Chapter 2

Banking Legislation and Regulation

Introduction

The period between 1980 and 1994 saw more legislative and regulatory change affecting the financial services industry than any other since the 1930s. This is hardly surprising, for the legislative and regulatory landscape was inextricably bound up with the profound transformation that took place within the industry. The structure of banking legislation and regulation might be compared to a stratified but active geologic formation: clearly identifiable separate levels are present, but these come into contact at various points, and sometimes collide. At the legislative level, Congress passed five major laws between 1980 and 1991, and significant bills were considered, if not passed, in nearly every session.[1] Regulatory change during the period was equally extensive, much of it stemming from these new laws. But because the federal banking agencies have authority to protect the safety and soundness of the banking system,[2] they often proposed and implemented new regulations under authority granted by earlier statutes. In addition, the existence of the dual banking system gave state legislatures and state banking authorities a significant role in the regulation of state-chartered institutions—and they played this role frequently. The constant interaction among all of these legislative and regulatory bodies was made even more complex by their occasional differences in viewpoint—and by the often-fragmented voice of a banking industry in which competing needs shaped conflicting responses to regulatory proposals.

---

[1] These five laws were the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA); the Garn–St Germain Depository Institutions Act of 1982 (Garn–St Germain); the Competitive Equality Banking Act of 1987 (CEBA); the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA); and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

[2] The Office of the Comptroller of the Currency is the primary federal regulator of national banks, as well as their chartering authority; the Federal Reserve Board is the primary federal regulator of (a) state-chartered banks that are members of the Federal Reserve System and (b) bank holding companies. The FDIC is the primary regulator of state-chartered banks that are not members of the Federal Reserve System.

With such a multiplicity of actors, it would be overly simplistic to identify the period 1980–94 with a single trend in policy. The early 1980s, after at least a decade of debate about restructuring the financial services industry, was dominated by movement toward deregulation: both DIDMCA and Garn–St Germain readily fall under that heading. Moreover, proponents of continued deregulation did not see 1982 as the end of that process, and continued to press for congressional action; their main objectives were to repeal Glass-Steagall and expand the powers of banks. Nevertheless, in Congress the momentum of deregulation slowed markedly, and certainly by 1989–91 the environment had become far more favorable to stringent bank regulation. By 1994, however, with the thrift and banking crises in the past, the climate in Congress and the industry was again conducive to at least some deregulation.

After 1982, none of the bills introduced in the 1980s to extend deregulation became law, and the main objectives of CEBA, passed in 1987, were to clean up various problems in the banking and thrift industries. As originally written, CEBA would have granted banks additional powers in securities, insurance, and real estate, but in its final form it created a comprehensive—albeit temporary—moratorium on federal regulators' ability to grant those powers. The attempt to legislate expanded bank powers continued, but FIRREA, passed in 1989 and described as "supervisory *re*regulation," concentrated on reforming the thrift industry and providing regulators with greater enforcement powers.[3] In 1991 FDICIA, like CEBA four years before, began as an ambitious attempt to repeal Glass-Steagall, expand bank powers, and restructure the banking industry but, again, ended much more narrowly, recapitalizing the Bank Insurance Fund and providing for banks what FIRREA had provided for thrifts: more supervisory regulation and oversight. So in Congress, although deregulation remained an undercurrent, the laws actually passed during the latter part of the period were aimed at recapitalizing the depleted deposit insurance funds and equipping regulators with a stronger—and, indeed, less flexible—hand in supervising depository institutions.

National legislative developments, however, form only part of the story. A great deal of regulatory activity took place within the federal banking agencies, although often congressional and agency strands would meet. For example, frequently the agencies asked Congress for legislative action, particularly with regard to supervision, enforcement, and dealing with failed and failing institutions. At the same time, the agencies were responsible for drafting regulations to implement statutory changes, and the agencies' interpretations of

---

[3] Daniel Gail and Joseph Norton, "A Decade's Journey from 'Deregulation' to 'Supervisory Reregulation': The Financial Institutions Reform, Recovery, and Enforcement Act of 1989," *Business Lawyer* 45, no. 3 (1990): 1103–228. It should be noted that only two years before passing DIDMCA, Congress had passed the Financial Institutions Regulatory and Interest Rate Control Act (FIRIRCA), which gave regulators a wide range of authority to enforce penalties in supervising depository institutions—thus, significant increases in supervisory regulation occurred nearly simultaneously with deregulation.

congressional intent were significant. The agencies also had the authority under previous laws to make new regulations that required no additional action from legislators. An important example of such authority, and one that had implications for the banking crises of the 1980s, was the Office of the Comptroller of the Currency's (OCC) procompetitive policy for chartering new banks, inaugurated in 1980 partly at congressional urging.

As was the case in Congress, deregulation and the reaction against it were crucial components of the regulators' policies. In general, all of the federal banking agencies endorsed deregulation, although they often differed as to its extent and the manner of accomplishing it. Of the three federal agencies, the OCC was generally the first to push for deregulation and did so most actively; both the Federal Reserve Board (FRB) and the FDIC were less sanguine about some proposals. Still, by the mid-1980s, regulators at all three agencies were increasingly allowing banks to enter new product areas.[4] At the same time, however, deregulation hardly meant an end to new regulation. Instead, it became one of the most important forces behind stricter regulatory developments in the 1980s and early 1990s. One of the most significant and comprehensive of these was the imposition of more-stringent capital requirements for banks: the regulators imposed mandatory capital-to-assets ratios in 1980–81, refined and made them more uniform in 1984–85, and then moved to a combination of risk-based and leverage capital ratios by 1988–92.[5] After the implementation of prompt corrective action (PCA) under FDICIA, capital ratios became key regulatory measures of bank soundness. The definition and redefinition of capital standards was one of the most pervasive regulatory stories of the 1980s and early 1990s.

The federal banking agencies also were active in responding to downturns in specific sections of the financial services industry. For example, when thrifts, including savings banks, were struggling with the interest-rate conditions of the early 1980s, the agencies adopted forbearance policies that would allow institutions to continue to operate even when failing to meet regulatory standards. The first formal use of forbearance in banking during the period was the Net Worth Certificate Program implemented under Garn–St Germain. The second was several years later, in 1986, when all three agencies responded to sectoral problems in agriculture and then energy by inaugurating capital forbearance programs for banks in the affected sectors.[6] By the end of the 1980s the broad use of regulatory forbear-

---

4 See Wolfgang H. Reinicke, *Banking, Politics and Global Finance: American Commercial Banks and Regulatory Change, 1980–1990* (1994); and George Kaufman and Larry Mote, "Glass-Steagall: Repeal by Regulatory and Judicial Reinterpretation," *Banking Law Journal* 107, no. 5 (1990): 388–421.

5 Most of this was accomplished without congressional action, though it is important to note that in response to the less-developed-country crisis, the International Lending Supervision Act in 1983 mandated that the regulators impose capital regulations on banks. Capital ratios would also form the heart of FDICIA's PCA provisions. For an explanation of PCA, see section on FDICIA below; and for an analysis of PCA, see Chapter 12.

6 Agricultural interests, especially, believed the regulators applied the capital forbearance program too restrictively, and this belief resulted in CEBA's mandating the agricultural loan-loss amortization program.

ance had been roundly condemned for contributing to the S&L crisis; its role in banking, however, had been much more limited. Nevertheless, by 1991 and the passage of FDICIA, lawmakers—having previously urged such programs—were now unwilling to allow the agencies to exercise discretion in keeping banks afloat.

Another regulatory issue involved the use of brokered deposits. Again, even as deregulation was the watchword in the industry and in Congress, some of the regulators—in the wake first of Penn Square's failure and then of the failures of other banks and thrifts—moved in 1983–85 to restrict the perceived risk that such deposits created for the deposit insurance funds.[7] Although the initial regulatory attempts were invalidated by the courts, this so-called hot money became one of the bêtes noires of those seeking causes for the thrift crisis. Eventually, both FIRREA and FDICIA placed limits on the use of brokered deposits by troubled institutions.

Although after 1982 Congress failed to grant banks new powers, from the early 1980s state legislatures and state banking authorities were increasingly allowing their state-chartered banks to enter securities, insurance, and real estate activities not permitted by federal statutes.[8] As has already been noted, regulatory decisions were also allowing banks into new areas. But although many of the new powers granted by the states were not thought to add significant dangers to the banking system, others—notably in real estate investment and development—were perceived as risky by the FDIC and the FRB, both of which proposed regulations in the middle to late 1980s to control them. The result was conflict not only among the agencies but also between the agencies, the states, and the industry. Neither of the proposed regulations was adopted, but this episode illustrates how the question of banking regulation could be played out beyond Congress.

FDICIA and its requirements mark the legislative boundary to the banking crisis, although in 1993 Congress did pass legislation that at least partly was a residual reaction to the crisis: a national depositor preference law. This law established a uniform order for distributing the assets of failed insured depository institutions. Although designed as part of a deficit reduction plan, the law was also intended to reduce the FDIC's losses from bank failures.

By 1994 the banking crisis was clearly over, and Congress sought to pull back from what it now perceived as the imposition of overly onerous regulatory requirements on banks. The beginning of this trend was embodied in the Riegle Community Development and Regulatory Improvement Act of 1994. Also in 1994, Congress returned to the more

---

[7] On this issue, the regulators disagreed considerably among themselves (see below).

[8] Victor Saulsbury's article ("State Banking Powers: Where Are We Now?" FDIC *Regulatory Review* [April/March 1987]: 1–17) reviews state banking powers as of 1987; see also the annual publication of the Conference of State Bank Supervisors, *The State of State Banking* (1988–92); and Advisory Commission on Intergovernmental Relations, *State Regulation of Banks in an Era of Deregulation* (1988).

structural industry issues that had become less critical during the immediate crisis. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 addressed the long-standing question of geographic expansion within the banking industry, but other structural issues, such as the separation between banking and commerce, have not been resolved even yet (though at this writing, a financial modernization bill is again under consideration). If FDICIA can be viewed as the end of the immediate legislative response to the banking crisis, a law passed five years later, the Deposit Insurance Funds Act of 1996, provided for the capitalization of the Savings Association Insurance Fund (SAIF) and thereby effectively closed the chapter on the troubled period of the 1980s and early 1990s.

Legislation, 1980–1991

After 1980, Congress was particularly active, attempting to legislate numerous reforms to the financial services industry and its regulatory structure. DIDMCA in 1980 was hailed as the first sweeping change in industry structure in half a century, and it was followed by significant legislation in 1982, 1987, 1989, and 1991. Moreover, few years passed without the presence of substantial banking bills on the legislative calendar.

In the past, major changes in banking legislation (notably the Federal Reserve Act of 1913 and the Banking Act of 1933) were direct responses to financial crises. Legislation is generally a reactive process, and banking legislation is no exception. In the case of banking, however, Congress has had difficulty not only anticipating problems but also addressing issues that legislators and others have recognized as requiring legislative action. Changes had been occurring in the financial services industry since the 1960s, for example, and had greatly accelerated starting in the 1970s, but these changes had not been addressed in legislation. The often-complex laws enacted in and after 1980 were therefore not only a reaction to crises in both the thrift and then the banking industry but also a response to the changes of the previous 20 years.

Deregulation: The Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn–St Germain Depository Institutions Act of 1982

In 1980 the problems in the thrift industry were already becoming apparent, and some provisions of DIDMCA were certainly an attempt to alleviate them. Nevertheless, this wide-ranging law can best be described as a response both to a high-interest-rate climate and to evolutionary change in the financial services industry. Many of the law's provisions had in fact been anticipated during the 1970s by the Hunt Commission and the FINE Study. The Hunt Commission (1971) had argued for the removal of regulatory restraints and the provision of additional powers under an umbrella of competitive equality among financial institutions. Its recommendations included the gradual removal of interest-rate ceilings on time and savings accounts, the addition of new lending and investment powers for financial institutions, removal of restrictions on statewide branching, and elimination of differential reserve requirements for different types of financial institutions.[9] The FINE Study (1975) echoed many of these recommendations.[10]

DIDMCA established phased-in uniform reserve requirements for all depository institutions to ensure the Federal Reserve's ability to conduct monetary policy, to stem the spate of industry withdrawals of member banks from the Federal Reserve System, and to equalize the positions of commercial banks and thrifts.[11] In addition, DIDMCA required the Federal Reserve to provide services (including access to the discount window) to all depository institutions for set fees. In response to the disintermediation caused since 1979 by the combination of deposit interest-rate ceilings and the sharp rise in interest rates, the law also provided for the gradual removal by 1986 of Regulation Q ceilings on maximum allowable rates on deposit accounts.[12] The removal of the ceilings was meant particularly to increase depository institutions' ability to compete against money market mutual funds, but the ceilings were also attacked for penalizing small savers who did not have access to instruments through which they could obtain market rates. The bill was therefore also proclaimed pro-consumer. The phaseout of the ceilings was to be achieved by March 31, 1986, and was to be overseen by the Depository Institutions Deregulation Committee (DIDC), which was created by the law.[13] In keeping with the general aim of increasing competition and remov-

---

[9] U.S. President, *The Report of the President's Commission on Financial Structure and Regulation* (1971). See pt. 2, pp. 23–112, for recommendations. The commission also advocated uniform federal income tax requirements for depository institutions, and consolidation of the regulatory and insurance agencies.

[10] See U.S. House Committee on Banking, Currency and Housing, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Financial Institutions in the Nation's Economy (FINE), "Discussion Principles": Hearings*, 94th Cong., 1st sess., 1975. See also "Symposium on the FINE Study," *Journal of Money, Credit and Banking* 9, no. 4 (1977): 605–61.

[11] Public Law 96-221. This discussion is based on the detailed description in Kerry Cooper and Donald Fraser, *Banking Deregulation and the New Competition in Financial Services* (1986), 105–25. See also Charles McNeill, "The Depository Institutions Deregulation and Monetary Control Act of 1980," *Federal Reserve Bulletin* 66, no. 6 (June 1980): 444–53; and Thomas McCord, "The Depository Institutions Deregulation and Monetary Control Act of 1980," *Issues in Bank Regulation* 3, no. 4 (1980): 3–7. The costs of the reserves required by Federal Reserve System membership were driving institutions to leave the System. One article noted that 60 banks withdrew during the first nine months of 1979; and in January 1980, Equibank ($1.9 billion in assets) announced its intention to leave the System—it would have been the largest such defection ever (John Yoch, "Fed Pullouts Seen Spur to Member Bill," *American Banker* [January 28, 1980], 14; also *American Banker* [January 20, 1980], 7). Legislative action to stem the withdrawals was endorsed both by the Carter administration and by Federal Reserve Board Chairman Paul Volcker.

[12] Disintermediation is "an excess of withdrawals from a depository institution's interest-bearing accounts over its deposits in such accounts" *(Encyclopedia of Banking and Finance*, ed. Charles J. Woelfel, 10th ed. [1994], 306). This occurs when rates on competing investments, such as Treasury bills or money market mutual funds, offer the investor a higher return.

[13] The DIDC consisted of the secretary of the treasury, and the chairmen of the FRB, FDIC, FHLBB, and National Credit Union Association (NCUA) as voting members, and the Comptroller of the Currency as a nonvoting member. For a discussion of Regulation Q and a detailed survey of DIDC actions, see R. Alton Gilbert, "Requiem for Regulation Q: What It Did and Why It Passed Away," Federal Reserve Bank of St. Louis *Review* 68, no. 2 (February 1986): 22–37.

ing regulatory differences among depository institutions, all such institutions were authorized to provide checking account services and NOW accounts or their equivalent. Moreover, thrifts were granted many powers that had been available only to commercial banks. For example, S&Ls could enter consumer loan and credit card businesses, and mutual savings banks could make business loans and accept demand deposits. Finally, the act preempted state usury laws concerning several kinds of loans, and made changes to the Truth in Lending Act.

One aspect of the law that received little attention during the debate over passage but would come to be viewed as crucial to the S&L crisis and to the brokered-deposits issue was the raising of the deposit insurance limit from $40,000 to $100,000. In the Senate, the first proposal was to increase the limit to $50,000 as an adjustment for inflation. But there was clear sentiment in Congress for a greater increase that would help draw deposits into the thrifts.[14] It has been argued that the S&Ls were the driving force behind the increase in insurance, and after the provision passed, the U.S. League of Savings Associations did state that it was "particularly helpful." Some of the bill's sponsors also believed that the increase would strengthen depository institutions' ability to compete with money market funds.[15] FDIC Chairman Irvine Sprague noted in testimony before Congress that an accurate adjustment for inflation would mean an insurance level of approximately $60,000, but he said nothing about a higher increase.[16] The Federal Reserve supported the proposed increase to $50,000 but was "inclined to favor an increase to $100,000."[17] The lower figure remained in the bill, however, until it was replaced by the $100,000 limit at a late-night House-Senate conference. The decision, scarcely remarked at the time, would come to be viewed by many as having weighty consequences.

---

[14] *Congressional Record*, S. 15278 (October 29, 1979). Senator Alan Cranston proposed the increase to $50,000; Senators William Proxmire and Jake Garn both supported the proposal but suggested a further increase was needed.

[15] Joseph Hutnyan and Jay Rosenstein, "Conferees Forge Financial Modernization," *American Banker* (March 7, 1980), 1; *Washington Financial Reports* (March 10, 1980), A-29; and Joseph D. Hutnyan, *The S&L Lobby: An Exercise in Customer Service*, consultant study no. 3, National Commission on Financial Institution Reform, Recovery and Enforcement, 1992, 22–23. See also L. William Seidman, *Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas* (1993), 178–79.

