Commentary: Overhauling the Financial System

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QUARTERLY REPORT

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Commentary:

Overhauling the Financial System
By Alvin C. Harrell

I. Symposium on Deposit Insurance Reform

This issue contains Part I of our symposium, Banking Law 1991, with a focus on deposit insurance, bank insolvency, and banking law reforms. It appears likely that federal deposit insurance will be at the center of the emerging debate of the future of the banking system. At the same time, bankers face unprecedented penalties for failure and a veritable minefield of lending pitfalls; together, these factors serve to discourage lending and have produced a credit crunch that threatens the entire economy.

FIRREA created new problems in the thrift industry and thereby contributed to a nationwide decline in real estate values, just as the criminal and financial penalties that were imposed on banks under FIRREA could produce a nationwide credit crunch and a spiral of downward economic activity. The result was public policy that converted economic expansion into recession. To date it would seem that the government has failed in its effort to micro-manage the American financial system by penalizing bankers, although it is not clear even yet that our policymakers understand the economic implications of this failure. It has little to do with old policies or the excesses of the 1980s; this is, in many ways, a FIRREA recession.

The Bush administration proposals for reform can be faulted for their failure to address the problems caused by FIRREA and the 1990 Crime Bill, although the proposals do show promise in other respects. At the same time, however, it is clear that many of the most important issues, such as the role of Congress and the popular media, have been completely misunderstood. In fact, the rational middle of the American public has completely misunderstood the lessons of the past and do not appreciate the nature of the problems that confront the financial system and the American economy today. Unless the

(Continued on page 147)


3. As one example, a former chairman of the Board of Governors of the Federal Reserve System, William H. Miller, wrote the following in his article, "The Role of the Federal Reserve in Times of Financial Distress": "It is also easy to forget the pitfalls, which a bank's board must analyze during the momentary decision that demands something of those who are caught in a crisis."

The Quarterly Report is published four times a year. Please address all correspondence concerning editorial content to Professor Alvin C. Harrell, Editor, Consumer Finance Law Quarterly Report, The Ohio State University School of Law, 250 N. Blackwell, Columbus, Ohio, 43210.
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Private Deposit Insurance Practices and Reform Proposals

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There are three basic elements of the deposit insurance puzzle that are in danger of being overlooked in the current debate. First, it should be obvious that banking is inherently a risky business. Banking requires that the lender extend credit to borrowers, whom the leader knows in only the most cursory manner, on the hope that these borrowers will later be able and willing to repay the money out of surplus earnings. Even the most superficial analysis will suggest the inherent uncertainties and the potential for problems that can arise to interrupt the hoped-for scenario. Among other things, anytime there is a period of economic distress borrowers will default in droves, and banking institutions will go broke.4 Inevitably the result will be a disaster for any deposit insurance fund.

(Continued on next page)

4. While President Bush urges "sound banks" to raise "sound loans" in order to "prevent problems," the economy is experiencing just such a problem. The economy is overheating and the Federal Reserve is raising interest rates to slow it down. But the problem is that the Federal Reserve is too slow to respond to the needs of the economy.

5. The results of the 1990 Crime Bill are clear: the federal government will be involved in the regulation of banks and financial institutions. This will lead to increased costs for banks and increased regulation for the customer. The result will be a decrease in the efficiency of the banking system. This will lead to a decrease in the overall economy.

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V.A. above, should prevent debtors from asserting affirmative claims, as well as defenses, based on unrecorded representations of the insolvent institution, against FDIC or FSLIC as receiver. 309 FIRREA appears to codify this view, albeit in somewhat vague language: "... any agreement which does not meet the requirements set forth in section [1823(e)] shall not form the basis of, or substantially comprise, a claim against the receiver or the [FDIC]." 310 The D'Oench doctrine and section 1821(d)(9) could severely undercut the bases of many "lender liability" claims based on unrecorded agreements or, under Langley v. FDIC, 311 on misrepresentations allegedly made by failed institutions' officers before the receiver's appointment.

