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Federalism, Boundary Conflicts and Responsible Financial Regulation

William A. Lovett

FEDERALISM, BOUNDARY CONFLICTS AND RESPONSIBLE FINANCIAL REGULATION

WILLIAM A. LOVETT*

I. INTRODUCTION

The United States faces a potential stampede of financial merger activity.[1] This merger and consolidation trend, if accelerated by the drastic deregulation or restructuring legislation under Senate consideration, could alter fundamentally the nature of American capitalism.[2] Although

* Professor of Law and Economics, Tulane University School of Law. B.A., 1956, Wabash College; L.L.B., 1959, New York University; Ph.D., 1967, Michigan State University. Member, New York bar.

The text of this Article comprised, in substantially similar form, Mr. Lovett's testimony before the House Banking Committee on April 11, 1984. *See Financial Deregulation: How the Financial System Can Best Be Shaped to Meet the Needs of the American People: Hearings Before the House Comm. on Banking, Finance and Urban Affairs*, 98th Cong., 2d Sess. 67-90 (1984) (statement of William A. Lovett). *See also Competitive Equity in the Financial Services Industry: Hearings Before the House Comm. on Banking, Housing, and Urban Affairs*, 98th Cong., 2d Sess. 1144-56 (statement of William A. Lovett). The current Article includes footnotes by the author.

1. Bank merger activity has been increasing rapidly. For example, in 1975, there were 138 mergers and $7.1 billion in assets acquired. In 1980, there were 190 mergers and $19.8 billion in assets acquired, and in 1982, there were 437 mergers and $47.2 billion in assets acquired. *See* S. RHOADES, MERGERS AND ACQUISITIONS BY COMMERICAL BANKS, 1960-83, Staff Studies No. 142 (1984) (Federal Reserve Board). Recently, antitrust limitations were relaxed even more. *See* W. LOVETT, BANKING AND FINANCIAL INSTITUTIONS LAW ch. 3 (1984). Moreover, on October 15, 1984, Comptroller of the Currency, C. Todd Conover, announced the lifting of his moratorium on nonbank banks. Many observers interpreted the action as further encouragement for bank expansion, interstate banking and financial conglomerates. Some 329 applications for nonbank charters were pending, designed to take advantage of this rapidly expanding loophole. *See Analysts Examine Court Ruling Effect on Fed's Reg. Y*, Am. Bankers A. Bankers News Weekly, Oct. 2, 1984, at 1; *Conover Lifts Nonbank-Bank Ban*, Am. Bankers A. Bankers News Weekly, Oct. 23, 1984, at 1; *OCC Set to Begin Approving Nonbank Bank Applications*, 43 WASH. FIN. REP. 532 (1984); *OCC Lifts Moratorium on Nonbank Bank Charters*, 43 WASH. FIN. REP. 607 (1984); *Fed to Rule on Four Nonbank Bank Applications by Early November*, 43 WASH. FIN. REP. 608 (1984); *Conover Says Nonbank Banks Should Start Up Quickly; More OCC Decisions Soon*, 43 WASH. FIN. REP. 657 (1984); *"Non-Leading Leaders" in House Blamed on Nonbank Bank Issue by ABA Official*, 43 WASH. FIN. REP. 662 (1984); *Gorton Tells ABA Quick Senate Action Likely on Bank Powers, Nonbank Banks*, 43 WASH. FIN. REP. 664 (1984). Most of the largest United States banks applied for multistate charters this way, and if approved by the Office of the Comptroller of Currency (OCC), the Federal Reserve Board, and courts, the pace of interstate expansion and mergers would be greatly accelerated.

2. *See* W. LOVETT, *supra* note 1, at 382-97. *See also Financial Deregulation: How the Financial System Can Best Be Shaped to Meet the Needs of the American People: Hearings*

most United States multinational banks suffer strain and vulnerability due to excessive loans to developing countries, this does not justify drastic increases in concentration of United States financial institutions, or their transformation into a network dominated by giant conglomerates.[3] Congress should continue the progress it has made in the late 1970's and early 1980's with gradual, carefully discussed, and deliberate deregulation. The Depository Institutions Deregulation and Monetary Control Act of 1980[4] and the Garn-St Germain Depository Institutions Act of 1982[5] brought greater rivalry to American financial markets, along with greater access to higher interest rates for small savers. This is a constructive development. But Congress must safeguard the long term interest of the economy, consumers, small and large business, communities all over the nation, and our traditions of decentralized free enterprise in America.[6]

II. Overall Goals for Financial Institutions Regulation

Formulating sound goals for monetary, banking, and financial institutions policy is essential.[7] This strategy should help promote economic growth, ample savings and efficient investment, full employment and low

Before the House Comm. on Banking, Finance and Urban Affairs, 98th Cong., 2d Sess. 61-135, 189-209 (1984) (statements of William A. Lovett and David M. Kotz) [hereinafter cited as *Hearing on Financial Deregulation*]. The original Garn bill would have encouraged nationwide financial conglomerates by greatly expanding the powers of bank holding companies. S. 2181, 98th Cong., 1st Sess. (1983), *reprinted in Competitive Equity in the Financial Services Industry: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 98th Cong., 2d Sess. 2-128 (1984) [hereinafter cited as *Hearings on Competitive Equity*].

3. Other remedies are sufficient for easing the strain on international banking. They include rescheduling and stretchout relief, additional lending, reduced budget deficits, declining interest rates, International Monetary Fund stabilization discipline, and perhaps, moderately increased international liquidity through the International Monetary Fund, World Bank, and other multilateral institutions. *See infra* notes 36-39.

4. Pub. L. No. 96-221, 94 Stat. 132 (codified in scattered sections of 12 U.S.C.).

5. Pub. L. No. 97-320, 96 Stat. 1469 (codified in scattered sections of 12 U.S.C.).

6. For further elaboration of the need for gradual, careful progress toward financial deregulation, see *Hearings on Financial Deregulation, supra* note 2, at 67-90 (statement of William A. Lovett); *Hearings on Competitive Equity, supra* note 2, at 1144-56 (statement of William A. Lovett), 1168-74.

7. For more complete background on United States financial institution policies, see generally W. LOVETT, *supra* note 1. Another convenient review is provided in Shepherd & Heggestad, *The Banking Industry*, in THE STRUCTURE OF AMERICAN INDUSTRY ch. 9 (W. Adams ed. 6th ed. 1982). Chairman Paul Volcker of the Federal Reserve Board summarized relevant goals as follows: (1) fair competition; (2) efficiency and minimal cost to consumers; (3) protections against concentration of economic resources, discrimination, conflict of interest, and other possible abuses; and (4) a strong and stable financial system, with continuing attention to safety and soundness. *Hearings on Financial Deregulation, supra* note 2, at 1680 (statement of Paul A. Volcker).

inflation. Interest rates and financial service charges should be used to achieve these goals, but should not be excessive or unreasonably discriminatory. Vigorous competition among financial institutions is needed, with relatively easy entry, but participants must be responsible and properly capitalized. Large multinational institutions are desirable for many purposes, yet excessive concentration or domination by these firms is undesirable. Decentralized enterprise and healthy local institutions are important in federal democracy, and their vitality should be encouraged.

A continuing flow of international trade, investment, credit and financial services is essential for world prosperity. Adequate liquidity, access to borrowing, reliable debt service, and responsible national economic policies should be linked together. Healthy economic recoveries, with low inflation, and a minimum of disruption or defaults are desirable for the community of nations.

