Deposit Insurance Issues and Their Implications for the Structure of the American Financial System

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ARTICLES

DEPOSIT INSURANCE ISSUES AND THE IMPLICATIONS FOR THE STRUCTURE OF THE AMERICAN FINANCIAL SYSTEM†

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I. INTRODUCTION

Deposit insurance issues are part of a larger package of issues that are dramatically affecting banking regulation and the structure of the American financial system. Deposit insurance provides a justification for bank regulation—a primary purpose for bank regulation being to protect the

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deposit insurance fund—and in turn faith in the effectiveness of bank regulation justifies the implicit public guaranty of bank deposits and provides a basis for the increasing federalization of the American banking system. At the heart of modern American banking law and policy is the belief that this regulation and federalization can preserve the safety and soundness of the banking system and, hence, the solvency of the deposit insurance system.

Yet no system of deposit insurance has ever survived for any serious length of time without massive infusions of public funds. In America, each successive failure of deposit insurance has led to adoption of an even more expansive system protected by ever more extensive regulation. Each failure of deposit insurance has been viewed as evidence that the powers of the bank regulatory agencies were inadequate and that more regulation was needed to protect the system. In effect, each failure of deposit insurance and bank regulation has provided a justification for more of both. Thus, the deposit insurance/bank regulation debate has been founded


2. Technically, deposits in U.S. banks are insured by the Federal Deposit Insurance Corporation rather than being guaranteed by the United States government. Banking regulation is supposed to prevent widespread bank failures and therefore make it unnecessary that public funds be used to bail out bank depositors. Nevertheless, as discussed infra, this is not a true insurance system, and the United States government implicitly guarantees the safety of bank deposits. See authorities cited supra note 1.

3. For a history of deposit insurance in the United States, see James R. Barth, The Great Savings and Loan Debacle 8-23 (1991); Josephine H. Ewalt, A Business Reborn—The Savings and Loan Story 1930-1960 3-30 (1962); Stephen K. Huber, Bank Officers' Handbook of Government Regulation ¶¶ 17.0-.09 (1989); Edward J. Kane, The S&L Insurance Mess—How Did It Happen? 1-18 (1989); Thomas B. Marvell, The Federal Home Loan Bank Board 84-111 (1969); Huber, supra note 1, at 48; see also Philip F. Bartholomew & Vicki A. Vanderhoff, Foreign Deposit Insurance Systems: A Comparison, 45 Consumer Fin. L.Q. Rep. 243 (1991) (Various systems of deposit insurance survive in other countries, but virtually all of these were adopted in the post World War II era and none have yet survived a serious test.).

on two generally unquestioned assumptions: (1) Deposit insurance is a public necessity that cannot be significantly cut back, and (2) any resulting problems can be solved by providing increased bank regulatory powers and penalties. This article will analyze both of these assumptions in the context of the American experience with deposit insurance and bank regulation in the twentieth century.

The latest American deposit insurance crisis culminated in the 1980's when it became apparent that the Federal Savings and Loan Insurance Corporation (FSLIC) was insolvent. In response, the United States government—apparently eager to avoid confronting fundamental deposit insurance issues raised by this insolvency—focused on shifting the blame elsewhere, and in consequence enacted legislation founded on the theory that the bulk of the insolvency was caused by wrongdoing in the industry. 5

It seems clear that Congress and the Bush administration overreacted to media reports of fraud in the industry by enacting new banking laws that imposed severe new restrictions and penalties on the American banking system. 6 In turn, these new laws probably precipitated another series of financial institution failures and economic problems, ultimately contributing to the near-insolvency of the Federal Deposit Insurance Corporation (FDIC). Yet, while this was essentially a result of the American system of deposit insurance, very little attention has been given to reform of the deposit insurance system by policy makers. In order to provide a perspective on this series of events and to help explain the relationships between deposit insurance, bank

5. See infra Parts V, VI, and VII. In contrast, members of the National Commission on Financial Institution Reform, Recovery, and Enforcement characterized the problem as a “massive failure in government” and “a systemic breakdown of government.” “This loss to the taxpayers was of such magnitude it can’t be explained by individual fraud.” U.S. League of Sav. Insts., 46 WASH. NOTES No. 19, at 2-3 (May 8, 1992).

regulation, and economic conditions, this article will begin with a brief historical overview of the American deposit insurance system.

II. HISTORICAL OVERVIEW: DEPOSIT INSURANCE AND BANK REGULATION IN AMERICA

A. Development of the Modern Regulatory System

Banking in America dates almost from the beginning of the Republic, and savings institutions (or "thrifts") began to develop in the early nineteenth century. Generally speaking, banks historically accepted consumer and commercial deposits and focused on commercial lending. Thrifts accepted consumer deposits and emphasized real estate lending and investment. Many short term consumer borrowing needs were met by specialized nondepository finance companies. Banks were generally state-chartered and unregulated until the financing needs of the Civil War led to the National Bank Act of 1863, creating the dual system of state and national banks. This legislation represents the first of three turning points in American banking history and the beginning of the federalization of the United States financial system. Thrifts remained subject only to state chartering and minimal regulation—and in some cases participated in state deposit insurance arrangements—until the 1930's. There was no federal deposit insurance of either banks or thrifts at this time.

The Great Depression of the 1930's changed all this, and the resulting legislation represents a second turning point in the development of the American financial system, with changes of a magnitude unequaled until the legislative

7. See JOSEPH J. NORTON & SHERRY C. WHITLEY, BANKING LAW MANUAL § 2.03 (Supp. 1988); Huber, supra note 1, at 118.
8. See authorities cited supra note 3. As used herein, the terms "savings institution" and "thrift" will include savings and loan associations, building and loan associations, and savings banks.
10. See NORTON & WHITLEY, supra note 7, § 2.03[3].
developments of 1989-1991. Like the National Bank Act of 1863, the changes of the 1930's represented a significant move toward federalization of the financial system, as well as a move toward functional regulation of banking activities. Ironically, the Depression era bank failures may have been exacerbated by the banking regulation of that period—in a precursor to the problems of 1989-1991—as bank examiners sought to protect themselves from charges that lax regulation was contributing to the banking collapse. In response, examiners began to require the marking of certain bank assets to current market values—a "mark to market" approach advocated and utilized increasing in the 1990's, thereby wiping out the stated capital of banks that had heavy investments in bonds whose values were affected by the stock market crash. There was a wave of massive losses as thousands of banks and thrifts failed; hundreds of millions of dollars were lost by depositors.

The result was a transformation of the American banking system, unequaled in history—until perhaps the current era—with enactment of the Banking Act of 1933 (separating commercial and investment banking, and establishing the FDIC), the Securities Exchange Act of 1934 (among other things authorizing the regulation of credit for the purchase or holding of securities), the Federal Home Loan Bank Act of 1932, the Home Owner's Loan Act of 1933, and the National Housing Act of 1934 (together creating an unprecedented scheme of comprehensive regula-

12. See, e.g., EWALT, supra note 3, at 3-30.
14. 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 77b-77e, 77j, 77k, 77m, 77o, 77s, 78a-78o, 78o-3, 78p, 78hh); NORTON & WHITLEY, supra note 7, § 2.03[5].
tion for thrifts). These laws created a comprehensive system of federal regulation and deposit insurance that placed control of American banking policy and regulation largely in the hands of powerful federal administrative agencies. For the first time, savings and loan associations were brought under the umbrella of federal regulation and were subjected to a comprehensive system of activities restrictions.

Banks and thrifts still had the option of a state or federal charter, but any institution with federally insured deposits was regulated by the FDIC or FSLIC in addition to the chartering authority. Federal deposit insurance quickly became a practical necessity for the survival of depository institutions, whether state or federally chartered. Consequently, in the 1930's, virtually the entire banking system was brought under the mantle of federal regulation. Since that time, it has become increasingly clear that state chartering and regulation exist largely at the sufferance of the federal government.  

B. Federalization of the Thrift Industry

Nowhere was the 1930's trend toward federalization more apparent than in the thrift industry. For several reasons—many of which are not widely understood—the thrift industry quickly came under the plenary control of its regulatory authority, the Federal Home Loan Bank Board (FHLBB). From their earliest beginnings, thrifts had been specialized institutions, focusing on real estate loans and investments. When the Federal Home Loan Bank System (FHLBS) and FHLBB were created, this traditional specialization was carved in the stone of a restrictive charter and regulatory structure. Thrifts were limited, first by law

17. 48 Stat. 1255 (1934) (codified as amended in scattered sections of 12 U.S.C.); Norton & Whitley, supra note 7, § 2.03[5].
18. See, e.g., Huber, supra note 9. This point has become increasingly clear in view of the Clinton administration's proposal to combine all banking regulatory authority in a single, all-powerful federal administrative agency, with regulatory authority over all state as well as national banks.
19. See discussion infra this Part.
and then even more so by a comprehensive and detailed body of regulations issued and enforced by the FHLBB, to very narrow categories of lending and investment activities.\(^\text{20}\)

In effect, the thrift industry was operating under a very narrow business plan written by Congress and its regulators. Law and regulatory policy essentially limited thrifts to investment in low yielding government securities and long-term, fixed-rate mortgage loans.\(^\text{21}\) Federally chartered thrifts—and state chartered thrifts in all but a few states—were required to have a “mutual” rather than a capital stock form of charter.\(^\text{22}\) As a result, such thrifts could not raise capital by sales of stock and there were no shareholders to supervise management; management had every incentive to distribute earnings in the form of salaries and little or no incentive to build capital through retained earnings. The regulators made things worse by basing salary guidelines—and, effectively, maximum salary levels—on asset size, thereby encouraging thrifts to grow rapidly without regard to profits or capital ratios. Capital ratios were widely believed to be of little or no importance, in part because of a belief that heavily regulated thrift operations were essentially risk-free.

In effect, in the postwar period the American thrift industry was being administered by federal regulators.\(^\text{23}\) Pursuant to regulatory policy—and with the blessings of Congress—the thrift industry grew rapidly on a very small capital base by soliciting interest rate-sensitive short-term


\(^{21}\) See authorities cited supra note 20.

\(^{22}\) See Barth, supra note 3, at 16; see also Richard Layne, Thrifts Lining Up for Partial Conversions, Am. Banker, May 27, 1992, at 16 (quoting a thrift executive as explaining the preference for mutual charters: A stock charter could result in shareholders who “have more say in the policy of the organization than management.”); Eric Rasmusen, Mutual Banks and Stock Banks, 31 J. Law & Econ. 395 (1988); Michael E. Staten, Thrift Risk and Ownership Structure, 43 Consumer Fin. L.Q. Rep. (back cover) (Fall 1989).

\(^{23}\) In a sense this represented President Roosevelt’s “New Deal” concept of an administered industry. Nevertheless, it flies in the face of common wisdom that problems in the thrift industry were the result of lax regulation.
deposits and investing the funds in long-term fixed-rate mortgages. The result was maximization of short-term income at the risk of creating enormous long-term contingent liabilities for taxpayers. But this was not merely an example of an inflexible regulatory structure preserving the historical orientation of an industry; this scenario also fit conveniently with a perceived political need to subsidize the housing industry. The result was an ample supply of low-cost, fixed-rate mortgage funds for home-buyers at no cost to society except for the enormous interest rate risk being imposed on thrifts by law and regulation.

This all worked reasonably well for about forty years as stable interest rates and property values disguised the inherent risks being assumed via deposit insurance and regulatory policies. But this was a prescription for disaster when national economic policies created an environment of volatile, rising interest rates and an explosive cycle of inflation and deflation in real estate values.

C. The Problems Surface

Events in the late 1970's and early 1980's made it painfully obvious to serious observers that the easy years of deposit insurance were over. For years, Federal Reserve Board (FRB) Regulation Q had controlled the interest rates

24. This is a need that remains to this day, as evidenced by the massive growth of FNMA and FHLMC secondary market operations. These entities represent, in essence, massive thrift institutions using implicit government guaranties to subsidize housing. There is also some evidence that history may be repeating itself, on an even grander scale, as the Clinton administration seeks to reduce the role of the FDIC in favor of a centralized bank regulatory commission that would be, to a large extent, controlled by the President. In conjunction with other measures designed to promote easier credit, this may lead to another round of politically motivated financial initiatives that will ultimately lead to the next deposit insurance crisis. See, e.g., Claudia Cummins, Comptroller to Urge Banks to Trim Cost of Making Small-Business Loans, AM. BANKER, Mar. 21, 1994, at 3; Claudia Cummins, Regulators Say Initiatives to Ease Credit are Working, AM. BANKER, Mar. 18, 1994, at 1 [hereinafter Initiatives]; Robert M. Garsson, Small Banks in ABA Skeptical about Superregulator Proposal, AM. BANKER, Jan. 12, 1994, at 3; Lawrence Lindsey, How to Corrupt Banking, FORBES, Jan. 31, 1994, at 100; Catherine A. Ghiglieri, Superregulator Dooms Dual Banking System, AM. BANKER, Mar. 9, 1994, at 7.
that banks and thrifts could pay on deposits. This worked as long as interest rates and inflation remained low. Nevertheless, as inflation and interest rates skyrocketed in the late 1970’s, modern technology allowed securities firms to offer “money market” mutual funds that invested the customer’s money directly in higher yielding government securities, thereby providing a high rate of return with a level of safety equivalent to an insured bank deposit. Money flowed out of low-yielding bank and thrift deposits into money market mutual funds, a process called “disintermediation” because it bypassed the traditional financial intermediaries (banks and thrifts).

Congress responded in 1980 by phasing out Regulation Q, thereby freeing banks and thrifts to match the higher rates being paid by money market funds. The 1980 Omnibus Banking Act also raised the deposit insurance limit from $40,000 to $100,000, implicitly encouraging thrifts to “outgrow” their portfolios of low-yielding mortgage loans by expanding their deposit base. As it became apparent that even more drastic action was necessary, Congress abolished the last vestiges of deposit interest rate controls and authorized banking institutions to offer money market deposit accounts comparable to the products being offered by the securities industry. These measures stemmed the outflow of funds and prevented a massive liquidation of the banking

25. See, e.g., Huber, supra note 3, ¶ 1.15; Norton & Whitley, supra note 7, § 2.05[3]. This was a part of the overall effort to promote housing by providing real estate lenders with an assured supply of low cost funds.

26. Norton & Whitley, supra note 7, § 2.05[3].


28. See 1980 Omnibus Banking Act, Pub. L. No. 96-221, 94 Stat. 145-150 (1980) (codified in scattered sections of 12 U.S.C., including Title III, Consumer Checking Account Equity Act of 1980); Norton & Whitley, supra note 7, §§ 2.05[3], 12.01-08. In fact, this was quasi-official policy and was urged upon this author by both regulators and industry trade association officials.

industry, but almost overnight the cost of funds for banks and thrifts shot up (deposit interest rates were deregulated at a time when market interest rates were at unprecedented high levels) as institutions sought to stem the outflow of funds by offering market rates of interest. Institutions with loan portfolios built on an assured supply of funds at Regulation Q levels of around 5 1/4% were suddenly paying in excess of 15% to attract or merely maintain deposits.\textsuperscript{30}

Both banks and thrifts suffered, but bank assets were invested primarily in short-term commercial loans (with maturities typically ranging from three to six months) and consumer loans with maturities of thirty-six months or less. With a prime rate of around 21%, banks were able to quickly reorder the asset side of their ledgers to increase income and compensate for the higher cost of deposits.\textsuperscript{31} But for thrifts it was a different story. Bound by federal law and regulation to investment in low-rate, long-term mortgage loans, thrifts could not easily adjust their income to match the increased cost of deposits. Thrifts with investment portfolio yields of around 6% were suddenly forced to pay over 15% to attract or retain deposits, thereby assuring heavy operational losses.\textsuperscript{32} As these losses depleted the already meager net worth of the thrift industry, it became apparent that virtually the entire industry—and hence the FSLIC—was insolvent. Obviously something had to be done, otherwise Congress would be forced to admit the true cost of the deposit insurance and regulatory system it had created.

\textbf{D. The Solution—A Desperate Gamble}

Not by chance, the high interest rates of the early 1980’s coincided with a high rate of monetary inflation. Among other things, this meant skyrocketing real estate prices. As

\begin{itemize}
\item[\textsuperscript{30}] This observation is based on this author’s personal experience as President of a small thrift in Oklahoma.
\item[\textsuperscript{31}] With inflation that matched or even outpaced interest rates, many borrowers were convinced that it was good business to borrow at double-digit rates and invest the proceeds in hard assets. Therefore, loan demand remained brisk despite the record-high level of interest rates.
\item[\textsuperscript{32}] See \textit{supra} note 30 and accompanying text.
\end{itemize}
Congress and the regulators looked for a way out of the statutory and regulatory mismatch of assets and liabilities that had been imposed on the thrift industry, that industry's historic expertise in real estate and the prospects for continued real estate inflation must have suggested an obvious option: bail out the thrifts by allowing and encouraging them to speculate on real estate.

Hence was born the asset "deregulation" of the 1980's. This was not really so much deregulation as it was a newly targeted regulation; thrifts were not granted the kind of lending and investment flexibility that other businesses (including banks) always have had, nor were they relieved of the microregulation of their operations that had been customary since the 1930's. Instead, thrifts were given new authority to invest in speculative real estate development projects—both in the form of direct investments in real estate and by expanded real estate construction and development financing authority, and were told by the regulators to use those new powers, or else. Recalcitrant managers who hesitated—perhaps on grounds of safety and soundness—were labeled old-fashioned and were characterized as being unable to adapt to the new realities; sometimes they were pressured out of office and replaced by real estate speculators or others willing to use the new activities powers to the fullest extent. Thrifts were told in no uncertain terms that a business strategy that merely contemplated a continuation of traditional thrift activities and underwriting standards was unsatisfactory to the regulators. Thrifts that cooperated received regulatory "forbearance" and were allowed, even encouraged, to grow rapidly in order to finance the new investments.