The receiver may also attempt to alter the status of certain types of claims to the benefit of the estate, by exercising its avoidance powers. Section V.B, above. For example, claims against the receiver may be countered with the defense that the transaction giving rise to the claim violated the statutes or regulations governing the financial institution.

E. Setoffs In Financial Institution Receiverships

Setoff issues can be extraordinarily complex, often involving three parties: the receiver of a failed financial institution, a depositor who is a borrower from the same institution, and a third-party purchaser of or participant in that loan. This article will not attempt to cover all possible setoff issues, but will address selected issues arising from a depositor/borrower's right of setoff.

A depositor who is also obligated on a debt to a failed financial institution is entitled to have his debt reduced by the amount of his deposited funds, and this setoff is not considered a preference over other depositors. 312

A depositor's right of setoff, if otherwise available, is unaffected by the subsequent assignment or participation of the loan to another lender. For example, if a participating bank buys a loan from an originating bank that later fails, the borrower can use his or her right of setoff to reduce the loan balance owed to the third party assignee by the amount he or she has on deposit at the insolvent assignor. 313 This setoff leaves the participating bank with only an unsecured claim against the failed institution's estate. 313 Other setoff issues which may give rise to controversy are whether, and under what circumstances, the beneficiary of a letter of credit issued by the insolvent institution may be able to setoff its obligations to be insolvent institution, 314 and what circumstances will permit obligations under loan participation agreements running between two institutions to be setoff after one becomes insolvent. 315

The right of the depositor to setoff vanishes if FDIC pays off the entire deposit immediately or makes an equivalent account available to another institution. But deposits in excess of the insurance limit will remain subject to setoff as will nondeposit creditor claims. It is not clear whether FDIC or RTC may induce the depositor to exercise his or her setoff rights against an assigned or participated loan by failing to pay off such deposits on the ground that the depositor has an equally valuable self-help remedy. Where this occurs, the insurance fund is relieved, but at the expense of the assignee or participant of the setoff loan.

VII. Conclusion

Like most omnibus statutes, the FIRREA receivership provisions treated in this article will not exactly make life simple for regulators, financial institutions, creditors or other third parties. The statute is complex, sometimes ambiguous and uncertain in its relationship to prior law, and far from self-explanatory. Despite such inevitable problems (many of which could be addressed by clean-up legislation, court interpretations) FIRREA probably simplifies prior receivership law. It eliminates the FSLIC-FDIC dichotomy, provides explicit claims procedures, and codifies receivership powers in many areas. To the extent that such legislation can be judged solely by its clarification of parties' substantive and procedural rights, history will probably consider FIRREA's receivership provisions a step in the right direction.

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soundness," can only make matters worse. For example, for most of its existence the thrift industry was restricted to making long-term fixed-rate real estate loans, in part because the regulators and Congress thought these were the safest and soundest investments, a judgment that proved disastrous for all concerned. (The Bush administration proposals are to be applauded for recognizing that diversification is necessary to the development of a healthy banking industry.)

There is no empirical evidence suggesting that our current system of deposit insurance and banking regulation compensates for the inherent risks in banking.

Indeed, some evidence suggests that "pervasive incentives" in the system may actually increase the risks, and, ultimately, the losses. Short of drastically reducing the scope of the deposit insurance system, there is probably very little that can be done to change this.

Yet the theory that bank regulation can prevent widespread bank failures serves as the foundation for our current deposit insurance system. As recounted by (Continued on page 192)

2. FIRREA v. Madsen/Dec. 379 F.2d 665 (9th Cir. 1967).
5. See FDIC v. State Bank of Vinton, 653 F.2d 139 (5th Cir. 1981) (the Court decision contained attempts to off-set bank participation obligations).
6. A bank earning 1% on assets must have 100 good loans of equal size for every one that is a total loss, just to break even. During a serious recession many banks will fail that test. Losses equal to just 1% of assets will wipe out the capital of the average bank. See, e.g., Hsu, Reinstein, & Bradley, Hibernia v. F.D.I.C.: What Can Be Learned from Private Insurers' Experience? in this issue, 140, at 144 ("examination and follow-up steps fail to reduce regulatory risk....") (quoting Grubb).
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C. Reporting Requirements

The Attorney General is required to report to Congress on the nature, number and disposition of civil and criminal proceedings relating to banking law violations. Reports also are to be made regarding the impact of the savings and loan crisis on the Federal court system.

