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## THE DEREGULATION OF BANKS

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### I. INTRODUCTION

Despite what politicians and competitors may claim to the contrary, the fact remains that banks in the United States have not been deregulated. The geographical and functional scope of bank activities has remained essentially unchanged for many decades. Only the interest rates banks may pay on certain types of deposits have been deregulated. This poorly understood distinction clouds the current debate over banking policy. This article describes the deregulation that has occurred and some of its effects, surveys the regulations that still exist, and suggests how the unfinished process of bank deregulation should be completed in the public interest.<sup>1</sup>

### II. THE CURRENT STALEMATE

The 98th Congress adjourned without action to reform the powers of banks and bank holding companies (BHCs). Although the House and Senate Banking Committees, the Reagan Administration, the federal banking regulatory agencies, and large segments of the banking industry all supported certain reforms, the changes on which a consensus existed would merely have added new restrictions. Philosophical differences separating the interested parties prevented any action on deregulation of bank and BHC activities.<sup>2</sup>

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1. For a succinct and expert analysis of the economics of bank deregulation, see COUNCIL OF ECONOMIC ADVISERS, ECONOMIC REPORT OF THE PRESIDENT 145-74 (1984).

2. Objections to broader securities powers of commercial banks became the principal obstacle to enactment of the bill. See 130 CONG. REC. S11117-30 (daily ed. Sept. 13, 1984); Letter from Representative Dingell to House Speaker O'Neill (September 26, 1984) (opposing consideration of the Senate-passed bill in the House). But see Note, *Restrictions on Bank Underwriting of Corporate Securities: A Proposal For More Permissive Regulation*, 97 HARV. L. REV. 720 (1984).

The Senate, under the leadership of Senator Jake Garn, adopted an omnibus banking bill which reinforced the existing limitations on BHC activities and closed the so-called "loopholes" that securities, insurance and other non-banking companies have used to facilitate their engaging in the banking business, and which BHCs have begun to use to avoid to some extent the geographic limitations imposed by the Douglas Amendment.<sup>3</sup> The bill also prohibited BHCs from using state-chartered banks to expand their involvement in the insurance business.<sup>4</sup> That is, the bill closed the "non-bank bank"<sup>5</sup> and "South Dakota"<sup>6</sup> loopholes in the Bank Holding Company Act of 1956 (BHC Act).<sup>7</sup> In addition, the Senate bill offered BHCs limited additional powers to deal in and underwrite municipal revenue bonds, mortgage-backed securities, and commercial paper.<sup>8</sup> It removed a few minor limitations on activities of BHCs, made numerous other amendments to the statutory structure regulating banks, savings and loan associations and their holding companies, and authorized the states to enact reciprocal legislation establishing exclusive interstate regions within which BHCs could acquire banks and other BHCs.<sup>9</sup>

By contrast, the House Banking Committee adopted a bill that would have closed all of the "loopholes" without giving banks and BHCs any additional powers.<sup>10</sup> The Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce adopted a similar, even more stringent bill.<sup>11</sup> In the end, the 98th Congress was unable to achieve a consensus on whether bank and BHC powers should be expanded, contracted, or left unaltered.

The current stalemate may reflect public opinion. Some polls suggest that there is little public support for expanded bank powers, although the misinformation and disinformation disseminated on these issues makes it hard to assess the weight to be accorded such survey results.<sup>12</sup> This stalemate leaves unresolved the imbalance that has increasingly troubled the banking industry since the process of banking "deregulation" began in the late 1970s. This process has lifted many of the restrictions that have been imposed since the enactment of the Banking Act of 1933<sup>13</sup> on the interest rates that banks could pay on their liabilities, especially smaller deposits. However, "deregulation" has reduced significantly neither the severe restrictions on activities

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3. See S. 2851, 98th Cong., 2d Sess. (1984); see also *infra* note 57.

4. See S.2851, 98th Cong., 2d Sess. (1984).

5. See *infra* text accompanying note 95.

6. See *infra* note 127.

7. 12 U.S.C. §§ 1841-50 (1982).

8. See S.2851, 98th Cong., 2d Sess. (1984).

9. See *id.*

10. See H.R. 5916, 98th Cong., 2d Sess. (1984).

11. See H.R. 5881, 98th Cong., 2d Sess. (1984).

12. See *New Poll Looks at Consumer Attitudes on Changing Financial Services*, American Banker, Oct. 20, 1984, at 3.

13. Act of June 16, 1933 (Banking Act of 1933), § 11(b), 48 Stat. 181-82 (1933) (codified as amended at 12 U.S.C. § 371(a), (b) (1982)).

permissible for banks and BHCs nor the limits imposed by the McFadden Act<sup>14</sup> and the BHC Act on the geographic areas in which banks and BHCs may conduct permitted banking activities.

### III. DEREGULATION OF DEPOSIT INTEREST RATES

The Banking Act of 1933 prohibited the payment of interest by member banks of the Federal Reserve System on demand deposits<sup>15</sup> and authorized the Federal Reserve Board (Board) to set the maximum rates of interest that member banks could pay on time deposits.<sup>16</sup> Under this authority the Board issued its Regulation Q, which defines the types of time deposits banks may issue and sets the maximum rate of interest banks may pay on such deposits.<sup>17</sup> Subsequent legislation and regulation extended similar limitations to all federally-insured banks and savings and loan associations.<sup>18</sup>

Until the mid-1960s, the legal limitations in interest rates payable on time deposits had little practical impact on the banking business, since market interest rates were generally below the Regulation Q ceiling.<sup>19</sup> Commencing in the mid-1960s, inflation led to rising interest rates that soon exceeded the ceiling rates mandated by Regulation Q. A "regulatory spread" developed between the cost of these deposits to banks (and other depository institutions) and the market-determined rates at which the deposits could be lent. The pre-existing regulatory spread on interest-free demand deposits increased.

Holders of larger deposits generally were able to avoid the restrictions on deposit rates.<sup>20</sup> These depositors received many services from banks at prices below cost and could invest at money market rates balances unused to compensate the banks for those services. Smaller deposits, usually called "consumer deposits," remained subject to the Regulation Q interest rate restrictions. Because the regulatory spread and the innate stability of consumer deposits made these deposits highly profitable, depository institutions competed vigorously for them.

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14. See 12 U.S.C. § 36 (1982).

15. See *id.* § 371(a).

16. See *id.* § 371(b).

17. 12 C.F.R. §§ 217-217.160 (1984).

18. The Board of Directors of the Federal Deposit Insurance Corporation established the maximum rates payable by insured non-member banks. See 12 U.S.C. §§1819, 1828 (1982); 12 C.F.R. § 329 (1984). The Federal Home Loan Bank did so for federally-insured savings and loan associations 12 U.S.C. § 1437 (1982); 12 C.F.R. § 526 (1984). Aside from a differential in favor of savings and loan association and savings banks, the limitations on all types of institutions were nearly the same as, and came to be called, Regulation Q after the Board's regulation.

19. During all of the period prior to November 24, 1964, the Regulation Q limit never exceed 4%, and Treasury bill rates were rarely that high. See *BD. OF GOVERNORS OF THE FED. RESERVE SYS., BANKING AND MONETARY STATISTICS 1941-1970*, Table 12.4 at 673 and Table 12.7 at 693 (1976).

20. All restrictions on interest rates on time deposits in excess of \$100,000 were suspended May 16, 1973. See *BD. OF GOVERNORS OF THE FED. RESERVE SYS., ANN. STATISTICAL DIG., 1971-1975*, Table 8 at 328 n. 4 (1976).

Since the institutions could not compete in terms of interest rates, they offered goods and services instead. Depending on the size of the customer's deposit, the goods offered ranged from scenic checks and toy animals to other more valuable premiums. Services included "free" checking accounts and assistance in balancing the customer's checkbook. Most importantly, banks saturated their market areas with offices (where permitted) in order to offer their customers as much convenience as possible. In the phrase most often used to describe this behavior, banks (and other depository institutions) "competed with brick and mortar."

To be sure, there are a variety of reasons for banks to establish many offices. For example, branching allows a desirable diversification of both assets and liabilities, which, if properly managed, can increase significantly a bank's stability. Long before Regulation Q became binding, banks in states permitting branch banking had established substantial branch networks. In California, which has authorized statewide branch banking by statute since 1909,<sup>21</sup> Bank of America had more than 500 branches before the inception of interest-rate regulation.<sup>22</sup>

Nonetheless, the evidence strongly suggests that banks offered their consumer and small business customers convenience as a major method of competition after the mid-1960s.<sup>23</sup> In 1960, when low market interest rates made Regulation Q ineffective, there were 1750 banking offices in California, or one for each 8981 residents. By 1979 the number of offices had increased to 4321, or one office for each 5478 California residents counted in the 1980 census. Similar results emerge for every state, although the increase in the number of offices generally was more pronounced in states permitting branch banking than in those committed to unit banking. For example, in 1960 Illinois had 966 banking offices, or 10436 residents per office, while in 1979 the state had 1734 offices, or one office for each 6585 Illinois residents counted in the 1980 census.<sup>24</sup>

Deregulation of consumer time-deposit interest rates began in 1978, when the Board authorized a certificate of deposit with an interest rate limited by the rate determined in the weekly Treasury bill auction and a maturity of six months.<sup>25</sup> To slow the rate at which consumers converted from interest-rate controlled deposits to the new certificate, the Board set the certificate's minimum denomination at \$10,000.<sup>26</sup> Despite this large minimum deposit,

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21. See CAL. FIN. CODE § 500 (West 1909).

22. *BankAmerica Corp.*, 1969 ANNUAL REPORT 32 (1970).

23. See Keeley and Zimmerman, *Deregulation and Bank Profitability*, FED. RESERVE BANK OF SAN FRANCISCO WEEKLY LETTER, July 14, 1984; see also Keeley, *Interest-Rate Deregulation*, FED. RESERVE BANK OF SAN FRANCISCO WEEKLY LETTER, Jan. 13, 1984.

24. See DEPT. OF THE TREASURY, GEOGRAPHIC RESTRICTIONS ON COMMERCIAL BANKING IN THE U.S., THE REPORT OF THE PRESIDENT, Table 2.2 at 39 and Table 2.3, at 31 (January 1981) (hereinafter cited as PRESIDENT'S REPORT) (number of branches); DEPT. OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE U.S., at 17 (1982) (population statistics).

25. See 43 Fed. Reg. 21435 (1978).

26. *Id.*

the amount invested in these less-regulated certificates grew to approximately \$178 billion by the end of 1980.<sup>27</sup> During this period, the amount held in savings deposits decreased by approximately \$20 billion.<sup>28</sup> In effect, customers began to move their funds from accounts subject to a substantial regulatory spread to accounts with a much lower spread.

This trend accelerated as Merrill, Lynch and Co. developed the Cash Management account and money market mutual funds (MMMFs) became popular. MMMFs offered investors the capability to withdraw funds on demand from accounts bearing interest at a market-determined rate. By December 1982, these funds held total assets of about \$233 billion.<sup>29</sup> The MMMFs invested a substantial proportion of these assets with depository institutions, purchasing large-denomination certificates of deposit that were not subject to Regulation Q. In effect, MMMFs permitted consumer depositors to avoid the regulatory spread imposed by Regulation Q and to earn a market-determined rate of interest on their liquid investments.

From December 1979 to December 1982, rate-regulated savings deposits at all depository institutions fell by more than \$50 billion, and small-denomination time deposits increased significantly less rapidly than the rate of inflation. Liabilities upon which depository institutions had earned a substantial regulatory spread ceased to grow, and indeed, decreased when adjusted for inflation. During the same period, large-denomination certificates of deposit exempt from interest rate controls grew by nearly \$110 billion.<sup>30</sup>

Faced by this shift away from rate-regulated accounts, depository institutions demanded the authority to compete on equal terms with the new consumer savings vehicles that were not subject to Regulation Q. Congress responded by creating the Depository Institutions Deregulation Committee (DIDC) in 1980,<sup>31</sup> charged with eliminating interest-rate controls over a period of six years. In 1981, after considerable delay caused in large part by the lack of consensus among depository institutions regarding the best way to accomplish interest-rate deregulation, the DIDC adopted a phased plan for removing interest-rate ceilings by the statutory deadline.<sup>32</sup>

By mid-1982, however, high and volatile interest rates had convinced many depositors that the flexibility and high rates that could be earned on even relatively small balances held with MMMFs offset their lack of federal

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27. See BOARD OF GOVERNORS OF THE FED. RESERVE SYS., STATISTICAL RELEASE E.3.4 (July 14, 1981).

