Financial Institutions - Regulation And Deregulation

Nanette LeFebvre
Carroll College, Helena, MT

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FINANCIAL INSTITUTIONS - REGULATION AND DEREGULATION

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Nanette Larsen LeFebvre
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This thesis for honors has been approved by the

Department of Business Administration.

Professor Jon Krutar, Director

Dr. Ann Bertagnolli, Reader

Professor Dennis Wiedmann, Reader
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INTRODUCTION

For as long as humanity has existed, so has the need for some means of exchange. Prior to the existence of modern money, people bartered for their needs, using everything from salt to fishhooks as crude forms of money. As people became more sophisticated, so did methods of exchanging one good for another. As early as 2000 B.C., some of the first "banks" were developed. Eventually, coins and paper money were created.

Financial institutions as we know them today are drastically changed from their original simple existence. As a result of increasingly diverse needs, coupled with rapidly changing technology, the structure and functions of financial institutions are becoming continually more complex. Increased regulation and supervision of these institutions have been necessary.

Over time, America’s financial institutions have been the subject of criticism for their failure to withstand troubled economic times. Inappropriate actions by key leaders of some of our banks and savings and loan associations have resulted in mistrust by the people they serve.

As we find ourselves on the heels of the immense savings and loan industry debacle of the 1980’s, we must evaluate where America’s financial institutions are headed. Not only is a stable financial system an essential factor in obtaining national economic stability, American citizens also are not willing to support the continued use of government funds for the bailout of failed institutions. By learning from the lessons of history, perhaps we can find a new and safe direction.
FROM THE BEGINNING

Although we may have difficulty imagining what type of bartering vehicle the earliest humans used, we do have knowledge of bartering in Egypt as far back as 2500 B.C., with items such as fish and shoes. In ancient Rome, soldiers were sometimes paid with salt. Consequently, salarium, the Latin word for salt, provides the basis for our word salary (Cantwell 1). In Babylonia in 2000 B.C., because financial dealings took place in the temples, the priests kept track of transactions on clay tablets. Thus, the temples and priests became some of the first-known banks and bankers (Cantwell 2).

No actual money, as we envision it today, existed for some time, however. Not until 650 B.C. did the idea of coins originate. Lumps of metal were used for exchange and had to be weighed for each transaction (Cantwell 3). The troublesome task of weighing, along with the need for a standardized means of exchange, led to the formation of coins from a mixture of gold and silver electrum. These early "coins" were crude--actually taking the form of metal "blobs."

Approximately 400 B.C., temples in ancient Greece took on the role of banks. Greek bankers not only accepted money for safekeeping, they also provided loans and charged interest accordingly (Cantwell 6). Greek coins were made from gold or silver and were shaped into smooth, circular forms.

Others took their turn at improving or creating coins. The first step toward a minting system was developed in Italy during the Renaissance, when
machines were invented to create blank coins and to stamp designs on them. During the sixteenth century, European goldsmiths were given people's money for safekeeping, for which they issued a receipt or a letter of credit. For the purpose of collecting and returning deposits, employees of the goldsmith seated themselves in the marketplace on benches called bancos. The modern word "bank" originates from this term (Cantwell 13).

The first settlers in North America used numerous items for trading purposes--furs, fishhooks, nails, and more. As with their predecessors, however, the need for a common medium of exchange evolved. Although many settlers used foreign coins, the first coins were minted in America during the 1600's. A Mint Act was passed in 1792 calling for the creation of the U.S. Mint. In 1836, coins were steam-pressed for the first time, resulting in America's first step toward the automation of coin production (Cantwell 16).

Although "state banks" began issuing paper money during the late 1700's in the form of bank notes, the United States Government did not begin to issue paper money until 1861 (Cantwell 23). Today all legal forms of American money--coins and currency--are created by the U.S. Government.

America's first "modern bank," the Bank of North America, was chartered in Pennsylvania in 1781 as the first privately-owned commercial bank (Cochran 56). The first Bank of the United States (BUS) was created in 1791 under the direction of Alexander Hamilton, our country's first Secretary of the Treasury (Jackson, 1986, 3).
The Bank Of The United States

Having a main office and eight branches, the First Bank of the United States (BUS) was both a central bank and a commercial bank. As a central bank, BUS acted as the Federal Government’s fiscal agent and issued the Government loans which were to be repaid with tax revenues. Loans issued by the Bank could not exceed its deposits, and paper money issued by the Bank was made government tender—so long as it could be converted into gold or silver.

Although only three state-chartered banks existed when the First Bank of the United States came into being, 75 such banks existed by 1805 and 90 by 1811. During this time, however, the Federal Government was not as powerful as it is today, and states’ rights activists were quite powerful. State banks resented the competition they encountered from BUS; thus their lobbying efforts played a vital role in the defeat of the rechartering of BUS. Even after their competition had been minimized, however, these early commercial banks continued to struggle due to poor management and an insufficient supply of gold and silver (Cochran 57).

The creation by state commercial banks of inadequately-backed paper money led to overexpansion of the money supply, resulting in inflation. The need for another federal bank became a reality. In 1816, under President Madison, the Second Bank of the United States was chartered and directed
within a structure quite similar to that of its predecessor. By 1819, the Bank had branches in every state of the Union and once again served as a fiscal agent for the Federal Government (Jackson, 1986, 4).

Lobbying efforts against the Bank were resumed by the state banking system, however. The state system resented having to compete with the federal bank and being forced to back its paper currency with gold or silver. Although such a requirement enhanced the soundness of the nation’s monetary system, political interests behind the state system once again prevailed in their efforts to lobby for states’ rights. Congress passed a bill to recharter the Bank of the United States, only to have it vetoed by President Jackson in 1832 (Jackson, 1986, 4).

The Free Banking Act of 1838

State banks continued to act as "printing press" banks in an attempt to fill the nation’s demand for money. As a result of the insufficiently backed bank notes, the nation’s banking system experienced one of its first real panics in 1837 as numerous banks began to fail. These failures, combined with a public distaste for the monopolistic privileges available to only a few banks under the legislation then required to establish banks, led to the 1838 enactment of a free banking act in the state of New York. This act allowed any group of people to incorporate and open a bank, as long as they placed government bonds or real estate bonds or mortgages with the State Comptroller as security (Cochran 57).
In response to the passing of the 1838 Act, the state banking business boomed. From 1844 to 1854, the number of state banks increased from 696 to 1208. By 1860, just prior to the Civil War, 1,562 state banks had $207 million worth of notes in circulation (Cochran 58). Unfortunately, a significant percentage of these notes had either depreciated in value or had become virtually worthless.

The National Banking System

The turbulent and uncertain status of the state banking system, coupled with a need to finance military operations, led to the passing of major bank legislation during the Civil War. In 1863, the first National Bank Act was enacted, followed by the passing of the National Bank Act of 1864. The primary purpose of the 1863 Act was two-fold: it introduced chartering of banks by the Federal Government, and it was aimed toward improving the soundness of currency in circulation. In addition, the Act allowed the sale of government bonds to national banks as a means of providing funding for the Civil War (Jackson, 1986, 5).