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foreign and nondepository financial institutions. The deposit insurance fund likely will be recapitalized by an indirect tax on the American people (in the form of higher deposit insurance premiums financed by reduced availability and higher relative costs for banking services), and the power of the regulatory agencies will be preserved or perhaps even enhanced again. In return, banks (or bank holding companies) likely will receive expanded branching and other powers focused outside the lending area.

One remaining question, of course, is the impact that all of this will have on the American economy. Smaller banks likely will not benefit from nationwide branching authority, or from insurance and securities underwriting powers, but will be squeezed by the higher capital standards and deposit insurance premiums, and will remain subject to the new regulatory powers and criminal penalties. As the larger institutions focus on the authority to offer new services and engage in new activities, it seems likely that banks all around the country will continue to restrain their lending. Indeed, this trend seems to be well under way and the current economic recession is probably one result. Regrettably the Bush proposals do not address this problem.

How much more of this can the economy stand? How much economic contraction or stagnation will the public be willing to endure in order to preserve the deposit insurance system? Perhaps attention (and blame) can be diverted elsewhere and the public will accept it all. But surely this remains a major question for the 1990s.

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10. Of course lower interest rates are also a response to the recession. However, without healthy bank lending lower interest rates may not mean more than panic speculation in the stock market and a resurgence of inflation.

11. It is ironic that one primary beneficiary of all this will be the recipients of the thrift industry, which remains saddled with a portfolio of fixed-rate mortgage loans that were mandated by the 1980s and are subject to regulations regarding the servicing of these loans.


(iii) Forced sale of real estate?
   d. Are there state exemptions and may they be waived in the Cardholder Agreement?
   e. Does the Bank need to put special language in the Cardholder Agreement to assure that the cardholder must pay attorney’s fees and expenses?

16. Penalties
   If the Bank fails to comply with applicable state laws:
   a. What penalty may be imposed by the state or collected by the cardholder?
   b. Is there a state class action remedy available to cardholders?
   c. Can the cardholder recover his attorney’s fees and expenses?
   d. Are there state agencies that are actively involved in protecting the rights of consumers?

17. Marital Rights
   a. What is the liability of a spouse for the other spouse’s debts?
   b. If a joint account is established, what is the effect of a separation on debts incurred (a) before the separation and (b) after the separation?
   c. If a joint account is established, what is the effect of divorce on debts incurred (a) before the divorce and (b) after the divorce?

18. Credit Life and Accident and Health Insurance
   a. May the Bank offer credit life or accident and health insurance relating to its accounts?
   b. What premiums may be charged?
   c. Does the Bank need to be licensed?
   d. Does the state have specific requirements as to insurance forms? Do insurance forms require state approval?

19. Please review and advise us of any comments you may have with respect to the enclosed forms and their compliance with and enforceability under the laws of your state.

20. Please advise us of any additional issues concerning the Program that should be considered under the laws of your state.

21. Is there any pending legislation, regulation or case that may impact your responses to the foregoing questions?

22. Please advise us as to the most efficient and effective way for us to be advised in the future as to changes in the laws of your state that would affect the Program.

23. If any of your responses would be changed if the bank issuing the credit cards were a national banking association instead of a state chartered bank, please identify the areas of difference.

Please provide us with copies of all statutes, regulations, cases and other authorities to which you make reference in your opinion.

The Bank has asked us to keep the legal fees for this project to no more than $2,500 per state. If you think you cannot answer the foregoing questions with this limit, please contact me to discuss an estimate of your fee before proceeding.

We would like to receive your response to this letter by [Date]. If you are unable to meet this time schedule, I would appreciate your contacting me prior to commencing work on this matter.

