift responsibility. Decreasing the statutory insurance maximum from the current $100,000 per account has typically been represented as having that effect. Increasing the minimum capital-asset ratio (but permitting subordinated debt to be counted as capital) has too.

Any effort put into decreasing the statutory insurance maximum could well be wasted. At this moment, deposits are being parceled out in $100,000 units. But they might be parceled out in $10,000 or even $2,000 units. No doubt, the cost of being fully insured increases as the statutory insurance maximum decreases. So the smaller the maximum, the fewer fully insured deposits there will be. My feeling is, though, that with the cost of parceling out having decreased as much as it has, any cut in the maximum will have to be drastic if it is to mean much; and if the cut is drastic, then individuals and nonfinancial companies will get protection by dealing only with those banks, if there are any, that have been judged too large or too important to be allowed to fail.

What we come to, then, is that a decrease, however drastic, in the statutory insurance maximum will not be effective unless the federal government (specifically, the FDIC) forgets about wanting to breathe new life into any large bank that, although having in fact failed, cannot for one reason or another be merged into an ongoing bank. The FDIC must also forget about doing purchase and assumption transactions. It could generate uncertainty enough by every so often paying off the depositors of a failed bank. But paying off randomly (and generating uncertainty requires payoffs determined by chance) could too easily be judged unfair. So it is probably no exaggeration to say, as I did, that the FDIC has to abandon the practice of (where able) finding acquirers for failing or failed banks and assisting in the acquisitions.

When Penn Square failed, the FDIC paid depositors off, thereby

29. See Working Group of the Cabinet Council on Economic Affairs 1985. See also, Rosenstein 1984, p. 3; and Wynter 1985*b*, p. 27.

imposing losses on some, and, in so doing, shook depositors the world over. Had Penn Square been merged into an ongoing bank, then, almost certainly, depositors would not have fled Continental as they did. But to get back on track, in the period from the failure of Penn Square to the failure of Continental, the FDIC paid off the depositors of 13 or so failed banks. If all those banks were small, it is not too difficult to imagine the FDIC deciding to pay off the depositors of all banks other than the largest.

When some of Continental's depositors panicked, so, it seems, did the FDIC. Thus it is very difficult to imagine the agency announcing that, so far as it is concerned, no bank is too large to be allowed to fail. Not that it has never by itself been up to coping with the incipient or actual failure of any of our largest banks. But having an agency willing, when necessary, to work out the details of a rescue plan, to serve as an intermediary between the FRB and a failing or failed bank, has surely been reassuring to depositors.

If it is most unlikely to, the FDIC nevertheless could announce its unwillingness to participate in any more rescues of failing or failed large banks. So, having made allusion to the FRB as lender of last resort, I must here drag it front and center. Perhaps by default it has responsibility for protecting against failures of our largest banks. (That is why it was so willing to go to the mat with the Bush task force when the task force threatened to strip it of its regulatory authority, and that could be why it was able to so thump the task force.) The responsibility is not well defined. But however shadowy, the FRB will, I suspect, go right on shouldering it.

Where will we be if the statutory insurance maximum has been decreased to, say, \$10,000, if the FDIC has firmly committed itself to paying off depositors of all failed banks and forsworn more rescue operations, and, finally, if the FRB has somehow or other indicated it will carry on as in the past few decades? The distribution of bank balances aside, about where we are now or, just possibly, with owners of balances in excess of the statutory maximum slightly more disposed to flee than they have been. Owners of balances in banks from small to (way) above average will all be, by law, fully insured. Owners of deposits that are not fully insured by law will have those deposits in only the largest of banks and will be looking to the FRB for protection. But if there is not much to be got from a decrease in the statutory insurance minimum and, what might seem to be so much more important, a change in FDIC policy, many will sigh with relief. The point is obvious enough. If effective, a shift of responsibility to private-sector depositors increases the probability of a bank run. That is why properly priced deposit insurance has such appeal.

The Treasury task force took risk-based insurance premiums very seriously. Indeed, it recommended adopting such. But before getting into the pricing of federal deposit insurance, I want to comment briefly on a common minimum capital-asset ratio of 9% or 10% for all banks but with subordinated debt counting as capital. We can forget about the implied increases in actual capital-asset ratios. Again, more capital means nothing unless it must be used to purchase relatively safe assets. What makes the proposal interesting is the reference therein to subordinated debt.

In rescuing Continental, the FDIC ignored the Treasury's objection and, going beyond all precedent, guaranteed even holding company creditors against loss. The suspicion must be that, for better or worse, the agency was looking to a future in which other holding companies would want to borrow (some perhaps to provide their bank subsidiaries with more capital). We should, however, be clear: a commitment to protect the money supply can be stretched without limit. Yet, having said that, I do believe that requiring every bank to have subordinated debt is a promising way of making bank supervisors of private-sector lenders. Unless I have misunderstood, the Treasury task force would simply allow banks to count subordinated debt as capital. But requiring banks to have subordinated debt is the way to impose private-sector discipline.