The National Bank Act of 1863 also created the Office of the Comptroller of the Currency, which still exists within the United States Treasury Department. As in 1863, the Comptroller remains responsible for the regulation and supervision of nationally chartered banks. One of the key revisions made by the Act of 1864 was the implementation of a bank examination system. Other revisions included requirements for minimum paid-in capital prior to
receipt of banking certification, as well as guidelines with respect to banks’ corporate structure (Jackson, 1986 5).

By the end of 1864, 508 banks had become nationally chartered. In an attempt to encourage state banks to obtain national charters, Congress imposed a tax on state bank notes. In 1864, the tax was 2 percent, followed by an increase to 10 percent in 1865 (Cochran 58). Consequently, the conversion of state banks resulted in a total of 1,644 nationally chartered banks by the end of 1866, with few state banks still in operation.

National banks were held accountable in part through reserve requirements, some of which could be held in the form of U.S. Treasury bonds. Banks located in cities were required to hold reserves in lawful money equal to 25 percent of their deposits, of which one-half could be on reserve in New York City banks.1 Country banks were held to a 15 percent reserve requirement, three-fifths of which could be deposited in a city bank (Cochran 59).

A Comeback For State Banks

Initially, the new national banking system provided vast improvements over the status quo and all but eliminated the state system. Problems arose, however, due to the national system’s inability to provide an adequate money supply. Checking accounts had existed in America since before the Revolution. They began to acquire increased importance as a means to offset the inelastic

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1*New York City has long-since been of key importance in the banking industry. For example, today the Chairman of the Federal Reserve Bank of New York is a permanent member of the Federal Reserve Board, unlike the Chairmen of the other twelve regional Federal Reserve Banks.*
supply of national bank notes. Checks began to dominate payment methods for large commercial transactions, and the increased use of checking accounts played an important role in the renewal of the state banking system. By 1892, the number of state banks once again surpassed the number of national banks (Cochran 60). The prospect was clear—America was destined to have a dual banking system, for the duality appeared to serve as a means of balancing the inadequacies of the two systems. The state system could address the unique demands of their particular community, while the national system could ensure a sound and adequate flow of currency.

Financial Institutions From 1900 to 1930

The Currency Act of 1900

The number of both state and national banks increased during the early years of the twentieth century. Growth in the area of national banking was due in part to the passing of the Currency Act of 1900 (otherwise known as the Gold Standard Act), which reduced capital requirements for national banks. The Act also allowed national banks to issue bank notes up to the full value of their deposited government bonds, as opposed to a previous 90 percent limit, and reduced the federal tax on bank notes (Cochran 60).

Unfortunately, quantity and quality did not necessarily go hand-in-hand, as many banks were small and weak. In fact, continued bank failures over time had already resulted in the panics of 1873 and 1884, followed by the famous Panic of 1907. At the beginning of 1907, the economy entered a period of
contraction, and some banks refused to pay out currency on demand. As the year progressed, contraction increased, and the public soon made a run on the nation's banks. As a result, banks around the country started withdrawing their deposits from New York banks. In a scramble to obtain cash, stocks were being sold, causing the Stock Exchange nearly to close (Degen 12).

The Panic of 1907 might have been worse, had it not been for the intervention of one of the nation's great financial powers of the time, Pierpont Morgan.\(^2\) Due to his enormous industrial and financial empire, along with his profession of investment banking, Morgan became very influential in the financial community. He took on the role of a lender to banks, in the absence of a central bank. Along with the funding necessary to keep banks in operation, Morgan provided strategies to aid the failing financial system. Yet, Morgan's intervention provided only temporary relief for the need of a central bank (Degen 14).

The lack of a central bank meant the absence of a "lender of last resort" for the country's banking systems, as well as a lack of sufficient regulation. By 1914, there were approximately 7,500 national banks in operation, with the number of state banks exceeding 19,000 (Cochran 61).\(^3\)

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\(^2\)Pierpont Morgan's financial empire is often referred to as "The House of Morgan." Today's influential J. P. Morgan Bank was named in his honor.

\(^3\)The 7,500 figure of 1914 compares to 4,000 national banks in 1990. The number of state banks in 1990 totaled about 8,000--only half of 1914's sum of 19,000 (Wells, Jackson, and Murphy 2).
The Aldrich-Vreeland Act

The Aldrich-Vreeland Act, passed in 1908, represented one of the first real attempts by Congress to address the issue of banking reform. A primary concern addressed by the Act was how to meet the public’s demand for currency through expansion of the money supply, in order to prevent massive withdrawals from the nation’s banks. The Act allowed banks to form National Currency Associations empowered to issue emergency bank notes via the placement of commercial paper or bonds with the associations. Taxes on the notes encouraged their retirement as soon as the emergency ceased (Degen 16, 17).

The Federal Reserve Act Of 1913

Although the Aldrich-Vreeland Act expired in 1915, its creation of a National Monetary Commission laid the foundation for the Federal Reserve Act. In 1912, after an extensive examination of the nation’s monetary system, the Commission issued a plan for reform. In response to the need for banking reform, President Woodrow Wilson asked Congress to confront the problem, resulting in the 1913 Federal Reserve Act (Degen 17). This act is one of the most crucial pieces of legislation passed in defining the structure of America’s monetary system, for it created our Federal Reserve System (The Fed).

The Act called for the establishment of the Federal Reserve Board, twelve Federal Reserve Banks, member banks and a Federal Advisory Council. The Act also included numerous other significant measures, including a new
system of bank reserves, management of check clearing and collection, the issuance and retirement of a new form of paper money (Federal Reserve Notes), and fiscal assistance to the Treasury (Jackson, 1986, 6).

The Federal Reserve Act of 1913 had a major impact in addressing the nation's need for banking regulation and for providing an elastic currency. In addition to obtaining supervisory authority over all national banks, the Board received considerable authority over state-chartered member banks.4 The twelve Reserve Banks assisted in controlling the money supply through their ability to dispense loans to member banks, just as they do today (Jackson, 1986, 6).

The Edge Act

Passed in 1919, the Edge Act introduced the ability of U.S. corporations to participate in international banking. Under the Act, the Federal Reserve charters such corporations, in which domestic banks are allowed to invest. Corporations under the Edge Act may not engage in banking activities within the United States, however, unless given authorization by the Federal Reserve Board (Ritter and Silber 139).

The Roaring 20's And The McFadden Act

As America came to the end of World War I, the country launched a new era of prosperity. Despite this promising outlook, however, bank failures were still all-too-common. During the 1920's, approximately 5,700 banks closed

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4As in 1913, today all national banks are required to be members of the Federal Reserve System. State banks have the option of obtaining membership, but are not compelled to do so.
Many of the failing banks were small state banks, most of which were not members of the Federal Reserve System. Because these failing banks were located predominately in farming communities, declining post-war agricultural prices received much of the blame.

Other significant changes took place during the 1920's. By the middle of the decade, the Federal Reserve initiated open market operations as a tool for easing monetary policy. In other words, the Fed engaged in the buying or selling of U.S. Government securities on the open market as a means of decreasing or increasing the money supply (the amount of money in circulation). Bank mergers and branching became more prevalent, and the expansion of bank branching was tied to the passing of the McFadden Act in 1927. This act authorized the Comptroller of the Currency to permit national banks to establish branches within the state where they were located. Restrictions of the law included the prohibition of interstate branching, and intrastate branching was allowed only to the degree state laws permitted state-chartered banks to branch (Jackson, 1986, 7).

