

THE EVOLUTION OF BANK REGULATION:
THE INTERPLAY OF REGULATORS AND THE REGULATED

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This dissertation investigates the evolution of commercial bank regulation by focusing on what lawmakers enact, how regulators implement it, and how it evolves. Much of the scholarly literature conceives of regulation either as a tool that is captured by the regulated industry or as a means by which government officials castigate business. According to these conceptions, relatively stable and consistent patterns of influence develop whereby one set of actors directs the actions of other actors within this policy realm. Not only do these approaches incompletely model the policymaking process, but they also oversimplify the relationships between the actors. In contrast, I argue that these conceptions of regulation are inaccurate and that banking regulation is a case of pluralism. By examining the periods with multiple federal regulators that were also marked by significant instabilities in the banking system, I argue that the evolution of regulation is more accurately understood as a process of “partisan mutual adjustment.” According to this conception, multiple actors within this policy realm exist in a state of interdependence in which they interact consequentially and exert influence upon the others whenever they choose to do so. This relationship among the actors explains the unusual policymaking pattern over this period in which numerous crises struck the banking sector, yet the actors persisted in their “deregulatory” efforts despite these events. Through this examination of banking regulation, my dissertation suggests policymakers be much more cognizant of the interdependencies among the actors and the countermoves that one actor’s moves can trigger in this dynamic environment. This approach prepares policymakers to institute reforms more likely to succeed at averting another financial crisis.

BIOGRAPHICAL SKETCH

Erik Filipiak received his Ph.D. in Government from Cornell University in May 2011. Though his concentration was in American Politics, and he focused on public policy issues, especially regulation and government-business relations. Erik received an M.A. in Government from Cornell in January 2008. Through the Exchange Scholar Program, he had the opportunity to spend three years at Yale University. Erik graduated Phi Beta Kappa from Hamilton College in May 2002 with a B.A. in Classical Studies and Government. While an undergraduate, he also had the opportunity to spend one year reading PPE and ancient history at Wadham College, Oxford.

To My Parents

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The subject of banking regulation is arguably not a common one for political scientists. My interest in it, however, was sparked by a paper written for Ted Lowi's "Government and Public Policy" course early in my graduate career. First and foremost, then, I owe a tremendous debt of gratitude to Ted Lowi for the endless encouragement and support he has given me through the years. He has most definitely gone beyond the duties of a committee chairman. I also want to thank his two administrative assistants, Jackie Pastore and Hollie Heath, while I was researching and writing away from Ithaca for managing all the correspondence and my many drafts. Martin Shefter, George Hay, and David Mayhew, who rounded out my committee, all deserve an equal share of thanks for their assistance and helpful suggestions throughout this project. I want to thank Martin for all his help on the presentation of my APSA papers. Though I did not have the pleasure of knowing George before undertaking this dissertation, his perspective from the legal academy has been invaluable as the project has progressed. Likewise, I owe David an immeasurable debt for the three years I spent researching and writing this dissertation at Yale under his auspices and the time spent studying with him as an undergraduate at Oxford. Even though my committee read over a number of drafts of each chapter, any remaining errors remain solely my own.

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LIST OF ABBREVIATIONS

BHC	Bank Holding Company
FHLBB	Federal Home Loan Bank Board
FDIC	Federal Deposit Insurance Corporation
FRB	Federal Reserve Board
FSLIC	Federal Savings and Loan Insurance Corporation
MBHC	Multi Bank Holding Company
OBHC	One Bank Holding Company
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
RTC	Resolution Trust Corporation
SEC	Securities and Exchange Commission

1. BANKING LAW, ITS IMPLEMENTATION, AND THE EVOLUTION OF REGULATION

Moments after conference committee negotiations concluded over the Dodd-Frank Act on June 25, 2010, the Senate Banking Committee Chairman Christopher J. Dodd (D-CT) declared, “It’s a great moment....No one will know until this is actually in place how it works. But we believe we’ve done something that has been needed for a long time” (Cho, Yang, & Dennis 2010). Sen. Dodd might have been referring to legislators having failed to read the 2,000 plus page financial regulatory bill, but his statement’s more likely meaning was that lawmakers simply did not know how the regulators would implement the statute. Thus, the Connecticut senator was acknowledging that the process of bank regulation entails much more than mere legislation. That said, however, *is there anything about bank regulation that permits us anticipate how it will unfold? How does regulation in the American banking system evolve? Put another way, what statutes do lawmakers enact, how do members of the bureaucracy implement this legislation, and how does the regulation evolve?*

My dissertation contends that much of American banking regulation can be understood and its evolution anticipated by knowledge of the policymaking process, the participants, and the relationship between them. Depending on when and where one observes bank regulatory policymaking, an individual will see participants cooperating, competing, having heated conflict, or taking an active role while their counterparts remain withdrawn from the process. Nevertheless, the interdependencies among the actors drive the results of this policymaking process. Over the course of the last century, banking policy has become increasingly complex, so it has mainly attracted attention from the banking industry, other financial firms and industries competing against banking, and policymakers in elected office and the bureaucracy. Bank regulatory policy emerges from the interaction of these groups and actors. In my policy study,

the regulators tend to be the most significant actors as they not only participate in the crafting of regulatory legislation, but implement the statutes through the writing and interpretation of various rules.

I argue that bank regulation can best be viewed as an instance of pluralism. Because bank regulatory policy occurs within a decision making system characterized by the absence of central control, separate branches, and a group of federal regulators sharing responsibility and power over the banking sector, the type of pluralism known as partisan mutual adjustment more specifically characterizes this case. Partisan mutual adjustment, according to the political scientist Charles E. Lindblom, describes a decision making system in which multiple, interdependent actors or units coordinate their actions by adjusting to one another (Lindblom 1965). Furthermore, interdependence requires that “every decision maker is directly consequential for at least one other, and all are related indirectly through at least one chain whose links are composed of direct relations” (Lindblom 1965: 22).

In theory, such a system of decision making could contain elements of central control, the absence of a commonly agreed upon criterion for decisions shared by all actors involved makes it partisan. Lindblom uses the term “partisan” to describe the decision making system because all actors within it do not share the same agreed upon criterion for deciding. Though there may be a common criterion among the different decision making units, there are undeniably some units that have a different criterion and possess the wherewithal to act upon it. Since no central authority exists to compel the entire group of interdependent units to coordinate their actions, the actors must consider the other decision makers’ options so as to avoid the worst outcome possible.

The policymaking system for bank regulation in the United States closely resembles such a decision making system. The American system contains many interdependent units that can enter or exit the policymaking process at will, but whose objectives ultimately depend on the actions of others in the system. As a result, coordination of decisions can be rather problematic given the interdependent decision making units do not share the same criterion. At times legislators and regulators work together on statutory reform whereas at other times they find themselves at loggerheads. Likewise, sometimes the regulatory agencies coordinate their actions toward some particular goal, irrespective of what lawmakers prefer, whereas at other times they appear to pursue different policy paths.

Before examining the ways in which others have explained the development of bank regulatory policy, it is worthwhile defining some of the central concepts involved. The banking system is simply the collection of commercial banks playing a predominant role in the nation's payments system. The payments system, of course, refers to the institutional arrangements by which payment transactions in the economy are settled. These payment transactions typically involve debiting and crediting the checking accounts of various entities rather than exchanging actual currency. Commercial banks are but one type depository institution that intermediates between savers and investors, but they have historically been the entities responsible for providing checking accounts. Checking accounts, which are also known as demand deposits, are the closest item to money next to actual currency because they are accounts that individuals can withdraw at any time upon demand. Unlike other types of depository institutions, though, commercial banks have traditionally created much of the nation's money supply through their issuing of checking accounts to businesses and individuals and their investment of those funds in

shorter-term commercial loans. Since 1863, commercial banks have had either a state or federal charter.

By defining a commercial bank in this manner, it then becomes possible to distinguish commercial banks from other bank-like entities that resemble banks. Though the class of depository institutions known as thrifts, which includes savings and loan associations (S&Ls), mutual savings banks, and credit unions, often resemble banks, they technically differ because they neither offer actual checking accounts nor do they invest much, if any, of their deposit dollars in commercial loans. Unlike commercial banks which have always been shareholder owned, most thrifts historically have been mutually owned. It was believed that this ownership structure would be most beneficial to thrift institutions seeking to instill the quality of “thrift” amongst their members. During the recent financial crisis, however, much of the news focused on Wall Street banks such as Bear Stearns, Lehman Brothers, and Merrill Lynch. These are investment banks. Unlike commercial banks, investment banks are not depository institutions. Rather than accept deposits and make loans, investment banks provide long-term capital through the securities markets either through the investment of their own funds or putting together securities packages to market to buyers in the secondary capital markets. My dissertation will clearly indicate when the institution under discussion is something other than a commercial bank.

By federal regulators, I mean the three agencies responsible for regulating the banking industry: these are the Office of the Comptroller of the Currency (OCC), the Federal Reserve System (the Fed), and the Federal Deposit Insurance Corporation (FDIC).¹ These three agencies maintain the safety-and-soundness of the banking system. Lawmakers created each of them as responses to different crises plaguing the banking system, and, in so doing, gave them different powers to accomplish their missions, not to mention different jurisdictions. The differing

¹ Federal lawmakers established the OCC in 1863, the Fed in 1913, and the FDIC in 1933.

jurisdictions and powers sometimes generated situations in which the three agencies did not share the same definitions of the public interest. In other words, elected officials created multiple regulatory agencies over a number of years with different powers and jurisdictions, but with similar though distinct objectives. A consequence of this proliferation was necessarily an environment in which the agencies became competitive in the use of their powers and the definition of their objectives. Each of the regulators has done this at times to demonstrate that their approach is the superior one.

Various scholars have focused on this competitive relationship between the agencies to explain regulatory policymaking. In an October 1974 speech to the American Bankers Association, Federal Reserve Chairman Arthur Burns described the regulatory system's problem as one of a "competition in laxity" that fostered "subtle competition among regulatory authorities, sometimes to relax constraints, sometimes to delay corrective measures" (Burns 1974: 18). In other words, Chairman Burns was describing a governmental failure known as a race to the bottom. Economists during the last decade have countered Burns' "competition in laxity" argument. In a Federal Reserve Bank of Richmond *Economic Quarterly* article, John Weinberg models competitive interactions between two bank regulators depending on the distribution of bank charters, regulators' objectives, and the funding of regulators' operating expenses. Though he does not test his model against the available historical record, Weinberg finds that a race to the bottom occurs when regulators are unable to cover all of their operating costs, but a race to the top can occur when these costs are covered by the funding mechanisms of the regulators (Weinberg 2002). The economist Richard Rosen, on the other hand, questions the race to the bottom argument by examining the switching of bank charters among regulators in the U.S. from 1983 to 1999. Rosen finds that the differentiation and specialization of regulatory

agencies is beneficial (Rosen 2003). Though interactions between the federal regulators have at times generated harmful effects such as competition, this dissertation does not argue that this interplay necessarily leads to a race to the bottom.

If the argument advanced by this dissertation is correct, then policymakers need to reconsider the Dodd-Frank Wall Street Reform and Consumer Protection Act. This dissertation argues that the dominant problem lies with the interdependences of the actors in this policy realm, especially the bureaucratic ones. Rather than address the problems resulting from such interdependencies, Dodd-Frank resembles other efforts since the Great Depression to “reform” the banking system by imposing limitations on private behavior and expanding the reach mutual dependence of governmental bodies. Despite these reform attempts, though, crises returned to the banking sector, most often with those private sector actors operating within the confines of the revised law and regulations. By failing to simplify and harmonize the bank regulatory system, the United States invites future problems in its banking system.

Since the policy implications of my argument differ significantly from those enacted into the statutory code as lawmakers responded to the various problems within the banking sector in the past several decades, it should then come as little surprise that the policymakers who enacted these regulatory reform laws drew upon rather different narratives to explain the banking problems and the reforms necessary to prevent their recurrence. The two most prominent explanatory theories have a storied pedigree, yet have reappeared to explain the recent crisis in yet another incarnation. In the first of these explanations, regulation provides the means to pursue some “public interest” and correct market failings. In the second of these explanations, though, regulation is “captured.” Capture supposedly occurs through the regulated industry or

some other privileged group gaining control over the regulator and using its influence to extract benefits from the larger society.

Furthermore, all the authors of the following explanations express nostalgia for the Banking Act of 1933, often referred to as Glass-Steagall.² In a nutshell, the Banking Act of 1933 contained two institutional thrusts and several regulatory ones.³ On the institutional side, the legislation created a deposit insurance system and reformed the Federal Reserve System. Then, on the regulatory side, it limited banks' activities, affiliations, and products offered. The following narratives, however, all conceive of Glass-Steagall almost entirely in terms of the restrictions it placed on banks activities, by confining them to the business of taking deposits and making loans, while largely ignoring the remainder of the law. By doing so, they are all able to conclude that the "repeal" of Glass-Steagall by the Financial Services Modernization Act of 1999 led to the recent banking crisis.⁴ In light of this reasoning, *what role, if any, did the "repeal" of Glass-Steagall have in causing the recent financial crisis or others of the late twentieth century?* Since the eighties, a number of scholars have debunked the factual premise that banks' securities activities underlay Glass-Steagall's creation (Macey 1984; White 1986; Shughart III 1988; Benston 1990). To date, though, scholars have not completed a thorough and accurate factual account of Glass-Steagall's "repeal." As my dissertation intends to show, the reforms enacted by the GLBA merely brought the banking statutes in line with the banking system's existing rules and regulations. Furthermore, Glass-Steagall's ostensible repeal had nothing whatsoever to do with the recent financial sector crisis.

² The statute commonly referred to as Glass-Steagall actually is titled the Banking Act of 1933, which FDR enacted June 16, 1933. Because there was a Glass-Steagall Act of 1932 altering the percentage of gold backing required for U.S. currency, it is technically incorrect to refer to the 1933 law as the Glass-Steagall Act. Consequently, this dissertation will not perpetuate this mistake, rather it will use the terms Glass-Steagall and the Banking Act of 1933 to refer to the same statute.

³ My dissertation will elaborate further on the framework erected by this statute in its second chapter.

⁴ The Financial Services Modernization Act (FSMA) of 1999 is also known by its alternative title of the Gramm-Leach-Bliley Act (GLBA) of 1999, taking its name from its three main congressional sponsors.

Shortly after JPMorgan Chase purchased the failing investment bank Bear Stearns, presidential candidate Barack Obama spoke on March 27, 2008 at Cooper Union concerning the nation's precarious economy.⁵ In his campaign address, Obama described deregulation's contribution to the worsening banking crisis in the following manner:

A decade later [than the nineties] we have deregulated the financial sector and we face another crisis. A regulatory structure set up for banks in the 1930s needed to change, because the nature of business had changed. But by the time the Glass-Steagall Act was repealed in 1999, the \$300 million lobbying effort that drove deregulation was more about facilitating mergers [alluding to the merger between Citicorp and Travelers Group that formed Citigroup in 1998] than creating an efficient regulatory framework. And since then we've overseen 21st century innovation....Not surprisingly, the regulatory environment failed to keep pace.

(Obama 2008)

Barack Obama's speech represented one of the earliest attempts by a presidential candidate to politicize the developing crisis and attribute its causes to deregulation. According to Obama, the latest financial crisis occurred because banking regulation no longer protected against the market failings of the banking system.

Other public officials and policy experts, though, soon followed with similar explanations of the financial crisis. Unlike Barack Obama, Senator Byron Dorgan (D-ND) held federal office throughout the 1990s and so voted on several of the "deregulatory" bills of the nineties. In *Reckless: How Debt, Deregulation, and Dark Money Nearly Bankrupted America*, Sen. Dorgan blames a particular statute from the late 1990s:

⁵ Bear Stearns was one of the five largest Wall Street investment banks whereas JPMorgan Chase was a financial services holding company which possessed subsidiaries in commercial banking, investment banking, and other sectors of the financial services industry.