[16] Testifying before Congress four years later, Chairman William Isaac (who succeeded Irvine Sprague in 1981) noted that he believed Congress had passed the $100,000 limit over the objections of the FDIC. House Banking Committee Chairman Fernand St Germain replied that he had agreed with the FDIC at the time but that "it was one of the things we had to compromise on . . . I thought it was a mistake" (U.S. House Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Inquiry into Continental Illinois Corp. and Continental Illinois National Bank: Hearings*, 98th Cong., 2d sess., 1984, 559). See also U.S. Senate Committee on Banking, Housing, and Urban Affairs, *Deposit Insurance Reform and Related Supervisory Issues: Hearings*, 99th Cong., 1st sess., 1984, pt. 1, 7.

[17] U.S. House Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Regulation Q and Related Matters: Hearings*, 96th Cong., 2d sess., 1980, 783, 836. The $100,000 limit had been written into H.R. 6216. Sprague noted that any increase in the insurance limit should be accompanied by a decrease in assessment refunds to maintain the ratio of the insurance fund to insured deposits.

Two years later, Garn–St Germain was largely an attempt to rescue the thrift industry, which by this time, due to earnings problems, was generally perceived to be in crisis.[18] The thrift lobby was strongly in favor of the provisions in the bill. Sources of funds were broadened: the act mandated creation of money market deposit accounts that could compete directly with money market mutual funds. The act also allowed federal, state, and local governments to hold NOW accounts; allowed federally chartered S&Ls to offer demand deposits; and required the DIDC to abolish by 1984 any remaining Regulation Q differentials (on maximum allowable rates on deposit accounts) between banks and thrifts. Federally chartered S&Ls and savings banks were given additional powers—most significantly, the power to invest up to 5 percent of their assets in commercial loans. S&Ls were also permitted to invest up to 30 percent of their assets in consumer loans, and were allowed to invest in state and local government revenue bonds.

Another significant element of the legislation, one promoted by the OCC, was revision of the rules on lending and borrowing by national banks.[19] With respect to regulations on loans to one borrower, national banks perceived themselves to be at a competitive disadvantage, for almost all state banking regulations provided more liberal rules than did national bank regulations.[20] (Smaller rural banks claimed that the existing 10 percent limit had forced them to turn down many loan applications, and in general an increase in the limit was seen as a necessary tool in the increasingly competitive banking environment.)[21] Garn–St Germain increased the limit on loans to one borrower from 10 percent of a bank's capital to 15 percent (for unsecured loans). The limit could be extended another 10 percent if the additional loans were secured by readily marketable capital.[22]

---

[18] Public Law 97-320. For discussions of Garn–St Germain, see Cooper and Fraser, *Banking Deregulation*, 127–43; and Gillian Garcia et al., "The Garn–St Germain Depository Institutions Act of 1982," Federal Reserve Bank of Chicago *Economic Perspectives* 7, no. 2 (1983): 1–31.

[19] See the statement of Comptroller of the Currency John Heimann before the Senate Committee on Banking, Housing and Urban Affairs, April 28, 1981, reprinted in OCC *Quarterly Journal, Special Anniversary Issue 1981–1991* (September 1992): 59. Heimann noted that the rigid loan-to-value ratios, the 30-year amortization requirement, and aggregate limitations on total real estate lending, construction lending, and second-lien real estate lending were at variance with evolving market realities, and deterred national banks from engaging in prudent and profitable loans.

[20] See Conference of State Bank Supervisors, *A Profile of State-Chartered Banking* (1981), 128–31.

[21] Charles Lord before Senate Banking Committee, October 30, 1981, reprinted in OCC *Quarterly Journal* 1, no. 1 (1981): 58.

[22] There was some concern among bankers that the OCC's regulation interpreting the law would be overly restrictive in its definitions of loan aggregation, but when the final rules were issued, banks were not forced to automatically aggregate loans to individuals with loans to corporations and affiliated subsidiaries in which the individual owned a majority interest, unless a "common-enterprise" test was met. For discussion of these issues, see Jay Rosenstein, "Banks Say Easing of Loan Limits Being Frustrated," *American Banker* (January 26, 1983), 2; Jay Rosenstein, "Comptroller Expected to Ease Proposed Loan Limit Formula," *American Banker* (March 15, 1983), 1; and Lisa J. Mc Cue, "Comptroller Eases Rules on Loan Limits," American Banker (April 13, 1983), 1.

Garn–St Germain also removed statutory restrictions on real estate lending by national banks, and gave the OCC the authority to set such rules in the future. The more significant of these restrictions had imposed maximum loan-to-value ratios for real estate loans under certain conditions, had required that certain kinds of real estate loans provide for amortization of the entire principal within 30 years, and had set aggregate limits on real estate loans.[23] In response to the removal of statutory restrictions, the OCC proposed a regulation that imposed no limitations on real estate loans. The agency believed the regulations had hampered national banks' ability to respond to changes in real estate markets, and believed also that decisions concerning national-bank lending were the responsibility of bank management. National banks responded very positively to the proposed removal of the regulations, and the new rules became effective in September 1983.[24] Many state laws continued to impose limits on commercial bank real estate loans; for national banks the new regulation preempted such limits, which still applied to state-chartered banks.

At the strong urging of the regulatory agencies, the law also enhanced the powers of the FDIC and the Federal Savings and Loan Insurance Corporation (FSLIC) to provide aid to troubled institutions. The legislation gave regulators the authority to make a loan to a failing institution, make a deposit in such an institution, purchase its assets, purchase securities it had issued, and assume its liabilities. One aspect of this authority provided for the purchase of net worth certificates from troubled institutions; these certificates would be counted as capital by the regulators and would therefore allow the institutions to continue operating until they could return to a sound condition. This authority was to last for three years. In addition, the law sought to address problems (stemming from geographic barriers to mergers and acquisitions) associated with locating acquirers for failing institutions. The FDIC could now authorize emergency interstate acquisitions of closed commercial banks or savings banks with assets over $500 million, as well as interstate mergers or takeovers of mutual savings banks of that same size which were in danger of closing. The asset size restrictions, which did not apply to the FSLIC, stemmed from a desire to placate those who saw the provision as an attack on the McFadden Act and Douglas Amendment, an attack designed (in their view) to lead to nationwide interstate banking.[25]

[23] The regulations had also placed restrictions on loans secured by leaseholds and had set limitations on forest tract loans. See 12 CFR 7.2000–7.2700 (1983).

[24] See *Federal Register* 48 (March 10, 1983), 10068, and *Federal Register* 48 (September 9, 1983), 40698. See also Laura L. Mulcahy, "Key Restrictions Dropped on Real Estate Lending," *American Banker* (September 12, 1983), 3; and Comptroller C. T. Conover's statement on liberalization of real estate lending rules (OCC *Quarterly Journal* 1, no. 3 [1982]: 23).

[25] Regulators also had to adhere to a set of priorities that, while keeping the insurance funds' losses to a minimum, sought to guarantee precedence in bidding to in-state institutions and same-type institutions. See Cooper and Fraser, *Banking Deregulation*, 132–33.

Legislative Stalemate, 1982–1986

One element that had had to be dropped from Garn–St Germain as too controversial was a provision to grant banks new powers to underwrite securities and deal in mutual funds. The battle over new bank powers would dominate the legislative agenda for the next five years. The contest over expanded powers involved all the varied interests attached to the industry: individual institutions, industry associations, state banking agencies, and federal banking agencies. Fernand St Germain, chairman of the House Banking Committee—perhaps forgetting that congressional opinion was hardly united—compared the debate surrounding these issues to a "Tower of Babel–like cacophony of voices."[26] A recent analyst of the politics of the period succinctly described the process as gridlock.[27]

The Reagan administration strongly believed that product deregulation was necessary if the banking industry was to be reformed, and Senator Jake Garn, who had become head of the Senate Banking Committee by virtue of Republican control of the Senate, made expanded powers a priority during (and beyond) his tenure as chairman. Even so, congressional supporters of expanded powers and the administration did not always speak with one voice.[28] Moreover, there were powerful forces militating against such change. The securities, insurance, and real estate industries all objected to bank entry into their businesses and mounted a considerable effort to thwart legislation that would permit it.[29] In addition, the banking industry itself was not united on these issues—the large money-center banks tended to be more interested in acquiring new powers than smaller institutions were, a state of affairs that made lobbying by bank trade associations rather complicated. Within Congress, some influential voices, arguing that new powers would inject too much risk into the system, resisted tampering with Glass-Steagall's separation between banking and com-

---

[26] William S. Moorhead, "Issues in Coming Revolution in Banking Legislation," *American Banker* (July 29, 1983), 4.

[27] Reinicke, *Banking, Politics and Global Finance*, 57–90. Reinicke provides a detailed discussion of legislative attempts to reform Glass-Steagall and argues that the period from 1980 to 1986 was one of mobilization but little effective action.

[28] In 1982–84, for example, the Treasury wanted to insulate banks from risk by requiring that expanded powers be conducted in subsidiaries of bank holding companies. See *Banking Expansion Reporter* 1, no. 8 (May 3, 1982): 2. Senator Garn, at least initially, did not. This debate fed into one between the regulators: the FDIC thought that new powers ought to be conducted in bona fide subsidiaries of the banks, whereas the Federal Reserve was happier with the administration's proposal—except that that proposal initially called for the Securities and Exchange Commission to regulate securities subsidiaries of the holding companies, a plan the Federal Reserve resisted.

[29] The associations representing these industries also frequently pursued judicial remedies against regulatory decisions that went against their interests. The Securities Industry Association, for example, attempted to overturn the FDIC ruling (see note 31) that state nonmember banks were not bound by Glass-Steagall restrictions, but the attempt was ultimately unsuccessful.

merce.[30] Finally, the banking agencies, too, had differing ideas about how new powers ought to be regulated, and this was all bound up with discussions about major reform of the financial regulatory structure.[31] Perhaps the best chance to legislate expanded powers occurred in 1984, when Garn piloted a somewhat less-ambitious bill through the Senate. The collapse of Continental Illinois in that year, however, furnished ample ammunition to opponents of the legislation and ensured that the bill did not move through the House Banking Committee.[32] All told, the situation was hardly conducive to decisive action, and a comprehensive solution was never reached during the period through 1994.

The Competitive Equality Banking Act of 1987

Legislative inaction ended in 1987 with the passage of CEBA.[33] The primary motive behind passage was to aid the deteriorating FSLIC. CEBA provided $10.875 billion toward recapitalization of the fund and created a forbearance program for certain "well-managed" thrifts, as well as providing for stricter accounting, appraisal, reserve, and capital standards for the thrift industry. Originally the bill was another piece of omnibus legislation that included expanded powers for commercial banks as a key provision. However, the continuing inability to find consensus on that issue resulted not only in the dropping of expanded powers from the bill but also in the adoption of a six-month moratorium on the granting of new powers in securities, insurance, and real estate by any of the federal banking agencies. The short time limit was ostensibly to allow Congress to reconsider the issue and come to a speedy decision. After the moratorium ended, both the Federal Reserve and the OCC would increasingly grant banks entry into new areas. At the legislative level, however, the thrift and bank crises would combine to make expanded powers a secondary matter for the remainder of the period.

---

[30] The most notable defenders of Glass-Steagall were Senators John Heinz and William Proxmire and Representatives St Germain and John Dingell. Heinz tried to push for a moratorium on new powers in 1983; Proxmire was also against repeal of Glass-Steagall for much of the period, although he had a change of heart and promoted such legislation in 1988. St Germain frequently tried to tie consumer provisions to new bank powers, and Dingell, chairman of the committee responsible for the securities industry (the Energy and Commerce Committee), strongly opposed allowing banks to enter that business.

[31] The FDIC, for example, ruled that state nonmember banks were not included within Glass-Steagall's prohibitions, and allowed such banks to establish securities subsidiaries in 1982; it expanded those powers in subsequent rulings in May 1983 to allow banks to underwrite corporate securities. This ruling produced tensions between the FDIC and the Federal Reserve. Consolidation of the federal agencies had been discussed for many years and returned to the fore in 1984 with the Bush Task Force. See *Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services* (1984).

[32] David S. Holland, "A Broad Banking Bill This Year? A Prediction," *Banking Expansion Reporter* 3, no. 17 (September 3, 1984): 1.

[33] Public Law 100-86. For a discussion of the law, see Stephen K. Huber, "The Competitive Equality Banking Act of 1987: An Analysis and Critical Commentary," *Banking Law Journal* 105, no. 4 (1988): 284–324.

CEBA did resolve one of the main points of contention that had dogged the debate over expanded powers, the "nonbank-bank" loophole. In 1970, under amendments made to the Bank Holding Company Act, banks had been defined as entities that both accepted demand deposits and engaged in commercial lending.[34] If the "bank" did only one or the other, it was not a bank and so not subject to the applicable Federal Reserve regulation. The OCC chartered the first nonbank bank in 1982 and was soon flooded with applications. Contemporary observers widely held that the loophole should be closed, although this view was not shared by firms attempting to use nonbank banks as a vehicle for entering banking. The nonbank banks were perfectly legal, however, and the Comptroller of the Currency, C. T. Conover, sought to use the issue to push for wider deregulation of the industry.[35] After a self-imposed moratorium from April 1983 to November 1984, the OCC resumed chartering nonbank banks and received more than 250 new applications within a few months.[36] However, as we have seen, Congress was unable to come to a consensus on further deregulation. The nonbank-bank issue might have languished in 1987 as well, but the needs of the FSLIC, which had already been frustrated in 1986, helped carry CEBA through Congress. The law created a new definition closing the loophole and placing restrictions on the activities of the 55 "grandfathered" nonbank banks.[37]

Most of the other provisions of CEBA can be summed up as efforts to encourage the revival or acquisition of failed or failing institutions, whose numbers were by then reaching truly alarming levels: 145 banks had failed in 1986, and in 1987 there promised to be many more. The new law made permanent, and expanded, the emergency interstate acquisition provisions originally adopted in Garn–St Germain.[38] Significantly, not only failed banks but also those in danger of failing became eligible for interstate acquisition. CEBA originated a new category of troubled institution: a bank "in danger of closing." When an insured bank's chartering agent made this determination, the bank became eligible for interstate acquisi-

[34] Public Law 91-607.

[35] Ross M. Robertson, *The Comptroller and Bank Supervision* (1995), 221.

[36] David S. Holland, "Nonbank Banks: An Update," *Banking Expansion Reporter* 5, no. 11 (June 2, 1986): 9.

[37] Firms that owned nonbank banks that had been chartered before March 5, 1987, were allowed to continue operating them without becoming bank holding companies, though they were not allowed to engage in expanded activities, offer products or services of an affiliate not permitted under the Bank Holding Company Act, or increase their assets at an annual rate greater than 7 percent. The new definition of bank included any institution insured by the FDIC, as well as any institution that both accepted transaction accounts and made commercial loans. The definition excluded federally insured thrifts, credit unions, certain trust companies, credit card banks under certain circumstances, and certain industrial banks. See Title I of CEBA. The Federal Reserve proposed regulations in 1988 under CEBA that were very harsh; in response to protests from the firms involved, changes were made easing the way in which asset growth would be calculated and removing required divestiture as a penalty for regulatory violations. Strict limits on cross-marketing and product expansion remained. See Barbara A. Rehm, "Fed Relaxes Restrictions on Nonbanks," *American Banker* (September 7, 1988), 1; and *Banking Expansion Reporter* 7, no. 21 (November 7, 1988): 15–17.

[38] These had been scheduled to end in 1985, but Congress had renewed them several times until July 15, 1986, when they expired. The FDIC had pushed for further liberalization, notably the halving of the $500 million asset figure.

tion. The FDIC's authority to permit and assist large emergency interstate acquisitions was expanded—either an entire bank holding company or a portion of it could be part of an interstate acquisition if a large bank subsidiary was in danger of closing. To facilitate such acquisitions, some state restrictions on subsequent branching by an out-of-state acquirer of a failing bank were eliminated. The law also allowed the FDIC to create "bridge banks," or temporary national banks, for up to three years in order to deal with situations in which an immediate acquisition could not be arranged but liquidation was problematic.[39] The Net Worth Certificate Program of Garn–St Germain was extended for five years.[40]

CEBA also provided a loan-loss amortization program for agricultural banks that had assets of $100 million or less, that adopted a capital restoration plan, and that maintained their percentage of agricultural lending. Such banks could amortize agricultural loan losses incurred after December 31, 1983. As early as 1985, the Independent Bankers Association of America had called for loan-loss deferrals for agricultural banks. Legislation proposed during that year failed in the Senate and was superseded in 1986 by the regulatory capital forbearance plans, but both bankers and some members of Congress questioned whether regulators were genuinely seeking to grant that forbearance. All three federal banking agencies opposed loan-loss deferrals in 1987, likening them to "cooking the books" and legislating "water to run up hill," but the program received enough support to pass.[41]

CEBA also contained consumer provisions dealing with expedited funds availability, changed the laws governing the operation and regulation of credit unions, exempted the federal banking agencies from certain provisions of the Anti-Deficiency and Gramm-Rudman-Hollings laws, and mandated a number of studies by the General Accounting Office and the banking agencies. CEBA also stated that insured deposits were backed by the full faith and credit of the United States. This had previously been articulated but never as part of a statute, and therefore it had never been made binding on the United States.[42]

---

[39] The notion of creating such entities was not new; it was included in FDIC-suggested legislation in 1983 (FDIC, *Annual Report* [1983], xi). The bridge-bank provisions were broadened under FIRREA in 1989. Under CEBA the FDIC could not establish a bridge bank until an insured bank was closed, but under FIRREA, a bridge bank could also be established in anticipation of a failure. In 1989 there were other revisions to the bridge-bank provisions as well (see Gail and Norton, "A Decade's Journey," 1148–49, and FIRREA §214).