28. See FDIC, BANK OPERATING STATISTICS, 1978 and 1980, Table A.

29. See 70 FED. RES. BULL. A13, Table 1.21 (July, 1984) at A13.

30. See BOARD OF GOVERNORS OF THE FED. RESERVE SYS., ANN. STATISTICAL DIG., 1970-1979, Table 13.B at 67 (1981) (1979 data); 70 FED. RES. BULL. A13, Table 1.21 (July, 1984) (1982 data).

31. The DIDC was created by the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132, (codified as amended at 12 U.S.C. §§ 3501-24 (1982)).

32. See 12 C.F.R. § 1204.115 (1984).

deposit insurance and the inconvenience of dealing with a distant MMMF by mail or wire transfer of funds.

Since the DIDC had proved incapable of creating an instrument fully competitive with the MMMFs, depository institutions demanded one from Congress. The Garn-St Germain Depository Institutions Act of 1982<sup>33</sup> instructed the DIDC to create such an instrument, which the DIDC did, effective December 14, 1982.<sup>34</sup> The Money Market Deposit Account (MMDA) that the DIDC authorized offered depository institutions a highly effective mechanism for competing with the MMMFs. Commercial banks alone had issued more than \$230 billion in MMDAs at the end of 1983. A portion of the MMDA deposits was withdrawn from MMMFs, whose assets declined by more than \$55 billion in a year. Some MMDA deposits converted from rate-regulated accounts. From year-end 1982 to the end of the first quarter of 1984, the seasonally adjusted amount of rate-regulated savings accounts at commercial banks declined by \$36 billion.<sup>35</sup>

At the same time that it authorized MMDAs, the DIDC also created the "Super-NOW" account upon which depository institutions could pay unregulated interest rates, while customers could make unlimited withdrawals by negotiable order of withdrawal.<sup>36</sup> This account also proved successful, though less so than the MMDA. At the end of 1983, \$29.5 billion had been deposited in Super-NOW accounts,<sup>37</sup> presumably much of it transferred from the rate-controlled NOW accounts that Congress had authorized nationwide in 1980<sup>38</sup> or from consumer demand deposit accounts upon which interest remains prohibited.

When the DIDC amended its regulations in October 1983 to eliminate all rate controls on time deposits with maturities greater than one month, the erosion of the regulatory spread continued. At the same time, the DIDC reduced in phases the minimum balance required to qualify for deregulated accounts from \$2,500 to zero by January 1, 1986.<sup>39</sup> After March 31, 1986, no regulations will control consumer deposit interest rates, although the

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33. Pub. L. No. 97-320, Title III, § 327 96 Stat. 1501; (codified at 12 U.S.C. § 3503(c) (1982)).

34. See 12 C.F.R. § 1204.122 (1984).

35. 70 FED. RES. BULL. A13, Table 1.21 (July, 1984). If this amount converted from savings deposits to MMDAs earning at least 9% annually, commercial bank interest expense increased by at least \$1.26 billion. From December, 1982 to December, 1983 the same table shows at line 41 that large time deposits at commercial banks declined by \$37.2 billion. See *id.* These certificates tend to bear a higher interest rate than MMDAs. This shift to lower-cost MMDA's undoubtedly helped to offset the additional expense from the savings deposit shift.

36. See 12 C.F.R. § 1202.122 (1984). Drafts drawn on NOW accounts function like checks drawn on demand deposits. However, the drawee institution reserves the right to require notice of withdrawal on NOW drafts and is not legally bound to pay the draft immediately upon presentation. See *infra* text accompanying note 99.

37. See 70 FED. RES. BULL. A13, Table 1.21, Line 12 (July, 1984).

38. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. 96-221, Title III, § 303, 94 Stat. 146 (codified at 12 U.S.C. § 1832(a) (1982)).

39. See 12 C.F.R. §§ 1204.108, 1204.121-24 (1984) (new time deposit regulations).

prohibition on the payment of interest on demand deposits will remain in effect, and deregulated transaction (NOW and Super-NOW) accounts will continue to be unavailable to corporations.<sup>40</sup>

#### *A. Effects of Interest-Rate Deregulation*

The new accounts authorized by the Garn-St Germain Act and the deregulation of interest rates on time deposits were a mixed blessing for depository institutions. They provided an effective and necessary competitive tool to stem the hemorrhage of consumer deposits out of the banking system, but they further eroded the regulatory spread. As previously described, when the regulatory spread emerged, depository institutions tended to expend a portion of it to increase the quantity of convenience and service they provided, in part by increasing the number of their offices. As the regulatory spread diminishes, this process will tend to reverse itself, unless other means develop to keep branch systems profitable at their current scope. Branches and unit banks created primarily as mechanisms for competing by brick and mortar may have to retrench.

Depository institutions have taken a variety of steps to respond to erosion of the regulatory spread, steps designed to enhance the profitability of their existing delivery systems. By consolidating branches and introducing greater automation, banks have attempted to reduce the unit costs of providing many banking services. They have increased service charges and have begun to charge for services that customers received without explicit charge in the past.

Depository institutions also have sought to obtain whatever economies of scale and benefits of diversification may be gained from consolidations, mergers and acquisitions. This trend may be expected to continue in states which permit such activity. The number of banking offices may decrease somewhat, as banks substitute interest-rate competition for competition with brick and mortar. The need for diversification of deposit and loan portfolios should motivate some unit banks to consolidate with branch bank or BHC systems, and the proportion of banking assets held by multi-office systems should increase.<sup>41</sup> Increased geographic diversification would help to stabilize bank earnings streams as the regulatory spread erodes. Of course, the statutory restrictions on branching and interstate banking discussed in detail below severely limit opportunities for such diversification.

Banks and BHCs also have sought to broaden their activities to include financial services not perceived as traditional banking services, such as: insurance brokerage and agency, real estate brokerage, financial data processing and software production, securities brokerage, insurance and securities underwriting, and real estate development. However, attempts to gain au-

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40. See 12 U.S.C. § 1832 (1982).

41. C. H. GOLEMBE & ASSOCS., *THE REGULATION OF BANK SIZE, HISTORICAL FOUNDATIONS AND FUTURE PROSPECTS* (1984) at 90-103; see also FED. RESERVE BANK OF ATLANTA, *INTERSTATE BANKING*, *ECON. REV.*, (May 1983).



thority for new activities that depository institutions could deliver conveniently through their existing branch systems have been unsuccessful, by and large, even though it seems obvious that depository institutions could gain economies of scope by using existing delivery systems to provide additional services with greater convenience to customers. We examine below the restrictions and limitations that the current statutory and regulatory structure imposes on commercial banks and BHCs that wish to enter these fields.

### B. *Bank Capital Rules*

As we have shown, "deregulation," to date, has meant simply elimination of the regulatory spread. At the same time, banks have been subjected to an additional regulatory burden, that of enhanced capital requirements. The impact of deregulation occurred just as banks were struggling to manage the effects of a severe and prolonged recession. Perhaps partially to offset the effect of these factors on their return on equity, banks have permitted their capital ratios to decline over the past few years. In 1970 the average regulatory capital of U.S. banks was about 8.7 percent of total assets.<sup>42</sup> By the end of 1983, this ratio had declined to about 6.5 percent for banks with total assets exceeding \$100 million.<sup>43</sup>

In response to this decline, the federal bank regulatory agencies issued guidelines for BHC and bank capital in 1981.<sup>44</sup> In June 1983, the Board and the Office of the Comptroller of the Currency (OCC) for the first time applied the guidelines to the seventeen very large "multinational" banks and BHCs.<sup>45</sup> In August, 1984 the regulators proposed that the capital guidelines be uniform for all sizes of banks and that the required minimum level of total capital be 6 percent of total assets.<sup>46</sup>

In the International Lending Supervision Act of 1983,<sup>47</sup> Congress granted

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42. The average regulatory capital ratio of U.S. banks is the ratio of "total capital accounts plus total reserves" to "total assets". BOARD OF GOVERNORS OF THE FED. RESERVE SYS., *BANKING AND MONETARY STATISTICS 1941-1970* 418, Table 6.11 (1976).

43. For 1983, the average regulatory capital ratio of U.S. banks was calculated as the ratio of the sum of line 108 "total equity capital", Line 109 "preferred stock", line 26 "allowance for possible loan losses", and line 27 "allocated transfer risk reserves" divided by line 1 "total assets". 70 FED. RES. BULL. A66-A67, Table 4.20 (June, 1984).

44. *Joint Press Release of the Comptroller of the Currency and the Federal Reserve Board*, FED. BANKING L. REP. (CCH) ¶ 5462 (Dec. 17, 1981). The Federal Deposit Insurance Corporation separately adopted guidelines for capital adequacy for insured non-member banks. 46 Fed. Reg. 62693 (1981).

45. Joint Press Release, Board of Governors of the Federal Reserve System and Office of the Comptroller of the Currency (June 13, 1983). The Federal Reserve Board reviewed and reaffirmed the June, 1983 amendments to the capital adequacy guidelines in a Federal Reserve press release. See Federal Reserve Press Release (Dec. 1, 1983).

46. The proposals of the three regulators differ slightly. For the Federal Deposit Insurance Corporation proposal, see 49 Fed. Reg. 29399 (1984); for the Federal Reserve Board proposal, see 49 Fed. Reg. 30317 (1984); for that of the Office of the Comptroller of the Currency, see 49 Fed. Reg. 34838 (1984).

47. 12 U.S.C. §§ 3901-12 (1982).

the regulatory agencies broad authority to impose particular capital ratios.<sup>48</sup> This new authority has been used, thus far, to impose capital requirements that wholly lack theoretical justification. The regulators have never presented an analytical basis to justify a particular level of capital as adequate.<sup>49</sup> On the contrary, the regulators' reasoning seems to be that the industry as a whole currently has a capital level of around 6 percent of total assets; that the capital level should not decline further; and that the regulators can draw no principled distinction between large and small banks. The regulatory agencies have never addressed the question of why the level of capital should not further decline, if financial markets would permit it to do so.

Nevertheless, there must be some intuitive agreement among all concerned that, given the aftermath of the domestic recession, the decline in energy prices, and the Third World debt problems, some enhanced equity cushion may be desirable for the safety of the federal deposit insurance fund and uninsured depositors.<sup>50</sup> Specific capital ratios also offer the regulators a means to control the growth of banks as Regulation Q authority disappears. If the regulators wish to promote financial intermediation through banks, they can tolerate lower capital ratios. If they wish to restrict lending of the types in which banks specialize, they can increase the capital requirements.

The banking regulators appear to perceive deregulation, namely, the elimination of the regulatory spread, as increasing the risk of bank failure. In some measure, this is probably true, since the earnings afforded by that spread probably tended to be more stable than the earnings available in an environment where money markets determine the rates banks must pay on their liabilities.<sup>51</sup> Even if this is true, the reason why possible increased variability in bank earnings requires additional bank capital remains elusive.

A bank's capital is not its first line of defense against insolvency. A substantial and stable revenue stream and a high level of liquidity afford far better protection against failure. Banks in some foreign countries, for instance, Japan, operate with significantly less capital than that which the regulators have required U.S. banks to maintain.<sup>52</sup> Savings and loan associ-

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48. *Id.* § 3907.

49. *See, e.g.,* First Nat'l Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674 (5th Cir. 1983); *see also* Staff Memorandum to Board of Governors of the Federal Reserve System, Regulations Establishing Procedures for Adherence to Board's Capital Adequacy Guidelines (July 20, 1984).

50. The question of deposit insurance is addressed in the last part of this article.

51. A recent study concluded, however, that the regulatory actions taken through May, 1978 to reduce interest-rate restrictions had no significant effect on bank solvency risk, as perceived by financial markets. Smirlock, *An Analysis of Bank Risk and Deposit Rate Ceilings*, 13 J. MONETARY ECON. 195 (1984).

52. *See* The Mitsubishi Bank, Ltd. (BanCal Tristate), 70 FED. RES. BULL. 518 (1984). In the *Mitsubishi Bank* opinion the applicant covenanted to maintain capital of the acquired U.S. bank at a ratio higher than that required of the applicant. *See id.* at 519. Governors Martin and Rice dissented from this order because of concern over the capital adequacy of the applicant. *See id.* at 520; *see also* Bank of Montreal (Harris Bancorporation), 70 FED. RES. BULL. 664, 667 (1984) (Partee, Governor, dissenting).

ations and federal savings banks in the United States may operate with much less capital than commercial banks, despite the fact that these institutions have powers similar to those of commercial banks.<sup>53</sup>

The capital requirements imposed by the federal bank regulators generally will increase the cost of engaging in the banking business, since a bank must obtain more capital to support each asset added to the balance sheet. The cost of capital, net of tax effects, typically exceeds the cost of debt. Thus, the higher the capital requirement, the greater the cost of funding assets. Especially since its efficacy is quite dubious, it seems unfortunate that the federal bank regulators have imposed this additional cost burden on banks. Banks may be tempted to take counter-productive actions to adapt to these requirements.