This represented a massive Congressional and regulatory "roll of the dice" in an effort to avoid facing the consequences of the failure of a deposit insurance system. While clothed in the rubric of "deregulation," this was a form of targeted

regulation, a new business plan mandated by Congress and the regulators. As a result, thrifts all over the United States paid premium interest rates to obtain funds for investment in real estate projects at the peak of an inflationary boom in real estate prices. When real estate prices collapsed so did many thrifts—and ultimately the FSLIC. The thrifts' meager capital had been wiped out by a government mandated asset-liability mismatch and a binge of real estate speculation.

III. WAS Deregulation the Culprit?

A. Where Deregulation Went Wrong

The foregoing historical overview already has answered the question asked above. Despite the record, however, many in government and the media seemingly still believe that "deregulation" was at fault and that the solution is additional functional regulation of the financial system. This view is shared by some in the industry who apparently long for a return to the days of Regulation Q, when thrifts were treated almost like branches of the FHLBB and bankers were in many ways protected from the uncertainties of competition in the financial markets. As an example, a study sponsored and published by the United States League of Savings Associations blamed the demise of the FSLIC on "deregulation" and advocated reregulation as the solution. This study became a model for some of the subsequent legislation and will be discussed here as an example of the arguments blaming deregulation for the demise of the FSLIC.

34. Later protestations by members of Congress, professing to be shocked by what had happened, seem almost laughable in retrospect. See, e.g., Huber, supra note 9, at 80 ("The expressions of outrage by members of Congress are reminiscent of Claude Rains (in the movie Casablanca) purporting to be shocked that there was gambling going on at Rick's Cafe.").

35. Norman Strunk & Fred E. Case, Where Deregulation Went Wrong: A Look at the Causes Behind Savings and Loan Failures in the 1980's (1988); see also Case, supra note 1, at 593.
The authors of Where Deregulation Went Wrong\textsuperscript{36} could not be better qualified for the task of reviewing the events that led to the FSLIC crisis. Consequently, a brief review of their credentials will be instructive. Norman Strunk has been associated with the thrift industry for fifty years, and served the U.S. League of Savings Institutions (now the Savings and Community Bankers of America) in positions ranging from Research Assistant to Chief Executive Officer. He was appointed CEO in 1952, and upon his retirement from the League in 1980, he became Secretary-General of the International Union of Building Societies and Savings Associations. Dr. Fred Case is Professor Emeritus at the Graduate School of Management at the University of California, Los Angeles. He has written eighteen books and has enjoyed an exceptional career as a successful economist and business consultant. In their study and report, these authors concluded that deregulation of the thrift industry during the 1980’s was the cause of the FSLIC insolvency.\textsuperscript{37}

\textbf{B. What Went Wrong?}

As noted above, there is a common belief that deregulation was the primary culprit in the insolvency of the FSLIC.\textsuperscript{38} The authors of Where Deregulation Went Wrong wasted no time in identifying this as the source of the problem. As suggested by the title of the book, they unequivocally laid the blame on deregulation: “The single most important development that precipitated the wave of failures was ‘deregulation’ which first produced operating losses for most institutions and then attracted venturesome entrepre-

\begin{footnotesize}
\begin{enumerate}
\item[36.] STRUNK \& CASE, supra note 35.
\item[37.] \textit{Id.} at xi-xii.
\item[38.] Associated Press reported the remarks of Theo H. Pitt, Jr., outgoing Chairman of the U.S. League of Savings Associations, at the League’s 1988 annual convention, as follows, “Mistaken deregulation by the Reagan administration bankrupted the savings industry’s deposit insurance fund, and the federal government, not the industry, should bail out [depositors in failed institutions] . . . .” \textit{Thrifts Propose Federal Bailout — Deregulation Blamed for Ills}, DAILY OKLAHOMAN, Nov. 1, 1988, at 13. For a more restrained report on the same remarks, see David B. Hilder, \textit{Head of Thrift Group Contends Industry Shouldn’t Pay More to Bail Out FSLIC}, WALL ST. J., Nov. 1, 1988, at A4.
\end{enumerate}
\end{footnotesize}
neurs to the business who led savings associations into unfamiliar business activities."\textsuperscript{39} This sentiment has been so widely repeated in the American media that it probably can be regarded as the accepted wisdom; yet this requires a dramatically short-term analysis that largely ignores events prior to the 1980's and relies on a very selective view of the status of the industry in the early part of that decade.

The authors of \textit{Where Deregulation Went Wrong} listed fifteen specific "causes" for the losses that doomed the FSLIC and afflicted the thrift industry in the 1980's.\textsuperscript{40} These include such broad economic developments as increased inflation and competition, followed by asset disinflation—factors that can hardly be blamed on deregulation—and a number of specific developments unique to the savings and loan industry. It is the latter that must be analyzed in explaining why the FSLIC and some segments of the thrift industry suffered so badly in comparison to other businesses and in comparison to healthy banks and thrifts. Yet a quick review of the "causes" listed in \textit{Where Deregulation Went Wrong} suggests a failure of regulation rather than deregulation. For example, the first "cause" listed by the authors in \textit{Where Deregulation Went Wrong} is the "[l]ack of net worth for many institutions as they entered the 1980s, and a wholly inadequate net worth regulation."\textsuperscript{41} Subsequent text reinforces the observation that this came at the end of fifty years of strict regulation of capital ratios and resulted from a regulatory emphasis on growth at the expense of net worth ratios during the 1960's and 1970's.\textsuperscript{42}

\begin{footnotes}
39. \textsc{Strunk & Case}, \textit{supra} note 35, at 14.
40. \textit{Id.} at 15-16.
41. \textit{Id.} at 15.
42. \textit{Id.} at 27-33. As noted by the authors, this was partly a result of the prevalence in the industry of the mutual form of charter, which provides executives no incentive to build reserves and provides no natural constituency (e.g. shareholders) supporting such an effort. In these circumstances the only source of pressure for "reserve accumulation" was the supervisory authorities. \textit{Id.} at 28. Surely the consistent failure of the FHLBB, over a period of 50 years and in spite of its awesome regulatory powers, to provide for adequate reserve accumulation, qualifies as a failure of regulation rather than deregulation. \textit{Id.} at 29. Until the need for capital in the industry became desperate, the Federal Home Loan Bank Board resisted the formation of stock charter S&Ls. \textit{See, e.g., Marvell, supra} note 3, at 117; \textit{see also}
\end{footnotes}
This cannot logically be blamed on the deregulation of the 1980's. Similarly, the "operating losses" cited by Strunk and Case began well before deregulation and continued through the industry's frantic efforts to deal with the soaring interest rates that raised the cost of funds above the yield on its portfolios of fixed rate mortgage loans. As discussed in Part II above, these losses resulted largely from fifty years of regulatory micro-management of the thrift industry. By the early 1980's, as a result of previous regulation that essentially limited thrifts to long-term, fixed-rate loans, soaring interest rates had made operating losses inevitable. Imposing these losses on an industry without adequate capital could only lead to widespread insolvencies. This had little or nothing to do with the subsequent deregulation.

Other specific causes cited by Strunk and Case include the inability of Federal Reserve Board Regulation Q to insulate the industry from market interest rates, the disastrous consequences of regulations limiting the industry to investment in long-term, fixed-rate mortgage loans, fraud and insider abuses that went undetected by examiners, ineffective accounting evaluations, delays and indecision in the examination process, a shortage of knowledgeable and experienced examiners, and failure of the FHLBB to deal with problem cases in a timely and adequate manner. Again it seems clear that these factors evidence a failure of regulation, not deregulation. In no way do these factors demonstrate that the deregulation of the 1980's was responsible for the insolvency of the FSLIC.

Of the fifteen "causes" listed in _Where Deregulation Went Wrong_, only two relate in any meaningful way to deregulation, and even these reflect a response by thrifts to specific

*supra* text accompanying note 22; *infra* text accompanying note 43.

43. A typical article describing the closure of 14 insolvent thrifts in Oklahoma in August, 1988, described the source of the problems at each institution. Again and again the article blamed the insolvency on desperate and creative strategies intended to overcome the operating losses that were imposed on all thrifts by national economic and regulatory policies. Finally, the article described one insolvency as resulting from the lack of a creative strategy to counter the operating losses. Kevin Laval, *Federal S&L Sweep Criticized*, _Daily Oklahoman_, Sept. 1, 1988, at 25.

problems created by earlier regulations. For example, the Garn-St. Germain expansion of thrift investment powers and the elimination of stringent lending regulations preceded a wave of imprudent business decisions, but in many cases this was merely a rearranging of the deck chairs on the Titanic. Many of the thrift executives (and regulators) involved already had shown an ample propensity for making poor lending and investment decisions, without deregulation. In any case, most of the losses that ultimately occurred were in the traditional areas of real estate lending and development, where thrift executives and their regulators had by far the most experience and the greatest expertise. Deregulation and expanded thrift powers did not cause these problems.

Similarly, there is little evidence that the much maligned foray of some institutions into junk bond financing and other similar ventures contributed significantly to the problems of the industry and the FSLIC. And while real estate development powers enabled many thrifts to participate directly in the collapse of real estate values in the southwest, any aggressive real estate lender could have done the same, with or without deregulation. Real estate lenders are inherently susceptible to losses in a declining market, and this fact has nothing to do with deregulation. By now it should be abundantly clear that a diversified investment portfolio and the ability to structure creative investment strategies are essential ingredients for any financial institution. It seems fruitless to lament the passing of interest rate and lending controls as if the regulated financial industry might somehow again insulate itself from the forces of external competition.

45. See, e.g., M. Danny Wall, The "Whys" and "Hows" of Investing in a Thrift, 42 CONSUMER FIN. L.Q. REP. 56 (1988). It seems extraordinary that so many analysts have ignored the collapse of real estate values as a major factor in the demise of thrift institutions that were largely limited by law to real estate loans and investments. For a brief description of the fate of American real estate markets in the 1990's, see David Frum, Real Estate, Victim of the '90s, WALL ST. J., May 18, 1992, at A14.

46. Oddly, authors Strunk and Case note that serious deterioration of thrift net worth ratios first occurred during the period when thrifts were most protected from interest rate competition by Regulation Q. See STRUNK & CASE, supra note 35, at 35.
Perhaps the better question is why major segments of the thrift industry blundered so badly in the very areas (real estate lending and development) that they and the regulators knew best, and why the safeguards of examination and supervision failed so miserably to identify and confront the problems before they became unmanageable. In short, why did the thrift industry, which despite the deregulation of the 1980’s remains one of the most heavily regulated industries in America, fare so poorly in comparison to the thousands of other businesses operating in the same environment, in most cases without the “benefit” of any regulation at all? While the answer is not apparent in the formal statements of conclusion by its authors, *Where Deregulation Went Wrong* reveals much information that is of value in analyzing the answers to this question.

First it should be noted that financial problems in the United States have not been limited to the thrift industry. Many industries have undergone a painful restructuring, and America has experienced a massive asset disinflation over the past decade. The banking and energy industries, among others, have faced the same dismal environment that doomed so many thrifts. Yet the consequences for these industries seem to have been more contained. What was different about the thrift industry?

In Chapter Three of *Where Deregulation Went Wrong* (The Net Worth Problem) the authors turn to a critical issue. The simple fact is that by the early 1980’s, after fifty years of massive federal regulation and subsidies (e.g. the Regulation Q deposit interest rate controls), the savings and loan industry was broke.\(^{47}\) Because the thrift industry as a whole already was broke at the time it was deregulated, it had far less than the substantial capital cushion that was needed to offset the risks of competing in the unregulated world of the 1980’s. But how could this be after fifty years of regulatory coddling and subsidies?

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\(^{47}\) By 1983, the industry as a whole was essentially broke. See **Strunk & Case**, *supra* note 35, at 38. If mortgage loan portfolios were revalued on a current market basis, the insolvency came even sooner.
Partly this was a result of the prevalence of mutual charters in the thrift industry. As noted above, this form of charter precluded additions to capital except by retained earnings, and executives of mutual associations had little incentive to build such reserves at the expense of expansion and salaries and other operating expenses.\(^{48}\) Indeed, FHLBB guidelines on salary levels and measurements of success in the thrift industry generally were tied to asset size and growth rather than profitability or reserve accumulation.\(^{49}\) Without shareholders, there was no countervailing pressure to build net worth or the bottom line. The only pressure came from the FHLBB, and that pressure generally was exercised in favor of growth rather than in favor of maximizing income and increasing net worth.\(^{50}\) As a result, the thrift industry entered the period of deregulation singularly ill-equipped to deal with the high risk world of competitive markets that was to characterize the 1980's.\(^{51}\)

Of course there was far more to the thrift crisis than merely a lack of adequate net worth going into a turbulent decade. There were other serious problems including some that were addressed by deregulation. Foremost among these was a management structure atrophied by decades of strict micro-regulation from Washington. Regulators told managers what kinds of loans to make (generally long-term, fixed-rate mortgage loans) and what the underwriting standards would be, and, through examinations, regulated appraisals and credit policies. Virtually every aspect of operations was closely supervised by Washington.\(^{52}\) Geographic and functional expansion were and are strictly limited. During the 1960's and 1970's some managers of mutually chartered thrifts became little more than branch managers for the

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48. See Strunk & Case, supra note 35, at 27; see also supra note 22.
49. See generally Strunk & Case, supra note 35.
50. See id. at 28-33.
51. See, e.g., id. at 49-53.
52. It is ironic that the legislation of 1989-1991 has generally reimposed these regulatory controls on both banks and thrifts so that today, almost any other business has more flexibility and discretion regarding the use of business judgment than does a bank or thrift.
The result was a financial system unable to cope with competition and innovation. This broad characterization probably is unfair to the many outstanding bank and thrift executives who successfully coped with these regulatory limitations, but the fact remains that by the 1970's a number of thrift executives were little more than administrators functioning on behalf of the FHLBB.

The forces of technology and competition served to render this system obsolete, and deregulation in the 1980's sought to permit an infusion of the kind of entrepreneurial spirit that is necessary in order for any business to survive in a competitive environment. Unfortunately, a number of thrift managers and regulators were not up to the job. Examiners, as often as managers, were ill-equipped to make the kinds of business judgments that were required of them during a period of dynamic economic changes, fluctuating interest rates, and volatile collateral values. It does not follow, however, that the fault lies with deregulation or that the solution is a return to the kind of centralized management by regulation that led to these problems in the first place.

Two factors that were discussed in Where Deregulation Went Wrong deserve emphasis: at precisely the worst moment for the thrift industry, with its net worth essentially depleted, the economy was racked by a series of wild economic cycles that saw interest rates surge madly and then collapse

53. Once again the prevalence of mutual charters is partly to blame. Without the pressure of shareholder interests, boards of directors and management answered only to the FHLBB. As a result, the FHLBB exercised considerable operating authority. Probably this is inevitable when a company without shareholders is subjected to strict regulation.

This tradition continued in the form of the thrift management "consignment" program whose institutions (operated by management hand-picked by the regulators) were consistently poor performers. Strunk and Case devote little attention to this aspect of the problem. See STRUNK & CASE, supra note 35, at 120, 128; see also Kenneth E. Scott, Yet Another 'Quick Fix' for the S&L Mess, WALL ST. J., April 3, 1992, at A12; cf. STRUNK & CASE, supra note 35, at 110, 156 (where "greater supervisory discretion over all institutions" is advocated as one solution to the ills of the system); Ken Baebel & Edward Goldings, Management Consignment Comes of Age, 18 FED. HOME LOAN BK. Bd. J. 16 (Nov. 1988).

Clearly in the 1990's, this tradition of regulatory micro-management lives on and, indeed, has spread to the commercial banking system, with potentially dire implications for the entire banking system. See infra Part IX.
(twice in fact during the decade 1978-1988), accompanied first by dizzying inflation and then by a staggering real estate disinflation that hit especially hard in the energy, mining, and agricultural areas of the country that are so dependent on commodities prices. This would be devastating to any industry dependent on stable interest rates and collateral values, as the long-term real estate lender always must be to some extent. This surge and then collapse of real estate values in many areas of the country probably would have doomed the FSLIC insurance fund with or without deregulation. Finally, Congress contributed to the problem by deregulating at the worst time and in the worst possible order: potential costs were deregulated several years before earnings, at the very time when those costs were skyrocketing.\textsuperscript{54} In these circumstances, it is surprising that so many thrifts survived intact and healthy. But this carnage was not an indictment of financial deregulation; it was merely another example of the potential costs of deposit insurance combined with restrictive banking regulation. And the worst was yet to come.

IV. THE INITIAL RESPONSE AND THE ROLE OF SYSTEMIC FACTORS

A. Proposals for Reform

As the seriousness of the FSLIC insolvency became apparent, various proposals surfaced. Business Week suggested that matters could be expedited if the thrift industry was simply abolished.\textsuperscript{55} Others discussed a more eclectic ap-

\textsuperscript{54} “Congress deregulated in exactly the inverse order it should have.” The S&L Mess—and How to Fix It, BUS. WK., Oct. 31, 1988, at 130, 131 (quoting Thomas P. Vartanian, former FHLBB General Counsel) [hereinafter The S&L Mess].

\textsuperscript{55} See id. Astonishing as it probably seemed to those associated with this venerable industry, Business Week was apparently serious; the idea has surfaced periodically ever since, sometimes advanced by competitors eager to be rid of this pesky industry. There are some signs that this may now be changing, at the very moment when the remainder of the thrift industry seems threatened by a disparity between bank and thrift deposit insurance premiums. See, e.g., Barbara A. Rehm, Thrift Fund Dead Without Bank Dollars, Panel Says, AM. BANKER, Mar. 15, 1994, at 1;
proach, suggesting the adoption of a patchwork of reforms that would include some concession to each of the major interest groups involved. The Wall Street Journal divided these proposals into four categories: "Narrow-Bank Plans" (calling for narrow limitations on thrift investment powers); "Early-Closure Plans" (advocating higher capital requirements and early closure of troubled institutions); "Capital and Supervision" plans (calling for "better supervision," additional regulatory reporting requirements, higher capital ratios, and risk-based deposit insurance premiums); and "Reduced Coverage" plans (reducing deposit insurance coverage to less than $100,000 or to cover only a portion of each deposit).