Financial Institutions From 1930 To 1970

America's First Banking Crisis

With the commencement of the Great Depression, the nation's banks experienced a wave of closures. While the number of bank failures in the 1920's had averaged roughly 600 per year, Americans witnessed 1,350 bank closures. Interestingly, many of these closures took place in the latter half of the decade, as opposed to the immediate post-war recession period.
failures in 1930 and nearly 2,300 in 1931. A key factor for the closures was a major downturn in the national economy. After reaching a peak in 1929, economic activity declined at a rapid pace, with real income falling by 11 percent from 1929 to 1930 (Degen 62).

In 1932, the Reconstruction Finance Corporation (RFC) was created as one of the Federal Government’s first attempts to "bail out" financial institutions (Jackson, 1986, 9). The RFC either provided direct financing to banks in need or authorized guarantees to assist in securing loans. As more and more banks declared "bank holidays," the need for further legislation became evident.

**Banking Act Of 1933**

On March 6, 1933, just two days after taking office, President Roosevelt declared a national bank holiday. In support of the President’s move to prevent further financial crisis, Congress passed the Banking Act of 1933—another one of the most influential banking acts to date. The Act provided a number of amendments to the Federal Reserve Act of 1913, including the creation of the Federal Open Market Committee and the granting of authority to the Fed to oversee transactions among member banks and foreign banks. In addition, the

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6The RFC has been compared to the Resolution Trust Corporation (RTC) established in 1989 to deal with the nation’s insolvent savings and loan associations. The RTC will be discussed later.

7A "bank holiday" refers to the closing of banks to prohibit massive withdrawals by depositors.

8The Fed had already begun open market operations in the 1920’s. The Federal Open Market Committee was formed to enhance control of these operations.
Act prohibited payment of interest on checking accounts/demand deposits and increased minimum capital requirements for banks (Jackson, 1986, 9).

In an attempt to enhance the stability of the nation’s financial system, the Act also called for the creation of the Federal Deposit Insurance Corporation (FDIC), which provided federal deposit insurance coverage up to $2,500 per account (Cochran 66). While all Federal Reserve banks were obligated to become members of the FDIC, state commercial banks could also obtain membership. Another fundamental portion of this legislation is known as the Glass-Steagall Act, which basically separated commercial banking and investment banking. The Glass-Steagall Act prohibited national banks from purchasing equity securities and from underwriting or dealing in securities except for guaranteed government debt obligations (Jackson, 1986, 9).9

Banking Act Of 1935

The major accomplishment of the Banking Act of 1935 was to intensify the power of the Federal Reserve to implement monetary policy. Under the Act, the Federal Open Market Committee was restructured into a twelve-member board and given the authority to buy and sell government securities as the major tool for controlling the country’s money supply. The structure of the Federal Reserve System’s governing board was also reworked, calling for seven members to be appointed by the President for staggered fourteen-year terms. The Comptroller of the Currency and the U.S. Treasury Secretary were no

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9There is presently a great deal of controversy as to whether or not the Glass-Steagall Act should be repealed, which will be discussed later.
longer included as Board members, in order to strengthen the Board’s independence (Degen 74). The Board also received expanded authority in setting reserve requirements for member banks and in controlling the discount rate—the interest rate paid by member banks on funds borrowed from the Fed (Cochran 66).

As a measure for preventing future bank failures, the 1935 Act granted the Comptroller greater control for approving national bank charters and gave the FDIC indirect authority for the approval of state bank charters. In other words, because banks deemed FDIC coverage essential to their success, denial by the FDIC for membership obstructed the opening of some banks.

Finally, the 1935 Act prohibited bankers from holding directorships on more than two bank boards at any given time. It also allowed national banks to make five-year real estate loans (Jackson, 1986, 10).

**Federal Deposit Insurance Act Of 1950**

Subsequent to the passing of the Banking Acts of 1933 and 1935, the nation’s banking industry remained relatively stable. World War II brought economic relief from the Great Depression. Banks began to prosper and regained the confidence of the American people. This confidence was largely attributed to the existence of the FDIC. Coverage increased from $2,500 per account in 1933 to $5,000 in 1934. In 1950, Congress passed the Federal Deposit Insurance Act putting the FDIC, originally created by the Banking Act of 1933, under a separate law (Jackson, 1986, 10).
Bank Holding Company Act Of 1956

Although the Banking Act of 1933 provided the Federal Reserve with some authority over bank holding companies, the Bank Holding Company Act provided more extensive control.\(^\text{10}\) Under the Act, approval by the Fed was necessary for the formation of a bank holding company or for acquisition of banks by companies already in existence. In addition, the Act prohibited bank holding companies from participating in non-bank activities, although exemptions may be granted with Fed approval (Jackson, 1986, 11).

The Bank Holding Act has received several amendments. The Douglas Amendment of 1956 was intended primarily to restrict bank holding companies from acquiring banks in more than one state. In 1970, the Act was amended to include one-bank holding companies and to limit the definition of "bank" to an institution which both accepts deposits and makes commercial loans (Jackson, 1986, 11).

**Bank Merger Act**

The 1960 Bank Merger Act, passed as an amendment to the 1950 Federal Deposit Insurance Act, was the first major legislation to deal with the issue of bank mergers. It required FDIC approval for any insured bank to merge with a non-insured bank. In addition, approval for the merging of two insured banks was required by the appropriate regulatory agency (the Fed, the FDIC,

\(^{10}\) A bank holding company is generally defined as a company that controls a bank. The 1956 Act referred to a bank holding company as one that controls at least 25 percent of the stock of two or more banks, thus excluding the one-bank holding companies (Cooper and Fraser).
or the Comptroller--depending on the banks' status). The Act prohibited the granting of mergers which would suppress competition, unless the detriment of such a merger was outweighed by the potential benefits to the community involved (Jackson, 1986, 12).
FINANCIAL INSTITUTIONS TODAY

From the chartering of the first commercial bank in 1782 through the passing of the Bank Merger Act in 1960, America’s banking system experienced critical evolution and change. Yet the growth of nearly two centuries of banking scarcely compares to the transformation seen during the last two decades. The diversification of financial institutions, rapid expansion of technological innovation, and the enactment of major legislation have all contributed to a financial system that can be described in two words: competitive and complex. Not unlike in the past, America’s financial institutions during the 1970’s and 1980’s have realized difficult times. As a result, both regulation and deregulation have played a major role in forming the structure of our financial system as it exists today.

Although America’s economy flourished during the 1960’s, prosperity came at the expense of surging inflation brought about by events such as the Vietnam War. An attempt to curb inflation via tight monetary policy had a direct effect on financial institutions. In addition, foreign interests in American banking as a result of a weak U.S. dollar brought about legislation relating to international banking. Yet, concern arose as to whether or not more could be done to help the financial system by way of regulatory reform.

Financial Institutions In the 1970’s

The Hunt Commission

In 1970, President Nixon appointed the Commission on Financial
Structure and Regulation—also known as the Hunt Commission (named after its Chair, Reed Hunt). "The attitude behind the creation of the Hunt Commission was that desirable changes in the system were being prevented by government regulation" (Degen 168). In their 1971 report, the Commission advocated less regulation to make financial institutions more competitive, resulting in a more stable financial structure. Although the Hunt Commission's recommendations were introduced as legislation, they failed to receive Congressional approval (Degen 168).