Regulatory authorities should work to achieve these objectives. Continued integrity of financial institutions and public confidence is indispensable. Equitable treatment of customers and institutions has been established as legal policy, and this policy should be maintained. Institutions must be carefully supervised, with appropriate discipline for accountability (including their international activities). Regulatory agencies, legislative oversight, and executive coordination should function smoothly and expeditiously to achieve these ends.

III. Main Themes of United States Financial Institutions Law

Federalism and the desire for decentralized financial institutions have been powerful themes in American law.[8] The nation fashioned a successful network of very large banks, including the world's biggest (Citicorp and Bank of America), along with large nationwide securities firms and insurance companies.[9] These separate industries already compete to a considerable extent with each other. More significantly, these powerful institutions are subject to the healthy competitive discipline of a few hundred regional banks, about 14,000 community banks, 4000 savings institutions, and 20,000 credit unions, along with thousands of securities dealers and insurance companies. The result has been a sound mixture, with good competition in each industry, and enough rivalry be-

8. For historical background, see generally W. Lovett, *supra* note 1; P. Studenski & H. Krooss, Financial History of the United States (1963). For special insight into the political tradition against concentrated power in banking, see R. Remini, Andrew Jackson and the Bank War (1967).

9. *See infra* Appendix, at 1074; *see generally* W. Lovett, *supra* note 1.

tween these industries, to serve customers well throughout the country, and to prevent excessive domination by the giants from the leading financial centers.

But there is already ample concentration in each of these industries, and we should not let them become much more concentrated. In banking, for example, the top fifty banks already have roughly half of United States total banking assets (including international activities), or as much financial weight as the remaining 14,500 banks altogether. (See Appendix). In securities distribution and underwriting, and the insurance industry, there is even greater nationwide concentration. There is no need for any significant enlargement of this aggregate concentration, and we should ensure that our present system continues. We should be proud of our decentralized finance and capitalism. It helps promote efficiency, competitive pricing and interest rates, along with fair access to credit for small business, housing, and other needs. Decentralization fosters social mobility, political pluralism, economic development and self-respect all over the country.

The crucial reasons for this decentralized success are the McFadden-Douglas boundaries[10] on bank branching and bank holding companies, the Bank Holding Company Acts of 1956 and 1970,[11] the Glass-Steagall Act[12] and its general separation of securities marketing from banking, and the state insurance regulation system.[13] Recent legislation, including the Depository Institutions Deregulation and Monetary Control Act of 1980[14] and the Garn-St Germain Depository Institutions Act of 1982,[15] have brought additional competition gradually without excessive disruption to this financial network.[16] We should continue careful, deliberate progress in the same manner.

Fortunately, there are no great scale economies for banks or depository institution operations that require drastic restructuring or enlarged

10. The McFadden Act of 1927, 12 U.S.C. § 36 (1982), and the Douglas Amendment to the Bank Holding Company Act of 1956, 12 U.S.C. § 1842(d) (1982), restrict the ability of banks to expand beyond state lines.

11. 12 U.S.C. §§ 1841-1850 (1982). *See* W. LOVETT, *supra* note 1, at 150-78.

12. The Glass-Steagall Act is the common name for four sections of the Banking Act of 1933, ch. 89, 48 Stat. 162 (1933) (codified in scattered sections of 12 U.S.C.). *See* 12 U.S.C. §§ 24, 78, 377, 378 (1976). *See also* W. LOVETT, *supra* note 1, at 135-38, 382-97.

13. *See* W. LOVETT, *supra* note 1, at 298-334; P. STUDENSKI & H. KROOSS, FINANCIAL HISTORY OF THE UNITED STATES (1963); J. WHITE, BANKING LAW (1976); Lovett & Devkins, *Multiple Office Banking and Market Extension Mergers*, 57 N.C.L. REV. 261 (1979).

14. Pub. L. No. 96-221, 94 Stat. 132 (codified in scattered sections of 12 U.S.C.).

15. Pub. L. No. 97-320, 96 Stat. 1469 (codified in scattered sections of 12 U.S.C.).

16. *See* W. LOVETT, *supra* note 1, at 21-22, 98-297, 382-97.

concentration in these markets.[17] Most banking market economists agree that economies of scale cease to be significant much beyond $50 million to $100 million in assets.[18] Moreover, computer technology is so powerful that it can adapt to all sizes of depository institution and banking activities.[19] Continuing antitrust protection should be encouraged in order to prevent any artificial market leverage over computerized technology.

Another basic theme of our modern financial institutions law is close supervision, accountability, and regulation to ensure fiduciary responsibility by banks, insurance companies, and those holding securities and pension fund assets.[20] Gradually, with efforts by many legislators at federal and state levels, we have developed a system that works well now. The Federal Deposit Insurance Corporation (FDIC), Federal Savings and Loan Insurance Corporation (FSLIC), and National Credit Union Share Insurance Fund protect depository institutions. Together with the limited Pension Benefit Guaranty Corporation for pension funds and the Securities Investor Protection Corporation for securities firms, they provide much more safety and soundness, and the basis for stronger accountability. Of fundamental importance are the depository insurance achievements, which have largely eliminated bank runs and widespread insecurity for banks and thrift institutions.[21] This federal deposit insurance tradition is backed up by supervision disciplines, and lender of last resort financing from the Federal Reserve system.[22]

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17. For an introduction to this literature, see Shepherd & Heggestad, *The Banking Industry*, in THE STRUCTURE OF AMERICAN INDUSTRY 330-38 (W. Adams ed. 6th ed. 1982).

18. For reviews of the literature on scale economies in banking, see McCall, *Economies of Scale, Operating Efficiencies and the Organizational Structure of Commercial Banks*, 11 J. BANK RESEARCH 95 (1980); Benston, Hanweck, & Humphrey, *Scale Economies in Banking: A Restructuring and Reassessment*, 14 J. MONEY, CREDIT & BANKING 435 (1982); S. RHOADES, THE IMPLICATIONS FOR BANK MERGER POLICY OF FINANCIAL DEREGULATION, INTERSTATE BANKING, AND FINANCIAL SUPERMARKETS, Staff Studies No. 137 (1984) (Federal Reserve Board).

19. *See* W. LOVETT, *supra* note 1, at 178-81. *See also* NATIONAL COMMISSION ON ELECTRONIC FUND TRANSFER, EFT AND THE PUBLIC INTEREST (1977); W. BAXTER, P. COOTNER, & K. SCOTT, RETAIL BANKING IN THE ELECTRONIC AGE: THE LAW AND ECONOMICS OF ELECTRONIC FUNDS TRANSFER 50-70 (1977); J.R.S. REVELL, BANKING AND ELECTRONIC FUNDS TRANSFERS (1983); Jones, *U.S. Banks Experiment with Home Banking*, BANKER, Jan. 1984, at 61.

20. *See* W. LOVETT, *supra* note 1, at 109-28, 213-22, 228-39, 279-320, 351-59; J. WHITE, BANKING LAW chs. 2, 3 (1976); INTER-BANK RESEARCH ORGANIZATION, THE REGULATION OF BANKS IN THE MEMBER STATES OF THE EEC (1978); H. BAER, THE BANKING SYSTEM OF SWITZERLAND (1964).

21. *See* W. LOVETT, *supra* note 1, at 109-28, 213-22, 228-39, 279-320, 351-59; P. STUDENSKI & H. KROOSS, FINANCIAL HISTORY OF THE UNITED STATES (1963).

