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ARTICLES

THE UNITED STATES BANKING SYSTEM

Edward L. Symons, Jr.*

I. INTRODUCTION

The increase in international banking activity over the last several decades has been substantial. This is the result of both the steady increase in international trade and the availability of technology that now makes it easy to transfer money across international borders with little effort and cost. Consequently, there is a heightened interest in the various regulatory environments under which banks operate throughout the world.

The banking model in the United States is noticeably different from the other three models commonly considered. Each system has developed in a different political and social culture. It is evident that economic philosophy is not separate from political philosophy. Rather, they are intertwined, as shown by the history of American political culture.

The colonization of America marked not only a physical but also an intellectual departure from long-standing European traditions. For centuries, European societies had been hierarchical and communal. Power, concentrated in the hands of feudal monarchs and priests, had flowed from the top down, not from the bottom up. Individuals had been regarded as having duties, not as enjoying rights.

In the late sixteenth and early seventeenth centuries, these realities began to change. As European economies grew and a

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“middle class” of merchants and entrepreneurs began to emerge, the ancient authority of “prince and pope” was challenged and in some cases overthrown. Reformation and rebellion swept both England and the Continent. Philosophers such as Thomas Hobbes and, later, John Locke gave intellectual credence to those developments by espousing the doctrine of liberalism, under which the political and social power originated, not with a divinely-chosen rule, but rather with individuals giving their consent to be governed.¹

This latter concept of consent was particularly popular among the Pilgrims, an English Puritan sect whose members came to Massachusetts in 1620. The Pilgrims had already defied the authority of the English Crown and, as a result, had to seek sanctuary in Holland. There, their liberal inclinations had only been reinforced by the political predilections of their Dutch hosts who in the late sixteenth century had rebelled against imperial Spain and who had subsequently established a constitution which gave substantial authority to individual states and citizens.²

The Pilgrims’ first political act in the New World was, notably, to sign the Mayflower Compact, an agreement whereby the colonists declared their intent to “covenant and combine ourselves into a civil body politic” and “enact . . . such equal and just laws . . . as shall be thought most meet and convenient . . . .”³ This Compact marked the beginning of an American liberal, individualist politics that, just over a century and a half later, would bear ripe fruit in the two documents — The Declaration of Independence and the Constitution (including the Bill of Rights) — that to this day continue to define the liberal framework of American political and economic life.⁴

These initiatives suggest the historical, political, and economic spirit of individualism in the midst of democracy in the United States — the spirit of an individualistic, free enterprise culture. Americans insisted on enjoying political and economic

². For a first-hand contemporary account of the Pilgrims’ sojourn in Holland, see WILLIAM BRADFORD, THE HISTORY OF PLYMOUTH COLONY (1948).
³. Id. at 100.
freedoms that in England had never been given more than lip service. This is important in understanding the diverse and numerous groups of financial institutions and regulatory agencies found in the United States.

The differences in the United States banking system are most notable in terms of the separation of banking from commerce generally, the separation of banking from non-banking financial services, the implementation of a multi-faceted supervisory structure, and the use of the Federal Deposit Insurance Corporation (FDIC) as a safety net. As the financial services world has generally moved in the direction of greater liberalization in all of these areas, the banking model of the United States has become more and more distinctive. The reasons for the differences between the United States and the other banking models are caused not only by historical and cultural factors, but also by the current power to stymie change of political interest groups that have grown out of these historical and cultural factors. Without recognition of both historical and cultural factors, and the related existing interest groups, it is impossible to understand various aspects of the United States banking model, such as the multiplicity of regulators, the multiplicity of institutions, the various geographic and activity restraints, and the separation of various types of financial institutions.

At least in the United States, the concept of the business of banking historically has been defined as three basic activities: deposit taking, credit granting, and credit exchange. As the American economy matured, bankers naturally sought to engage in a broader range of both financial and commercial activities. Only a few additional activities, such as fiduciary and trust powers, were permitted to banks by statute. Most broader activities, as well as geographic expansion, were not permitted. As a consequence, bank affiliation and bank holding company (BHC) structures steadily evolved so that banks could both expand over a greater geographic area and engage in a broader range of activities prohibited to banks themselves.

To limit geographic expansion over the 2,500 mile breadth of the United States, and the affiliation of general business activities with commercial banks and the business of banking, the United States Congress passed a variety of legislation. In particular, it passed the Banking Act of 1933, often referred to as the
Glass-Steagall Act,⁵ which requires substantial separation of commercial from investment banking. In 1956 it passed the Bank Holding Company Act (BHCA), which permits BHC subsidiaries to engage only in certain financial, but not commercial, activities that are closely related to banking.⁶

Today, the United States has a complex system for the supervision of banks. First, there are the three federal banking agencies: the Federal Reserve System, the Comptroller of the Currency, and the FDIC. Second, there are the fifty state banking departments. Finally, there are a variety of other federal regulators affecting the operation of banks, such as the Securities and Exchange Commission (SEC).

This complexity certainly carries a price. It is a common statement that United States banks are losing market shares and that, in general, they are falling apart. However, while much has changed, American banks have done a good job of holding their own. While large corporations have switched from bank loans to the commercial paper markets to fund their activities, this has not resulted in any loss to the American economy. At the same time, banks have steadily turned to more fee-based income and have thus captured different portions of the broader financial services market. Finally, in terms of return on assets and return on equity, American banks compare favorably to banks located in other countries.

Nevertheless, the United States has much to consider with respect to its banking system. Areas of particular interest include interstate banking, the expansion of retail community banking powers, such as mutual fund and insurance agency activities, and more emphasis on competition regulation rather than on what is commonly called “micro-regulation.”

II. THE EARLY HISTORY OF BANKING IN THE UNITED STATES

The early history of banking in the United States involved banks formed pursuant to corporate charters individually authorized by the state legislatures, as well as unincorporated, private banks. As the early economy of the United States evolved,

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bank and corporate charters were sought for a variety of purposes, particularly to benefit agriculture, industrial, and public improvements such as canals, roads, and waterworks. The mixture of banking and commerce in many of these incorporated entities did not originate in the United States. It was reminiscent of much of the economic activity in Europe. As a consequence, banking enterprises became heavily involved in many commercial undertakings, and it was a common experience that the combination was not successful. For example, if a canal venture was a business failure, so much of the bank’s assets were lost in the venture that the bank could not redeem its notes, and thus it could not function as a bank. In a sense, what was occurring was a type of investment banking, and this mixing of banking and commercial activities was not viewed as unusual in the United States. Overall, the idea of uniting banking and business appeared to survive until the passage of the Free Banking Law in New York in 1838.

State legislatures in the early 1800s steadily increased the number of banks. Over the years, this action resulted in the granting of so many individual charters that American banking eventually became much like it is today, a system generally committed to the “free” chartering of banks and free competition among the banks, but eventually limited to traditional banking activities.

Many early banking charters simply granted the “usual” banking powers without further definition. Apparently, everyone knew what a bank did, for there had been numerous unincorporated private banks prior to banks receiving corporate charters. But banks, like other profit motivated enterprises, often sought to do more. The eventual response was to grant charters with a more complete and limiting definition of the business of banking to deposit taking, credit granting, and credit exchange. Partly, this was based on a belief that banks were important both to the success of enterprise and to the functioning of the economy. In order to assume these two roles, it was determined that banks should be provided with powers that enabled them to assist in the functioning of the economy and in serving enterprise, but which prevented them from becoming so involved in enterprise

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8. Id. at 337.
that their stability would by compromised.

The first incorporated bank in the United States was the Bank of North America, incorporated by the Continental Congress in 1781 and reincorporated in Pennsylvania by an act of the Pennsylvania Assembly in 1782 because of doubts as to the validity of the original charter. The bank was viewed largely as a government agency but it was also given power to receive deposits and to make private loans. Agricultural interests, which were much opposed to the Bank of North America, forced the repeal of its charter in 1785, and substantially limited the powers granted in its 1787 re-charter. The re-charter expressly prohibited the bank, viewed as a creature of the central government, from trading in merchandise and from owning more real estate than was necessary for its place of business or for loan collateral.

The First Bank of the United States was chartered in 1791. Its charter was prepared by Alexander Hamilton and patterned after the charter of the Bank of England. The charter was unusual in that it was much more detailed and restrictive than the early bank charters granted by the states. Similar to the charter of the Bank of North America, the Bank of the United States was expressly forbidden from dealing or trading in commodities or goods.