The failure of the Commission's suggestions was somewhat unfortunate, for it could be said the Commission was "ahead of its time" in determining necessary aspects of banking reform. The Commission's recommendations included eliminating interest rate restrictions under Regulation Q, broadening the loan and investment authority of depository institutions, streamlining examination and supervisory functions into two new agencies (one for federally-chartered and one for state-chartered institutions), creating a single depository insurance agency, and encouraging states to allow statewide branching, and more (Cooper and Fraser 111, 112).¹¹

FINE

In 1975, Congress commissioned a study resulting in the culmination of FINE—the Financial Institutions and the Nation's Economy report (Degen 168).

¹¹Until now, reference made to financial or depository institutions has focused on banks. However, thrift institutions—including savings and loan associations, savings banks and credit unions—were also in existence and had a separate deposit insurance corporation. These will be discussed later.
Proposed changes under FINE included the elimination of Regulation Q (interest rate restrictions), repeal of the statute prohibiting interest payments on demand deposits, relaxed branching restrictions, broadened powers for thrift institutions, and the consolidation of supervisory and deposit insurance functions under a single agency (Cooper and Fraser 112). As with the Hunt Commission, Congress once again failed to approve legislation needed to implement FINE's proposals. These attempts to bring reform likely failed because the degree of concern was not yet significant enough to overcome objections to change by special interest groups (Degen 168).

**International Banking Act Of 1978**

The International Banking Act of 1978 essentially allowed foreign banks to open in the United States according to the same regulatory guidelines as domestic banks. Such banks were subject to the Fed's reserve, reporting and examination requirements and could obtain FDIC coverage. Foreign banks also were held accountable under the Bank Holding Act in regard to interstate and non-banking activities. The main distinction, however, was that foreign banks were not allowed to open both a federally-chartered branch and a federally-chartered agency within a single state (Jackson, 1986, 13).\(^{12}\)

**Financial Institutions Regulatory And Interest Rate Control Act Of 1978**

Although the Financial Institutions Regulatory and Interest Rate Control Act did not introduce any type of major reform, it did address three key issues.

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\(^{12}\)A branch receives deposits, an agency does not.
Under Title II, the Act implemented restrictions on management and director positions of depository institutions. Title VI, known as the Change In Bank Control Act, required that the acquisition of an FDIC-insured bank or of a bank holding company in control of an FDIC-insured bank be approved by the appropriate federal regulatory agency. The intent of Title VI was to encompass situations not covered by the Bank Merger or Bank Holding Company Acts. Finally, Title X called for the creation of the Financial Institutions Examinations Council. The Council’s charge was to recommend uniform principles for the federal examination and supervision of all financial institutions by the various agencies (Jackson, 1986, 13).

The 1980’s - A Decade Of Deregulation

The country’s financial system during the 1980’s faced increased concern about soaring inflation, international competition, technological advances, and competition from non-depository institutions. As a result, diversification and deregulation became prominent. During the early part of the decade, Congress responded to the system’s struggle to compete via major legislative change. While such change eased regulatory restrictions, the ultimate results proved to be disastrous.

Depository Institutions Deregulation And Monetary Control Act Of 1980 (DIDMCA)

Also known simply as the Monetary Control Act or the Omnibus Banking Act, this statute represented a major move by Congress to deal with the nation’s rapidly changing financial system (Cooper and Fraser 105). The Act
served as the first principal attempt at reorganizing the system since the Banking Act of 1933 and contained many of the recommendations made in the Hunt Commission and FINE reports. Although D_IDMCA failed to confront such issues as expanded branching powers and consolidation of regulation and deposit insurance, it did include the following major ten provisions (Cooper and Fraser 116):


2. Instructed the Federal Reserve System to provide services, including access to the discount window, to all depository institutions.

3. Instructed the Federal Reserve to publish a price schedule for services and to charge all users of Fed services on the basis of the established price schedule.

4. Consolidated the power to set interest rate ceilings (Regulation Q) in the Deregulation Committee and instructed the Committee to eliminate the ceilings gradually. Interest rate ceilings were to be eliminated by March, 1986.

5. Authorized all depository institutions nationwide to provide, in effect, checking account services.

6. Empowered all depository institutions, in effect, to pay interest on demand (checkable) deposits.

7. Raised the federal deposit insurance coverage on individual accounts from $40,000 to $100,000 (for all insured depository institutions).

8. Authorized savings and loan associations to expand greatly their consumer loan business, to issue credit cards, and to offer trust services.
9. Authorized mutual savings banks to make business loans and to accept demand deposits from business customers.

10. Eliminated the effects of state usury laws on certain types of loans (mortgage, business and agricultural).

**International Banking Facility Deposit Insurance Act**

In 1981, the Federal Reserve authorized the formation of International Banking Facilities (IBFs) by depository institutions, Edge and Agreement Corporations, and agencies of foreign banks located in the U.S. IBFs are exempt from interest rate restrictions, reserve requirements and deposit insurance assessment, allowing them to operate as if they were located abroad (Jackson, 1986, 15 and Ritter and Silber 143). The purpose of this act was to attract back to the United States dollars lost to foreign banks (Ritter and Silber 142).

**Bank Export Services Act Of 1982**

Under the Bank Export Services Act, bank holding companies and Edge Act Corporations were permitted to invest in export trade companies under the Federal Reserve System’s regulatory supervision. The purpose of this act was to enhance the availability and efficiency of export trade services for U.S. producers and suppliers (Jackson, 1986, 15).

**Garn-St. Germain Depository Institutions Act Of 1982**

Known simply as the Garn-St. Germain Act, this was the second law calling for sweeping reform of the nation’s financial structure passed in the 1980’s. The primary focus of Garn-St. Germain was to afford sufficient
deregulation to the thrift industry in order for it to become more competitive. The Act greatly expanded the lending authority of thrift institutions in regard to business and consumer loans, allowing them to take part in riskier ventures.

Another major provision of the Garn-St. Germain Act was to permit all financial institutions to create money market deposit accounts (MMDA) with limited checking privileges and market interest rates. MMDAs were essential for enabling financial institutions to compete with money market mutual funds (Cooper and Fraser 133).13

The Act also enhanced the lending authority and operating flexibility of national banks. For example, prior to Garn-St. Germain, national banks were allowed to lend a maximum of 10 percent of their capital to a single borrower. The Act increased this amount to 15 percent. In addition, national banks were granted approval to form bank services companies and to invest in export trading companies (Cooper and Fraser 138).

Some of the other provisions under the Garn-St. Germain Act included prohibiting bank holding companies from participating in the business of selling insurance, expanding the FDIC’s power to assist in mergers of insured depository institutions, and permitting interstate and inter-industry acquisition of troubled financial institutions (Cooper and Fraser 138, 139).