22. *Id.*

We learned in previous depressions what disasters could flow from speculative booms and financial panic. Most of us now assume that modern banking and thrift institution regulation would prevent any future recurrence of such a tragedy. We should always remember that in the Great Depression nearly half the bank liquidity and savings of the country were destroyed, national income was cut in half, and one-fourth of the labor force was unemployed for years.[23] As a result, modern regulation followed for these institutions, and failures became quite rare between 1940 and 1980.[24] They should not be allowed to run rampant in the future.[25] Continued regulation must be even more vigilant, because of strain flowing from overloads of indebtedness in international banking during the late 1970's and early 1980's.[26] In certain respects, the excessive buildup of international lending and borrowing represents another big speculative boom, connected with worldwide inflation and deficit finance. We are forced to live with its consequences throughout the 1980's, and perhaps beyond, and must act with great care in regulating financial markets.

Reasonable safety and soundness for banks and other financial institutions require adequate reserves and capital accounts, together with regular inspection of asset quality and loan portfolios.[27] Greater attention must be paid to the matching of maturities between liabilities (deposits, certificates of deposit, borrowing and capital funds) and assets (loans, mortgages, securities, Treasury bills and cash reserves) in supervising modern asset-liability management techniques.[28] Fortunately, computer age technology makes safety and soundness easier to maintain, provided that federal agencies have full access to current computer runs on these matters.

It is also important that banks, other depository institutions, and

23. *See* W. LOVETT, *supra* note 1, at 47-49.

24. *Id.* at 109-28.

25. Recently, significant concern has been expressed about a substantial increase in the rate of bank failures between 1982 and 1984. *See, e.g.*, Dentzer, Ma, McAlevey & Leslie, *Keeping the Banks Afloat*, NEWSWEEK, Sept. 3, 1984, at 54; *Isaac Warns of Bank Nationalization: Predicts 75 Bank Failures for Year*, 43 WASH. FIN. REP. 653 (1984); *Partee Sees Deregulation Leading to Need for Increased Supervision*, 43 WASH. FIN. REP. 618 (1984); Knapp, *Penn Square Revisited*, BANKERS MAG., Jan.-Feb. 1984, at 75; *How Not to Run a Money-Center Bank: The Report of Continental Illinois Corporation's Special Litigation Committee*, INT'L CURRENCY REV., Sept. 1984, at 14; Thurow, *America's Banks in Crisis*, N.Y. Times, Sept. 23, 1984, (Magazine), at 48; *Inter-agency Feuding and the Penn Square Fiasco*, INT'L CURRENCY REV., Oct. 1982, at 31.

26. *See infra* notes 36 & 40.

27. *See supra* notes 20-22 and accompanying text.

28. For a brief introduction to current liability management techniques, see Rohlwink, *How Asset and Liability Management Improves Performance*, BANKER, Mar. 1984, at 41.

insurance companies remain sufficiently separated so that accounting integrity, reserves, and capital can be securely maintained.[29] The worst dangers in financial institutions management include the commingling of assets, borrowing, and the sharing of losses among related entities of a conglomerate enterprise.[30] The most common source of institutional failure results from self-dealing transactions among corporate insiders and related companies in a conglomerate family of enterprises. Leaders in these enterprises are tempted to cover up misuse of bank, insurance, pension or other assets, and to conceal their maladministration and breach of fiduciary responsibilities. All too often the weaknesses in their other enterprises (whether real estate development, mineral exploration, or foreign investment, among others) are not rectified, and the bank or financial institution fails, with substantial losses to the public or federal insurance liabilities.

For these reasons banking and depository institution activities, insurance marketing and underwriting, and the marketing and distribution of securities should remain separate as independent, unrelated industries.[31] Safety and soundness of banks and insurance companies can be better supervised this way. Meanwhile, the securities industry is regulated quite differently by the Securities and Exchange Commission (SEC) supervised disclosure mechanism and the SEC's regulation of the securities exchanges and the National Association of Securities Dealers.[32]

Finally, we should realize that the fiduciary character of banking, savings and loans, mutual savings banks and credit unions, together with insurance companies, is well established under American law.[33] They have special responsibilities and duties to the public. The economy depends upon their reliability and financial soundness. Banking and insurance should not be fields for speculative adventures or free-wheeling, fast

29. *See supra* notes 20-22 and accompanying text.

30. For the classic illustration of conglomerate risk management problems, see the case study on United States National Bank, concerning deposit assumption in large banks. J. WHITE, BANKING LAW 833-47 (1976).

31. *See generally* W. LOVETT, *supra* note 1. Proper supervision of depository institution and insurance companies requires administrative accountability. Securities regulation, by contrast, relies upon public disclosure and investor litigation disciplines. If holding companies are allowed to commingle activities from all these areas, sound regulatory supervision could be easily weakened. Conceivably, a coordinated multi-industry system could evolve eventually at the federal level, but this would require unusual effort to harmonize all agencies involved and would probably entail federal insurance regulation.

32. *See id.* at 261-70. *See also* D. RATNER, SECURITIES REGULATION 150-91 (1978); R. JENNINGS & H. MARSH, SECURITIES REGULATIONS (5th ed. 1982); N. WOLFSON, CONFLICTS OF INTEREST: INVESTMENT BANKING (1976).

33. *See* W. LOVETT, *supra* note 1, at chs. 2, 3, 4, 6.

buck profit promoters.[34] They are by nature well-regulated, closely supervised, conservative industries, that have a long tradition of fiduciary accountability and responsibility to the public interest. These industries have benefited from healthy competition and a great deal of decentralization. This blend of supervised competition and localized service is in the best interests of the public and the economy.

IV. Special Challenges for the 1980's

During this decade, Congress faces four major challenges that affect the regulation of banking and financial institutions: (1) excessive government deficits; (2) international debt overloads and rescheduling strains; (3) controversies between large and small financial institutions around the country over boundaries between banks, thrifts, securities firms, and insurance companies; and (4) the regulatory framework for supervising financial markets. These problems are interrelated, and call into question certain aspects of financial institutions regulation.

A. Budget Deficit Problems

The gravity of our budget deficit problem is now widely recognized in financial circles around the world.[35] During the next year or two, Congress should agree on a sensible, long run compromise for spending priorities and a bearable tax load. Once the structural deficit gap is eliminated, a substantial consensus on pragmatic monetary policy will be easier to achieve. Long term interest rates should fall substantially, with significant alleviation for the domestic economy, and a better climate within which to resolve international debt rescheduling problems.

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34. In the history of banking and insurance, unusually rapid growth and short-term profits are often associated with higher risk investment and loans, the purchase or recruitment of additional deposits or policies with generous terms or conditions, and/or reducing capital and reserves, thereby increasing leverage and potential vulnerability. The most speculative and adventurous strategies often have brought failures to their institutions, and therefore are discouraged by more experienced industry leaders. For a recent restatement of this traditional, conventional wisdom, see Address by C.T. Conover, Commercial Lending: Back to the Basics, Robert Morris Associates Fall Conference, San Juan, Puerto Rico (Oct. 31, 1984).

35. For the importance of fiscal discipline and deficit reduction, see W. Lovett, *supra* note 1, at 374-82; W. Lovett, Inflation and Politics: Fiscal, Monetary, and Wage-Price Discipline (1982); United States Council of Economic Advisors, Economic Report of the President to the Congress (1984); A. Rivlin, Economic Choices 1984 at 19-43 (1984); P. Erdman, Paul Erdman's Money Book: An Investor's Guide to Economics and Finance (1984). The Federal Reserve Board has also emphasized the importance of budgetary restraint especially during the 1980's. For critical views abroad, see *West Germany's Schmidt at ABA Warns U.S. About Budget, Trade Deficits*, 43 Wash. Fin. Rep. 667 (1984).