The creation of the First Bank of the United States reflected the continuing concern of agrarian interests with respect to the Bank of North America. A fundamental debate over the bank ensued between Alexander Hamilton and Thomas Jefferson. Jefferson reflected a major cultural theme of the United States by expressing his fear of concentrated power in any form. He instead wanted a weak government that would leave people free to their own devices and free from governmental intrusion. The First Bank of the United States became a powerful competitor of the exiting state-chartered banks. By the time its charter expired in 1811, it had acquired many of the functions of a central bank. It made substantial loans to both private business and the government. It circulated notes that became an important uniform currency. All of these successful activities were sig-

9. Id. at 50-51.
10. Id. at 128.
11. Id. at 129.
significant in preventing the bank from being re-chartered because it was such a powerful competitor of the privately owned, state-chartered banks. The combination of the substantial number of state-chartered banks and the cultural fear of concentration of power caused the bank not to be re-chartered, but rather to expire in 1811.13

A variety of economic problems occurred during and subsequent to the War of 1812, and as a result the Second Bank of the United States was chartered in 1816.14 In addition to the problems that had plagued the First Bank, the Second Bank suffered from mismanagement, which ranged from poor judgment to fraud. The concerns we have today with loans to insiders and affiliates were also serious abuses in the Second Bank of the United States. As with the First Bank, the Second Bank of the United States developed many of the values of a central bank, including creating a more stable currency and causing state-chartered banks to maintain adequate reserves. Thus, in effect, the Second Bank played a de facto regulatory role on a nationwide basis. One could say that these activities of the Second Bank, which limited absolute freedom of bank entrepreneurs, were a major aspect of its downfall. It was as true then as it is today that a pure laissez-faire approach guarantees trouble, and that regulation is necessary to protect fundamental interests of society and the existence of competition. While Congress passed the re-charter of the Second Bank in early 1832, the bill was vetoed by President Jackson.

A. Free Banking

The demise of the Bank of the United States forecasted a new era of growth for state-chartered banks. Some lessons had been learned by previous state bank misadventures. Both states and financial institutions attempted to protect depositors by restricting bank activities. Eventually, the substantial banking activity in the states caused the development of free banking, which resulted in easy entry. It permitted incorporation of a bank by any group without the need for a special legislative act.

The New York Free Banking Act of 1838 later became a principal source for the provisions of the National Bank Act in 1864 and for the banking laws of other states. It contained some

13. Hammond, supra note 7, at 199, 206, 212-16.
evolving banking provisions which were to become increasingly important and historically relevant, such as provisions requiring bank reports, examinations, and reserves.\textsuperscript{15} The grant of banking powers in the Free Banking Act was not a source of controversy. It was assumed that everyone knew what was meant by banking — the traditional core banking functions of deposit taking, credit granting, and credit exchange. The limited scope of activities was consistent with the cultural suspicion of concentration of economic and political power in the United States. By limiting the scope of bank economic activity, greater economic and, therefore, political freedom would be protected.

\textbf{B. The National Bank Act}

The National Bank Act (originally titled the National Currency Act) was passed in 1864.\textsuperscript{16} As a part of Congress's attempt to create a market for federal bonds to finance the Civil War,\textsuperscript{17} the primary purpose of the Act was to establish banking as a federal function. The National Bank Act also furthered other federal concerns, such as the development of a uniform national currency and a federal depository system for government funds. The language of the Act was principally drawn from the New York State Banking Act and was supplemented by material from the banking acts of several other states. With this Act came the creation of the Office of the Comptroller of the Currency, which is to this day the primary regulator of nationally chartered banks.

Rather than forming one bank that could operate on a national scale — as was true with the First and Second Banks of the United States — the National Bank Act codified a free banking issuance of charters through federal law rather than state law. It also built on the experience of the state free banking laws by including several important provisions: (1) a requirement of reserves against deposits;\textsuperscript{18} (2) limitations on the ability of national banks to own real estate;\textsuperscript{19} (3) capital requirements;\textsuperscript{20}

\begin{itemize}
\item \textsuperscript{15} Edward L. Symons, Jr., The "Business of Banking" in Historical Perspective, 51 Geo. Wash. L. Rev. 676, 689-92 (1983).
\item \textsuperscript{17} Symons, supra note 15, at 689-701.
\item \textsuperscript{18} Hammond, supra note 7, at 731-32.
\item \textsuperscript{19} 12 U.S.C. § 29 (1988).
\item \textsuperscript{20} 12 U.S.C. § 51 (1988).
\end{itemize}
and, (4) restrictions on loans to a single borrower.\textsuperscript{21}

The National Bank Act, along with the creation of the Office of the Comptroller of the Currency, provided for many advances in bank regulation. It established a central agency to develop expertise in examining and supervising banks, and it required worthwhile reports of condition. Also, concepts such as capital adequacy and restrictions on loans to a single borrower became integral parts of both the state and federal bank regulatory systems.

C. The Dual Banking System

One of the expectations of the National Bank Act was that it would displace or destroy the state-chartered banks. For a variety of reasons, but principally because of the development of true deposit banking or checking account activity, this displacement did not occur. Rather, a dual banking system was created — a system in which banking institutions could be chartered by either a state government or the federal government.\textsuperscript{22} The strength of this dual banking system can be seen today, both in the existence of the fifty state banking departments and in the fact that several federal laws defer to the states for purposes of bank regulation and general bank corporation law. A few examples of bank regulation deference are branch banking\textsuperscript{23} and trust and fiduciary powers.\textsuperscript{24} Somewhat similar deference to state law is reflected in the BHCA, largely with respect to BHC geographic expansion powers.\textsuperscript{25}

By the same token, the laws of many states today have what are known as wild card statutes, which defer to federal law. Wild card statutes provide that state-chartered banks have all powers granted to national banks by federal law.

Today there is substantial overlap between the state and federal regulatory systems. The overlap first began with the Federal Reserve Act in 1913, wherein state-chartered banks that became members of the Federal Reserve System were subject to federal regulation. A more significant overlap occurred with the passage of the Federal Deposit Insurance Corporation Act in

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\item 22. Symons & White, supra note 12, at 23-24, 64-65.
\end{itemize}
1933, resulting in the situation today whereby virtually all state-chartered banks have FDIC insurance. As such, they are subject to federal regulatory supervision by the FDIC. The Banking Act of 1933, particularly the Glass-Steagall Act, represented the first federal act that covered all banks, whether state or federally chartered. It expressly prohibited any banking institution from engaging in both deposit taking and investment banking. The scope of federal regulation was further increased in 1980 when the Depository Institutions Deregulation Act required all depository institutions to hold some reserves with the Federal Reserve, either directly or indirectly.

As a consequence, the current dual banking system consists of two interrelated regulatory systems rather than two independent regulatory systems. Whether a bank has a state or national charter, and whether the bank is or is not a member of the Federal Reserve, will determine the varying degrees of state and federal regulation to which the bank will be subject.

D. The Federal Reserve System

Problems with the inelasticity in the money supply and other defects in the banking system came to a head in the panic of 1907. Development of a central bank was viewed as a necessary step to stabilize the banking system. Visions of a central bank were controversial for most of the same reasons raised almost a century before in the Jacksonian era and during the termination of the Second Bank. The idea of a powerful central bank once again aroused agrarian objections. In response to many of these problems, greater government participation in the proposed central bank system was provided, and twelve regional federal reserve banks were established. The purpose of the Act was to provide an elastic currency, to afford means of rediscounting commercial paper, and to provide better supervision of banking. During the 1920s, the Federal Reserve was unable to control the large number of bank failures. While membership in the Federal Reserve continued to grow during the 1920s, numerous small, weak banks, still wary of the Federal Reserve System, refused to become members.

Today, the Federal Reserve has substantial regulatory au-

authority. One of its major functions is to formulate and implement monetary policy. The Federal Reserve System also engages in some regulation and supervision of banking institutions. The Board has primary federal supervisory and examination responsibility for state-chartered banks that are members of the System. In addition, the Federal Reserve has primary supervisory responsibility for BHCs and their non-bank subsidiaries.

III. THE GREAT DEPRESSION AND THE FEDERAL DEPOSIT INSURANCE CORPORATION

The Great Depression, which began in the early 1930s, presented the banking system with its most difficult challenge. The banking and securities regulatory structure that emerged from the Depression bore little resemblance to the relatively unregulated system known in 1929. Congressional reaction to the Depression established the pervasive government regulation that now typifies the nation’s financial structure, and much of the remainder of the history of bank regulation has concerned the effects of the decisions made during the Depression era.28

In summary, the significant aspects of the Banking Act of 1933 were as follows: (1) for the first time, the United States created a pervasive program of federal deposit insurance in an attempt to preclude bank runs by reassuring depositors that their “grocery money” would be safe; (2) the Act prohibited the payment of interest on demand deposits (checking accounts); (3) the Act required the separation of securities activities and affiliates from commercial banks (the Glass-Steagall Act); and, (4) the Act began the regulation of BHCs by limiting the ability of holding companies to vote their stock in subsidiary banks.29

The purposes of the FDIC have remained largely constant since 1933: to maintain confidence in the banking system, protect bank depositors, and promote safe and sound banking practices.30 These purposes can be summarized as two: (1) the protection of the funds of small depositors; and, (2) the stability of, and public confidence in, the general banking system. Obviously, the second purpose is also a substantial responsibility of the

Federal Reserve System as the lender of last resort.

As well as insuring deposits of virtually every chartered bank in the United States, the FDIC is the primary federal regulator for the approximately 8,000 state-chartered banks that are not members of the Federal Reserve System. Also, the FDIC has the power to engage a variety of means of aiding faltering banks. Finally, the FDIC acts as receiver for all failed national banks and has the power to act as receiver for failed state-chartered, FDIC-insured banks.