13Due to the interest rate restrictions of Regulation Q, money market mutual funds were invented as a vehicle for providing investors with a higher return. In the early 1970’s, rate ceilings were eliminated for larger time deposits. Deposits of $10,000 or less, however, were subject to the interest rate ceilings. Consequently, small savers pooled their funds (mutual funds) to buy large-size certificates of deposit (CDs) and other instruments with a higher yield.
The Great Savings And Loan Debacle

Initially, the failure of America’s savings and loan (S&L) industry during the 1980’s was deemed comparable to the banking system’s crisis of 1933. While comparisons might be made in terms of the number of failed institutions, no such comparisons exist regarding the financial impact and loss of public confidence. Before discussing the events of the S&L crisis, we must briefly review the history and organization of the industry.

Federal Home Loan Bank Act

The first known American savings and loan was formed in Pennsylvania in 1831 (Logan 4). Not until the 1932 passing of the Federal Home Loan Bank Act was the Federal Home Loan Bank System established (Wells and Smale 9). As with banks, this is a dual system, with both federal and state chartered institutions. The Act created the Federal Home Loan Bank Board (FHLBB), consisting of three members appointed by the President, under which twelve regional Federal Home Loan Banks were established. In 1934, the Federal Savings and Loan Insurance Corporation (FSLIC), which was to be administered by the FHLBB, was created to provide deposit insurance for S&Ls. Consequently, supervision, regulation and insurance of federally-chartered savings and loans were conducted by a single entity--the FHLBB (Ritter and Silber 89).

Business went smoothly for the new industry until the 1970’s, when it began to experience competitive difficulty due to strict regulation and inflation-
induced high interest rates. In 1980, Congress removed interest rate restrictions and increased FSLIC coverage (Cooper and Fraser 118). With the passing of the Garn-St. Germain Act in 1982, new opportunities were presented to S&Ls as they received expanded lending and investment authority. The industry, however, seems not to have been prepared to handle its new power.

The S&L Downfall

Although blame for the downfall of the S&L industry has been shared by many--accountants, auditors, lawyers, regulators, owners--the two key contributing factors are interest rates and insurance coverage (Miles and Woodward 2). Initially, the savings and loan industry had a two-fold purpose: promotion of thrift and financing of homes. Long-term interest mortgages were funded by short-term deposits, and as long as a sufficient spread between the two could be maintained, all was well. In fact, in the early years of the S&Ls, managers were said to live by the three-six-three rule--pay three percent on savings, make mortgages at six percent, and be on the golf course by three p.m. (Bentson 92).

Inflation set in during the 1970's, however, causing a dramatic increase in interest rates. Once interest rate ceilings were lifted, savings associations found it necessary to increase interest paid on savings deposits in order to compete with other financial intermediaries. Unfortunately, they were still earning a comparatively low return on their long-term fixed-rate mortgages.
This imbalance caused many S&Ls to become economically insolvent.

New investment authority granted by the Garn-St. Germain Act, coupled with FSLIC coverage, resulted in savings associations quickly becoming "hot" commodities. The potential to earn substantial returns on real estate investments, with virtually no risk due to deposit insurance, was too great a temptation for some to resist. A combination of mismanagement and blatant disregard for the law culminated in significant losses.

Much criticism has been aimed at regulatory and supervisory officials for not responding to troubled institutions more quickly. Adoption by the FHLBB of new regulatory accounting principles allowed many economically insolvent S&Ls to stay in operation when they should have been closed (Bentson 93). In addition, lobbying efforts by the industry successfully delayed congressional action. Nonetheless, the third major financial restructuring mandate of the 1980’s was passed.

Financial Institutions Reform, Recovery and Enforcement Act (FIRREA)

FIRREA became effective in August of 1989, providing drastic modifications to the structure of the nation’s savings and loan industry. For example, capital requirements for thrifts were increased, and the definition of assets qualifying as capital decreased. Under the Act, the Federal Home Loan Bank Board was abolished, and regulatory authority over S&Ls was transferred to the newly created Office of Thrift Supervision (OTS). The OTS, a bureau of the U.S. Treasury Department, is now responsible for rechartering, regulating,
examining, and supervising savings and loan associations (Ritter and Silber 91).

The Resolution Trust Corporation (RTC) was formed to deal with insolvent thrifts. Once they are seized by the OTS, insolvent thrift institutions are given to the RTC for the purpose of sale and/or liquidation (Miles and Woodward 6). The Federal Housing Finance Board (FHFB) acquired the FHLBB’s lending authority and the responsibility of overseeing the twelve district Federal Home Loan Banks (Wells and Smale 8).

Finally, FIRREA introduced pivotal changes in the formation of depository insurance. The FSLIC was dissolved, with the FDIC acquiring responsibility for insuring both banks and savings institutions under two separate insurance funds. Deposits at commercial and savings banks are covered by the Bank Insurance Fund (BIF), and savings and loan association deposits are insured by the Savings Association Fund (SAIF) (Ritter and Silber 94).

Determining how much time will be necessary to "clean up the S&L mess," or how much money it will cost is difficult. According to the Office of Thrift Supervision Journal (DuPre, 1990), however, the cost is estimated to be as much as $300 billion. Others speculate the final bill will be closer to $500 billion--$2,000 for every man, woman and child in America.

Credit Unions

While our main focus has been on banks and savings and loan associations, in order to have a complete picture of America's financial industry, we must review one other financial depository institution--the credit
union. As with savings and loan associations, credit unions are sometimes referred to as "thrift institutions." The concept of credit unions came to this country from Europe (Cooper and Fraser 10), with the first American credit union opening in New Hampshire in 1909. Organized as cooperatives for people with a common interest, initially credit unions offered only savings accounts and short-term consumer loans (Ritter and Silber 44). In 1970, the National Credit Union Association (NCUA) was formed as the agency responsible for overseeing the regulation, insuring and chartering of federal credit unions. Credit union deposits became insured up to $100,000 per depositor under the National Credit Union Insurance Fund (NCUIF) (Wells and Smale 20).

With the deregulation of the early 1980's, credit unions were allowed to offer checking accounts and long-term mortgage loans. Although subject to reserve requirements of the Fed, credit unions also maintain borrowing privileges from the Fed. Like other depository institutions, credit unions have a dual (federal and state) chartering system. Most of the country's 15,000 credit unions are federally-chartered, and, therefore, are regulated and supervised by the NCUA (Ritter and Silber 92). State-chartered credit unions fall under the command of the state in which they are chartered.

Unlike other depository institutions, credit unions have not been plagued with consistent problems. Their lack of troubles can be largely attributed to the "low-key" nature of their transactions. For example, rather than getting
involved with long-term mortgage or real estate loans, credit unions focus on short-term consumer lending. In addition, credit unions have the distinct benefit of being exempt from federal taxes.

**Regulation In The 1990’s**

**Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991 (S. 543)**

The most recent attempt by Congress to address banking reform resulted in the passing of Senate Bill 543 in November of 1991. Although the Act is not considered to include extensive changes to the nation’s financial system, important changes have been made.

**Deposit Insurance Reform**

Senate Bill 543 increases the FDIC’s borrowing authority from $5 billion to $30 billion. The FDIC is required to repay the Treasury with deposit insurance premiums and to rebuild the Bank Insurance Fund (BIF) within 15 years. Other deposit insurance reform measures include the elimination of coverage on bank investment contracts and the restriction of brokered deposits to only the healthiest banks. The $100,000 per account insurance protection remains intact; however, the FDIC will implement a system of risk-based deposit insurance premiums for banks.