### *C. Bank Responses to Increased Capital Requirements*

With the regulatory spread diminished, banks require additional sources of income in order to generate adequate returns to attract the capital necessary to support the growth of the business. Banks must strive to balance their portfolios to achieve an expected rate of return, on whatever level of capital the regulators may require, that approximates that expected on alternative investments with comparable risk. Bank management can seek the necessary additional income in two principal ways: by managing existing and additional activities to increase revenues and by increasing the risk of the existing activities, that is, by investing in riskier assets. Of course, bank management generally will follow both avenues.

Heightened capital requirements may add to the pressure on banks and BHCs to stress activities upon which they can earn fee income in order to increase revenues without increasing assets. It also will tend to induce banks to eliminate less profitable activities. Management can redeploy the capital invested in those activities to more profitable lines. Even if a line of business is not discontinued, banks may limit it to the most profitable geographic and demographic market segments. For this reason, increases in capital requirements mandated by the regulators may compel banks and BHCs to reduce the level of their service to their communities. The capital requirements certainly will cause increases in charges for bank services.

If regulations restrict additional activities as revenue sources, the incentive becomes greater for banks to increase the risk of their bank portfolios. A regulatory capital adequacy requirement actually may reduce the stability of an institution's income stream by creating this additional incentive to make high-risk, high-return investments. Other things being equal, higher capital requirements should not lessen significantly the frequency of bank failures.

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53. The Federal Home Loan Bank Board has proposed rules to enforce more strictly the requirement that federally-insured savings and loan associations achieve a capital level of 3% and to restrain excessive growth. *See* 50 Fed. Reg. 6891 (1985).

*D. Geographic and Functional Deregulation as an Alternative to Enhanced Capital Requirements*

It appears to the authors that expanded functional and geographic powers for banks and BHCs may in many instances provide both additional earning power and stability to support bank capital growth and may reduce the incentive to invest in higher-risk assets that capital requirements create. Functional and geographical diversification could provide the larger revenue stream and greater liquidity that are the true supports for both depositors and stockholders. Any new powers should emphasize those financial services which existing bank and BHC delivery systems can provide conveniently and efficiently. Permitted geographic expansion should allow utilization of technology already in place serving existing branch systems to support expanded service areas. New services should not call for management skills appreciably different from those banks now possess.

Studies have shown that a number of the financial services activities that banks and BHCs have sought to enter either have earnings less variable than those of traditional banking activities, such as insurance agency, brokerage and service, and life insurance underwriting, or possess revenue streams that tend to move counter-cyclically to those of traditional banking services, namely those conducted by banks acting as securities broker/dealers, savings and loan associations, and in a real estate capacity other than lessor, subdivider and builder.<sup>54</sup> Other activities proposed seem to show both greater variability of earnings than and a pro-cyclical relationship with traditional banking activities. These include real estate development, leasing and management, and property and casualty insurance underwriting.<sup>55</sup> It is possible that these last activities are inherently more profitable than traditional commercial banking. Based on the evidence, it appears that the authority to

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54. See Wall and Eisenbeis, *Risk Considerations in Deregulating Bank Activities*, FED. RESERVE BANK OF ATLANTA ECON. REV., (May 1984), at 15; see also Embersit and Quinn, *Financial Motives For Mixing Financial Services*, American Banker, April 26, 1984, at 4. With the exception of property and casualty insurance underwriting, banks and BHCs already engage in these services to a limited extent in the United States or abroad. See, e.g., Federal Reserve Board Press Release, Dec. 4, 1984, (concerning Citicorp). None of these activities calls for managerial resources substantially different from those which banks and BHCs already possess. Diversifying into these businesses would not create conglomerates of the type in fashion during the 1960s. But see Rhoades, *The Implications for Bank Merger Policy of Financial Deregulation, Interstate Banking, and Financial Supermarkets*, BOARD OF GOVERNORS OF THE FED. RESERVE Sys. STAFF STUDY No. 137 (1984). The analogy Mr. Rhoades draws between industrial conglomerates and expanded financial services powers for banks and BHCs is faulty. The industrial conglomerates relied for their success on financial and managerial synergies that often proved illusory. Broader financial services powers for banks and BHCs would simply permit delivery of greater volume through existing distribution systems, driving down unit costs of delivery for all of the services.

55. See *supra* note 54.

engage in certain additional activities could reduce the variability of bank and BHC earnings and possibly increase their return on capital. This authority could therefore help to offset the consequences of the disappearance of the regulatory spread and the cost of augmenting capital in response to regulatory requirements.

#### IV. RESTRICTIONS ON GEOGRAPHIC EXPANSION

Of the various restrictions imposed on commercial bank activities, the branching restrictions remain the most inexplicable. Indeed, the President's Report on Geographic Restrictions on Commercial Banks in the United States noted that, notwithstanding the increasing ineffectiveness of prohibitions against geographic expansion by commercial banks, the prohibitions retain "an almost mystical significance" to their supporters.<sup>56</sup>

In reviewing the history of the Douglas Amendment to the BHC Act,<sup>57</sup> the Board in *Bank of New England Corporation (CBT Corporation)*<sup>58</sup> concluded that the Douglas Amendment amounted to a "renunciation of federal interest" in the regulation of interstate bank acquisitions. The Douglas Amendment was, and was intended to be, no more than an application to BHC regulation of the policy governing the branching powers of national and state member banks reflected in the McFadden Act.<sup>59</sup> Thus, notwithstanding the acrimonious debate of the issue on the national level and the long roster of national studies devoted to it,<sup>60</sup> Congress has consistently refused to treat bank structure as a matter of national concern, relegating its determination largely to state law. To state this proposition is to illuminate its irony, given the evidence of the link between banking structure and performance and the national concern with the safety and soundness of the banking system.<sup>61</sup>

##### A. Restrictions on Branching

Branching was not prohibited under very early American banking law. The First and Second Banks of the United States each had branches in major cities. Given the Treasury agency functions that the Bank of the United

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56. PRESIDENT'S REPORT, *supra* note 24, at 1.

57. Section 3(d) of the BHC Act prohibits acquisitions by BHCs of banks located in a state other than that in which the BHC's banking operations are principally conducted, unless the law of the state in which the bank to be acquired is located expressly permits such acquisition. See 12 U.S.C. § 1842(d) (1982). Although referred to as the Douglas Amendment, it was part of the BHC Act as originally enacted in 1956. See *id.*

58. 70 FED. RES. BULL. 374 (1984), *aff'd sub. nom.*, *NorthEast Bancorp. v. Board of Governors*, 740 F.2d 203 (2nd Cir. 1984), *cert. granted* \_\_\_\_ U.S. \_\_\_\_.

59. 102 CONG. REC. 6858 (1956), (quoted in *NorthEast Bancorp.*, 740 F.2d at 207).

60. See PRESIDENT'S REPORT, *supra* note 24, at A.1—A.5 (Appendix A to chapter 1).

61. See Hawke, *Continental Rescue: Is it Time to Reassess State Banking Powers*, *American Banker*, August 10, 1984, at 4.

States exercised, however, these branches probably existed as much for the convenience of the Government as for the convenience of customers and the efficient operation of the bank.<sup>62</sup> State-chartered banks of that era, including banks owned by states, likewise maintained branches.<sup>63</sup> The silence of the National Bank Act of 1864<sup>64</sup> on the issue of branching suggests that the subject was not one of great debate at the time.<sup>65</sup> As the power to branch could not be inferred from the Act's silence, the Supreme Court refused to view it as an incidental power of national banks.<sup>66</sup>

It is not clear when the branching issue became as controversial and contested as it is today. One might attribute opposition to branching to the rise of agrarian politics and the populist revolt. Yet, while the rhetoric of the controversy harks back to those days, the controversy itself appears of more recent origin.<sup>67</sup> Congress did not deal with this issue directly until 1927 when it enacted the McFadden Act,<sup>68</sup> which permitted branching for national banks only within the city, town or village in which the bank was located and then only if state law permitted state-chartered banks to maintain such branches. At the same time, Congress made these restrictions applicable to state-chartered member banks.<sup>69</sup> Indeed, although the McFadden Act started its legislative life as a genuine effort to liberalize branching, its intended effect when enacted was to curtail the branching powers of state member banks rather than to give national banks significant branching powers.<sup>70</sup> As

62. *McCullough v. Maryland*, 17 U.S. (4 Wheat.) 415, 424-5 (1819); F. REDLICH, *THE MOLDING OF AMERICAN BANKING*, Part I 113-116 (1968).

63. See Gorinson, *Depository Institution Regulatory Reform in the 1980s: The Issue of Geographic Restrictions*, 28 *ANTITRUST BULL.* 227, 238-9 (Spring 1983).

64. Act of June 3, 1864, Ch. 106, 13 Stat. 100. (codified as amended at 12 U.S.C. § 21 *et. seq.* (1982)).

65. Debates during the 19th century regarding branching mainly concerned abuses such as the "shaving shops", which were city branches of banks located in remote towns or villages that redeemed the notes issued by the bank at a substantial discount. The National Bank Act did deal indirectly with branch banking because it permitted a state bank converting to a national bank charter to retain whatever branches it was then operating. 13 Stat. 484 (1864).

66. See *First National Bank of St. Louis v. State of Missouri*, 263 U.S. 640 (1924). Beginning in 1922, the Comptroller of the Currency (OCC) permitted limited facilities for check cashing and deposit taking in the city or town where the national bank was located if state law permitted state banks similar or more liberal branching. The OCC continued this practice even after the Supreme Court's 1924 branching decision. See Fisher and Golembe, *The Branch Banking Provisions of the McFadden Act as Amended: Their Rationale and Rationality*, reprinted in *REPORT OF SUBCOMM. ON FINANCIAL INSTITUTIONS OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 94th Cong. 2d Sess., COMPENDIUM OF ISSUES RELATING TO BRANCHING BY FINANCIAL INSTITUTIONS 11-12* (October 1976) (hereinafter cited as *COMPENDIUM*).

67. It is also noteworthy that many Western states, including California, adopted state-wide branching at the very time when populist feeling was strong and influenced policy. *CAL. FIN. CODE* § 500 (West 1909).

68. Act of Feb. 25, 1927, § 7, 44 Stat. 1228.

69. *Id.* § 9 at 1229.

70. See *First National Bank of Logan v. Walker Bank & Trust Co.*, 385 U.S. 252, 257-258 (1966).

a result, both national banks and state member banks in states with more liberal branching laws were at a severe competitive disadvantage vis-a-vis non-member state banks. The Banking Act of 1933 corrected this inequity by permitting national banks and state member banks to branch to the full extent permitted by the law of their home states.<sup>71</sup>

When the McFadden Act was cast in its present form by the Banking Act of 1933, the evidence demonstrated that branch banks had fared better than unit banks in weathering the Depression.<sup>72</sup> Some witnesses before the Senate Banking Committee, particularly the Comptroller of the Currency, urged Congress to expand modestly bank branching powers to assist banks in meeting the adversities of the Depression.<sup>73</sup> Senator Glass was sympathetic to that view, but all that the 1933 changes to the McFadden Act could accomplish, given the continuing political opposition to branching, was merely to assist national and state member banks in those states whose branching laws were more liberal than the provisions of the McFadden Act as originally enacted in 1927. The national policy of relegating the determination of banking structure to the states was preserved and even enhanced.

Given the continued, vociferous opposition to the liberalization of branching laws, states have been slow to permit change. A majority of states either prohibits branching entirely or severely restricts it; only a small minority of states permits essentially unrestricted statewide branching.<sup>74</sup> Even states which recently liberalized their branching laws, such as New York, retain home office protection provisions for smaller communities.<sup>75</sup> Although the issue has been debated since the 1930s, no state permits interstate branching unconditionally, even in natural market areas which straddle state boundaries.<sup>76</sup>

### *B. Other Restrictions on Entry*

Even states with the most liberal branching laws condition the granting

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71. Act of June 16, 1933, §5(b), 48 Stat. 164.