With a strengthened Federal Reserve System, a new FDIC, and an already powerful Comptroller of the Currency, the banking structure evolved from the Depression with a federal regulatory scheme designed to control as many banks as possible without eliminating the state banking system. State-chartered banks were subject to Federal Reserve regulations if they joined that system, or FDIC control if they wished merely to have the safety of federal insurance. These three agencies, assisted by several federal agencies that supervise or regulate other financial institutions, constitute the bulwark of federal banking regulation today. Obviously, since a bank may be subject to more than one of these regulatory bodies, a degree of cooperation and unified rulings are essential to their success. The degree of diversity in regulation, as well as function, of these agencies, therefore, must be kept in mind to determine whether the system that has emerged from United States banking history is one that should be perpetuated.

IV. MODERN TRENDS IN BANKING

A. The Bank Holding Company Act

The passage of the BHCA in 1956 was driven by two concerns: (1) geographic expansion through affiliated banks; and, (2) the affiliation of banks with commercial enterprise. Subsequent to the Banking Act of 1933, two developments took place involving the affiliation of individual banks with various financial and non-financial activities.

One development was the formation of BHCs, designed to permit a bank to affiliate with other banks outside its normal geographic territory. This development enabled banks, through the holding company structure, to avoid the rules against the branching of a single bank, whether in-state or interstate, by creating the holding company parent and then opening addi-
tional subsidiary banks which technically are not branches of each other.

The holding company format also enabled banks to affiliate with non-banking activities (e.g., insurance, farming, and manufacturing) that might otherwise have been prohibited as activities outside the business of banking.

Both of these developments caused concern. One concern was that ownership of several banks by a single BHC could create an undue concentration of banking resources. The second concern was that the ownership by a BHC of non-bank enterprises could create undue connections between banks and other businesses. As a consequence, the BHCA was passed in 1956 to regulate the concentration and geographic expansion of BHCs owning two or more banks and their affiliation with non-banking, and particularly non-financial, activities. In 1970, the BHCA was amended to include BHCs owning only one bank.

B. International Banking

Historically, as the activities of the businesses that banks serve have expanded beyond the boundaries of the United States, so have the activities of the banks, as they strive to continue to provide all possible banking services to their corporate customers.

National banks and state-chartered banks that are members of the Federal Reserve may create a foreign branch of the bank with the approval of the Federal Reserve. Thus, such banks may do business as a bank and be regulated as a bank in a foreign country. Foreign banking activity of state-chartered, non-member banks is virtually nonexistent. A second permissible form of international banking is for a United States bank or BHC to own a bank that is separately incorporated in a foreign country.

It is well understood that in many foreign countries banks are permitted to offer a broader variety of financial services than are banks in the United States. These activities sometimes are termed "merchant banking" and involve the provision of investment banking, and insurance and export financial services, including the power to take title to goods being exported or imported. As a consequence of these concerns, Congress passed the Export Trading Companies Act in 1982. A significant provision

of the Act enables banks incorporated in the United States to engage in various forms of "merchant banking" in their international trade financing activities. However, few export trading companies have been created.

A more popular approach to international banking has been what is known as the Edge Act corporation, which is a domestic subsidiary or affiliate of a United States bank engaged in international banking and finance, including those activities which take place in the United States.\textsuperscript{32} Such a corporation may have branches and subsidiaries both in foreign countries and in other states in the United States that the BHC might not be able to branch into otherwise.

Entry of foreign banks into the United States is comparatively recent, and so the concern over their regulation also is more recent. The basic legislation in this area is the International Banking Act of 1978.\textsuperscript{33} Generally, the International Banking Act provides the following: (1) restriction on interstate deposit taking activities by foreign banks; (2) application of Federal Reserve requirements to foreign branches and agencies; (3) requirement of deposit insurance for branches of foreign banks doing a retail business; (4) application of the non-bank activity restrictions of the BHCA to foreign banks that operate branches or agencies; and, (5) availability of Federal Reserve discount window access to foreign bank agencies and branches.\textsuperscript{34} The Act generally made substantial strides toward national treatment of foreign banks operating in the United States, providing approximately equally competitive positions for foreign banks, as compared to United States banks, with respect to their United States operations.

C. The Federal Financial Institutions Examination Council

From an examination of the history of the American banking system, it is evident that there is a diverse and frequently overlapping group of regulators. As a consequence, there has been a gradual movement to simplify the regulatory system and reduce the number of regulators.

A first step along this uncertain road was the establishment of the Federal Financial Institutions Examination Council in 1978. Its purpose is to attempt to make consistent among the various federal regulatory agencies the regulations and standards for examination of financial institutions, so that any regulator looking at a particular financial institution would apply the same standards and reach the same conclusions regarding the safety and soundness of the institution as would any other regulator. The Examination Council was given only an advisory role but its work has had some effect on the separate regulators.

V. SUMMARY OF BANKING STRUCTURE SINCE 1980

A. Legislation

In 1980, banking legislation in the United States took on a different tone from that of the 1930s legislation — a tone of deregulation. In that year, Congress began the process of lifting the limit on interest rates that financial institutions could pay and allowed savings associations to make a limited amount of both consumer loans and investments in commercial real estate. At the same time, Congress raised the ceiling on federal deposit insurance from 40,000 dollars to 100,000 dollars per account, which is even today probably the highest government deposit insurance in the world.\(^{35}\)

In 1982, Congress passed a further deregulation statute, the Garn-St. Germain Depository Institutions Act, in which Congress removed additional barriers among the various types of financial institutions.\(^{36}\) Under that Act, savings associations were given bank-like loan powers. All depository institutions were given the power to offer money market deposit accounts, which are not limited as to interest rate payable by the institution, are not subject to reserve requirements, and may be coupled with a checking account in order to make third-party payments. Through such a coupling, banks were permitted to compete effectively with the money market mutual funds offered by securities firms.

Savings associations suffered large losses in the mid-1980s and began to fail by the hundreds. Congressional legislation then


began to take on a different tone — one of increased regulatory authority, rather than deregulation. In 1987, Congress concluded that the savings association problem could be solved for approximately ten billion dollars and passed the Competitive Equality Banking Act of 1987 (CEBA). While the Act in part sought to create more competitive equality among banks and savings associations, the legislation also put a moratorium on various deregulation efforts. The primary objective of CEBA was to provide a period of regrouping without substantial changes in powers, and to replenish the financial resources of the then existing Federal Savings and Loan Insurance Corporation (FSLIC). The legislation suggested that Congress faced great uncertainty in trying to reconcile questions of deregulation of bank powers and geographic expansion with the increasing concern over the safety and soundness of the banks and thrift institutions. The Act was ineffective. Thrift institutions and bank failures continued to grow and the FSLIC did not have sufficient funds to support the losses suffered by the thrift institutions.

As a consequence, in 1989, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA). The legislation totally reorganized the supervisory structure and powers of the thrift institutions, placed the thrift insurance fund under the administration of the FDIC, and gave the FDIC significantly enhanced regulatory enforcement powers. The Act may increase the likelihood of consolidation of the depository institutions industry, not only due to the closing of numerous failed thrifts, but also due to the authorization which enables BHCs to acquire savings and loan associations. FIRREA also created the Office of Thrift Supervision, under the Secretary of the Treasury, with the same degree of autonomy as the Comptroller of the Currency. This new entity now has principal authority for the examination, operation, and regulation of federal savings associations. Overall, the Act was the most important piece of legislation concerning America's financial institutions since the 1930s.

The driving force behind the legislation was the funding of the deposit insurance costs of the failed thrifts. In brief, the ini-

tial authorized cost was fifty billion dollars. The expected cost to
the United States taxpayers has been hotly debated, and has
been estimated to be as much as five-hundred billion dollars, in-
cluding interest costs.

In 1991, Congress passed the FDIC Improvements Act.\textsuperscript{40} This Act again increased supervisory powers and attempted to
reform the structure and cost of the insurance system. The legis-
lation required the early closing of institutions whose tangible
equity capital drops below two percent of assets, effectively
redefining when a depository institution becomes insolvent.\textsuperscript{41} It
also strengthened the idea that failed institution resolution
should occur on a least-cost basis. Nevertheless, the real force
behind the legislation was the necessity of providing the Bank
Insurance Fund with additional financial resources. The FDIC
borrowing authority from the United States Treasury was in-
creased from three billion to thirty billion dollars.\textsuperscript{42}

Yet another way the legislation attempted to reduce the
cost of failed institutions was to limit fully secured discount win-
don loans by the Federal Reserve, the long-term use of which
was thought to allow uninsured depositors time to leave an insti-
tution, thus increasing the cost of failure to the deposit insur-
ance funds. The Act also limited the ability of institutions to
accept brokered deposits, another area that is believed to have
contributed to losses in failed thrift institutions.

When all is considered, however, Congress has yet to deal
systemically with restructuring the bank regulatory system to be
consistent with the various historic policies of safety and sound-
ness, public confidence, economic neutrality, efficiency, and ac-
ceptable levels of bank concentration.