**Prompt Corrective Action**

S. 543 introduces guidelines for "prompt corrective action" in dealing with institutions that become undercapitalized. Such institutions are required to submit detailed plans for improving their capital position to an acceptable level. If an undercapitalized institution fails to submit a plan, or its plan falters, regulators have the authority to implement necessary restrictions and recapitalization efforts. Perhaps one of the most meaningful provisions of S. 543 is the requirement of regulators to provide annual on-site examinations of all FDIC-insured institutions.
Too Big To Fail

Senate Bill 543 is also aimed at eliminating the "too big to fail" theory. Effective January 1, 1995, the FDIC is not allowed to protect uninsured depositors that would result in losses to the insurance fund. A systemic risk exception may be granted only with approval from the FDIC, the Federal Reserve Board and the Treasury Secretary. Such an exception would be deemed necessary to prevent serious adverse effects on the nation's economy.

Consumer Protection

S. 543 requires disclosure to customers of information on yields and fees, including deposit accounts' annual percentage yield, and prohibits interest calculations considered to be unfair. The Act also obligates lenders to submit a copy of the appraisal report to all loan applicants. The bill introduces an FDIC Affordable Housing Disposition Program, which allows low- and moderate-income buyers and non-profit organizations to purchase affordable housing properties from the FDIC. Finally, customers and regulators are to receive notification prior to the closure of a bank branch.

Bank Activities

S. 543 basically protects the status quo in regard to banking activities. For example, state banks are not allowed to participate in activities prohibited to national banks unless the state banks are adequately capitalized and have received FDIC approval. In addition, state banks are allowed only the same insurance underwriting privileges granted to national banks. S. 543 also enhances safeguards against insider abuse and requires that independent accountants perform annual audits.

Foreign Bank Supervision

In response to the international BCCI\textsuperscript{14} banking scandal, S. 543 calls for significant tightening of authority over foreign banks by the Federal Reserve. The Act requires foreign banks to receive approval from the Fed prior to opening any branch, agency

\textsuperscript{14}BCCI stands for the Bank of Credit & Commerce International, an international bank which has failed in large part as a result of fraudulent practices
or lending company in the United States. The Fed may also examine a foreign bank’s American offices, and federal regulators have the discretion to close such offices. The Act also requires "foreign banks to report any loans to a person or group of persons secured by 25 percent or more of the stock of any domestic insured depository institutions" (DPC Legislative Bulletin, 1992).
THE FUTURE OF AMERICA'S FINANCIAL SYSTEM

A close study of the various historical events and regulatory developments that have contributed to the current structure of our nation's financial system permits us to evaluate the future direction of that system. More importantly, by learning from the lessons of the past, we can help shape the financial system of tomorrow.

Regulation Recap

Legislation passed to date has resulted in the following regulatory structure.15

Comptroller of the Currency

The Comptroller is responsible for the chartering, regulation and supervision of the approximately 4,000 national banks. This figure comprises about 32 percent of the total number of banks in the country, involving 59 percent of the total deposits. The Office of the Comptroller is part of the U.S. Treasury Department and was established in 1863 under the first National Bank Act.

Federal Reserve System

The Federal Reserve System was instituted in compliance with the Federal Reserve Act of 1913. Since then, the Fed has continually been granted increased power of authority through a variety of laws, including the Banking Acts of 1933 and 1935, the Bank Holding Company Act of 1956, and the

15Sources for the following information have either been given in previous chapters of this paper or come from publications by Ritter and Silber, Wells and Smale, or Wells, Jackson and Murphy.
Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991. Currently, the Fed serves as the nation’s central bank and is responsible for the regulation and supervision of state-chartered member banks. These banks include approximately 1,000 in number, or 8 percent of the aggregate number of banks, and hold 16% of the total deposits.

The Fed also regulates the nation’s 5,000 plus bank holding companies and has considerable authority over foreign banks within the United States. As a result of the Garn-St. Germain Act of 1982, all depository institutions--savings and commercial banks, credit unions, and savings and loan associations--are subject to the Fed’s reserve requirements, whether or not they are members of the Federal Reserve System. All national banks are required by law to be members of the Fed, even though their regulatory agency is the Comptroller of the Currency.

Federal Deposit Insurance Corporation (FDIC)

The FDIC was established by the Banking Act of 1933 and underwent significant metamorphosis with the passing of FIRREA in 1989. The FDIC is the regulatory agency for state-chartered banks that are not members of the Federal Reserve System. Although over 7,000 such banks exist, representing 60 percent of the total number of banks, they hold only about one-fourth of the total deposits.

As of 1989, the FDIC is also responsible for providing deposit insurance to both banks and savings and loan associations. The Bank Insurance Fund
covers commercial and savings banks, while the Savings Association Insurance Fund has replaced the FSLIC in insuring savings and loan associations. All national banks and most state banks are insured by the FDIC. Non-member state banks are not obligated to obtain FDIC coverage, but most do so in order to attract depositors.

Savings and Loan Associations

Upon enactment of FIRREA in 1989, the Office of Thrift Supervision, a department within the U.S. Treasury, assumed the duty of chartering, regulating, supervising and examining savings and loan associations. The Resolution Trust Corporation handles insolvent thrifts, and the Federal Housing Finance Board (FHFB) governs the twelve regional Federal Home Loan Banks. The FHFB serves in a capacity similar to that of the Federal Reserve Board in terms of its regulatory authority; both Boards oversee the examination of member institutions and require members to submit annual condition reports. The FHFB's responsibilities are somewhat more specific than the Fed's in some aspects, however. For example, the FHFB is responsible for seeing that Federal Home Loan Banks "carry out their housing finance mission" (Wells and Smale 8). In meeting this mission, the FHLB promotes community-oriented mortgage lending and affordable housing advance programs.

Credit Unions

Established in 1970, the National Credit Union Association is the agency in charge of chartering, regulating, supervising and examining credit unions.
As of September 1990, roughly 8,500 federal credit unions and 4,400 state-chartered credit unions existed. Deposits of both federal and state-chartered credit unions are insured by the National Credit Union Share Insurance Fund.

Other Agencies

The U.S. Department of Justice has been granted the authority to review proposed mergers, acquisitions, and other changes as they relate to the structure of the financial industry. If such proposals are deemed to be anti-competitive, Justice can file suit to block implementation.

The Securities and Exchange Commission administers regulation of securities transactions. The SEC also enforces public disclosure requirements, especially as they relate to bank holding companies.

Regulatory Reform

Although impossible to address thoroughly all aspects of our nation’s financial industry in a single paper, several key issues on which the industry’s future rests can be identified.

Justification for Regulatory Reform

Learning from the downfall of the savings and loan industry is imperative if we seek to strengthen the soundness and stability of our nation’s financial system. From 1980 to 1989, over 500 FSLIC-insured thrifts were classified as insolvent and were subsequently liquidated or merged. This figure represents more than three-and-a-half times the total of thrifts declared as insolvent in the previous 45 years of FSLIC’s existence (Wells, August 1990,
3). As indicated previously, the bailout costs of dealing with the troubled S&Ls have been estimated to be between $300 and $500 billion.