72. Between 1920 and March 1933, 11,125 banks failed, or about 36% of all banks in existence in 1921, involving 14.5% of total bank deposits. While the percentage of larger banks that failed rose in the 1929 to 1931 period, still the bulk of the failed banks were small and the majority were state non-member unit banks. See H. P. WILLIS AND J. M. CHAPMAN, *THE BANKING SITUATION* 297-316 (1934).

73. See *Hearings Before a Subcomm. of the Senate Comm. on Banking and Currency pursuant to S.71*, 71st Cong. 3rd Sess. 2-29 (Jan. 19, 1931) (statement of J.W. Pole, Comptroller of the Currency); *Hearings Before a Subcomm. of the House Comm. on Banking and Currency on H.R. (10241) 11362*, 72nd Cong. 1st Sess. 6-10 (March 14, 1932).

74. 1 FED. BANKING L. REP. (CCH) ¶ 3106 (1984).

75. See N. Y. BANKING LAW § 105 (McKinney 1971).

76. Massachusetts permits out-of-state banks to establish Massachusetts branches if the statute law of the banks' home states expressly authorized fully reciprocal interstate banking on the same terms as Massachusetts. MASS. GEN. LAWS ANN. ch. 167, § 39 (West 1984). In addition, there are two national banks that operate grandfathered interstate branches. See *infra* note 87.

of branch permits on a finding of public convenience and necessity.<sup>77</sup> This requirement is intended to protect existing banks against "undue" competition from new entrants into the market, and is enforced somewhat unevenly. It is difficult to assess how states which permit branching liberally apply these licensing requirements. The ratios of branch offices to population in state-wide branching states exhibit wide variations<sup>78</sup> that are difficult to explain, especially without making allowance for demographic variations. Such an explanation is a task beyond the scope of this article. In any event, application of the licensing laws to give undue protection to existing institutions could diminish substantially the beneficial competitive effects of liberal branching laws.<sup>79</sup> Thus, in order to achieve more competitive local markets, reform of the branching laws must be combined with administration of the licensing laws to ensure that they do not create undue barriers to de novo entry.

### C. Bank Holding Company Expansion

Expansion through multi-bank holding companies is not an adequate

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77. Both New York and California require a showing that the branch will promote the public convenience and advantage, in addition to the showing of adequate capital to support the branch operation. *See, e.g.,* CAL. FIN. CODE § 503 (West 1983 Supp.); N.Y. BANKING LAW, § 29 (1971).

78. The following table shows the ratios of residents to banking offices in 1979 and 1960, calculated from the data cited *supra* at note 24, for states that permitted statewide branching in both years. States marked with an asterisk had some form of "home office protection" law in one or both years. Such laws limit the ability of banks to establish branches in areas in which the head office of another bank is located.

State	Residents Per Office		
	1980	1960	Decrease
Alaska	3361	5650	2289
Arizona	5128	7115	1986
California	5478	8981	3503
Connecticut*	4722	9494	4772
Delaware	3563	6110	2547
Hawaii	5710	6796	1086
Idaho	3589	5851	2262
Maryland	4208	8378	4171
Nevada	5549	6810	1261
North Carolina	3253	6632	3379
Oregon*	4173	7187	3014
Rhode Island	3834	8765	4931
South Carolina	4045	8329	4283
Utah*	4235	7417	3182
Vermont	2704	4382	1678
<u>Washington*</u>	<u>4172</u>	<u>7669</u>	<u>3498</u>
AVERAGE	4233	7223	2990

*See supra* note 24.

79. *See Baker, Does Antitrust Law Preclude the Need for Geographic Constraints on Banking*, in COMPENDIUM, *supra* note 66, at 221, 235-236; McCall and Peterson, *The Impact*



substitute for branching. Where permitted, multi-bank holding companies offer opportunities for geographic diversification and for attaining some efficiencies of scale. However, the evidence indicates that geographic expansion by the multi-bank holding company route may be more costly and less efficient than expansion by branching.<sup>80</sup> In any event, although some unit banking states, such as Texas, permit multi-bank holding companies within the state, others do not or restrict them severely, so that even intra-state expansion through the multi-bank holding company device is prohibited or substantially restricted by the law of a number of states.<sup>81</sup>

As for interstate expansion, only two states, Maine and Alaska, permit free entry by out-of-state BHCs; New York permits it on a reciprocal basis only, and Delaware, Maryland, Nevada, Virginia, Nebraska, and South Dakota permit such entry subject to restrictions designed principally to inhibit the new entrants from becoming significant competitors for local consumer and small business financial services.<sup>82</sup> Another approach is regional interstate banking, such as that adopted in New England and the Southeast and under discussion in other regions.<sup>83</sup> Such arrangements permit interstate acquisition of banks only within a region and only by BHCs that conduct their banking operations principally within the region. It is an approach that seems at odds with the basic notion of the United States as a single economic entity and market. Moreover, regional interstate banking deprives the shareholders of acquired banks of the opportunity to realize the highest potential value of their investment, since it eliminates many bidders. However, the concept faithfully reflects the resistance to liberalization of the geographic restrictions on bank expansion and the policy of leaving innovation in this field to the states.

This fragmented and scattered approach to the permissible geographic scope of BHC banking activities is the result of the Douglas Amendment to the BHC Act,<sup>84</sup> which, as earlier discussed, reflects the same philosophy as the McFadden Act, namely, an abandonment of federal supremacy with respect to this important aspect of bank structure. Recent Board decisions made in administering the BHC Act reflect the Board's self-appointed role as a guardian of state law restrictions on BHC interstate expansion. In *Mellon National Corporation* (Heritage Bancorporation),<sup>85</sup> the Board dealt with a decision of the Comptroller of the Currency that the merger of Girard Bank, a Pennsylvania-based bank, and Heritage National Bank, a New Jersey-based bank with a branch in Philadelphia maintained since 1813, was

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*of De Novo Commercial Bank Entry*, in COMPENDIUM, *supra* note 66, at 499, 517-18.

80. See PRESIDENT'S REPORT, *supra* note 24, at 8.

81. See ASSOCIATION OF BANK HOLDING COMPANIES, A PRACTICE GUIDE TO BANK ACQUISITIONS AND MERGERS VI-2 to VI-5 (1983).

82. See 3 BANKING EXPANSION REP. 4-5 (Aug. 20, 1984).

83. Such regional interstate banking legislation was upheld in *NorthEast Bancorp. v. Board of Governors*, 740 F.2d 203 (2nd Cir. 1984), *cert. granted* \_\_\_\_ U.S. \_\_\_\_.

84. 12 U.S.C. § 1842(d) (1982); see *supra* note 57 (discussing § 3(d) of BHC Act).

85. 70 FED. RES. BULL. 441 (1984), *aff'd sub. nom.*, *Girard Bank v. Board of Governors*, 748 F.2d 838 (3rd Cir. 1984).

a bank merger permissible under the McFadden Act.<sup>86</sup> The Board nevertheless used the subsequent acquisition of Heritage Bancorporation by Mellon National Corporation, an acquisition apparently necessitated only by tax considerations, as the jurisdictional lever to declare the interstate acquisition violative of the Douglas Amendment.<sup>87</sup>

Similarly, although perhaps less surprising, the Board ruled in *Seattle Bancorporation* (Alaska Pacific Bancorporation)<sup>88</sup> that the acquisition by a Washington-based BHC of an Alaska-based BHC violated the Douglas Amendment. Although Alaska law permits such an acquisition, the Board found that the transaction, as measured by relative shareholdings after the acquisition, was in economic reality the acquisition by an Alaska BHC of a Washington-based BHC in the face of Washington state law which prohibits acquisitions of local banks by out-of-state BHCs except under certain very limited circumstances.<sup>89</sup>

Finally, the Board's decision in *Old Stone Corporation*, (First Federal Savings & Loan Association),<sup>90</sup> which reiterates the Board's position that BHCs cannot acquire savings and loan associations except under the emer-

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86. *Id.* at 442.

87. *See id.* at 446. The acquisition of Heritage Bancorporation by Mellon National Corporation was part of a step transaction, being preceded by a merger of Girard Bank into Heritage National Bank. *See id.* at 442. Heritage Bancorporation technically no longer owned a bank when it was acquired and the Board had, on prior occasions, declined jurisdiction under § 3 of the BHC Act in transactions that were, in effect, bank mergers subject to the Bank Merger Act. *See, e.g.*, Board letters to James W. Ault of May 19, 1982. Indeed, subsequent to its *Girard/Heritage* decision, the Board reverted to its former position and took the astounding view that the Board may require an application under § 3 of the BHC Act whenever a transaction raises policy issues, but may dispense with such an application where there are none. *See* Board letter to AmSouth Bancorporation of Sept. 5, 1984, *reprinted in* 3 BANKING EXPANSION REP. 15 (Oct. 1, 1984). That position is untenable. The BHC Act requires applications for certain transactions defined in the statute, and none for those not within the definitions. *See* 12 U.S.C. § 1842(a) (1982). The Board thus had good reasons to decline jurisdiction and let the Comptroller's decision stand. Heritage National Bank is one of only two national banks that have branches in more than one state. The other, The Bank of California, has been acquired by a Japanese bank. *See supra* note 52. These banks are grandfathered because their multi-state branches predate enactment of the National Bank Act. Thus, the policy implications of permitting the acquisition were minimal.

88. 70 FED. RES. BULL. 667 (1984).

89. *Id.* at 669-70. Even this result is unsatisfactory. It is by no means unusual for companies to acquire targets larger than themselves, and it is not clear how the Board would have ruled if the companies had been more equal in size. The order illustrates clearly the Board's hostility to interstate banking. In *First Bank System, Inc.* (Golden Spike State Bank), the Board denied an application by a Minnesota-based multi-state bank holding company to acquire a Utah bank through an intermediate BHC subsidiary owning a bank in Montana. *See* First Bank System (Golden Spike State Bank), 70 FED. RES. BULL. 771 (1984). Under Utah law, a Montana-based BHC could acquire a Utah bank, while a Minnesota-based BHC could not. *See id.* at 773. Opinions of the Attorney General and the Banking Commissioner of Utah that Utah law permitted the acquisition were part of the record before the Board. *See id.* Nevertheless, the Board determined that even if the state agencies correctly interpreted Utah law, the state statute was insufficiently explicit to meet the test of the Douglas Amendment. *See id.* at 774.

90. 70 FED. RES. BULL. 593 (1984).

agency provisions applicable only to failing thrift institutions,<sup>91</sup> can justifiably be viewed as concerning geographic expansion rather than product expansion, given the substantial equalization of bank and thrift powers in recent years.<sup>92</sup> This denial of a small savings and loan acquisition seems incongruous in light of the massive acquisitions of failing savings and loan associations permitted under the emergency provisions of the Garn-St Germain Act to Citicorp in California, Illinois and Florida<sup>93</sup> and of the *U.S. Trust*<sup>94</sup> and subsequent decisions permitting the interstate acquisition of consumer banks.

The Board's decisions convey little sense of how the Board would like to see the financial industry restructured, if at all. The Board is a master of the opaque, particularly in areas that have high political visibility. The Board's efforts to slow the "non-bank bank" movement, discussed below, may be motivated largely by a desire to prevent the erosion of the separation of banking from commerce and industry, a policy of long standing that commands substantial support. Nonetheless, the Board's position cannot be fully explained in terms of that policy and, more likely, reflects also an

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91. The Board's reasoning on the issue of BHC acquisition of savings and loan associations, developed in *D.H. Baldwin*, 63 Fed. Res. Bull, 280 (1977), is quite tenuous. In line with the Act's legislative history, §4(c)(8) of the BHC Act has been consistently interpreted as imposing two, but only two, tests for BHC entry into an activity. First, the activity must be closely related to banking, a test which the activity of a savings and loan association concededly meets (63 FED. RES. BULL. at 821); and second, BHC entry must result in certain defined public benefits which outweigh certain defined possible adverse consequences. See 12 U.S.C. §1843(c)(8) (1982); see also *Nat'l Courier Ass'n v. Board of Governors*, 516 F.2d 1229, 1232-33 (D.C. Cir. 1975) (discussing two tests). Yet in *D.H. Baldwin*, the Board fastened on the "proper incident" language in the "closely related" test as though it were a third test and held that the concurrent jurisdiction of the Board and the Federal Home Loan Bank Board over BHCs owning savings and loan associations made this activity not properly an incident of banking. See 63 FED. RES. BULL. at 282, 284-286. The Board evinced no similar concern regarding Securities and Exchange Commission jurisdiction over BHC brokerage subsidiaries. See *BankAmerica Corporation (The Charles Schwab Corporation)*, 69 FED. RES. BULL. 105 (1983); 12 C.F.R. §225.25(b)(15). The Board's position on BHC acquisitions of savings and loan associations is better explained by the Board's strong inclination to avoid erosion of the Douglas Amendment. But this position is inconsistent with § 4(c)(8) as construed by the courts and, in other contexts, by the Board. It conflicts with the several consumer bank decisions of the Board in which the Board articulated its duty to approve applications that meet the criteria for approval enumerated by the statute, even if the result offends policy considerations the Board views as important. See *infra* note 98. Even if the language of § 4(c)(8) of the BHC Act is not liberalized in line with Senate action in the 98th Congress, the Board's authority to justify denial of applications or imposition of onerous conditions to approvals by reference to factors entirely dissimilar from the statutorily enumerated adverse consequences remains to be litigated.