[40] Huber, "CEBA," 303–8.

[41] See Bartlett Naylor, "Senators Pledge Farm Bank Aid Hearings in '86," *American Banker* (December 5, 1985), 1; Jay Rosenstein, "Banking Groups Appeal for Farm Lending Relief," *American Banker* (February 7, 1986), 3; Paul Tosto, "Bills Seek to Help Plight of Agricultural Banks," *American Banker*, (February 4, 1987), 6; and Jay Rosenstein, "Federal Regulators Oppose Allowing Stretchout of Bad Farm Loans," *American Banker* (April 3, 1987), 14. Relatively few banks were enrolled in the program—never more than 50 at any one time. All of these banks were small, with average assets of approximately $25 million.

[42] Huber, "CEBA," 318.

Although CEBA's moratorium on new bank powers had been intended to provide time to construct a legislative solution to that issue, Congress failed to act on new powers before the moratorium ended. Not surprisingly, Glass-Steagall quickly returned to the fore in 1988 when a dramatic shift occurred in Congress: Senator Proxmire, who had long been reluctant even to discuss repeal, now supported it. His bill to provide additional securities powers to banks swiftly passed the Senate. In the House, St Germain eventually responded with a more limited bill, but Dingell proposed an even more restrictive bill, and the combined squabbles over provisions and turf meant that no legislation emerged from the House. These developments pushed the decision-making process on Glass-Steagall issues from the legislative to the regulatory and judicial arenas.[43]

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989

The S&L crisis absorbed congressional energies throughout 1989 and resulted in passage of a law—FIRREA—that significantly restructured the regulation of thrifts.[44] The statute abolished the FSLIC and replaced it with the Savings Association Insurance Fund (SAIF), under separate FDIC management from the Bank Insurance Fund (BIF), also created by the law. Financial institutions' ability to transfer from one insurance fund to the other was restricted for five years, and was made subject to FDIC approval. The law also created the FSLIC Resolution Fund and the Resolution Trust Corporation (RTC), under the sole management of the FDIC, to handle former FSLIC institutions that were insolvent. (An organizational restructuring in 1991 removed the RTC from FDIC management.)[45] The Federal Home Loan Bank Board (FHLBB) was abolished and a new thrift regulator, the Office of Thrift Supervision (OTS), was created within the Department of the Treasury to oversee the industry.

FIRREA also imposed stricter accounting and other standards on thrifts: thrift capital standards were required to be at least as stringent as those for national banks; thrifts were required to adhere to national-bank limits on loans to one borrower and on transactions with

---

[43] For a summary of S. 1886, the Proxmire Financial Modernization Act of 1988, see *Banking Expansion Reporter* 7, no. 8 (April 18, 1988): 8–10. Reinicke argues that beginning in 1987, even though Congress had failed to act, legislators increasingly believed that U.S. banks required new powers in order to compete in the globalized financial industry. Banking regulators came to hold the same view, with Alan Greenspan replacing Paul Volcker as chairman of the Federal Reserve Board. See Reinicke, *Banking, Politics and Global Finance*, 91–133.

[44] Public Law 101-73. For a full discussion of the S&L crisis, see Chapter 4.

[45] A provision in the Resolution Trust Corporation Refinancing, Restructuring and Improvement Act of 1991 displaced the FDIC as sole manager of the RTC, abolished the RTC Board of Directors, and created the office of CEO of the RTC as well as an executive committee made up of four senior vice presidents. See RTC, *Annual Report* (1991), 2.

affiliates; limits were imposed on the activities of state-chartered thrifts; the use of brokered deposits was restricted; and investments in junk bonds were prohibited.[46]

In addition, some significant aspects of FIRREA applied to commercial banks. The Deposit Insurance Fund was dissolved and its assets and liabilities transferred to the Bank Insurance Fund under FDIC management. The law mandated that BIF levels had to be increased until the ratio of the fund to total insured deposits reached 1.25 percent. The reserve ratio was to be maintained at that level thereafter unless the FDIC Board of Directors determined that potential risks required a higher level, to a maximum of 1.5 percent. FIRREA enacted a schedule of rising BIF assessment rates that would move assessments from 8.3 basis points to 15 basis points by January 1, 1991. The FDIC Board of Directors could not raise the assessment rate above 15 basis points before 1995 unless either the reserve ratio failed to rise during any given year or the agency projected that the BIF would first reach the designated reserve ratio at some time before 1995. After that time, the Board could raise assessment rates above the statutory rate if the reserve ratio was expected to drop below 1.25 percent.[47]

An important element of FIRREA was its cross-guarantee provisions. These were intended to protect the deposit insurance funds by establishing that insured financial institutions were liable for losses incurred by the FDIC (and for losses that the FDIC reasonably anticipates incurring) in connection with either (1) the default of a commonly controlled insured depository institution or (2) any assistance provided by the FDIC to any commonly controlled depository institution in danger of default. For example, healthy affiliates of a bank holding company (BHC) that controlled a failed institution could be required to pay a share of the loss incurred by the FDIC in resolving the failed institution. The cross-guarantee provisions applied to institutions controlled by the same BHC, or to one depository institution controlled by another. The FDIC could waive this liability if it determined that waiver was in the best interest of the BIF or the SAIF.[48]

FIRREA significantly expanded the enforcement authority of banking regulators. The FDIC was given authority to terminate insured banks' insurance coverage more quickly, and to suspend temporarily the deposit insurance of a bank with no tangible capital. Regulators' cease-and-desist (C&D) authority was extended to cover specific bank activities. Temporary C&Ds could be issued to restrict an insured bank's growth. Temporary C&Ds could also be issued if regulators concluded an activity would result in "significant" damage

[46] Boston University School of Law, *Annual Review of Banking Law* 9 (1990): 2–31. FIRREA, of course, had many other elements. For a guide to monographs and articles discussing the law, see Office of Thrift Supervision, *Financial Institutions Reform, Recovery, and Enforcement Act of 1989: Bibliography* (1993).

[47] See FIRREA, §208.

[48] See FIRREA, §206.

to bank assets or earnings, or if bank records were too incomplete to allow determination of its financial condition. The law also greatly increased the civil money penalties that could be imposed on federally insured banks. The statute also required banks that could not meet capital adequacy requirements to obtain FDIC approval before accepting brokered deposits. Finally, FIRREA required each federal banking agency and the RTC to establish real estate appraisal standards and created an Appraisal Subcommittee (under the Federal Financial Institutions Examination Council) to set those standards.[49]

The Federal Deposit Insurance Corporation Improvement Act of 1991

As Congress dealt with the thrift crisis, the number of bank failures remained at a high level and put increasing strain on the BIF. By 1990 it was clear that the fund needed to be replenished. In the aftermath of the S&L disaster, the political climate was such that Congress was intent on finding ways to make the U.S. financial system more stable. In 1991 the Bush administration put forward a wide-ranging plan that would reform the deposit insurance system, provide for increased supervision of and intervention in undercapitalized banks, limit states' ability to authorize banking powers, consolidate the regulatory structure, allow nationwide interstate banking, give new powers to commercial banks, and permit cross-ownership in the financial industry.[50] Many of these supervisory and regulatory issues were endorsed in bills sponsored by the House and Senate Banking Committee chairmen, Henry Gonzalez and Donald Riegle.[51] However, the idea of giving banks new powers was not met with great enthusiasm. Gonzalez said that given the problems with the BIF, he did not believe new powers had the same priority as reform of deposit insurance. The S&L bailout was embedded in political memory. Gonzalez noted, "People would say, 'That's what you did with the S&Ls.' " In the midst of the debate, one lobbyist remarked that members of Congress were concerned that any banking legislation with the word "deregulation" attached to it would "come back . . . to bite them."[52]

The combination of the specter of the S&L debacle plus the usual disputes that accompanied banking legislation doomed much of the administration's plan as well as the alternatives offered by Congress. None of the more drastic proposals for limits on deposit

---

[49] KPMG Peat Marwick, *Financial Institutions Reform, Recovery, and Enforcement Act of 1989: Implications for the Industry* (1989), 1-7ff, 21-3. Many of these provisions also applied to savings banks (see chapter 3 in same).

[50] Robert M. Garsson, "Treasury Treads Easy on 'Too Big to Fail,' " *American Banker* (February 6, 1991), 1.

[51] Robert M. Garsson, "Gonzalez Unveils Insurance Plan," *American Banker*, (January 4, 1991), 2; and Robert Trigaux, "Early Rescues Gaining Favor But Banks Wary," American Banker (January 25, 1991), 1. The Gonzalez bill called for a new independent bank regulator, early intervention into troubled banks, limits on deposit insurance to $100,000 in all accounts, the end of the regulators' "too-big-to-fail" policy, limits on state powers, and risk-based deposit insurance premiums. Riegle's bill had similar components and advocated strong and early regulatory intervention into institutions that fell below minimum capital requirements.

[52] Robert M. Garsson, "Bush Bill Passes Test, But Margin Only 3 to 2," *American Banker* (July 1, 1991), 1.

insurance for individuals proved politically viable.[53] It remained difficult to get agreement on the creation of a new regulatory structure. And many of the other provisions in the Treasury plan (including expanded powers and removal of the separation between banking and commerce) were opposed by one interest group or another. After several months of legislative bargaining, the banking lobby began to fear passage of a law that would repeal Glass-Steagall but simultaneously take away securities and insurance powers that banks already had. After the administration plan was rejected, the lack of consensus coupled with the need to recapitalize the BIF led Congress to abandon attempts to achieve structural reform of the industry. Nevertheless, FDICIA[54] resulted in significant regulatory change.

FDICIA increased sixfold the FDIC's authority to borrow from the Treasury to cover insurance losses, raising it from \$5 billion to \$30 billion. Any borrowing was to be repaid through deposit insurance assessments. The FDIC was also authorized to borrow funds on a short-term basis for working capital, the borrowing to be repaid by sales of assets acquired from failing institutions. In addition, the law provided that the BIF was to achieve its designated reserve ratio of \$1.25 per \$100 of insured deposits within 15 years, and that the SAIF's capitalization was to occur within a "reasonable" period of time.

Aside from providing for the necessary recapitalization, FDICIA was above all a supervisory law, created in a climate shaped by the S&L bailout, the ongoing crisis in commercial banking, and a belief that both had occurred because the supervisory system had failed to act swiftly enough to head off problems. The provision of FDICIA that most reflected this belief was prompt corrective action. The law required the federal banking agencies to develop five categories of capitalization for institutions, with a ladder extending from "well capitalized" to "critically undercapitalized." As an institution's capital ratio dropped down the ladder, the regulator was required to take increasingly severe action, ranging from restricting certain activities to closing institutions that remained critically undercapitalized.

In response to the belief that on-site examinations were an integral part of ensuring safe operation, federal regulators were required to conduct annual safety-and-soundness examinations of all insured institutions.[55] In addition, FDICIA required each institution with more than \$150 million in assets to provide its regulator with an annual financial statement audited by an independent public accountant. The federal bank and thrift agencies were required to create safety-and-soundness standards in three areas: operations and management;

---

[53] Measures that would have limited insurance to \$100,000 per individual per institution, and that would have limited insurance to \$100,000 per individual per institution with another \$100,000 coverage on an Individual Retirement Account, were both defeated. A move to end pass-through insurance coverage for large accounts opened by pension funds also failed. See Garsson, "Bush Bill Passes Test," 1.

[54] Public Law 102-242.

[55] Healthy institutions with less than \$100 million in assets could be examined every 18 months. Federal regulators were permitted to alternate their examinations with those of state regulators.

asset quality, earnings, and stock valuation; and employee compensation. The agencies were also required to revise their risk-based capital standards to account for interest-rate risk.

In a reaction to the obvious fact that real estate had been causing banks problems since the mid-1980s, the law mandated the adoption of uniform standards for real estate lending by insured depository institutions. The law also addressed the issue of states granting powers to banks: insured state-chartered banks could no longer engage in activities not permitted to national banks unless the bank met regulatory capital standards and the FDIC determined that the activity would not pose a risk to the insurance fund. FDICIA also placed new restrictions on the use of brokered deposits. These restrictions built on the ones in FIRREA but now were based on the capital position of institutions. Undercapitalized institutions were no longer allowed to accept brokered deposits and were subject to interest-rate limits on deposits solicited directly from the public. Adequately capitalized institutions could accept brokered deposits but only with FDIC permission; they, too, were subject to interest-rate limits. Well-capitalized institutions could operate without restriction.

Deposit insurance reform was enacted as well. Most significantly, the long-discussed system of risk-based premiums was required to be in place by 1994.[56] Although the more draconian attempts to roll back deposit insurance for individuals were removed before the bill was passed, the law did require the FDIC to aggregate an individual's interests in all IRAs, Keogh Plans, and some other pension accounts and insure only the total up to $100,000. FDICIA therefore contained some reduction in deposit insurance coverage.

FDICIA had many other provisions, and one of the most important of these sought to limit the "too-big-to-fail" policy. The FDIC was now made to use the least-cost alternative in resolutions unless it was decided—with the agreement of a two-thirds majority each of the FDIC Board of Directors and the Board of Governors of the Federal Reserve, and the agreement of the secretary of the treasury (in consultation with the president)—that the failure of an institution constituted systemic risk. In addition, FDICIA established a relationship between a bank's capitalization and the Federal Reserve's ability to provide assistance through the discount window: for critically undercapitalized banks, the Federal Reserve would have to demand repayment within no more than five days, and if that limit were vio-

[56] The use of risk-based premiums had been discussed for many years, but regulators were faced with finding a system that accurately assessed risk (see FDIC, *Deposit Insurance in a Changing Environment* [1983], appendix A). In 1984 the Bush Task Force endorsed their use provided this could be done, and in 1984–85 the FDIC supported their use, but they were not adopted. See *Blueprint for Reform* (1984), 83; FDIC, *Annual Report* (1984), xvi, and *Annual Report* (1985), xvi; and Bartlett Naylor, "Risk-Based Deposit Insurance Idea Comes under Fire at Senate Hearing," *American Banker* (July 24, 1985), 1. As an alternative, the FDIC (in a 1984 bill sent to Congress) suggested that assessment rebates be related to risk. See the Federal Deposit Insurance Improvements Act of 1984, reproduced in *Washington Financial Reports* 42, no. 22 (May 28, 1984): 932.

lated the Federal Reserve would be liable for increased costs to the FDIC.[57] A decision by the FDIC to act in the Federal Reserve's stead by providing open-bank assistance might have rendered this provision less substantial. However, this avenue was essentially closed by the Resolution Trust Corporation Completion Act of 1993, which effectively prohibited—unless the systemic-risk exception had been invoked—the use of BIF or SAIF funds to benefit the shareholders of insured depository institutions, a likely outcome of FDIC open-bank assistance.[58]

Banking legislation traveled a long road between 1980 and 1991. Deregulation marked the beginning of that road and was perceived as a way to create a more stable and profitable banking system. Deregulation continued to stretch across the entire period. In 1991, the Bush administration's plan sought to address issues the legislative process had left unanswered since the early 1980s. But the climate in 1991, instead of leading to another stalemate over new powers, compelled Congress to mandate a less-discretionary system of supervision. Deregulation was by no means dead, but many feared that the banking crisis would continue. Thus, the notion that deregulation did not mean "de-supervision" was—at least at that time—very powerful.

Regulation

Regulatory policies set by the federal banking agencies, often but not always in conjunction with legislative changes, were also important to the banking environment from 1980 to 1994. Five of the most significant issues were entry, capital adequacy, regulatory forbearance, brokered deposits, and expanded powers.[59] Although very different in nature, the regulations and proposed regulations in these areas for the most part reflected the need to support the safety and soundness of both individual institutions and the industry as a whole in the changing financial environment. (Regulatory forbearance does not readily fit this description but was an important corollary to the imposition of capital adequacy standards—and it illustrates how regulatory policy could pursue conflicting strategies at the same time.) Most of the regulations issued or proposed in all these areas can be viewed as a regulatory response to deregulation. The fact that the restrictions on brokered deposits and on expanded powers were ultimately not adopted by the agencies but were later incorpo-

---

[57] Larry D. Wall, "Too-Big-to-Fail after FDICIA," Federal Reserve Bank of Atlanta *Economic Review* 78, no. 1 (January/February 1993): 1–2. See also Chapters 1 and 7.

[58] Public Law 103-204, §11.

[59] This discussion surveys only some of the most important regulatory issues and is not meant to provide a comprehensive history of the large volume of regulation from 1980 through 1994.

rated in FIRREA and FDICIA illustrates the changing times: deregulation remained strong in the mid-1980s but by the end of the decade that strength was considerably diminished.