Very truly yours,

[Lender Counsel]

IV. Transformation of the Banking System — The New Community Banker

At the risk of over-dramatizing the problem, it seems possible that one victim of the new federal approach to banking policy will be the community banker.18 The traditional community banker is a long-time resident of his or her community, knows his or her customers (and their families) personally, and is prone to go the extra mile to help them out during periods of temporary financial difficulty.19 When loans go bad, he or she will be accused of “good old boy” banking, of having inadequate loan policies and committees and procedures. The regulatory powers and criminal penalties provided under FIRREA and the 1990 Crime Bill put the community banker in a very precarious position. The lesson is clear: In the future bankers will need to avoid developing close relationships in the community and will need to focus instead on internal loan policies and committees, and regulatory compliance.

Moreover, as likely part owner of the bank and perhaps with other investments in the community, the community banker has a lot to lose when the FDIC seizes the bank and uses bank insiders. Because of the new regulatory enforcement penalties and powers,20 future bankers will need to be essentially judgment-proof, people who have been unsuccessful in managing their own financial affairs. It will be very dangerous for any person with significant personal assets to live with the new risks associated with community bank lending operations. The new banker may also need to be divorced, in order to avoid the risk of the FDIC seizing the home and assets of his or her spouse and other family members.21 (Commentary continued on page 212)

20. This relationship has always been the backbone of the American banking industry. See M. Mayer, THE BANKERS (19) (1974) ("The Small Town Banker is Part of Everything").


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XIII. Written Agreements Entered After Commencement of Service

The protections of the SSCRA apply primarily with respect to obligations entered into prior to commencement of military service. Nothing in the Act prevents the modification, termination, or cancellation of any contract, lease, or bailment or any obligation secured by mortgage, trust deed, lien or other security in the nature of a mortgage or the repossession, retention, foreclosure, sale, forfeiture, or taking possession of property which is security for any obligation or which has been purchased or received under a contract, lease, or bailment pursuant to a written agreement of the parties thereto, executed during or after the period of military service.41

XIV. Conclusion

The Soldiers’ and Sailors’ Civil Relief Act of 1940 offers wide-ranging protections for members of the military service. Many of the benefits must be applied for and granted by a court. While some of the other protections are automatically granted, those adversely affected may seek relief from a court. The purpose of the Act is to provide protection for those servicepersons who require it; upon a proper showing that the ability of the serviceperson to perform is not materially affected by reason of his military service, the benefit will not apply in most instances.

This article addresses many of the significant provisions of the SSCRA. The Act has a number of other sections which are also important, and attorneys should familiarize themselves with all of them.

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It is not difficult for the community banker to anticipate each new wave of social and regulatory fashion, compliance requirements, and underwriting theories. This may make it increasingly likely that efforts to serve the financial needs of the local community will lead to bank losses and regulatory penalties in times of economic distress. As a result, the community banker of the future may need to be an expert in the employment of an out-of-town institution, with minimal personal assets and minimal employment ties to the local community. This will only benefit the bank to remember that he or she is primarily serving the needs of the bank regulatory agencies and the deposit insurance fund, rather than the independent members of the local community.

Above all, the future community banker (and, as an extended party, the bank’s attorney) will need to have an appreciation for the dominant role in modern bank finance.

V. Does Banking Regulation Really Matter?

Despite any discussion of banking in the 1990s and the effect of FIRREA and the 1991 proposals is purely speculative at this point.44 Still, it seems obvious that modern banking laws have some of the adverse effects noted above. While it seems likely that FIRREA at least partly is responsible for the credit crunch, other scenarios should also be considered.

One of these is the possibility that the level and stringency of federal banking regulation simply do not matter very much in terms of micro-economic analysis. Just as one should not expect too much benefit from federal regulation, perhaps it would be a mistake to overstate the harm resulting from misguided federal law. It is quite possible that most bankers will do precisely what they think is best despite and regardless of the nature and extent of federal regulatory powers, fines, and penalties.