Of all the shortsighted, greedy, and downright ignorant actions that helped create the economic collapse, none was more pronounced than the action of Congress and President Clinton to repeal the banking protections that were put in place after the bank failures of the 1930s. That action came in the form of the Financial Services Modernization Act [of 1999]. (Dorgan 2009: 33)

Thus, the North Dakotan attributes the recent banking crisis to market failings resulting from the Financial Services Modernization Act's statutory repeal of Glass-Steagall. Given the ideological tendencies of Obama and Dorgan, however, an individual familiar with American politics and policymaking would not find them unexpected.

More surprising, though, are Judge Richard Posner's recently revised views. Posner founded the law and economics movement and was a longtime champion of neoclassical economics. In *A Failure of Capitalism*, he argues that "excessive deregulation" of the last few decades contributed largely to the crisis (Posner 2009: 289). According to Judge Posner,

The seeds of failure were sown in the movement to reduce the regulation of banking and credit, which began in the 1970s. They germinated during the Clinton Administration, when the housing bubble began and the deregulation of banking culminated in the repeal of the Glass-Steagall Act...and it was decided not to bring the new financial instruments, in particular credit-default swaps, under regulation even to the limited extent of moving trading in swaps to exchanges, which would have given the public information about the scope, risks, and value of these instruments. (Posner 2009: 270-1)

In this way, removal of banking regulations, particularly Glass-Steagall, created the environment in which the market failed. As all three of these perspectives envision the banking system, and

concluded that the crisis occurred because lawmakers repealed existing regulatory statutes protecting against market failures.

In contrast to these “public interest” views that explain the banking crisis as the result of inadequate regulation that caused the market to fail, the “capture” perspective focuses on the corruption of government actors and the very regulatory process itself. Paradigmatic of the capture views on the recent crisis are those that focus, in the words of Nobel prize-winning economist Joseph Stiglitz, “not only [on] capture by special interests but also by particular ideologies” (Stiglitz 2010: 50). These new applications of the capture approach differ from the traditional one which focuses almost exclusively on special interests gaining leverage or control over their respective regulators and then using their position to extract material benefits. The newer applications stress ideology over material benefits.

According to former IMF chief economist Simon Johnson and his coauthor James Kwak, bankers now compose a “new oligarchy” (Johnson & Kwak 2010: 6).⁶ In *13 Bankers*, Johnson and Kwak argue:

[A]s banking became more complicated, more prestigious, and more lucrative, the *ideology* of Wall Street—that unfettered innovation and unregulated financial markets were good for America and the world—became the consensus policy in Washington on both sides of the political aisle. Campaign contributions and the revolving door between the private sector and government service gave Wall Street banks influence in Washington, but their ultimate victory lay in shifting the conventional wisdom in their favor, to the point where their lobbyists’ talking points seemed self-evident to

⁶ In an earlier *Atlantic* article titled “The Quiet Coup,” Johnson argues similarly that “the finance industry has effectively captured our government” (Johnson 2009: 46). In this process, according to Johnson, “the American financial industry gained political power by amassing a kind of cultural capital—a belief system” (Johnson 2009: 50).

congressmen and administration officials. (Johnson & Kwak 2010: 5-6) (*Italics in the original*)

Though bankers captured legislators and regulators through material incentives, they more importantly achieved a stranglehold on government by gaining adherents to their free market creed within policymaking circles. This ideological capture, according to Johnson and Kwak, made repealing Glass-Steagall possible and eliminated “the safest banking system that America has known in its history” (Johnson & Kwak 2010: 35).

Writing in his recent book *Capital Offense*, *Newsweek*'s national economics correspondent Michael Hirsh explains that a “free-market fundamentalism” based on the notion that “what’s good for Big Finance is good for America” took hold (Hirsh 2010: 19). According to him,

The main reason the catastrophe occurred is that the people in charge of our economy, otherwise intelligent and capable men...permitted themselves to believe, in the face of a rising tide of contrary evidence, that markets are for the most part efficient and work well on their own. (Hirsh 2010: 26)

Like Johnson and Kwak, Hirsh argues that an ideological capture occurred by stating, “The Wall Street lobby could not have transformed Washington—and the economy—without the *idea* of free-market fundamentalism behind it” (Hirsh 2010: 27) (*Italics in the original*). Hirsh, though, proceeds to defend Glass-Steagall vis-à-vis those individuals who, mistakenly in his opinion, conclude the statute’s repeal played little role in the crisis. According to him,

The blinding complexity and interconnections created by derivatives—precisely because they were going to overwhelm government supervisors—demanded that there be strong firewalls and capital buffers between Wall Street institutions and their

affiliates, and between banks and nonbanks and insurance companies. Otherwise there would be no more islands of safety....The repeal of Glass-Steagall took things in precisely the opposite direction. (Hirsh 2010: 183-184)

Although ideological capture was the main cause of the recent financial crisis, according to these authors, the repeal of Glass-Steagall that resulted from this capture certainly helped create a financial environment free of necessary safeguards.

THIS DISSERTATION'S APPROACH

To reach its explanations, this dissertation employs a case study revealing the interaction among federal banking regulators and other actors interested in the policy realm. Though the American banking system has been characterized as a dual system due to the existence of competing state and federal regulators, the federal agencies have gained the dominant position by far in the relationship over the last few decades. Consequently, the legal scholar Kenneth Scott's model of a dual banking system with competition between state and federal regulators is no longer accurate, for as Henry Butler and Jonathan Macey succinctly explain, "Federal preemption and uniformity, rather than competition and diversity, are the legal norms in banking regulation" (Butler & Macey 1988: 678).

As evidenced by the time periods covered in my case, the evolution of the banking system has been anything but a continuous process. The economist Benjamin Friedman memorably described this discontinuous evolution in the following way:

A time-traveler from 1940, or even 1900, would probably feel more nearly at home on first disembarking in the financial markets than in most other major arenas of 1980 American economic activity. He would immediately recognize major classes of

financial market participants and their chief activities, including banks taking deposits and making loans.... (Friedman 1980: 10)

Consequently, my case study focuses on periods of great change in the banking system.

Whereas my first chapter covering the period of 1914-1933 depicts a setting with only the OCC and Fed, my other three chapters covering the period 1969-1999 depict a setting where the Federal Reserve, the FDIC, and the OCC wrestled with the return of instabilities and problems in the banking system on a scale not seen since the 1930s.

Although political scientists have attempted to explain bank regulatory policy, they have often focused too heavily on the allocation of regulatory responsibilities to the exclusion of other significant elements (Meier 1985; Eisner, Worsham, and Ringquist 2000). In contrast, my dissertation focuses not only on the allocation of regulatory responsibilities, but also on the content of regulatory statutes and rules, for it is the specific content of these items that defines the avenues regulatory agencies have available to accomplish their tasks. As the banking law scholar Kenneth Scott argued in his 1977 *Stanford Law Review* article on the dual banking system, “one cannot understand the working of the [banking] system without at least a general knowledge of the correspondence between the distribution of regulatory functions and the structure of agency jurisdiction” (Scott 1977: 5). Therefore, my dissertation devotes considerable attention to banking legislation, especially as it influences or alters regulators’ jurisdictions and responsibilities. Since much of the regulatory process, however, occurs after the statutes are delegated to the regulators for implementation, I devote particular attention to the decisions and rules produced by the agencies, not to mention the actions they take to fulfill their responsibilities. Doing so provides another window into the regulatory agencies and how the agencies understand and pursue their goals.

THE STRUCTURE AND DISTRIBUTION OF REGULATORY AUTHORITY

Out of the three federal bank regulatory agencies, the Office of the Comptroller of the Currency (OCC) is the oldest dating back to the Civil War era; the National Currency Act of 1863 established the bureau within the Treasury Department.⁷ The new bureau, which was also known as the Bureau of the Currency, was led by the Comptroller of the Currency. The president appointed the Comptroller to a five-year term subject to the Senate's advice and consent. In the event that the Comptroller was unable to fulfill his duties or the position was vacant, the Deputy Comptroller would discharge the office's powers. The following year, however, lawmakers revised the statute and replaced it with the National Bank Act of 1864.⁸ As the National Bank Act's purpose statement indicated, the statute was intended "to provide a National Currency, secured by a Pledge of United States Bonds, and to provide for the Circulation and redemption thereof" (*U.S. Statutes at Large* 13 (1864): 99). Federal legislators created both statutes not as regulatory measures per se, but rather as means of providing a more reliable and elastic currency and as a way of generating revenue. Moreover, the standardized design of these national banknotes would also help combat the counterfeiting problem that had long plagued state banknotes.

To foster a distribution network, the legislation directed the Comptroller to charter a system of national banks.⁹ Individuals seeking to obtain a charter were required to put up specified amounts of capital, but these levels varied depending on the population of the area in which the bank was located. In order to issue banknotes, however, a national bank had to

⁷ The OCC predates the Interstate Commerce Commission (ICC) by nearly twenty years.

⁸ Except for its purpose statement, the National Bank Act was untitled at the time of its enactment. A decade later lawmakers enacted the National-Bank Currency Act of 1874 that officially renamed the 1864 statute the "National-Bank Act" (*U.S. Statutes at Large* 18 (1874): 123).

⁹ To distinguish national banks from their state-chartered counterparts, these institutions were required to use the terms "National," "National Association," or "N.A." in their corporate titles. To protect the value of the title, national banks are the only types of banks that may use the term "National" in their corporate names.

purchase a requisite amount of federal securities to be placed in the hands of the Comptroller. Doing so allowed a national banking association the right to issue a specified number of banknotes bearing its own corporate title on the bills. Although the mandate that national banknotes be backed by federal securities on deposit with the Comptroller minimized any losses to noteholders, national banks received another mechanism whose “only purpose [was] the protection of depositors” (Pike 1932: 516). According to the National Bank Act,

The shareholders of each association formed under the provisions of this act...shall be held individually responsible, equally and ratably, and not one for the another, for all contracts, debts, and engagements of such association, to the extent of the amount of their stock therein, at the par value thereof, in addition to the amount invested in such shares. (*U.S. Statutes at Large* 13 (1864): 103)

This mechanism was known as the double liability of bank shareholders.

To limit conflicts of interest between OCC officials and their constituents, the National Bank Act prohibited the Comptroller and his deputy from “be[ing] interested [directly or indirectly] in any association issuing national currency under the provisions of this act” (*U.S. Statutes at Large* 13 (1864): 100). Although the OCC was located within the Treasury Department, it was off-budget and self-funding. During its first half century, the agency funded its activities through the sale of banknotes and the fees it assessed for its examinations of national banks that it was required to examine to verify their capital backing for their note issue. The OCC maintained a flat fee structure on these examinations regardless of a bank’s asset size.

Like other nonbanking corporations, national banks possessed standard corporate powers, such as the right to own property and the right to sue and be sued. But lawmakers also endowed the new entities with other attributes unique to commercial banks. Drawing upon many of the

existing state free banking statutes, the National Bank Act defined a national bank as possessing a combination of enumerated and incidental powers:

[Every association shall] exercise under this act all such *incidental powers* as shall be necessary to carry on the *business of banking* by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; [and] by obtaining, issuing, and circulating notes according to the provisions of this act. (*U.S. Statutes at Large* 13 (1864): 101) (Italics added)¹⁰

The OCC became responsible for interpreting the meaning of these powers. It was largely through the use of the incidental powers clause that national associations and the Comptroller wishing to expand national banks' permissible activities relied. Moreover, national banks did not receive their first major statutory grant to enter another financial services industry until 1913's Federal Reserve Act when they gained the ability to enter the trust and fiduciary business on a very limited extent. At the same time, they obtained the power to make agricultural loans secured by farm land.

A half century after establishing the national banking system, federal legislators were still dissatisfied with the safety-and-soundness of the banking system, so they created the Federal Reserve System in late 1913.¹¹ According to the statute's preamble, lawmakers sought "[t]o provide for the establishment of Federal Reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes" (*U.S. Statutes at Large* 38 (1913): 251). Yet, as the

¹⁰ National banks' corporate powers appear under Title 12, Section 24, Paragraph 7 of the U.S. Code.

¹¹ In particular, lawmakers were reacting to the effects of the Panic of 1907 in which the banker J.P. Morgan and his associates were forced to act as a pseudo-lender of last resort for the nation. For a recent account of the Panic of 1907, see Robert F. Bruner and Sean D. Carr. 2007. *The Panic of 1907: Lessons Learned from the Market's Perfect Storm*. Hoboken, NJ: John Wiley & Sons.

economist and Federal Reserve historian Allan Meltzer explains, “Omission of a broad statement of purpose or policy objective was not an oversight. The act represented a compromise between many different groups that had very different purposes in mind” (Meltzer 2003: 65). The organization’s lack of focus was evident in the construction of the system of reserve banks. The Federal Reserve System was to be a self-funding, independent agency with a public-private hybrid governance structure.

The Federal Reserve Act directed the Treasury Secretary, the Agriculture Secretary, and the Comptroller to form a committee, select between eight and twelve cities to serve as locations for reserve banks, and then to divide the continental U.S. into districts with each district having one reserve bank. The legislation designed the reserve banks with nine person boards of directors. Each board was divided equally into three groups. The three Class A members were to be selected from stock holding banks within each district, the Class B members were to be actively engaged in some commercial activity within each district at the time of appointment, and the three Class C members were to be selected by the Federal Reserve Board. The act further imposed a sunset provision on the reserve banks’ charters of twenty years. Having first authorized the creation of a system of reserve banks, lawmakers ordered the creation of a Federal Reserve Board (FRB) to help direct the reserve banks.¹² The Board consisted of seven members, five of whom the president appointed subject to Senate confirmation and two of whom, namely the Comptroller and the Treasury Secretary, served in an *ex officio* capacity. The presidential appointees had staggered terms of ten years in duration. The Federal Reserve Act, however,

¹² Until 1935, the chairman of the FRB used the title of governor and his vice chairman used the title of vice governor. With the enactment of the Banking Act of 1935, however, the titles were changed to chairman and vice chairman, respectively, and the Federal Reserve Board was renamed the Board of Governors of the Federal Reserve System. The Banking Act of 1935 also removed the two *ex officio* members from the Board. Though the Board’s name is officially the Board of Governors since 1935, for the sake of brevity, my dissertation will employ both terms interchangeably when referring to the entity.

failed to specify the specific principal agent relationship between the reserve banks and the FRB, thus leading to subsequent coordination problems.

Designed to operate according to the dictates of real bills, the Federal Reserve was supposed to provide a more stable banking system and a more reliable money supply “discount[ing] notes, drafts, and bills of exchange arising out of actual commercial transactions” (*U.S. Statutes at Large* 38 (1913): 263). To replace national banknotes and add currency during times of economic duress, the reserve banks gained authority to issue a new paper currency backed by government securities known as the Federal Reserve Note.¹³ In so doing, the Federal Reserve Act rendered the Comptroller irrelevant in monetary matters and made him little more than a chartering and regulatory authority for banks. Each reserve bank also obtained authority to conduct open markets operations under rules and regulations prescribed by the FRB. Through open market operations, reserve banks could buy or sell government securities, gold, or other bills and drafts in the money market, but the decision-making resided in the individual reserve banks’ boards. Although the Federal Reserve’s founders did not envision this policy tool becoming its dominant option, the ability it allowed the Fed to affect the money supply through the purchase and sale of government securities made it very alluring. Furthermore, open market operations provided the Fed with a means of self-funding by collecting margins on the government securities in which it dealt.