Regulators, of course, acted on many other fronts, such as insider transactions and management interlocks. They responded to innovations in banking practice; for example, they created a regulatory definition of highly leveraged transactions and implemented guidelines for examiners in their evaluations of leveraged-buyout loan portfolios.[60] As Congress intended when it created the Federal Financial Institutions Examination Council (FFIEC) in 1978, regulators used this organization as a vehicle for developing uniform regulatory changes across the various agencies.[61] The FFIEC, whose membership includes all the banking regulators, facilitated major revisions to Call Reports (the information banks were asked to provide grew steadily in both volume and complexity). Moreover, the regulators often responded to industry concerns about regulatory burden by abolishing and simplifying many regulatory requirements and streamlining the various application processes.

Entry

Regulation begins at an institution's point of entry into commercial banking. Among the federal regulators, only the OCC serves as a chartering agent, setting entry policy for all national banks. All other commercial banks, whether they become members of the Federal Reserve System or not, are chartered by the individual state banking authorities. Chartering authorities at both national and state levels seek to determine a proposed bank's potential for successful operation. Making this assessment generally involves examining the bank's capital adequacy, the character and experience of its proposed management, its ability to attain a certain level of profitability, and the role of the bank in its community. There were, however, variations among state requirements, and there were also differences between states and the OCC.

The most striking policy shift in chartering occurred at the very beginning of the period under consideration. In 1980 the OCC, partly in response to congressional criticism, significantly changed its chartering policy, focusing more on the organizing group and its operating plan and less on the ability of a community to support another bank. The new policy stated that a competitive marketplace would promote a more sound banking system that better served the consumer. The OCC would therefore "foster competition through the chartering of national banks."[62] This led to an immediate and substantial increase in new na-

---

[60] FDIC, *Annual Report* (1990), 22

[61] The FFIEC was created by Title X of FIRIRCA and came into existence on March 10, 1979. See Robert J. Lawrence, *Origin and Development of the Examination Council* (1992), 15.

[62] 12 CFR 5.20(c).

tional bank charters, an increase that lasted into the mid-1980s (see figure 2.1).[63] During the 1970s the OCC had approved an average of 58 percent of new bank applications each year. In the 1980s this rose to 89 percent.[64] In addition, the previous policy on applications had provided for much of the application material to be available to the public, for public comment and, potentially, for a hearing on the application; after 1980 this no longer obtained.[65]

National bank chartering decreased in 1985 as economic decline and bank failures began to plague the Southwest, and rolling regional banking problems continued for the remainder of the period. Chartering at the state level showed no real trend during most of the 1980s but fluctuated within a fairly narrow range. State bank charters did decline steadily after 1988 and were especially low from 1992 through 1994 (figure 2.1).

The boom in Texas in the early 1980s had led to a situation in which, as one Houston banker noted, "Everyone who has two nickels to rub together is opening a bank or trying to."[66] Most of the new banks in Texas were national banks chartered under the new policy, and this aroused some concern. A national-bank president remarked in 1983 that the OCC policy "needs to be looked at . . . with the changes brought about by deregulation, I don't think everybody's going to survive. There are going to be fatalities."[67] Later that year it was reported in the press that the OCC, after finding that many newly chartered banks had quickly become problem institutions, was planning to tighten its chartering policy. Michael Mancusi, senior deputy comptroller for national operations, noted that more than a third of the national banks chartered in California in the previous two years were "receiving a high degree of attention" from the agency.[68]

In 1985 the OCC began to require of most groups applying to form a new bank that they designate their CEO before charter approval; in the following year, the agency required statements on formal lending policies and funds-management strategies. Even so, the OCC chartering policy continued to generate criticism, with some observers suggesting that the agency would approve applications regardless of ability, capital, or the community's eco-

---

[63] Eugene N. White, *The Comptroller and the Transformation of American Banking*, 1960–1990 (1992), 53–54. For congressional criticism of the previous policy, see U.S. Senate Committee on Banking, Housing, and Urban Affairs, *Majority Staff Study on Chartering of National Banks: 1970–1977*, 96th Cong., 2d sess., 1980, 4. Even before the Senate document was released, however, the agency was considering a new policy to provide greater freedom of entry (*Majority Staff Study*, 73). In 1978–79, before the formal policy change, the proportion of approvals of new bank applications rose significantly (White, 88). For a discussion of chartering policy at the OCC, see OCC, *Major Issues Affecting the Financial Services Industry* (1988), 157–60. See also Bernard Shull, "Interstate Banking and Antitrust Laws: History of Public Policies to Promote Banking Competition," *Contemporary Policy Issues* 6, no. 2 (1988): 34–37.

[64] White, *Comptroller*, 88.

[65] See 12 CFR 5.3 (1979).

[66] Phillip L. Zweig, "37 Bank Openings in Texas This Month to Set Record," *American Banker* (January 4, 1983), 1.

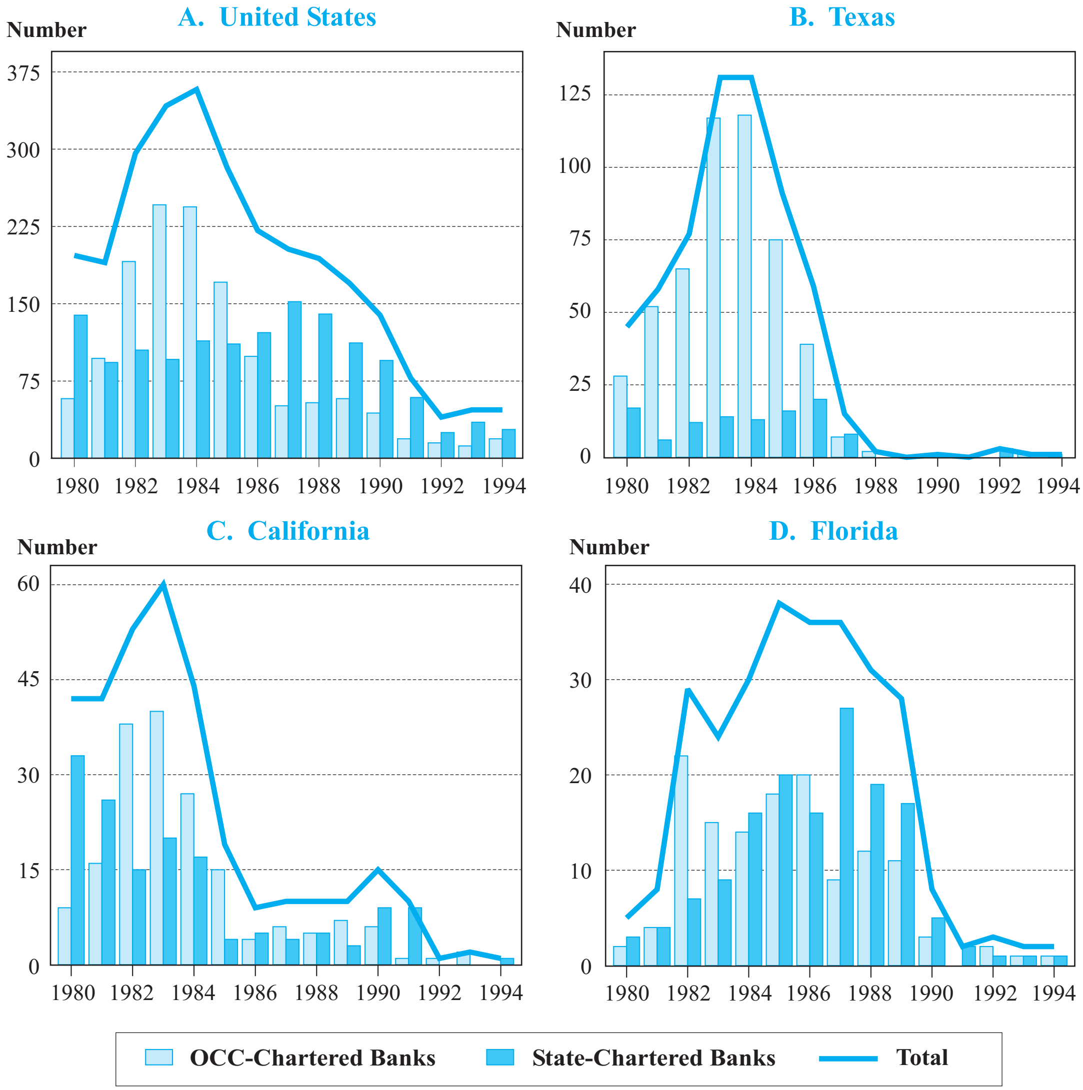
[67] Ibid., 6.

[68] Jay Rosenstein, "Comptroller May Tighten Chartering Process," *American Banker* (October 12, 1983), 3.

nomic need. In 1988 FDIC Chairman L. William Seidman called the policy "shortsighted" because many of the new banks were failing at significant cost. The OCC defended its policy, saying it required the agency to "strike a proper balance between procompetitive entry

Figure 2.1

Newly Chartered Banks:
United States, Texas, California, and Florida, 1980–1994



and 'a reasonable likelihood of a proposed bank's success.' " The agency did note in 1989 that a disproportionate number of new national banks had come under special supervision, but it attributed this largely to the economic downturn in the Southwest, where more than 51 percent of national banks chartered between 1980 and 1987 were located. Comptroller Robert Clarke argued that any attempt to revise chartering standards to make them less "procompetitive" would be harmful.[69]

The criteria by which state banking authorities evaluated charter applications were very similar to those used by the OCC, except that state banking codes often contained an additional element. In Texas, for example, applicants had to establish the existence of a public necessity for the proposed bank, and a public hearing on the application was normally held. In both California and Florida the "public convenience and advantage" were to be assessed, as well as the community's ability to support the bank.[70] Such additional elements did not necessarily mean a huge gulf between national and state chartering standards. The criteria were subjective, and state banking authorities had a good deal of discretion. Nevertheless, it was remarked that the OCC's new policy made Texas state charters seem relatively harder to obtain.[71] The volume of national versus state charters in that state during the early 1980s appears to bear this out (figure 2.1). California presented a somewhat different picture. Whereas state charters accounted for approximately two-thirds of the charters in California during 1980–81, during the next four years national bank charters dominated, with state charters reduced to approximately one-third of all charters in the state (figure 2.1). Florida provided yet another pattern. Again, national bank charters increased during the early 1980s, but state charters rose as well, surpassing national charters by 1984 (figure 2.1). These three states are not necessarily representative, but from 1980 to 1994 they did account for 29 percent of all state charters and 59 percent of all national bank charters. It is clear that the OCC's change in policy had a very significant effect on national bank chartering during the 1980s, but national charters certainly did not uniformly replace state charters as the vehicle of choice for new banks.

The FDIC had no direct role in chartering; however, in its role as insurer it had a significant effect on *state* chartering decisions. New institutions were seldom deemed viable without federal deposit insurance, and a state was extremely unlikely to grant a commercial bank charter without the FDIC's approval of the bank's application for insurance.[72] The

[69] Barbara A. Rehm, "Charter Curbs Seen Hurting Competition," *American Banker* (April 11, 1989), 2. OCC, Major Issues (1989), 157–60.

[70] See TEX. REV. CIV. STAT. ANN Banks and Banking §342–305 (West, 1991); CAL. Financial Code §361(2–5) (West, 1992); and FLA. STAT. ANN. §658.20–21 (West, 1986, 1991).

[71] Zweig, "37 Bank Openings," 5.

[72] The requirement for FDIC insurance was sometimes a legal one—see, for example, FLA. STAT. ANN. Title 38, §658.22. Almost no uninsured commercial banks were chartered during the period considered by this study.

FDIC's evaluation of deposit insurance applications for state nonmember banks, like the charterers' evaluation of charter applications, covered capital structure, future earnings prospects, management, and the needs of the community to be served. In 1980, the FDIC adopted a policy stating that initial capitalization should be sufficient to provide a ratio of unimpaired capital to total estimated assets of 10 percent after three years; applicants with less than $750,000 in initial capital were discouraged. This minimum initial net capital requirement was later raised to $1 million and then, in 1992, to $2 million. Starting in 1992, initial capital was to be sufficient to provide a ratio of Tier 1 capital[73] to total estimated assets of at least 8 percent after three years.[74] These requirements would have effectively superseded any more-lenient state regulations on capital.[75] National banks and state member banks received insurance as a matter of law, upon FDIC receipt of certification by either the OCC or the Federal Reserve. FIRREA in 1989 authorized the FDIC to comment on applications to the other federal banking agencies, and FDICIA in 1991 required all institutions seeking federal deposit insurance to apply formally to the FDIC for coverage.[76]

Capital Adequacy

The trend toward deregulation in the 1980s reinforced regulators' belief that some level of capital was necessary to maintain the safety and soundness of banking. Capital was variously viewed as a cushion against unforeseen losses, a means to enhance public confidence in banking institutions, a way to foster prudent growth, and a protection for depositors. There was, however, much debate over what the level should be and what mechanism should be used in setting it.[77] During the 1970s the federal banking agencies' approach to evaluating capital adequacy had been to create bank peer groups, set target capital ratios for

---

[73] For the definition of Tier 1 capital, see discussion of capital adequacy below.

[74] FDIC Statement of Policy, March 31, 1980; *Federal Register* 57 (April 13, 1992), 12882. The FDIC clarified the guidelines for granting insurance to operating institutions in 1987 (see FDIC Statement of Policy, May 28, 1987; *Federal Register* 52 [June 9, 1987], 21736).

[75] State requirements on minimum capital varied widely and often depended on the population of the area being served. In addition, state banking authorities often had the discretion to set whatever capital levels were deemed appropriate. In 1985, statutory state capital requirements ranged from $25,000 in some states (for banks in rural areas) to $1.5 million. By 1989, the range was from $25,000 to $4 million (Conference of State Bank Supervisors, *A Profile of State-Chartered Banking* [1986], 107–8, and [1990], 137–41).

[76] See 12 U.S. Code 1814; FIRREA, §205 (2)(b)(A), states: "Any application or notice for membership or to commence or resume business shall be promptly provided by the appropriate Federal banking agency to the Corporation and the Corporation shall have a reasonable period of time to provide comments on such application or notice. Any comments submitted by the Corporation . . . shall be considered by such agency." For the requirement to apply for insurance, see FDICIA §115, which amends §5 of the Federal Deposit Insurance Act [12 U. S. Code 1815(a)].

[77] For a more detailed discussion of the politics of the debate over capital adequacy during the 1980s, see Reinicke, *Banking, Politics and Global Finance*, 134–57.

each group, and then adjust those targets according to the situations of individual institutions.[78] There were no specific minimum capital requirements. But bank capital levels steadily declined during the decade, mostly because of decreased capital at the nation's largest banks.[79] In addition, several large banks failed, with attendant costs to the FDIC. The combination of declining capital levels and large-bank failures exacerbated both regulatory and congressional anxiety, and prompted the regulators to explore new approaches to capital adequacy. First and foremost was the need to create a mandatory capital ratio. This need was formalized by the establishment, in 1979, of an FFIEC task force to study the issues and move toward a uniform legal definition of capital.[80] But the banking industry resisted moves to raise and codify capital requirements, and—partly as a result—in 1980 the OCC backed away from deciding to tighten its own legal definition of capital.[81]

One of the most contentious issues was the role of subordinated debt, which banks had increasingly used from the late 1960s onward to prop up declining capital levels.[82] The FFIEC proposed guidelines dividing capital into primary capital, which was characterized by its permanence, and secondary capital, which included subordinated debt. Primary capital would include common and perpetual preferred stock, surplus, undivided profits, contingency and other capital reserves, mandatory convertible instruments, and loan-loss reserves. Secondary capital would include limited-life preferred stock, and subordinated notes and debentures.[83] The FFIEC eventually decided to include secondary capital in the definition of what would constitute regulatory capital, but average maturities would have to be at least seven years, and secondary capital would be limited (for regulatory purposes) to 50 percent of primary capital. For determining capital adequacy, banks would be placed into one of three groups, depending on their size. The FDIC, however, held that since subordinated debt cannot be used to absorb unanticipated losses, it ought to be excluded, and

---

[78] Each agency used its own categories and measurements, however. See Arnold A. Heggestad and B. Frank King, "Regulation of Bank Capital: An Evaluation," Federal Reserve Bank of Atlanta *Economic Review* 67, no. 3 (1982): 38–39.

[79] See FFIEC, *Capital Trends in Federally Regulated Financial Institutions* (1980), 2–5.

[80] FFIEC, *Annual Report* (1979), 12.

[81] The most significant change being contemplated by the OCC was the removal of subordinated debt and loan-loss reserves from the statutory definition of capital. See Teresa Carson, "CofC May Trim Definition of Capital, Lift Loan Limits," *American Banker* (July 24, 1980), 1; and Jay Rosenstein, "Comptroller's New Definition of Capital Is Viewed by Banks as Too Restrictive," *American Banker* (September 28, 1980), 3. In fact, the OCC announced that it would ease capital requirements for small banks and would count 100 percent of loan-loss reserves as capital for all national banks, as opposed to 50 percent (James Rubenstein, "Comptroller Eases Capital Rules for Small, Well-Managed Banks," *American Banker* [March 26, 1981], 1).

[82] James G. Ehlen, "A Review of Bank Capital and Its Adequacy," Federal Reserve Bank of Atlanta *Economic Review* 68, no. 11 (1983): 54.