B. Regulatory Enforcement Powers

A final aspect of the current banking model in the United
States is the supervisory enforcement powers of the bank regu-
lators. As banks and BHCs have steadily received expanded pow-
ers through both legislation and decisions by courts and admin-
istrative agencies, and so have been exposed to additional risk in

\textsuperscript{40} The Federal Deposit Insurance Corporation Improvements Act of 1991, Pub. L.
the eyes of the regulators, the supervisory enforcement activities of the regulators have increased. Congress has agreed with the need for additional supervisory enforcement, as it has provided the regulators with a steadily increasing array of supervisory enforcement powers. The most important powers are the following: (1) cease and desist and temporary cease and desist orders; (2) temporary suspension and permanent removal of officers, directors, and other institution affiliated persons; (3) civil money penalty orders; and, (4) capital directives. 43

Permanent cease and desist orders may be issued to stop unsafe or unsound practices, to stop violations of law, rule, regulation, or conditions imposed in connection with applications, and to stop violations of written agreements between the bank and the regulator. 44 A permanent order may be issued only where a violation or practice has been established in an administrative hearing. The grounds for permanent cease and desist orders are only somewhat different from the grounds for temporary cease and desist orders.

Temporary cease and desist orders may be issued immediately, without an administrative hearing first having taken place. 45 For a temporary cease and desist order to be issued, the violation or threatened violation, or the unsafe or unsound banking practice specified in the notice of charges, must be likely to cause a significant dissipation of assets, or of the condition of the bank, or seriously prejudice the interest of depositors. In theory, such orders are designed to address critical threats to an institution and, therefore, allow an exception from normal United States adjudicatory procedures that provide for due process. In fact, it appears that the current law effectively authorizes the agencies to accompany virtually every notice of charges for a permanent cease and desist order with an immediate temporary cease and desist order.

The procedure for suspension or removal of officers, directors, and other persons affiliated with banks and BHCs is somewhat complicated and involves more difficult proof than that required for a cease and desist order. Persons may be removed both for conduct in the bank and for prior conduct at another bank or business. The regulator must prove the following: (1) a

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violation of a statute or regulation, an unsafe or unsound banking practice, or a breach of fiduciary duty; (2) some loss or prejudice to the bank or its depositors or some financial gain to the individual (which enables a removal action to proceed without having either to quantify the loss or to prove substantial loss or serious prejudice); and, (3) the violation, practice, or breach either involves personal dishonesty, or demonstrates willful or continuing disregard for the safety or soundness of the bank.\textsuperscript{46}

Interim suspensions can also be ordered. The proof is virtually the same except that the temporary suspension must be thought to be "necessary for the protection of the"\textsuperscript{47} institution or its depositors. It is not at all clear that the additional requirement really adds anything to the burden of proof of the agency. It is possible for an attorney or accountant to be suspended or removed as an affiliated person, and the power can even apply to an entire law firm or accounting firm. Finally, it is important to note that any suspension or removal of an officer or other person from one institution automatically bars that person from further activity with respect to all other insured depository institutions in the United States.\textsuperscript{48}

The most dramatic changes made by FIRREA with respect to supervisory enforcement powers concern the civil money penalty provisions.\textsuperscript{49} There now are three tiers of violations. A first tier violation involves a violation of any law or regulation, any final or temporary regulatory order or condition, or any written agreement. A person acting in the utmost good faith can violate this first tier standard. A second tier violation requires a first tier violation or reckless engagement in an unsafe or unsound practice or breaching a fiduciary duty, plus having such violation, practice or breach being part of a pattern of misconduct, or causing more than minimal loss to the institution, or resulting in pecuniary gain to the individual. Therefore, in a second tier violation there is some modest scienter requirement. The third tier violation includes a second tier violation in the sense of a violation, practice or breach, plus the individual knowingly or recklessly causing a substantial loss or receiving a substantial gain.

Penalties are usually assessed against an individual rather

than against a bank, in order to get directly to the root of the problem and to penalize the cause of the violation — the individual — rather than the victims — the bank, its depositors, and its shareholders. A typical basis for a civil money penalty is a violation of the various bank lending limits, such as making loans to insiders and affiliates. The amount of the civil money penalty can be substantial. While the first tier penalties are for minor violations, a violator may be liable for a penalty of up to 5,000 dollars per day. Second tier penalties can be as much as 25,000 dollars per day, and third tier penalties can be as high as one million dollars per day.

A final important aspect of regulatory supervision powers is the capital directive. The banking agencies are given the authority to establish minimum levels of capital and to issue “directives” enforceable in a federal district court in the manner that cease and desist orders are enforced. Under the banking agency regulations, the agency notifies the bank of the agency’s intent to issue a directive. The notice includes the amount or ratio to be required, as well as the proposed deadline. The bank has an opportunity to respond in writing if it does not consent to the proposed directive. Following consideration of the bank’s response, if any, the agency may issue a directive or require the bank to submit an acceptable plan of its own. Once the directive is final, any subsequent violation is enforceable just as a final cease and desist order is enforceable, without any further due process hearing.

C. Summary of Current Structure and Scope of Powers in the United States Banking Model

There are two general chartering authorities for banking institutions — the state and federal governments. Thus, we have state-chartered banks and federally-chartered banks. A state-chartered bank is primarily regulated by each state’s department of banking. A national bank is primarily regulated by the Office of the Comptroller of the Currency (OCC).

After this initial, simple outline, matters become more complicated. All national banks must be members of the Federal Reserve System and must be insured by the FDIC. Consequently,

they are subject to some regulation by both agencies in addition to the OCC. In order to compete with national banks for deposit funds, virtually all state-chartered banks also are insured by the FDIC and, thus, are subject to both that agency’s regulations and their state banking department’s regulations. Some state-chartered banks are members of the Federal Reserve System and, therefore, are also regulated by the Federal Reserve. Consequently, one can say that we have three types of banking institutions: (1) national banks; (2) state-chartered member banks; and, (3) state-chartered non-member banks.

The complications can be even greater. For example, suppose that there is a state-chartered, non-member bank and a national bank owned by the same BHC. The state-chartered bank is regulated by both the state banking department and the FDIC. The national bank is primarily regulated by the OCC. The holding company and its non-bank subsidiaries are subject to the regulation of the Federal Reserve Board under the BHCA. In addition, there is the regulatory authority of the SEC over certain financial institution activities, particularly the issuance of securities by the parent BHC.

If one were writing on a clean slate, it is doubtful that such a regulatory structure would be designed. Nevertheless, each element of the regulatory structure has come about at least partly because of historically felt needs of American society responded to by Congress in the evolution of the American banking system since the eighteenth century.

The United States appears to stand alone as the only nation that does not have a system of nationwide banking. While the ability to engage in something approximating nationwide banking has improved significantly in the last decade, the topic remains a major concern. It is evident that the combination of economic problems in banking (with the resulting legislative changes) and electronic capabilities have significantly changed the way banks conduct business and the limitations on their geographic expansion. Various loopholes, qualifications, and statutory exceptions have been created, with the result that the current interpretation of the law appears to reflect neither the traditional underlying policies of geographic limitation nor the modern reality of technology and international banking. In fact, the irony is that the largest banks have managed to bob and

weave through the supposedly restrictive laws governing geographic expansion to reach national markets in a substantial way — the large banks that the laws were designed to restrain, in fact, have been most successful in avoiding them. As a consequence, it appears that Congress will have to face the issue of developing a more rational system of nationwide banking.

The United States also stands almost alone as the only country which extensively limits the financial products and services that a bank may offer or be affiliated with. This issue arises both in the policy of separating banking and non-banking financial services and in the policy of separating banking and commerce.

Because of these limitations, the BHC structure is essentially unique to the United States. It is a structure wherein a holding company controls the stock of one or more commercial banks as well as the stock of other, non-banking entities that engage in businesses “closely related to banking.” While the BHC structure has been rather successful as a vehicle to avoid geographic limitations, it has been less successful as a vehicle to enable banks to affiliate with a broader scope of permissible activities. Nevertheless, BHCs clearly have the power to engage in a variety of financial-related services, such as mortgage banking, personal property and real estate leasing, data processing, courier services related to banking activities, some management consulting activities, a limited range of insurance underwriting with respect to credit life, accident and health insurance, and a rather extensive array of securities activities. Consequently, unlike many holding companies found outside the United States, United States BHCs may not be used to link banking and commerce. Rather, they may be used as a cumbersome means to integrate various financial services.

In the United States, a unique bank regulatory structure is equally evident as compared to those of other countries. In virtually all other countries, one authority regulates banking, securities, and insurance activities. Again, there are cultural and historical reasons for the differences. For the historical reasons previously discussed, the United States has about 12,000 commercial banks. By contrast, in other countries fewer financial institutions exist, and so supervisory relationships can be more informal.

While other countries have some areas of regulatory overlap, the United States is probably unmatched in this area. There has
been extreme resistance to changing the regulatory structure. Many of the state-chartered, non-member banks prefer the ready access they have to the state banking departments. There also is a belief in the United States that a multifaceted regulatory system safeguards against unyielding, unchanging, excessive regulation. Historically, the system has permitted banks to change regulators if one agency is viewed as excessively burdensome in its regulatory approach or if the statutory authority for the banking institution is viewed as too restrictive. A third arguable value of the multifaceted United States regulatory structure is the related concept of competition. At various times one regulator has displayed a greater willingness to change, with the result being that the different approach of another regulator has turned out to be valuable and subsequently adopted by other bank agencies. Finally, and related to the initial value of access, is the view that the multifaceted regulatory structure is consistent with the evolution of an American political system divided into a pluralist number of interest groups whose public debate is ultimately conducive to the public interest. Historically, it can be argued that such a methodology has yielded results not sought by any of the various constituencies, but results that have well served the public interest.