B. International Debt Rescheduling

Unfortunately, the international debt rescheduling crisis is more serious than most people realize.[36] Less developed countries (LDC's) have about $850 billion in foreign debt, roughly half owed to international banks.[37] United States multinational banks have the largest chunk of these loans ($175 billion), an amount substantially larger than the net capital of our biggest banks involved.[38] This exposure is dangerous to banking solvency in the United States, and a chain reaction of LDC defaults could reverse economic recovery in many countries. Widespread defaults would forebode a dreary situation for the United States government. The government could be forced to bail out the big banks, which would necessitate creating more money with more inflation, or increasing government debts and deficits, or enlarging tax revenues substantially to cover these losses (in some combination or other).

Unhappily, the LDC debt crisis could last another five to ten years, depending partly on the speed with which the United States and other major industrial countries eliminate their own budget deficits. If the United States takes a long time to achieve budget discipline, with continued high interest rates in the interim, the period of rescheduling crisis and strain for American multinational banks will be lengthened accordingly. Thus, the world debt crisis, major American bank vulnerability, and excessive budget deficits are tragically linked. It seems likely that part of the LDC debt load may have to be written off as a loss, though this may be accomplished gradually with skillful regulatory supervision.[39]

What are the implications for financial markets and their regulation? The main conclusions are the following. (1) United States bank

36. For current reviews of the world debt crisis, see P. ERDMAN, PAUL ERDMAN'S MONEY BOOK: AN INVESTOR'S GUIDE TO ECONOMICS AND FINANCE (1984); *Symposium on World Debt and The Monetary Order*, 4 CATO J. (1984); W. CLINE, INTERNATIONAL DEBT: SYSTEMIC RISK AND POLICY RESPONSE (1984); Lovett, *Managing the World Debt Crisis: Alternative Solutions and Economic Strains*, __ STAN. J. INT'L L. __ (1985) (forthcoming); Bergstrand, *Bretton Woods Revisited*, NEW ENGLAND ECON. REV., Sept.-Oct. 1984, at 23 (Federal Reserve Bank of Boston); H. Terrell, *Bank Lending to Developing Countries: Recent Developments and Some Considerations for the Future*, 70 Fed. Res. Bull. 755 (1984); J. MAKIN, THE GLOBAL DEBT CRISIS: AMERICA'S GROWING INVOLVEMENT (1984).

37. Lovett, *Managing the World Debt Crisis: Alternative Solutions and Economic Strains*, __ STAN. J. INT'L L. __ (1985) (forthcoming).

38. *Id. See also* H. Terrell, *Bank Lending to Developing Countries: Recent Developments and Some Considerations for the Future*, 70 Fed. Res. Bull. 755 (1984).

39. As developing countries insist upon reduced interest rates on existing external debts as a precondition for servicing these debts (even under liberal rescheduling arrangements), the profitability of these loans should decline. *See, e.g.*, Witcher, *Banks Give Ground on Mexico Debt Terms in Exchange for Close Watch on Economy*, Wall. St. J., Aug. 30, 1984, at 23, col. 1.

regulators, supervision, and Congress must be more vigilant than ever. We are living on the edge of major financial fragility for ourselves and the world economy, in a period of strain that could last for five to ten years. (2) We should avoid radical, rapid restructuring of financial markets, and prevent a stampede of destabilizing mergers.[40] These markets already have suffered major strains from electronic funds transfer and computer technology and increased competition for deposits and higher interest rates. Savings institutions have been burdened by older, low interest mortgage portfolios. Happily, few institutions have failed so far, and disruption to depositors, the public, and our economy has remained at a minimum. (3) We should continue the recent pattern of gradual, deliberate, and carefully discussed progress in allowing more competition for financial markets. Major gains for the public interest have been achieved with incremental, methodical deregulation, and responsible regulatory supervision.[41] We should not discard accumulated success, thereby upsetting an already shaky world financial situation.

C. Boundary Controversies

There is a Great Boundary Fight now underway—between large and small financial institutions, between banks, thrifts, securities firms and insurance companies, and among the states.[42] This boundary controversy intensified during the late 1970's when money market funds and cash management accounts broke into traditional deposit markets of banks, and especially thrift institutions. By the early 1980's, after international banking lost its growth momentum, some of the nation's biggest banks, led by Citicorp, urged that boundaries between all financial institutions be drastically reduced, so that inter-industry mergers could occur

40. A rapid stampede of bank mergers and takeover efforts would destabilize management for many financial institutions, increase pressures for accounting manipulation, and maximize the incentive for the appearance of high profitability. With increased variability of interest rates, thinner profit margins and a serious overhang of LDC debts, troubled energy and agriculture loans, and other strained industries, it would be disruptive to encourage this radical, rapid restructuring now, particularly since many thrift institutions have not recovered fully from severe disintermediation in the late 1970's and early 1980's.

As Federal Reserve Board Governor J. Charles Partee observed recently, deregulation of interest rate ceilings paid on depositors' funds has made the cost of funding substantially greater and more volatile than ever. He noted a tendency "to squeeze operating margins and to increase incentives to find higher yielding assets, by capitalizing on market advantages, by taking more risks or by moving out on an upward sloping yield curve." Partee considers the latter two alternatives "very dangerous," and noted that the "increased risk of major missteps heighten[s] the need for close monitoring and supervision." *Partee Sees Deregulation Leading to Need for Increased Supervision*, 43 WASH. FIN. REP. 618 (1984).

41. *See supra* notes 13 & 16 and accompanying text.

42. *See* W. LOVETT, *supra* note 1, at 382-97.

on a large scale, thereby encouraging the creation of nationwide financial conglomerates (with banking, insurance, and securities subsidiaries).[43] Some major securities firms, including Merrill Lynch, sought to participate in this trend. Several conglomerates involving securities were formed, such as Sears-Allstate-Dean Witter-Coldwell Banker (retailing, insurance, securities and real estate), Shearson-American Express (brokerage, credit cards and travel), and Prudential-Bache (insurance and securities), which could be leaders in such a transformation.[44] Another complication was than some of the weakened and large savings and loans needed to be recapitalized due to their earnings squeeze in the late 1970's to early 1980's, which led to some major savings and loan mergers, including a few acquisitions by leading banks.[45] A final factor was confusion among regulatory agencies over nonbank banks, i.e., a loophole under the Bank Holding Company Act[46] which allowed the acquisition or establishment of banks that merely perform one of the two primary bank functions, i.e., accepting deposits or making commercial loans.[47] A variety of outside companies, including a savings and loan affiliate (Dimension Financial Corp.) have established, or are attempting to establish, nonbank banks as a step toward wider market participation. Many major banks are eager now to establish nationwide deposit collection networks.

There is no coherent consensus among the banking, thrift, insurance, and securities industries on these boundary issues.[48] Some participants argue that they should grow and profit at the expense of other

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43. *Id.*

44. *Id.*

45. *Id.*

46. 12 U.S.C. § 1841(c) (1982). *See also Constitutionality of State Nonbank Bank Laws Debated at Fed Staff Hearing*, 44 WASH. FIN. REP. 225 (1985).

47. *See supra* notes 1 & 42.