[83] *Federal Register* 46 (June 23, 1981), 32498.

voted against sending the proposal to the agencies. Its Board of Directors eventually rejected both the proposal and, for the time being, uniform capital guidelines.[84]

In 1981 the Federal Reserve Board and the Comptroller of the Currency adopted a set of guidelines on capital ratios that mirrored most of the FFIEC proposals. Banks were divided into three groups on the basis of asset size: multinational, regional, and community. The multinationals—the 17 largest banks—would be treated individually and had no mandated capital requirements but were expected to reverse the decline in their capital positions. The implication was that if multinationals did not significantly better their capital levels, regulators would establish numerical standards.[85] For regional banks (assets between $1 billion and $15 billion), explicit ratio guidelines were set: these banks were expected to operate above a primary-capital-to-assets ratio of 5 percent. Community banks (assets below $1 billion) were expected to maintain a ratio of at least 6 percent. In addition, banks were divided into three supervisory zones according to their total-capital-to-assets ratios. Multinational and regional banks with a ratio of 6.5 percent were designated "adequately capitalized," those between 5.5 and 6.5 percent were "possibly undercapitalized," and those below 5.5 percent were "presumed undercapitalized." Community banks were ranked similarly, but with ratios set half a percentage higher. Banks that fell into the two lower zones would receive increasingly greater supervisory attention and would have to submit plans to rebuild their capital positions.[86]

The FDIC, still stressing the importance of equity capital, adopted more-stringent guidelines on capital adequacy. It used a single measure—the ratio of adjusted equity capital to adjusted total assets—and set a 6 percent threshold for all state nonmember banks regardless of size. Chairman William Isaac noted that the agency's position against counting limited-life instruments toward capital adequacy had long been known and that it was unfair to vary requirements depending on size, as smaller banks had urged for some time.[87] For all banks, the FDIC also set a minimum acceptable ratio of 5 percent. Any institution falling below this level was to initiate a specific program to remedy the capital deficiency.[88] Since most FDIC-supervised institutions had assets under $1 billion, capital adequacy regulation was in fact more consistent than might have appeared on the surface. Thus, a sub-

---

[84] Lawrence, *Examination Council,* 17; Jay Rosenstein, "Exam Council Gives Views on Capital," *American Banker* (November 12, 1981), 1; and Phil Battey, "Regulators Fail on Uniform Bank Capital Policy," *American Banker* (December 18, 1981), 1.

[85] Reinicke, Banking, *Politics and Global Finance*, 140.

[86] Heggestad and King, "Regulation of Bank Capital," 39. For the OCC's view on capital adequacy at this time, see statement of Comptroller John Heimann before the Senate Banking Committee in April 1981, reproduced in *OCC Quarterly Journal*, pilot issue (1981): 37.

[87] Battey, "Regulators Fail," 20.

[88] See FDIC Statement of Policy on Capital, PR-86-81 (December 17, 1981).

stantial amount of codification had been achieved, even though significant differences remained.

The less-developed-country debt crisis provoked the next significant change in capital regulation in 1983.[89] The crisis had created great anxiety about the condition of both U.S. money-center banks and the banking system as a whole.[90] During the debate over how to deal with the situation, many in Congress came to believe that the adverse effects on the U.S. economy would have been mitigated if the regulators had imposed more rigorous capital standards on multinational banks. Initially neither the OCC nor the Federal Reserve had indicated a desire to change its capital regulation, and the joint program that the three agencies presented to enhance the supervision of international lending did not address capital adequacy.[91] Legislators held not only the regulators but also the banks responsible for the crisis, and the industry's resistance to increased supervision of international lending only strengthened the legislators' resolve to stiffen capital standards.

In 1983 the OCC's authority to impose explicit capital requirements was challenged in court; the case helped overcome the agencies' reluctance to accept stronger capital standards. Eventually, the International Lending Supervision Act of 1983 directed each agency to ensure that all banking institutions maintained adequate capital levels, and failure to do so was made an unsafe and unsound practice.[92] Even before the law passed, the Federal Reserve and the OCC set minimum capital levels for multinational banks at the same level as for regionals.[93]

The agencies had also committed themselves to working toward uniform capital standards, and in 1984 each agency published new proposals. The FDIC and OCC plans were very similar, and set the minimum primary-capital-to-assets ratio for all well-run banks at 5.5 percent, and the minimum total capital ratio at 6 percent. The Federal Reserve Board's proposal retained the then-current zone concept with regard to total capital levels but set the same minimum primary-capital ratio for all institutions—5.5 percent. Even as these proposals were being discussed, the FDIC was pressing to phase in a much higher total capital ratio of 9 percent, in a combination of a minimum 6 percent equity and up to 3 percent subordinated debt. Chairman Isaac argued not only that this would provide greater cushions for institutions but also that sophisticated debt holders would impose greater discipline on

---

[89] This discussion is based on Reinicke, *Banking, Politics and Global Finance*, 142–49.

[90] On the LDC crisis, see Chapter 5.

[91] For the proposed program, see *Banking Expansion Reporter* 2, no. 9 (May 2, 1983): 5.

[92] For a detailed discussion of the law, see Cynthia C. Lichtenstein, "The U.S. Response to the International Debt Crisis: The International Lending Supervision Act of 1983," *Virginia Journal of International Law* 25, no. 2 (1985): 401–35.

[93] Whereas the OCC imposed regulations, the Federal Reserve Board continued its approach of issuing only guidelines (*Banking Expansion Reporter* 2, no. 12 [June 20, 1983]: 11).

banks. Federal Reserve Board Chairman Paul Volcker endorsed the plan, as did a Treasury Department proposal, but it was never acted upon.[94] When the final rules were announced in 1985, the FDIC and OCC regulations were based largely on their proposals, and the Federal Reserve, while keeping the capital zones for supervisory use, also implemented minimums of 5.5 percent primary- and 6 percent total-capital ratios.[95] All the agencies also issued regulations concerning capital directives. Substantial uniformity had been achieved not only between the agencies but also with respect to banking institutions regardless of asset size.

Even as the banking agencies were making the new rules final, all the regulators were pronouncing them insufficient.[96] The imposition of enforceable capital ratios had motivated banks to expand off-balance-sheet activities, such as letters of credit, loan commitments, and interest-rate and currency swaps: such activities incurred risk but did not have to be backed by capital. One study noted that during the first half of 1985, the inclusion of standby letters of credit into bank assets would have decreased the primary-capital ratio among 12 money-center banks by approximately 11 percent.[97] Regulators were concerned that these activities could injure liquidity and undermine safety and soundness, and they quickly undertook development of risk-based capital standards. These focused on credit risk, and would link capital requirements to the riskiness of bank activities.[98] Off-balance-

[94] Robert Trigaux, "Isaac, in a Shift, Warns Convention on Nationalization," *American Banker* (October 23, 1984), 45; William Isaac, "Brief Comment," *American Banker* (January 17, 1985), 4; Bartlett Naylor, "Volcker to Propose Risk-Based Capital Rule," *American Banker* (September 12, 1985), 1; and Maggie McComas, "More Capital Won't Cure What Ails Banks," *Fortune* (January 7, 1985), available: LEXIS, Library: NEWS, File: FORTUN. Industry observers viewed the proposal as a "fishing-expedition" move toward some form of stricter capital standards (Richard S. Vokey and Kevin L. Kearns, "Issues in Capital Adequacy Regulation," *Bankers Magazine* 168, no. 5 [1985]: 40).

[95] *Banking Expansion Reporter* 4, no. 7 (April 1, 1985): 16–17; and *Federal Reserve Bulletin* (June 1985): 440–41. For a summary of the new regulations, see R. Alton Gilbert, Courtenay C. Stone, and Michael E. Trebling, "The New Capital Adequacy Standards," Federal Reserve Bank of St. Louis *Economic Review* 67, no. 5 (1985): 12–20.

[96] See statements by William Isaac of the FDIC, Michael Patriarca of the OCC, and Paul Volcker of the Federal Reserve Board in, respectively, Jay Rosenstein, "FDIC Raises Capital Ratio Requirements," *American Banker* (February 12, 1985), 30; John P. Forde, "Capital Guidelines Revision Foreseen," *American Banker* (March 29, 1985), 1; and Naylor, "Volcker to Propose," 1.

[97] Reinicke, *Banking, Politics and Global Finance*, 151. The Federal Reserve stated that between year-end 1981 and midyear 1985, letters of credit at multinational banks had increased from 5.8 percent of aggregate assets to 11.5 percent (*Banking Expansion Reporter* 5, no. 3 [February 3, 1986]: 3). It was reported that by early 1987 the decision to impose risk-based capital standards had decreased the use of standby letters of credit (Lisabeth Weiner, "Some Banks Turn More Cautious in Issuing Standby Credit," *American Banker* [February 5, 1987], 1).

[98] Risk-based capital was not new in the 1980s; in the 1950s the Federal Reserve Board had used a risk-based system called ABC (Paul M. Horvitz, "Warming Over the ABC Idea," *American Banker* [February 26, 1986], 24; and William R. Keeton, "The New Risk-Based Capital Plan for Commercial Banks," Federal Reserve Bank of Kansas City *Economic Review* 74, no. 10 [1989], 42, note 2).

sheet items would be converted into on-balance-sheet credit equivalents and assigned a risk weight. All three agencies issued preliminary risk-based capital proposals by mid-1986. The agency approaches differed somewhat, although they were basically very similar, and the agencies were confident they could reach uniform standards. Both the FDIC and the Federal Reserve Board favored making risk-based capital a supplement to current capital standards, whereas the OCC advocated making it a replacement for them.[99] In addition, as of mid-1987, the OCC's definition of what would become Tier 1 capital included loan-loss reserves, while the Federal Reserve's did not. There was also some disagreement on the appropriate risk weighting for longer-term government securities.

Initially larger banks in particular did not favor the risk-based proposals, fearing they would place U.S. banks at a competitive disadvantage in pricing fee-generating financial services.[100] These objections had less force after U.S. regulators joined their international counterparts in 1986 in working to create a common set of risk-based requirements.

The Basle Committee on Banking Regulations and Supervisory Practices reached agreement on a general set of principles in June 1988.[101] The standards defined capital and set risk weights and credit conversions for off-balance-sheet items; the standards were then implemented by each nation's banking regulators.[102] Capital was defined as consisting of two tiers: Tier 1 capital included fully paid common stock and perpetual noncumulative preferred shares; Tier 2 capital included undisclosed reserves, revaluation reserves, general loan-loss reserves (limited in amount, generally up to 1.25 percent), hybrid debt/equity capital instruments, and subordinated debt (limited to a maximum amount of 50 percent of Tier 1). U.S. regulators had previously counted loan-loss reserves as primary capital, but an increasingly strong belief that capital should consist primarily of equity and the need to find common ground among the international regulators combined to help change that. Banks were to have a minimum of 4 percent Tier 1 capital and 8 percent total risk-based capital by

---

[99] "Risk-Based Capital Plan," *American Banker* (February 26, 1986), 3; Robert Trigaux, "Comptroller Unveils Risk-Based Plan," *American Banker* (March 26, 1986), 1; and *Banking Expansion Reporter* 5, no. 8 (April 21, 1986): 6–8.

[100] Robert M. Garsson, "Comptroller Says Regulators May Issue One Risk-Based Capital Proposal by Fall," *American Banker* (July 11, 1986), 10. The Independent Bankers Association of America (IBAA), which represented smaller banks, was more receptive, believing that such institutions would benefit from lower capital requirements. See also Robert M. Garsson, "US, British Join in Bank Capital Rules," *American Banker* (January 9, 1987), 1; and Bart Fraust, "At Banking Conference, There Was Bad News—And Worse News," *American Banker* (April 3, 1987), 8.

[101] The committee was made up of representatives of bank regulatory agencies in Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

[102] For further details on capital definition and risk weights, see the text of the Basle agreement, which is reproduced in *BNA's Banking Report* 51, no. 4 (July 25, 1988): 143–55. Earlier Basle proposals had limited Tier 1 capital only to common equity; see *Banking Expansion Reporter* 7, no. 3 (February 1, 1988): 18.

the end of 1992. By the end of 1988, the U.S. regulators had set final risk-based capital rules in a process that involved making further refinements and compromises.[103]

Debate continued, however, over what ought to become of the old capital standards. The FDIC rules retained the old total-capital-to-assets ratio (the leverage ratio), stating that banks would have to maintain the higher of 6 percent capital or the amount determined by the risk weighting of assets. The Federal Reserve Board also held to the 6 percent minimum but suggested it might be lowered in the future. The OCC, which had originally argued for complete removal of the old ratio, now pressed for a 3 percent minimum capital requirement. Comptroller Clarke argued that maintaining the old ratio would destroy incentives for banks to retain low-risk assets under the new risk-based rules, and suggested that the OCC would strengthen the 3 percent standard by excluding loan-loss reserves and incorporating interest-rate risk.[104] The differences between the two agencies persisted because of their different orientations: the FDIC was primarily concerned with protecting the deposit insurance fund, whereas the OCC wanted banks to be freer to expand profitability. The impasse was eventually ended with a compromise offered by the Federal Reserve Board which set the minimum leverage ratio at 3 percent—but only for banks with CAMEL ratings of 1.[105] Banks with lower ratings would have to hold between 100 and 200 basis points in additional capital (and, for the most troubled institutions, possibly more). Most banks would therefore need to maintain ratios of between 4 and 5 percent, midway between the FDIC and OCC recommendations.[106] In 1991, when FDICIA used both risk-based capital levels and the leverage ratio to define capital category standards and those categories became the triggers for PCA, regulatory capital levels acquired even greater importance. Although bank regulators have continued to amend capital standards to better reflect bank risk, as of this writing the dual system of risk-based and leverage capital standards remains in place.

---

[103] For example, the Federal Reserve had pushed for a risk weighting of 100 percent for home mortgages but eventually went along with 50 percent. The Federal Reserve also believed that longer-term government securities, by virtue of interest-rate risk, ought to be assigned a risk weight higher than zero, but the final rules placed all Treasury securities, regardless of maturity, in the zero-risk category. See Barbara A. Rehm, "Fed Compromises on Final Risk-Based Capital Rules," *American Banker* (August 4, 1988), 2; and Bart Fraust, "Impact of Risk-Based Capital Rules to be Eased," *American Banker* (October 12, 1988), 3.

[104] Jim McTague, "FDIC Set to Adopt 6% Capital Minimum," *American Banker* (March 14, 1989), 2; and Barbara A. Rehm, "Comptroller Favors 3% Capital to Back Low-Risk Assets," *American Banker* (April 5, 1989), 3.

[105] The CAMEL rating system refers to capital, assets, management, earnings, and liquidity. In addition to a rating (from 1 to 5) for each of these individual components, an overall or "composite" rating is given for the condition of the individual bank. The CAMEL rating system is discussed in detail in Chapter 12.

[106] Barbara A. Rehm, "Fed Seeks to Close Gap in Proposal on Capital Ratios," *American Banker* (October 26, 1989), 1, 23; Barbara A. Rehm, "Fed Mulls 3% Capital Minimum for Banks in Best Condition," *American Banker* (November 24, 1989), 1; and Barbara A. Rehm, "A Magic Number from Fed Brings Accord on Capital," *American Banker* (November 28, 1989), 1.

Formal Regulatory Forbearance

The formal practice of forbearance was inaugurated with Garn–St Germain's Net Worth Certificate Program for savings banks. Qualifying institutions and the insurers exchanged notes that created "regulatory capital," allowing institutions to meet regulatory requirements and continue to operate.[107] Commercial banks were not included then, but soon afterward weakness in the agricultural and energy sectors began to exact its toll on those institutions. As early as 1983, it was reported that the banking agencies were instructing their examiners to be lenient in criticizing farm-bank managements that were trying to cope with increasing credit problems.[108] Nevertheless, although cognizant of sectoral economic problems, the FDIC believed that mismanagement contributed significantly to agricultural-bank failures, and the agency resisted attempts to provide it with authority to allow banks to renegotiate loans with farmers and then write off the losses over a period of years.[109] All of the banking agencies did, however, encourage banks to work with borrowers who were experiencing difficulties, provided the institutions' practices were generally consistent with safety and soundness; and all of the agencies also instructed examiners to handle credit problems "with understanding."[110]

But as increasing numbers of agricultural banks continued to fail, congressional and industry sentiment prompted the regulators to formulate plans to further assist troubled banks in 1986.[111] The three banking agencies opposed proposals that would have either created a new net worth certificate program or permitted loan-loss deferrals; they said they were reluctant to engage in "accounting gimmicks" that would undermine the integrity of the banking system.[112] The agencies did, however, issue a joint statement reaffirming their policies not to discourage banks from implementing work-out plans with their agricultural borrowers when appropriate. The agencies also encouraged banks to take advantage of the fact that they would not be required to automatically charge-off loans that had been re-

---

[107] See Chapter 6 for a discussion of the Net Worth Certificate Program, and Chapter 1 for an analysis of the use of forbearance.

[108] Lisa J. Mc Cue, "Farm Bankers Urged to Show Forbearance," *American Banker* (August 4, 1983), 3.

[109] Kim Kaplan and Bartlett Naylor, "FDIC Snubs Bill to Help Farm Banks Cope with Bad Loans," *American Banker* (July 25, 1985), 3.

[110] The regulators' response was the subject of a joint policy statement issued on April 3, 1985. See OCC *Quarterly Journal* 4, no. 2 (1985): 16.