Others urged a return to controls on savings interest rates, in order to contain the costs of funds of financial institutions. This would appear to be a practical impossibility, and the proposal never received serious consideration in view of the new technologies that offer so many market-rate alternatives to depositors. Business Week also editorialized that financial institutions should be required to back insured deposits with Treasury Securities. Others urged the merger of the bank and thrift deposit insurance funds,


56. For a description of several competing theories on how the situation could have been dealt with, see David B. Hilder, Shaky Coverage—Thrift Industry Crises May Force an Overhaul of Deposit Insurance, WALL ST. J., July 27, 1988, at 8 [hereinafter Shaky Coverage].

57. Id. It is noteworthy that to some extent all of these proposals were incorporated in the subsequent legislation, except the proposal to reduce deposit insurance coverage.


59. The likely impact of such a scheme on business lending and investment and mortgage financing was generally not noted in such proposals. Business Week occasionaily seems to reflect an attitude, apparently common on Wall Street, that banks and thrifts are no longer needed because the securities industry can handle all of America's financial needs. See Stop Giving Thrifts A Free Ride, BUS. WK., Oct. 31, 1988, at 172 [hereinafter Free Ride]. These articles frequently criticized the governmen for giving banks and thrifts a "free ride," although it is not clear how healthy banks and thrifts, forced to pay higher assessments to the FDIC as a result of their competitor's mistakes, and shackled by an enormous and unique regulatory burden, are getting a "free ride."
another solution ultimately adopted to some extent, and the phase-out of federal deposit insurance.\(^{60}\) The latter proposal never received serious consideration by policy makers.\(^{61}\) On the other hand, most every commentator acknowledged that the government played a role in creating the problem, and that the taxpayers ultimately would have to finance at least part of the solution.\(^{62}\) The question then became, at what price to the industry?

As noted above, \textit{Where Deregulation Went Wrong} listed—with a brief explanation—a series of reforms that had previously been implemented or proposed by the regulators, and then advocated—with somewhat less detail—a series of additional possible measures. The previous regulatory “reforms” were a precursor of later legislative action: higher net worth requirements; limitations on “direct” (equity) investments by thrifts; stricter single borrower loan limits; tightened requirements for new charters; new classification of assets requirements for troubled loans; new appraisal requirements; mandatory compliance with generally accepted accounting principles (GAAP); accounting changes for acquisition, development, and construction (ADC) loans; revisions to the change in control laws; and increased

\(^{60}\) See, e.g., George Melloan, \textit{It's Time to Put FSLIC Out of Its Misery}, \textit{WALL ST. J.}, Oct. 25, 1988, at A25. For obvious reasons the banking industry has opposed any merger of FSLIC with FDIC. Nevertheless, in the late 1980's Knight-Ridder News Service quoted Citicorp Chairman John Reed as suggesting that FDIC assistance may be inevitable. “It is inconceivable to think of a solution to the FSLIC problem that will not affect our insurance costs.” See \textit{Taxpayer Bailout of S&Ls Seen}, \textit{LAS VEGAS REV. J.}, Oct. 30, 1988. This article suggests that, at the least, FDIC deposit insurance premiums will be raised to the level being paid by thrifts. \textit{Id.} FDIC head William Seidman has suggested other ways that banks and their holding companies might contribute more to the insurance fund. See Catherine Yang et al., \textit{Why Bill Seidman Has Wall Street's Back Up}, \textit{BUS. WK.}, Dec. 12, 1988, at 102-03. Ultimately, as discussed \textit{infra}, the bank and thrift insurance systems were merged administratively and bank insurance premiums rose to the thrift level. At this writing the pressures seem to be mounting for a complete merger of the two funds. See \textit{supra} note 55.

\(^{61}\) \textit{Id.} Strunk & Case assert that “[t]he public will not accept such [ideas] as reducing the insurance limit to $40,000 or $50,000.” \textit{STRUNK & CASE, supra} note 35, at 160; cf. Melloan, \textit{supra} note 60.

\(^{62}\) See Melloan, \textit{supra} note 60; see also \textit{The Speaker's Wishes}, \textit{WALL ST. J.}, Sept. 21, 1988, at 26; \textit{Tax Dollars Seen as Hope for Sick S&Ls}, \textit{DAILY OKLAHOMAN}, Sept. 20, 1988, at 17.
regulatory staff. But if this was an effort to forestall punitive legislation by embracing reregulation at the agency level, it didn’t work; in the subsequent legislation the FSLIC and FHLBB were abolished and most of these proposals were incorporated in even more severe form.

Other changes advocated in Where Deregulation Went Wrong also showed up in the subsequent banking legislation, including greater regulation and supervision over the securities and secondary mortgage market transactions of banking institutions, greater supervisory control over investments in financial instruments (such as futures and options), greater federal control over state chartering authorities and state chartered institutions, and more extensive regulatory involvement in the operation of banking institutions. These proposals also bear a resemblance to the legislative package promoted by the U.S. Savings League in the late 1980’s as an appropriate “price” for the thrift industry to pay in return for a taxpayer bailout of the FSLIC. This “agenda for meaningful reform” also included risk-based capital requirements; capital-based limits on commercial real estate lending authority; restrictions on junk-bond investments, loans to one borrower, and asset growth; and limitations on state thrift agencies and brokered deposits. Once again, it is striking how many of these proposals found their way into the subsequent banking legislation, reflecting the extent to which increased regulation was embraced as the cure-all for deficiencies in the deposit insurance system.

As Where Deregulation Went Wrong makes clear, all of these reforms were premised on the basic theory that deregulation in the industry was the primary cause of the failure of the FSLIC. “In effect, the proposals [amounted] to a call for re-regulation of the thrift industry and [blamed]
much of the industry's current... crisis on abuses of deregulation. It was a neat package, politically safe and convenient, and may even have been welcomed by those thrift executives and regulators who were never comfortable with deregulation in the first place. But to the extent that these "reforms" were premised on the simple conclusion that deregulation was the root cause of the insolvency of the FSLIC, they did not address the more fundamental problems relating to deposit insurance. Instead, they led to additional, often questionable regulation, ultimately doing even more harm to the health of the American financial system. Systemic problems in the deposit insurance system were almost entirely ignored.

B. Systemic Problems in Deposit Insurance

It has been noted elsewhere that there are fundamental contradictions within a system of deposit insurance that uses an implicit taxpayer guarantee to protect private parties in risk-intensive financial transactions so they can earn above-market yields risk-free, and that purports to offset this risk by limiting and regulating the investment of insured deposits in an otherwise competitive and functionally unregulated

68. *Id.*

69. Apparently this was sold to the industry as a kind of preemptive strike on the theory that reregulation was coming, so it was better to help guide the process and influence the outcome rather than offering only futile resistance. Considering the makeup and mood of Congress, that may well have been the case, but jumping on a political bandwagon designed to obscure the real causes of the problems proved to be a high risk strategy, as Congress and the media embraced a very punitive solution. Beyond this, reregulation poses obvious risks for the long-term health of the industry. Some banking industry leaders have long been aware of this danger, but their views have not prevailed. See, e.g., *Banking Official Sees Bleak Future*, DAILY OKLAHOMAN, Dec. 6, 1988, at 22:

The commercial banking industry easily could become obsolete without serious legislative reform, the president of the American Bankers Association warned . . . .

Technology has permitted easy entry into the financial services business by institutions outside the traditional banking industry . . . and their services are expanding.

*Id.*
financial market. It is these dichotomies that create the much-discussed "perverse incentives" that are inherent in any government system of deposit insurance. These perverse incentives are a by-product of combining virtually unlimited deposit insurance with "functional" regulation—that is, direct regulation of investment activities as the safeguard for deposit insurance. But it is not clear that any amount of regulation, no matter how extensive the powers of the regulatory agency, can fully compensate for the basic incentive for managers to risk someone else's money for short term gain or for the inherent inability of examination staffs to guard against imprudent risks by predicting the future success or failure of business and risk-related decisions. Restricting and regulating activities' powers may even make things worse by limiting flexibility and creativity, forcing managers to take even greater risks within the parameters of limited activities to compensate for an undiversified and inflexible business strategy. Despite the media focus on creative savings institution transactions involving such things as junk bonds, race horse sperm banks, and futures trading, it was in the traditional arena of real estate lending and investment—where the experience level was highest and the impact of the subsequent reform legislation is the lowest—that most of the losses in the thrift industry occurred. Viewed in this light, it is difficult to see how any of the 1989-1991 "reforms" would have prevented the deposit insurance crisis. An aggressive bank or thrift manager seeking to

70. See, e.g., Fred Smith, Cap the Financial Black Holes, WALL ST. J., Sept. 29, 1988, at 24; Alvin C. Harrell, Commentary: A Perspective on the Financial System, 42 CONSUMER FIN. L.Q. REP. 119 (1988); cf. STRUNK & CASE, supra note 35, which recognizes this dichotomy, but again seems to equate business risk with deregulation, as if the industry can avoid market and competitive risks by returning to a regulated environment. See generally BARTH, supra note 3; KANE, supra note 3.

71. See, e.g., Smith, supra note 70; Free Ride, supra note 59; see generally BARTH, supra note 3; KANE, supra note 3.

72. For example, insider fraud, frequently cited as a primary cause of the problem, can be divided into three categories: "Dead horse-dead cow" swaps, where loans and investments were traded between parties to establish artificial valuations or to avoid detection of losses by regulators; "Uncle Sap Loans," where bankers conspired with borrowers to loot the institution by making bad loans; and "Friends in Government," where political pressure was used to delay enforcement actions. See, e.g.,
maximize current returns at the wrong point in an economic cycle can lose just as much money by making bad real estate loans as by investing in junk bonds. The notion that real estate mortgage lending is inherently safe is surely untenable after the experience of the last decade. Yet the reforms of 1989-1991 do not address these structural problems and may even exacerbate them.

The basic problem is the incongruity of maintaining functional regulation in a competitive business environment as a means of guaranteeing the safety of large investments (through deposit insurance) in a high-risk business. Functional regulation presupposes that examination and supervisory authorities can consistently measure the adequacy and predict the outcome of business strategies and decisions in a competitive and constantly changing economic environment. It is unlikely that this will ever be the case. One would have to believe that, given more examiners, greater powers, and a larger budget, the banking regulators would have foreseen the general collapse of inflation and the dramatic deflation in certain commodities and real estate values over the past decade. One may as well believe that a properly staffed and funded Department of Energy could foresee and prevent fluctuations in oil and gas prices or that a larger staff and more enforcement powers for the Department of Agriculture could prevent recurring problems in agriculture.73

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Eugene H. Melthvin, The Best Way to Rob a Bank, READER'S DIG., Aug., 1988, at 161. Again, it is difficult to see how deregulation contributed to age-old regulatory problems such as these, or how reregulation will serve to prevent them in the future. Nonetheless, the Reader's Digest advocates more examiners and “great civil-enforcement power.” Id. at 168.

73. The calls for more enforcement powers were particularly absurd, in view of the overwhelming battery of such powers that were already available. The savings and loan industry has, for at least 50 years, been one of the most heavily regulated in America, and even some of the “deregulation” legislation included greater regulatory enforcement powers. See, e.g., NORTON & WHITLEY, supra note 7, § 6.04(3) (summarizing the expansion of enforcement powers under FIRRA, the Financial Institutions Regulatory and Interest Rate Control Act of 1982, Pub. L. No. 95-630, 92 Stat. 3641). Members of Congress have still not learned this lesson. See, e.g., Bank Regulators Let Claims Slip Away, Critic Charges, DAILY OKLAHOMAN, June 3, 1992, at 19 (describing a congressional allegation that 75% of S&L failures involve wrongdoing).
In reality, the entire system of financial examination and supervision is ill-suited to the control of business decision-making, aside from traditional auditing functions to monitor compliance with legal and accounting standards relating to such matters as internal controls, financial reserves and ratios, and compliance with consumer credit and other laws. Once the examination authorities turned over these functions to independent auditors—who admittedly are better equipped for this task—it left little for bank and thrift examiners to do except to focus on judgmental matters such as the direction of investment policies and the quality of loan underwriting strategies and decisions. Yet it is in these areas, where qualitative examiner oversight has been the greatest, that the problems have been the worst. There is no significant evidence that more examiners, a bigger regulatory budget, increased regulatory enforcement powers and penalties, and regulatory micro-management of business decisions will help prevent bank and thrift insolvencies, as Strunk and Case (and others) have suggested. Yet this was the general thrust of the legislative and regulatory response to the problems in the deposit insurance system.

Armed with scholarly commentary like Where Deregulation Went Wrong, and backed up by an almost hysterical popular media, it was probably inevitable that Congress would embrace punitive reregulation as the primary solution to the insolvency of the deposit insurance funds. In turn, this has increased costs and reduced the strategic flexibility of banking institutions, increased the industry’s dependence on the business judgment of Congress and the regulators, and engendered a lending contraction that created the recession of 1990-1991 and hobbled the anemic economic recovery of 1992-1993.

74. Federally insured S&Ls have long been required to submit to an annual accounting audit, in addition to regular federal examinations, partly to assure that thrifts are complying with GAP. Ironically, in many instances it was the federal regulators who led the fight to substitute creative regulatory accounting principles, in an effort to improvise technical sources of capital to bolster the published balance sheets of insolvent thrifts and make the regulatory system appear effective.

75. See Strunk & Case, supra note 35, at 156.
But before turning in more detail to the legislative response to the deposit insurance crisis and its consequences, it may be instructive to review the response of the popular media in the United States to the deposit insurance crisis and the role of this media response in framing the political environment for the debate on the appropriate solution.

V. THE ROLE OF THE U.S. MEDIA: A BONFIRE OF CREDIBILITY

Any consideration of the impact of the 1980’s deposit insurance crisis on American public policy must take into account the extraordinary media environment in which the public policy deliberations occurred. Media coverage of the deposit insurance crisis during the period of 1989-1991 served to reinforce significant public and political misconceptions about the problems involved. A cover story in *Newsweek* magazine, entitled *Bonfire of the S&Ls*, 76 was typical of this coverage and will be used as an example for purposes of this analysis. The *Newsweek* story illustrates the ways that media coverage has tended to influence the public debate on deposit insurance.

As just one example, the first page of the *Newsweek* article described the basic problem as follows:

Rogues and swindlers paraded across the business pages and through the courts, accused of looting astronomical sums. Inept state and federal regulators fumbled to figure out what was going on, and bumbling politicians resolutely looked the other way, all the while accepting millions in campaign contributions.

. . . .

It is an unfair drain on honest citizens to pay the piper for knaves and fools, and it will hit the young and poor harder than the old and rich. 77

76. Larry Martz et al., *Bonfire of the S&Ls*, *Newsweek*, May 21, 1990, at 20 [hereinafter *Bonfire*].

77. *Id.*
A sidebar to the *Newsweek* article, entitled *The Operators*, described the FSLIC insolvency: "Taking advantage of permissive rules, inept regulators and trusting depositors, S&L wheeler-dealers prospered by sinking other people's savings into high-risk real-estate speculations." This statement was followed by the pictures of three thrift executives, implicitly representing the entire thrift industry, with the following description of each:

**DON DIXON**

King of the Texas "loan stars," Dixon bought a $2 million beach house and airplanes with S&L money.

**DAVID PAUL**

Chairman of a Miami S&L, Paul says he kept his thrift's $13 million Rubens at his house for safekeeping.

**CHARLES KEATING**

The former head of Lincoln Savings is the target of a $1.1 billion fraud suit—the largest in U.S. history.

As to the losses, *Newsweek* reported that "[t]he money, $250 billion of it including bailout costs, was stolen or squandered on playthings and development projects that made no sense: shopping centers in the desert, overbuilt condos, grandiose

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78. *Id.* at 20-21. It might be noted that very few of these "S&L wheeler-dealers" prospered as a result of his or her foray into the thrift industry. As for sinking depositors' money into real estate, that is precisely what thrifts were (and are) required by law to do. That real estate turned out to be more "speculative" than anyone imagined, partly as a result of changes in the U.S. tax laws, presumably that is not the fault of the thrift industry or its regulators. Today banking institutions are again being pressured to extend high-risk real estate loans, this time under the Community Reinvestment Act and fair-lending guidelines. See, e.g., Harold Black, *Is There Bias in Lending? The Numbers Won't Tell You*, AM. BANKER, Mar. 21, 1994, at 8.

79. *Id.* at 21.
new cities like Keating's Estrella project outside Phoenix with almost nobody to live in it.\textsuperscript{80}

The \textit{Newsweek} story is typical tabloid journalism, and if nothing else illustrates how the American media has been influenced by the success of publications like \textit{The National Enquirer}. Still, \textit{Newsweek} purports to be a serious journal, and it was striking to see such publications ignore the serious issues in order to focus entirely on the more sensational aspects of the deposit insurance crisis. Among other things, \textit{Newsweek} used isolated examples, shown in the most unfavorable light and given unwarranted emphasis, to misrepresent the basic nature of the problem. For example, the sentence quoted above, claiming that "\$250 billion . . . including bailout costs, was stolen or squandered," uses a figure that includes administrative, legal, and other costs—some of them perhaps excessive—incurred in the federal relief effort, but characterizes the entire amount as part of the "theft" in the industry. As to the real estate "development projects" that made no sense, the authors of the \textit{Newsweek} article imply that they knew all along that real estate collateral values would crash, but of course most ordinary mortals had no way to predict that in advance.

What was the point of this media crusade to vilify the thrift industry and its business misjudgments? Whatever its purpose, the obvious implication was that the deposit insurance system could only be saved by imposing additional regulations and even criminal sanctions on the managers of banks and thrifts. This implication had dire consequences for public policy and the American economy, as it served to justify the subsequent reregulation and even criminalization of banking law and supervision.