Although the Federal Reserve lacked the authority to charter any banks, its founders created an immediate constituency by stipulating that all national banks become members. They also permitted state-chartered commercial banks or savings banks to join the System provided these entities met certain examination standards and subscribed to the capital stock of the reserve

¹³ National banknotes had been in decline for years as the opportunity cost of investing in federal securities drove national banks to minimize their government holdings and instead redirect their resources to more productive credit uses; by the mid thirties, national banknotes disappeared entirely from circulation.

bank located in their respective districts. Thereafter, banks belonging to the Federal Reserve System were known as “member banks.” To help the reserve banks determine the quality of potential borrowers’ collateral, the Federal Reserve Act required member banks to submit to regular examinations; it assigned the Comptroller responsibility for conducting the examinations, including those of state member banks.¹⁴ Furthermore, the statute changed the OCC’s examination fee schedule from that of a flat fee to a variable one based on the size of a bank’s assets. Consequently, the additional examination responsibilities given to the OCC resulted in greater revenue for the agency, but also threatened state banks with having to cover the costs of two separate examinations.

To manage the banking system’s role in money creation better, the Fed received two policy tools of note. The System obtained the ability to impose reserve requirements, what the Federal Reserve Act refers to as “bank reserves,” on member banks. Reserves required member banks to maintain a portion of their deposits interest-free as legal reserves for the protection of depositors. Thus, bank reserves provided both a liquidity protection, but also a means by which the Fed could alter the amount of money in circulation by changing the amount of reserves it required of members.¹⁵ In addition, the legislation directed the Fed banks to create discount windows where member banks facing liquidity shortages or having deficient reserve accounts could borrow. The Reserve banks lent to member banks against specified asset categories by rediscounting against the item and lending a portion of its value; the rate charged in this process is known as the discount rate. At the Fed’s inception, the discount rate was supposed to be the primary means by which it accomplished its monetary objectives. It was through the discount window that the Federal Reserve served as the lender of last resort to members. As former Fed

¹⁴ The reserve banks, however, received the authority, if the chose to exercise it, to except a state bank examiner’s report in lieu of an OCC one.

¹⁵ In practice, however, the Fed has rarely altered reserve requirements.

Chairman Paul Volcker explains, though, the lender of last resort role is rather difficult to carry out, for “I’m not sure I’ve ever seen a pure liquidity problem. Typically, significant liquidity problems arise because there is some question of solvency, or there would be no lack of willing lenders” (Volcker & Gyohten 1992: 204). Partly because the Federal Reserve failed its role as lender of last resort in the early years of the Great Depression, lawmakers responded to the banking panics by creating the third and most recent federal regulatory agency.

Established by the Banking Act of 1933 to administer the Temporary Deposit Insurance Fund, the Federal Deposit Insurance Corporation (FDIC) is the newest of the three federal bank regulatory agencies.¹⁶ This independent agency had a three member board of directors, composed of the Comptroller and two presidential appointees subject to Senate confirmation. Because Glass-Steagall was primarily a reform of the Federal Reserve System, lawmakers required all member banks to join the new system of deposit insurance. They also gave nonmember banks the option of joining, but required those that joined the insurance fund to become Federal Reserve members by 1938. In addition to receiving an appropriation at its inception from the Treasury of \$150,000,000, the FDIC also generated revenue by requiring the banks it insured to purchase stock in the agency. Because insured banks were not charged premiums based on their condition or the riskiness of their assets, a condition now referred to as moral hazard was created. Needless to say, policymakers have been unable to eliminate the moral hazard through the years, and the subsequent increases in deposit coverage have only increased the agency’s exposure to bank failures.

The agency became the chief federal regulator of insured nonmember state banks. It did not participate in the chartering of banks because doing so might constitute a conflict of interest when placing an institution into receivership. The FDIC has two roles:

¹⁶ The FDIC is oftentimes referred to simply as the “Corporation” in the banking statutes.

to purchase, hold, and liquidate...the assets of national banks which have been closed by action of the Comptroller of the Currency, or by vote of their directors, and the assets of State member banks which have been closed by action of the appropriate State authorities, or by vote of their directors...and to insure...the deposits of all banks which are entitled to the benefits of insurance under this section (*U.S. Statutes at Large* 48 (1933): 168).

These dual roles actually represent distinct functions that could just as easily be separate.

Through the 1950s, the FDIC possessed two tools for resolving bank failures. These included closing the bank permanently and providing a deposit payoff up to the statutorily mandated coverage limit or carrying out a purchase and assumption whereby the FDIC sells all the assets of the failed bank while providing a subsidy for some portion of the bank's bad assets.

Employing the purchase and assumption method allows the FDIC essentially to transfer customer deposits above and beyond the deposit insurance limits. As the economist William Keeton explains, "Under the current system, the effective level of coverage depends on two factors—the statutory insurance limit and the way the FDIC handles bank failures" (Keeton 1990: 25).

PLAN OF THIS DISSERTATION

With the preliminaries now complete, I now turn to outlining briefly the contents of my remaining chapters. The next four chapters present the interplay between federal regulators and the other interested policy actors. My second chapter investigates the effect of policymakers' interplay on bank regulation during 1914-1933. Because the Federal Reserve Banks did not commence operations until November 1914, interaction of any sort between federal regulatory agencies was moot until then. In the period before the Depression, the real bills doctrine

significantly influenced policymakers' views of the banking system by dictating that banks strictly limit themselves to extending credit for commercial purposes. With the outbreak of WWI and America's entry into the war in 1917, elected officials and regulators found themselves deviating from the doctrine as they enlisted banks' assistance in the financing of the war effort. It was due in large part to this wartime experience that banks obtained their first real experience with other sectors of the financial services industry, such as the securities sector. When the First World War ended, banks continued to venture further into the other financial services industries with the help of the two federal regulators. Lawmakers responded to these developments with a series of statutory changes updating the U.S. Code so that it was more closely in line with the existing regulatory rules. This process culminated with 1927's McFadden Act that not only granted national banks limited intra-city branching rights, but also explicitly approved banks' authority to engage in the securities business. Needless to say, real bills adherents disapproved of these developments, for they believed that such expansions of banking harmed the banking system and fueled speculation. Because real bills adherents lacked the necessary policy influence that followed the stock market crash, they were able to do little other than to express their dismay for much of this period.

My chapter proceeds to recount the process by which lawmakers responded to the worsening banking system through a series of bills, ultimately culminating in the Banking Act of 1933 that created the FDIC and separated commercial banking from other financial services industries. Although the chapter's principal story ends with Glass-Steagall's enactment, the narrative reviews the contents of a few subsequent New Deal pieces of banking legislation that significantly affected the structure and distribution of the banking regulation throughout the rest of twentieth century.

Following WWII, the banking system settled into a stable, yet profitable period that lasted for nearly three decades. My third chapter then examines the Nixon/Ford/Carter years of 1969-1980. During this period, volatile interest rates arose and wreaked havoc on a banking industry constrained by Glass-Steagall's rate ceilings and activity restrictions that limited banks to deposit taking and loan making. Furthermore, bank failures reappeared on a scale not seen since the Great Depression. In response to these developments, bankers sought new activities and products to meet their profitability needs.

Because federal lawmakers failed to enact legislation expanding banks' permissible activities, regulators instead dominated this process. This interplay heightened as a result of 1970's statutory reform that gave the Fed complete regulatory authority over bank holding companies. Meanwhile, regulators also contended over the resolution methods used to resolve a number of prominent bank failures of the era. As the seventies concluded, legislators extended the domestic banking regulatory framework to encompass foreign banks operating in the U.S. Then, in President Carter's last year in office, federal lawmakers enacted the first in a series of major pieces of regulatory reform legislation.

My fourth chapter examines the twelve years of the Reagan and Bush presidencies. The period commenced with interest rates at all time, double-digit highs and banks struggling to remain solvent given the rate differentials they faced. Just after the Fed relented and rates began falling, the LDC debt crisis occurred revealing other potential flaws in the banking system as large American money center banks had lent vast sums internationally to earn returns greater than domestic lending allowed. Although thrifts had begun showing serious financial problems when Reagan took office, their condition worsened such that by the middle of the 1980s hundreds were failing. Soon after, banks began failing in large numbers too. Because the bank

and thrift failures increased at the end of Reagan's second term, the brunt of resolving the failures fell on his successor.

The period 1981-1992 proved to be one of the most active since the New Deal as reflected by significant banking legislation. In Reagan's second year in office, lawmakers enacted another major deregulatory bill; this one focused on the thrift industry, yet it still contained a number of important provisions for the banking sector. The other four pieces of major banking legislation all essentially sought to strengthen and extend banking regulation in the face of first the LDC debt crisis and then the bank and thrift crises. Although the two major pieces of banking legislation promoted by the Bush Administration originally sought to modernize the banking system, opposition within Congress ultimately forced the administration and its Capitol Hill supporters to abandon these efforts. Throughout this entire period, there was significant interplay among regulators seeking to resolve the many bank failures. Faced with more legislative inaction in the face of their efforts to expand banks' activities and grant them more possible revenue streams, regulators took it upon themselves as they interacted with one another to expand their constituents' business activities.

Chapter 5 investigates the banking system of the Clinton years. The nation only just exited a recession and the banking and thrift industries were still littered with hundreds of failures. Consequently, the new president entered office having to complete the task of resolving all these failures. The Democratic Party controlled both Houses of Congress and the White House prior to Clinton's first midterm election, creating new lawmaking possibilities after years of divided government.

The period 1993-1999 proved to be a very active time as regulators interacted with one another to influence the direction of the banking system. Although the number of bank failures

declined after Clinton took office. The regulators maintained their interplay as they used their statutory authority to write new rules and thereby shape the banking industry. By far, most of the interaction in this realm occurred between the OCC and the Federal Reserve, which struggled to reshape the banking system. Two pieces of legislation were particularly significant, measures repealing banking regulations that existed since the 1920s and 1930s. The first of these repealed the 1927 McFadden Act limiting intrastate and interstate bank branching. The second, Gramm-Leach-Bliley, repealed some of the remaining provisions of Glass-Steagall. In so doing, however, Gramm-Leach-Bliley basically updated the statute books so that they accorded with the existing body of regulations. My fifth chapter concludes by discussing the changes in the regulatory structure that resulted from Gramm-Leach-Bliley.

In the concluding chapter, I begin by reviewing the process by which U.S. banking regulation evolved as interplay between the regulators and other actors. Then, I consider what contribution, if any, the enactment of Gramm-Leach-Bliley and Glass-Steagall's "repeal" made to the recent financial crisis. Finally, I draw upon my case to discuss a few likely developments in bank regulation in light of the recently enacted Dodd-Frank Act.

2. BANKING REGULATION WITH TWO FEDERAL AGENCIES: 1914-1933

This chapter presents banking regulation as it evolved through the interplay of two regulatory agencies and lawmakers from the outbreak of WWI until President Franklin Roosevelt's first year in office. Since Glass-Steagall established the Federal Deposit Insurance Corporation (FDIC) in 1933, the two federal regulatory agencies involved in this era were the Office of the Comptroller of the Currency (OCC) and the Federal Reserve.

This chapter begins by introducing the real bills doctrine, the leading banking theory of the time, through which key policymakers interpreted events. It proceeds to examine the ways in which commercial banking expanded beyond the confines of the real bills doctrine. This evolution occurred through statutory reforms, most notably a series of statutes expanding the types of assets the Federal Reserve could discount for member banks, and regulatory rulings offered by the two federal agencies. Throughout the twenties, commercial banks continued to expand the extent of their activities, not to mention establish affiliates for the purposes of entering the securities business. From the stock market crash of 1929 until the enactment of the Banking Act of 1933, the chapter focuses on the interplay among lawmakers since the two regulators had basically proven themselves ineffective at stemming the banking crises.

In the period recounted here, commercial banks enjoyed their widest range of powers from 1927 until 1933. It was the McFadden-Pepper Act (McFadden Act) of 1927 that codified many of the previous regulatory rulings by the Comptroller of the Currency, including the ability of national branch to engage in intra-city branching to a limited extent and the power to engage directly in the securities business. The statute also altered other aspects of the regulatory structure by granting the Federal Reserve banks permanent charters. Despite the McFadden Act's conferral of securities powers, adherents of the real bills doctrine still dominated banking

policy, and disapproved of banks expanding beyond demand deposits and short-term commercial loans. Because no other theory of banking displaced them and they were the only individuals issuing warnings before the stock market crash of 1929, their perspective greatly influenced subsequent legislative responses. It was this doctrine that Sen. Carter Glass (D-VA) championed through the early thirties that produced Banking Act of 1933 with its banking restrictions. Though the Democrats controlled both elected branches of the federal government when the Banking Act was enacted, compromises with a number of key personnel such as Rep. Henry Steagall (D-AL) forced Glass and his supporters to compromise their banking doctrine and include other reforms like a deposit guarantee.

BANKING FROM WWI THROUGH THE LATE TWENTIES

To understand the banking system during the first third of the twentieth century, it is necessary to begin with the real bills doctrine.¹⁷ This theory, after all, greatly influenced policymakers' views on the proper role of banks in the economy. Real bills dates back to Adam Smith; he memorably illustrated the doctrine using the following analogy:

The coffers of the bank, so far as its dealings are confined to such customers [i.e. merchants], resemble a water pond, from which, though a stream is continually running out, yet another is continually running in, fully equal to that which runs out; so that, without any further care or attention, the pond keeps always equally, or very nearly equally full. (Smith 1979: 304)

The doctrine views the money and banking systems as self-adjusting. According to the economist Lloyd Mints, individuals espousing the real bills theory believed,

¹⁷ This theory was also known by other names such as the “commercial loan theory of banking” and the “qualitative theory.”

If only “real” bills are discounted, the expansion of bank money will be in proportion to any extension in trade that may take place, or to the “needs of trade,” and that, when trade contracts, bank loans will be correspondingly paid off. Closely associated with this point of view is the doctrine that, if only commercial loans are made, the currency will have a desirable elasticity and the banks will at all times be in a liquid condition. (Mints 1945: 9)

As a result, real bills dictated commercial banks concentrate on extending credit for short-term purposes in commerce and trade, thereby providing commercial loans. The theory’s implication, as Susan Hoffman explains, is that “bankers, not the government, determine the money supply” (Hoffman 2001: 105). Though the Federal Reserve Act gave Fed officials the discount function, their role was supposed to be rather passive as the statute limited the types of assets against which they discounted.

Lawmakers created the Federal Reserve System in December 1913, but the Reserve Banks did not commence operations until November 16, 1914. Though the Federal Reserve and Comptroller of the Currency shared jurisdiction over the banking industry and space in the Treasury Building in Washington, conflicts arose almost immediately between the two regulatory agencies over the examination of member banks. The Federal Reserve Act, after all, had assigned the Comptroller’s Office the duty of examining member banks and altered its fee structure so that banks no longer paid a flat rate but rather paid based on the amount of assets they possessed. Making matters worse, the Comptroller of the Currency at the time, John Skelton Williams, notified all member banks “to send the Federal Reserve Agents of their districts a duplicate of the next report of condition, omitting certain schedules such as interest

rates charged, number of depositors, bills rediscounted, and liabilities of directors as payers or endorsers” (Robertson 1995: 107). According to OCC historian Ross Robertson,

[I]t was the position of the Comptroller’s staff...that Federal Reserve officials were not empowered to scrutinize highly confidential portions of examination reports. The only information really necessary for Reserve Bank use, they held, was that required in the extension of credit via the discount window. (Robertson 1995: 108)

Though this struggle may appear non-political, it resulted partly from the Federal Reserve’s corporate structure. Because three directors of each reserve bank were drawn from the respective district’s banking industry, there was little to constrain them from abusing their positions and exploiting the examination report information. This conflict over bank examinations persisted through the late thirties.

This competition between the OCC and the Fed undeniably reflected a coordination problem, but it was by no means the most important type of competition affecting the banking industry’s evolution. Instead, the more significant yet less noticed competition influenced the activities in which member banks engaged. Whereas the Comptroller exercised more direct control over national banks’ activities, the Federal Reserve influenced member banks indirectly by conducting the rediscounting of banks’ assets. Although the Fed controlled the rate charged in the discounting process, lawmakers controlled the determination of what assets were permissible for discounting. The resulting interplay from these two agencies resulted in a competition that contributed to the banking industry’s expansion beyond the confines of real bills.