It is not only that every bank must be required to have subordinated debt; every bank must be required to have short-term subordinated debt; or, if that is not strictly right, forcing banks to refinance frequently would seem a useful precaution. What restraint is there in 30-year subordinated debt that was issued yesterday?

I have been using the phrase "subordinated debt." A better choice would have been "uninsured debt." Requiring every bank to have insured subordinated debt would be a bad joke. The point to be made, though, is that having some uninsured debt does not, in general, substitute for having all uninsured debt. Even a mandatory 5% subordinated debt-asset ratio would not be a cure-all. If that is what theory tells us, we can also look about; it is not that subordinated debt will be brand new to banks.[30]

As I indicated above, the Treasury task force took risk-based insurance premiums very seriously. I do not believe, though, that moving now from the pricing policy of the present would be wise. Despite some remarkable intellectual efforts, we are still too far from agree-

30. Horvitz (1984) has advanced a different argument for requiring every bank to have uninsured subordinated debt. Quite simply, if every insured bank had such debt, then the FDIC would be better protected against loss than it currently is. Presumably, a bank with FDIC-insured deposits cannot be closed so long as it has positive equity capital. Thus, once having spotted a bank that is bound to fail, the FDIC must wait and, unless exceptionally lucky, experience a loss. But if all insured banks had subordinated debt, the agency would have a margin for error; it could be a little late in closing a bank and yet experience no loss.

ment on how federal deposit insurance should be priced when there is uncertainty about how banks are fixed or what they are about. There may be no real harm in fining a bank the management of which has been judged "bad." If we are to go on trusting in the judgments of the federal bank regulatory agencies, it may be desirable to have a means of enforcing compliance that involves even less fussing than does issuing a cease-and-desist order. The question, though, is whether we are currently in a position to make more than trivial changes in the pricing policy that has served us so badly since 1934.

In the literature on the pricing of government deposit insurance, the insuring agency is represented, perhaps rightly, as being, in effect, a bank examiner. Its problem is to find out, among other things, how good banks' loans are. If that is really the problem, then a scheme for getting banks to sort themselves out and, thus, pay appropriate premiums is what we should want.[31] Knowing what class of schemes to search over is different, though, from having found a scheme that, with high probability, will work. Remember, for research on how to price government deposit insurance, the objective is an intensely practical one.

What I wonder about is whether insurance premiums should be based on outcomes. Suppose that there are two banks and, further, that they have been following different loan policies, one riskier than the other. At any moment in time, the outcomes for the two banks may be identical. Suppose that they are. Does it follow that they should pay identical insurance premiums over the period until they are again examined?

It may be that loan policies can be identified only by outcomes or that small sample errors simply have to be accepted. I myself wonder whether risk-rating industries and, within industries, companies or just companies is a practical possibility. The implication may be, however, that we should not have risk-based insurance premiums.

With unchanged loan policies, banks will, of course, over a long enough period of time, pay approximately appropriate insurance premiums even if rated by outcomes. But there is no comfort for me in that obvious truth. Policies, not outcomes, would seem to be what matter; and it troubles me, perhaps unnecessarily, that with insurance premiums based on outcomes a bank that should be encouraged to persist in its (conservative) policy will not be and only because it has experienced a bit of bad luck.

31. See Kanatas (1984), a genuine contribution to the literature on the pricing of government deposit insurance. Kanatas credits Kane (1983) with the basic insight that the insurance policy of the federal government should be incentive compatible.

IV. A Brief Summing Up

It certainly would seem that I have argued myself into a corner of despair. If I am right, present-day federal bank regulatory policy cannot (should not) be counted on to keep the banking industry sufficiently safe and sound or, in other words, to prevent the misallocation of resources implicit in taxpayers being at risk. Yet, as I have also argued, there is no obvious alternative to the policy of the present.

If there is an alternative that should appeal to us, it is, amazingly enough, essentially the one first proposed many years ago. As I have argued, though, requiring banks to back transactions account and perhaps other balances 100% with Treasury debt does not suffice; banks have to be split into separate businesses or companies. The question, for which there are only arbitrary answers, is what sorts of balances the businesses engaged in providing payments services should have. An obvious answer is only transactions account balances. But those who feel strongly that the money supply should be broadly defined will not applaud that answer.

I am in a corner of despair only if banks are special, and that they are has not yet been established. If they are not, then all we could possibly want from bank regulation is safe transactions account balances for the relatively poor and financially naive. And if those folks are able, when told, to distinguish the risky from the safe, then there is no need to regulate banks. Under the laissez-faire policy, some transactions account balances are safe. Conceivably, all are; but, so far as I know, neither has that yet been established.

If I am in a corner of despair, technological change may lift me out. A government can always resist the introduction of a new and better technology. Our federal government may not be inordinately stubborn, though, and if it is not, then one day in a not-too-distant future we will be living in an economy virtually without a physical means of payment. All or nearly all trades will be effected with bookkeeping entries. When they are, protecting the money supply will be a hopelessly vague objective, and those who nevertheless want to persist will not know how to go about regulating banks.

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