Of course, funding of real estate is what thrifts were and are required by law to do, regardless of the prospects for real estate values. To do otherwise would be a violation of a thrift's charter obligations—and associated legislative requirements, such as the Community Reinvestment Act. In these circumstances when real estate values crash, obviously

\textsuperscript{80} \textit{Id.} at 23.
the result will be disaster. For the thrift industry and its deposit insurance fund this was (and is) mandated by law and regulation.\textsuperscript{81} The insolvency of the FSLIC was the result of a clear public policy choice to subsidize real estate lending and development. To blame the resulting costs on fraud in the industry served only to obscure the real lessons of the FSLIC insolvency.

\textit{Newsweek} further fueled the fires of political resentment by speculating that "[t]he burden will be unfair, since honest people [will] have to pay for thieves."\textsuperscript{82} Even assuming that thrift highflyers were responsible for significant losses, this was a gross misrepresentation of the problem. As Charles Keating has reportedly noted, even if he was personally responsible for losses of $1 billion, that does not explain where the other hundreds of billions of dollars went.\textsuperscript{83} There were just not that many highflyers or big operators in the industry. In its \textit{Bonfire} article, \textit{Newsweek} suggested over and over that the money was embezzled by crooks in the industry, but Professor Stephen K. Huber of the University of Houston has identified the real culprit: The benefits went to the millions of Americans who enjoyed low-interest, fixed-rate home mortgage loans during most of the postwar period, even after market interest rates rose well above the yield on thrift mortgage loan portfolios.\textsuperscript{84} In addition, as \textit{Newsweek} acknowledged in passing, some of the benefits went to the savers who earned high interest rates on savings deposits without risk, at the expense of the deposit insurance fund.\textsuperscript{85} But the media clearly was not interested in this aspect of the story; \textit{Newsweek} failed even to mention the devastating asset-liability mix that was mandated by law for thrifts. Instead, \textit{Newsweek} and much of the rest of the cultural elite seemed

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\textbf{81.} & Id. In this regard, history shows every sign of ultimately repeating itself. \\
\textbf{82.} & See Id. \\
\textbf{83.} & Id. \\
\textbf{84.} & See Huber, supra note 9. \\
\textbf{85.} & See Bonfire, supra note 76, at 23. \\
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determined to blame greed, deregulation, and crooks in the industry.\textsuperscript{86}

In the same issue, Newsweek featured a related article on the causes of the problems in the thrift industry, entitled \textit{How Did It Happen?}\textsuperscript{87} Demonstrating again that Newsweek has its own axes to grind, the article began by summarizing its conclusions as to the causes of the debacle: "The warped campaign-finance system, failures to police white-collar crime, ethical permissiveness—all contributed to the S&L crisis and all could, without dramatic reform, cause the next scandal."\textsuperscript{88} It seems incredible that Newsweek could so completely overlook the basic structural factors that brought down the thrift industry and have doomed every system of deposit insurance in American history. While there may well be additional problems in the banking system, \textit{How Did It Happen?} demonstrates how ill-equipped the American media is to understand or explain the important issues involved.

\textit{How Did It Happen?} did note, very briefly, that the high inflation of the 1970's left thrifts in an untenable position, holding low-yield, fixed-rate mortgages while paying higher market rates on savings.\textsuperscript{89} But there was no mention of the fact that this scenario was mandated by federal law, or of the impact of federal regulation on thrift operations and the decline in thrift capital ratios in the 1960's and 1970's. Instead, the article laid the blame on the "deregulation" of the 1980's, which permitted thrifts to "[buy] everything from

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\textsuperscript{86} See generally Harrell, supra note 20. Professor Huber estimated that only about 10-15\% of the losses in the industry were due to fraudulent or obsessive practices, the rest being the result of basic structural flaws in the system and common negligence. Huber, supra note 3, at 79. Business Week put the losses due to fraud ("not as important as many people think") at $15 billion, and pointed out that of the $500 billion total estimated cost of the "bailout," only $155 billion was attributable to losses in the industry. The rest, $345 billion, was attributable to the government's administrative costs, interest, and bungling. Michael J. Mandel & Jim Bartimo, The Incredible Expanding Thrift Bailout, BUS. WK., May 28, 1990, at 60.

\textsuperscript{87} Steven Waldman & Rich Thomas, How Did It Happen?, NEWSWEEK, May 21, 1990, at 27.

\textsuperscript{88} Id.

\textsuperscript{89} Id. In view of the federal mandate to hold such mortgages, it is ironic that this section of How Did It Happen? is entitled "A Failure of (De)Regulation." Cf. Harrell, supra note 20, at 216-17.
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palatial estates for their owners to an Iowa plant that converted manure to methane."90 How can it be that a purportedly serious article could ignore the fact that virtually all significant thrift losses resulted from real estate lending and investment, which despite the very modest "deregulation" of the 1980's was still largely mandated by law and regulation?

*Newsweek* also mentioned, in two brief sentences, the possible impact of increasing the federal deposit insurance limit to $100,000, but then seemed to infer that this only became a problem because of things like Don Dixon taking his wife on a "gastronomic fantastique" tour of fancy European restaurants.91 Perhaps this is the kind of thing *Newsweek* 's readers want to know about, but it has very little relevance to the insolvency of the deposit insurance system. *Newsweek* 's subsequent suggestion that Don Dixon's eating habits would have been different if only there had been more and better-paid federal examiners with greater regulatory powers merely serves to illustrate the kinds of political motives that have been driving American banking policy since 1989.

In *Bonfire*, *Newsweek* lists all of the other things that society could buy with $250 billion—defense, education, health care, environmental cleanup, and infrastructure.92 But of course, any federal subsidy precludes use of the same funds elsewhere. Obviously, if it had not been for federal deposit insurance, society could have done some of those other things instead. Said another way, instead of subsidizing real estate by forcing thrifts to invest in fixed-rate mortgages, Congress might have limited the thrift industry to investment in auto loans or educational loans, thereby subsidizing those industries. Alternatively, Congress might have limited thrifts to financing the cleanup of environmental hazards, or to financing the federal deficit. Instead, Congress decided to generously insure deposit accounts and to essentially limit

90. Waldman & Thomas, supra note 87.
91. Id.
92. See *Bonfire*, supra note 76, at 20.
investment of thrift deposits to real estate. In an era of rising interest rates and declining real estate values, the ultimate results were inevitable, but unless one is going to conduct a comprehensive review of government spending priorities, what is the point of emphasizing how many aircraft carriers could have been built instead?\textsuperscript{93} The suggestion in \textit{Newsweek} that somehow America could have had all of its postwar housing at low, fixed interest rates and still have spent the money spent elsewhere, if only there had not been all of these crooks in the thrift industry, simply ignores the real nature of the public policy choices that must be made.

Having largely ignored the real causes of the deposit insurance crisis, \textit{Newsweek} went on to grind its own axe. An entire page was devoted to "The Impact of Political Money" and the need to reform the role of lobbying and campaign finance.\textsuperscript{94} While this is undoubtedly a sexy topic, the role of the "Keating five" and others like them was little more than a footnote in the development of the deposit insurance crisis. What about the other hundreds of billions of dollars in losses? Even \textit{Newsweek} claims nothing more than some delay in a few notorious thrift closures as a result of the "political money."\textsuperscript{95} Yet it concluded that "never has so much money gone to such key legislators who worked so hard for measures that cost taxpayers so dearly."\textsuperscript{96} This absurd statement was followed by yet another reminder that "[n]ear Phoenix, Keating built the Phoenician, a lavish hotel with gold-leaf ceilings and $12 million in Italian marble."\textsuperscript{97} The relevance of this observation to the issue in question is not entirely clear, except perhaps to support \textit{Newsweek}'s general inference that the existence of a luxury hotel near Phoenix is evidence that American society is suffering from some sort of moral

\begin{footnotes}
\footnote{93. Today the U.S. government subsidizes housing finance even more directly, through FNMA and the FHLMC. These entities represent enormous interest rate and credit risks for the U.S. taxpayer, as they are in essence huge, government sponsored thrift institutions. See, e.g., Howard Rudnitsky & Matthew Schirin, \textit{Nice Work If You Can Get It}, \textit{Forbes}, May 11, 1992, at 138.}
\footnote{94. Waldman & Thomas, supra note 87, at 28.}
\footnote{95. \textit{Id.}}
\footnote{96. \textit{Id.} What's that sound coming from Winston Churchill's grave?}
\footnote{97. \textit{Id.}}
\end{footnotes}
decay that can only be corrected by more government regulation.

*How Did It Happen?* concluded by noting briefly the inherent "moral hazard" of federal deposit insurance, and to its credit recognized that the deposit insurance system is simply more costly than our politicians ever have admitted.98 Nevertheless, the article then reverted to form and laid the final blame on a "Culture of Financial Crime," comparing bank and thrift executives who make bad loans to a bank robber or a purse snatcher, and comparing society's failure to confront these issues with Adolf Hitler's theory of "the big lie."99 While the *Newsweek* features provide no specific recommendations, one is left with the distinct impression that only the regulators really understand the banking business and that the only solution is to give the regulators absolute power to jail lenders, or seize their property without due process, and to insulate the regulators from judicial review and the political process. In the context of this kind of media environment, the extraordinary banking legislation of 1989-1991 becomes more understandable if not excusable.

The sensationalism and mischaracterization of the causes of the FSLIC insolvency by the popular media generated a widespread public misunderstanding that made rational discussion of genuine solutions all but impossible. In response, Congress and the Bush administration embraced a cure that was probably worse than the disease, as discussed next.

VI. THE LEGISLATIVE RESPONSE


As noted in Part IV above, when the seriousness of the deposit insurance crisis became apparent in the late 1980's, numerous proposals for reform became the subject of debates

98. Id. at 32.
99. Id.
within government, business, and academic circles. Generally these proposals can be grouped into two broad categories: (1) those proposals intended to reduce the threat to the deposit insurance fund by reducing the level of financial risk in the banking system, generally by means of increased regulation and regulatory powers; and (2) those designed to reduce the scope of deposit insurance or the liabilities of the deposit insurance funds. Attendant to these deposit insurance-related proposals were various other banking law proposals such as nationwide branching and expanded bank powers—not enacted as of this writing—and consumer protection proposals such as “Truth in Savings.”

This discussion will focus on those provisions enacted that most directly relate to deposit insurance and “safety and soundness” issues. Some of the more interesting proposals for deposit insurance reform that were not seriously considered will be discussed in Part VIII below. While the 1989-1991 legislation incorporates some elements from both of the basic approaches noted above, by far, the greater emphasis in the 1989-1991 legislation was placed on the first type of proposals, those designed to reduce the level of risk in the system by means of increased regulation. As discussed in Part VII below, this has had significant implications for the American banking system and economy.

The banking legislation of 1989-1991 reflects a basic public policy decision to place restrictions on the banking system rather than seeking to limit the scope of deposit insurance liabilities. Apparently this reflects the policy preferences of the major players in American government today. As previously noted, the popular media sensationalized the criminal aspects of the deposit insurance problem, probably because that made better copy for public consumption. This in turn reinforced a political propensity to blame “crooks” in the industry as an alternative to admitting that a major government entitlement program had simply failed. It also permitted the government to extend its control over

100. This was enacted as part of the FDIC Improvement Act of 1991, discussed infra Part VI.D.
the financial system. Obviously eager to avoid blame and to enhance their own powers, the regulatory agencies also embraced a regulatory expansion as the preferred solution. The Bush administration, stung by allegations arising from the involvement of the President's son in a failed Colorado thrift, was in no position to protest. In any case, the Bush administration seemed to favor a shift of financial risk (and financial rewards) to firms outside the banking system.\footnote{See, e.g., Richard X. Bove, Brokered Deposit Rule Will Cripple Bank Lending, AM. BANKER, June 3, 1992, at 1; Richard X. Bove, Dawn of an Era Offers Profits To the Nimble, AM. BANKER, May 28, 1992, at 1 [hereinafter Dawn of an Era]; Richard X. Bove, National Policy Will Not Favor Banks Anymore, AM. BANKER, April 30, 1992, at 1 [hereinafter National Policy].} As a result, virtually every major player in the development of the 1989-1991 legislative response was viewing the crisis from a perspective that favored reregulation and even criminalization of banking as the solution to the insolvency of the deposit insurance funds. In this environment it is not surprising that the resultant legislation reflects that approach. Each of the major 1989-1991 banking laws will now be described briefly in terms of its impact on the deposit insurance and banking systems.

\section*{B. FIRREA}

detail is beyond the scope of this article. Nonetheless, the basic thrust of FIRREA, in the context of its impact on deposit insurance, will be briefly noted.

FIRREA abolished the insolvent FSLIC and established a new insurance fund for thrifts called the Savings Association Insurance Fund (SAIF). The name of the insurance fund for banks was changed to the Bank Insurance Fund (BIF). Both the SAIF and the BIF are administered by the FDIC.\textsuperscript{104} The remaining FSLIC assets and liabilities were transferred to the FSLIC Resolution Fund—administered by the FDIC—for liquidation or other disposition.\textsuperscript{105}

The Resolution Trust Corporation (RTC) was established to resolve thrifts that became insolvent between January 1, 1989 and August 9, 1993. This time period was later extended. The RTC is administered by the FDIC and is scheduled to go out of existence in 1996.\textsuperscript{106} The Resolution Funding Corporation (REFCO) was established to issue $30 billion in bonds for use by the RTC in resolving insolvent thrifts. The thrift industry is required to contribute money through assessments on the regional Federal Home Loan Banks (FHL Banks), which are owned by thrifts, and through direct assessments as needed to service and pay the REFCO bonds.\textsuperscript{107} As the needs of the RTC have increased over time, Congress has periodically supplemented these sources of funding with direct appropriations from the United States Treasury. Although such appropriations have become increasingly difficult to obtain, at this writing, the necessary funding (and its source) remains uncertain. The total cost—most of it in the form of administrative costs and other losses incurred by the FDIC and RTC—probably will be in the range of $250-$500 billion.

The independent FHLBB was abolished and was replaced by the Office of Thrift Supervision (OTS), an office

\textsuperscript{104} See FIRREA § 211. Of course both SAIF and BIF are "funds" only in an accounting sense, as there is no segregated depository or other means to trace the actual cash flows within the federal government.
\textsuperscript{105} Id. § 215.
\textsuperscript{106} Id. § 501.
\textsuperscript{107} Id. § 511.
in the United States Department of the Treasury.\textsuperscript{108} The FHL Banks, which previously had functioned as an administrative arm of the FHLBB—despite being “owned” by their thrift members—were removed from the regulatory function and placed under a new agency, the Federal Housing Finance Board (FHFB).\textsuperscript{109} As a result of these changes, thrifts pay the OTS directly for examinations. Obviously one purpose of these changes was to punish the FHLBB by legislating it out of existence and transferring its functions to other agencies. Nonetheless, for most of the people involved, this meant little more than a change of agency names. At the time the FDIC was perceived as being rewarded for doing a good job of preserving its insurance fund with a massive increase in its powers and jurisdiction and by the dismemberment of a competing agency (FHLBB/FSLIC). Today, with the FDIC having teetered on the brink of insolvency despite sharply higher deposit insurance premiums and a new line of credit from the United States Treasury, and with a new political focus on promoting credit for social purposes, that perception has changed. At this writing, proposals are under discussion that would essentially strip the FDIC of its regulatory functions, leaving it as solely a deposit insurer. Still, under the 1989-1991 legislation the FDIC retained—and even furthered—its power though with increased Congressional involvement, as discussed below, in part because an enforcement-minded Bush administration and a reregulation-minded Congress had no place else to go for a mechanism to enforce the multitude of new banking law provisions and regulations. As noted, the Clinton administration has proposed consolidating all bank regulatory powers into a single, powerful agency that would be more amenable to the influence of the President.

Under the 1989-1991 legislation, deposit insurance premiums have risen dramatically for both banks and thrifts with additional increases likely.\textsuperscript{110} Dramatically higher

\begin{flushleft}
\textsuperscript{108} \textit{Id.} § 301.
\textsuperscript{109} \textit{Id.} § 702.
\textsuperscript{110} \textit{Id.} § 206; \textit{see also} sources cited \textit{supra} note 103. Current estimates call for BIF premiums to peak in 1996, but absent structural changes there is no end in sight for
\end{flushleft}
capital standards were also imposed on banks and thrifts by this legislation. Institutions that fail the capital standards are prohibited from using deposit brokers and face other regulatory penalties including (at stipulated benchmarks) mandatory receivership.

FIRREA placed severe new restrictions on thrift lending and investment activities. The FDIC was given override authority to prohibit thrifts from engaging in any activity that it characterizes as a threat to the deposit insurance fund. A new Qualified Thrift Lender (QTL) test restricts thrifts to real estate lending activities and some consumer finance, and contains new penalties for deviation. Thrifts are prohibited from acquiring below-investment grade ("junk") bonds and were required to divest existing holdings—at the "bottom" of the market. Nonresidential real property loans were limited to 400% of capital—with some exceptions.

There were various changes to the rules governing mergers and acquisitions of financial institutions designed to make it easier for banks to acquire thrifts. In addition,

SAIF premium increases. See, e.g., Rehm, supra note 55.


112. FIRREA § 224.

113. Id. §§ 301, 303, & 714(b).

114. Id. § 222.

115. Id. § 301.

the regulatory authorities were given extensive new civil and
criminal enforcement powers, and $75 million annually was
appropriated for investigation and prosecution of banking
crimes.\textsuperscript{117}

Overall, FIRREA was premised on the theory that the
deposit insurance system was inherently sound and that the
insolvency of the FSLIC was an aberration caused by de-
regulation in the 1980's and widespread dishonesty and
incompetence in the thrift industry. This was a beguiling
view for a Congress and administration (and a public)
hesitant to face up to the economic and political realities
of—and their responsibility for—a failed deposit insurance
and bank regulatory system. In effect, FIRREA punished
healthy banks and thrifts (and—indirectly, through higher
banking costs—the public) for the failures of this system.