While virtually all nations have some form of deposit insurance, it is probable that the United States deposit insurance system is the one in which the government plays the largest role. Again there may be cultural reasons for this phenomenon. In the majority of countries that have relatively few banks, informal government oversight of banks may be more persuasive in causing the private sector to play a larger role in supporting and resolving troubled and failed banks. Also, the idea of individualism often causes American institutions, as well as individuals, not to cooperate with the suggestions of government authority. As a consequence, in the United States the deposit insurance scheme is largely government operated. The federal insurance scheme guarantees up to 100,000 dollars without any risk to the depositor. The system historically has been funded by annual premiums charged to banks. The premium rate has increased significantly in the last several years to where it is approaching an annual rate of between 0.23 percent and 0.31 percent of in-

sured deposits.

The rest of the safety and soundness regulatory scheme in the United States is similar to that in other nations. It appears that the driving concern which caused intervention is primarily about systemic risk — risk to the bank credit and payments system as a whole.

A brief summary of current bank and BHC powers completes the historical discussion of the United States banking model. The historical articulation of the power to engage in the business of banking permits banks to engage in deposit taking, credit ranging, and credit exchange.\textsuperscript{5} Today these activities take numerous permissible forms, limited on a public policy basis by the principles of safety and soundness, economic neutrality in the allocation of credit, and economic concentration. Even activities within the business of banking may be limited so that the exercise of the power does not violate these underlying principles.

For example, the deposit taking power is limited with respect to brokered deposits.\textsuperscript{6} The credit granting power is subject to limits on loans to a single borrower,\textsuperscript{57} on loans to insiders,\textsuperscript{58} and on loans to affiliates.\textsuperscript{59} The credit exchange power is subject to limits on a single customer and on aggregate dollar values of bankers acceptance.\textsuperscript{60}

Banks have additional specific powers, beyond the general business of banking power, expressly granted by statute. If an activity is not within the business of banking, it must be expressly granted by statute to be a bank power. Examples of express powers are loans secured by liens on real estate,\textsuperscript{61} leases of personal property that are not the functional equivalent of loans,\textsuperscript{62} trust and fiduciary powers,\textsuperscript{63} and owning and dealing in investment securities.\textsuperscript{64} Primarily through regulatory interpretation and judicial decision, the scope of these various powers has

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gradually expanded. The most notable areas of expansion have been in the area of securities activities, finance leasing, and credit exchange activities such as interest rate swaps.

BHCs have the power to engage in activities "closely related to banking," as well as various express powers. In theory, the power to engage in activities closely related to banking should be broader than the power to engage in the business of banking. To some extent this is the case, but not to the extent one would expect. Particularly with respect to securities and insurance powers, BHC powers are only marginally greater than bank powers, most notably in the area of corporate equity securities underwriting. On the other hand, BHCs do have broader real estate powers than banks, such as real estate leasing. Finally, BHCs have some express powers, the most interesting of which is the power to own up to five percent of the voting shares (common stock) of any company. As with any other bank or BHC power, this power is subject to the regulatory determination that a particular exercise of the power is an unsafe or unsound practice.

VI. THE CREATION AND THE SHREDDING OF THE UNITED STATES BLUEPRINT FOR BANK POWERS AND REGULATION

The state banking laws and the National Bank Act historically have limited banks to three types of "business of banking" powers — deposit taking, credit granting, and credit exchange. These limitations on powers are based on long-standing United States policies of safety and soundness of the banking system, economic neutrality in the allocation of credit, and limitation of the concentration of economic power.

Beginning in the 1930s, Congress enacted legislation, beyond the National Bank Act and the Federal Reserve Act, to construct additional walls to separate financial institutions. The first wall was the Glass-Steagall wall separating commercial

banking from the securities business. That wall has been under steady attack through both the activities of banks and the activities of bank holding company non-bank subsidiaries. The second wall was the Regulation Q wall, which limited price competition among banks by imposing interest rate ceilings. That wall was eliminated in 1986. A third wall was the McFadden wall, which effectively prohibited interstate banking, particularly when coupled with the Douglas Amendment to the BHCA — which prohibited BHCs from acquiring banks outside their home office state unless the laws of the target state explicitly provide for such entry. This wall, too, has largely fallen, partly because of changes in state laws permitting national or regional interstate banking, partly by the permanent grandfathering of the non-bank banks which, for technical definitional purposes, were not banks under the BHCA (until CEBA in 1987) and so are not limited by the prohibition of the Douglas Amendment, and partly by judicial interpretation.

In a sense, these three walls — the Glass-Steagall wall, the Regulation Q wall, and the McFadden wall — were all developed to support and protect the historic concept of the business of banking: to keep that activity separate from other commercial endeavors; to keep that activity from being part of an unduly concentrated entity; and to maintain public confidence.

As securities companies, in particular, have been able to offer deposit-like products, and as inflation and technology have made such products both attractive and feasible, the historic special protection of the business of banking has been deteriorating. This development has put a strain on what parts of the

70. 12 C.F.R. § 217.7 (1983).
walls do remain, as well as on the profitability of the banking system. Market forces are continuing to surge over and around the various historic protections. The walls have fallen and the blueprint has been shredded largely by judicial and administrative decision, rather than by Congressional restatement of policy. The federal legislative grid lock is evident, other than for necessary funding of the cost of dealing with troubled and failed depository institutions. In general, regulators have been attempting to protect the stability of the banking system — by trying to monitor and control the velocity of change in activities, by trying to increase the capital of banks to protect against unforeseen losses, and by increasing the use of supervisory enforcement powers to discipline both banks and individual directors and officers of banks who go beyond the activities deemed permissible to financial institutions.

A. The Permissible Powers and Affiliations for Banks

Steadily increasing affiliations between institutions with bank charters and securities, insurance, real estate, and other entities have again raised questions about the proper powers and affiliations for banks. The BHCA has always had, as one of its fundamental policies, a provision that banks should be separated from general commercial activities.\(^4\) The history of United States bank regulation suggests that this policy was rather well-established even before the passage of the BHCA. Banks generally have been prohibited from making equity investments in commercial enterprises in the United States.

While it is reasonable to suggest that the policy of separating banking from various financial activities may need reexamination, there is little historical support, and therefore a limited expectation, for this policy to be completely abolished in the United States. The absence of such a separation would most probably lead to a repetition of the early banking experience in the United States, when bank investment in commercial activities caused significant loss of depositors' funds. Even a prohibition of bank participation in such equity investments, if coupled with authorization for general commercial enterprises to control banks, would adversely affect the economic neutrality of banks' credit granting decisions and test any fire walls erected — a reg-

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ulatory approach that historically has failed in times of economic stress.

There is, however, some historical support for changing the scope of the separation of banking from other financial activities. The legislative history of the BHCA of 1956 stated: "Your committee believes that BHCs ought not to manage or control non-banking assets having no close relationship to banking." Based on this statement of policy, the Act then permitted, subject to stated limitations, bank affiliations with subsidiaries that were "of a financial, fiduciary or insurance nature."

There are numerous historical examples of affiliation between banks and other financial activities. One of the primary reasons for the enactment of the National Bank Act was to place banks in the securities business. The federal government needed national banks to distribute its securities to finance the Civil War. The banks purchased and either held or resold those securities. In addition, trust management as a form of securities activity has been closely affiliated with banking at least since shortly after the end of the Civil War. Some banks began their operations as insurance companies. Currently, savings banks in New York and a few other states continue to sell life insurance as they have done for decades.

There are reasons for these affiliations. They do not necessarily undermine the principles of the BHCA with respect to safety and soundness, economic neutrality, and economic concentration. Moreover, there is a fundamental relation among banking, securities, and insurance activities. All involve the taking of some form of deposit. All take large amounts of public financial wealth, either as general deposits, insurance premium deposits or special deposits for investment purposes. All have the provision of money related services as their primary purpose. All serve as an indirect method of consumer loans and investments in other sectors of the economy. All serve as critical points of exchange for financing general commercial enterprises in our economy that should remain economically neutral. All act as allocators of our capital resources to their most efficient use in our economy. The government, therefore, regulates each activity to promote safety and soundness and economic neutrality.

76. See Bank Holding Companies Act of 1956, 70 Stat. 135, 137, § 4(c)(6).
Perhaps because of this historical basis, there has been a gradual broadening of the scope of permissible affiliations of banks to encompass other forms of financial institutions. Thus, affiliations between banking, securities, and insurance entities are becoming more common. All of these activities provide for some form of investment opportunity. To a certain extent, real estate investment has been included within this grouping, most commonly where the real estate activity is a passive investment by the bank rather than where the bank is actively engaging in real estate development.