48. W. LOVETT, *supra* note 1, at 382-97. Some of the largest multinational banks support nationwide banking, with broadened powers, including insurance, securities, and real estate. They are positioned to exploit such growth and merger opportunities advantageously, and the top 10 to 15 banks also suffer serious overloads in developing country loans (with potential insolvency risk if many defaults occur). Many large regional banks, on the other hand, fear pre-emption and dominance by the largest banks in any rapid merger stampede. They prefer regional bank expansion in various sections of the country to nationwide growth. The majority of smaller and independent banks support traditional McFadden-Douglas state boundaries on deposit gathering, although many would endorse broader bank powers. Thrift institutions support established boundaries, for the most part, though some large thrifts think more like regional banks. (Most banks oppose upgrading thrift charters to equality with bank powers). The insurance industry generally resists the idea of giving markets to banks, especially the smaller companies and independent agents. Likewise the real estate industry fears invasion by banks, their traditional suppliers of credit. Securities marketing firms and mutual funds generally oppose significant broadening of bank powers, and insist that money market funds are not

industries, but this selfish outlook tends to be resisted (not surprisingly) by many firms that would suffer in the restructuring process. Nor has there been sufficient agreement among the regulatory agencies.[49] These conflicts pose serious questions for Congress, and new legislation will not be easily enacted under these circumstances.[50]

In this situation Congress should move carefully, and avoid any stampede metality. Market forces at work could solve many problems without drastic legislative action or radical restructuring of the financial markets. As long as Congress avoids drastic restructuring, and continues to support the established tripartite system of financial regulation (banking and depository institutions, insurance companies, and securities firms), the artificial profit prospects and gains that would flow from a nationwide stampede of merger activity should ease and cool down. When this mood for radical, quick transformation passes, further investments in boundary probes and interpenetrations will have to justify themselves by the cold reality of market performance. In this light, we

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really full-service banking activities. Throughout this fighting over boundaries there is a parochial attitude and a tendency to claim public advantages for their own objectives.

From a broad public interest standpoint, however, one must bear in mind such considerations as federalism and independent financial enterprise in community life, along with the great benefits of inter-industry competition, product rivalry, and innovation.

49. Much of the advocacy for eliminating established boundaries has come from former Treasury Secretary Donald Regan, and his appointee, Comptroller of the Currency, C. Todd Conover. *See, e.g., Hearings on Financial Deregulation, supra* note 2, at 1626-34 (statement of C. Todd Conover). FDIC Chairman William Isaac has followed suit, but wants stronger enforcement powers to deal with unsound banks and authority to vary insurance assessments according to risk. *See, e.g., Hearings on Financial Deregulation, supra* note 2, at 1588-97 (statement of William Isaac). The Federal Reserve takes a much more cautious stance on powers and interstate expansion, and will defer to congressional compromises. But the Federal Reserve strongly supports ending the nonbank loophole, eliminating the "South Dakota problem" (which allowed out-of-state banks to set up South Dakota insurance subsidiaries to sell insurance only in other states), and streamlined procedures for administration of the Bank Holding Company Act. The Federal Home Loan Bank Board and National Credit Union Adminstration have taken cautious positions, emphasizing the need to maintain the health and vitality of their industries. *See, e.g., Hearings on Financial Deregulation, supra* note 2, at 1600-22 (statement of Edwin J. Gray, Chairman of the Federal Home Loan Bank Board).

50. Senator Gorton (R. Wash.) offered a frank assessment of legislative prospects of 1985, explaining that the nonbank bill (closing this loophole) was popular but "held hostage to the passage of broader legislation." He suggested that only modest powers expansion was likely, rather like the greatly stripped down version of powers expansion (S. 2851) that passed the Senate at the close of the 1984 session. *Gorton Tells ABA Quick Senate Action Likely on Bank Powers, Nonbank Banks*, 43 WASH. FIN. REP. 664 (1984). Conover supported closing the loophole if "significant new powers" were given to banks. He deemed the Senate-passed Garn bill (S.2851) "barely acceptable" in this area. *Conover Says Nonbank Banks Should Start Up Quickly; More OCC Decisions Soon*, 43 WASH. FIN. REP. 657 (1984). Since the congressional party and ideological balance did not change much in the November 1984 elections, reduced objectives seem realistic.

should see traditional market specialization patterns reasserting themselves, with limited room for sustainable changes.[51]

In banking, some states are experimenting with limited, carefully regulated access for out-of-state bank investments and merger activity.[52] Each state should accept only those bank holding company transactions that benefit its own citizens, business activity, and/or financial enterprises.[53] Thus, the pace of overall interstate banking activity will slacken greatly, the evolving pattern of banking strength will be more evenly divided and balanced among the states and major cities, and banking mergers will remain less highly concentrated. McFadden-Douglas boundaries should be retained throughout this process, so that a nationwide stampede or chain reaction of interstate banking mergers can be prevented. Thus, the banking tradition, with its independence and vitality for local

51. Establishing new business and customer loyalties normally requires substantial time, effort and investment in financial and human resources. This helps explain natural specialization patterns, and their relative stability. A gradual erosion of boundaries is preferable to a drastic destablization that undercuts the markets, good will, and investments of well-established and respectable enterprises. This applies particularly to financial intermediaries, with strong reliance interests built up for their customers, depositors, borrowing clientele, and communities being served. Recent strains from excessive inflation, deflationary discipline and greater variability of interest rates, confused expectations, and risk enhancement have created enough difficulty. Radical regulatory changes that might need rapid alteration and relief are not desirable in the financial markets. Evolutionary progress is preferable for most interests, and will better serve the public over the long run.

52. The current trend toward interstate banking or deposit gathering is cautious, limited, and non-uniform. A few states are permissive, some allow limited (non-homogeneous) regional compacts, but thus far most states have taken no action whatsoever. *See, e.g.*, Peagam, *Speeding Towards Interstate Banking*, EUROMONEY, Jan. 1984, at 81-84; *Antitrust Laws Won't Prevent Bank Industry Concentration, Panel Told*, 42 WASH. FIN. REP. 792 (1984); Dunham & Syron, *Interstate Banking: The Drive to Consolidate*, NEW ENGLAND ECON. REV., May-June 1984, at 11 (Federal Reserve Bank of Boston); Syron, *The "New England Experiment" in Interstate Banking*, NEW ENGLAND ECON. REV., Mar.-Apr. 1984, at 5 (Federal Reserve Bank of Boston); Address by Emmett J. Rice on Progress Toward Interstate Banking, Before the National Association of Urban Bankers (June 21, 1984); Anderson, Buynak & Balazsy, Jr., *Regional Interstate Banking*, ECON. COMMENTARY, June 18, 1984 (Federal Reserve Bank of Cleveland); Buynak, Anderson & Balazsy, Jr., *Banking Without Interstate Barriers*, ECON. COMMENTARY, Mar. 12, 1984 (Federal Reserve Bank of Cleveland; Pavel, *1984 Bank Structure Conference Highlights*, ECON. PERSP., July-Aug. 1984, at 13 (Federal Reserve Bank of Chicago); Osborn, *How the Sunbelt Can Build the World's Biggest Bank*, EUROMONEY, Aug. 1984, at 60; Fraser, *Structural and Competitive Implications of Interstate Banking*, 9 J. CORP. L. 643 (1984); Ginsburg, *The Future of Interstate Banking*, 9 J. CORP. L. 655 (1984); Frieder, *Legislating for Interstate Bank Expansion: Financial Deregulation and Public Policy*, 9 J. CORP. L. 673 (1984); *Regional Compacts Called Intermediate Step to Full-Scale Interstate Banking*, 43 WASH. FIN. REP. 537 (1984); *Eight Midwest States Consider Regional Banking*, 43 WASH. FIN. REP. 668 (1984).

53. This solution is better suited to incremental, non-destablizing "reform" in financial markets, and it imposes a sound test for real benefit to the states, cities and communities involved.

and regional banks, can be preserved as much as possible, and American banking will remain more competitive as an industry.