By enacting amendments to the Federal Reserve Act on September 7, 1916, lawmakers revised both the national banking and Federal Reserve Systems, thereby leading the banking

system further from the principles envisioned by real bills. First, the statute granted national banks the authority to enter the insurance industry by declaring,

[I]n addition to the powers now vested by law in national banking associations organized under the laws of the United States any such association located and doing business in any place the population of which does not exceed five thousand inhabitants, as shown by the last preceding decennial census, may, under such rules and regulations as may be prescribed by the Comptroller of the Currency, act as the agent for any fire, life, or other insurance company authorized by the authorities of the State in which said bank is located to do business in said State. (*U.S. Statutes at Large* 39 (1916): 753)

Second, the legislation empowered national banks to issue mortgages and “make loans secured by improved and unencumbered real estate located within one hundred miles of the place in which such bank is located, irrespective of [Reserve] district lines” (*U.S. Statutes at Large* 39 (1916): 755). The statute limited national banks to devoting no more than twenty-five percent of their capital to such real estate loans. The amendments also expanded the Federal Reserve’s discounting powers so that member banks could receive advances secured against good collateral rather than discounting their existing assets. This new tool proved helpful when the Fed later tried to sell war bonds, for it allowed member banks to purchase more government bonds in anticipation of reselling them in the near future. Thus, banks could borrow on the government’s obligations rather than against their own assets.

When the United States entered WWI in April 1917, the Federal Reserve’s role evolved as the institution became the Treasury’s fiscal agent. The Fed sacrificed some of its independence in the process, but gained prominence as it assumed the role of a more traditional

central bank. To finance the war, the Treasury issued enormous amounts of debt through a series of bond drives.¹⁸ The Reserve Banks and their chief executives organized the bond drives and enlisted member banks help selling the bonds to the American public. As the Federal Reserve explained its wartime policies of promoting bond sale afterwards,

From the outset, [the FRB] recognized its duty to cooperate unreservedly with the Government to provide funds needed for the war and freely conceded that the great national emergency made it necessary to suspend the application of well-recognized principles of economics and finance which usually govern banking operations in times of peace. (Federal Reserve Board 1921: 11)

Thus, the Fed did everything in its power to discount loans and provide advances to facilitate the purchase of the government bonds. Perhaps the economic historian Harold Moulton was right when he wrote, “The most that can be said against the system is that it made the financing of the war too easy, encouraging the use of bonds for that purpose” (Moulton 1938: 392).

It was through the bond drives of the First World War that many banks gained significant exposure and experience to the securities industry. As the political economist Nelson Peach explains,

[N]ot only did they become familiar with the technique of distributing securities, but they gained many contacts with investors and won their confidence, partly because of their patriotic mission, partly because they offered bonds of unquestioned soundness. Individuals, formerly prejudiced against all types of securities, became security minded and potential customers for future issues of corporate securities. The banks, having once overcome the traditional skepticism of large masses of people who had

¹⁸ The federal bonds were known as Liberty Bonds and Victory Bonds. The federal government issued four rounds of Liberty Bonds: the first one in May-June 1917, the second one in October 1917, the third one in April-May 1918, and the final one in September-October 1918. The Victory Bonds were issued in April-May 1919.

saved money, found it easy to approach them a second time with other securities.

(Peach 1941: 32-33)

Although many banks distributed the war bonds through the traditional commercial bank structure, others developed different organizational forms for the purpose.

One option was for banks to create an internal bond department. Because the bond department structure was internal to the bank, it lacked corporate separateness and its profits and losses were directly reflected on the bank's balance sheet. Being merely a division of the commercial bank, the department had the same officers and directors. Since the department was internal to the bank, it was limited to dealing solely in debt obligations. Though debt obligations were technically securities, they represented fixed claims rather than residual claims. National banks were allowed to invest and deal in such fixed claims from their very inception with the requirement that they possess U.S. government securities before issuing banknotes.

For those banks desiring to enter more areas of the securities industry than simply the bond business, though, the affiliate structure was preferable. An affiliate was a separately incorporated and capitalized entity, hence it possessed a corporate separateness from its parent bank.¹⁹ Though banks created affiliates for a host of different activities, this corporate form first became popular as a means for national banks entering the trust business. The fiduciary business was popular among state-chartered institutions, for it allowed them to engage in almost all financial services activities, but national banks explicitly lacked such authority. Trust companies were nothing more than state-chartered banks. Therefore, national banks created trust affiliates as state-chartered banks to compete in the trust business. In 1903, the First National

¹⁹ In recent decades, the banking industry has had a similar organization known as the "Section 20" subsidiary. This entity is a subsidiary of the bank holding company, so it is regulated by the Board of Governors, yet it is affiliated with the banks within the holding company. These "Section 20" subsidiaries were permitted to engage in activities impermissible to banks under Glass-Steagall's Section 20.

Bank of Chicago gave birth to the first trust affiliates when it chartered the First Trust and Savings Bank of Chicago (White 1984: 93). With the enactment of the Federal Reserve Act, national banks received the authority to conduct fiduciary business, thereby leading a number of them to absorb their trust affiliates.²⁰ Some national banks, however, wanted to preserve their ability to engage in other aspects of the securities business still prohibited to them, so these ones absorbed their trust affiliates and spun off their securities activities by establishing securities affiliates.

The securities affiliate, though, definitely predated enactment of the Federal Reserve Act that allowed national banks to absorb portions of their trust affiliates and spin off other segments of them. Even though state-chartered banks could engage in a wider range of activities, such as the trust business, even their charters prohibited certain activities. As a result, national banks developed the securities affiliate, which they chartered under general state incorporation laws rather than banking laws. In early 1908, the First National Bank of New York incorporated First Securities Company, the first significant securities affiliate (Osterweis 1932). Some three years later in July 1911, the National City Bank of New York chartered the National City Company to serve as its securities affiliate. According to the Harold van Cleveland and Thomas Huertas, co-authors of an institutional history of Citibank, National City Corporation differed from other securities affiliates in two important ways: National City Bank, being the nation's biggest bank, formed the largest affiliate, and the affiliate quickly became a holding company for stocks of bank located across the country (Cleveland & Huertas 1985: 64). The other large New York City based commercial bank, the Chase National Bank of New York, did not charter its securities affiliate the Chase Securities Corporation (CSC) until May 1917. The CSC dealt principally as a

²⁰ When national banks absorbed their trust affiliates, they often changed their corporate titles from “national bank” to “national bank and trust company.”

corporate underwriter and manager of large securities issues for the first ten years of its existence (Wilson, 1986: 13). In other words, the CSC conducted little, if any, securities business with the general public during the period. According to the banking industry expert Steven Osterweis, “the growth of the [securities affiliate] movement was moderate until the post-war decade of common stocks when it was given a great impetus” (Osterweis 1932: 125). The growth of commercial banks’ involvement in the securities industry can be seen in the following table. The data on this type of commercial bank activity is somewhat sparse in part because the activities fell outside of the purview of federal authorities.

Table 1: Number of Commercial Banks Engaged in the Securities Business, 1922-33

Year	National Directly Engaged	National Security Affiliate	State Directly Engaged	State Security Affiliate	Total
1922	62	10	197	8	277
1923	78	17	210	9	314
1924	97	26	236	13	372
1925	112	33	254	14	413
1926	128	45	274	17	464
1927	121	60	290	22	493
1928	150	69	310	32	561
1929	151	84	308	48	591
1930	126	105	260	75	566
1931	123	114	230	58	525
1932	109	104	209	53	475
1933	102	76	169	32	379

Source: Peach, W. Nelson. 1941. *The Security Affiliates of National Banks*. Baltimore, MD; Johns Hopkins Press. P. 83.

The changing needs of the banking system were not lost on policymakers. From the First World War onwards, federal lawmakers enacted a number of statutory revisions for the Federal Reserve and the national banking systems. To aid financing U.S. involvement in the war, for instance, Washington amended the Federal Reserve Act in June 1917. This bill expanded the list of assets that the Reserve Banks could discount, thereby making extensions of credit easier. Yet it also sought to entice state nonmember banks to join the Federal Reserve, promising “any bank becoming a member of the Federal Reserve System shall retain its full charter and statutory

rights as a State bank or trust company, and may continue to exercise all corporate powers granted it by the State in which it was created” (*U.S. Statutes at Large* 40 (1917): 234). In late September of the following year, legislators passed another bill amending the Federal Reserve; this law further expanded national banks’ fiduciary powers and explicitly declared national banks to have trust powers equal to their state-chartered competitors. Then, in 1920 and 1921, to help finance the remaining government war bonds still circulating, lawmakers enacted measures specifically extending discounting authority to encompass Liberty Bonds. The federal government thus made the securities business more enticing and profitable for banks purchasing or distributing government bonds. On March 4, 1923, federal lawmakers enacted yet another legislative reform of the Federal Reserve System. The Agricultural Credits Act of 1923 was designed to make more credit available for the struggling agricultural industry, which had been suffering since the decline of commodity prices following the war. In addition to creating new facilities to provide direct extensions of credit to farmers, this statute granted the Reserve Banks the ability to discount and make advances to “producers of staple agricultural products in their raw state” (*U.S. Statutes at Large* 42 (1923): 1479). Policymakers were once again facilitating the Federal Reserve and member banks in extending credit for purposes other than commercial loans.

This legislative trend essentially culminated on February 27, 1927 when President Coolidge signed the McFadden Act.²¹ The statute provided national banks limited branching authority; it granted national banks intra-city branching rights provided that their respective state-chartered counterparts possessed the same ability. The law also permitted state banks converting to national banks or the merger of two or more national associations to keep their

²¹ Although commonly known as the McFadden Act of 1927, the law’s complete title is the McFadden-Pepper Act based on its two congressional sponsors, House Banking Committee Chairman Louis T. McFadden (R-PA) and Sen. George W. Pepper (R-PA).

existing offices and operate them as branches. Though the law is chiefly remembered as the first one granting national banks the right to open branches, it did so only to a very limited extent.

Aside from the branching matter, the McFadden-Pepper Act brought about a number of other significant changes to the banking system. It repealed the Federal Reserve Act's twenty-year charter for Reserve Banks; it also changed national banking association charters to an indefinite length. Continuing the trend of broadening discount authority, the McFadden Act granted the Reserve Banks greater leeway to discount bank assets and provide advances to members, thereby encouraging member banks to extend credit for other purposes than mere commercial ones.

Most importantly, McFadden codified many of the securities powers acquired by national banks and their affiliates over the preceding decade. The relevant section of the statute stated,

That the business of buying and selling investment securities shall hereafter be limited to buying and selling without recourse marketable obligations evidencing indebtedness of any person, copartnership, association, or corporation, in the form of bonds, notes and/or debentures, commonly known as investment securities, under such further definition of the term 'investment securities' as may by regulation be prescribed by the Comptroller of the Currency. (*U.S. Statutes at Large* 44 (1927): 1226)

The McFadden Act proceeded to limit national banks to investing no more than twenty-five percent of their capital stock and unimpaired surplus in the securities of any single debtor. The statute, however, exempted securities issued by the federal or state governments from this limitation. Nearly four months after the McFadden Act became law, the Comptroller issued regulations on June 30 defining "marketable" securities. According to him, "marketable"

securities met three criteria: they would be of a large enough quantity so that a market for them would be possible; they would be issued in such a way as to uphold the marketability of them; and, the agreement under which they were issued would separate the party paying the obligation from the party performing the fiduciary responsibility (Office of the Comptroller of the Currency 1928: 11). Not only did more commercial banks enter the securities business in McFadden's wake, but those banks already active in the securities industry altered their activities. The Chase Securities Corporation, for instance, experienced a change in policy and expanded its business from underwriting corporate issues to retail distribution of securities to individual Americans (Wilson 1986: 13).

Although the 1920s was supposedly a decade marked by a robust American economy, the banking industry as evidenced by the number of suspensions experienced significant trauma. Though these difficulties affected all commercial banks, state-chartered ones experienced more of the effects than nationally chartered ones. Moreover, nonmember banks suffered considerably more suspensions than member banks did. As the economist Walter Spahr explained in a 1932 *American Economic Review* article,

(1) The heaviest failures, absolutely and relatively, are among the state banks; (2) the failures are greatest among banks with small capitalization; (3) they are heaviest in small towns and villages; [and] (4) they are heaviest among banks outside the Federal Reserve system. (Spahr 1932: 215)

Not only did hundreds of banks suspend payments and fail, but the state-level deposit insurance programs either failed or ceased operations by the close of the decade. In the aftermath of the Panic of 1907 while federal policymakers were contemplating reforms that culminated in the

Federal Reserve, eight states instituted deposit insurance programs for state-chartered banks.²² The eight states were Oklahoma, Kansas, Nebraska, Texas, Mississippi, South Dakota, North Dakota, and Washington.²³ The deposit insurance programs all derived most of their funding from assessments levied on the state-chartered banks that were members. Some of the programs made membership optional whereas others made it mandatory. Irrespective of membership, though, the suspensions and failures that afflicted banks in rural America proved devastating for these funds and caused them all to cease operations by decade's end. Washington was the first deposit insurance program to shut down in 1921 whereas Texas was the last one to do so in 1930.

The problems afflicting the health of the banking system, though, did not go unnoticed by policymakers. One of the most respected legislative banking experts, Sen. Carter Glass (D-VA), though he supported the McFadden Act for its branching provisions, came out strongly against the ills of the banking system towards the end of the decade. Drawing upon his adherence to the real bills doctrine, he expressed concern for “the economic integrity of the Federal Reserve banking system” as increasing amounts of money were diverted to finance stock purchases (Glass 1929). Further on in that same August 1929 letter to the editor, Glass argued, incorrectly it turned out, that “the [Federal Reserve] board and the banks are definitely required by law not to permit the stock market to control them by illegally appropriating trust funds which belong to commerce and industry” (Glass 1929). Needless to say, warnings such as this one failed to have much of an impact as the overall economy still appeared to be doing well and the brunt of the bank suspensions and failures were occurring mainly in rural areas among nonmember banks. It

²² A U.S. Attorney General's ruling from July 1908 prohibited national banks from joining the funds.

²³ The dates of each respective state establishing its fund were as follows: OK in 1908, KS in 1909, NE in 1909, TX in 1909, MS in 1914, SD in 1915, ND in 1917, and WA in 1917.

would take a more drastic event, or series of events, to make people reconsider banking reform and the principles underlying it as informed by the real bills theory.

THE STOCK MARKET CRASH, THE ONSLAUGHT OF THE GREAT DEPRESSION, AND POLICYMAKERS' RESPONSES

Although the stock market had begun its incredible expansion in March 1928, it did not peak until September 3, 1929. From this point onward as reflected in the Dow Jones Industrial Average (DJIA), the stock market declined for the next month and a half before it finally crashed initially “Black Thursday,” October 24, then continued on “Black Monday,” October 28,” and “Black Tuesday,” October 29, 1929. Economic catastrophe did not ensue immediately, but a recession had definitely begun by the last quarter of the year. The market collapse of late October undeniably made headlines and even stoked panic among the public, but an economic collapse the likes of which ultimately developed was not foreseen.

Elected officials apparently failed to recognize the severity of the developing economic storm, for they were rather slow to act. Though the federal government was under the Republican Party’s unified control, President Herbert Hoover, for instance, remained silent on the subject until December when he delivered his first annual message to Congress. In the address, Hoover suggested creating a joint-legislative-executive commission to examine the entire country’s financial system and to consider separating commercial and investment banking. Needless to say, members of the president’s party on Capitol Hill did not take up his overture.

As 1930 began, economic circumstances were deteriorating. A full-fledged economic depression had not yet materialized, but deflationary effects were appearing and economic output was declining. In addition, the money supply was contracting as evidenced by declining deposit and loan amounts. While the banking system was not experiencing a crisis, failures continued

plaguing the industry, but these struck predominantly rural, nonmember banks. As a result, the banking industry was not attracting significant calls for reform. Operating in fits and starts, securities markets in the springtime appeared, at least for a short time, to recover some of their lost values.