Generally speaking, the permissible affiliations for banking organizations are regulated by the Federal Reserve for bank holding companies' non-bank subsidiaries, by the FDIC for state-chartered non-member banks that are not part of a holding company, and by the comptroller for national banks. Generally, the FDIC has permitted state-chartered non-member banks to engage, through subsidiaries, in some insurance, securities, data processing, travel agency, and other services, if such activities are permitted by the state where the bank is chartered. There has been an increasing trend of new powers being granted by state legislatures to state banks either directly or through subsidiaries, but Congress has limited this development in its 1991 legislation. The Comptroller of Currency, for national banks, also has approved additional powers for banks and bank subsidiaries, rather than through the holding company structure, particularly with respect to securities activities.

1. Securities Activities

Banking organizations have been most successful in expanding their powers in the area of securities activities. Essentially all of the development has come from favorable federal agency and court decisions. This is so, notwithstanding the general belief that the Banking Act of 1933 in its securities provisions, often called the Glass-Steagall Act, required a complete separation of commercial and investment banking activities. It is evident that federal banking law today does not require com-

plete separation. Instead, for state-chartered, non-member banks, federal law has only constructed a prohibition of commercial and investment banking activities in the same entity. Non-member banks are prohibited from themselves engaging in certain securities activities; however, they are not prohibited from affiliating with such activities. With respect to member banks and BHCs, recent interpretations have permitted banking organizations to include various brokerage, mutual fund, and general underwriting activities, so long as the non-bank affiliated institution is not engaged principally in underwriting. In fact, the securities powers of banking organizations have been expanded to such an extent that it is questionable whether banks feel a continuing need for any additional federal legislation in the area.

One area of particular significance has been the development of section 20 subsidiaries. Section 20 prohibits banks that are members of the Federal Reserve System from being affiliated with any business organization “engaged principally” in investment banking activities. Through a long line of cases tracing back to 1984, banking organizations have gained substantial underwriting powers. The issue of underwriting began with Bankers Trust Company engaging in commercial paper private placement activities with institutional purchasers. The activity was conducted in the bank, and not in the BHC or a non-bank subsidiary. Because of this, the activity was covered by 12 U.S.C. section 24(7), permitting national banks and state-chartered member banks to purchase and sell securities as agent for a customer, and 12 U.S.C. section 378, which prohibits any entity engaged in investment banking from engaging in the business of receiving deposits. The critical element of the initial Bankers Trust litigation was the holding by the Circuit Court for the District of Columbia that the term “underwriting” in the Glass-Steagall Act may apply to agency activities such as the commercial paper activity, but does not apply unless there is a public offering of securities.

In a subsequent development, Bankers Trust transferred its private placement, commercial paper activities to the holding

company. Since the activity could be conducted in the bank, it is evident that it could be conducted in the holding company. The Federal Reserve Board, however, went beyond the basis provided in the Circuit Court's decision and ruled that the activity was also permissible because as an affiliate of a member bank for purposes of Glass-Steagall, the affiliate would not be "engaged principally" in activities prohibited by section 20 — the "underwriting" of securities. In defining what is meant by "engaged principally," the Board utilized a "gross revenue" level of five percent, which has subsequently been raised to ten percent, as a basis for determining that an activity is not substantial. In other words, so long as the securities affiliate's underwriting and dealing activities constitute less than ten percent of its gross revenue, the entity is not violating the Glass-Steagall Act.

Subsequently, Citibank, J.P. Morgan, and Bankers Trust sought to underwrite and deal in a broader range of investment securities, such as mortgage-backed securities, municipal revenue bonds, and consumer receivable-related securities, through wholly-owned non-bank subsidiaries. A critical component of these applications was that they proposed to combine in a single affiliate both "eligible" securities activities such as government securities underwriting and dealing, with underwriting and dealing in ineligible securities. The purpose of including the eligible securities was to generate permissible revenue, causing the ten percent limit to be much higher. In the subsequent appeal, an important interpretation of Glass-Steagall, the Court of Appeals for the Second Circuit concluded that while the original goal behind the Glass-Steagall Act may have been to sever completely the commercial and investment banking industries, "it fell short of this goal — a victim of legislative compromise." Rather, commercial banks were prohibited only from affiliating with investment activities regarded as speculative or risky and that did not include eligible securities — securities in which banks are permitted to deal and underwrite. The court approved the

87. Id. at 58.
Board's general conclusion that a subsidiary would not violate section 20 of Glass-Steagall if no more than five to ten percent of its gross revenues were derived from activities involving bank-ineligible securities.

Since that decision, the range of permissible activities under section 20 has been expanded significantly. Banking organizations have since been allowed to underwrite and deal more generally in corporate debt, and even equity, securities. However, authorization to engage in equity securities underwriting and dealing is subject to individual review and order by the Board. The Board is particularly concerned with equity underwriting activities and so has developed various fire wall restrictions to try to reduce any risk to the affiliated bank and BHC during times of economic stress.

In 1989, the Board approved various applications to engage through the section 20 subsidiary as agent in the private placement of all types of securities, including related advisory services. In addition, the Board has allowed some extension of credit by the affiliated bank to the issuer of the securities and has also permitted some placement of securities with either the parent BHC or another non-bank affiliate. Such activities are, in substance, quite close to firm commitment underwritings and go well beyond agency activities.

In 1990, the Federal Reserve Board authorized three foreign banks that were not subsidiaries of, or themselves, BHCs to establish section 20 subsidiaries. In so doing, the Board necessarily had to approve certain modifications to the fire walls to reflect the fact that most of the applicants' operations were conducted outside the United States and that the applicants' activities would not adversely affect the federal deposit insurance safety net. Under the International Banking Act of 1978, the foreign banks were regarded as BHCs for purposes of Glass-Steagall, and therefore the general limitations on securities activities were applied.88

In the area of investment advice and brokerage, the Board has approved a steadily expanding array of combinations of securities brokerage and investment advice in a single bank affiliate. The critical aspect of the Board's analysis was its determination that the combination of investment advice and brokerage

services does not constitute a "public sale" of securities within the meaning of section 20 of Glass-Steagall. Rather, "public sale" is part of the concept of "underwriting," which is not present in brokerage and investment advice activities. In engaging in these activities, the banking organization affiliate must act solely as an agent, not offer securities to the public as an agent for an issuer, and not make a market in securities with its own funds; instead, it must deal individually with customers when providing investment advice and brokerage. This type of combined activity was initially allowed by the Board for institutional customers, which included individuals with a net worth of one million dollars or greater. Ultimately, the Board has approved the offering of combined investment advice and securities brokerage services to retail customers as well as institutional customers.

In a related development in 1988, the Board approved the application of the Bank of Nova Scotia to acquire a full service brokerage firm located in New York City that would provide financial advice to the Canadian federal and provincial governments.\(^89\) This decision permitted interlocking officers of the bank serving as directors of the brokerage affiliate. In addition to the government work, the affiliate would provide securities brokerage and investment advice to institutional customers.

A third important aspect of banking organizations' securities activities has been mutual funds. As banks are increasingly capable of engaging in mutual fund activities, it is evident that they have a substantial capability to engage in securities activities with their complete retail customer base. While banks are clearly allowed to advise mutual funds, there are Glass-Steagall difficulties involved in banks underwriting and distributing mutual funds. In general, the banking agencies have permitted banks and BHCs, and their non-bank subsidiaries, to provide investment advice to customers regarding the purchase and sale of shares of mutual funds which are advised by a holding company affiliate. Under United States securities laws, the dual roles are required to be disclosed, and the banking organization employees are obligated to advise customers to read the prospectus before investing, as well as to inform customers in writing that the mutual fund shares are not bank obligations insured by the FDIC or in any other way guaranteed by the bank.

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On the whole, banks and BHCs have been exceptionally successful in expanding the range of permissible securities activities. Through various administrative interpretations that have been affirmed by the courts, a broad range of securities activities have been held to be permissible under Glass-Steagall, subject to the regulators’ established limitations for purposes of safety and soundness.

2. Insurance Activities

While banking organization insurance activities have, like securities activities, been the subject of extensive administrative and judicial examination, they also have been the subject of important legislative determinations. Under the original 1956 BHCA, permissible non-banking activities included those of a “financial, fiduciary or insurance nature.” As a consequence, BHCs were allowed to engage in a variety of insurance activities including credit life, accident, and health insurance (insuring the borrower), as well as property and casualty insurance (insuring the collateral).

A significant change occurred when the BHCA was amended in 1982 to specifically provide that “it is not closely related to banking or managing or controlling banks for a BHC to provide insurance as a principal, agent, or broker except . . .” as specifically delineated in seven detailed exemptions, A through G in the statute. Thus, for BHCs, insurance has gone from being considered generally closely related to the business of banking to being considered generally not closely related to banking. The Federal Reserve Board has elaborated the seven exemptions. The resulting regulations have been the subject of much litigation.

Two statutes involve insurance activities of national banks. The level of detail of these statutes is much less than those applicable to BHCs. As a consequence, in more than one

instance the Comptroller of Currency has authorized insurance activities for national banks that the Federal Reserve has denied for BHCs.

One example is the provision of insurance in towns up to a population of 5,000. The issue is governed for national banks by 12 U.S.C. section 92 and for BHCs by 12 U.S.C. section 1843(c)(8)(C). For BHCs the Federal Reserve permits the sale of insurance in towns with a population less than 5,000 if the holding company has a lending subsidiary in the town and the insurance activities are carried out only in that town and the surrounding area.