For thrift institutions (savings and loans and savings banks) this gradual evolution will be less threatening, and more favorable to their recovery from a squeeze on earnings (between older mortgage revenues and the rising cost of funds) in the late 1970's and early 1980's.[54] Some thrifts are developing a new strategy for the later 1980's, with more sophisticated real estate investment programs. Many thrifts will continue the tradition role of taking medium-term deposits and investing in longer term mortgages, with more sales of mortgages to the secondary market. Other thrifts may upgrade themselves to the role of commercial banks, which might be encouraged further by federal and state chartering authorities. Credit unions are more highly differentiated, and should be less affected by these developments, except that credit unions are an effective pressure for healthy price competition in financial markets.[55]

Insurance companies will gradually receive more competition, with some states leading the way.[56] The trend toward more direct-writer competition and price rivalry should be strengthened. But it would be undesirable to open the gates, all at once, to a stampede of insurance company takeovers by large banks, securities firms, and other outside corporations. This would disrupt the health of many insurers and independent insurance agencies, and increase dangers of fraudulent manipulation and misuse of insurance reserves and capital.[57] In the long run, a

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54. Thrift institutions have suffered a hard passage in the late 1970's and early 1980's, and have not fully recovered. *See* W. LOVETT, *supra* note 1, at 226-47. *See also* Bennett, *Restructuring the S&L Industry*, FRBSF WEEKLY LETTER, Jan. 11, 1985 (Federal Reserve Bank of San Francisco).

55. *See, e.g., Hearings on Competitive Equity, supra* note 2, at 1350-51 (statement of Edgar F. Callahan, Chairman, National Credit Union Administration); W. LOVETT, *supra* note 1, at 248-60.

56. For general background on insurance regulation and trends, see COMPTROLLER GENERAL OF THE UNITED STATES, ISSUES AND NEEDED IMPROVEMENTS IN STATE REGULATION OF THE INSURANCE BUSINESS, REPORT TO CONGRESS (1979); A. TOBIAS, THE INVISIBLE BANKERS (1982); R. MEHR & E. CAMMACK, PRINCIPLES OF INSURANCE (7th ed. 1980); C. WILLIAMS & R. HEINS, RISK MANAGEMENT AND INSURANCE (4th ed. 1981); INSURANCE, GOVERNMENT, AND SOCIAL POLICY (S. Kimball & H. Denenberg eds. 1969); W. LOVETT, *supra* note 1, at 298-334.

57. Adequate reserves are needed to support insurance company obligations under their contracts. Life insurance reserve requirements are based upon mortality experience and interest accumulation projections. For property and liability insurers, loss reserves and unearned premium reserves should be maintained. These requirements provide the resources to meet expenses, liabilities, and to prevent insolvency. Examination of assets and policy valuation is needed for these purposes, along with regulations and supervision to minimize fraud, embezzlement, and unsound investment practices. Insolvency associations are generally desirable, especially for property-liability insurance. *See* W. LOVETT, *supra* note 1, at 298-334.

federal insurance agency may be helpful in supervising the insurance industry, but it would be prudent to move this way deliberately, with extensive hearings, studies, and discussion for all interests affected.[58]

Securities marketing is, for the most part, properly segregated from commercial banking and insurance.[59] As a separate industry, the securities industry brought helpful competition to the financial sector. Mutual funds and money market funds have made banking and thrift institutions more competitive, and have helped to eliminate excessively low Regulation Q ceilings on deposit interest rates. Without this outside competition, American savers would still be contending with much lower interest rates.[60] Money market accounts offered by depository institutions now compete effectively with money market mutual funds. The Glass-Steagall[61] boundary still serves to separate trust account and other fiduciary responsibilities of commerical banks from the distribution and marketing of securities, and to preserve inter-industry rivalry. Both commercial banking, along with thrift institutions, and securities have ample competition within their own ranks, and the largest commercial banks need not dominate the securities industry.[62] Whether commercial banks should be

58. Some consumer advocates urge stronger federal regulation, and certain industry professionals have endorsed federalized regulation. Most insurance companies, however, prefer the state regulatory tradition because it is familiar, comfortable, and largely favorable to their interests. *See* W. LOVETT, *supra* note 1, at 330-33. But more industry professionals might support federal regulation, if necessary, as a defense against a general takeover of their industry by commercial banking.

In any event, we should preserve accountability, supervision, and adequate reserves, and provide insolvency insurance for most companies in the industry. A push from overextended international banks to quickly consummate many acquisitions of large insurance companies and from safe regional banks to replenish their consolidated bank balance sheets and earnings does not justify disrupting insurance markets. Moreover, the competence of giant bank bureaucracies might now be questioned, especially in light of their overlending to third world nations. *See supra* note 36.

Meanwhile, insurance companies and agents make the following arguments against letting banks sell or underwrite insurance: (1) the powerful leverage of banks as lenders can distort insurance decisions; (2) coercion-tying dangers may arise; (3) invasions of privacy may arise from bank misuse of checking account, borrower, and other financial data; (4) underwriting reserves may be threatened; (5) excessively concentrated economic power could result; and (6) many insurance companies, their marketing networks, and independent insurance agents could suffer undue disruption and losses.

59. *See* W. LOVETT, *supra* note 1, at 135-38, 261-97, 382-97 (1984).

60. *Hearings on Financial Deregulation, supra* note 2, at 95 (testimony of William A. Lovett).

61. 12 U.S.C. §§ 24, 78, 377, 378 (1976).

62. Securities marketing is a much smaller industry in the aggregate. In 1984, securities firms (and "investment" bankers) may have had roughly $120 billion in assets, and perhaps $10-12 billion in equity. Commercial banks, by contrast, had about $2000 billion in assets and $120 billion in equity. Insurance companies had perhaps $750 billion in assets. W. LOVETT, *supra* note 1, at 264-66.

allowed to affiliate with discount brokers is a closer question, but the courts have allowed this recently.[63]

The boundaries between insurance, commercial banking, and securities have been useful as well.[64] Insurance companies and banks are strong competitors in managing pension fund resources, along with some independent union and association pension plans. The three industries compete against each other for tax-sheltered investments and retirement accounts. While the banks seek some additional insurance marketing and underwriting authority, Congress should move cautiously in allowing increased rivalry. We should avoid disrupting the soundness of insurance companies, reserves, capital accounts, and the insurance distribution system, which plays such a strong role in small business enterprise and local community life throughout the country.

Finally, we should try to preserve the great competitive benefits of our tripartite financial services sector, with its strongly decentralized character:[65] (1) commercial banking is decentralized and competitive, and further disciplined by rivalry from thrift institutions in every state; (2) insurance underwriting is decentralized and competitive nationally, though more highly concentrated than banking; and (3) securities distribution and marketing are more concentrated nationally, but highly competitive as a risk capital market. These industries have kept each other on their toes competitively, and effectively serve the public interest.

It would be a serious mistake to convert these industries into a highly concentrated, nationwide oligopoly of giant conglomerates through a massive stampede of needless mergers.[66] Leveraged buyouts,

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63. Congress seems likely to accept this extension of banking activity. *See* J. WHITE & E. SYMONS, BANKING LAW 463-95 (1984) (particularly the "Schwab" decision, Securities Indus. Ass'n v. Board of Governors, 104 S. Ct. 3003 (1984).

64. *See* W. LOVETT, *supra* note 1, at chs. 3-8. *But see* GOLEMBE ASSOCIATES, INC., COMMERCIAL BANKING AND THE GLASS-STEAGALL ACT (Feb. 18, 1982) (prepared for the American Bankers Association); Byland, *U.S. Banks Respond to Market Pressures*, BANKER, Feb. 1984, at 85; Taylor, *Deregulation and the Banking Image*, BANKERS MAG., July-Aug. 1984, at 10; Sandler, *Entry Problems: Investment Banking Proves a Tough Field for Commercial Banks*, Wall St. J., Sept. 19, 1984, at 1, col. 6; *Partee Sees Deregulation Leading to Need for Increased Supervision*, 43 WASH. FIN. REP. 618 (1984).