Though President Hoover made little effort at reforming the nation's banking system along the lines outlined in his December 1929 congressional address, the two Houses of Congresses mounted initial attempts at reform. Beginning February 25, 1930, the House Banking Committee, which Rep. Louis T. McFadden still chaired, held hearings on the relatively narrow matter of the structure of the banking industry. Three committee members had all ready submitted bills: HR 8367 prohibited banking groups and chains entirely; HR 8363 permitted branch and chain banking, but subject to certain limitations; and, HR 8005 granted branching rights to banks nationwide. The witnesses testifying before the committee reflected a lack of consensus within the banking industry. The divergent testimony and views of members prevented the committee from reporting any legislation, thereby leaving the issue of branching unresolved.

Rather than confine itself to the changing structure of the banking industry, the Senate considered a much broader reform of the Federal Reserve System. This broader legislative project originated with Sen. William H. King's (D-UT) S.Res. 71 in April 1929 requesting the Banking Committee or one of its subcommittees examine a list of twenty-one questions he had prepared concerning member banks and the Fed. The questions included investigating whether legislative reform was necessary to prevent speculative uses of bank credit and what the effects of branch and chain banking were. The Senate Banking Committee, however, postponed the matter until the latter half of the year. Although interest in S.Res. 71 had increased due to the

stock market crash, the Senate became tied up with other legislative matters, so the committee delayed it further until spring 1930. Just as the Banking Committee was about to act on S.Res. 71, though, it approved a substitute resolution sponsored by Sen. Carter Glass in April which the Senate then approved in May. Because Glass was one of the drafters of the original Federal Reserve Act and therefore recognized by both parties as a banking expert, Chairman Peter Norbeck (R-SD), a progressive, appointed the Virginian chair of the special subcommittee conducting the investigation. It was from this platform that Glass would begin drafting and introducing legislation that ultimately became the Banking Act of 1933.

Chairing a subcommittee investigating the Federal Reserve System, Glass hired H. Parker Willis his old friend and collaborator from the 1913 Act as his committee aide.²⁴ With the help of Willis, Sen. Glass then introduced a banking reform bill (S. 4723) on June 17 to guide the subcommittee as it worked. Interestingly enough, the bill did not require the separation of commercial and investment banking, nor did it provide for deposit insurance or a resolution mechanism for failed banks. Though S. 4723 did not mandate Federal Reserve membership for all banks, it sought to entice state banks to join by instituting interest on member bank reserves. The bill provided national banks with branching rights equal to those of their state-chartered competitors in their respective states. Finally, the Glass bill clamped down on speculative uses of credit by restricting national banks' loans to individuals involved in the securities business with oversight provided by the OCC and by restricting member banks similarly with Federal

²⁴ According to the Chicago economist J. Laurence Laughlin, Rep. Glass selected Willis for the role of subcommittee expert based on his acquaintance with him as noted economics professor at Washington & Lee University where his two sons had attended (Laughlin 1933: 105). Willis was a Chicago educated economist; he taught at W & L from 1889-1905, entered journalism thereafter, served as first Secretary of the Federal Reserve Board, and then became a noted banking professor at Columbia. Willis, like Glass, came to be one of the nation's most respected banking authorities.

Reserve oversight. This bill marked the first iteration of what eventually became Glass-Steagall. The subcommittee hearings on S. 4723, however, did not begin until December 1930.

Meanwhile, the first of three panics struck the banking system.²⁵ Although this panic lasted only from October until December, it claimed nearly 650 commercial bank casualties. The crisis' nadir appeared when two of the country's largest banking institutions failed; these two failures represented the notorious side of banking. One of these institutions was Caldwell and Company, a chain of banks headquartered in Tennessee, but tied to banks all over the southeastern U.S. The November failure of this banking chain directly led to the suspension of forty banks. The family that controlled the Caldwell chain had engaged in all sorts of extra-banking affairs, such as the newspaper business, insurance, and even bribery of elected officials. Fraud played a significant role in the bank's failure.

Worse still was the Bank of the United States' (B.U.S.) failure; this state-chartered bank began in the New York garment district and grew to encompass nearly sixty branches around the metropolitan area.²⁶ The B.U.S.'s collapse represented the nation's largest bank failure to date; the institution's failure also indicted the affiliate structure, for the firm had a large securities affiliate network.²⁷ The bank's name misled countless depositors, many of whom were immigrants, for it mistakenly implied the U.S. stood behind the institution. The Bank of the U.S.'s failure shocked the American public and generated runs on other New York banks.

Needless to say, the midterm election could not have occurred at more inauspicious moment for Republican lawmakers. Not only was the national economy on a downward spiral,

²⁵ The terms "banking panic" and "bank run" are often used interchangeably, but it is possible to distinguish between them in a useful manner. A "bank run" occurs when depositors or note holders rush to a bank and demand payment of the bank obligations they hold whereas a "banking panic" refers to the same phenomenon but involving a large number of banks. A "banking panic," however, does not need to entail a run on every bank in a banking system.

²⁶ Franklin D. Roosevelt was governor of New York when this state-chartered bank failed.

²⁷ Two of the bank's senior executives, President Bernard K. Marcus and Vice President Saul Singer, received prison terms at Sing Sing for fraudulent interference with their affiliates.

but also key segments of the country were experiencing the worst banking panics in decades. As a result, voters were bound to hold Republicans accountable at the ballot box. Though they held both Houses of Congress, Republicans did so with the slimmest of majorities; they controlled each chamber by a single seat. The narrow Republican House majority endured little more than a year.

Just as the first banking panic was concluding, the third session of the 71st Congress was beginning; this session ran from December 1, 1930 until March 3, 1931. As a result of the ostensible calming in the banking sector, the political impetus for banking reform lessened somewhat. The improved situation proved short-lived, for the second banking panic erupted from March to June of 1931. This panic struck hardest in New York, Pennsylvania, and the Midwest. Because many of the money-center banks, in addition the Federal Reserve Bank of New York, were located in New York City, this panic proved especially harmful not only in the domestic banking system, but also in the international one. European central banks, for instance, even felt the panic's effects as New York had difficulty maintaining the fixed exchange rates entailed in the gold standard.

Unfortunately for the banking system, the timing of the second panic coincided a nine month period in which Congress was out of session. As a matter of fact, the 72nd session did not begin until December 7, 1931. Thus, it should not be surprising that the elective branches of the federal government accomplished almost nothing during 1931 pertaining to banking reform. President Hoover certainly could have demanded a special session of Congress, for Republicans still controlled both Houses for part of the year. For whatever reason, though, Hoover chose not to do so. He instead addressed the nation's worsening economic situation through executive branch initiatives entailing voluntarism on the part of the citizenry. For example in the autumn

months, Hoover persuaded New York bankers to create the National Credit Corporation (NCC), which resembled WWI's War Finance Corporation, to assist fragile banks. Collaborative efforts such as this one, however, proved unsuccessful now as bankers and other members of private industry were fearful of lending good money after bad to aid troubled institutions.

Having spent much of the year on his own combating the Depression, President Hoover finally sought congressional assistance when the 72nd session began in December. By this time, however, a handful of Republican Representatives had died, and Democrats successfully gained four seats through the special elections that delivered them a majority. When Congress reconvened in December for Hoover's annual message, four House special elections to fill the seats of deceased members eliminated the slim Republican majority and instead gave the Democrats control. It was this change in party control that ousted Rep. Louis T. McFadden, Chairman of the House Banking and Currency Committee, and replaced him with Rep. Henry B. Steagall (D-AL).

During his fourth year in office, Hoover collaborated significantly more with Capitol Hill. The two elective branches of the federal government began the year, for instance, by enacting the Reconstruction Finance Corporation (RFC) Act. This law established a temporary government agency to extend financing to banks. To prevent the Federal Reserve System from taking bad assets onto its balance sheet, Sen. Glass used his senatorial position to restrict the agency to funding its activities through the bond market. Consequently, the Reconstruction Finance Corporation was handcuffed despite the worsening economic conditions. Furthermore, the limitations placed on the RFC thwarted it from filling in as a lender of last resort to the banking system, something the Fed had failed to do following the stock market crash.

Nearly a month after enacting the RFC Act, President Hoover signed the Glass-Steagall Act.²⁸ Working across the aisle with two Congress' leading banking experts, Hoover prevailed upon Rep. Steagall and Sen. Glass to shepherd a bill relaxing the type of collateral member banks could borrow against through the reserve banks. This widening of acceptable assets provided for another way for the Fed to serve as lender of last resort, yet it also provided a means for the Fed to expand the money supply. Rep. Steagall was more than willing to comply with Hoover's wishes since doing so permitted an inflating of the money supply whereas Sen. Glass was somewhat reluctant at first to comply. The bill's inflationary aspects troubled Glass because they departed from his views on sound money and real bills. The Virginian eventually agreed to sponsor the legislation provided that he could include a sunset provision for the Fed powers of March 3, 1933. The measure's overall effect was inflationary; it foreshadowed banking legislation to come over the next few years.

Meanwhile, Sen. Glass was busy pursuing his own proposed banking legislation. In January, he introduced the second version of his bill (S. 3215) reforming the Federal Reserve System. This bill mandated Federal Reserve membership for all commercial banks, contained a Liquidation Corporation to resolve bank failures, regulated group banking and bank holding companies, granted national banks statewide branching authority, prohibited member banks from underwriting securities, limited the extension of reserve bank credit for securities activities, raised the discount rate, removed the Treasury Secretary from the FRB, recognized the authority of the OMPC, and directed the OCC to examine all bank affiliates. The proposed legislation contained no deposit insurance fund. Because the bill generated significant protest during the

²⁸ The Glass-Steagall Act of 1932, of course, is not to be confused with the Banking Act of 1933, which many individuals mistakenly also refer to as the "Glass-Steagall Act."

committee hearings, however, Glass revised it and introduced another version in the middle of March.

Completion of February 1932's Glass-Steagall Act delayed the revision of Sen. Glass' third banking bill (S. 4115). Although the Federal Reserve membership mandate and branch banking provisions of the previous bill generated the most complaints from witnesses in the committee hearings, both provisions remained in the bill's third incarnation. Moreover, the bill also permitted trade area branching within fifty miles of a bank's head office irrespective state lines.

This version still contained a Liquidation Corporation to resolve the assets of failed banks. Nonetheless, it also contained some new provisions. For instance, S. 4115 lowered the amount of capital required for rurally situated national banks, not to mention national banks succeeding failed banks. Perhaps most important of all, it was in this bill that Glass introduced his required separation of commercial and investment banking. This proposed legislation abandoned the pretense of regulating member banks' securities affiliates, and instead required their separation within three years. Needless to say, Glass appeared to generate even more animosity from the banking system with this latest bill. Bankers disliked its divestiture requirements. The Federal Reserve Board, joining other bankers in their complaints, found fault with the required separation and instead preferred limiting extensions of credit between banks and their affiliates. The Board also disliked the notion of funding the Liquidation Corporation through the Federal Reserve System and member banks, so it proposed funding it through the Treasury instead. The implication of this proposal, of course, was that the full faith and credit of the U.S. government would be at stake. Finally, the Comptroller disliked the bill because of its greater focus and burdens imposed on national banks.

Strong opposition prevented S. 4115 from getting out of committee, so Sen. Glass mounted yet another legislative attempt in mid April when he introduced S. 4412. Two of the most contentious aspects of the previous bill (S. 4115) still remained: namely the forced separation of member banks and their securities affiliates within three years and statewide branching rights. Furthermore, most of the provisions remained from the prior version. In an effort to accommodate the FRB, however, Glass strengthened the Board's control over the foreign transactions of the twelve reserve banks. He also included restrictions on loan advances to bank affiliates. Unlike the previous three Glass bills, this one received floor action in May. Nonetheless, S. 4412 engendered intense animosity from opponents that fellow senators submitted over fifty amendments. Glass even amended his own proposed legislation during the debate to prohibit interstate branching and extend the deadline by two years on the divorce provision. Because of intense opposition and Glass' ill health, though, the Senate postponed further consideration of S. 4115 until year's end.

While Glass was embroiled in a Senate battle over his proposed banking legislation, Rep. Henry Steagall was championing a banking bill with deposit insurance as its centerpiece. On March 7, 1932, he introduced his first deposit insurance bill (H.R. 10241). This bill created a Federal Bank Liquidating Board (FBLB) to insure bank deposits and to appoint agents to handle the liquidation of failed banks' assets. In doing so, it eliminated the existing system of double liability of national bank stockholders and replaced it with a clearer, and supposedly more efficient payment timetable. The bill required the FBLB to make its first payment to depositors within sixty days of a bank's failure and to complete its final payment to them within one year. The FBLB insured all member banks and obtained its funding from payments received from member banks, reserve banks, and the Treasury. Though the bill did not provide for increased

oversight of bank activities or restrictions on various activities, it sought to improve the health of small, rural banks by requiring them to have capital levels of at least \$50,000 and a ten percent surplus. During the Banking Committee's hearings in March and early April, however, the FBLB provisions of the bill generated particular controversy, thereby causing Chairman Steagall to revise the proposed legislation.

On April 12, Rep. Henry Steagall introduced his second deposit insurance bill (HR 11362). This second bill clearly sought to attract wider legislative support by lowering the payments from insured banks and by permitting the RFC to loan funds to the FBLB, not to mention opening the insurance to all banks regardless of Federal Reserve membership. In exchange for lowering insurance premiums, however, the proposed legislation delayed the FBLB's repayment timeframe: the agency was now required to make its first payment within ninety days and its final one within eighteen months. To protect the health of the deposit insurance system, this bill authorized the FBLB to remove the officers of national banks, under certain circumstances, if they were engaging in detrimental behavior. Seven days after its introduction, the House Banking Committee reported HR 11362. Then, on May 25 the full House began debate on HR 11362. In the floor debate, Rep. Louis McFadden led opposition to the bill. Rep. Louis McFadden led the opposition which challenged the proposed legislation on the grounds that it ran contrary to the dictates of sound banking and that the state level experiences with deposit guarantee had not ended well. Nevertheless on May 27, the House passed Steagall's bill; it then proceeded to the Senate where it died in the Banking Committee without being considered.

Since economic conditions continued to worsen through the middle of the year, the federal government enacted two other emergency measures. Before adjourning in mid July for

the upcoming presidential election, legislators attached emergency related provisions to two broader bills. One was a rider attached to the Home Loan Bank Act; it expanded the monetary supply by allowing national banks to issue more national banknotes. The other one was connected to the Emergency Relief and Construction Act; House Speaker John Nance Garner (D-TX) attached the amendment broadening the RFC's lending abilities in return for publicly disclosing the recipients of the agency's aid. Once in operation, this disclosure measure undoubtedly caused further damage to the economy and the banking system as it instilled fear among the general public upon discovering which institutions received assistance. Though elected officials only enacted emergency measures, the House and Senate also made efforts during the year to institute deposit insurance and reform the Federal Reserve System.

When the 72nd Congress reconvened in December for its second session, it truly was a lame duck. Franklin D. Roosevelt had just defeated incumbent President Hoover in a landslide election and carried large numbers of Democrats into Congress on his coattails. Even though the new Democratic administration and the Democratic House and Senate majorities did not take office until early March 1933, Senator Glass still sought to gain passage of his banking reform bill that the senate had postponed from June. After continued prodding from Glass, Senate leaders finally acceded to the Virginian's wish of debating S. 4412. Debate began on the Glass bill in early January, but it quickly came to a halt as Sen. Huey Long (D-LA) mounted a filibuster for days to thwart the provisions allowing in-state branching across county lines. Needless to say, Glass' two major concessions were unable to sway enough senators to invoke cloture. He agreed to amend to bill by extending the divestiture period from three to five years and by constraining new intrastate branching powers of national banks to states providing

reciprocal ones to state-chartered institutions. Sen. Long's filibuster thus effectively killed the fourth Glass bill.