Immediately after FIRREA was enacted, the American
economy entered the longest peacetime recession in its
history. Very few politicians or commentators seem to have
made the connection between these two events, but it seems
inescapable. The recession was driven by a lending slow-
down that was triggered by the punitive approach of FIRREA
and its progeny and the accompanying campaign to vigorou-
ly prosecute directors, managers, professionals, and bor-
rowers associated with failed banks and thrifts. As the
economy faltered, Congress responded with part two of the
trilogy of new laws comprising the 1989-1991 banking
legislation, the 1990 Crime Control Act.

\begin{center}
\textbf{C. The 1990 Crime Control Act}
\end{center}

The Comprehensive Thrift and Bank Fraud Prosecution
and Taxpayer Recovery Act of 1990, Title 25 of the Crime

Control Act of 1990,\textsuperscript{118} was signed into law by President Bush on November 29, 1990. The purpose was to tighten further the regulatory control of the banking system and to provide additional civil and criminal penalties for bankers who deviate. As noted by other commentators,

[t]he Act was adopted in the context of highly publicized statements . . . that as many as 60% of the thrift failures [were] attributable to [criminal and fraudulent] activity. The Act also reflects a prevailing view in Washington that, because of the staggering cost that will be incurred by the government . . . in connection with the failure of so many financial institutions . . . extreme measures are justified.\textsuperscript{119}

FIRREA had failed to correct the problems in the deposit insurance system and in fact worsened the condition of the financial system, torpedoing the economy in the bargain. In response Congress, reiterating its approach to financial regulation, enacted a measure that was even more extreme.

The Crime Control Act authorizes an injunction to seize the assets of any person designated by the regulatory agencies\textsuperscript{120} and also authorizes prejudgment attachment of the personal assets of any person subject to a proceeding brought by the regulatory agencies.\textsuperscript{121} The Crime Control Act also permits the regulatory agencies—without prior notice, a hearing, or any judicial oversight—to issue a cease and desist order freezing the assets of any person.\textsuperscript{122} These and other similar provisions in the Crime Control Act seemingly deprive financial institutions of the most basic due process requirements of the Constitution.

The Crime Control Act also permits the FDIC, RTC, or other regulatory agency acting as conservator or receiver to avoid any transfers made by institution-affiliated parties

\begin{footnotes}
\item[119] Stevens et al., supra note 4, at 181 (from which this discussion is derived).
\item[120] Crime Control Act § 2521(a).
\item[121] Id. § 2521(b).
\item[122] Id. § 2596.
\end{footnotes}
within five years of the appointment.\textsuperscript{123} This places in jeopardy any transaction with a thinly capitalized banking institution or its affiliated parties. The Act also provides subpoena power to the regulatory agencies and provides rewards for "whistle-blowers" and others who turn in their bosses or colleagues for banking law violations.\textsuperscript{124} Additional investigative, restitutatory, and civil and criminal forfeiture powers are provided,\textsuperscript{125} and "golden parachutes" can be knocked out when a bank is at risk of becoming insolvent.\textsuperscript{126} Liabilities of institution-affiliated parties to the regulatory agencies are, in many cases, not dischargeable in bankruptcy; the agencies can override the normal bankruptcy exemptions so as to seize homesteads and other property normally exempt from creditors.\textsuperscript{127} The Crime Control Act authorizes fines and penalties up to $20 million and life in prison without parole for certain regulatory violations.\textsuperscript{128} The statute of limitations is extended to ten years by the Act.\textsuperscript{129}

The Crime Control Act further criminalized the bank regulatory process and imposed even more severe penalties for financial institution-affiliated parties who violate the very complex matrix of regulations created by Congress and the regulators. Not surprisingly, bankers became even more risk-averse, and the economy stumbled again in the aftermath of this legislation. As the economy stagnated, even more banking institutions became insolvent, and the cost of resolving insolvencies rose. By mid-1991, the FDIC was nearing insolvency. Congress responded with the FDIC Improvement Act of 1991.

\begin{flushleft}
123. Id. § 2528.
124. Id. §§ 2534, 2561-94.
125. Id. §§ 2508, 2509, 2524, 2525, & 2532.
126. Id. § 2523; see also Gregory J. Pulles, The FDIC Proposal on Golden Parachutes and Indemnification, 46 CONSUMER FIN. L.Q. REP. 70 (1992).
\end{flushleft}
D. FDICIA

The FDIC Improvement Act (FDICIA) was enacted in November, 1991.\textsuperscript{130} David Roderer, a noted banking law specialist with the law firm of Jones, Day, Reavis & Pogue in Washington, D.C., identified twelve “themes” that seem to run throughout this seemingly disjointed piece of legislation:

1. FDICIA again enhanced the powers of the FDIC as primary regulator of the banking system.
2. It reinforced the move towards nonjudicial enforcement remedies by further enhancing the administrative enforcement powers of the regulatory agencies.
3. It reemphasized on-site bank examinations.
4. It increases functional (activities) regulation by limiting the permissable activities of banking institutions.
5. It provided multiple regulatory agencies for each institution.
6. It reemphasized capital as a matter of primary importance.
7. It provided mandatory trigger points for regulatory seizures (for example, based on capital).
8. It adopted the traditional thrift model of regulation by essentially prohibiting any activity not specifically permitted by law or regulation.
9. It also adopted the traditional thrift regulatory model by mandating consumer services and disclosures and creating new substantive consumer rights (e.g., the Truth in Savings Act).
10. It contained a large number of provisions promoted by special interest groups.
11. It dealt with disposition of assets by the RTC.

12. It required early intervention in the form of regulatory seizure of still-solvent financial institutions.\(^{131}\)

FDICIA affects every bank, thrift, and credit union and its officers, directors, accountants, attorneys, and consultants.\(^{132}\) As noted, the scope and variety of the FDICIA rules defy the common belief that this was a "narrow" bill—though admittedly it may be termed "narrow" in comparison to some of the proposals that were attached to earlier versions and were ultimately rejected by Congress. Generally, regulators and institutions had one year to implement the changes. Some of the specific changes include

1. Federal regulators were directed to set compensation standards to essentially determine the salaries of financial institution managers.
2. Audit committees must be made up of outside directors and in large institutions must have members with financial expertise and outside counsel.
3. Federally chartered banks and thrifts can acquire or be acquired by any insured depository institution.
4. The Truth in Savings Act and its implementing regulation (Federal Reserve Board Regulation DD) mandate uniform disclosures of certain data, based on the Truth in Lending Act model.
5. Institutions with capital below 2% must be placed into conservatorship.
6. Institutions are placed into five categories: (1) Well Capitalized, (2) Adequately Capitalized, (3) Undercapitalized, (4) Significantly Undercapitalized, and (5) Critically Undercapitalized. Subject to certain exceptions, institutions in the

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131. David Roderer, Address at CLE Seminar in Oklahoma City on Financial Institutions Law in the 1990's (May 1, 1992).
132. This summary of the FDICIA is attributed to a memorandum of Dec. 14, 1991, from the Washington law firm of Malizia & Spidi. The assistance of Samuel J. Malizia and Bravitt C. Manley, Jr., is gratefully acknowledged.
two lowest categories must dismiss all directors and senior officers in office more than 180 days prior to the date the institution became undercapitalized.

7. Tougher restrictions were imposed on loans to financial institution insiders.

8. Independent annual audits are required for all banks and thrifts and assets over $150 million; all audits must follow standards set by the regulatory agencies.

9. The regulatory agencies may remove, suspend, or bar any independent auditor, for "good cause."

10. State banks must conform their activities to those permitted for national banks.

11. FDICIA adds twelve new grounds for federal seizure of a bank or thrift.

12. Enforcement actions are authorized on new, amorphous grounds such as unsatisfactory asset quality, management, earnings, or liquidity.\footnote{133}

For thrifts, there was some minor consolation. Thrift consumer lending authority was increased from thirty percent to thirty-five percent, the Qualified Thrift Lender test was reduced from seventy percent to sixty-five percent, and the range of qualifying assets was expanded. Arguably, the value of the thrift charter was enhanced relative to the bank charter because the new regulatory powers and restrictions are more akin to the traditional regulatory environment for thrifts.\footnote{134} As a result, in some ways banks were hurt more.

\footnote{133} Id.


Clearly the 1989-1991 legislation marks a major turning point in the evolution of the American banking system. Indeed, this legislation can be seen as the third of three seminal events in American financial history, along with the creation of a national banking system during the Civil War and the creation of federal deposit insurance and the federal regulatory structure during the Depression. Together these three events form a consistent pattern that evinces a clear trend toward increasing federal control of the American banking system. At the same time, these events reflect an effort to reduce the level of financial risk in the banking system by severely penalizing bankers who take risks that fail.

Yet, while these three watershed developments together form a consistent pattern of federalization, in no way were they prompted by consistent or similar events. The National Bank Act resulted from a financial crisis brought about by the Civil War, an occurrence clearly extraneous to the banking system and hence unavoidable as a matter of banking policy. The depression-era reforms resulted from a world-wide economic collapse. While federal banking and monetary policy may have played a role in triggering the Depression, the banking system was to a degree affected by forces beyond its control. In contrast, the 1989-1991 legislation was a direct response to developments inside the banking system. Indeed this legislation was enacted for a narrow purpose in an atmosphere largely oblivious to any concern with larger issues relating to the impact on the national economy. That narrow purpose was to save the existing deposit insurance system and to preserve (or even enhance) the bank regulatory system while absolving Congress and the administration from political blame.

As discussed in the next section, these purposes appear to have been accomplished. The remaining question is whether these purposes are ultimately compatible with the
need for entrepreneurial risk-taking by bankers as an engine for economic growth.

VII. THE IMPLICATIONS FOR DEPOSIT INSURANCE AND BANKING REGULATION IN THE 1990’s

A. Introduction

There has been much criticism of the congressional response to problems in the banking system and the inability of Congress to address the fundamental problems facing the American deposit insurance system. As noted above, since the public and media discovered the insolvency of the FSLIC in the late 1980’s, banking law reform efforts have been driven by an apparent desire to preserve the regulatory and deposit insurance system, a desire derived in large part from a perceived need to protect the political reputations of Congress and the Bush administration while extending federal control over the financial system. The result has been

135. This discussion is indebted to portions of Alvin C. Harrell, Commentary: Strong Banks, Weak Economy, 46 CONSUMER FIN. L.Q. REP. 49 (1992).
136. See, e.g., Richard X. Bove, Reform Fiasco Presages Bleak Future for Banks, AM. BANKER, Dec. 3, 1991, at 1; Robert M. Garsson, Congress’ Rx for Banks: A Fatal Dose?, AM. BANKER, Dec. 20, 1991, at 1; William M. Isaac, U.S. Better Face Up to Bank Crisis, AM. BANKER, Feb. 27, 1992, at 4; William M. Isaac, Reform Fiasco Teaches a Lesson, AM. BANKER, Jan. 16, 1992, at 4; Martin Lowy, If Banks Can’t Take Risks, Uncle Sam Must, AM. BANKER, Dec. 30, 1991, at 4 (“Something must be done to save the economy from the consequences of congressional shortsightedness.”). In the aftermath of FDICIA, Congress continues to focus on measures restricting and penalizing the regulated financial systems. See, e.g., Another Banking Billing May Be Considered in 1992, 45 WASH. NOTES NO. 49, at 1 (Dec. 6, 1991) (“Gonzales also said he plans to examine the effect of bank mergers on credit availability; community access to credit; and the effect on employees who could lose their jobs and benefits when banks merge.”); Robert M. Garsson, House Panel Eyes Flaws in Bank Law: Lobbyist Hopeful that Pay Provision Will be Killed, AM. BANKER, Jan. 16, 1992, at 2; Robert M. Garsson, Congress Likely to Put Banks on Back Burner, AM. BANKER, Dec. 24, 1991, at 1; Myopic West Urged to Raise Sights, SUNDAY OKLAHOMAN, May 10, 1992, at 22 (“The Malfunctions of the financial system have been real . . . . One of the major problems . . . . is to improve the performance of this system.”). The Clinton administration seems to recognize some of the basic problems, though it has been unable or unwilling to address these effectively. See, e.g., Initiatives, supra note 24, at 1.
a continual focus on efforts to shift the blame and enhance federal authority rather than to reform the system.

Given the central role of the regulated financial system in the American economy, it is surprising that more attention has not been given to productive reform of that system. Preoccupied with a political need to impose punitive measures on financial institutions and anyone associated with them, Congress and the popular media apparently have not given serious consideration to the inherent flaws in the regulatory and deposit insurance systems, or to any reform except more and tougher regulation. This tougher regulation has tended to discourage bank risk-taking, resulting in a lending slowdown or "credit crunch." While a few commentators have recognized this credit crunch as a cause of the 1989-1991 recession, public debate has generally ignored this aspect of the problem.¹³⁷ Even if they note the reduced availability of credit, media commentators typically have responded by repeating the usual demand for an easier monetary or fiscal policy or alleging some form of improper discrimination, while conveniently ignoring the impact of the 1989-1991 banking legislation.¹³⁸

¹³⁷ For an excellent exception see John J. Gorman, Fear of Personal Liability Has Chilling Effects on Lenders, AM. BANKER, Jan. 16, 1992, at 4; see also Novack, supra note 130, at 102.
¹³⁸ See, e.g., Howard Banks, Kick the Economy in the Shins, FORBES, Nov. 25, 1991, at 35 ("The banks are being excessively cautious about lending . . . . The solution? . . . . [I]t is up to the Federal Reserve to get the U.S. off the dime. But the Fed, too, has shown no great courage . . . ."); David M. Gordon, Here's a 6-Point Plan for Rebuilding the Fundamentals of Our Economy, L.A. TIMES, Dec. 29, 1991, at D2 (urging, incredibly, higher taxes, government policies to "push up" workers' wages, a new "bill of rights" for workers and consumers, and policies to substitute a political process for the "capriciousness" of private sector lending and investment decisions, as a means of making America more competitive and curing the underlying weakness of the economy. David Gordon is Professor of Economics at the New School for Social Research in New York. His views seem to have been embraced by the Clinton administration and Congress.); Alan Murray, Growth Formulas—Democratic Candidates Offer Host of Proposals to Spark the Economy, WALL ST. J., Jan. 6, 1992, at A1; Alan Murray, Finding a Tonic—As the Economy Sags, Washington Scrambles for Ways to Fix It, WALL ST. J., Dec. 9, 1991, at A1 (discussing tax cuts, increased spending, lower interest rates, government purchases of bank equity, and individual retirement accounts, but never mentioning the 1989-1991 legislation); John R. Rutledge, Whiskey or Rotgut?, FORBES, Mar. 2, 1992, at 71 (seeking "lower capital gains rates to help break through the credit crunch, so banks will again make money
This suggests that whatever public debate there may be on banking law issues in the 1990's will have to confront two primary issues: (1) what new pressures, penalties, and restrictions will be imposed on regulated financial institutions in an effort to overcome the effects of the 1989-1991 legislation and promote greater credit availability, and (2) how long it will take before these measures begin to have an adverse impact on the deposit insurance fund?\textsuperscript{139} The possible consequences of this public policy focus, including the implications for the American economy and the future of the financial system, may ultimately prove surprising to many in government, the industry, and the media.

B. Economic Implications of Recent Banking Legislation and Policy

Over the years, American college students have been treated to assurances by their economics professors that there will never be another Great Depression like that of the 1930's because policy makers now understand and can avoid the underlying causes of that economic disaster: namely (1) the banking crisis and resulting monetary contraction, (2) the Smoot-Hawley tariffs, (3) the 1930's tax increases, and (4)

\textsuperscript{139} See, e.g., National Policy, supra note 101, at 1; Dean Foust et al., How Deep is the Hole?, BUS. WK., Dec. 9, 1991, at 30.
regulatory constraints imposed during the 1930's. Yet, on a more modest scale, government policies during the Bush administration replicated each of these factors: (1) FIRREA, the 1990 Crime Bill, and the 1991 banking legislation impaired the effectiveness of the banking system as a funding mechanism for entrepreneurial activities; (2) signs of impending protectionism abound; (3) even during the Reagan era taxes had begun to increase, and the trend has continued since 1989; and (4) an avalanche of new regulations has been imposed on financial institutions and other businesses since 1989. While no one is predicting a repeat of the 1930's, recent U.S. banking and economic policies bear a striking resemblance to the policies of that era. The early direction of the Clinton administration seems to be following a similar path. While there is an apparent recognition of the adverse effects of the punitive legislation and regulation of the Bush era, the response to date has been largely limited to rhetoric and additional regulatory pressures. In these circumstances, it seems likely that a lack of productive

143. See, e.g., Warren T. Brookes, Real Estate Gains Tax Must Be Cut, DAILY OKLAHOMAN, Dec. 6, 1991, at 10. The political gimmicks proposed by President Bush and being debated in Congress would do little or nothing to reverse this trend, and ultimately seem likely to create pressures for higher taxes on the general populace.
144. See, e.g., Peter Brimelow & Gregory Viscusi, Socialism by Another Name, FORBES, Dec. 9, 1991, at 100; Robert Genetski, The True Cost of Government, WALL ST. J., Feb. 19, 1992, at A14 (estimating that new regulatory burdens have cost the economy $271.7 billion since 1988).
risk-taking will continue to hobble the banking system and the American economy.\footnote{146}

Despite all of the talk about the 1930's, however, the more likely prototype for America in the mid-1990's is the late 1950's. This was a period of low growth, punctuated by recessions—a very dull economy. It was also a period of very conservative bank and thrift lending, with a banking system dominated by old-line, traditional (i.e., risk-averse) bankers who still remembered the lessons of the Great Depression. New bank and thrift charters were rare, and there was not the competition in banking services that we came to expect in later years. Generally it was difficult to get business credit, absent an established banking relationship.