From 1980 through 1990, 1,205 FDIC-insured banks failed. In 1989 alone, over 200 such banks failed, and by the end of 1990, another 1,100 institutions were on the FDIC problem list (Smale, 1992, 1). Although the total number of failures declined in 1990 (168 versus the 206 of 1989), the problem is far from over. Franklin Edwards, a Professor at Columbia University, makes the following analogy in regard to our financial system:

The situation today is similar to the rotting frame of an old house. Each piece of supporting timber has rotted from the inside. From casual observation, it is impossible to determine whether the supports are sound. A few probes with a sharp instrument, however, quickly reveals that the timber has rotted, its ability to support the house gone. Despite this enfeebled condition, the house miraculously stands, until one day a brief but intense gust of wind takes it down with a crash. (4)

Ironically, Professor Edwards made this statement in 1987--right before our savings and loan industry came "down with a crash."

A myriad of reasons exist for the country's numerous bank and thrift failures. In some cases, mismanagement has been the primary factor. In others, deregulation without simultaneous boosting of supervision has caused collapse. Financial institutions have been faced with increased competition from non-depository institutions and have had to absorb losses from loans to third-world countries that will never be paid. In response to volatile interest rates, an unstable economy and rapidly growing technology, the condition of our financial industry is drastically and quickly changing. Yet, because the
national welfare of our economy is dependent on a stable financial system, the potential and real ramifications of these changes cannot be ignored.

Some financial institutions will inevitably fail, as do other businesses, but the failure of these institutions impacts our economy in pervasive and significant ways. Financial experts contend if the industry is to survive, regulatory reform is needed to increase the stability and competitiveness of our financial institutions. Even President Bush is calling for "a banking reform plan to bring America's financial system into the 21st Century" (Cranford, February 1991, 285). There is not a consensus, however, as to what shape reform should take.

Deposit Insurance Reform

The mandate of risk-based insurance premiums by the Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991 (Senate Bill 543) is crucial to the future of depository insurance. By holding banks more accountable via assessing premiums on the basis of risk, management will undoubtedly become more cautious in their business practices. The downside is that customers may have to shoulder the burden for these higher premiums through higher fees. Nonetheless, institutions determined to be higher-risk should be required to disclose that fact publicly. Risk-based premiums, however, are just the beginning.

The initial purpose of FDIC coverage was to prevent runs on depository institutions and to protect the "small investor." Senate Bill 543's eradication
of the "too big to fail" theory is helpful but does not extend far enough. For example, the U.S. is the only country that formally insures interbank deposits (deposits in institutions by other depository institutions) up to the $100,000 limit. If the FDIC’s mission of protecting the small investor is to be upheld, perhaps this type of protection should be eliminated. In addition, the FDIC currently allows a maximum coverage of $100,000 per individual account. By planning several family accounts, a single individual can be covered in excess of $1,000,000 within a single bank.\textsuperscript{16} If the purpose of FDIC is truly to protect small investors, perhaps accounts should be established by social security number, with only one account per social security number allowed per institution. The resulting decrease in coverage may encourage bank management to become more risk averse.

Finally, some financial experts question whether or not FDIC coverage should even exist (Edwards 10). Advocates of abolishing depository insurance argue that it is not necessary to provide stability to our financial system and that such stability can and should be provided by the Federal Reserve System as a "lender of the last resort." Opponents of FDIC coverage maintain that by using the Fed, management would be even less likely to enter into risky ventures. Whether or not the Fed could render as much stability as the FDIC is debatable. Given the history of our nation’s financial system, beginning with

\textsuperscript{16}For example, maximizing insurance coverage would be done by combining accounts with children, spouses, grandchildren, etc., and perhaps by establishing trust accounts in addition to individual and joint accounts.
the banking crisis of 1933 and culminating with the savings and loan catastrophe of 1980's, depository insurance appears absolutely essential to sustaining public confidence.

**Interstate Branching**

The issue of interstate branching is one of great controversy. Traditionally, local control of banks has been strongly supported in the United States (Wells, 1991, 9). Due to inaction from the Federal Government in this area, states have taken the initiative. Most states allow some degree of interstate banking, with approximately half allowing nationwide entry, and only a handful prohibit any type of interstate banking. This is one aspect of banking in which the United States is unique; almost every nation in the free world permits nationwide branch banking. In addition, it is our only industry to lag behind geographic nationalization (Gart 21, 22).

Opponents of interstate branching maintain that preserving local control of depositor funds is of primary importance. The concern arises over whether or not funds deposited locally will be made available to fulfill local credit demands. For example, a bank may have to decide between an investment opportunity at its main location in Minneapolis, Minnesota, and one at its branch in Helena, Montana. The optimal opportunity likely exists in Minneapolis, meaning Helenans may have to go unfunded if a "credit crunch" exists. In other words, the argument presented is that monies deposited in Helena should be available to borrow in Helena.
On the other hand, branch banking may be of benefit during trying economic times. For example, "the more restricted the geographic reach of an institution, the more narrow the economic base in which it is likely to operate" (Woodward, 1990, 15). Certain geographic areas may encounter economic problems specific to their area. As a case in point, of the 206 banks that failed in the U.S. in 1989, 166 were located in the energy-depressed states of Texas, Louisiana, and Oklahoma. Another 13 bank failures were related directly to difficulties in agricultural communities (Smale, 1991, 3). If branches located in these areas have a parent bank and/or branches in locations experiencing prosperity, they may be the key to survival for their struggling peers.

Another major concern of opponents of interstate branching is whether or not the smaller banks will be able to compete with branch banks due to economies of scale. Though empirical studies have been done on this issue, no determination has been made that economies of scale in banking exist to such a degree as to represent a significant threat of banking concentration in the absence of branching restrictions (Cooper and Fraser 44). Historically, fear of concentration has been a result of societal concerns, especially in terms of agricultural interests.

If financial institutions must become more competitive to survive, interstate branching must be allowed. The strategy small banks need to adopt for survival focuses on service provided. If a small bank excels in responding to the needs of its community, it will ably compete with branch banks. Service
is truly the key. As one small-town bank declares, "Where others have their branches, we have our roots."\(^\text{17}\)

Furthermore, anti-trust laws and other regulatory requirements will limit concentration by larger banks. Anti-trust laws prohibit monopolies. In addition, before a depository institution is able to obtain a charter or open a branch, it must prove that its services are needed, that it will be able to show a profit within a reasonable time, and that its existence will not create material harm to existing institutions. Ours is a free-market society in which the "Invisible Hand" works toward creating a balance.

**Glass-Steagall Act**

The other leading debate regarding deregulation pertains to the Glass-Steagall Act and its separation of commercial and investment banking. Those who want the Act repealed argue such a move is essential to allowing commercial institutions to become adequately competitive. They contend the synergy exists and through investment banking activities, depository institutions can increase profits resulting in higher returns for their customers. Furthermore, proponents of repealing Glass-Steagall insist that regulatory supervision will adequately address concerns over conflict-of-interest or potential abuses.

Allowing commercial banking and investment banking to "join hands" may increase profits for financial institutions. In light of recent history,

\(^\text{17}\)This is the motto of the State Bank of Townsend, Montana.
however, such an association seems destined for disaster. Within the securities industry, major abuses of insider trading have become a critical issue, as we have seen in recent years, as has the collapse of notable securities firms. In addition, we have witnessed a major stock market "crash" as recently as 1987 and several major downturns in the market since. One has to question what sort of impact a market plunge would have on the status of our nation's financial institutions if they were allowed to engage in securities ventures. Finally, the nation is still recovering from what happened when the S&L industry was allowed to engage in risky new ventures as a result of deregulation in the early 1980's.