While congressional action on banking reform ground to a standstill, the Depression exhibited no signs of abating. Although the third and most significant banking panic began in October 1932, it did not reach its apex until early March 1933. In the process, numerous states declared bank holidays for state-chartered institutions to calm the worried public.

One of the worst hit states, if not the epicenter, was Michigan. Two extremely troubled banking groups dominated the Wolverine State: the Guardian Group and the Detroit Banking Group. Both holding companies were less than ten years old and had directors in common with the automobile industry. In fact, the Ford family controlled a large portion of the Guardian Group's stock, and Henry Ford was one of the largest depositors in both groups. The Reconstruction Finance Corporation had been providing emergency assistance to both holding companies since before the start of 1933, but the groups' financial situations became more precarious in February as the banking panic was developing in Michigan. The onset of the panic further sapped the Guardian Group's resources as public fears grew about the banks' declining asset values, causing the Guardian Group to seek out additional RFC assistance.

To raise capital levels, the corporation proposed a large loan contingent upon the group raising several million dollars worth of collateral from its principal investors. The banking group, though, was unable to find the requisite money. When President Hoover and RFC officials then approached Henry Ford about his contributing another four and a half million dollars in equity, he adamantly refused. In response, Ford threatened to withdraw millions of dollars from his own personal accounts in both holding companies, thereby worsening the situation even more. As a result on Valentine's Day 1933, Michigan Governor William

Comstock ordered an eight-day state banking holiday. Seven days later, though, the governor extended the state banking holiday indefinitely. Because many of the banks from surrounding Midwestern states such as Ohio and Illinois held large reserves in Michigan banks, the panic in Michigan soon engulfed the entire region. At this time, though, individual states were declaring their own moratoria to control the spreading panic. This federalist approach was problematic, for the states lacked jurisdiction over the national banks located within their borders.

Just as the banking panic in the upper Midwest was reaching its height, the Senate Banking Committee's investigation into the banking industry was revealing some of its most shocking details. Though the Banking Committee had created the investigative panel at President Hoover's request in April 1932, the panel and its first two chief counselors maintained a low profile by focusing their energies on examining the securities market and the evils of short selling. As the banking historian Vincent Carosso explained of the early component. The "Senate Bear Hunt," as the banking historian Vincent Carosso explains, "failed to uncover any Democratic conspiracy or other organized raids designed to discredit Hoover and destroy public confidence in his efforts to bring about recovery" (Carosso 1970: 324). Not until Committee Chairman Peter Norbeck appointed Ferdinand Pecora lead counselor on January 24, 1933 did the panel refocus its investigation on the evils of the commercial banking industry. Unlike his two predecessors and the senators serving on the panel, Pecora was aware of the broad investigative authority granted by the original Senate resolution and used it to expand the inquiry.

Broadening the investigative panel's inquiry, Pecora began in mid February by taking testimony from individuals associated with. After having spent a few days in mid February examining the Insull failure, Pecora next turned his attention to the National City Bank and its securities affiliate National City Company. This marked Pecora's first investigative foray as the

lead counsel of the Senate panel into the commercial banking industry. In hearings spanning from February 21 until March 2, testimony revealed numerous abuses by the nation's largest commercial bank and securities firm such as circumventing a federal law in 1911 prohibiting national banks from engaging in the securities business, promoting questionable securities to the public in an overly aggressive manner, and compensating executives excessively. Ferdinand Pecora's memoirs conclude that "the two chief instruments which facilitated these abuses [by National City] were the investment affiliate and the secrecy with which the management was allowed to operate" (Pecora 1939: 130). Though the 73rd Congress renewed the mandate for the Banking Committee's investigation upon taking office, Pecora's damage to the banking industry was done. National City Company was the largest retailer and distributor of securities at the time, but, four days after the investigation concluded looking into the bank, National City announced it was liquidating its securities affiliate. The following day, the Chase National Bank announced the voluntary divestiture of its securities affiliate the Chase Securities Corporation (CSC). In the wake of the down securities market and startling revelations, the owners of the two largest securities companies announced on March 8 and 9 that they were voluntarily closing their businesses.

Because of the environment in which he entered office, President Franklin Roosevelt could not avoid using his inaugural address to confront Americans' many economic worries. In his March 4 inaugural, he maintained that the United States would recover under his leadership, but he emphasized,

[I]n our progress toward a resumption of work we require two safeguards against a return of the evils of the old order: there must be a strict supervision of all banking and credits and investments, so that there will be an end to speculation with *other*

people's money; and there must be provision for adequate but sound currency.

(Roosevelt 1938: 13) (Italics added)²⁹

Thus, Roosevelt signaled his support for significant banking reform, something that Senator Carter Glass had been advocating for the past few years, and his predecessor had been fighting.

Since Michigan declared its bank holiday, President Hoover had been seeking to alleviate the spreading panic by declaring a nationwide bank holiday, but President-elect Roosevelt provided no clear indication as to the action's constitutionality or that he would uphold it. Consequently, Hoover vacillated over the matter and failed to act, allowing the nation's banks to sink deeper into trouble. Even though he provided no guidance to Hoover on a national bank moratorium, President Roosevelt drew upon 1917's Trading with the Enemy Act on March 6 when he declared a nationwide bank holiday.³⁰ The holiday required all banks, regardless of their chartering authority, to suspend their operations for the four day period spanning from March 6 through March 9. Roosevelt later extended the bank holiday.

Though the president had called legislators into session the day after his inauguration, Congress did not convene its special session and launch the "first hundred days" until March 9. Congress began that very day by enacting retroactive legislation approving FDR's emergency bank holiday, not to mention providing for the inspection and orderly reopening of the nation's

²⁹ Roosevelt reused the phrase in a March 29 speech when he asked Congress for federal securities legislation based on the "ancient truth that those who manage banks, corporations and other agencies handling or using other people's money are trustees acting for others" (Roosevelt 1938: 93-94). The Progressive legal scholar Louis Brandeis popularized the phrase "other people's money" by using it as the title of a series of articles he published in 1913 for Harper's Weekly concerning the Money Trust. Although it is unknown whether he intentionally borrowed the phrase from Adam Smith, it is quite probable that he was aware of Smith's usage. In *The Wealth of Nations*, Smith writes, "The directors of such companies [i.e. joint-stock companies], however, being the managers rather of *other people's money* than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own" (Smith 1981: 741) (Italics added). Roosevelt, though, would reuse the phrase a few weeks later in a March 29 congressional speech in which he requested

³⁰ Savings banks did not need the holiday because they all ready possessed the legal means to restrict payments to depositors since they held only time deposits rather than demand deposits.

commercial banks. Toward this end, both chambers approved the speedily drafted Emergency Banking and Relief Act with little debate; the bill became law March 9.

Two days after the Emergency Banking Act became law, Sen. Glass introduced the fifth version of his banking bill (S. 245).³¹ This version resembled the measure the Senate debated in January, except for one crucial addition; it contained a deposit guarantee mechanism. Evidently fearing that the recent events of the Midwestern banking panic made some type of deposit guarantee unavoidable, Sen. Glass sought to address the issue before it once again defeated his reform attempt.

The Roosevelt Administration approved of the broad outlines of this version, except for three aspects. First, FDR believed branching should occur within individual counties rather than on a statewide basis depending on state law. Second, the president opposed eliminating the Treasury Secretary's *ex officio* reserve board position. Third, and most importantly, he vehemently disapproved of deposit insurance. In an "off the record" comment during his first press conference on March 8, President Roosevelt explained his reasoning on the grounds that "The general underlying thought behind the use of the word "guarantee" with respect to bank deposits is that you guarantee bad banks as well as good banks. The minute the Government starts to do that the Government runs into a probable loss" (Roosevelt 1938: 37). Although inhabitants of this time period did not possess the concept "moral hazard" that now exists, Roosevelt's comments appear to indicate he had a fear that deposit insurance would have difficulty distinguishing between good and bad banks, thereby the information shortage would contribute to greater government losses.

³¹ Having turned down Franklin Roosevelt's offer to become Treasury Secretary, Sen. Carter Glass (D-VA) instead became Appropriations Committee Chairman. Because Glass took the Appropriations Chair, Sen. Duncan Fletcher (D-FL) became Banking Committee Chairman. Fletcher, though, made special arrangements so that Glass could chair a Banking subcommittee on which all the Banking Committee members served and thereby still direct the Senate's banking reform efforts.

Sen. Glass' banking subcommittee marked up S. 245 over the following several weeks. To ease legislative passage, the Virginian sought to accommodate some of the administration's concerns. Though he refused to budge on statewide branching, he and his subcommittee compromised over deposit insurance. Understanding that Roosevelt opposed deposit insurance, especially anything guaranteeing 100% of all bank deposits, they made a few alterations. First, the subcommittee introduced a graduated scale for the deposit guarantee; the scale guaranteed 100% of deposits beneath \$10,001, 75% of deposits between \$10,000 and \$50,000, and only 50% of deposits above \$50,000. Second, the subcommittee limited the Treasury's initial contribution to the insurance and liquidation corporation's capital base to \$150 million; thereby limiting taxpayers' exposure. Third, Glass' subcommittee delayed the operation of any insurance corporation until July 1, 1934. In addition to these three concessions, the panel also deleted the provision stripping the Treasury Secretary of his Federal Reserve Board seat.

Having assuaged the Roosevelt administration, the subcommittee added a few other provisions. First, the subcommittee decided that excessive competition to attract deposits contributed to the speculation of the crash, so it imposed interest rate ceilings on savings and time deposits while prohibiting the payment of interest on demand deposits. Second, members of the subcommittee introduced other provisions interlocking directors and officers from serving banks and other non-financial firms and banks and securities firms. Second, subcommittee members introduced a provision prohibiting interlocking directors. In other words, individuals serving on bank boards as directors would be prohibited from serving as directors of nonbanking firms. Third, the subcommittee reduced the period for banks to divest their securities activities from five years to two.

After the subcommittee finished making these changes, Sen. Glass on May 10 introduced a sixth version of his bill (S. 1631). Three days later, the full Senate Banking Committee considered the measure. Before reporting S. 1631 on May 17, the committee added two more items. First, the panel added protections for banks' minority shareholders. Second, the committee attached a provision separating commercial banking and insurance by prohibiting bank officers from making insurance policies. The Banking Committee, however, rejected an attempt by Sen. William G. McAdoo (D-CA), President Wilson's former Treasury Secretary, to institute the deposit insurance program immediately.

While the Senate was considering Glass' latest bill, Rep. Steagall on May 16 introduced another banking bill (HR 5661), which the House Banking Committee approved within three days. Steagall's bill differed from the Senate's one in a few ways. First, rather than delegating authority to the Federal Reserve Board to set interest rate ceilings on time deposits without any specific limits, the House version established a maximum rate of 3% that the FRB could not exceed. Second, Steagall's bill strengthened the Fed's open market operations by preventing individual reserve banks from engaging autonomously in such operations. Third, HR 5661 omitted any branch banking provisions. Fourth, so as not to disadvantage nonmember banks, the bill established a new government corporation to provide deposit insurance. When Steagall's bill reached the House floor on May 20, the chamber completed debate in only four hours. Finally, three days later the House of Representatives easily approved the legislation by the margin of 262 to 19.

On May 19, the Senate began debating Glass' bill. During the debate, the major point of contention among senators concerned the deposit guarantee. Employing a brilliant parliamentary ploy, Sen. Arthur H. Vandenberg (R-MI) introduced an amendment to force a vote on creating a

deposit insurance fund that would immediately cover deposits up to \$2,500 at all banks without any prior examination. With the assistance of Vice President John Nance Garner, the Senate adopted Vandenberg's amendment. Vandenberg's provision, of course, makes perfect sense in the context of the recent banking panic experienced by Michigan. On May 25, the upper chamber finally approved the banking bill by voice vote.

A few days later on June 1, the conference committee convened. With the special legislative session's end fast approaching, however, conferees relatively quickly worked out the necessary agreements to produce a report eleven days later. The conference report largely followed the Senate version except for deposit insurance. The deposit guarantee provisions drew upon HR 5661 instead. In addition, the conferees eliminated the double liability of national bank shares going forward, formally created the Federal Open Market Committee to conduct open market operations, and increased the amount of shares that member bank directors were required to have. Given the nation's recent ordeals with banking panics and the legislative impetus on Capitol Hill for significant reform, final congressional approval was merely a formality.

When the conference committee submitted its final report, congressional approval was merely a formality. On June 13, the Senate passed the conference report by voice vote whereas the House approved it with only six lawmakers voting "nay." Three days later President Franklin Roosevelt signed the Banking Act of 1933.

The resulting legislation has received praise from numerous scholars for its role in creating a healthy banking system. Milton Friedman and Anna Schwartz, for instance, argue in their coauthored *Monetary History of the United States, 1867-1960*:

Federal insurance of bank deposits was the most important structural change in the banking system to result from the 1933 panic, and, indeed in our view, the structural

change most conducive to monetary stability since state bank note issues were taxed out of existence immediately after the Civil War. (Friedman and Schwartz 1963: 434)

On the opposite side of the political spectrum, scholars such as institutional economist John Kenneth Galbraith contend, “With this one piece of legislation the fear which operated so efficiently to transmit weakness was dissolved....Rarely has so much been accomplished by a single law” (Galbraith 1997: 191-192). Because the Banking Act contained a number of important reforms, not the least of which was deposit insurance, it is worth reviewing briefly the statute’s contents.

The Banking Act basically contained two institutional thrusts and several regulatory ones. First, Glass-Steagall established the Federal Deposit Insurance Corporation (FDIC) to administer a deposit insurance fund. The statute authorized the FDIC to open a Temporary Federal Deposit Insurance Fund on January 1, 1934; this fund insured deposits up to \$2500. Then, the statute required a permanent fund replace the temporary one on July 1, 1934. Unlike the temporary fund, the permanent one contained a sliding scale for coverage whereby “100 per centum of such net amount not exceeding \$10,000; and 75 per centum of the amount, if any, by which such net amount exceeds \$10,000 but does not exceed \$50,000; and 50 per centum of the amount, if any, by which such net amount exceeds \$50,000” (*U.S. Statutes at Large* 48 (1933): 173). Though such a sliding scale for deposit insurance never went into effect, opponents of the insurance provision were largely responsible for it as a way of avoiding a blanket guarantee of deposits.

Second, Glass-Steagall reformed the Federal Reserve System. It lengthened the terms of Federal Reserve Board members from ten to twelve years and specified that the Board’s main offices would be located in D.C. The Banking Act also formally created a Federal Open Market

Committee (FOMC) composed of one representative from each of the twelve reserve banks and meeting at least four times annually in the nation's capital, but it did not provide for a means of the Board compelling reserve banks to participate in open market operations, only that they would have to abide by rules laid down by the Board. So as to constrain the Fed's open market operations, the statute mandated that the paper "eligible for open-market operations shall be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country" (*U.S. Statutes at Large* 48 (1933): 168).

On the regulatory side, Glass-Steagall instructed the Fed to create interest rate ceilings for member banks' deposit accounts; it effectively prohibited interest on demand deposits with a statutorily imposed rate of zero percent. The law granted mutual savings banks the authority to join the Federal Reserve System. It required bank holding companies owning 50 percent of the stock in two or more member banks to register with the FRB if the holding companies wished to exercise their shares. Glass-Steagall also equalized branching restrictions so that national banks had the same branching rights in their respective home states as state-chartered institutions had. The statute eliminated the double liability imposed on national bank shareholders resulting from any future offerings of additional shares. By adding Sec. 23A to the Federal Reserve Act, the Banking Act imposed certain "firewalls" on the transactions between member banks and their affiliates. For instance, Sec. 23A limited banks in the extensions of credit made to their affiliates; they were prohibited from extending more than ten percent of surplus plus capital to any one affiliate whereas they were prohibited from extending more than twenty percent of capital plus surplus to all affiliates combined. Finally and most memorably, the law separated

commercial from investment banking.³² To achieve this separation, Glass-Steagall employed four particular sections: Section 16 limited national banks' securities activities, Section 20 prohibited affiliations between Fed member banks and securities firms, Section 21 prohibited securities firms from accepting deposits, and Section 32 prohibited member banks and securities firms from sharing directors.³³

Because Glass-Steagall's permanent deposit insurance plan was behind schedule in the summer of 1934, federal lawmakers on June 16 enacted the Federal Deposit Insurance Extensions Act. This statute postponed the permanent fund's starting date an entire year to July 1, 1935. It also doubled the temporary fund's amount of coverage effective July 1, 1934 from \$2500 to \$5000, not to mention preempted the permanent plan's sliding scale for taking effect.³⁴ Just as the permanent deposit insurance plan was scheduled to begin operations the following year, federal lawmakers enacted on June 28, 1935 yet another statute extending the temporary deposit fund until August 31.