[111] The executive director of the Kansas Bankers Association noted in 1985 that, despite claims to the contrary, the banking agencies were not exercising forbearance (Kaplan and Naylor, "FDIC Snubs Bill," 7). Another midwestern banker suggested in early 1986 that legislative action might not be necessary, "but the regulators need to give us as much forbearance as possible to help us take our losses without closing everybody down" ("Severe Problems in the Midwest," *Bankers Magazine* 169, no. 1 [1986]: 25).

[112] Jay Rosenstein and Bartlett Naylor, "Regulator Says 300 Farm Banks May Fail by '88," *American Banker* (February 24, 1986), 1, 21; and "Comptroller's Letter on Agricultural Banks," *American Banker* (March 6, 1986), 4. For a contemporary discussion of the issues, see FDIC, "Farm Bank Problems and Related Policy Options" (February 1986).

structured, as long as future payments of principal and interest at least equaled the face amount of the loan.[113] Most significantly, the regulators agreed on a capital forbearance program not only for the agricultural banks but also for troubled banks involved in the increasingly distressed energy sector. The agencies resolved not to take enforcement action against banks whose capital-to-assets ratios failed to meet regulatory minimums but were at least 4 percent. Banks also had to meet the regulatory definition of an "agriculture" or "oil-and-gas" bank, and their weakened capital position had to stem from external economic factors, not mismanagement. Banks were required to submit acceptable plans for capital restoration, which was to occur within seven years, as well as annual progress reports. The deadline to apply for forbearance was year-end 1987.[114]

Banks did not seek to enter the program in large numbers. The OCC noted that by early June 1986, it had received only 14 applications and had admitted 4 banks. By the end of that year, 52 banks had been admitted to the program. In early 1987, some legislators complained that few banks applied to the program because too many hurdles had been placed in the way of approval. In any case, they believed the program afforded banks insufficient relief.[115] In response to industry and congressional pressure and with the growing realization that banking conditions were still worsening, in mid-1987 the regulators expanded the capital forbearance program considerably by allowing any bank to apply if the bank could demonstrate that its difficulties resulted primarily from economic problems beyond the control of management. Moreover, the fixed minimum capital ratio of 4 percent was eliminated, and the program—originally set to expire at the end of 1987—was extended for two additional years.[116] After these changes were made, more banks participated in the program: 156 banks were admitted in 1987, and 93 more were admitted in the program's final two years, bringing the total admitted to 301. Of this total, one year after leaving the program 201 were operating as independent institutions, while 35 had been merged without FDIC assistance and 65 had failed. The expanded program was not, however, sufficient to halt congressional moves for a loan-loss amortization program for farm banks,

---

[113] See FRB, *Annual Report* (1986), 192. Banks were instructed to account for debt restructurings in accordance with GAAP principles, specifically FASB 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings." See also FDIC Bank Letter BL-15-86, April 11, 1986; and OCC *Quarterly Journal* 5, no. 2 (1986): 51.

[114] See FDIC Bank Letter, BL-12-86, March 27, 1986; and OCC Banking Circular no. 212, March 28, 1986, in OCC *Quarterly Journal* 5, no. 2 (1986): 48–54. The OCC also announced that it would temporarily increase national-bank lending limits on loans to one borrower for banks that had experienced losses in the two sectors. See Jay Rosenstein, "Comptroller Says Rule Easing Loan Limits for Some Is Final," *American Banker* (November 20, 1986), 14. See also *Federal Reserve Bulletin* 72, no. 6 (June 1986): 392.

[115] OCC *Quarterly Journal* 5, no. 3 (1986): 61; and Paul Tosto, "Bills Seek to Help Plight of Agricultural Banks," *American Banker* (February 4, 1987), 6. In response, two senators, Alan Dixon and Nancy Kassebaum, renewed attempts to pass loan-loss amortization plans for farm banks. This would become part of CEBA, as discussed below.

[116] See John C. Rasmus, "Capital Forbearance for Commercial Banks," *Journal of Agricultural Lending* 1, no. 4 (1988): 28–30; FDIC Bank Letter BL-24-87, July 9, 1987; and OCC *Quarterly Journal* 6, no. 3 (1987): 37.

which was enacted under the Competitive Equality Banking Act of 1987.[117] This program was substantially smaller in scope. A total of 33 banks were admitted; 27 of these survived as independent institutions one year after leaving the program, while 2 had merged and 4 had failed.[118]

Brokered Deposits

Penn Square's demise in 1982 not only helped the regulators obtain new powers to deal with failing institutions but also focused attention on another regulatory issue: the increasing use of brokered deposits.[119] Starting in the early 1970s, brokered CDs had come to be used increasingly as funding sources, first by money-center banks and then by regional and smaller institutions.[120] The brokered CD market was divided into two parts: the wholesale institutional market, where CDs were issued in denominations of $100,000 or more, and the retail market, where CDs were in denominations not exceeding $100,000.[121]

The potential abuses of brokered deposits received relatively little attention until the failure of Penn Square, where the amount of brokered funds had risen from less than $20 million to $282 million just before the bank failed.[122] By early 1983, the FDIC was expressing concern about deposit brokers that were dividing money into packages of $100,000 without necessarily conducting any credit analysis to ascertain the conditions of the offering institutions.[123] The deposit insurers feared that brokers were singling out institutions known to have problems in order to earn higher fees. Later that year Representative St Germain asked the banking regulators for a detailed plan for supervising money brokers in the wake of Penn Square. By early 1984, both the FDIC and the Federal Home Loan Bank Board (FHLBB) proposed that brokered deposits be insured only up to $100,000 per broker per bank.[124]

---

[117] For a discussion of the program under CEBA, see the section above on that law.

[118] These loan-loss amortization program totals exclude banks that were in both the capital forbearance and loan-loss amortization programs; those banks are included in the totals for the capital forbearance program.

[119] See Chapter 9 for a discussion of Penn Square's failure.

[120] Brokered deposits are certificates of deposit issued by a financial institution and purchased by an investor through a third-party intermediary; the third party receives a fee or commission from the issuing institution.

[121] See Caroline T. Harless, "Brokered Deposits: Issues and Alternatives," Federal Reserve Bank of Atlanta *Economic Review* 69, no. 3 (1984): 14–25.

[122] Phillip L. Zweig, "Brokered Penn Square Funds Soared Just before Collapse," *American Banker* (November 19, 1982), 3.

[123] Money brokers disputed this. In 1984 Merrill Lynch said it performed credit reviews on banks and had not marketed CDs issued by any of the banks that failed in that year. See Jay Rosenstein, "Merrill Lynch Challenges Isaac's Remarks," *American Banker* (December 14, 1984), 3. However, in 1983 Kominz Co., a California broker, said it had "returned" to the practice of analyzing Call Report data from institutions before brokering funds. The company said competitive pressures had forced it to drop the practice some time before, and agreed that the unregulated money-brokerage business had "gotten out of hand" (Richard Ringer, "CD Broker Proposes Self-Regulation," *American Banker* [August 9, 1983], 1).

[124] Lisa J. Mc Cue, "St Germain Asks Regulators to Supervise Money Brokers," *American Banker* (September 9, 1983), 1; and Jay Rosenstein, "Insurance Limits Considered on Pensions, Custody Deposits," *American Banker* (October 25, 1983), 1.

Many observers agreed that some form of regulation was required, but some viewed the proposal as an overreaction. The CD brokerage industry was obviously concerned, and argued that this regulation would effectively destroy a business that provided real benefits to financial institutions. Comptroller C. T. Conover (as a member of the FDIC Board of Directors) had voted against the FDIC proposal, saying it was "like shooting ants with elephant guns." The Treasury agreed that the proposed regulation was much stronger than necessary.[125] Members of Congress also expressed concern about the proposed regulation, and the House Committee on Government Operations held extensive hearings on the subject in March. The OCC argued for a supervisory approach that would allow an institution to accept up to twice its capital in brokered deposits as long as brokered deposits did not exceed 15 percent of total deposits. No institution with a capital ratio under 3 percent would be allowed to accept any brokered deposits. The Federal Reserve Board shared FDIC and FHLBB concerns and was willing to support their proposal but urged that a less-sweeping approach be mandated by legislation. Those testifying on behalf of money brokerage agreed that the misuse of such funds should be prevented, but they argued that the proposed regulations would restrict the legitimate and generally helpful use of brokered funds by depository institutions.[126]

Despite the obviously divided opinion, both the FDIC and the FHLBB decided to press on with their rule, which was to become effective in October. This prompted one of the larger money brokers, FAIC Securities, to sue, arguing that the agencies had overstepped their authority. The Securities Industry Association soon followed with another lawsuit, claiming that the two agencies had "heavy-handedly slammed the door shut on a mechanism that provides a real service to the nation's savers and deposit-taking institutions."[127] The situation changed dramatically in June, when the U.S. District Court in Washington, D.C., ruled that the agencies had overstepped their authority, maintaining that the statutes creating deposit insurance focused on ownership of deposited funds and not on the manner in which deposits were arranged.[128]

The FDIC announced its determination to appeal and, in response to the ruling, put a temporary regulation in place requiring institutions that relied heavily on brokered deposits to file detailed monthly reports on brokered deposit amounts. The regulatory dynamic became somewhat fractured and uncertain, as did the fate of money brokers and the institu-

---

[125] Lisa J. Mc Cue, "Agencies Propose Broker Limits," *American Banker* (January 17, 1984), 1.

[126] U.S. House Committee on Government Operations, *Proposed Restrictions on Money Brokers: Hearing*, 98th Cong., 2d sess., 1984.

[127] Andrew Albert, "Broker Sues, Shakeout Seen," and Richard Ringer, "Isaac Vows Close Supervision," both in *American Banker* (March 28, 1984), 1; and Andrew Albert, "Securities Industry Sues to Void Broker Rules," *American Banker* (April 13, 1984), 1.

[128] Lisa J. Mc Cue, "Brokered Funds Issue Seen Likely to Go to Congress," *American Banker* (June 22, 1984), 1.

tions that used them. Congress continued to debate the issue, but the possibility existed that the FDIC might win its appeal before legislation could be enacted. Congress was considering three bills on the use of brokered deposits, all of which limited the amount of short-term insured brokered funds to 15 percent of deposits or 200 percent of unimpaired capital and surplus, whichever was less. In September a House subcommittee released a report claiming that (a) brokered deposits were not a significant source of deposit growth for most rapidly growing problem institutions, (b) “forceful use of . . . existing supervisory powers on a case-by-case basis” would be the most effective regulatory policy, and (c) elimination of insurance coverage would probably not achieve increased market discipline.[129]

The agencies that were pressing for regulation insisted that brokered deposits continued to be a growing problem. FDIC Chairman Isaac noted near the end of 1984 that of the approximately $22 billion in brokered deposits in FDIC-insured banks, more than 40 percent of that amount was in banks with CAMEL ratings of 3, 4, or 5. At the same time, the Federal Reserve Bank of New York published a research study supporting both the contention that a relationship existed between brokered deposits and weak financial institutions and the contention that banks with high levels of brokered deposits raised FDIC costs and were therefore a threat to the insurance fund.[130] The study did not, however, completely endorse the FDIC/FHLBB proposal but suggested that a regulatory cap, to be enforced by the banking agencies in the same manner as capital adequacy, would be a way to address abuses while not eliminating the benefits of such deposits.

Early in 1985 the court of appeals upheld the decision barring federal regulators from ending deposit insurance on brokered deposits. The FDIC vowed to appeal further, but clearly congressional opposition to the proposed regulation remained strong.[131] By mid-1985 the brokerage industry was willing to accept a bill put forward by Representative Garcia similar to those proposed in 1984. The FDIC reluctantly expressed its willingness to

---

[129] In H.R. 5913, sponsored by Representatives Robert Garcia and Charles Schumer, institutions that failed to meet certain minimum capital requirements would not be able to accept any new brokered deposits. In Title VIII of S. 2851, sponsored by Senator Garn, they would not be able to accept any new insured brokered deposits. In S. 2679, sponsored by Senators D’Amato, Mattingly, Hawkins, and Cranston, they would not be able to hold any insured brokered funds. H.R. 5913 also contained (a) a requirement that brokers report to the deposit insuring agencies, (b) a provision that deposit insurance coverage be denied for any funds placed through a broker for an agency of the U.S. government or for a depository institution, and (c) “a general limit on deposit insurance benefits payable on the funds placed by any one person through any one broker to no more than $100,000 in any 4-year period.” See U.S. House Committee on Government Operations, *Federal Regulation of Brokered Deposits in Problem Banks and Savings Institutions: Report*, 98th Cong., 2d sess., 1984, 8–11.

[130] Sherrill Shaffer and Catherine Piché, “Brokered Deposits and Bank Soundness: Evidence and Regulatory Implications,” Federal Reserve Bank of New York research paper no. 8405 (1984). A study done for Merrill Lynch by Cates Consulting Analysts argued that brokered CDs did not significantly contribute to bank failure (Sanford Rose, “Refocusing on Brokered Deposits,” *American Banker* [February 26, 1985], 1).

[131] Representative Barnard’s Government Operations Subcommittee prepared another report in April 1985 with conclusions similar to those of 1984.

compromise. William Isaac said the cap should be placed at 100 percent rather than 200 percent of net worth but that although "we do not like it, we can accept such a bill." At the same time, however, the FDIC kept up its efforts by proposing a new regulation to require banks to keep records of individuals and institutions that placed money through brokers.

The debate over the proposed regulation ended suddenly in October 1985 when the court of appeals rejected the two agencies' request for a rehearing on the court's decision and, at the same time, L. William Seidman became chairman of the FDIC. He viewed brokered deposits in a more favorable light and said the proposed insurance limit would have "eliminated the benefits of the evolution of the financial marketplace."[132] The FDIC decided not to appeal further, and in December it withdrew the proposed insurance-limit regulation. The following June it also abandoned the proposed record-keeping rule. This decision was doubtless made easier by the fact that from 1984 to 1985 brokered deposits in commercial banks had dropped significantly. The issue would, however, return to the legislative agenda in the aftermath of the thrift crisis, and both FIRREA in 1989 and FDICIA in 1991 would mandate limitations on the use of brokered deposits by troubled institutions.

Expanded Powers

As is discussed above, federal legislation during the 1980s provided commercial banks with few new powers, but congressional action was by no means the only route banks could take to get them. Action by state legislatures and state banking authorities, as well as decisions by the federal regulators, could and did fill the vacuum created by the gridlock in Congress. States, both in response to congressional inaction and as a perceived means to encourage economic growth, were particularly active in providing new powers to their banks during the 1980s. The states' ability to do so derived from the fact of the dual banking system, which was the product of a long history reaching back to the beginnings of banking in the United States. Although the creation of the Federal Reserve System in 1913 and the FDIC in 1933 had imposed increasing federal regulation on state-chartered banks, the states were quite deliberately allowed considerable regulatory autonomy, a situation Congress had refrained from altering. State-chartered nonmember banks, for example, had always been exempt from Glass-Steagall, and states exercised control over the availability of interstate banking within their borders.

Some observers credit the dual banking system with stimulating innovation in banking, to the benefit of both the industry and consumers. Notable examples of state-level innovations in the 1970s that were eventually adopted nationwide included NOW accounts

---

[132] For William Isaac's remarks, see *American Banker* (July 17, 1985), 2. Seidman's statement was made at the convention of the U.S. Savings League. See Mark Basch, "Seidman Takes a Conciliatory Stance on Brokered Deposits, But Plans Curbs," *American Banker* (November 6, 1985), 1.

and ARMs, the former developed in Massachussets and the latter in California. Moreover, although Congress did not enact nationwide interstate banking until 1994, during the 1980s many states gradually created a de facto system of interstate banking. Other observers, however, hold that the dual banking system fostered a dangerous "competition in laxity" between the states and the chartering authority of national banks, the OCC, with each outbidding the other in making powers available.[133]

But the determining factor behind the federal regulators' decisions to permit banks entry into new areas was not necessarily regulatory competition. As has been noted, to varying degrees all three agencies endorsed additional powers for commercial banks. All three also favored a congressional resolution of the debate, but in the absence of federal legislation, the regulators had the ability to act and were under a great deal of pressure to do so. The OCC, with its strong support of deregulation, was often the most aggressive in this respect. In 1982 Comptroller C. T. Conover stated the OCC position on bank applications for new activities: "Very simply, if a bank can make a strong case that a proposed activity is legal, our inclination is to approve it."[134] During the early 1980s, for example, the OCC authorized national banks to offer discount brokerage and investment advisory services, operate futures-commission merchant subsidiaries, and underwrite credit life insurance.[135] By the late 1980s the Federal Reserve Board was increasingly allowing bank holding companies to enter many new areas.[136] The FDIC did not have authority to permit state banks to engage in new activities, but it did rule in 1984 that insured nonmember banks could establish or acquire subsidiaries that were engaged in securities activities.[137]

The FDIC ruling was, of course, an acknowledgment that states could allow banks into such businesses and were in fact doing so. Indeed, from the mid-1980s on, many states began allowing state-chartered banks to enter not only securities underwriting and brokerage but also real estate development, equity participation, and insurance underwriting and brokerage. By the end of the decade 29 states permitted state-chartered banks to engage in some form of securities underwriting, and only 7 barred banks from the securities brokerage business. Half the states allowed banks into some type of real estate development, and

---

[133] See Kenneth E. Scott, "The Dual Banking System: A Model of Competition in Regulation," *Stanford Law Review* 30, no. 1 (1977): 1–49; Arthur E. Wilmarth, "The Expansion of State Bank Powers, the Federal Response, and the Case for Preserving the Dual Banking System," *Fordham Law Review* 58, no. 6 (1990): 1132–256; and Advisory Commission on Intergovernmental Relations, *State Regulation of Banks*.