65. Decentralization, local banking, and regional balance would be much more difficult to maintain if banking, insurance, and securities were scrambled together into conglomerate organizations. The traditions of state supervision and dual regulation would be greatly weakened, and only federal regulation would be likely to sustain some vitality.

66. In the long run, it would be difficult to prevent massive consolidation into nationwide financial conglomerates. Securities and insurance are much more concentrated than banking, and allowing consolidated conglomerates from all three industries (and perhaps major retailing networks like Sears) would convert banking into a far more concentrated nationwide industry, with a weak competitive fringe. This transformation would eliminate the rivalry of separate industries—banking, securities and insurance.

merger mania, fearful managements, and promoter profits could achieve this result within a few years, especially with current laxity in antitrust enforcement.[67] This transformation would reduce substantially the competitive bargaining power of small business and typical families in dealing with financial markets. Effective interest rates on loans and borrowing would increase for all but larger corporations, and deposit interest rates would decline for small firms and ordinary families.[68] Services to individuals and small business would erode in quality. We would eliminate one of the great strengths and guarantees of decentralized free enterprise, the separation and independence of financial intermediation from large industrial corporations.[69] Our present capital and financial markets function quite well on the whole. They are highly automated and computerized and becoming more efficient this way. It would be an enormous blunder to destroy the benefits of decentralized competition and rivalry in our financial services industries.

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67. With respect to leveraged buyout incentives, see J. WHITE & E. SYMONS, BANKING LAW 374-76 (1984); Osborn, *Leveraged Buyouts: Too Good to Be True?*, EUROMONEY, Apr. 1984, at 20; Gelman & Tsuruoka, *The Case for Stripping Banks*, NEWSWEEK, Oct. 22, 1984, at 80; Brown, *Goodbye to Greenmail*, EUROMONEY, Sept. 1984, at 14; Morton & Corbett, *Market Repositioning: The Challenge for Medium-Sized Banks*, BANKERS MAG., May-June 1984, at 60; Wallace, *Investing: Regional Banks are Still Bargains*, N.Y. Times, Sept. 16, 1984, at F10, col. 2; Bleakley, *The Merger Makers' Spiraling Fees*, N.Y. Times, Sept. 30, 1984, at F1, col. 2; Gordon, *Merger Mania in Pennsylvania*, EURONOMONEY, Sept. 1984, at 121.

With respect to laxity in current antitrust law, see W. LOVETT, *supra* note 1, at ch. 3; *Hearings on Financial Deregulation*, *supra* note 2, at 692-779 (testimony of Arnold A. Heggestad); J. BURKE, ANTITRUST LAWS, JUSTICE DEPARTMENT GUIDELINES, AND THE LIMITS OF CONCENTRATION IN LOCAL BANKING MARKETS, Staff Studies No. 138 (1984) (Federal Reserve Board); S. RHOADES, THE IMPLICATIONS FOR BANK MERGER POLICY OF FINANCIAL DEREGULATION, INTERSTATE BANKING, AND FINANCIAL SUPERMARKETS, Staff Studies No. 137 (1984) (Federal Reserve Board); *The Future of Small Depository Institutions in an Era of Deregulation, Financial Innovation and Technological Change* in PROCEEDINGS OF A CONFERENCE AT THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (Jan. 23, 1984).

68. Extensive literature shows that high concentration in local banking markets means somewhat higher charges and fees to smaller borrowers, and somewhat less generous conditions for smaller depositors. Larger business borrowers and depositors, on the other hand, have access to much stronger regional or even national competition for these purposes. *See, e.g.*, Shepherd & Heggestad, *The Banking Industry*, in THE STRUCTURE OF AMERICAN INDUSTRY (W. Adams 6th ed. 1982). Major increases in concentration, with powerful, multimarket institutions and conglomerates, would substantially raise barriers to new entry and potential competition as well.

69. Much better small business opportunities, easier capital formation, and more efficient financial intermediation flow from a highly deconcentrated, extremely competitive financial system. If, by contrast, banking and finance were dominated by large conglomerates, this traditional independence and ease of access to borrowing and credit could be substantially weakened.

D. *Regulatory Organization*

The American network of financial institutions regulation is adapted to its federal tradition, which includes the separation of banking, thrift institutions, securities marketing, and the underwriting of various types of insurance. We have developed sound patterns of teamwork and data sharing among most of the regulatory agencies.[70] We should not alter these arrangements without good reasons. If things function effectively, drastic changes are unnecessary.

In banking and thrift institution regulation, significant change at this stage in regulatory organization is unwarranted.[71] Because of dual chartering, a sound tradition that few challenge, we need federal state chartering and examination authorities. The Treasury Department, a major influence upon the economy, is a sensible place for the Comptroller or a Federal Banking Commission.[72] But the Federal Reserve, as our central bank and money market regulator, needs strong regulatory authority to perform its functions, especially in light of the continuing world debt crisis. We should realize, in addition, that the Federal Reserve has a much stronger and more talented staff. Federal deposit insurance and examination discipline is needed by state and federal banks alike, and is best provided by a strong, independent agency such as the FDIC, which is not prejudiced in favor of larger national banks, like the Office of Comptroller of Currency (OCC).[73] Meanwhile, thrift institu-

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70. Traditions of regulatory data sharing and collaboration have become highly sophisticated. *See* W. LOVETT, *supra* note 1, at 100-26; J. WHITE, BANKING LAW (1976); C. GOLEMBE & D. HOLLAND, FEDERAL REGULATION OF BANKING 1983-84, at 66-74 (1984).

71. As Senator Jake Garn observed in the 1984 hearings, the resolution of broader powers and altered boundaries among financial institutions probably would precede any significant rearrangement of regulatory authority for banks, thrift institutions, securities firms, or insurance companies. As Senator Garn remarked, "powers, and authorities first" and "powers need to be determined first before you go to regulation or geographical distribution." *Hearings on Competitive Equity, supra* note 2, at 1169-70.

If, however, banking, insurance, and securities marketing are permitted altogether for financial conglomerates and holding companies, with significant interconnection of resources, reserves, and facilities, then regulation, supervision and accountability will need to expand accordingly. Ultimately, all three industries probably would require effective regulation at the national level, with closely coordinated federal agencies.

72. Most other countries place banking regulation under their central banks or finance ministries. *See, e.g.*, INTER-BANK RESEARCH ORGANIZATION, THE REGULATION OF BANKS IN THE MEMBER STATES OF THE ECC (1978); H. BAER, THE BANKING SYSTEM OF SWITZERLAND (1964); S. BRONTE, JAPANESE FINANCE: MARKETS AND INSTITUTIONS (1982).

73. Historically, at least during the last generation, the OCC has been a weaker, less talented, and substantially less representative agency than the Federal Reserve. The OCC has tended to favor the interests of larger national banks, and has become at times, some complain, almost a lobbying organization for bigger banks. Whatever Federal Banking Commission should succeed the roles of the OCC and FDIC, it should be carefully structured to represent

tions are better supervised and insured by their own agencies, the Federal Home Loan Bank Board, the FSLIC, and the National Credit Union Administrator, with the National Credit Union Share Insurance Fund (NCUSIF). Coordination disciplines have been successful in recent years under the Federal Financial Institutions Examination Council, and the Depository Institutions Deregulation Committee was useful in implementing some aspects of the Depository Institutions Deregulation and Monetary Control Act of 1980.[74]

Proposals are being advanced now among scholars, though hardly among financial institutions, that federal deposit insurance (FDIC, FSLIC, and NCUSIF) should be abolished and replaced with "risk oriented" private deposit insurance.[75] Such thinking reflects serious naivete and ignorance of banking history and a long series of banking panics and depressions. Most responsible economists around the world repudiate this thinking, but it is worth restating the logic behind government deposit insurance and lender-of-last-resort support for banks and depository institutions. Even though private insurance might be sufficient for

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large, regional, and community banks equally. A system of defined representative board members, somewhat like the Federal Reserve Bank, should be employed, with one member for multinational banks, another for regional banks, and another for community banks, with perhaps two public members.