Meanwhile, legislators were engrossed in passing another seminal banking bill. Unlike the Banking Act of 1933, the Banking Act of 1935 was truly an administration bill as its Federal Reserve components largely reflected the wishes of the newly appointed Governor of the Federal Reserve Marriner Eccles. Enacted on August 23, 1935, the Banking Act of 1935 contained three separate titles: Federal Deposit Insurance, Amendments to the Federal Reserve Act, and Technical Amendments to the Banking Laws.

³² Whereas many scholars and policymakers employ the term "Glass-Steagall" to mean only the four sections of the Banking Act of 1933 separating commercial and investment banking, I use the term to refer to the law in its entirety. Interestingly enough, the GLBA only repealed Sections 20 and 32 of Glass-Steagall; Sections 16 and 21 still remain.

³³ Section 5(c) extended Glass-Steagall's Section 16 limitations on banks' securities activities to state [Fed] member banks. Although Section 16 prohibits national banks from investing in securities, it makes some exceptions by introducing the distinction between eligible and ineligible securities.

³⁴ The law exempted mutual savings banks failing to qualify under the required assessments and examinations from receiving the benefit of the doubling of coverage.

The Banking Act of 1935's first title terminated the temporary deposit insurance fund and replaced it with another permanent plan. It also automatically admitted all those banks insured under the temporary plan unless they notified the federal government in writing within thirty days of their desire to withdraw from the system. Going forward, the statute raised the standards of admission for any other banks wishing to gain insurance for their deposits; the FDIC would now consider a bank's capital position, the prospects for profitability, its management, and the needs of the community it was seeking to serve. The statute also required the FDIC to prohibit the payment of interest on demand deposits and to limit the interest rates nonmember insured banks paid on other accounts. Moreover, the FDIC even gained the ability to bail out troubled depository institutions:

Until July 1, 1936, whenever in the judgment of the board of directors such action will reduce the risk or avert a threatened loss to the Corporation...the Corporation may, upon such terms and conditions as it may determine, make loans secured in whole or in part by assets of an open or closed insured bank, which loans may be in subordination to the rights of depositors and other creditors, or the Corporation may purchase any such assets or may guarantee any other insured bank against loss by reason of its assuming the liabilities and purchasing the assets of an open or closed insured bank" (*U.S. Statutes at Large* 49 (1935): 699).

Although the statute maintained the preexisting coverage limit of \$5,000 per account, it eliminated insured banks' stock subscriptions and replaced them with an annual assessment rate of one-twelfth of one percent of total deposits.

As for the Federal Reserve, the Banking Act of 1935 made some significant changes to the. The Banking Act's second title made a number of important alterations to the Federal

Reserve System. First, it renamed the Federal Reserve Board and the members of the Board, reduced the Board's membership from eight to seven members by removing the Treasury Secretary from his ex officio seat, and increased the term of office for the Governors from twelve to fourteen years. Likewise, the law renamed the head officials of each of the reserve banks "president" rather than "governor" and gave the Board veto power over each bank's board of director's choice for bank president. The Banking Act also granted the Board of Governors the ability to alter member banks' reserve requirements within a narrow range. The measure further expanded the assets that the reserve banks could discount, thereby giving them some discretion to influence member banks' choice of assets. Finally, the statute reorganized the structure of the FOMC so that the FRB now controlled open market operations. It achieved Board domination by altering the FOMC's membership to include all seven Board members and five of the reserve bank presidents on a rotating basis.

As for other amendments to the banking laws, the most notable change was Sec. 304's order that thereafter provided national banks gave six months notice, double liability of bank shareholders would cease to exist.

CONCLUSION

This chapter recounted bank regulatory policy's development from the opening of the Federal Reserve System through the Banking Acts of 1933 and 1935. It showed this evolution resulted from the interplay of regulators, elected officials, and other actors involved in the bank policy realm. Although statutory changes played a significant role, regulatory actions and rulings also played a large role. Throughout the period covered here, the real bills doctrine dominated banking thought and provided an idealized vision of a banking system, yet the reality diverged noticeably from this theory. Additionally, federal lawmakers were complicit from

WWI onwards as they enacted a series of statutes expanding the types of assets Federal Reserve members could discount, thereby encouraging member banks to extend credit for purposes other than commercial loans. This process culminated in 1927's McFadden Act which not only provided national banks with very limited branching rights, but also updated the banking statutes to incorporate the right to engage in the securities business.

During this period, the Fed had only a very limited regulatory role pertaining to acting as lender of last resort, a responsibility at which it failed miserably following the stock market crash, and setting reserve requirements for member banks. The OCC, on the other hand, possessed a significant regulatory role over national banks which it used to expand the activities and powers of these depository institutions. Neither of these two federal agencies had any authority over many of the nation's banks. Furthermore, both agencies failed to work together, and, in so doing, necessarily contributed to the banking crises of the early thirties.

With regulators unable or unwilling to handle the crises in the banking system following the stock market crash, federal lawmakers became involved in the policymaking process. Throughout much of the Hoover administration, President Hoover generally tried to handle banking policy on his own with as little input from Congress as possible, and when he did work with Congress on legislation, the results tended to leave action in private hands rather than governmental bodies. Needless to say, competing proposals held by members of the House and Senate further complicated banking reform during the Hoover presidency. Following his inauguration, President Roosevelt resolved differences between the White House and Congress by delegating regulatory reform to Sen. Glass. Although Democrats controlled both the executive and legislative branches by 1933, disagreements between House and Senate Democrats necessitated compromise over the two main reform proposals. As a result, the Banking Act of

1933 joined restrictions on banks activities based on the real bills doctrine with deposit insurance. The Banking Act of 1935 excoriated much of Sen. Glass' real bills principles, yet left the activity restrictions in place. As the remaining chapters will show, this regulatory structure had tremendous longevity.

3. POLICYMAKERS RESPOND TO WEAKNESSES IN BANKING REGULATION: 1969-1980

This chapter presents bank regulatory policy during the Nixon, Ford, and Carter administrations. Before investigating this twelve year period, however, this chapter recounts the seminal revisions to banking law from the mid 1930s through 1966 that fundamentally altered the regulators' constituencies, objectives, and relationships. These statutory reforms primarily concerned the FDIC and the Federal Reserve. Then, the chapter turns to the enactment of the Bank Holding Company Act Amendments of 1970. This statute closed the loophole by which one bank holding companies (obhcs) were unregulated, and, in so doing, established the Federal Reserve as the sole regulator of all bank holding companies.

Soon after lawmakers completed this major statutory revision, though, bank failures reappeared of a size and scope not experienced before. To cope with some of these failures, the FDIC began experimenting with a previously unused resolution mechanism to provide financial assistance and thereby avoid closing the banks. This action marked the start of what ultimately became known as the too big to fail doctrine. Ironically enough, the FDIC first use this resolution mechanism in the 1971 failure of Unity Bank and Trust Company, of Roxbury, Massachusetts. Unity was a small, single office bank, but the FDIC was unable to find any buyers for the failed bank and feared repercussions from closing a minority bank serving a minority neighborhood. This resolution mechanism, though, had enormous ramifications for the other two regulators, especially as they began the process of issuing rulings permitting banks to expand into other avenues of business. Overall, however, the federal regulators were relatively restrained in the use of their rulings to expand bank's activities; this was likely due in part to their having to cope with the increase in significant failures of banks under their supervision.

Nonetheless, the twelve years described in this chapter were a busy time for lawmakers as they mounted persistent efforts to reform banking regulation and update the outmoded laws. During this period, the Nixon White House and then the House Banking Committee mounted huge studies of the banking system and possible regulatory reforms, but legislators proved unable to act upon most of the proposals. Elected officials, though, did enact a handful of relatively minor statutes altering the regulatory landscape, including ones increasing from \$5,000 to \$20,000, granting banks and thrifts in certain northeastern states the ability to offer NOW accounts, and extending the domestic bank regulatory structure to apply to foreign banks operating in the United States. Faced with continued problems in the banking system and a federal court decision threatening to overturn a host of financial offerings from bank and thrift institutions, lawmakers in 1980 finally enacted major regulatory reform with the Depository Institutions Deregulation and Monetary Control Act (DIDMCA). Among other things, this legislation extended the Fed's powers to set reserve requirements over all depository institutions excluding credit unions regardless of membership status, authorized the new transaction accounts that depository institutions were experimenting with in lieu of checking accounts, increased deposit insurance coverage limits fivefold, and phased out interest rate ceilings over a five year period. This statutory reform marked the start of the so-called "deregulatory" period, which is the point at which this chapter concludes.

PRELUDE TO THIS PERIOD

Although the two decades following WWII are often overlooked because of the banking system's stable and profitable performance, significant changes occurred to the structure and distribution of regulation with the enactment of a handful of banking statutes.

The first of these changes occurred in late September 1950 when President Truman signed the Federal Deposit Insurance Act (FDIA) of 1950. Essentially, the legislation broke off section 12B of the Banking Act of 1933 that created the FDIC, and gave the agency its own statute. With the exception of a brief time from 1935-1936, the FDIC only had two resolution methods. This law gave the agency another means to handle bank failures by creating the “essentiality” provision contained in section 13(c):

[T]he Corporation, in the discretion of its Board of Directors, is authorized to make loans to, or purchase the assets of, or make deposits in, such insured bank, upon such terms and conditions as the Board of Directors may prescribe, when in the opinion of the Board of Directors the continued operation of such bank is essential to provide adequate banking service in the community. (*U.S. Statutes at Large* 64 (1950): 888-889)

In this way, the agency gained the ability to operate as a pseudo-lender of last resort. The statute also reduced the premiums of insured banks through a rebate system that credited depository institutions’ payments for the upcoming year at the conclusion of each calendar year. Finally, FDIA doubled the level of deposit insurance coverage from \$5,000 to \$10,000.

Lawmakers, however, apparently were still unsatisfied with the depositor protection provided by the FDIC a decade a half later, for they enacted another bill increasing the coverage amount by fifty percent. Although the Financial Institutions and Supervisory Act of 1966 dealt primarily with issuing federal bank and thrift regulators temporary powers to handle unsafe banking practices and to remove bank and thrift officers engaging in such activities, the law also raised deposit coverage from \$10,000 to \$15,000. The increase came from the House Banking and Currency Committee, which had tried to double the amount, but the conference committee

subsequently cut the increase in half. Thus, in nearly thirty years of existence, the FDIC's coverage limits had more than tripled in absolute dollar amounts, making the agency's potential liability much greater in the event of bank failures.

Nearly six months after the FDIC gained its statutory independence, the Federal Reserve received its operating independence from the Treasury. Aided by the conflicting problems of financing the Korean War and maintaining a stable monetary policy, the two agencies ultimately reached the Treasury-Fed Accord in March 1951 that freed the central bank from maintaining a fixed price on the federal government's securities beyond the next issue. In conjunction with a new Fed Chairman concerned with the independence of the institution, the Fed was now ready to devote its full energies to managing the money supply free from outside interference.

Through the mid fifties, policymakers had been contending with the spread of the holding company movement within the banking industry. A bank holding company (bhc) is nothing more than a holding company controlling or owning one or more commercial banks.³⁵ This form of banking organization was previously known as group banking. According to the economist Allan Meltzer,

Heightened political interest in monetary policy induced the System to look for external supporters in Congress and among the public. Banks and financial institutions under regulatory control became a source of support, particularly after the 1956 Bank Holding Company Act increased the Board's power to approve or reject applications for new bank powers. (Meltzer 2009: 46)

The FRB solved this spreading problem and acquired a new constituency when the Bank Holding Company Act (BHCA) of 1956 made it the sole regulator of bank holding companies.

³⁵ Bank holding companies can be identified by their corporate titles which often contain one of the following terms: *banc*, *bancshares*, or *corp*.

Enacted May 9, 1956, the BHCA introduced several important items. First, it defined a bank holding company (bhc) as:

any company (1) which directly or indirectly owns, controls, or holds with power to vote, 25 per centum or more of the voting shares of each of two or more banks or of a company that is or becomes a bank holding company by virtue of this Act, or (2) which controls in any manner the election of a majority of the directors of each of two or more banks.... (*U.S. Statutes at Large* 70 (1956): 133)

This definition, however, applied neither to single bank holding companies nor to partnerships.³⁶ Thus a new loophole was created. Furthermore, the act defined a “bank” as “any national banking association or any State bank, savings bank, or trust company” (*U.S. Statutes at Large* 70 (1956): 133). In this way, lawmakers defined banks according to the type of charter they possessed, yet doing so delegated the matter of determining the activities that constituted banking to the chartering authorities.

The BHCA required all entities qualifying as a bank holding company to register with the Board of Governors. The Fed also gained authority to issue all the necessary rules and orders necessary to implement the act.³⁷ Henceforth, any entity seeking to form a bank holding company needed to obtain the FRB’s prior approval. Likewise, the act required holding companies to receive prior approval before merging with another bhc or acquiring upwards of five percent of another bank’s voting shares. The statute included the Douglas Amendment, named after Sen. Paul H. Douglas (D-IL), prohibiting bhcs from acquiring banks located outside

³⁶ Single bank holding companies are often referred to as one bank holding companies (obhcs). In contrast, the BHCA only regulated bank holding companies owning multiple banks, also known as multi bank holding companies (mbhcs).

³⁷ The Federal Reserve developed Regulation Y to promulgate rules for bank holding companies and their activities.

of their home state unless the state laws of the target bank explicitly authorized such purchases.³⁸ The BHCA provided aggrieved parties with the right of judicial review from the U.S. Court of Appeals in their respective districts.

More importantly, the legislation made it unlawful thereafter for any bank holding company to acquire any corporation that was neither a bank nor another bhc. Furthermore, it required holding companies to divest their interests in nonbanking companies within two years, but authorized the Board to issue no more than three one year extensions. The BHCA, however, did not entirely prohibit bank holding companies from engaging in nonbanking activities, for it provided several exceptions for their subsidiaries. The most important of these exceptions included sec. 4(c)(6) which stated:

[The prohibitions in this section shall not apply] to shares of any company all the activities of which are of a financial, fiduciary, or insurance nature and which the Board after due notice and hearing, and on the basis of the record made at such hearing, by order has determined to be *so closely related to the business of banking or of managing or controlling banks* as to be a *proper incident* thereto and as to make it unnecessary for the prohibitions of this section to apply in order to carry out the purposes of this Act. (*U.S. Statutes at Large* 70 (1956): 137)(Italics added)

Afterwards, the Board narrowly interpreted the phrase “so closely related to the business of banking” by considering it in relation to the specific banks within the group that it severely limited affiliations with nonbanking interests. Finally, the BHCA imposed a series of provisions in section 6 making it illegal for banks, regardless of Fed membership, to extend credit or loans to any of the nonbanking affiliates in the group. Section 6 thus made Glass-Steagall’s section

³⁸ The Douglas Amendment appeared as section 3(d) of the BHCA.

23A irrelevant as it provided no circumstances under which credit could be extended among affiliates.