92. See 12 U.S.C. § 1464(c) (1982), as amended by Title III, Part B of the Garn-St Germain Depository Institutions Act of 1982. The decisions of the Board which take thrift institutions into account in analyzing the competitive effects of BHC mergers and banking market concentrations underline this point. See, e.g., *Commercial Landmark Corporation (The First Tahlequah Corporation)*, 70 FED. RES. BULL. 651 (1984).

93. See *Citicorp (Fidelity Federal)*, 68 FED. RES. BULL. 656 (1982); *Citicorp (First Federal)*, 70 FED. RES. BULL. 149 (1984); *Citicorp (Biscayne Federal)*, 70 FED. RES. BULL. 157 (1984).

94. 70 FED. RES. BULL. 371 (1984), *pet. for review pending*, 11th Cir., Nos. 84-3269, 3270; see also *infra* note 98 (decisions cited therein).

inclination in favor of geographic restrictions on banks and BHCs because of the increase in the size of banking institutions that would accompany geographic deregulation.

Currently, the "non-bank bank" movement represents the principal way both for BHCs to avoid the strictures of the Douglas Amendment and for non-banking companies to enter the banking business. The BHC Act defines "bank" as any institution which accepts deposits that the depositor had a legal right to withdraw on demand and that engages in the business of making commercial loans.<sup>95</sup> In recent years, companies engaged in activities other than the ownership of banks discovered that by acquiring a bank and "handicapping" it either by having the bank not accept demand deposits or not make commercial loans, they could avoid the reach of the BHC Act and yet engage in banking activities, including the acceptance of insured deposits. BHCs then realized that they could similarly avoid the prohibition of the Douglas Amendment on interstate bank acquisitions by seeking approval from the Board for acquisitions of such handicapped banks as non-banking companies under section 4 of the BHC Act, to which the Douglas Amendment does not apply.<sup>96</sup> To avoid the resistance of state agencies to such endeavors, national bank charters can be employed for this purpose.<sup>97</sup>

In its *U.S. Trust* decision, the Board acknowledged that, despite its policy objections to this development, it had to approve such applications if the statutory criteria of section 4 of the BHC Act were met.<sup>98</sup> Earlier, the Board had sought to impede this development by defining "demand deposits" and "commercial loans", the components of the "bank" definition in the BHC Act, so broadly as to include NOW accounts in the former and the acquisition of money market instruments and bank time deposits in the

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95. 12 U.S.C. § 1841(c) (1982).

96. *See id.* § 1843.

97. Attacks are being launched against these endeavors on two fronts. In *Independent Bankers Ass'n v. Conover* it was claimed that the Comptroller of the Currency cannot charter national banks which are incapable of exercising both commercial lending and demand deposit functions. *See Indep. Bankers Ass'n v. Conover*, No. 84-1403 Civ.-J-12, slip op. M.D. Fla. (1984). Reliance was placed on *National State Bank of Elizabeth, N.J. v. Smith*, which held that, prior to enactment of express authorization by Congress in 1978 (Pub. L. 95-630, §1504, 92 Stat. 3713 (1978), codified in 12 U.S.C. § 27(a) (1982)), the Comptroller had no power to charter a national bank whose activities would be confined to the exercise of trust powers. *Nat'l State Bank of Elizabeth, N.J. v. Smith*, Civ. No. 76-1479, (D.N.J.), *rev'd on other grounds*, 591 F.2d 223 (3d Cir. 1979). The other line of attack is state legislation, such as that recently enacted in Florida, which prohibits the operation in the state of any bank which does not offer both commercial loans and demand deposits. *See FLA. STAT.* 658.296 (1984). Such laws raise profound Commerce Clause and Supremacy Clause issues.

98. *See* 70 FED. RES. BULL. at 373. These policy concerns were more recently reiterated in several cases. *See* Bankers Trust New York Corporation (Bankers Trust Company of Florida, N.A.), 71 FED. RES. BULL. 51 (1985); Bank of Boston Corporation (Bank of Boston Trust Company of Southeast Florida), 71 FED. RES. BULL. 55 (1985); Suburban Bancorporation (Suburban Bank Washington N.A.), 71 FED. RES. BULL. 61 (1985); *see also* Letter of Chairman Paul Volcker to Senator Jake Garn of Nov. 1, 1984 (accompanying release of these orders).

latter.<sup>99</sup> At the same time, it urged Congress to close this "loophole" because of the dubious validity of its own regulatory efforts to stem the tide.<sup>100</sup> Indeed, the courts invalidated these regulatory redefinitions of what constitutes a "bank" for BHC Act purposes,<sup>101</sup> and the Board faces numerous applications by BHCs for the creation of non-bank banks.<sup>102</sup> Congress adjourned without acting, and it is not clear whether a new Congress will be able to deal with these issues in 1985. Thus, the "non-bank bank" route to geographic diversification by BHCs not only has inherent functional limitations and operating inefficiencies, but faces the threat of future retroactive congressional action.<sup>103</sup>

#### V. THE ECONOMIC EVIDENCE

With the intrusion of many non-bank providers of financial services not similarly restricted, the protection afforded to smaller local banks by the various restrictions on entry into new geographic markets discussed above becomes increasingly illusory. Such illusions die slowly, however, and the political resistance to change remains vigorous. Rational analysis so far has carried little weight.

The limited evidence gleaned from economic research suggests that economies of scale in banking, particularly in the supply of retail banking services, are relatively modest, although they do exist.<sup>104</sup> Economies of scale

99. See 12 C.F.R. § 225.2(a) (1984), 49 Fed. Reg. 818 (1984). The Board set forth its explanation of these regulatory changes as an appendix to the revised Regulation Y. See 49 Fed. Reg. 833-42 (1984).

100. See, e.g., 70 FED. RES. BULL. 71 (1984).

101. The Board's revised view of the definition of demand deposits was first announced in *First Bancorporation* (Beehive Thrift and Loan), 68 FED. RES. BULL. 253 (1982), *rev'd sub. nom.*, *First Bancorporation v. Board of Governors*, 728 F.2d 434 (10th Cir. 1984). The provisions of the revised Regulation Y reflecting the new definitions of both demand deposits and commercial loans were invalidated in *Dimension Financial Corporation v. Board of Governors*, No. 83-2696 (10th Cir. Sept. 1984), *pet. for cert. granted* \_\_\_\_ U.S. \_\_\_\_ (1985).

102. In order to enable the 98th Congress to deal with the issue of "non-bank banks" the Comptroller of the Currency imposed a moratorium as of March 31, 1984 on new national charters for "non-bank banks" until the end of the congressional session. See 43 WASH. FIN. REP. 607 (1984). When Congress adjourned without action, the Comptroller resumed processing applications for such charters. On November 1, 1984, the Comptroller granted applications for 29 preliminary charters and revealed that some 332 applications were pending before his office. See Comptroller of the Currency, Press Release of Nov. 1, 1984. Subsequently, the Comptroller approved many of these applications. See, e.g., 43 WASH. FIN. REP. 784 (1984).

103. S. 2851 would have grandfathered "non-bank banks" acquired by BHCs prior to July 1, 1983. See S. 2851, 98th Cong., 2d Sess. § 104(c) (1984). The chairmen of both the House and Senate Banking Committees have indicated that future legislative efforts to close the "loophole" would not have a later grandfather date. See 43 WASH. FIN. REP. 571 (1984).

104. See, e.g., PRESIDENT'S REPORT, *supra* note 24, at 13; Guttentag, *Branch Banking: A Summary of the Issues and the Evidence*, in COMPENDIUM, *supra* note 66, at 99, 100-101; Baker, *Does Antitrust Law Preclude the Need for Geographic Restraints on Banking*, in COMPENDIUM, *supra* note 66, at 221, 233; Benston, *The Optimum Banking Structure: Theory and Evidence*, in COMPENDIUM, *supra* note 66, at 458.

achieved by larger banks have been insufficient to threaten well-managed small, local banks.<sup>105</sup> How the electronic data processing and telecommunications revolution will affect this balance remains unclear; it is likely to generate increased scale economies in certain areas,<sup>106</sup> but interchange systems and other cooperative efforts will permit smaller banks to participate fully in these technological developments,<sup>107</sup> as they have participated in bank credit card systems. No economic research we have noted suggests that well-managed community banks could not survive and prosper in the more competitive setting that the abandonment of restrictions on free entry would engender.

Studies have found that statewide branching may lead to higher statewide concentration ratios, with fewer banks holding larger statewide deposit shares.<sup>108</sup> Nationwide branching may reasonably be anticipated to result in higher concentration ratios on the national level.<sup>109</sup> However, the total number of banks serving the country's financial needs is not in itself sacrosanct.<sup>110</sup> To the extent that the current low concentration ratios present on the national level and in most states are the result of artificial regulatory restrictions on branching and BHC geographic expansion, the banking structure that free entry would bring about is likely to produce services more efficiently.

The market for financial services to larger corporate customers is already essentially nationwide or broadly regional and is highly competitive. In this market, larger banks offer most banking services throughout the nation,

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105. See Rhoades, *Structure-Performance Studies in Banking: An Updated Summary and Evaluation*, BOARD OF GOVERNORS OF THE FED. RESERVE SYS. STAFF STUDY NO. 119 (1982).

106. For example, point-of-sale terminals, ATMs and cash management services for corporate customers.

107. This assumes, of course, that branching law restrictions will not obstruct the ATM interchange systems that would permit such cooperative participation by smaller banks. In *Independent Bankers Ass'n of New York State v. Marine Midland Bank*, the district court held a grocery store-owned point of sale terminal to be a branch of each bank whose debit card holders could use the terminal. See *Independent Bankers Ass'n of New York State, Inc. v. Marine Midland Bank, N.A.*, 583 F. Supp. 1042 (W.D.N.Y. 1984), *rev'd*, No. 84-189, slip. op. at 6 (2d Cir. 1985). The Second Circuit reversed the lower court's decision on the ground that the ATM was not maintained by a bank. No. 84-189, slip op. at 6. Any other decision would have substantially affected existing interchange systems such as Plus-System and Cirrus. Bills to overturn the effect of the lower court decision were introduced but died as Congress adjourned without action. See, e.g., S. 2898, 130 *Cong. Rec.* S9609-9612 (daily ed. August 1, 1984).

108. See PRESIDENT'S REPORT, *supra* note 24, at Appendix 43-45, 53-54.

109. See generally, C. H. GOLEMBE & ASSOCS., *supra* note 41.

110. No one suggests that the Canadian or European model, i.e., a few very large banks with branch systems that cover the overwhelming share of the market for banking services, is desirable for the United States. Nor is there any prospect that completely free interstate entry would produce such a system. However, the argument has been well made that if the total number of banks in the United States were reduced from the present level of more than 14,000 to 100, and if each of these banks could be patronized conveniently by all potential customers, meaning if all banks competed throughout the United States, the choices available to consumers would be far superior to what they are today. See Guttentag, *Branch Banking: A Summary of the Issues and the Evidence*, in COMPENDIUM, *supra* note 66, at 107.

using loan production offices, Edge Act subsidiaries, and correspondent banking relationships. By contrast, competition for small business and consumer financial services remains quite local, notwithstanding inroads made through nationwide credit card solicitation campaigns, commercial finance company affiliates, and other devices. There is evidence that banks with statewide branches deliver consumer and small business services more efficiently than do unit banks.<sup>111</sup> Thus, although the number of banks in each state and in the nation as a whole may decline through mergers or acquisitions under a system of liberalized branching, competition in local markets quite likely would be enhanced, resulting in better services at a lower price. Even the mere threat of entry under such a system would tend to lead to improved performance.<sup>112</sup> The evidence suggests that a system which permits banks to establish branches both statewide and nationwide, would result in better, cheaper banking services. There is no evidence that such a system would impose unacceptable risks on the federal deposit insurance system or possess other offsetting disadvantages.