The purpose of financial institutions is to accept deposits and to make loans. They should become more competitive by doing what they are designed to do and by doing it well. Allowing them to participate in the investment and insurance industries is not the answer.

Prevention

Once agreement has been reached about the specific functions depository institutions are to perform and what their geographic limitations are, implementing adequate supervision and examination is essential. Regular, thorough examinations must be performed for all depository institutions. Forbearance must be avoided, and capital requirements must be enforced. By implementing strict corrective measures on troubled institutions as early as possible, the number of failures will undoubtedly decline. For example, Senate
Bill 543 requires banks that become undercapitalized to submit a detailed plan for rebuilding capital structure. Further, the process of regulation and examination can and should be made more efficient via consolidation.

**Regulatory Consolidation**

As outlined in the "Regulatory Recap" above, three separate federal agencies currently serve as regulatory authorities over the nation's banking industry. Adding to the complexity of this situation is the fact that in some cases supervisory authority is both conflicting and overlapping (Blinder 10). A three-tiered system is not the most efficient manner of executing regulatory authority. One agency should be responsible for the chartering and regulation of national banks. This concept is supported by the current Chairman of the Federal Reserve, Alan Greenspan, who said: "We believe that whatever the regulatory form and structure under which new activities are permitted, one agency should have oversight responsibility for the banking organization as a whole" (Wells, October 1990, 10).

Not only would streamlining the regulatory process improve efficiency, it also would assist in applying consistent regulatory standards. Because the FDIC is the agency ultimately responsible for paying the bill when a bank or savings and loan association defaults, it makes sense the FDIC be the agency in charge. The Federal Reserve System would still maintain some authority through its enforcement of reserve requirements.

Finally, as we have learned from the savings and loan debacle, regulatory
and elected officials must be held accountable for their actions. Unfortunately, ethics cannot be mandated. Therefore, it is up to the American people to take the initiative to demand our officials act in a fiscally and ethically responsible manner. Citizens should hold their financial institutions accountable by reviewing annual financial reports and questioning practices that appear to be suspicious. For example, if an institution increases its service fees, customers should seek justification—perhaps the increase is due to increased FDIC risk-based premiums. Or, if an institution’s financial reports indicate any losses, customers should inquire about why the losses occurred and what corrective measures are being taken.

**Competition - Foreign Banks and Nonbank Organizations**

As long as depository institutions are to be limited in their diversification powers, it seems only fair that efforts be taken to limit their competition from foreign entities and nonbank organizations. The need for limiting competition can be supported by the fact that technological advances have succeeded in virtually eliminating geographic and distance barriers. During the 1970’s, we witnessed rapid expansion of electronic funds transfer systems (EFTS), including automated teller machines (ATMs) and point-of-sale terminals (POS) (Bowden 151). Such innovation has enabled banks to circumvent branching restrictions. In addition, sophisticated telephone systems, facsimile machines and other means of telecommunication have greatly increased the ability of foreign banks and nonbank institutions to compete with depository institutions.
Foreign Banking In The United States

Clearly, foreign banking competition in the U.S. cannot totally be eliminated due to fair trade theory and the possibility of retaliation if such elimination were to occur. Unlike today, U.S. banks located abroad somewhat dominated the international banking arena prior to the 1970’s. In fact, according to William Jackson of the Congressional Research Service, "Banks from almost 60 countries operate banking offices here, with a banking asset 'market share' of $696 billion, or 23%" (1990, 2).

Currently, foreign banking activities are governed under the International Banking Act of 1978 and the Change in Bank Control Act of 1978. Essentially these acts hold foreign banking practices to the same restrictions as domestic institutions. The Federal Reserve serves as the regulatory authority for foreign banks in regard to examination and issuance of approval before foreign banks can open a branch, agency or lending company in the United States. Although these mandates do a great deal to ensure sound banking practices by foreigners, they do not limit foreign banks’ ability to compete with domestic banks. Perhaps the banking industry can engage in lobbying efforts toward limiting any competitive edge foreigners have. Recommendations about what form such limitation should take would require further study.

Nonbank Institutions

Diversification by nonbank institutions into the financial field has compounded the problems realized by depository institutions relating to
diversification restrictions. Banks and thrift institutions are not allowed to participate in security transactions, but nonbank firms can offer services such as checking accounts. For example, in 1977 Merrill Lynch developed the Cash Management Account (CMA) (Cooper and Fraser 5).\textsuperscript{18} A CMA can be started with an investment such as stocks, bonds, or cash, on which the investor is allowed to write checks. Other nonbank firms have followed Merrill Lynch’s lead in offering such accounts, as well as in making available certificates of deposit and other types of savings certificates (Cooper and Fraser 206). The availability of commercial loans also extends well beyond the boundaries of depository institutions.

Banks and thrift institutions should pursue legislative assistance in limiting the scope of nonbank firms. We do live in a free market, capitalistic society where increased government regulation is not taken lightly. It would seem, however, that equity is also important. If depository institutions are given limited powers to ensure a stable financial system, concessions should be made to allow them to be successful.

\textsuperscript{18}Merrill Lynch is primarily an investment banking firm.
CONCLUSION

From the first bank that opened in Pennsylvania in 1782 to the over 20,000 depository institutions open today, our nation’s financial system has witnessed drastic growth and change. Many of these institutions have experienced great success, while others have ended in failure. Increased global competition and innovative technology have contributed to the system’s rapidly changing structure.

As financial institutions struggle to survive intense competition, merger and consolidation are undoubtedly the key concepts to describe the future of America’s financial system. As smaller institutions find it increasingly difficult to compete, they are likely to sell-out to larger institutions or simply to cease operations. Those who do survive will do so as a result of the service they provide or by finding a niche in the market.

Inevitably, regulatory reform will continue, although when and to what degree are uncertain. The dichotomy of providing sufficient deregulation to enhance competitiveness, while maintaining a financial system that is administratively sound, will continue to trouble political leaders. As Congressman Stephen Neal stated in regard to the Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991 (S. 543), "As far as fixing the problem for the long term, we don’t do it."¹⁹

The future of our nation’s financial system goes beyond the assurance

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¹⁹Congressman Neal was quoted by John Cranford in the Congressional Quarterly, November 30, 1991.
our savings account deposits are guaranteed--this system has the power to
impact our entire way of life. Jean Wells of the Congressional Research
Service states:

Overall, the delivery system for financial services becomes
important since it is the steady supply of finance which enables
a Nation's economy to operate smoothly. (1987, 1)

A common philosophy is "if it works, don't fix it." Recent trends toward
increased failures of banks and thrifts indicate "it isn't working." These failures
are constant reminders of the intimate relationship between America's
economic health and the stability of our financial institutions (Edwards 2).

Our government faces numerous challenges in caring for the American
people. Financial resources are not unlimited. Valuable taxpayer dollars can no
longer be wasted on bailing out insolvent institutions when we have a society
plagued with homelessness and starvation. We must learn from the past as we
work to shape tomorrow.


Works Consulted