The Comptroller has long allowed national banks headquartered in large cities to sell insurance in towns of 5,000 or less if the bank has a branch in the small town. In subsequent litigation, it was determined that a national bank, from a town of 5,000, could sell insurance not only in that town but also statewide and nationwide. However, in a case initially decided in February, 1992 it was determined that the relevant statute, 12 U.S.C. section 92, had been repealed by Congress in 1918. The case is still in litigation.

In response to the difficulties that the banking organizations have faced in gaining federal approval of expanded insurance activities, banking organizations have turned to state legislation. Over time, about one-third of the states have authorized a variety of insurance activities for state-chartered banks and their subsidiaries. As a consequence, until 1991 it was possible for financial institutions to engage in broader insurance activities through state banking law than through federal law. The 1991 FDICIA legislation generally prohibits state banks from exercising powers not permissible for national banks, but does grandfather institutions already engaged in the sale of general insurance products and annuities permitted by state law. Also under FDICIA, a Delaware state law designed to permit out-of-state banking organizations to use Delaware chartered state banks for nationwide insurance underwriting and brokerage was preempted with respect to underwriting.

The various complexities and inconsistencies that have de-

veloped since the simple statement in the 1956 BHCA with respect to insurance powers reflect the power of the American insurance industry lobby in Congress. While many of the limits on banking organization securities powers have been dismantled, Congress has consistently increased the limits on banks and BHCs entering into the insurance business, whether through agency or underwriting activities. This has occurred without any apparent policy justification based on the concepts of safety and soundness, economic neutrality, or economic concentration.

As a consequence, banking organization insurance powers are largely a mishmash. While national banks have been allowed to sell a broad range of annuities, the clearest statement of the insurance industry’s lobbying power is that national banks may act as agents for the sale of credit life insurance to their customers in connection with loan transactions. In addition, BHCs have been permitted to engage in a somewhat broader array of insurance activities, but largely covering only credit life, accident, and health insurance.  

VII. GEOGRAPHIC EXPANSION AND ECONOMIC CONCENTRATION

The concentration of economic resources and its perceived effect on political power has been a significant concern in United States bank and BHC regulation. Until the 1980s, limits on economic concentration were an indirect result of limits on geographic expansion. Limits on geographic expansion indirectly limited economic concentration by prohibiting mergers of banks and BHCs in different markets. As the limits on geographic expansion have been relaxed, the issue of economic concentration in banking has begun to be confronted more directly as a policy concern.

Today, most states permit some form of statewide banking and some form of interstate banking through multibank BHCs. While in any particular situation the specific laws of the various states involved must be considered, the focus here is on the policy question and projected legislative action.

In general, banks have sought a more “liberal” system that will permit them to engage in nationwide mergers. Their argument is that in European countries, Japan, and Canada, a relatively small number of banks hold the vast bulk of banking as-

sets and those countries have not suffered from such a structure. Banking history in the United States, of course, has been different. The issue is whether the United States would be better served by a small number of large banks rather than by the current system of a large number of small banks. One should recognize that going to a system of larger, nationwide banks necessarily will cause a concentration of decisionmaking power both within the private banks and within the regulatory agencies.

While the total number of banks in the United States has not changed dramatically, bank consolidation within holding companies has been significant, with the number of non-holding company banks falling steadily. Total domestic banking assets held by the largest 100 banking organizations has also steadily increased to where, by 1991, thirty-seven organizations held fifty percent of banking organization assets in the United States.

Because of the historic concern over the concentration of financial power in banks, the issue has gradually become focused on whether there should be congressionally determined, direct limits on the size of financial institutions in addition to limits imposed by the general antitrust laws. The general United States antitrust laws currently apply to banking organizations. These statutes, read alone, are rather nebulous. They have been substantially elaborated by almost nine decades of antitrust case law and by United States Department of Justice merger guidelines. As the interstate restrictions have been eliminated for bank mergers and acquisitions, under current antitrust law and guidelines, there are essentially no limits on mergers of the largest banks and BHCs located in different cities.

On the surface, it appears to be easier to deal with concentration as a question of pure economics. It is appealing when confronted with the nuances of national policy questions to be satisfied with the apparent certainty of "by-the-numbers-type" answers which can be added, subtracted, multiplied, or divided, as with the Department of Justice merger guidelines methodology. There are two problems with this approach. First, underlying the illusion of certainty in the numbers, there are extremely difficult questions in determining the numbers. Second, there are substantial questions of public policy which do not yield to a numerical analysis. The broader question of public policy is how

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dispersed the power over allocation of credit should be in a free enterprise society. Credit is a key aspect in the production and distribution of products in our society; access to credit for all businesses is an important aspect of public policy.

One of the major purposes of bank regulation is to maintain the stability of public confidence in the payments and monetary system. As a consequence, it is generally agreed that our largest banks are already too large to be allowed to fail. Today, the large failing banks are sold with a heavy government subsidy or are otherwise bailed out by the government in order to maintain the stability of our financial system. It would seem to follow that if we allow the big banks to become even bigger, we will only guarantee more government regulation of banks.

History suggests that we either cannot, or are unable to, regulate to prevent failure. As a consequence, it is worth consideration to determine whether we should at least regulate to minimize the damage, in order to better assure political and social stability. The impressiveness of the immense economic power of United States financial institutions has only been matched in impressiveness by their human limits, as evidenced by such problem banks as Continental Illinois, M Corp, First Republic, Seafirst, First Pennsylvania, Security Pacific, and Bank of New England, as well as others which have required substantial government assistance.

If the human limits of the largest banks are as impressive as their powers, arguably we need limits on economic concentration so that the maximum possible freedom of banks is maintained in our free enterprise society and regulation is minimized. Otherwise, larger banks will almost certainly only mandate an even greater regulatory scheme, further removing banks from market discipline as the federal government is required to protect the banking system from concentrations of market risks.

Consistent with this philosophy of trying to minimize government regulation while protecting public policy, in 1985, Paul A. Volcker, then Chairman of the Board of the Governors of the Federal Reserve System, testified before banking committees in the House and Senate concerning the issues involved in interstate and regional banking. He indicated a need to avoid un-

due concentration of banking resources and to maintain a climate in which small institutions can flourish. Mr. Volcker recognized both the substantial technological advances that have occurred, as well as the numerous non-banking competitors which are not subject to any geographic restriction. He suggested that there is a need to deal with the economic concerns, while also protecting the safety and efficiency of the banking system, preventing undue concentration of economic resources, and assuring benefits to the users of banking services. He concluded that the present antitrust law provides considerable protection against local markets becoming noncompetitive, but not sufficient protection of public policy concerns raised by concentration of resources on a national or regional scale.

Therefore, Mr. Volcker suggested limitations which might be taken to forestall the substantial risks of increased concentration. He recognized that some might view the limitations, at the margin, as involving "essentially arbitrary judgments,"\(^\text{101}\) as they would be simple quantitative measurements of relative size. Such quantitative measurements have substantial value, however, in terms of predictability, certainty, and relative ease of administrative enforcement. His recommendation envisaged limitations on the largest banking organizations acquiring other banks. The largest BHCs in terms of domestic banking assets, perhaps the top twenty-five or fifty, would be prohibited from merging with each other. Further, banks would be prohibited from obtaining (through acquisition) more than a fixed share of the nationwide total of assets, perhaps less than five percent. Additional prohibitions would similarly limit the increase of concentrations of assets in any one state or region.

A. Overview of Current Issues of Geographic Expansion, Economic Concentration, Bank Powers, Public Policy and Regulatory Structure

The banking industry generally seeks broader activity powers, freedom to consolidate, and less regulation. The broader powers suggest, at least theoretically, a laissez-faire approach, permitting banks to have largely unrestricted powers, at least in

\(^{101}\) Id. at 433. See also Hearings Before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs, House of Representatives, Apr. 24 & 25, 1985, Serial No. 99-17, 7 (also containing the testimony and quote).
terms of financial activities. The ability to consolidate suggests that we move to a system of larger, nationwide banks. Because of history and the too-big-to-fail doctrine, this necessarily would cause both centralization of decisionmaking within the private banks and greater regulatory power due to the degree of risk to government policies.

While proponents of the laissez-faire approach historically have argued for the separation of economic from social or political policy, that is not how United States society has functioned. Large aggregations of economic power are not viewed as independent from social and political values. Therefore, any short term approach utilizing a laissez-faire methodology of regulation will ultimately result in the reposition of federal regulation, as occurred in the 1930s. We must search for a middle ground between laissez-faire and market insensitive regulation.

Adam Smith's *The Wealth of Nations* is cited for many laissez-faire approaches. In general he is cited for the idea that selfishness and self-interest ultimately serve the public good. Adam Smith saw no moral virtue in selfishness; rather, he saw its dangers. His suspicion of self-interest and lack of government attention to economic activity is summarized in one of his best known remarks: "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices." Thus, Smith did not praise self-interest as a virtue, but simply saw it to be a driving economic force. He explained how this impulse could be harnessed to the social good, in order to prevent producers from raising prices until customers could afford to pay no more. His answer was competition, and competition assured by government regulation that tamed pure laissez-faire selfishness. The emphasis then should be on achieving as much competition as possible, rather than permitting mergers and expanded activities as laissez-faire right. To put it differently, Adam Smith and others have recognized that small economic units, whether they be retailers, banks, or manufacturers, are an important refuge of political independence. The elimination of smaller entrepreneurs is a natural tendency of large firms that seek to extend their influence. United States society

103. *Id.* at 144.
appears to have as a principal desire the provision and protection of relatively small economic units in what is a republic. If the market is not regulated to assure competition, it might fail.