The argument against branch banking has frequently been supported by the claim that it leads to a diversion of loanable funds from smaller towns and rural areas to larger cities, particularly the city where the branching bank is headquartered. The evidence does not support this claim. Indeed, what evidence there is suggests the opposite, namely, that larger branch banks put a higher percentage of their assets into loans than smaller unit banks. Since statewide branch systems develop, in part, to achieve greater diversification, this fact hardly surprises; the more diversified institutions need not maintain liquidity reserves at levels necessary for unit banks and they can safely commit more assets to loans. Statewide branch banking results in greater availability of credit to local businesses and facilitates the transfer of loanable funds from surplus to deficit areas without discrimination in favor of urban areas or headquarters cities.<sup>113</sup>

Finally, banking expansion has always had to contend with the fear of "undue concentration of resources," a concept clearly more political than economic in nature. Since 1970, this nebulous concept has become a statutory criterion in the list of adverse consequences to be considered by the Board under section 4(c)(8) of the BHC Act when determining whether to permit BHC non-bank activities. The concept looks to more than raw size.<sup>114</sup> It has little to do with concentration and competition. Some fear that, if banks were geographically deregulated, consolidations would tend to create more

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111. See, e.g., Baker, *Does Antitrust Law Preclude the Need for Geographic Constraints on Banking*, in COMPENDIUM, *supra* note 66, at 221, 230-231; PRESIDENT'S REPORT, *supra* note 24, at 145-46.

112. See PRESIDENT'S REPORT, *supra* note 24, at 17-18; McCall and Peterson, *The Impact of De Novo Commercial Bank Entry*, in COMPENDIUM, *supra* note 66, at 517-18.

113. See PRESIDENT'S REPORT, *supra* note 24, at 14-15; Guttentag, *Branch Banking: A Summary of the Issues and the Evidence*, in COMPENDIUM, *supra* note 66, at 103-04.

114. See P. B. HELLER, HANDBOOK OF FEDERAL BANK HOLDING COMPANY LAW 269 (1976).

large institutions whose economic power and influence over social and economic policies might be enhanced by their size.

There is no obvious reason why banks and BHCs should be treated differently from other enterprises for purposes of controlling market concentration. Most observers concede that the antitrust laws generally provide adequate protection against monopoly power and assure economic diversity in other areas of the economy. There is no reason to assume that they would fail to do so in the banking area. Indeed, the fact that banks now compete with a far wider group of financial services providers would substantially mitigate the effects of higher concentration ratios for traditional banking activities on the state or national level. For these reasons, the concept of "undue concentration of resources" is an emotional, not a measurable concept.<sup>115</sup> It is politically potent, however, and, as noted, appears to have found acceptance even with the Board. Yet it is hard to believe that consumers, if clearly presented with the choice, would prefer financial services of lower quality at a higher price for the sake of avoiding "undue concentration of resources" and its highly ephemeral impact on the country's social and economic policies. To date, however, notwithstanding the evidence amassed over time in support of the removal of barriers to geographic expansion by banks, Congress has given no indication that it can arrive at a consensus in favor of change and reassert federal supremacy over this important national issue.<sup>116</sup> By default, the states, subject to the same paralyzing political pressures, are left to govern the field.

It is ironic that the downfall of Continental Illinois Corporation should serve as an argument against geographic and product deregulation. Continental Illinois' fall was caused, first, by bad domestic commercial lending practices, which hardly involves novel banking functions, and second, by the fact that, as a bank in a unit banking state, Continental Illinois could acquire no substantial stable consumer deposit base and was largely dependent on domestic and foreign money markets, the most volatile funding sources. Some congressional rhetoric against banking geographic and product deregulation in the aftermath of the Continental Illinois affair suggests that President Jackson's battle against the Second Bank of the United States is very recent history indeed.<sup>117</sup> Such rhetoric serves only to confuse and

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115. Such shibboleths mean all things to all people. As Donald Baker pointed out, perhaps with Lewis Carroll in mind, "monopoly," to the rural unit banker secure behind legal barriers to entry into his market, means some evil, giant bank located in a vast and distant city that threatens his Jeffersonian values; to another it simply means the absence of effective consumer choice, as likely represented by the market enjoyed by the Jeffersonian banker. See Baker, *Does Antitrust Law Preclude the Need for Geographic Constraints on Banking*, in COMPENDIUM, *supra* note 66, at 221-22.

116. The Senate's omnibus banking bill proposed in the 98th Congress again expressly delegated to the states the power to determine bank structure, by granting authority to the states to permit reciprocal regional BHC companies. See S.2851, 98th Cong., 2d Sess. title IX (1984).

117. See, e.g., 130 CONG. REC. H1031-34 (daily ed. Feb. 29, 1984) (statement of Rep. St Germain).



obfuscate an important national policy issue and thus retard its resolution.

Perhaps over time, smaller banks, particularly in unit banking states, which are the backbone of resistance to change,<sup>118</sup> will discover that competition cannot be avoided and local monopoly or oligopoly maintained by restricting de novo geographic expansion of commercial banks. Other institutions not similarly restrained will simply take up the competitive slack. Until this fact is both rationally and emotionally accommodated by the banking industry, however, much valuable time will be lost. The ability of banks to meet the challenges of deposit interest rate deregulation and of the new market place for financial services through geographic expansion may be severely impaired.

## VI. FUNCTIONAL RESTRICTIONS

The holding company device gives banks the ability to provide a broader range of financial services without geographic restraints, since the BHC Act imposes no geographic restraints on BHC non-banking activities. This does not substantially ameliorate either the geographic or the functional restrictions imposed on banks. Operations through multiple corporate units, as already mentioned, tend to be less efficient and more costly. Furthermore, without questioning the wisdom of section 23A of the Federal Reserve Act,<sup>119</sup> its quantitative restrictions on, and collateralization requirements for, bank lending to affiliates impart some inefficiencies into combined bank and non-bank operations, since two separate funding systems are required. More importantly, the functional range of financial services that a BHC system can offer through its non-banking units remains strictly circumscribed and, in fact, does not add substantially to the range of services which banks can provide directly.

The functional limitations on bank activities are of ancient lineage, dating back at least to the charter of the Bank of England of 1694. They did not spring from a desire to protect the public interest by assuring the separation of banking from industry and commerce; rather, they were anti-competitive restrictions intended to prevent banks from competing with merchants in the sale of goods. Presumably, the restrictions were accepted as a fair price for the monopoly on banking services granted by the charter. When development of deposit banking by joint stock companies in the early 19th century dissipated that monopoly, the restrictions on activities remained.

The United States followed this English pattern. Banks were subjected early on to stringent activity restrictions. The attempt to define, first in legislative charters and later by statute, the "business of banking"<sup>120</sup> and to

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118. See *United States v. Citizens and Southern Nat'l Bank*, 422 U.S. 86, 118-19 n. 30 (1975).

119. 12 U.S.C. § 371(c) (1982).

120. See Symons, *The Business of Banking in Historical Perspective*, 51 GEO. WASH. L. REV. 676 (1983).

bar entry into other activities, has been the norm of functional regulation of banking in the United States to this day. Thus, the public interest basis for the policy of separating banking from industry and commerce appears to be a later rationalization of a pre-existing condition, although its strong viability today is indisputable.<sup>121</sup>

The National Bank Act of 1864,<sup>122</sup> patterned after the New York Free Banking Act of 1838, attempted to give a well-defined content to "the business of banking" and to accommodate future needs by granting the power to engage in such other activities as might be incidental to those specifically enumerated.<sup>123</sup> Except for the additional restrictions added by the Glass-Steagall Act in 1933,<sup>124</sup> this grant of enumerated powers dating from another age has had to suffice for national banks adjusting to the enormous economic, social and political changes of the last 120 years. The courts' traditional, strict construction of the incidental powers clause has not made this task any easier.<sup>125</sup> Thus, the ability of banks, particularly national banks, to respond to changes in the marketplace by offering new services has been relatively limited.

Even the most modest experimentation on the state level has led to congressional criticism and threats of intervention. Both major banking bills considered by the 98th Congress would have limited the power of the states to permit state-chartered banks owned by BHCs to offer services which neither national banks nor BHCs are authorized to provide.<sup>126</sup> That prohibition was not confined to broadened activities authorized for export only, as may be the case with the insurance powers of state banks under South Dakota law.<sup>127</sup> Rather, these bills were Congress's response to the enlarged functional powers that a number of states have given to banks under their charter jurisdiction in various fields of endeavor, such as real estate owner-

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121. See Schull, *The Separation of Banking and Commerce: Origin, Development and Implications for Antitrust*, ANTITRUST BULL. 255, 259-65 (Spring 1983).

122. Act of June 3, 1864, ch. 106, §8, 13 Stat. 101 (1864) (codified principally in 12 U.S.C. § 24 (1982)).

123. See 12 U.S.C. § 24 (1982).

124. Sections 16 and 21 of the Glass-Steagall Act limit the underwriting powers of national banks to U.S. Government and general obligation state and municipal securities, and prohibit generally the combination of deposit-taking and securities underwriting in one institution. 12 U.S.C. § 24 (1982).

125. See, e.g., *Arnold Tours, Inc. v. Camp*, 472 F.2d 427 (1st Cir. 1972); *National Retailers Corp. of Arizona v. The Valley Nat'l Bank*, 411 F. Supp. 308 (D. Ariz. 1976), *aff'd per curiam*, 604 F.2d 32 (9th Cir. 1979).

126. See S. 2851, 98th Cong., 2d Sess. § 104(g) (1984); H.R. 5916, 98th Cong., 2d Sess. § 6 (1984). Each bill would have prohibited the exercise of such expanded power outside the bank's home state.

127. South Dakota law permits the acquisition of South Dakota banks by out-of-state BHCs, if the banks so acquired do not compete significantly with local banks; it also gives South Dakota banks the power to engage in all facets of the insurance business. See S.D. COMP. LAWS ANN. §§ 51-18-40 to 42 (1983). The attorney general of South Dakota has rendered an opinion construing the statute to mitigate substantially its objectionable "for export only" features. See Letter of Mark Meierhenry, Attorney General, of Nov. 3, 1983.

ship and development, and the insurance, mutual funds, and travel agency businesses. For example, the key state of New York is seriously considering giving substantial insurance powers to its state banks.<sup>128</sup>

Until now, the Board has disclaimed jurisdiction under the BHC Act to regulate the activities of banking subsidiaries of BHCs and their domestic operating subsidiaries, as long as the functional powers possessed by such operating subsidiaries do not exceed those of the parent bank.<sup>129</sup> Although the legislative history of the BHC Act fully supports this position,<sup>130</sup> the Board has given some indication that it has this position under review, and appears to favor congressional action imposing restrictions on state experimentation in this respect.<sup>131</sup> Congress has been importuned by the insurance lobby to cut off the ability of states to expand state bank insurance powers.<sup>132</sup> Thus, even the basic tenets of the long-established dual banking system<sup>133</sup> cannot resist the eager onslaught of trade groups intent on keeping competition from banks at bay.

As to the range of permissible BHC non-bank activities, the regulation listing them is lengthy and in the process of further extension.<sup>134</sup> Most of the permissible activities, however, are simply traditional banking functions.<sup>135</sup> Of the permissible activities, only securities brokerage and the very limited remaining insurance agency powers are likely to enhance service offerings through existing retail branch systems of banks,<sup>136</sup> although presently pending

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128. For an excellent overview of the relevant state law, see Wallison and Toumey, *Continued Banking Deregulation Seems Inevitable*, *Legal Times*, Mar. 5, 1984, at 14-21.

129. See 12 C.F.R. § 225.22(d) (1984).

130. See Wallison and Toumey, *supra* note 128, at 16.

131. See 49 Fed. Reg. 811 (1984) (comments on adoption of § 224.22(d)); see also *Financial Services Industry—Oversight Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 1st Sess. 60 (1983) (statement of Paul A. Volcker, Chairman, Federal Reserve Board of Governors). If the recent proposal of the Federal Deposit Insurance Corporation (49 Fed. Reg. 48,552 (1984)) is adopted, all insured banks will have to conduct insurance underwriting and real estate development activities through subsidiaries. If the Board then reverses its position and subjects these subsidiaries to the restrictions imposed by § 4(c)(8) of the BHC Act (12 U.S.C. § 1843(c)(8) (1982)), it will have successfully blocked BHC entry into these activities.