No banker intentionally violates the law or makes a bad loan, except in the rare instances of a collusive deal with a confederate borrower or similar fraudulent transaction. Thus, in many cases the possibility that regulators will invoke sanctions may well be considered no more remote or irrelevant as to be only a minor consideration in the credit granting process. In this regard it is only when subsequent developments (such as an unanticipated reversal of the debtor’s fortunes or a collapse of collateral values) casts retroactive doubt on the wisdom of the loan that regulatory enforcement powers become a real threat.

As a result, it is possible that the increase in regulatory enforcement powers in FIRREA and the 1990 Crime Bill are having little effect on bank lending practices. Of course, for the unlucky banker who guesses wrong and suffers major losses, the result can be disastrous. And widespread asset write-downs in a particular industry or region may have a temporary chilling effect on new loans of that type (a current example being commercial real estate lending in many markets). But otherwise the general nature of regulatory powers may not be deemed particularly relevant by lenders who believe they are making only “good” loans. If lending practices are governed primarily by the profit motive then a banker may consider it unimportant whether he or she is subject to penalties of $1,000 per day or $1 million per day for hypothetical regulatory violations and errors of judgment that are not thought to be occurring.45

As a result, it is possible that the enforcement overkill of FIRREA and its progeny may not be doing as much damage to the economy as has been feared. At the same time, however, the new enforcement powers may likewise be having little effect in terms of reducing the risks to the deposit insurance funds. And that would mean that society still has to find other ways to protect the deposit insurance system.

VI. Alternative Solutions to the Deposit Insurance Problem

In responding to the deposit insurance crisis, recent attention has focused almost entirely on preserving the (Continued on page 222)
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Bush Insurance Fund (BIF).26 Probably is inevitable that the financial system is thus the point of immediate concerns. But there are issues at stake that are far more important than just the short-term task of shoring up the BIF. If the Congressionally sponsored another short-sighted political patchwork like FIRREA, then the entire banking system could follow the thrills and drag the entire economy down with it.27

In addressing the current dilemma it should be emphasized that the problem is not just one of an inadequate deposit insurance reserve. While there may be fundamental defects in our deposit insurance system that have contributed to the problems and should be corrected, in part the deposit reserve is inadequate because of other problems in the financial system. Most current proposals address this by accepting (formally or implicitly) consolidation in the industry as a means to reduce competition and prop up the earnings of surviving institutions (so that, in turn, they can afford to pay higher deposit insurance premiums to bolster the BIF). But any strategy that calls for a contraction of the banking system is inherently dangerous. The same process by which an expansive banking system creates money and generates economic activity28 can also work in reverse. Again the fate of our real estate markets in the aftermath of FIRREA (and the resulting shrinkage of the thrift industry) serves as an instructive example. The current infatuation with proposals that are designed to be politically inexpensive, and fail to confront the issue of taxpayer liability for the failure of a federal insurance system, are all too reminiscent of the similar failures to confront the FSLIC insolvency during the early 1980s.29

The current legislative proposals contain many constructive elements designed to correct some obvious flaws in our deposit insurance system and to redress archaic restrictions on the activities of banking institutions. But this may not be enough. Recapitalizing the BIF (and avoiding political liability for its insolvency) should not be the sole basis for our banking law reforms. Any 1991 legislation should also address misguided and counterproductive provisions in FIRREA and the 1990 Crime Bill that are unduly discouraging bank lending, fundamental defects within the deposit insurance system, and problems relating to the methods of resolving insolvent financial institutions. In short, there are four broad areas that Congress and the administration should address as a part of any 1991 banking legislation:

1. Solvency of the deposit insurance fund. This problem is obvious to everyone. Parts of the solution seem clear: Restricted deposit insurance coverage, abandoning the "too big to fail" policy, market pricing for deposit insurance premiums. These and other solutions are ably covered by the articles in this symposium. To some extent the Bush administration proposals address these issues, but it remains to be seen whether they go far enough and whether they will be effectively enacted by a contentious Congress.

2. Expanded powers for banking institutions. This solution also seems obvious, as will be discussed in more detail in Part II of this symposium (to appear in the next issue). Once again the Bush administration deserves credit for tackling the (Continued on back cover)