[134] C. T. Conover, speech to the American Bankers Association on October 19, 1982, reprinted in OCC *Quarterly Journal* 2, no. 1 (1983): 40.

[135] Ibid. 3, no. 3 (1984): 19–20.

[136] Reinicke, *Banking, Politics and Global Finance*, 102–13; and Helen Garten, *Why Bank Regulation Failed* (1991), chap. 4.

[137] FDIC, *Annual Report* (1984), 39.

23 allowed some form of equity participation. Six states permitted their banks to engage in insurance underwriting beyond credit life insurance.[138]

The states' moves to expand commercial bank powers were not unanimously applauded. Some critics suggested that state legislators were being lured into passing laws by the specious promise of economic growth. The vice president of the Conference of State Bank Supervisors, a group that generally supported expanded powers, noted in 1983 that some proposals were "competitive knee-jerk activities conceived without a hell of a lot of thought."[139] Nor were federal banking regulators completely sanguine about states' expansion of bank activities. Federal Reserve Board Chairman Volcker worried that states were rushing ahead with "little conscious sense of some of the broad public interests at stake" and said the federal government should impose limits on the power of states to authorize activities that Congress decided were a threat to safety and soundness.[140] The FDIC also expressed concern about bank involvement in historically "nonbank" activities, sought comment in 1983 on the need to regulate such activities, and issued a proposed rule in 1984. In 1985 the agency proposed an amended rule that FDIC-insured banks be required to place insurance underwriting and real estate investment or development activities in separately capitalized subsidiaries to insulate the bank from potential increased risk.[141]

The FDIC proposal proved controversial. The agency maintained that, as insurer, it ought to be able to set some guidelines, but state banking authorities, state-chartered banks, and industry associations all opposed the rule, protesting that it arbitrarily and indiscriminately assigned risks that often did not exist. The agency was accused of overstepping its authority, violating states' rights by preempting state legislation, and damaging the dual banking system. Moreover, the combination of then-current Federal Reserve Board policy and the proposed FDIC rule would have meant that only state nonmember banks would be allowed to engage in real estate development at all.[142]

The other federal regulators had misgivings as well. The OCC opposed the regulation because it asserted potential FDIC jurisdiction over national banks.[143] The Federal Reserve

---

[138] FDIC, "State Bank Powers Study" (1991). See also Saulsbury, "State Banking Powers."

[139] Richard Ringer, "States Rush to Deregulate," *American Banker* (May 9, 1983), 7.

[140] Richard Ringer, "Volcker Urges Care on Deregulation," *American Banker* (May 10, 1983), 1; and Lisa J. Mc Cue, "Volcker Supports Powers Bill to Give Banks Market Parity," *American Banker* (March 28, 1984), 3.

[141] FDIC, *Annual Report* (1984), 41, and (1985), 57. The first rule had also covered travel agency activities and insurance and real estate brokerage, but the FDIC decided those activities could be adequately dealt with on a case-by-case basis. In January 1985 the FHLBB passed a rule restricting direct investments by S&Ls.

[142] Regulation Y permitted bank subsidiaries of bank holding companies to establish a nonbanking subsidiary only if the parent bank was allowed to engage in the activities directly. Since real estate activities were viewed as inherently risky, some Federal Reserve Board staff saw this "regulatory squeeze" as a positive situation. Bankers and state bank regulators did not share this view. See *Washington Financial Reports* 44, no. 3 (January 21, 1985): 75.

[143] FDIC, comment letter received from Acting Comptroller of the Currency H. Joe Selby (July 22, 1985).

Board, given its preference for limiting state powers, was broadly sympathetic to the concept behind the proposed rule and was even soliciting comment itself on ways to curtail real estate activities,[144] yet it was leaning toward restricting such activity to nonbank subsidiaries of bank holding companies rather than permitting it in direct subsidiaries of banks themselves. The Federal Reserve Board was also concerned about the legal issues involved in the FDIC's regulating state member banks and bank holding companies and their nonbank affiliates. So while urging coordination between the two agencies, the Board said that if the FDIC decided to proceed with the rule as proposed, FRB-regulated institutions should be excluded.[145] The FDIC postponed implementing the regulation, and by late 1986 the FRB proposed its own regulation: not only state member banks but also state-chartered bank subsidiaries of bank holding companies would be prohibited from direct investment in real estate, which would be allowed only through a separately incorporated real estate subsidiary of a bank holding company that met certain capital requirements. Banking industry groups opposed the FRB's proposal much as they had the FDIC's.[146]

The FDIC and the FRB were unable to reach consensus about their respective regulations and in late 1987 the FDIC withdrew its proposed regulation, stating that there was not yet sufficient evidence about the degree of risk the activities posed to the insurance fund.[147] At about the same time, however, the FRB was considering (a) imposing higher capital requirements on holding companies of state-chartered banks that conducted real estate investment through a subsidiary and (b) tightening the regulation of transactions between banks and real estate subsidiaries.[148] The FRB's proposed real estate rules attracted congressional reaction to the extent that a bill was sponsored in 1989 to prevent the Federal Reserve from exercising control over subsidiaries of state banks within holding companies. One commentator claimed that the agency allowed the rules to remain as proposals while it engaged in "de facto rulemaking" by procuring certain commitments from applicants seeking to form or expand holding companies within which a bank subsidiary planned to use its state-granted real estate powers. It was suggested that the Federal Reserve actually preferred not to implement the rule but, rather, to continue demanding higher capital levels of institutions that were unwilling to refrain from real estate activities.[149] In any case, the FRB proposal never became a regulation.

---

[144] *Washington Financial Reports* 44, no. 3 (January 21, 1985): 75.

[145] FDIC, comment letter received from Secretary of the FRB William W. Wiles (February 26, 1985).

[146] *Washington Financial Reports* 47, no. 21 (December 1, 1986): 851–52.

[147] FDIC, *Annual Report* (1987), 30. The Board of Directors indicated that the agency intended to "reevaluate whether a broad-based regulation for real estate investments . . . [was] necessary."

[148] Barbara A. Rehm, "Fed Weighs Restrictions on Real Estate," *American Banker* (November 3, 1987), 1.

[149] Barbara A. Rehm, "House Measure May Foil Fed Efforts to Gain Control of State Bank Limits," *American Banker* (April 10, 1989), 1; and John D. Hawke, "Fed Needs New Approach to Real Estate," *American Banker* (August 16, 1989), 4.

In early 1991, the FDIC again announced plans to limit the authority of state-chartered banks to invest in real estate and sell insurance. The issue of powers available to state-chartered banks, however, was settled later in that year under FDICIA. That law prohibited insured state-chartered banks from engaging in an activity not permitted for a national bank unless the FDIC decided that the activity posed no significant risk to the Bank Insurance Fund and the bank met agency capital standards. The dual banking system was not swept away and flexibility was not abolished, yet regulatory concerns were addressed.

After the Crisis: Legislation, 1992–1994

FDICIA marks a natural endpoint to a discussion of legislation during the banking crisis of the 1980s and early 1990s, but later legislation usefully places the crisis in context, for as it became apparent that the banking industry had recovered, attitudes toward regulation changed. As has been noted, deregulation had never left the legislative and policy agenda, even when the thrift and banking industries were in greatest difficulty. Not surprisingly, this held true as times grew better. Two laws enacted in 1994, although they do not reflect an abandonment of the "reregulatory" provisions of FIRREA and FDICIA, suggest a changed legislative and regulatory climate: the Riegle Community Development and Regulatory Improvement Act (the CDRI Act) and the Riegle-Neal Interstate Banking and Branching Efficiency Act.[150] The first covered a wide variety of issues, including review and elimination of outmoded and duplicative regulations as well as some change in examination policies. The second authorized interstate banking and branching for U.S. and foreign banks over a three-year period. Neither the notion of decreasing the regulatory burden on banks nor that of removing restrictions on geographic expansion was new,[151] but their enactment into law is a measure of the banking industry's recovery compared with its condition in 1989–91.

First, however, a year before Congress passed the two laws just mentioned, it enacted (as part of the Omnibus Budget Reconciliation Act of 1993) a national depositor preference statute, which established a uniform order for distributing the assets of failed insured depository institutions.[152] Under depositor preference, a failed bank's depositors (and the FDIC, as subrogee in the place of insured depositors it has already paid) have priority over nondepositors' claims. Without depositor preference, under a receivership depositors (and the FDIC as subrogee) are treated as general creditors and, along with other general credi-

[150] Public Laws 103-325 and 103-328.

[151] For example, the Treasury had issued a report on geographic constraints in 1981, and legislation that attempted to reform the banking laws was introduced in Congress in 1985, 1987, and 1991. See Mark. D. Rollinger, "Interstate Banking and Branching under the Riegle-Neal Act of 1994," *Harvard Journal on Legislation* 33, no. 1 (1996): 195–98.

[152] Public Law 103-66. During 1993 Congress also passed the Resolution Trust Corporation Completion Act, which provided further funding for the RTC, restructured SAIF funding, and set an earlier date for RTC termination in addition to providing for the transfer of its operations and assets to the FDIC.

tors, receive a pro rata share of the proceeds. Depositor preference statutes were already in force in 28 states and therefore applied to some state-chartered institutions, but not to any national banks.

The FDIC had recommended national depositor preference in 1983 and had suggested a national depositor preference statute in the mid-1980s.[153] The lack of such a law had implications both for the way in which the FDIC handled bank failures and for the insurance fund. Most failures were handled through purchase-and-assumption transactions (P&As) in which general creditors usually received the same treatment as depositors and so were often fully protected. Moreover, contingent liabilities that might later be included among creditors' claims, such as letters of credit, could complicate matters even more. The presence of such liabilities made it difficult to estimate the transaction's cost and might even make a P&A unworkable, as had been the case with Penn Square in 1982. Depositor preference, it was believed, would not only result in a smaller cash outlay by the FDIC but also make transactions simpler, more predictable, and significantly less expensive to the insurance fund. In addition, it was believed that depositor preference would restrain bank risk, since nondepositor creditors would have to be more concerned about the bank's manner of doing business. One potential problem was that hitherto-unsecured nondepositors might seek to become secured creditors, thereby evading the effects of depositor preference and possibly even increasing resolution costs for the FDIC.[154] FDIC savings might also be lessened by shifts from unsecured claims to deposits.

The main impetus for the reemergence of depositor preference was not, however, debate about these issues but, rather, the pursuit of deficit reduction. As one means toward this end, the Clinton administration had proposed increasing examination fees for state-chartered banks. But industry groups representing those institutions opposed that move, and the search for alternative sources of deficit reduction quickly led to depositor preference as a potential substitute for increased examination fees.[155] Since BIF losses are counted as budget outlays, the estimated reduction in costs to the FDIC would have the effect of lowering the deficit. National depositor preference was also intended to reduce the FDIC's losses from bank failures, but it is not yet clear whether shifts in the liability structure of troubled institutions will actually have that effect, or how great those savings will be.

---

[153] FDIC, *Deposit Insurance in a Changing Environment* (1983), III-9-10; FDIC, *Annual Report* (1985), xv; and *American Banker* (March 14, 1986), 3.

[154] This discussion is based on Stanley C. Silverberg, "A Case for Depositor Preference," *FDIC Banking and Economic Review* (May 1986): 7–9. See also Eric Hirschhorn and David Zervos, "Policies to Change the Priority of Claimants: The Case of Depositor Preference Laws," *Journal of Financial Services Research* 4 (1990): 111–25.

[155] One of the most important forces behind this substitute was the Conference of State Bank Supervisors. See Bill Atkinson, "States Push Alternatives to Hitting Their Banks with Higher Fees," *American Banker* (March 30, 1993), 7.

The two 1994 acts (the CDRI Act and Riegle-Neal) emerged from congressional consideration, in 1993, of several different banking policy issues that were drawn together into a loose package of banking reforms that would wend their separate ways through the legislative process.[156] Together these constituted attempts to satisfy competing interest groups, such as community development advocates and those who were pressing for financial modernization and regulatory relief. One of the bills included a community banking development proposal; another was a reaction to the regulatory regime that had been instituted in 1989–91 (particularly to its perceived effect on the so-called credit crunch); and a third addressed geographic expansion, which had failed to be enacted in 1991–92.[157] All these concerns would be reflected in the two laws passed in 1994.

In 1993 the Clinton administration had put forward a plan that was to provide grants and other subsidies to community development lenders. One means of gaining support for that bill was simultaneously to address concerns over regulatory burden. Well before the 1993 legislative session, the banking industry had been pushing for regulatory change. In May 1992, the American Bankers Association (ABA) and state bankers associations had announced that approximately 20 provisions of FDICIA and other statutes ought to be repealed or modified. ABA President Alan R. Tubbs noted that "there has been a strong impulse to tar banks with the same brush as the S&Ls" and that undue regulation made "credit less available to those who need it."[158] The trade groups noted that they were already in discussions with legislators who might introduce the desired legislation; many of their concerns were covered in the bill entitled the Economic Growth and Financial Institutions Paperwork Reduction Act of 1993 (H.R. 962).[159]

Clearly congressional support for addressing the regulatory issue was substantial, and the banking agencies had already begun working toward reforms.[160] Perceptions differed,

---

156 Indeed, for a brief period all were combined in a single bill. See *Congressional Quarterly Almanac* 50 (1994), 101–2.

157 The interstate branching issue and concern over the credit crunch were not entirely separate from each other. The Bush administration, in a 1992 reform package that included regulatory relief, noted that interstate branching would "ultimately improve . . . the quantity of credit available" (*BNA's Banking Report* 58, no. 14 [April. 6, 1992]: 579).

158 *BNA's Banking Report* 58, no. 18 (May 4, 1992): 769–70.

159 A few regulatory reform proposals had already been passed as attachments to a housing bill in 1992. See *Congressional Quarterly Almanac* 48 (1992), 120. The credit crunch received considerable attention in Congress, with numerous hearings held from 1990 to 1993. See, for example, U.S. Senate Committee on Banking, Housing, and Urban Affairs, *Credit Availability: The Availability of Credit in Our Economy and to Try to Determine Whether or Not There Is Currently a Credit Crunch*, 101st Cong., 2d sess., 1990; U.S. House Committee on Banking, Finance and Urban Affairs, Subcommittee on Domestic Monetary Policy, *The Credit Crunch: Hearings*, 102d Cong., 1st. sess., 1991; and U.S. House Committee on Government Operations, Subcommittee on Commerce, Consumer, and Monetary Affairs, I, 103d Cong., 1st sess., 1993.

160 For actions that the banking agencies took before 1993, for example, see FFIEC, *Study on Regulatory Burden* (1992), appendix D. See also U.S. General Accounting Office, *Regulatory Burden: Recent Studies, Industry Issues and Agency Initiatives* (GAO/GGD-94-28, 1993), appendix 3.

however, as to which regulatory changes could be made without affecting safety and soundness.[161] When the bill (H.R. 962) was incorporated into what would become the CDRI Act in 1994, many provisions had been altered. Much of the final legislation dealt with paperwork reduction (removing duplicative filings, streamlining regulations, simplifying Call Reports, etc.).[162] The law also required the banking agencies both to establish a process whereby financial institutions could appeal regulatory decisions and to create an ombudsman's office. The provisions that most directly affected safety-and-soundness supervision were a modification to FDICIA's exception to annual examinations: the asset ceiling that enabled banks to qualify for an 18-month examination cycle was raised from $100 million to $250 million; in addition, banks with $100 million or less in assets could qualify for the extended interval if their composite ratings were outstanding or good, whereas under FDICIA, only an outstanding rating made a bank eligible.[163] Over the next two years, as a result of the regulatory improvement provisions of the CDRI Act, many agency regulations were abolished or altered.[164]

The other significant piece of banking legislation passed in 1994 was the Riegle-Neal Interstate Banking and Branching Efficiency Act. Like the reform of Glass-Steagall, the removal of restrictions on interstate banking and branching had frequently appeared on the policy agenda during the 1980s and early 1990s but had never been enacted.[165] Restrictions on interstate banking and branching had long been enshrined in the U.S. banking system and stemmed from deep-seated mistrust of financial concentration, the belief that a bank should be tied to its community, and strong notions about states' rights. All of these had combined to produce essentially a unit banking industry,[166] until economic expansion in the late 19th century and the increased distances involved in commerce led to a need for more sophisticated financial networks. By the early 20th century, therefore, branching had become increasingly common at the state level, although some banking interests still resisted it.

---

[161] For discussion of these issues, see U.S. House Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance, H.R. 962, *The Economic Growth and Financial Institutions Regulatory Paperwork Reduction Act of 1993: Hearings*, 103d Cong., 1st sess., 1993.

[162] This discussion covers only a part of the CDRI Act, which, in addition to community development and paperwork, dealt with small-business capital formation, money laundering, and national flood insurance.

[163] The CDRI Act also gave the banking agencies the power to raise this ceiling by regulation to $175 million two years after the law had been in effect, as long as the raised ceiling was deemed consistent with safety and soundness.