132. Both the Senate and House bills would extend the restrictions placed on the insurance activities of non-bank subsidiaries of BHCs by the Garn-St Germain Act of 1982 (12 U.S.C. § 1843(c)(8) *as amended*) to all holding company subsidiaries, *i.e.*, to bank subsidiaries and their subsidiaries. See S.2851, 98th Cong., 2d Sess. § 104(d) (1984); H.R. 5916, 98th Cong., 2d Sess. § 2(b) (1984).

133. See Brown, *The Dual Banking System in the United States*, in *COMPENDIUM*, *supra* note 66, at 239.

134. See 12 C.F.R. § 225.25(b) (1984); 49 Fed. Reg. 9215 (1984) (for pending proposal of additions to list of permissible activities).

135. See 12 C.F.R. § 225.25(b) (1984).

136. The sharing of branch premises by national banks with third parties, including those affiliated with the bank, is permissible. See 12 C.F.R. § 7.7516 (1984); see also Comptroller of the Currency, Staff Interpretive Letter of December 2, 1984, *FED. BANKING L. REP. (CCH)* ¶85,438 (1984).

proposals may add financial planning and counseling and tax planning and tax return preparation to this list.<sup>137</sup>

With the Board's approval in *BankAmerica Corporation* (The Charles Schwab Corporation)<sup>138</sup> of discount brokerage as a permissible non-banking activity, a retail-oriented service of considerable potential was added to the list of permissible non-banking activities. The unanimous affirmance of the Board's order by the Second Circuit and by the Supreme Court underlines the solid legal basis for the Board's decision; indeed, the activity appears plainly permissible for national banks.<sup>139</sup> However, the final chapter in this saga is not yet written. In the *BankAmerica* order, the Board stressed the absence of advisory services and investment recommendations, apparently to demonstrate that the brokerage activity, the buying and selling of securities as agent on the order of customers, was not a "public sale" of securities within the meaning of section 20 of the Glass-Steagall Act.<sup>140</sup> The Supreme Court's reasoning in its affirmance of the Board's order, however, makes clear that the term "public sale", as used in section 20, means "underwriting".<sup>141</sup> Thus, there should be no barriers, other than the bottomless litigation fund of the Securities Industry Association, to BHC entry into full service brokerage.<sup>142</sup>

As to the other cluster of retail-oriented financial services particularly well suited to help depository institutions make the best possible use of

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137. See proposed 12 C.F.R. §§ 225.25(20), (22) (contained in 49 Fed. Reg. 9220 (1984)).

138. See *BankAmerica Corporation* (The Charles Schwab Corporation) 69 FED. RES. BULL. 105 (1983), *aff'd sub. nom.*, *Securities Industry Ass'n. v. Board of Governors of the Fed. Reserve Sys.*, 716 F.2d 92 (2d Cir. 1983), *aff'd*, \_\_\_\_\_ U.S. \_\_\_\_\_, 104 S. Ct. 3003, 82 L. Ed. 2d 158 (1984).

139. See Decision of the Comptroller of the Currency in *In re Security Pacific Discount Brokerage* (Aug. 26, 1982), and *In re Union Planters Bank* (Brenner Steed and Associates, Inc.) (September 20, 1982), *aff'd in relevant part sub. nom.*, *Securities Industry Association v. Comptroller of the Currency*, 577 F. Supp. 252 (D.D.C. 1983), *aff'd* (D.C. Cir. No. 84-5085). However, the geographic branching restrictions severely hamper full exploitation by banks of the power to engage in discount brokerage, since the district court in *Securities Industry Association* deemed bank brokerage offices to be "branches" subject to the McFadden Act. See 577 F. Supp. at 259-60.

140. See *BankAmerica*, 69 FED. RES. BULL. at 114; 12 U.S.C. § 377 (1984) (§ 20 of Glass-Steagall Act).

141. See 82 L. Ed. 2d 158, 167-8.

142. Indeed, the Comptroller of the Currency has already permitted some combination of investment advisory and brokerage services. See Decision of the Comptroller of the Currency in *In re American National Bank of Austin* (Sept. 2, 1983). The validity of the decision is being contested by the Securities Industry Association in the District Court for the District of Columbia, but proceedings there were held in abeyance pending the Supreme Court's decision in the *BankAmerica* (Schwab) case and the final determination of *Securities Industry Ass'n. v. Comptroller of the Currency*. See 15 SEC. REG. L. REP. 2236 (1983). Although there are no legal obstacles to combining securities brokerage with investment advice, the Board nevertheless appears to be concerned with such arrangements, even where the broker merely acts as a conduit for third-party generated advice. See *Fed Strives to Hold Investment Advice Line*, 3 BANKING EXPANSION REP. 17-18 (Sept. 17, 1984).

existing branch facilities, such as insurance brokerage or agency, the law severely restricts the ability of banks and BHCs to enter the field.<sup>143</sup> The Garn-St Germain Act amendments to section 4(c)(8) of the BHC Act largely abolished the discretion the Board possessed to allow banks and BHCs perform insurance activities, a discretion which the Board, in any event, always exercised with considerable caution.<sup>144</sup> Except for certain grandfathered activities, BHCs are essentially confined to performing credit life, disability, and unemployment insurance services directly related to credit extensions by the BHC system, and to certain severely circumscribed property insurance agency functions that must relate to certain limited credit extensions by finance company subsidiaries of BHCs.<sup>145</sup> Current efforts to bring convenient access to insurance services to retail customers at bank branches thus take the distorted form of rental agreements under which third party, unaffiliated insurance agents or brokers establish offices at bank branch premises.<sup>146</sup>

Other services that present law forecloses, but which would be an appropriate rounding out of bank services offered to local markets, include the sale of mutual funds<sup>147</sup> and commingled funds for the investment of Individual Retirement Accounts,<sup>148</sup> and municipal revenue bond underwriting as a service to local government.<sup>149</sup> Expanded powers to engage in venture

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143. A national bank may not sell insurance other than credit life and disability insurance in connection with its extensions of credit. *See Saxon v. Georgia Ass'n of Indep. Insurance Agents*, 339 F.2d 1010 (5th Cir. 1968); *Indep. Bankers Ass'n of America v. Heimann*, 613 F.2d 1164 (D.C. Cir. 1979), *cert. denied*, 449 U.S. 823 (1980). National banks in towns with populations of 5000 or less have broader insurance powers. *See* 12 U.S.C. § 92 (1982).

144. *See* 12 U.S.C. § 1843(c)(8); *BankAmerica Corporation (B.A. Insurance Company)*, 66 FED. RES. BULL. 660 (1980) (denying application to engage de novo in home mortgage life insurance). The Board now has indicated a willingness to reconsider home mortgage life insurance in light of the restrictions on insurance, other than credit insurance, imposed by the Garn-St Germain Act to § 4(c)(8) of the BHC Act. *See* 49 Fed. Reg. 9217 (1984).

145. *See* 12 U.S.C. § 1843(c)(8) (1982). The Export Trading Company Act permits certain additional insurance functions relating to exports, but these are likely to be wholesale services, offered to corporate customers and not the type of retail service that would be most valuable to banks to offer. *See* 12 U.S.C. § 1843(c)(14) (1982); 12 C.F.R. §§ 211.31-34 (1984).

146. *See* Comptroller of the Currency Staff Interpretive Letter of December 2, 1983, FED. BANKING L. REP. (CCH) ¶ 85,438 (1983); *see also, Bank of America Offices Offer New Product: Insurance*, *American Banker*, Sept. 6, 1984, at 1.

147. S. 2851, as passed by the Senate in the 98th Congress, did not propose to add this power. *See* S.2851, 98th Cong., 2d Sess. § 104(e) (1984). Senator Garn had intended to amend S.2851 to include it, but was unable to accomplish this on the floor of the Senate. *See* 130 CONG. REC. S9775-6 (daily ed. Aug. 7, 1984).

148. The District Court for the Northern District of California held that advertising and marketing collective investments funds for the investment of Individual Retirement Accounts violates the Glass-Steagall Act. *See Investment Co. Inst. v. Conover* (N.D. Calif. C-84-0742, Aug. 28, 1984). The District Court for the District of Columbia more recently has upheld the power of banks to market such arrangements. *See Investment Co. Inst. v. Conover*, D.D.C. Civ. No. 83-0549 (Nov. 8, 1984).

149. S. 2851 would have permitted the underwriting of municipal revenue bonds through a BHC subsidiary designated as a depository institutions securities affiliate. *See* S.2851, 98th Cong., 2d Sess. § 104(e) (1984).

capital financing would also enhance the ability of BHCs to serve the financial needs of small businesses.<sup>150</sup> Finally, the ability to underwrite mortgage-related securities would be a valuable complement to bank mortgage lending activities and would augment funds available for housing by permitting banks to generate additional loanable funds through the sale of conventional mortgages to institutional investors.

Dispassionate consideration of the services banks and BHCs should be able to provide without violating the separation of banking from commerce and industry would expand their permissible service offerings, particularly in the insurance areas. As already pointed out, the types of new services that would permit more efficient use of existing branch systems will not increase risk exposure and may contribute to bank and BHC earnings stability. However, Congress, here as in the case of geographic barriers, has given little weight to rational analysis and, giving way to pressure from various special interest groups, appears unable to reach a workable consensus.

Without eroding the concept that banking should remain separate from commerce and industry, the scope of financial services that banks and BHCs should be able to supply must be redefined. This redefinition must be based on an impartial appraisal of the nature of each service considered, its risks and earnings potential, its capital demands, its suitability for delivery through the branch systems banks have available, its managerial requirements, and similar factors. The services we have mentioned; full service securities brokerage, insurance agency and brokerage, municipal revenue bond and mortgage-related securities underwriting, the sale of mutual funds, and limited venture capital investments, all meet these criteria. Furthermore, these services do not erode the separation of financial intermediation from commercial and industrial operations. Unfortunately, there seems little prospect that Congress will create a statutory framework in which banks and BHCs can perform this range of financial services in an efficient and productive manner. The price for the inefficiencies and distortions that the limitations on bank and BHC diversification force banks to meet and contend with, as well as that engendered by the new competitive environment created by the deregulation of interest rates and the rise of non-bank financial services competitors, is borne largely by the consumer. Ultimately, the cost may also be borne by the deposit insurance funds, since some banks, which

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150. The BHC Act prohibits the ownership by BHCs of more than 5% of the voting stock of any company other than one engaged in activities closely related to banking as defined by the Board. See 12 U.S.C. §1843(a) (1982). The Board has defined "voting securities" broadly to include, among other things, preferred stock and limited partnership interests, both common venture capital investment vehicles. See 12 C.F.R. § 225.21(1) (1984). The Board has also issued a policy statement in the context of so-called interstate stake-out investments that beclouds the permissible scope of such venture capital financing. See 12 C.F.R. § 225.143 (1984). The Board's general counsel, in a private letter ruling of November 5, 1984, held that these guidelines equally apply to stake-out investments in non-banking companies. See Letter of Michael Bradfield, General Counsel, of Nov. 5, 1984. The ruling did not deal with venture capital type investments. See *id.*

might survive in a more accommodating regulatory environment, will fall by the wayside.

#### VII. THE RELEVANCE OF FEDERAL DEPOSIT INSURANCE

Opponents of the relaxation of geographic and product restrictions presently imposed on banks have claimed that eliminating these restrictions would result in more bank failures, with unacceptable demands on the federal deposit insurance fund. It is claimed that the loosening of geographic limitations would lead to ruinous competition and thus to increased numbers of bank failures. Similarly, it is claimed that product deregulation would increase bank risk-taking and, given the troubled state of the banking industry today, also result in more bank failures.

As to the impact of lifting geographic restrictions, all the existing evidence rebuts the claim that ruinous competition and bank failures would result. The history of the relaxation of geographic restrictions on bank expansion suggests that expansion is largely accomplished through acquisitions and consolidations, not through ruinous competition. This was true of California in the early part of the century, of North Carolina, Virginia and Texas later, and most recently, of Florida and Pennsylvania. Perhaps the best evidence refuting these claims comes from New York. When statewide branching was finally permitted and the large New York City banks expanded into other parts of that state, the competitive outcome clearly favored the local up-state banks. There was no evidence of competitive excesses, and there was no drain whatsoever on the FDIC insurance fund. The evidence is overwhelming that bank failures that impose burdens on the insurance fund are the result of poor or dishonest management, not of ruinous competition.<sup>151</sup> California, with its statewide branching and liberal market entry rules, has not been a heavy contributor to the roll of failing banks, and its most spectacular bank failure in recent years was entirely the result of mismanagement.<sup>152</sup>

There is no question that the federal deposit insurance system was designed, in part, to maintain the fragmented nature of the industry by promoting the survival of smaller unit banks.<sup>153</sup> Such banks inherently lack the stability of banks having widely dispersed branches. Small unit banks can draw a stable consumer and small-business deposit base only from a narrow market. The federal deposit insurance system, however, renders this

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151. See Benston, *The Optimum Banking Structure: Theory and Evidence*, in COMPENDIUM, *supra* note 66, at 470-72.