President Kennedy changed all this by opening the floodgates to waves of new bank charters in the early 1960's. Though he was probably motivated by political rather than economic sentiment, this unleashed a thirty-year torrent of financial competition and economic growth, bidding up savings interest rates, expanding the availability of credit, and creating an era of "go-go" banking, culminating with the deregulation of the 1980's. In the process, tremendous opportunities were created for bankers, lawyers, entrepreneurs, depositors, borrowers, and investors. It also created enormous risks for the deposit insurance funds, risks that could not be constrained by banking regulation and examinations. Ultimately—due in part to unstable monetary policies—the economy overheated and began a roller-coaster ride of inflation, recession, volatile interest rates, and finally a collapse of real estate and commodities prices, dooming the FSLIC and much of the fixed-rate thrift industry to insolvency. In response, as noted above, the government decided to blame the bankers (and thrift executives, and their apprais-

\footnote{146. The Bush administration apparently believed that it could solve this problem by lecturing senior bank examiners on how to examine banks. \textit{See Brady Seeks Looser Loan Control}, \textit{Daily Oklahoman}, Dec. 17, 1991, at 13; \textit{see also} Debra Cope, \textit{Robson Renews Call for More Bank Loans: Lindsey Warns of Riots' Effect}, \textit{Am. Banker}, May 12, 1992, at 1. But bankers are not likely to be persuaded by a temporary change in examiner attitudes during an election year, having witnessed use of the government's extraordinary new powers under FIRREA and its progeny over the past three years.}
ers, accountants, lawyers, etc.) and to purge the banking system of risk. The result was FIRREA and its progeny and a return to the stagnant economy of the late 1950's.

In the 1990's, the long-term trend of streamlining, consolidation, and job cutbacks by major American corporations will continue, but there is no longer any growth in small business employment to take up the slack. Because of concerns about the deposit insurance funds, it is probably not possible to emulate President Kennedy's expansion of the banking system; indeed, quite the opposite, a contraction of the banking system and a decline in banking competition are well underway. The current emphasis on the Community Reinvestment Act and fair lending issues is unlikely to take up the slack. Continuing slow and uneven economic growth is likely if current banking laws and policies are maintained.

C. Strong Banks and Thrifts in the 1990's

One surprising aspect of this scenario is the likelihood that economic difficulties in the 1990's will coexist with a financially strong banking system. The "tough" banking laws of 1989-1991, which did so much to destroy entrepreneurial bank lending and to depress the American economy, have largely succeeded in one respect: the deposit insurance system has been preserved, recapitalized directly by the taxpayer and indirectly by banking law and policy.

The banking system of the 1990's will continue to contract, and consolidation in the industry will reduce expense ratios, economic risk, and competition. The combination of a slow-growth economy—caused in part by the

retrenchment of banks—and draconian regulatory powers and penalties—which in part induced that retrenchment—will continue to promote very conservative bank lending and investment policies, in turn insulating many banking institutions from the economic losses usually associated with a poor economy. This scenario is already evident in many parts of the United States. As the cycle moves across the country, regulated financial institutions that served their communities with entrepreneurial lending policies will disappear—consolidated, seized by the regulators, or merged. In early 1993, this trend reached California, one of the last bastions of optimistic banking. Across the country entrepreneurial lenders have been replaced by bankers who charge high rates but are unwilling to take significant risks—the prototype prudent banker of the 1990’s. These bankers learned their lesson when they saw their more liberal colleagues lose their jobs and personal assets or even go to jail.

These changes represent a victory for the advocates of “narrow banking,” the notion that insured deposits should be used only in super-safe transactions. They also represent a victory for advocates of federal credit allocation, as it becomes accepted that such allocation is necessary to offset the contractionary impact of the 1989-1991 legislation. The apparent intent of modern American banking law and policy is to privatize lending and investment risk in order to relieve the pressures on the deposit insurance fund, while increasingly mandating the direction of those risks. The Federal Reserve Bank has done its part by lowering short-term interest rates, thereby reducing the financial system’s cost of funds and enhancing the profits of conservative banks, while sending a message to depositors that they will have to look outside the insured banking system—and thereby assume their own risks—if they want a higher return on their investments.¹⁴⁸ Many are doing just that by withdrawing

insured deposits to speculate in the stock market, which has reached lofty levels as a result, thereby enticing even more speculation. In turn the remaining assets of the regulated banking system are being subjected increasingly to federal credit allocation measures.

After a few more years of liquidation and consolidation, the American banking system will emerge well capitalized, efficient, and highly profitable. As a whole it will be smaller (though many institutions will be larger), less competitive, and will operate in a narrow market niche. Healthy, risk-averse banks and thrifts will co-exist alongside deteriorating, impoverished communities. Concerns about community access to financial services will become a paramount national issue and will be addressed largely by showcase projects designed to satisfy political considerations. The oligopolistic profits of a constrained banking system will be shared with politically active groups and by investment in politically correct projects, in return for protection from competitive pressures. Banks and thrifts have become the utilities of our


Ultimately, of course, we can expect a political backlash, and perhaps even some equivalent of the “excess profits tax” imposed on oil companies in the 1970’s. It is even possible that banks and thrifts will be made the political scapegoats for the emerging economic malaise of the 1990’s.

150. See, e.g., Rick Tuttle, Looking Beyond PR to True Commitment, L.A. TIMES, Jan. 3, 1992, at B7 (article by Los Angeles City Controller Rick Tuttle calling for the Federal Reserve Board to require (as a prerequisite to approval of the Security Pacific/Bank of America merger): (1) “lifeline” financial services similar to those “already in place for telephone and utility services,” (2) check cashing services below “so-called ‘market rates,’” and (3) funding by banks of a “multibank community development corporation . . . to [make] loans and [take] equity partnerships in targeted businesses.” Presumably the beneficiaries would be “targeted” through a political process); see also Fed Warns Banks of Risk On Bias in Minority Lending, DAILY OKLAHOMAN, May 12, 1992, at 13 (noting passive government credit allocation).
financial system, and society will have to look elsewhere for venture financing and entrepreneurial risk-taking.\footnote{151} This will create an enormous opportunity for traditional non-bank financial institutions, whose managers, owners, and directors do not have to worry about being made scapegoats for the next failure of deposit insurance.\footnote{152}

These traditional non-bank alternatives will not, however, be enough to fill the void left by the contraction of the banking system, absent a more imaginative public policy response. Indeed, it is already too late to avoid some of the resulting economic dislocations. One solution would be the repeal of FIRREA and a substantial part of the other federal legislation enacted since 1989, plus real deposit insurance reform. This would require an admission that federal policy has been on the wrong track for many years, a reversal of

\footnote{151} This utility-like approach to banking is already evident in the overriding emphasis on bank regulatory compliance in most banks and thrifts today. One entrepreneurial mortgage banker recently complained of a "cultural shock" after joining a banking organization. He found that the emphasis on meetings, reports, and procedures seemed to take precedence over doing the work and serving customers. After a year he left to join a smaller institution outside the bank regulatory system. See Paul S. Nadler, \textit{Culture Shock Can Choke Growth}, \textit{Am. Banker}, Jan. 6, 1992, at 4; see also Debra Cope, \textit{Era of By-the-Book Regulation Dawns}, \textit{Am. Banker}, Dec. 26, 1991, at 10 ("While the regulatory damage-control mode was tailored for troubled banks, even healthy institutions will feel the efforts. They are likely to include higher regulatory costs and more conservative lending policies . . . . There may even be a decline in innovation."); George Freibert, \textit{Lenders must Learn To Think Like Regulators}, \textit{Am. Banker}, Feb. 10, 1992, at 4. Unfortunately, the utility model is not well suited to banking institutions. Normal utility companies have a natural monopoly and operate in a generally risk free environment. In contrast, the essence of banking is entrepreneurial risk-taking. To eliminate that risk is to eliminate the function of banking. Some commentators believe that this represents an intentional effort to funnel bank deposits into low-risk U.S. Treasury securities as a means to help the U.S. government fund its budget deficit, at the expense of private borrowers. See, e.g., Richard X. Bove, \textit{The Deficit Lurks Behind Pointless Capital Rules}, \textit{Am. Banker}, May 20, 1992, at 1.

policy that does not seem likely at this juncture.\textsuperscript{153} If this seems unlikely at the federal level (as indeed it does), then perhaps some of the reform proposals discussed in the context of the federal deposit insurance crisis (and largely ignored by federal policy makers) will hold lessons for state policy-makers seeking to preserve a role for state-chartered institutions in the 1990's. Some of these reform proposals are discussed below.

VIII. PROPOSALS FOR REFORM

A. Introduction

As noted in Part V above, the proposals for reform that came to the fore in the late 1980's generally were grounded on either (1) a desire to reduce banking risk, or (2) an effort to reduce the scope of deposit insurance. The legislation of 1989-1991 focused almost entirely on the former approach, while much of the scholarly comment focused on the latter. This discussion will describe some of the proposals for deposit insurance reform that have received scholarly—though generally not legislative—attention.\textsuperscript{154}

In a 1991 article in the \textit{Consumer Finance Law Quarterly Report},\textsuperscript{155} United States Senator Connie Mack described ten categories of deposit insurance reform then under consideration in the United States Senate. All of these proposals fall into one of the two categories noted above. Each is designed either (1) to reduce banking risk by increasing bank regulation or (2) to reduce the scope and risk of deposit

\textsuperscript{153} Others have drawn similar, extraordinary analogies. See, e.g., Cope, supra note 151, at 10 (quoting Bert Ely: "The parallels to the breakup of the Soviet Union are mind-boggling. We're witnessing the last gasp of the central planning process of banking regulation.").


insurance. All of the proposals in the first category have to some extent been adopted at the federal level, while those in the second category essentially have been ignored by United States policy makers.

Those proposals noted by Senator Mack that were designed to reduce banking risk through increased regulation (and a brief description of each) are,

Higher Capital Standards

Higher capital standards are designed to discourage risk by giving the owner/manager more to lose and the taxpayer a larger margin of safety.\(^{156}\)

This encourages capital deficient institutions to reduce lending and asset levels in order to improve capital ratios.

Risk-Based Capital

Owners/managers can choose their own degree of risk tolerance without exposing the insurance funds, by holding an amount of capital that rises commensurately with risk.\(^{157}\)

One weakness of this approach is the limited ability of examiners to accurately predict the risk characteristics of lending and investment strategies. This encourages banks and regulators to err on the side of caution by investing in low-risk alternatives to lending, like U.S. Treasury securities.

Risk-Based Premiums

If managers know that greater risk will invoke higher insurance premiums, they can make up their own minds on the amount of exposure they will accept.\(^{158}\)

The FDIC implemented a risk-based deposit insurance premium structure (effective January 1, 1993) to allow real market prices on risk that calls for a premium rate between

\(^{156}\) Id. at 117.
\(^{157}\) Id.
\(^{158}\) Id.
23¢ and 31¢ per $100 of domestic U.S. deposits, depending on the institution’s risk classification system. Once again the limited ability of the regulators to assess market risk limits the effectiveness of this approach. So far there has been no effort to supplement this with a system of private sector evaluations.

Narrow Bank [Powers]

[Some proposed that deposit-granting institutions] . . . be allowed only short-term government or other low-risk market-to-market securities. Affiliates, separate in a holding company, would be . . . [the only means for banking institutions] to undertake other, possibly expanded, activities. 159

While this was not specifically included in the 1989-1991 banking legislation, the changes clearly encouraged banking institutions to follow this approach. The result has been a significant slow down in bank lending.

Early Intervention

This requires the regulators to impose a mandatory system of restrictions as a bank’s condition deteriorates. When capital falls below 3 percent, the bank [must] . . . be taken over by the regulators and sold. This . . . [is designed] to protect the taxpayer by closing banks before the cushion of capital is gone. 160

159. Id.
160. Id. The most recent of the above noted proposals to be adopted was the notion of risk-based deposit insurance premiums. On May 12, 1992, the FDIC proposed an increase in deposit insurance premiums (from the current 23 basis points to an average 28 basis points), based in part on a risk-based allocation formula. The rate charged a given institution would depend on a matrix of factors that blends the institution’s level of capital with subjective factors relating to the discretionary judgment of the FDIC staff, as follows:

<table>
<thead>
<tr>
<th>Amount of Capital</th>
<th>Healthy</th>
<th>Supervisory Concern</th>
<th>Substantial Concern</th>
</tr>
</thead>
<tbody>
<tr>
<td>Well Capitalized</td>
<td>25</td>
<td>28</td>
<td>30</td>
</tr>
<tr>
<td>Adequately Capitalized</td>
<td>28</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>Other</td>
<td>30</td>
<td>30</td>
<td>31</td>
</tr>
</tbody>
</table>
Unfortunately this means that still-solvent banking institutions may be seized by the regulators based on a temporary drop in collateral values or other exigencies. This may reinforce the modern propensity of bankers to shun productive lending and investment risk. These measures, virtually all of which were incorporated to some extent in the 1989-1991 legislation (private sector risk-evaluation being the primary exception), rely on increased regulation to reduce financial risk in the banking system. Of course, as noted in Part IV above, the 1989-1991 legislation also provides many other inducements for reduced risk in the form of civil and even criminal penalties for bankers who err. All of this has indeed tended to discourage risk-taking in the banking industry, with the consequences described in Part VII above. The result has been to preserve federal deposit insurance at the cost of altering the basic nature and function of the banking system.

In the same article, Senator Mack also described five categories of potential deposit insurance reforms that would reflect a different approach:

Private Insurance: Mutual Guarantees

Under this proposal every bank, either singly or in consortium, would be guaranteed by a subset of other banks. Banks providing the guarantee would need to fully understand their exposure. The private markets would develop sources of information and techniques to examine and oversee guaranteed banks in order to meet this need. A stop-loss provision would prevent the insolvency of one bank from bringing down its guarantors.

Thus, a highly capitalized institution may be charged a very high premium rate, based on subjective judgments of the regulators. See, e.g., 46 WASH. NOTES No. 20, at 1-2 (May 15, 1992). The proposed changes took effect January 1, 1993. See Proposed Rules, FDIC Assessments, 57 Fed. Reg. 21617 (May 21, 1992), and Letter from Stanley J. Polin, Director, to Chief Executive Officer, FIL.-77-92 (Nov. 5, 1992).
Each guarantee would run for a specified time period. If, at renewal, an institution faced higher insurance rates, it would receive a strong signal to recapitalize and to review its operations. If a bank was unable to obtain insurance at any price and was unable or unwilling to raise new capital, the bank would be closed.\textsuperscript{161}

The private market evaluations inherent in this system likely would provide a better risk profile than the current federal system.

End Policies That Tend to Make All Depositors Whole

In resolving large bank problems, the FDIC has made whole those not legally covered by insurance. This eliminates the discipline of potential failure.\textsuperscript{162}

A reversal of this policy would help reinstate market discipline in banking.

Reduce Coverage

[This proposal would make the $100,000 deposit insurance limit] apply to an individual's total deposits, rather than to each deposit in several institutions. Another suggestion has been to provide a lifetime entitlement to $100,000 of insurance.\textsuperscript{163}

A simpler approach would be to merely limit each person to $100,000 per institution.

Coinsurance

[Deposit insurance could provide 100% insurance up to the first $50,000 and 95% on the second $50,000

\textsuperscript{161} Mack, supra note 155, at 117.

\textsuperscript{162} Id.

\textsuperscript{163} Id.
and keep reducing the percentage covered as the amount increases.\textsuperscript{164}

The remainder could be covered by private deposit insurance, in order to encourage private-sector risk evaluation.

Narrow the Definition of a Deposit

Deposit insurance coverage has been extended by the FDIC broadly interpreting the concept of a deposit. Proponents of depositor discipline recommend reversing this trend.\textsuperscript{165}

These proposals are designed to protect the deposit insurance fund by reducing the scope of the government's deposit insurance liability, without encumbering the banking system with a broad array of new functional restrictions, regulations, and liabilities. None of these proposals have received serious consideration at the federal level, where policy makers have preferred the regulatory approach. Nonetheless, these proposals deserve analysis, and each will be described briefly below.

\textbf{B. Private Deposit Insurance and Mutual Cross-Guarantees: The 100\% Cross-Guarantee Concept}

The preeminent advocate of bank cross-guarantees is Bert Ely, of Ely & Company, Inc.\textsuperscript{166} He has described his proposal as follows:

Briefly, the 100\% cross-guarantee concept would be an industry self-insurance mechanism that would use the earnings and capital resources of the entire banking system to protect all deposits in every bank. Each bank would enter a cross-guarantee contract that would protect all deposits, including balances of more

\textsuperscript{164} \textit{Id.}

\textsuperscript{165} \textit{Id.}

\textsuperscript{166} This discussion is excerpted and derived from Bert Ely, \textit{Deposit Insurance Reform: 100\% Cross-Guarantees are the Only Answer}, 45 CONSUMER FIN. L.Q. REP. 148 (1991); see also Christine E. Blair & Gary S. Fissel, \textit{A Framework for Analyzing Deposit Insurance Pricing}, 4 FDIC BANKING REV. No. 2, 29-31 (Fall 1991).
than $100,000, from any loss of principal, interest, or liquidity, if it fails (i.e., becomes insolvent). Other liabilities of the guaranteed institution also could be protected under the 100% cross-guarantee contract. Each cross-guarantee contract would be issued by an ad hoc syndicate of banks called “first-tier guarantors.” Each guarantor bank itself would be guaranteed by a separate syndicate of guarantor banks. Syndicates would be organized by specialized firms called syndicate agents. Cross-guarantee contracts would be syndicated in a manner comparable to the syndication of insurance risks at Lloyd’s of London.¹⁶⁷

In effect this would create a private insurance and risk evaluation system for bank deposits.¹⁶⁸

Banks making such guarantees would collect insurance premiums from each of the banks they guarantee. These premiums would be based on a private sector risk evaluation and would discourage unsound banking practices. Banks would still become insolvent, of course, but the guarantee contracts would allow the guarantee banks to impose operating restrictions as capital declined. Ultimately, the syndicate of guarantor banks could take over the guaranteed bank before it became insolvent, enabling it to fully protect all deposits and other guaranteed liabilities without significant loss.¹⁶⁹

There is every reason to expect that this process would be far more orderly and efficient, and less disruptive, than the current federal system. The guarantors would have a strong incentive to act efficiently, since their own money would be at stake; they would have to reimburse depositors and other guaranteed liabilities for any loss.¹⁷⁰ They would not be governed by political considerations. Nevertheless, a reinsurance system of contractual risk allocation should permit the avoidance of ruinous losses if the guarantors

¹⁶⁷. Ely, supra note 166, at 153-54.
¹⁶⁸. Id. at 154.
¹⁶⁹. Id.
¹⁷⁰. Id.
miscalculated the risks of a particular guarantee. In effect, this would permit the risk to be passed through the guarantor banks to their own guarantors. If necessary, a stop-loss provision would "spread the loss across the entire banking system." In effect, the earning power and the equity capital of many banks would constitute a "solvency safety net" that would permit the banking "system to survive losses even more extensive than those suffered by depositors during the Great Depression." No taxpayer dollars or restrictive examination procedures would be involved. Government insurance could still be offered as a backup to 100% cross-guarantees, but in reality this would not be needed.