Congress has yet to determine whether the policies have changed. With the substantial elimination of limits on geographic expansion, and the substantial elimination of the Glass-Steagall Act which separates banking from securities activities, an important component of what remains is the historic, deep-seated distrust in the United States of economic concentration. While we may well be willing to allow other types of institutions to fail, we do not wish to have a crisis of public confidence in the banking system. As a consequence, failing banks generally have been sold or otherwise dealt with by utilizing a heavy government subsidy. The banks, and particularly the large banks, enjoy substantial government protection through the support of the FDIC structure.

Congress has the opportunity to act in all areas — to construct limits on economic concentration that would affect only the largest banks; to limit bank powers to traditional banking activities which do not systemically permit risky activities that in the past have caused billions of dollars of losses; and under such a structure of limited size and limited risk exposure, to concomitantly reduce the scope and burden of government regulation. But the history of banking legislation since 1980 suggests it is doubtful that anything significant will occur. Rather, banks, and particularly the largest banks, will continue to bob and weave through supposedly restrictive laws governing geographic expansion and asset powers, to reach national and international markets in a large and broad way.

The boundaries of financial service markets have been substantially blurred. This can be seen as a sweeping historical process covering the years since the 1930s. Adam Smith would not be surprised at the failure of the 1930s strait jacket legislation. Regulation is necessary to some extent to protect the public interest from the failure of markets (competition) and institutions (public confidence in the payments system). We must let the markets and institutions be free to operate, but must place outer limits on their permissible consolidations and activities.

The fundamental problems of bank risk and instability are always with us. The question is how to deal with them in the circumstances of today. The issue of confidence is the most central and the most intangible aspect of banking, and is the basis
for a stable system. We have historic fears of powerful, central, financial institutions, and thus desire decentralization of power. But we also recognize the risks that can be represented by many independent banks that are susceptible to liquidity problems. It ought to be possible to deal with both concerns. The Federal Reserve ought to be able to create an elastic supply of currency and to provide liquidity to a national financial system so long as asset powers are not so unregulated that there is lawful systemic risk.

In general, what has happened over the last fifty or sixty years is that both the source of funds of banks and the types of bank assets (powers) have changed. Both have become more volatile. Thus, both sides of the balance sheet have contributed to a more unstable environment. How do we deal with these circumstances?

FDIC deposit insurance is not very effective in forestalling liquidity problems because large depositors are not covered and can quickly withdraw or withhold their funds. Deposit insurance works well with small depositors, but not with large depositors. There are two basic ways to deal with regulatory reform. One way is to develop a renewed environment of carefully regulated relationships not unlike what we developed in the 1930s. There would be significant restrictions on the business open to various types of institutions. The second alternative would acknowledge the permanence of new ways of doing business, including the presence of large depositors, and would attempt to create safeguards sufficient for this new system. How do we do that?

Adam Smith would argue that we could develop market-oriented solutions that would permit individual bank management discretion within clearly established and vigorously enforced supervisory guidelines which are few in number and substantially nondiscretionary in nature. These guidelines would be such protections as capital ratios that do not favor investment securities over private lending, market value accounting for all or most assets, only historic bank asset and liability powers (and their functional equivalents) within the FDIC net, public disclosure of all regulatory determinations, and FDIC failure resolution policies that severely limit the use of purchase and assumption-type transactions that effectively insure everybody. Can we do this without returning to the pre-Depression financial panics? The continuation of deposit insurance protects small depositors so that their purchasing power stability would continue in force at
all times. Thus, we would not have to worry about that type of bank run.

A market oriented approach is preferable to a regulatory approach. Recent experience in the United States, using a regulatory approach for the difficult thrift and bank failure problems, shows us that regulators tend to paper over emerging problems, until they are so devastating that they cannot be ignored and huge losses are the consequence. Our web of regulatory complexity is so strong now that it can only be broken down under severe stress, which is the worst possible circumstance.

A variety of market forces can be developed. One is not raising, and perhaps even limiting, the 100,000 dollar limit on deposit insurance. Another is requiring banks to use some type of private, back-up insurance to encourage larger depositors. Asset and liability powers, and loan to value ratios, should be limited to traditional banking where the risks are manageable. While there certainly would be bank failures and consequential dislocations, they would be minor, isolated, and not disruptive of the entire payment system, public confidence, and the small depositors safety net structure. Persuading Congress to adopt a methodology which would result in a smaller and less significant federal program is a doubtful proposition, but one which ought to be pursued.

VIII. Conclusion

The structure of United States regulation of its approximately 12,000 banks, as well as of other types of financial institutions, is largely a result of United States history and cultural values.

With respect to commercial banks, there are two general chartering authorities — the state and federal government. All national banks must be members of the Federal Reserve System and must be insured by the FDIC. All state-chartered banks, in order to compete with national banks for deposits, also are insured by the FDIC. A state-chartered bank is primarily regulated by the state's department of banking, but is also regulated by the FDIC. A national bank is primarily regulated by the Office of the Comptroller of the Currency.

BHCs are permitted to own not only banks, but also non-bank subsidiaries that engage in activities "closely related to banking." BHCs and their non-bank subsidiaries are subject to the regulation of the Federal Reserve Board under the BHCA.
Compared to other countries, banks in the United States historically have been somewhat limited in their activities. Until the 1930s, a rather close connection developed between investment banking (securities firms) and commercial banking. The connection with insurance companies has been less obvious. Nevertheless, principally through regulatory and judicial determinations, banks and BHCs have gradually been able to engage in a broader array of many securities and some insurance activities. The uncertain outline of these powers causes constant disagreement and a good deal of attention, but little action, in Congress.

Another dissimilarity between bank regulation in the United States and elsewhere involves limitations on geographic expansion. National banks may have branches only within the state where the bank is headquartered. But the geographic limit on multiple bank subsidiaries of a BHC is different. Bank subsidiaries of a BHC may not be located outside the state in which the holding company’s principal bank subsidiary is located, unless the law of the other state specifically authorizes bank ownership by the out-of-state holding company. Most states now permit some form of interstate BHC banking; some are limited by region of the country, and others are limited by the purpose or powers of the bank, such as a limited purpose bank for the issuance of credit cards.

Foreign banks began to increase their presence significantly in the United States in the 1970s. As is true with United States banks abroad, the most common forms of foreign bank presence in the United States are agencies, branches, and subsidiaries. Branches are empowered to accept deposits from people in the United States, while agencies are not. Also, since the International Banking Act of 1978, foreign banks are authorized to establish Edge corporations to do any international banking business in the United States. In general, the Act made substantial strides toward national treatment of foreign banks operating in the United States, providing approximately equal competitive positions for foreign banks with respect to the full range of their United States operations.

Finally, the multiplicity of bank regulators in the United States has continued. While the structure of the three major federal agencies and the fifty state departments of banking has largely remained unchanged, their supervisory enforcement powers have increased dramatically with respect to cease and desist
powers, suspension and removal powers, civil money penalties, and capital directives.

In the early 1980s, Congress provided for more powers and fewer restrictions on financial institution activities. Beginning in the late 1980s, Congress redressed the imbalance by increasing regulation. It is rational to expect that as there is a rise in risk to government and the American taxpayer, so too there will be a rise in regulation. But with all of our regulation, we were unable to head off the largest financial disaster in the history of the United States. We have stabilized the system only through a large, undefined tax to make up for the financial institution losses.

The losses have been large because we have been slow to close insolvent institutions and have encouraged institutions to take too much risk. So long as we allow financial institutions to raise funds cheaply through the device of federal deposit insurance, we must be sensitive to reducing the risk to taxpayers. History suggests that increased regulation is not the way.

In 1873, in *Lombard Street*, Walter Bagehot suggested the route to market or competition regulation, rather than micro-regulation: 104

"The business of banking ought to be simple; if it is hard, it is wrong. The only securities which a banker, using money that he may be asked at short notice to repay, ought to touch are those which are easily saleable and easily intelligible. If there is a difficulty or a doubt, the security should be declined." 105

Certainly there will always be reasonable disagreements over what bank assets are easily saleable and easily intelligible. And, as Bagehot also noted, "Every great crisis reveals the excessive speculations of many houses which no one before expected..." 106

But, in general, Bagehot's suggested approach will lead to the freest and fairest markets, with the least regulation. Broader, innovative financial activities are certainly permissible and to be encouraged, but not at the risk of unintended government subsidies borne by taxpayers. And so, the high cost and burden of regulation can be avoided without limiting the scope...

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105. Id.
106. Id. at 77.
of financial activities permissible in the United States. This can be accomplished by limiting those within the deposit insurance net and redressing the imbalance by reducing regulation.