[164] For the response of the banking agencies to the law's requirements on regulatory reform, see Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision, *Joint Report: Streamlining of Regulatory Requirements* (September 23, 1996).

[165] Congress considered legislation on interstate banking in 1985, 1987, and 1991.

[166] Branch banking was not completely absent. In the early years of the republic, both the First and Second Banks of the United States had branches, and some branch banking systems were present before the Civil War, but when the National Bank System was established in 1867, it consisted of unit banks only. See David L. Mengle, "The Case for Interstate Branch Banking," Federal Reserve Bank of Richmond *Economic Review* 76, no. 6 (1990): 5.

During the early decades of the 20th century, debate over the desirability of expanding branching continued; but with state banks able to branch, national banks were at a competitive disadvantage. The 1927 Pepper-McFadden Act somewhat remedied this: if state banks could branch, national banks were allowed to branch within the city in which they were located. The Banking Act of 1933 went somewhat further, allowing national banks a power to branch equal to the power accorded state-chartered institutions. No bank that was a member of the Federal Reserve System, however, could branch across state lines, and this remained the case until 1994.[167] It should be noted that intrastate branching became increasingly common. In 1977, for example, statewide branch banking was prevalent in 20 states, whereas unit banking was prevalent in 12. By 1990, those numbers had changed to 33 and 3, respectively.[168]

In addition to restricting branching, federal laws had placed limits on creating interstate banking through acquisitions. The Douglas Amendment to the Bank Holding Company Act of 1956 prohibited a bank holding company (BHC) from acquiring a bank in another state unless that other state's laws authorized such out-of-state acquisitions; thus, control of such expansion was left to the states. Not until 1975 did Maine became the first state to allow entry by out-of-state bank holding companies.[169] The limitations imposed by the Douglas Amendment were liberalized somewhat in 1982 and 1987, but only to allow emergency acquisitions in the case of failed, and then of failing, institutions. Aside from these exceptions, federal law on interstate acquisitions remained unchanged until 1994. The situation on the ground, however, had changed considerably. By January 1986, 28 states permitted some form of acquisition by an out-of-state BHC; by May 1990, 46 states did; by the time Riegle-Neal was passed, only Hawaii did not have such a law, and two-thirds of the states permitted entry from BHCs in any state.[170]

Such developments certainly helped to broaden support for legislation allowing interstate banking. As has already been noted, the matter had been under discussion for some time, but legislation had failed to get through Congress. By 1993, however, with the banking crisis over, a consensus developed that change was required. In 1993 the Clinton administration came out in favor of interstate banking and branching legislation, with Treasury Secretary Lloyd Bentsen noting that the country already had a de facto system of

---

[167] State nonmember banks could establish interstate branch networks in a state in which such networks were permitted by law. Several states did permit them; by 1994 and before Riegle-Neal, these included Alaska, Nevada, New York, North Carolina, Oregon, and Rhode Island. All of these states, however, required reciprocity by the state where the bank seeking entry was headquartered. See *Banking Policy Report* 13, no. 16 (September 5, 1994): 10.

[168] CSBS, *Profile* (1977), 95, and (1990), 111.

[169] Rollinger, "Interstate Banking and Branching," 185.

[170] See CSBS, *Profile* (1986), 99–104, and (1990), 127ff; and Rollinger, "Interstate Banking and Branching," 194. These statutes varied greatly; some states authorized de novo entry, some allowed acquisitions by any BHC in any state, and some allowed entry only by BHCs in certain regions. The overall trend was certainly toward nationwide interstate banking.

interstate banking, albeit a patchwork, and that the United States was operating "with laws and regulations made for another time in America."[171] Such sentiments were echoed by many as the Riegle-Neal bill went through Congress in 1994. To an extent, therefore, the legislation was viewed as simply making federal law consistent with reality.

What was still debated, however, was whether such deregulation would lead to overconcentration and how credit availability would be affected, particularly in less-affluent communities. (Significantly, the community development banking provisions of the CDRI Act were moving through Congress during the same session.)[172] The regional banking crises that had just passed were a strong argument in favor of allowing geographic expansion: banks would no longer necessarily be tied to the economic well-being of a specific region and would thereby have protection against just the sort of regional downturns that had occurred in the 1980s and early 1990s.[173] One lobbyist for NationsBank believed that the earlier conflict between large and small banks over interstate expansion had evaporated because small banks had come to believe that they would be able to prosper in the new environment. Moreover, the bill addressed the concerns of state banking authorities about control of the expansion process.[174] As one analyst stated, "Federalism is a key component of Riegle-Neal."[175]

Under Riegle-Neal, adequately capitalized and managed bank holding companies were allowed to acquire a bank in any state beginning on September 29, 1995; the provisions of the Douglas Amendment were thereby effectively repealed. The law did establish limits on deposit concentration. Interstate acquisitions would be prohibited if the resultant BHC would control either (a) more than 10 percent of U.S. bank and thrift deposits or (b) more than 30 percent of the deposits in the home state of the bank to be acquired (except for initial entries into a state). However, host states could waive the limit; and state deposit-concentration limits, whether higher or lower, would supersede the Riegle-Neal state concentration limit. Acquisitions remained subject to state laws that set a minimum period during which a target bank had to have been in existence before acquisition, up to a maximum of five years. Compliance with the Community Reinvestment Act and state community reinvestment laws was required. The acquisition of a failed or failing bank by an out-of-state BHC was not subject to any of the conditions otherwise applicable to the acquisition of an out-of-state bank.

---

[171] *Congressional Quarterly Almanac* 49 (1993), 161.

[172] Ibid. 50 (1994), 94.

[173] For a discussion of these issues, see Rollinger, "Interstate Banking and Branching," 210–38.

[174] For a discussion of the politics surrounding the bill, see Joseph D. Hutnyan, "Interstate Banking Politics," *Banking Policy Report 13*, no. 11 (June 6–20, 1994): 4–6.

[175] Carey C. Chern, "Interstate Banking Issues after the Riegle-Neal Act of 1994," *BNA's Banking Report* 65 (September 11, 1995): 415.

The other main provision of the law allowed adequately capitalized and managed banks to merge across state lines beginning June 1, 1997; this provision effectively repealed the restrictions of the McFadden Act. The same U.S. and state concentration limits applied to this provision, and again the statewide limits did not apply to initial entries into a state and the limit could be waived by the host state. Neither limit applied to a merger involving only affiliated banks. Compliance with state minimum-age laws and community reinvestment laws was required, and an exception was provided for mergers involving failed or failing banks. Foreign banks were permitted to establish and operate interstate branches, either de novo or by acquisition and merger, to the same extent that a bank chartered in the foreign bank's home state could, and parallel provision was made for foreign banks to establish and operate national bank branches.

As noted above, the states were given a great deal of control over the pace and scope of the expansion of interstate branching. Under the law, states were permitted to "opt out" of interstate branching by passing, before June 1, 1997, an explicit law prohibiting it. Conversely, states were also allowed to "opt in," or permit interstate branching, by enacting appropriate legislation before June 1, 1997.[176] By enactment of appropriate legislation, states could also permit interstate bank mergers involving the acquisition of a branch, but without the acquisition of the bank.[177]

Given the gradual moves that had been made at the state level, the Riegle-Neal Act was not as revolutionary as it would have been if it had been enacted in 1985. Still, nationwide interstate banking and branching are likely to shape—and may accelerate—existing trends toward increased consolidation and concentration within the banking industry. However (as a recent study has noted), passage of the act does not mean its provisions will be used by most, let alone all, of the industry. The law "only increases the structural alternatives available . . . Neither it nor the marketplace mandates that all banking organizations select an identical structure."[178]

One additional post-FDICIA statute, rooted in the solutions adopted to deal with the S&L debacle, was the Deposit Insurance Funds Act of 1996.[179] It effectively closed the

[176] For a discussion of the "opt-in/opt-out" debate, see Edward J. Kane, "De Jure Interstate Banking: Why Only Now?" *Journal of Money, Credit and Banking* 28, no. 2 (1996): 141–61.

[177] This overview of Riegle-Neal is drawn from a summary of the law prepared by the FDIC (unpublished FDIC document, April 1995). The law includes other provisions not discussed here. A detailed summary of Riegle-Neal appears in Chern, "Interstate Banking Issues."

[178] David Holland et al., "Interstate Banking—The Past, the Present and Future," *FDIC Banking Review* 9, no. 1 (1996): 10.

[179] Public Law 104-208. See Title II, Economic Growth and Regulatory Paperwork Reduction, Subtitle G, §2701 et seq. Some of this discussion on the SAIF is drawn from material in an unpublished FDIC briefing document compiled by Christine Blair and James McFadyen (January 1997).

chapter on the S&L crisis. As noted above, in 1989 FIRREA had created two deposit insurance funds, the BIF and the SAIF, the latter replacing the insolvent FSLIC fund. Both insurance funds were required to be capitalized at a reserve ratio of 1.25 percent of insured deposits. The BIF reached this goal in May 1995. The SAIF, however, remained undercapitalized, and as of March 31, 1995, had a reserve ratio of just 0.31 percent. Eighteen months later the SAIF had a reserve ratio of 0.59 percent, approximately $4.5 billion short of full capitalization.[180] The reason the SAIF failed to reach the reserve ratio was that by statutory requirements SAIF premiums were diverted to other purposes, notably the payment of interest on bonds issued by the Financing Corporation (FICO) created in 1987 under CEBA.[181]

By 1994, the SAIF's condition began to generate serious concern.[182] Deposits in savings associations had been expected to grow but instead were declining, and the decline raised the possibility of default on payments due on the FICO bonds.[183] In addition, on July 1, 1995, the SAIF would assume the Resolution Trust Corporation's responsibility for the resolution of failed member institutions; in its then-undercapitalized condition, the fund might have been rendered insolvent by a single large failure. Moreover, as the BIF drew closer to its designated reserve ratio, the assumption was that the FDIC would respond by reducing BIF assessment rates, putting SAIF-insured institutions at a long-term competitive

[180] For insurance-fund reserve ratios during this period, see FDIC, *Quarterly Banking Profile* (1995 and 1996).

[181] The FICO was created as the vehicle for recapitalizing the FSLIC. The law authorized the FICO to raise funds for the FSLIC by selling bonds to the public (Huber, "CEBA," 293–4). The FICO had an annual draw of up to $793 billion against SAIF assessments until the year 2019. But not all SAIF assessment revenue could be used to meet interest on the FICO obligations. The assessment revenue that could not be used was that from "Oakar" and "Sasser" institutions. (Oakar institutions are BIF-member banks that have acquired SAIF-insured deposits and pay deposit insurance premiums to both the BIF and the SAIF. Sasser institutions are commercial banks or state savings banks that have changed charter from a savings association to a bank but remain members of the SAIF.) In addition, under FIRREA, SAIF assessments were diverted not only to the FICO but also to payments to the FSLIC Resolution Fund and the Resolution Funding Corporation (a quasi-private agency which was created under FIRREA to raise $30 billion for the RTC by selling 30-year bonds). See U.S. House Committee on Banking, Housing and Urban Affairs, *The Condition of the Savings Association Insurance Fund* [SAIF], 104th Cong., 1st sess., July 28, 1995, 85.

[182] See U.S. General Accounting Office, *Deposit Insurance Funds: Analysis of Insurance Premium Disparity between Banks and Thrifts* (GAO/AIMD-95-94, 1995). This report was prepared in response to a June 10, 1994, request by Congress. For some time, however, the FDIC had been concerned about the condition of the SAIF and about the disparity between BIF members and SAIF members. See, for example, the January 1992 letter from FDIC Chairman William Taylor to Richard G. Darman, director, Office of Management and Budget, and the September 1993 letter from Acting FDIC Chairman Andrew C. Hove, Jr., to Representative James Leach, both of which are reproduced in U.S. House Committee on Banking and Financial Services, Subcommittee on Financial Institutions and Consumer Credit, *Condition of the Deposit Insurance Funds and the Impact of the Proposed Deposit Insurance Premium Reduction on the Bank and Thrift Industries: Hearings*, 104th Cong., 1st sess., 1995, 222–25.

[183] Jim McTague, "Thrift Crisis, The Sequel," Barrons (August 29, 1984): 34.

disadvantage. (This did occur in 1995.)[184] Such a situation would create an incentive for institutions to shift deposits from SAIF to BIF insurance, and although the attendant shrinkage in the SAIF assessment base would mean the fund would become capitalized more swiftly, the stronger SAIF members would most likely be the ones able to succeed in moving deposits to the BIF, leaving weaker institutions covered by an insurance fund with a higher risk profile.[185] Moreover, the migration of deposits would end up diluting the BIF.

Movement toward a legislative solution began in earnest in 1995 but was not uncontentious. Many bankers felt that SAIF-insured institutions were attempting to shirk their responsibility for capitalizing the SAIF and were hoping to push Congress into having the banks help pay for the S&L debacle. In June 1995, the position of the ABA president was that Congress should not act, but watch and wait.[186] By contrast, the bank regulatory agencies, the Treasury, the GAO, and many in Congress believed that a swift solution was necessary. The FDIC, the Office of Thrift Supervision, and the Treasury worked together to create a plan for presentation to Congress that would be acceptable to the diverse elements within the banking and thrift industries. By July 1995, the main elements in this framework had been developed: to capitalize the SAIF fully, there would be a special assessment on institutions with SAIF-insured deposits; FICO payments would be spread over all FDIC-insured institutions; and there would be a call for the merger of the deposit insurance funds. The 1995 version of the bill failed to become law when President Clinton vetoed the Budget Reconciliation Bill, of which it was a part. The plan was eventually enacted as part of the Budget Act for fiscal 1997.

The law imposed a one-time special assessment on SAIF-assessable deposits, payable within 60 days of enactment. (On October 8, 1996, the FDIC Board of Directors set the assessment at 65.7 basis points, payable on November 27, 1996, thereby raising $4.5 billion and fully capitalizing the fund.)[187] In addition, the law expanded the FICO's assessment au-

[184] The FDIC's Board of Directors lowered BIF assessment rates after the fund reached its reserve ratio. Effective in May 1995, the average rate fell from 23.2 basis points to 4.4 basis points, with the risk-based assessment range between 4 and 31 basis points. BIF assessment rates were lowered again in November 1995, effective January 1, 1996, with a range of 0 to 27 basis points. By contrast, as of September 1996, SAIF assessment rates remained at the much higher level of 23 to 31 basis points, with an average assessment rate of 23.4 basis points. Even after full capitalization of the SAIF, the FICO payments were expected to keep SAIF rates significantly higher until 2019, when the last of the FICO bonds will mature.

[185] By mid-March 1995, six SAIF-insured thrifts with $80 billion in deposits had announced their intention to form banking affiliates (see Steve Cocheo, "Is It a Bank? Is It a Thrift? It's a Colossal Flanking Maneuver," *ABA Banking Journal* 87, no. 5 [May 1995]: 7).

[186] Howard McMillan, Jr., "What SAIF Crisis?" *ABA Banking Journal* 81 (June 1995): 13.

[187] "Weak" institutions and certain other ones [see §2702(f)(1–3)] were exempted from paying the assessment. Exempted institutions were to continue to pay SAIF assessments at rates of 23 to 31 basis points per year for up to three years. For purposes of the special assessment, the SAIF deposits of certain BIF-member Oakar institutions and converted savings associations were decreased by 20 percent. These Oakar institutions also received a permanent 20 percent reduction in their SAIF-assessable deposits for future regular assessments.

thority to all FDIC-insured institutions and separated the FICO rate-setting process from that of deposit insurance. The law provided that the FICO assessment on BIF-assessable deposits was to be set at one-fifth the assessment imposed on SAIF-assessable deposits. Beginning either on January 1, 2000, or on the date when there are no longer any savings associations (whichever is earlier), all insured institutions will pay equal FICO premiums. The law also required that before January 1, 1999, SAIF assessment rates not be lower than BIF rates; and it eliminated the previous minimum semiannual assessment of $1,000.[188] Finally, the law called for the merger of the BIF and the SAIF on January 1, 1999, but only "if no insured depository institution was a savings association on that date."

Conclusion

Between 1980 and 1994 there was clearly a tremendous amount of legislative and regulatory change. In Congress, in the federal regulatory agencies, and in the states, many processes were taking place simultaneously. For example, at the same time that legislation sought to provide new powers for banks, the banking agencies (pushed by Congress) were also moving toward uniform capital requirements. But despite the many overlapping and contrasting movements, the pattern that clearly emerges, particularly in legislation, is this: at the beginning of the 1980s, with passage of both DIDMCA and Garn–St Germain, deregulation of the financial services industry, and especially thrifts, was dominant. Then as the S&L crisis deepened and the banking crisis evolved, the emphasis turned to what has been described as reregulation. This development was most evident in FIRREA and FDICIA, both of which produced a great deal of change in the regulatory area. By 1994, with the banking industry's evident return to good health, deregulation was more acceptable—but when and how far the pendulum will swing back are questions for the future.

---

[188] On December 11, 1996, because the SAIF was fully capitalized, the FDIC Board of Directors lowered SAIF assessments to a range of 0 to 31 basis points and adopted a rule, identical to that already in place for the BIF, that would allow further adjustments within a 5-basis-point range without notice and comment; the Board then immediately reduced SAIF assessment rates to a range of 0 to 27 basis points.