This private system would accomplish the major purposes of the current FDIC system, but would relieve banks of much of the onerous, burdensome (and unnecessary) regulation that is stifling bank lending and national economic growth. It would no longer be necessary to protect politicians from public ire over the costs of deposit insurance by pretending that most insolvencies are the result of criminal acts. Much of the punitive 1989-1991 banking legislation could be repealed, or a new system of institutions could be created outside the current federal system, and such institutions would feel free to fuel economic growth by lending to promising small businesses.

Institutions that took greater risks would, of course, pay a price in terms of higher deposit insurance premiums, but that is already the case. And it seems very reasonable to expect that a private, risk measurement system (with the guarantors' own money at risk) would provide a more accurate risk assessment than the current regulatory

171. Id.
172. Id.
173. Id.
174. Id.
175. Id. Obviously this system could be implemented at the state level, entirely outside the federal regulatory and deposit insurance system.
176. See id. at 156.
177. See id.
178. See id.
179. See id.
approach. Very conservative institutions could expect to pay far less than under the current system.  

The 100% cross-guarantee concept offers the possibility of numerous benefits to the financial system, to the economy, to the taxpayer, and to the political process. These benefits are summarized in the Appendix.

C. Eliminate Coverage of All Deposits and the Concept of “Too Large To Fail”

This seems an obvious way to reduce the government’s deposit insurance liability, yet it has been difficult to adopt and implement. It seems apparent that deposit insurance up to a maximum of $10,000-$25,000 would protect small depositors, while larger depositors have ample incentive to conduct their own market research and seek out prudent investment alternatives. The problem is that some banks are considered so important to the economy that they are deemed “too large to fail” (TLTF), so that they—and their deposits without limitation—must be protected at any cost. The preeminent critic of this policy is Professor George G. Kaufman of Loyola University.

The concept of TLTF appears to be, in part, a tool used by politicians (and regulators) to avoid tough political decisions. In addition, the insolvency of a large institution—which has obviously been under close scrutiny by examiners—demonstrates the inadequacies of bank regulation and supervision as a means of preserving the solvency of financial institutions. The entire system of bank regulation is founded on the assumption that such regulation can protect the deposit insurance fund by preventing bank failures, and the failure of a large institution might call this into question. The concept of TLTF also plays “on the widespread public fears of the contagiousness of bank fail-

180. See id.
181. See George G. Kaufman, Too Large to Fail is Too Costly to Continue, 45 CONSUMER FIN. L.Q. REP. 135 (1991).
182. The remainder of this discussion is excerpted or derived from Kaufman. Id. at 135.
183. Id. at 135.
ures, that is, on fears that a bank failure may ignite a chain reaction\(^\text{184}\) of bank runs and failures that would destroy “healthy’ banks nationwide, other financial institutions, and possibly even nonfinancial institutions and the entire economy.”\(^\text{185}\) This concern is largely nonsense, but that has not prevented its use as a basis for the TLTF theory.

Kaufman notes the concern that large bank failures are “likely to cause a spill over effect because of”\(^\text{186}\) four factors: “[t]he large number of depositors; . . . [t]he large number and dollar amounts of corresponding balances and Fed funds borrowing from other banks; . . . [t]he presence of foreign deposits; and . . . [t]he important role such banks play in the economy and the payments system.”\(^\text{187}\) These concerns have been consistently cited by regulators and politicians as the justification for the TLTF policy.\(^\text{188}\) Todd Conover, former Comptroller of Currency, has testified that if “Continental had failed and been treated in a way in which depositors and creditors were not made whole, we could very well have seen a national, if not an international, financial crisis the dimensions of which were difficult to imagine. None of us wanted to find out.”\(^\text{189}\) Irvine Sprague, an FDIC director during Continental’s rescue, has written that “[t]he problem was there was no way to project how many other institutions would fail or how weakened the nation’s entire banking system might become . . . . Various scenarios were laid out, and they all signaled doomsday.”\(^\text{190}\) Former FDIC Chairman William Seidman warned that “[t]he bottom line [re: TLTF] . . . is that nobody really knows what might happen if a major bank were allowed to default, and the opportunity to

\(^{184}\) Id.
\(^{185}\) Id.
\(^{186}\) Id.
\(^{187}\) Id. at 135-36.
\(^{188}\) Id. at 136.
\(^{190}\) Id. (quoting IRVINE H. SPRAGUE, BAILOUT: AN INSIDER’S ACCOUNT OF BANK FAILURES AND RESCUES 155 (1986)).
find out is not one likely to be appealing to those in authority or to the public.” 191 Kaufman contends that such statements indicate that regulators have focused on reducing their political risk rather than seeking to understand the possible consequences of a large bank failure.192

Perhaps, as Kaufman notes, it is “too severe a standard to expect bank regulators to have a better understanding of the economics of the banking system than others.” 193 But recent research since has made it quite clear that a nationwide financial contagion is very unlikely, considering today's global financial markets.194 Some minimal level of deposit insurance would be sufficient to "discourage[] smaller depositors from starting a flight from bank deposits to currency."

Additionally, the Federal Reserve could step in to prevent a decline in the money supply and bank reserves should such a flight take place.195 Because it is impractical to conduct their financial operations with currency, larger depositors search out safer depositories rather than flee to currency.196 The result might be a movement of funds within the system, but not from the system as a whole.

The TLTF policy is almost entirely political. Politicians and regulators seem eager to ignore “good news” to the contrary.198 But the cost of policies that encourage large institutions to continue operating, despite economic insolvency, are clear.199 Private market discipline has been largely destroyed, “and greater risk-taking by big banks is encouraged”200 so long as the risks fall into politically favored categories. This clearly contributed to the large losses of the

191. Id. (quoting L. William Seidman, Remarks Before Garn Institute Deposit Insurance Forum, in WASH. D.C.: FED. DEP. INS. CORPS., Nov. 14, 1988, at 9 (second and third alterations in original)).
192. Id.
193. Id.
194. Id.
195. Id.
196. Id.
197. Id.
198. Id.
199. Id.
200. Id.
FSLIC and FDIC in the 1980's. In addition, of course, "[s]maller banks are discriminated against and put at a competitive disadvantage."202

Kaufman contends that unfounded fear of bank runs—viewed as a contagion—lie behind "most economic TLTF arguments."203 A run may occur when a bank is viewed by many of its depositors as unable to timely repay all uninsured deposits in full.204

Although a run may cause a bank to have liquidity problems, if depositors are mistaken in believing that their bank is insolvent, a run will not cause the bank to fail.205 In this context, a bank run is a liquidity problem and nothing more; it generally "will not expand into a solvency problem."206

There are numerous mechanisms for handling liquidity problems, and "[s]olvent banks experience little difficulty in obtaining sufficient liquidity through liquid asset sales or borrowings from other banks to meet deposit outflows."207 If the depositors are correct, and the bank is insolvent, insolvency and liquidity problems will be intertwined and exacerbated.208 Even so, these problems were not caused by the run.209 If, upon becoming insolvent, banks were timely reorganized, runs would be unlikely to occur.210 Kaufman supports this conclusion by citing a sixty year old study for the American Bankers Association211 and a study of bank crises in major countries,212 concluding that a run "will rarely
destroy a solvent bank and is not a serious public policy concern."\(^{213}\) There does not appear to be a rational, non-political basis for the TLTF policy.\(^{214}\)

D. Reduced Deposit Insurance Coverage

Obviously one possible solution to protect the FDIC would be to reduce insurance coverage. It is surprising that this approach has not received greater attention, in view of the belief that the increase in deposit insurance coverage from $40,000 to $100,000 and the *de facto* coverage of all deposits in large institutions contributed to the insolvency of the FSLIC and the near-insolvency of the FDIC. Yet, there are several fundamental reasons why this approach has not been adopted. The first is political; any reduction in deposit insurance coverage likely would not be popular. Further, it would amount to an admission that bank regulation cannot effectively constrain bank risks and that depositors must bear more of that risk. While no doubt this will ultimately prove to be the case, it has not been deemed politically prudent to admit such in public.

In addition, the ability of depositors to spread their deposits over several institutions, thereby obtaining *de facto* 100% deposit insurance coverage of any amount, regardless of the per account limit, limits the prospects for reducing the scope of deposit insurance coverage by simply lowering the dollar limit. Nonetheless, this approach holds the potential for increasing somewhat the self-discipline of large depositors.\(^{215}\) There is no apparent reason why deposit insurance should protect such depositors.

It seems clear that requiring depositors to consider the health of their bank would lead to more prudent banking.\(^{216}\) The real problem, Ely claims, is that in Washington, D.C. the prospect of depositor and shareholder discipline is the least

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213. *Id.*
214. *Id.*
215. The remainder of this discussion is excerpted or derived from Ely, *supra* note 166; see also Blair & Fissel, *supra* note 166.
desirable means of "disciplining a bank."\textsuperscript{217} The preferred line of defense is bank regulations because that justifies a massive federal intervention in banking and finance. Advocates of depositor discipline argue that the regulators are unable to do the job.\textsuperscript{218} In effect, those who would rely on depositor discipline have recognized the lack of effectiveness of regulatory discipline.\textsuperscript{219} As a result, depositor discipline is an anathema to those who favor regulatory control as a matter of political philosophy.

Decreasing deposit insurance limits (perhaps to a percentage of each deposit), restricting depositors in the number of insured accounts they can have, and requiring a private guarantee system as coinsurance are among the proposals to increase depositor discipline.\textsuperscript{220} Monitoring banking activities is admittedly not easy,\textsuperscript{221} nor is any other consumer decision. But to recognize this is not to say that the regulators have done a superior job in that regard. There is ample evidence that regulation is no substitute for depositor and shareholder discipline.

It seems clear that the increase in the deposit insurance limit significantly contributed to the 1980's S&L crisis.\textsuperscript{222} Nevertheless, raising the limit only served to make it slightly easier to put money into insured deposits because depositors are not limited in the total amounts that can be insured; depositors are only limited in the amounts that can be insured in each institution.\textsuperscript{223}

Limiting the total insured amounts individuals may have in different banks would be a difficult but not impossible task.\textsuperscript{224} To make a significant difference, the deposit insurance limit would have to be reduced sharply, probably to as low as $10,000 or $25,000. Still, such a level would be ample to protect small depositors.

\textsuperscript{217} Id.
\textsuperscript{218} Id.
\textsuperscript{219} Id.
\textsuperscript{220} Id.
\textsuperscript{221} Id.
\textsuperscript{222} Id.
\textsuperscript{223} Id.
\textsuperscript{224} Id.
Unless the TLTF policy is eliminated, any attempt to invoke depositor discipline at the federal level would be ineffective.225 As noted above, even if not legally insured, all deposits in a large failed institution would be protected by TLTF policy.226 For example, even as the necessity of the TLTF policy was being questioned by legislators, regulators protected uninsured depositors when they took over the Bank of New England.227 In contrast, regulators did not invoke the TLTF policy when they were unable to sell a small Harlem bank; large depositors suffered when regulators paid off only the insured depositors.228 Those concerned with fairness were outraged at the different action taken by regulators in the two cases.229 Nevertheless, there is no likelihood that the TLTF policy will be abandoned.230

E. Private Deposit Insurance

Another proposal would combine reduced deposit insurance coverage with private insurance coverage. This approach would seek to increase depositor discipline and for the first time create an effective system of private insurance coverage. The latter feature, integrating private insurance concepts into a deposit insurance system, may be the most creative and innovative aspect of the deposit insurance reform proposals. This suggests a need to consider the implications of private insurance concepts in the context of deposit insurance. This analysis has been done in an extensive study by Professor James R. Barth, Philip F. Bartholomew, and Michael G. Bradley.231 The following is derived from their report.

225. Id.
226. Id.
227. Id.
228. Id.
229. Id.
230. Id.
The basic purpose of insurance is to spread individual economic risks among the larger universe of all those insured, thereby diffusing those risks.\textsuperscript{232} Insurance is essentially a system whereby the resources of many insureds exposed to risk are combined to offset losses incurred by a few. Losses are usually covered by the accumulation of advance payments of premiums.\textsuperscript{233} Alternatively, resources may be collected after losses have occurred.\textsuperscript{234}

"Economic risk" refers to the risk that economic value will be reduced.\textsuperscript{235} "Private insurers cover [only] ‘insurable’ economic risks."\textsuperscript{236} These generally have the following characteristics: "risks for which there are numerous loss exposures; losses that are unintended and unexpected by the insured; losses that are definite and measurable; and losses that are unrelated, so that catastrophic systemic loss is extremely unlikely."\textsuperscript{237} Some have argued that with deposit insurance catastrophic losses are likely, and therefore, it is not feasible for private insurers to provide all deposit insurance.\textsuperscript{238}

Nevertheless, as the foregoing discussion regarding bank runs suggests, the latter concern is probably overblown and therefore should not be an impediment to development of a system of private deposit insurance. Private insurers manage risk by "risk avoidance," "risk retention," "loss control" and "risk transfer."\textsuperscript{239} In order to utilize these methods, private insurers depend on reinsurance strategies such as ratemaking, underwriting, loss adjustment, contractual constraints on behavior, and structural requirements.\textsuperscript{240} Each of these will be discussed briefly, along with the implications for private deposit insurance.

\begin{footnotes}
\footnote{232. Id. at 142.}
\footnote{233. Id.}
\footnote{234. Id.}
\footnote{235. Id.}
\footnote{236. Id.}
\footnote{237. Id.}
\footnote{238. Id.}
\footnote{239. Id.}
\footnote{240. Id.}
\end{footnotes}
1. "Ratemaking"

Reasonably accurate loss and expense predictions are required for ratemaking. A rate is the price charged for each unit of [insurance] coverage. A premium [reflects] ... the rate and the number of units insured." Rates must be set so that premiums cover both losses and operating expenses. Rates should also encourage those insured to minimize losses. Additionally, rates should remain relatively stable. In order to minimize loss, the amount of deductible paid by the insured is a critical factor in pricing. Generally, insurance risks are separated into groups comprising a "sufficiently large, yet homogeneous, number of insureds." All members within a group are then subjected to a uniform rate.

Accurate evaluation of expected losses is crucial to insurance underwriting. Most underwriters use historical experience to estimate losses. Nevertheless, historical data must be tempered with the ratemaker's own experience and judgment concerning past losses. In the context of deposit insurance, rates would have to be based on a reasoned evaluation of the financial risks being assumed by each institution. Since this is done regularly by bond rating agencies, it would likely be feasible in this context as well. Nonetheless, it represents a challenging task for any deposit insurer.
2. "Underwriting"

In order to minimize the effects of those seeking insurance with an above average risk, private insurers engage in extensive research. The goal of this research is to correlate rates with insured risks in an effort to avoid large losses. This requires a rational system of risk classification, in the context of premium rates, and in turn this requires considerable information concerning each insured.

Underwriters must continually monitor and re-evaluate their risk selection, classification, and pricing. If this process reveals the possibility of excessive losses or risk exposure, the underwriter may require the insured to pay a higher rate or deductible, or alternatively, the underwriter may simply cancel or refuse to renew the policy.

An important part of underwriting is reinsurance. It is intended to avoid unnecessary risk concentration by assuring that risk is truly spread among the various insurers.

Bert Ely's proposal for cross-guarantees, discussed above, would meet these tests for private deposit insurance. The fundamentals of underwriting analysis, in conjunction with rate making as discussed above, should present no inordinate difficulties in the context of private deposit insurance.

3. "Loss Adjustment"

Once an insured has shown that a loss has occurred and it is determined that he or she is insured for such loss, the insurer will pay the claim. Bert Ely's cross-guarantee proposal should assure that such losses are identified early and covered. In the context of private deposit insurance,
there would need to be some mechanism for providing advance notice to depositors of any proposed changes in coverage, so as to permit them to take precautionary steps as desired. None of these issues appear to present insurmountable difficulties.

4. "Constraints on Behavior"

Various constraints are placed on private insurers with the intent to protect the insured from unfair treatment.\textsuperscript{260} In addition to preventing insurers from charging excessive and unfairly discriminatory rates, many states have laws that require the insured be given a reasonable amount of time to seek alternate insurance prior to cancellation.\textsuperscript{261} Such constraints can actually make it more difficult for one to obtain insurance because the insurer's ability to minimize risk is limited once a policy has been issued.\textsuperscript{262}

5. "Structural Requirements"

If a private insurer confronts an important structural event, "it [will] collect[] new data to determine if the actuarial basis for setting prices needs to be changed[,] ... re-examine[] the behavior of those insured to determine if insurance should be limited or denied,"\textsuperscript{263} reassess the insured's risk characteristics to determine whether another rate or deductible is called for, reevaluate the use of coinsurance or reinsurance, and possibly impose structural requirements for those insured.\textsuperscript{264}

These insurance concepts suggest that, despite certain hurdles that would have to be overcome, private deposit insurance remains a viable alternative to federal deposit insurance.