152. The only large bank failure in California in recent years, that of the United States National Bank of San Diego, was caused entirely by fraudulent loans to insiders and their business affiliates.

153. The objective of a highly fragmented banking system still retains considerable vitality. In June, 1984, a member of the House Banking Committee introduced remarks into the Congressional Record vigorously supporting this objective. 130 CONG. REC. E2622, (1984) (statement of Rep. Vento).

inherent instability unimportant for most depositors. Deposit insurance also makes it possible for such banks to fund themselves from sources beyond their service area through means such as brokered deposits. These remote funding sources are highly volatile, however, and may impair significantly the bank's ability to manage its liquidity wisely.<sup>154</sup> Moreover, the smaller unit bank is necessarily subject to a geographic concentration of assets, as its service area for loans to individuals and small and medium-sized businesses tends to be confined to the service area of its single office. Deregulation of deposit interest rates may undermine further the stability of smaller unit banks. For these reasons, it appears likely that maintaining the geographic limitations in the face of deposit interest rate deregulation will result in higher demands on the federal deposit insurance fund. As interest rate deregulation has increased the risk to the fund, geographic deregulation could help to reduce it.

It is also argued that increased concentration, the emergence of a smaller number of larger banks as the result of free interstate branching or holding company expansion, will create the necessity for more massive federal rescue efforts comparable to those arranged for Continental Illinois Corporation, as more banks reach a size where, in defense of the banking system as a whole, the Government cannot permit their failure.<sup>155</sup> The additional contention is made that this perception gives the very large banks an unfair advantage over their smaller competitors, at least in terms of the cost of funds.<sup>156</sup> Such a perception can become a self-fulfilling prophecy, but it need not and should not be permitted to endure. In light of the acrimonious debate in Congress and elsewhere over the Continental Illinois rescue, and the wide-spread perception of that action's unfairness to uninsured depositors of smaller banks which have not been protected by the federal regulators, Congress soon must address this issue.

With adequate Federal Reserve support, the failure of even a very large bank need not endanger the banking system as a whole nor disrupt the functioning of the payments system and the implementation of monetary policy. Even in the case of Continental Illinois, steps might have been taken that would have substantially eased the impact of a failure of that organi-

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154. The FDIC and the Federal Savings and Loan Insurance Corporation (FSLIC) have attempted to control the exposure of the deposit insurance funds caused by the practice of retail deposit brokerage. For the views of the FDIC and FSLIC on the dimensions of this problem, together with the counter arguments, see *Discussion of Issues Raised by Commenters on a Regulation Governing Deposit Brokerage*, 49 Fed. Reg. 13003, 13005-07 (1984). The Federal District Court for the District of Columbia enjoined the FDIC and FSLIC from implementing the final rule. See 49 Fed. Reg. 27295 (1984), *aff'd*, FAIC Securities v. United States, No. 84-5408, slip. op. at \_\_\_\_ (D.C. Cir. Jan. 30, 1985).

155. See *Testimony of C.T. Conover, Comptroller of the Currency, before the House Comm. on Banking, Housing and Urban Affairs*, 98th Cong. 2d Sess. (Sept. 19, 1984); see also N.Y. Times, Sept. 20, 1984, at D1 (reporting testimony of C.T. Conover); American Banker, Sept. 20, 1984, at 1 (same).

156. See Shull, *New Antitrust Constraints for the Era of Bank Deregulation*, American Banker, Aug. 24, 1984, at 4, 6.



zation on the banking system and the payments system.<sup>157</sup> While the evidence is contested by the FDIC, and while hindsight can justifiably be viewed with suspicion, evidence collected by the staff of the House Committee on Banking, Housing and Urban Affairs suggests that only six banks would have been rendered insolvent by liquidation of Continental Illinois National Bank.<sup>158</sup> If this is so, the Federal Reserve System and the FDIC could readily have helped these smaller banks survive the liquidation of their correspondent. Whatever difficulties the FDIC might have encountered pale beside the implications of the nationalization of Continental Illinois that resulted from the rescue. If additional statutory authority for the Federal Reserve System is required, the Board should seek it.

For all of these reasons, revision of the deposit insurance system is an urgent matter. In its report to Congress required by the Garn-St Germain Act, the FDIC recommended legislation allowing the insurance assessment to vary somewhat to reflect the riskiness of each insured bank.<sup>159</sup> The report also recommended consideration of the possibility of private participation in providing deposit insurance.<sup>160</sup> These revisions to the deposit insurance system itself would be coupled with increased, standardized financial disclosures by banks.<sup>161</sup>

The FDIC acknowledges, however, that there are significant conceptual and practical difficulties to implementing the proposals.<sup>162</sup> It is unclear whether the FDIC can measure the riskiness of a bank with sufficient accuracy and timeliness to justify a variable deposit insurance premium. To be a significant deterrent to management risk-taking practices, an increase in the insurance assessment would have to significantly reduce bank earnings per share. However, the impact of the assessment increase on the earnings of a troubled bank might itself disturb the bank's safety and soundness.

There is also the question of timing. To be an effective deterrent to disfavored actions, the increase in the insurance premium must be levied at the time bank management decides to engage in the disapproved behavior. As a practical matter, the premium increase proposed by the FDIC would

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157. The FDIC, perhaps with Federal Reserve assistance, could have implemented the "partial payoff" technique with Continental Illinois. See *infra* note 167.

158. See *Testimony of William Isaac, Chairman of the Federal Deposit Insurance Corporation, before the House Comm. on Banking, Housing and Urban Affairs*, 98th Cong. 2d Sess. (Oct. 4, 1984); see also *N.Y. Times*, Oct. 5, 1984, at 37 (reporting testimony of William Isaac); *Wall St. J.*, Oct. 5, 1984, at 8 (same).

159. FDIC, *DEPOSIT INSURANCE IN A CHANGING ENVIRONMENT* (1984) (report submitted pursuant to § 712 of the Garn-St Germain Depository Institutions Act of 1982). For discussion of the variable insurance premium, see Chapter II.

160. *Id.* at VII-1.

161. *Id.* at IV-1. The federal banking regulators have already moved toward increased disclosure. The FDIC recently solicited comments on a voluntary disclosure scheme for insured non-member banks. See 49 Fed. Reg. 26809 (1984). The OCC issued an advance notice of proposed rulemaking seeking advice on the most effective way to develop a compulsory disclosure system. See 49 Fed. Reg. 28566 (1984).

162. FDIC, *supra* note 159, at xiv.

occur only after bank examiners have discovered that the disapproved risk had been taken. Increasing the assessment after the risk has been taken further weakens the bank.

Most importantly, announcement of an increase in a bank's insurance assessment might cause a run on that bank. Uninsured depositors would simply avoid a bank paying a higher insurance premium in favor of any bank that the FDIC has categorized as less risky, unless the riskier bank offers a sufficiently higher return to compensate for the special risk. For this reason, a "silent run" by uninsured depositors might occur after announcement of an increase in the deposit insurance premium, unless the institution significantly increased the deposit interest rates it offers. This increase in the cost of funds may hasten its doom.

The FDIC Chairman recently suggested, apparently independently of the proposal for a variable insurance premium, that insured banks be required to increase their capital to 9 percent of total assets, with a large proportion of that requirement eligible to be met by subordinated debt.<sup>163</sup> A capital level of 9 percent would place a somewhat greater cushion between the insured depositors (and thus the deposit insurance fund) and the risk-taking activities of the bank. However, no market exists for the subordinated debt of most banks. Although a market might develop, this source of "capital" might be very expensive. In addition, this mandated capital structure for banks and BHCs would create all of the problems of regulatory capital requirements that we have identified earlier.

Rather than requiring additional capital or varying the insurance premium, the authors believe that the historic purposes of deposit insurance would be promoted more effectively by reducing the level of insured deposits to \$40,000 per account, the level that prevailed prior to enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980.<sup>164</sup> The increase to \$100,000 per account was enacted by Congress without hearings or committee consideration, and little or no debate preceded this significant step.<sup>165</sup> Congress placed no additional funds at the disposal of the insurance funds to match the 250 percent increase in their potential liability.

Reducing the coverage per account would both limit the aggregate liability of the deposit insurance system and make a merger and assumption of liabilities less likely to be the most cost-effective technique for the FDIC to use in dealing with a failing bank.<sup>166</sup> Thus, the FDIC would revert to carrying out its original mandate: to pay off the insured depositors and

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163. *FDIC Soft-Pedals Bank-Discipline Plans*, Wall St. J., Oct. 2, 1984, at 14.

164. Pub. L. No. 96-221, (codified as amended at 12 U.S.C. §§ 3501-24 (1982)).

165. See HOUSE CONF. REP. No. 842, 96th Cong., 2d Sess. 78, reprinted in 1980 U.S. CODE CONG. & AD. NEWS 236, 308 (accompanying H.R. 4986); SENATE CONF. REP. No. 640, 96th Cong., 2d Sess. 78, reprinted in 1980 U.S. CODE CONG. & AD. NEWS 236, 308 (same).

166. C.H. GOLEMBE AND D.S. HOLLAND, *FEDERAL REGULATION OF BANKING 1983-84* 50 (1983).

liquidate the bank. Except in the most unusual circumstances, it should be compelled to do so even in the case of large banks.

In order to limit the consequences of such liquidations for the payments mechanism and the national economy, the FDIC should resume making prompt partial pay-outs to uninsured depositors, as it was doing on an experimental basis prior to the rescue of Continental Illinois Corporation.<sup>167</sup> Since uninsured depositors would be placed at greater risk and more deposits would be uninsured, depository institutions with significant uninsured deposits should comply with the same financial disclosure rules that apply to BHCs subject to SEC regulation.<sup>168</sup> The steps just outlined would strengthen the deposit insurance funds until bank and BHC geographic and product diversification could stabilize the industry.

### VIII. CONCLUSION

For the reasons developed in the foregoing, the authors believe that political resistance to necessary changes in bank structure and function must be broken if the banking system is to be kept intact in the face of the many difficulties that beset it. Congress, confronted by confused and discordant outcries of self-interest from many different groups, has been unable to reach any consensus.

The burden to make the case for coherent change must thus fall on the bank regulators, particularly on the Board, as the most prestigious and, at least in the perception of Congress, the most dispassionate, expert body on the nation's banking system. The evidence supporting relaxation of both functional and geographic restrictions is strong, as is the urgency of resolving this issue. The Board is best able to demonstrate convincingly to Congress the interrelationships sketched in this article between these restrictions and the issues of deposit insurance, bank performance, and the safety and soundness of the banking system. If that were done, Congress would find it difficult to ignore the need for change. The Continental Illinois debacle presented a unique opportunity to make the case for the assumption of federal responsibility for the branching issue, but that opportunity was lost amid strident recriminations. The case for reasoned, functional deregulation should not require any such destructive examples.

Failure to act wisely and expeditiously will, over time, result in a banking

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167. The FDIC recently conducted an experiment with "partial payoff", under which uninsured depositors received in cash immediately the percentage of their deposit that the FDIC estimated they would recover upon final liquidation of the failed bank. See *FDIC Analysis of Modified Payoffs May Not Be Ready for Several Months*, DAILY REP. FOR EXECUTIVES (BNA) No. 208, at A-17 (Oct. 26, 1984). The FDIC issued "receivers certificates" to the uninsured depositors for the remainder of their deposits. If the FDIC recovers more than it estimated, dividends will be paid on the receivers certificates, up to their face amounts; if the FDIC recovers less, it will bear the loss. This technique was used approximately nine times during the period of the experiment. The experiment ended shortly before the federal banking regulators arranged financing for Continental Illinois Corporation. See *id.*

168. See SEC Release 33/6458, 48 Fed. Reg. 11113 (1983).

system more and more removed from the realities of the marketplace in which it is supposed to function. Non-bank competitors, free of the increasingly archaic restraints that govern banks, will exploit the most lucrative market opportunities in the financial services sector as such opportunities present themselves. The profitability of banks, and thus the soundness of the banking system, will decline. Implementation of the Board's monetary policy through a shrinking banking system may become more difficult. Finally, the deposit insurance funds and indirectly, the American taxpayer, will be forced to contribute more frequently to the effort to pick up the pieces of bank failures that prudent and timely congressional action might have avoided.