74. Pub. L. No. 96-221, 94 Stat. 132 (codified in scattered sections of 12 U.S.C.).

75. FDIC Chairman Isaac has been supporting risk-oriented FDIC insurance premiums. *See Hearings on Competitive Equity, supra* note 2, at 1281-86 (statement of William M. Isaac); *Hearings on Financial Deregulation, supra* note 2, at 1588-97 (statement of William M. Isaac). *See also Isaac Warns of Bank Nationalization: Predicts 75 Bank Failures for Year*, 43 WASH. FIN. REP. 653 (1984). Closely related to this effort is more market discipline and moral hazard for larger depositors. *See* Hertzberg, *FDIC Handling of Latest Bank Failures is Another Step to Discipline the System*, Wall St. J., Apr. 15, 1984. *See also* Furlong, *FDIC's Modified Payout Plan*, FRBSF WEEKLY LETTER, May. 18, 1984 (Federal Reserve Bank of San Francisco); Keran & Furlong, *The Federal Safety Net for Commercial Banks*, FRBSF WEEKLY LETTER, July 27-Aug. 3, 1984 (Federal Reserve Bank of San Francisco); Bennett & Pyle, *Risk-Adjusted Deposit Insurance Premiums*, FRBSF WEEKLY LETTER, Aug. 10, 1984 (Federal Reserve Bank of San Francisco); Bennett, *Bank Regulation and Deposit Insurance*, FRBSF WEEKLY LETTER, Aug. 17, 1984 (Federal Reserve Bank of San Francisco); Scadding, *Insurance and Managing Bank Risk-Taking*, FRBSF WEEKLY LETTER, Oct. 19, 1984 (Federal Reserve Bank of San Francisco). David Pyle justifiably asserts:

> [D]eregulation is increasing the scope for risk-taking by banks and other depository institutions. These include new asset and product line activities, such as real estate and insurance; the increased uncertainties of coping with deposit rate competition; and financial innovations such as brokered funds, which allow banks to raise funds nationally and to reduce their reliance on local markets in which they are better known. . . [I]mproved monitoring and control of bank activities to prevent insolvency may be more important than differentially pricing risk in protecting the insurance funds.

Scadding, *Insurance and Managing Bank Risk-Taking*, FRBSF WEEKLY LETTER, Oct. 19, 1984 (Federal Reserve Bank of San Francisco) (citing Pyle, *Deregulation and Deposit Insurance Reform*, ECON. REV., Spring 1984, at 5 (Federal Reserve Bank of San Francisco)).

occasional bank failures, this would not adequately prevent more widespread financial panic from spreading in a chain reaction. Because most modern nations use deposit insurance, central bank, and treasury support for their banking networks, most of them now believe that old fashioned, widespread financial panics and depressions will not occur again. There may be leeway for variation of deposit insurance premium risks and differential rate charges. But implementing such a policy is not easy. Risk variations among banks or other institutions are not simple to quantify. For example, how should enhanced risks for major United States banks due to LDC debt exposure be factored into premium structures? Realistically, the largest fifteen to twenty multinational banks now involve far greater insolvency risks as a class than regional or community banks.[76] How much greater? One hundred percent? Five hundred percent? One thousand percent? Should these risks be publicized? Could confidentiality be justified under SEC accounting? Would publication increase the strains upon international banking? Would rescheduling negotiations, already difficult, with some countries become even more awkward? Can government bank regulators impose differential risk premiums with integrity and fairness against large and small banks or other financial institutions? Would this involve political influence?

The most important requirement today for regulation of banks and financial institutions is continued vigilance, professionalism, and integrity. Recent strains upon the major multinational banks (resulting from the recession in the early 1980's and LDC debt overloads) need continuing attention from federal authorities. Major runs and bank failures, such as Continental Illinois and its de facto receivership, should be minimized. This requires stronger supervision, especially from the Federal Reserve, together with skillful rescheduling of LDC debts and collaboration with the International Monetary Fund and other central banks.

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76. *See supra* notes 36-40. Crucial questions are whether federal banking agencies would have the courage to, or should, raise risk premiums for the top 10 to 15 multinational banks to cover the risk of widespread LDC default. LDC debt exposure for the largest United States banks now substantially exceeds their net capital. By some standards, most of the United States multinational banks are "problem banks," i.e., with risk ratings of three to four under present CAMEL criteria. CAMEL refers to five factors delineated according to Uniform Interagency Bank Rating System: (1) capital adequacy; (2) asset quality; (3) management ability; (4) earnings performance; and (5) liquidity. For an explanation of the rating system, see W. LOVETT, *supra* note 1, at 117; C. GOLEMBE & D. HOLLAND, FEDERAL REGULATION OF BANKING 1983-84, at 70-71 (1984). *But see Conover Concedes U.S. is Unprepared to Let Large Money Center Banks Fail,* 43 WASH. FIN. REP. 445 (1984). *See also How Not to Run a Money-Center Bank: The Report of Continental Illinois Corporation's Special Litigation Committee,* INT'L CURRENCY REV., Sept. 1984, at 14.

Congress should exercise its oversight function with greater vigor and responsibility as trustee for the public interest.

Appendix

Aggregate Concentration

Banks and Other Depository Institutions

Total Deposits and Assets ($ billions)

	Consolidated Deposits[1]	Percent of Deposits	Consolidated Assets[1]	Percent of Assets
Commercial Banks	1,409.7		1,915.9	
Bank of America	94.3	6.7%	122.2	6.8%[2]
Citicorp	76.5	12.1%[3]	130.0	13.2%[3]
Chase Manhattan	56.9		80.9	
Manufacturer's Hanover	43.9		64.2	
J. P. Morgan	37.9		58.9	
First Interstate	30.5		40.9	
Continental Illinois	28.2		42.9	
Chemical New York	27.9		48.3	
First Chicago	27.4		35.9	
Security Pacific	25.8		37.0	
Top Ten Commercial Banks	449.3	31.9%	661.2	34.5%
Top Twenty Commercial Banks	604.7	42.9%	885.4	46.2%
Top Fifty Commercial Banks	791.8	56.2%	1,145.1	59.8%
Remaining 14,500 Commercial Banks	617.9	43.8%	770.8	40.2%
Savings and Loan Associations (3,833 Institutions)	603.4			
Mutual Savings Banks (424 Institutions)	207.9			
Credit Unions (20,000 Institutions)	80.8			
Agencies and Branches of Foreign Bank and Edge and Agreement Corps	36.3			
Total All Deposits	2,338.1			

1. Consolidated deposits and assets for top fifty United States banks as of September, 1983. Data from Association of Bank Holding Companies.
2. Citicorp 6.8% is asset leader.
3. Top two banks (Citicorp and Bank of America).

NOTE-The top twenty commercial banks have the large majority of international assets, or $265 billion of $317 billion (84%). (Sources: Federal Reserve Board, Council of Economic Advisors, Association of Bank Holding Companies).