\textsuperscript{260} Id.
\textsuperscript{261} Id.
\textsuperscript{262} Id. at 143.
\textsuperscript{263} Id.
\textsuperscript{264} Id.
F. Eliminate Federal Deposit Insurance

The simplest possibility would be to just go “cold-turkey,” by eliminating federal deposit insurance entirely. This alternative should not be dismissed out-of-hand; it is a serious proposal that has been extensively explored by Catherine England, at the Cato Institute, from whose work this discussion is taken. Ms. England suggests that federal deposit insurance be eliminated in conjunction with a requirement that all bank assets be marked to market value. Any depository that was insolvent on a market-value basis would be closed immediately and any losses would be covered by the current deposit insurance fund. All remaining institutions would be solvent.

Thereafter, the financial positions of all banks and S&Ls would be reported “on a market-value basis.” Because insolvent institutions would be eliminated from the market, no one would have reason to panic. Depositors could be expected to exercise some care in choosing where to bank, reintroducing depositor discipline into the system. Advertising of capital and liquidity ratios and other relevant data would assist depositors in this regard, and “money would [tend to] flow from weaker institutions to those with stronger capital positions.”

An occasional weak institution would fail, but the early warnings provided by depositor discipline would limit the losses, and in any case the risks would be lower than those being assumed today by bank customers flocking to mutual funds and other uninsured investment products. The rewards

265. This proposal has, of course, been implemented by individual institutions with some success. This discussion will consider the possibility of implementation on a system-wide basis. This discussion is excerpted and derived from Catherine England, Federal Deposit Insurance Reform: The Road Not Taken, 45 CONSUMER FIN. L.Q. REP. 249 (1991).
266. Id. at 254.
267. Id.
268. Id.
269. Id.
270. Id.
271. Id.
to society, in terms of a renewed vigor in banking, would be great. Without deposit insurance to distort the market, institutions with below average market capital would be forced to raise additional capital in order to improve their balance sheets.\textsuperscript{272} All institution managers would carefully monitor their investments to avoid unnecessary risk.\textsuperscript{273} Yet without the fear of regulatory retaliation, bankers could be expected to again assume creative risks where the economics were sound.\textsuperscript{274} Bankers could return to banking.

Thrifts would no longer be forced by federal law into a high-risk, undiversified real estate lending strategy.\textsuperscript{275} This, in turn, would lead to the development of new deposit and loan strategies that should be more responsive to consumer needs and interest rates.\textsuperscript{276} In addition, institutions would be more effective in handling problem loans.\textsuperscript{277}

In the absence of federal deposit insurance, bankers would again compete as to deposit safety, customer service,\textsuperscript{278} and community development. Capital levels would be bolstered through the "use of subordinated debt or extended liability for stockholders,"\textsuperscript{279} and would soon return to traditional levels of fifteen to twenty percent. This could lead to the development of private insurance as well as bank rating services to assist depositors.\textsuperscript{280} Yet creative risk-taking would not be stifled by arbitrary regulations or fear of regulatory fines and penalties. Given regularly updated market-based information, bank customers would have little reason to become unduly concerned and withdraw their funds from healthy depositories.\textsuperscript{281}

Withdrawals from weaker institutions would provide an early-warning system that would benefit shareholders,
managers, and customers, exposing those institutions to market discipline. As a result, there is reason to believe that fewer institutions would fail. Industry-wide failures, such as those resulting from over-regulation of the thrift industry, would be very unlikely. As Ms. England pointed out,

[a] sound financial institution can meet its obligations with or without the confidence of its depositors. An institution that relies on confidence alone without any substance . . . is by definition a confidence racket, a "con game." This sentiment is echoed by Professor George G. Kaufman: "One of the public's major misconceptions about banking is that one needs to have faith in one's bank and banker. Nothing could be further from the truth! Faith belongs in churches; good assets belong in banks."

Without federal deposit insurance, the banking system would be less subject to destabilizing systemic runs than the current federalized system in which depositor safety depends largely on the whim of federal policy-makers. Historical evidence indicates that systemic runs were relatively rare before deposit insurance. Instances to the contrary, including the runs during the Depression on sound institutions, "have been explained by examining the assets of the institutions in question." The regional crises and bank runs that have occurred in the United States are at least partially the result of branch banking restrictions.

As Ms. England noted,

Before 1920, three broad factors worked to protect against systemic runs. First, uninsured bank customers sought to remain fairly well informed about the

282. Id.
283. Id. (alterations in original) (footnotes omitted).
284. Id. (citing Kaufman, supra note 181).
285. Id. at 254-55.
286. Id. at 255.
287. Id.
relative health of local banks. Chaotic, panic-driven runs on solvent institutions were not the norm. Second, the market responded to that demand for information by providing readily available data about the relative strength of competing depositories. Third, and most important, bankers sought to prevent conditions that would lead to unease among their depositors. Bankers' care in making lending decisions led to their general reputations for being conservative and penny pinching, no doubt, but such habits also protected the life savings of depositors. Bankers' concerns about the threat of illiquidity also led to clearinghouse agreements and interbank loans that provided cash to solvent institutions in the face of unexpectedly large withdrawals. Moreover, though losses did occur at individual banks, they generally were limited as insolvent institutions were quickly closed.\footnote{288. Id.}

With modern technology and global communications, depositors would be even better protected today, in the absence of federal deposit insurance.\footnote{289. Id.}

Ms. England concluded that the banking system would be stabilized by four key factors:

1. Bank owners and managers would again assume the responsibility for attracting and retaining depositors. This would focus their attention on safety and financial strength. Knowing that wary depositors might withdraw their funds quickly in the event of problems, depository managers would attempt to identify and anticipate problems before making risky decisions.

2. Uninsured depositors would not continue to fund the activities of incompetent, fraudulent, or speculative depository owners or managers. This factor illustrates a schizophrenic attitude in much of the literature supporting federal deposit insurance. First

\footnote{288. Id.}
\footnote{289. Id.}
it is argued that uninsured bank customers would be so skittish that they would quickly remove deposits from institutions about which there was any hint of trouble. Then the claim is made that uninsured depositors would be taken to the cleaners by frauds and fools. In fact, depositor skepticism would protect uninsured customers as well as the economic system from the continued operation of institutions run by individuals who unwisely fund uneconomic loans and investments. Such skepticism would place a natural brake on losses created by incompetent or fraudulent managers, a brake that was lacking in the thrift crisis, despite heavy regulatory oversight.

3. Institutions with sound management and strong balance sheets would be rewarded rather than punished. Strong banks would experience lower funding costs as depositors traded off stability for interest paid on their funds—just as investors do now with other financial instruments.

4. Finally, the market would expand the interbank loan markets to protect against illiquidity. Market-value accounting would become more widely adopted as a means of protecting solvent banks and reassuring depositors. Higher effective capital standards would develop. Neither depositors nor bankers benefit when the banking system suffers from instability, so there would be strong incentives for stabilizing mechanisms to evolve. 290

G. **Summary and Conclusions—Deposit Insurance Reform**

True reform of the U.S. deposit insurance system would incorporate elements that recognize the limitations of banking regulation as a means of preventing bank insolvency, together with efforts to introduce investor and depositor discipline and private insurance coverage into the system. Unfortunately, the 1989-1991 legislation took mostly

290. *Id.*
the opposite approach. Private party discipline and private insurance concepts were essentially excluded from the system, while there was total reliance on increased regulation and penalties as the means to protect deposit insurance. The result has been to squeeze a considerable measure of private risk from the system and to move toward the concept of "narrow banks"—heavily regulated institutions that avoid entrepreneurial risk-taking and instead function somewhat like utilities. The resulting credit contraction has prompted, and justified, aggressive new credit allocation measures under the rubric of community reinvestment and fair lending concerns. This has transformed the American financial system and economy in ways that have yet to be recognized by most Americans.

IX. REFLECTIONS AND CONCLUSIONS

The basic lesson of this analysis is straightforward: In the late 1980’s, salvation of the deposit insurance system became the driving force in financial reform efforts, overshadowing efforts to modernize the banking system and even concerns about the health of the U.S. economy. Deposit insurance had outgrown its original, modest boundaries to become the most expensive entitlement program in the history of the United States—and perhaps the world.

Worried about the public reaction to this huge expense, Congress and the Bush administration sought to shift the blame elsewhere. Aided by a media eager to publicize the more sensational aspects of the problem, politicians popularized the notion of widespread dishonesty in the financial system and then responded by criminalizing the bank regulatory system in order to punish the “crooks.” The result was a massive change in the nature of the American banking system with economic implications far beyond the deposit insurance issues involved.

More logically, Congress could have addressed the root causes of the problems, by reforming deposit insurance and recognizing the limits of bank regulation. Obvious possibilities for reform included a reduction in deposit coverage and measures to allow private insurance supplementation.
Instead, the approach has been to maintain and even extend the broad and exclusive scope of federal regulation and to protect the deposit insurance fund by reducing the risk in the system. In effect, the advocates of "narrow banking" have won the field, though this result has been accomplished indirectly and without illuminating public debate. The result is a banking system sapped of its entrepreneurial spirit, unable to provide the monetary fuel for significant or prolonged economic growth.

Ironically, the justification for all of this is the need to provide the comfort of deposit insurance to the ordinary citizen, so that he or she can conduct daily affairs without concern about investment risks. Yet to some extent the effect has been just the opposite. As banks have become hesitant to take lending risks, and have de-leveraged in an effort to meet the new capital requirements, they are in less need of deposits. The interest rates paid on insured deposits have dropped accordingly to historically low levels.

In response, the average citizen (who is supposed to be the beneficiary of deposit insurance) has, in increasing numbers, decided that he or she does not need it and would rather earn a higher rate of interest without deposit insurance. As productive risk and consequently high returns are squeezed out of the banking system, more and more of the risk that used to be borne by professional bankers is being assumed by ordinary citizens. Seduced by higher yields and possibly unaware of the full risks, depositors are withdrawing insured funds to invest in securities via mutual funds or in mortgage derivative instruments that carry considerable investment risk. Should the market turn, an entire class of middle income investors could suffer devastating losses. In the meantime, excessive banking regulation and federal credit allocation measures are impairing the viability of the banking system, threatening the existence of community banks, and possibly setting the stage for the next federal deposit insurance crisis.

291. See, e.g., Huber, supra note 1, at 127.
292. See, e.g., Ely, supra note 166, at 151.
It appears that both borrowers and depositors will ultimately bear the cost of this financial disintermediation. Federal deposit insurance has been saved, but at a frightful cost to the larger society.

APPENDIX

Benefit 1. 100% cross-guarantees would offer the only way to completely integrate deposit insurance reform and the restructuring of financial services because cross-guarantees will completely shift restructuring decisions and associated insolvency risks to the private sector (eliminating the disincentives to entrepreneurial lending embodied in the current regulatory approach, with its harsh civil and criminal penalties).

Benefit 2. Implementation of 100% cross-guarantees can occur much more quickly and completely than any other deposit insurance reform proposal. Many banks and S&Ls would be ready to switch to 100% cross-guarantees as early as the first anniversary of the legislation authorizing 100% cross-guarantees.

Benefit 3. The 100% cross-guarantee concept represents the only comprehensive reform of deposit insurance that has been offered. Further, 100% cross-guarantees would reform federal deposit insurance by effectively replacing it. All other proposals, by attempting to reform federal deposit insurance, are trying to repair the irreparable.

Benefit 4. The solvency safety net constructed by the stop-loss feature in all cross-guarantee contracts would effectively privatize the federal safety net, thus eliminating the risk of loss to taxpayers. Shifting the safety net function to 100% cross-guarantees would then permit the Federal Reserve to concentrate on its monetary management duties.

Benefit 5. 100% cross-guarantees would not take away any existing protections for depositors and the financial system; cross-guarantees could be added to the now existing protections. Retaining federal deposit insurance, up to $100,000, only as a backstop for 100% cross-guarantees, would give small depositors confi-
dence that their deposits are just as well protected as they now are. Because of the strength of 100% cross-guarantees, it is highly unlikely that this backup protection would ever be called upon.

Benefit 6. 100% cross-guarantees would dramatically reverse the declining creditworthiness of American banks. This reversal in turn would raise public and marketplace confidence in American banks, thus allowing them to raise funds more cheaply. Cheaper funds would bring lower interest rates to borrowers.

Benefit 7. 100% cross-guarantees would enhance the overall competitiveness of American banks. Not only would they enjoy a lower cost of funds, but appropriately capitalized banks would pay substantially less for deposit insurance than they now pay. In addition, banks would be free of many regulatory burdens that now add greatly to their operating expenses while limiting their operational flexibility.

Benefit 8. The 100% cross-guarantee concept would build on the existing strengths of the banking system, most notably the equity capital already invested in it. This capital and its earning power are more than enough to enable the banking system to withstand another Great Depression, once 100% cross-guarantees become a reality.

Benefit 9. The 100% cross-guarantee concept would greatly increase financial stability within the banking system by explicitly protecting all domestic and foreign deposits in American banks from bank insolvency losses that occur for whatever reason. This explicit protection would end uncertainties about the strength of the banking system whenever a bank with substantial uninsured deposits (deposits of more than $100,000 per depositor) gets into financial difficulty. Today, this uncertainty is competitively damaging to American banks because other industrialized nations are not afflicted by uncertainties about the strength of their financial institutions.
Benefit 10. By protecting all deposits, 100% cross-guarantees would eliminate the daylight overdraft risk. A daylight overdraft is the risk that a bank will not be able to cover its payments system overdraft at the end of a business day because it has suddenly become insolvent. Because 100% cross-guarantees could easily be extended to cover all liabilities of the payments system, guarantors would effectively bear daylight overdraft risk as part of assuming the overall solvency risk of a guaranteed bank.

Benefit 11. Timely takeovers of failing banks, before they became insolvent, would improve the overall efficiency of the economy by ridding the banking system of inefficient competitors. One of the hidden costs of the FSLIC debacle has been that it has burdened the banking system with overcapacity in the form of continued operation by inefficient and insolvent S&Ls whose losses are being subsidized by the taxpayer.

Benefit 12. 100% cross-guarantees would eliminate any need for depositor discipline. Because guarantors would protect all deposit balances, including balances of more than $100,000, there would be no need to rely on depositors to discipline the risk-taking proclivities of bankers. Thus, 100% cross-guarantees would shift risk assessment activities from a highly risk-adverse set of creditors (bank depositors) to that source of funds (equity capital) that is best suited to assess and price financial risks.

Benefit 13. The 100% cross-guarantee concept would eliminate the regulatory practice of too-big-to-fail. Today, regulators cower at the thought of liquidating a large bank for fear that uninsured depositors in that bank, and in other banks, will stampede. However, because guarantors would protect all deposits, large depositors would not panic even if the biggest bank is taken over by its guarantors and sold to another bank or even liquidated. A weak bank might lose depositors who are dissatisfied with the bank's services, but
depositors protected by 100% cross-guarantees would not flee out of fear for their funds.

Benefit 14. Because 100% cross-guarantees would eliminate practically all risk to taxpayers, federal deposit insurance would no longer represent a $2.8 trillion contingent liability of the federal government.

Benefit 15. The risk-deterring effect of risk-sensitive premiums would encourage banks to lend and invest more wisely than many banks do now. Wiser lending would lead to a more productive use of credit within the economy, which in turn would enhance economic growth. In effect, risk-sensitive premiums would eliminate the "moral hazard" in deposit insurance that has caused so much wasteful lending and investing in recent years.

Benefit 16. Risk-sensitive premiums would largely, if not completely, eliminate the cross-subsidy in flat-rate deposit insurance premiums, a subsidy that flows from good banks to the bad. In 1991, that cross-subsidy cost America's better banks more than $3 billion. Risk-sensitive premiums would cause the nation's riskier banks, taken as a group, to pay for most, if not all, of the insolvency losses the failed banks in this group incur.

Benefit 17. 100% cross-guarantees would permit banks to escape the one-size-must-fit-all mentality of bank regulation. Regulation effectively would shift to the cross-guarantee contract and to the risk-balancing incentives of risk-sensitive premiums. This shift would give individual banks the flexibility to negotiate contractual terms that would permit them to innovate at their own pace and to tailor their capital structure to the lending and investing strategy best suited for that bank.

Benefit 18. 100% cross-guarantees would greatly improve opportunities for community banks by freeing them of the practical effect of the too-big-to-fail policy.
No longer would community banks be constrained from accepting deposits of more than $100,000. Cross-guarantees also would have an especially beneficial effect on the cost of funds for community banks in addition to permitting them to operate more efficiently. Without 100% cross-guarantees, many community banks will have an increasingly difficult time surviving in the banking marketplace.

Benefit 19. The 100% cross-guarantee concept can easily be extended to protect the liabilities of all providers of financial services, including securities firms, money market mutual funds, insurance companies, and even government-sponsored enterprises (GSEs).

Benefit 20. The 100% cross-guarantee concept can be structured to permit nonbank firms to participate as guarantors, provided that the cross-guarantee obligations of these firms are themselves guaranteed by other guarantors. Broadening the capital base available to guarantee bank deposits and other bank liabilities in this manner would further strengthen the financial backing of America’s banks.

Benefit 21. Perhaps the greatest benefit of 100% cross-guarantees would be to substantially depoliticize the banking business, because banks would no longer have an incentive to seek political salvation for their banking troubles. Thus, 100% cross-guarantees would free the political process from the inherent flaws of federal deposit insurance.294

294. Ely, supra note 166, at 155-56.