The Federal Reserve's bank holding company authority underwent revisions a decade later with the Bank Holding Company Act Amendments of 1966. For the purposes of the Board's subsequent actions concerning bhcs, three revisions were of most importance. First, section 3(c) of this statute amended section 2(b) of the BHCA to read as follows, "'Bank' means any institution that accepts deposits that the depositor has a legal right to withdraw on demand" (*U.S. Statutes at Large* 80 (1966): 236). In this way, lawmakers began refining the definition of a bank from one based on the type of charter to one based on the activities engaged in. Second, the act revised the BHCA's section 4(c), moving what had been the sixth paragraph to the eighth paragraph. The wording of this paragraph remained practically unchanged. Third, section 9 of this statute totally repealed the BHCA's section 6, thereby making section 23A operable again. This revision represented a liberalizing of inter-affiliate transactions.

THE NIXON/FORD YEARS

As President Nixon entered the White House in 1969, banking regulation was once again attracted Capitol Hill's attention. Though the BHCA controlled the spread of mbhcs, obhcs had grown significantly over the last five years. The Nixon Administration had promised legislators that it would offer bills in both Houses to reform holding company regulation, but it missed a number of deadlines, leading House Banking and Currency Committee Chairman Wright Patman (D-TX) on February 17 to offer his own bill (HR 6778). Rep. Patman's bill closed the loophole that exempted obhcs. Among other things, HR 6778 extended bank holding company regulation to obhcs under the Federal Reserve Boards' jurisdiction and mandated the holding companies divest all their nonbanking activities regardless of when they began them.

Citing the worrisome “trend toward the combining of banking and business,” President Nixon finally announced on March 24 two identical administration bills (HR 9385 and S 1664) that he was sending up to Capitol Hill. In contrast to the Patman bill which gave sole regulatory responsibility to the Fed, the administration’s bills divided the responsibility among the three federal regulators. Rather than mandate the divestiture of nonbanking activities, the Nixon bills exempted nonbanking activities begun prior to July 1, 1968. Furthermore, the administration measures delegated the determination of permissible nonbanking activities, such as operating a mutual fund, to the court system. Upon its introduction to in the House, Patman expressed his disapproval of the proposed legislation by saying, “The Administration bill has crippling defects right at the nerve center of this entire legislative effort” (Congressional Quarterly 1970a).

A few weeks after the introduction of the Nixon Administration bill, the House Banking Committee began hearings on the proposed legislation. Spanning from April 15 until May 9, Patman’s Committee held some fourteen days worth of hearings. During this process, the committee heard testimony from numerous witnesses from the regulatory agencies, the banking industry, banking trade groups, and consumer groups. The main concerns involved allocating regulatory authority and handling obhcs’ all ready acquired nonbanking activities.

On June 27 by a 29-5 vote, the Banking Committee approved HR 6778. Though the approved version maintained much of Patman’s original bill, such as concentrating regulatory oversight of all bank holding companies in the Federal Reserve, it contained a few noteworthy changes. The committee inserted a “functionally related” test for the Board of Governors to use when determining the permissibility of bhcs’ nonbanking activities. The committee also added a prohibition against holding company subsidiaries selling mutual fund shares and serving as an

insurance agent. Furthermore, the committee included a grandfather date that upheld obhcs' nonbanking activities entered into before February 17, 1969.

The Banking Committee passed HR 6778 in mid summer, but the House did not approve the bill until November 5. The House passed version still granted the Board of Governors all regulatory oversight of bank holding companies. It also maintained the Banking Committee's "functionally related" test, not to mention the specific prohibitions against certain holding company nonbanking activities. It redefined a bank holding company as a company controlling one or more banks, rather than as one holding at least twenty-five percent of the voting shares. House members amended the grandfathering date, rolling it back from February 17, 1969, to May 9, 1956, the day on which the BHCA was enacted. By rolling back the date in this way, the House required any single bank holding companies that acquired nonbanking activities since the original BHCA to divest themselves of them. With the congressional session drawing to a close, HR 6778 proceeded to the Senate where it waited until the following year for consideration.

Before year's end, though, lawmakers completed work on one other banking bill of note. With the current statutory authority to establish interest rate ceiling about to expire, Congress needed to extend regulators' Regulation Q authority. Otherwise, commercial banks and thrifts might outbid one another for funds, thereby endangering the health of the banking system. The Senate first passed a bill (S 2577) in mid November extending interest rate control authority until September 22, 1970, and providing another source of mortgage financing through the federal government.

Following on the Senate's action, Rep. Patman and nineteen Banking Committee co-sponsors introduced a bill (HR 15091) on December 4 that extended rate ceiling authority March 22, 1971, employed the Federal Home Loan Bank Board to establish a secondary market for

mortgages, permitted national banks to make mortgage loans with only ten percent down for periods of up to thirty years, and, most importantly for regulatory purposes, raised the deposit insurance coverage limit from \$15,000 to \$25,000. The House approved HR 15091 thirteen days later by a margin of 260-136, but a number of Republicans voted against the measure.

According to Congressional Quarterly, the Republican member of the Banking Committee in particular opposed HR 15091 because they were of the understanding that the bill would only pertain to Regulation Q authority (Congressional Quarterly 1970b).

With Christmas nearly a week away, a conference assembled the following day and reached an accord. Conferees adopted the House extension for interest rate ceilings, dropped the provision granting national banks greater mortgage lending powers, and lowered the House bill's deposit insurance increase by \$5,000 to \$20,000. Both chambers the next day easily approved the conference report. President Nixon signed the Credit Control Act of 1969 on December 23. This statutory change was primarily important because it raised FDIC coverage, thereby increasing the federal government's contingent liability in the event of bank failures.

As 1970 began, the issue of banking reform and the perceived threat of one bank holding companies and their expansion persisted on the minds of lawmakers. President Nixon signaled on February 2 his continued interest in banking reform when he included in his first Economic Report the announcement that he intended to appoint a presidential commission on the structure and regulation of the banking system.

Nearly two months passed without any further action on the proposed bank holding company legislation when President Nixon announced on April 21 that he was appointing Reed O. Hunt to chair his presidential commission. A week later in a planning meeting of the commission held at the Treasury Department, though, Hunt announced that the commission

would be unable to produce any study of the obhc problem until early 1971 at the soonest. Consequently, members of Congress hoping for presidential guidance would have to wait quite a bit longer.

It was in this context that the Senate Banking and Currency Committee considered proposed legislation on the regulation of one bank holding companies. In addition to HR 6778 which the House had all ready passed, the Banking Committee had a bill (S 1052) introduced by Sen. William Proxmire (D-WI) closely resembling the original HR 6778 and the Nixon Administration's bill (S 1664). In more than ten days of hearings beginning May 12, the committee heard testimony on the policy issue; it received testimony from administration officials, the federal banking regulators, banking trade group representatives, members of the banking industry, and members of competing industries. Among the regulators, the principal concern revolved around the assignment of regulatory jurisdiction. Whereas the Comptroller of the Currency insisted that lawmakers should divide the responsibility among the three federal regulators, the FDIC, somewhat surprisingly, came out in favor of assigning one agency the responsibility, reasoning, "It might be extremely difficult to achieve unanimity among the three agencies" (Congressional Quarterly 1971). The Fed, of course, had basically favored consolidating the responsibility under it from the start.

The Senate Banking Committee eventually reported a bill (HR 6778) on August 10. The committee's bill resembled the House's by granting the Board sole regulatory authority. It defined a bank holding company as any company determined by the FRB to have control over a bank or controlling twenty-five percent or more of the election of a bank's directors. Unlike its House counterpart, this one did not prohibit specific nonbanking activities, rather it delegated those decisions to the Board. As for obhcs' nonbanking activities, the bill permitted retention of

activities begun before March 24, 1969, thereby establishing a much later grandfathering date than the House. The Senate Banking Committee's HR 6778 mandated the divestiture of nonbanking activities begun after that date, but granted the holding companies at least five years to comply and the option of receiving an additional five year extension with the FRB's permission. It also prohibited banks from tying in extensions of credit to the purchase of other services from affiliated companies within the banking group. Finally, it created a "public benefit" test for the Board to use when determining whether to permit nonbanking activities.

The next month on September 16, the Senate approved HR 6778 by a 77-1 margin; Sen. Proxmire was the lone dissenting vote. With the exception of a few alterations, the upper chamber passed the bill as reported by its Banking Committee. Of greatest significance, the Senate adopted one of Proxmire's amendments moving back the grandfather date from March 24, 1969 to June 30, 1968. The chamber also exempted a certain class of trust companies chartered under Missouri law along with Rhode Island chartered mutual savings banks. Although the Senate maintained the anti-tying provisions of the bill, it amended them to exclude transactions involving solely bank-related products such as deposits, loans, and fiduciary services.

The conference committee, however, did not convene until mid November. The most significant disagreement to be resolved concerned what criteria would determine the nonbanking activities of holding companies. The Senate's version of HR 6778 contained both a "functionally related" and a "public benefits" test whereas the House version contained only the former. Furthermore, the Senate bill did not prohibit any specific nonbanking activities. The other major point of contention surrounded the grandfathering of nonbanking activities. The House approved measured required divestiture of nonbanking activities begun since the

enactment of the original Bank Holding Company of 1956 whereas the Senate measure contained the more recent date of June 30, 1968. The Senate conferees ultimately prevailed not only in gaining adoption of their grandfathering date, but also weakening the determination of permissible nonbanking activities going forward by requiring the FRB to apply both the “functionally related” and “public benefits” tests. Although the House’s version contained more stringent anti-tying provisions, the conference adopted the Senate’s version instead with its exemptions for typical bank products. Likewise, the conference kept the Senate’s grant of legal standing to bhcs’ competitors to bring judicial review challenges. The conference submitted a final report on December 15.

With the end of the first session of the 91st Congress fast approaching, the two chambers wasted little time approving the conference report. Even though House conferees acquiesced in most of the Senate’s demands for the proposed legislation, Rep. Patman defended the bill in the House claiming, “the version of the bill that is now being presented...is substantially similar to the bill originally introduced by me in February 1969” (Congressional Quarterly 1971). The House easily approved the report December 16 with only four members opposing. The next day the Senate followed suit by voice vote. Even Sen. Proxmire, who provided the sole nay vote earlier, evidenced a change of mind and voted for the report, stating, “the bill recommended by the joint House-Senate conference committee is a fair compromise and represents an effective approach to regulating one-bank holding companies” (Congressional Quarterly 1971). With congressional approval completed, President Nixon signed HR 6778 December 31.

In addition to assigning the Federal Reserve Board sole regulatory responsibility, the Bank Holding Company Act Amendments of 1970 introduced other important changes to the structure and distribution of banking regulation. First, the legislation redefined a bank holding

company as any company having control over one or more banks. Such control included acting directly or indirectly through another entity to vote at least twenty-five percent of the voting shares, controlling the selection of a majority of a bank's directors, or having been determined by the Board to be exercising a controlling influence on one or more banks. Partnerships were still exempted from this definition. Second, the statute redefined "bank," which appeared in sec. 2(c) of the original BHCA, to mean "any institution...which (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans" (*U.S. Statutes at Large* 84 (1970): 1762). By defining banks as depository institutions that made both commercial loans and provided demand deposits, lawmakers had inadvertently created the "nonbank bank" loophole, whereby firms could perform either function and avoid being classified as a bank. Third, to differentiate banks from other depository institutions, the law defined a "thrift institution" to mean "(1) a domestic building and loan or savings and loan association, (2) a cooperative bank without capital stock organized and operated for mutual purposes and without profit, or (3) a mutual savings bank not having capital stock represented by shares" (*U.S. Statutes at Large* 84 (1970): 1763). This redefinition of thrift institutions resembled the way in which the BHCA originally defined banks based on their charter type.

Fourth, and most importantly for the purposes of determining the interests bank holding companies may have in nonbanking organizations, the statute replaced Sec. 4(c)(8) of the BHCA with the following:

[The prohibitions of this section shall not apply to] shares of any company the activities of which the Board after due notice and opportunity for hearing has determined (by order or regulation) to be *so closely related to banking or managing or controlling banks* as to be a *proper incident* thereto. In determining whether a

particular activity is a *proper incident* to banking or managing or controlling banks the Board shall consider whether its performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public...that outweigh possible adverse effects. (*U.S. Statutes at Large* 84 (1970): 1765)(Italics added)

By inserting this new section into the statute, legislators granted the Board of Governors greater leeway to interpret holding companies' activities, thereby liberalizing the activity restrictions.

With the Bank Holding Company Act Amendments of 1970, federal lawmakers successfully updated banking law to close one loophole through which banking organizations were expanding into nonbanking activities. The day before the House approved the conference report for HR 6778, however, the Supreme Court heard oral arguments in the case of *Investment Company Institute v. Camp*.³⁹ The case arose out of two separate but related actions by the Comptroller of the Currency, one involving a rule generated permitting banks to establish and run collective investment funds and the other involving an order granted to the First National City Bank of New York permitting the establishment and operation of such a fund.⁴⁰ Basically, the case concerned banks' attempt to enter the mutual fund industry.

In reaching its ruling which it delivered in April 1971, the Court considered Glass-Steagall's legislative history and the restrictions it imposed on banks' activities; this was the institution's first interpretation of the Banking Act's activity restrictions. The Justices began by drawing on their holding from the previous year's case of *Association of Data Processing Service Organizations v. Camp*, in which they held that aggrieved parties that suffer from the competition posed by bank entry into their industry have legal standing to sue (397 U.S. 150

³⁹ The Investment Company Institute (ICI) is the trade group representing investment companies, which include mutual funds, and investment trusts. From 1971 onwards, the ICI was a repeat litigant against the banking industry. The trade group was established following the 1940 enactment of the Investment Company Act.

⁴⁰ These two original controversies arose in the sixties from actions taken by the OCC under William B. Camp's predecessor James J. Saxon.

(1970)). The Supreme Court then considered the mutual funds and determined they fell within the meaning of the term “securities” prohibited by the Banking Act, so it overturned the Comptroller’s two actions. Furthermore, the majority opinion indicated that the most troubling aspect was the Comptroller’s *post hoc* rationalizations of his rule-making exercise:

[T]he Comptroller adopted no expressly articulated position at the administrative level as to the meaning and impact of the provisions of Sections 16 and 21 as they affect bank investment funds. The Comptroller promulgated Regulation 9 without opinion or accompanying statement. *ICI v. Camp* 401 U.S. 617 (1971)

The Justices temporarily halted banks’ expansions into other financial services industries, but their reasoning did not preclude all expansions, rather it appeared to indicate the need to provide adequate justification on the part of the regulatory agency. The Court may have preserved the Glass portion of the Banking Act, but the Federal Deposit Insurance Corporation (FDIC) was about to pervert the Steagall component irrevocably.

Although an action undertaken by the FDIC in July 1971 involved the first use of another method for handling bank failures rather than an expansion of the banking industry’s activities, it had far-reaching effects as the subsequent four decades have shown. Prior to this date, the FDIC used two methods for handling failures: either it closed the bank and paid off depositors or it sold off the bank’s assets, thereby transferring the accounts to another bank. Because the Unity Bank and Trust Company of Roxbury, Massachusetts was a very unappealing acquisition due to its clientele and neighborhood, a payoff would have most likely been the only available option. As a result, Unity’s closure threatened to deprive the community of banking services, and, according to regulators, might even lead to racial unrest. According to FDIC board member Irvine Sprague, “In 1971 no one could be sure that the failure of a black bank in a rundown urban

center would touch off a new round of 1960s-style rioting. The Watts...and Detroit race riots....came very readily to mind when we thought about Unity” (Sprague 1986: 38). Working with area bankers and the Massachusetts Banking Commissioner, since Unity was a state-chartered institution, the FDIC crafted a plan to bring in new bank management and provide loans from both the private sector and the federal government; it announced its plan on July 27.⁴¹ Thus began the FDIC’s foray into bank bailouts, yet this action received scant notice.⁴²

Meanwhile, pursuant to its recently altered BHCA authority, the Board of Governors announced Regulation Y changes. Having considered the meaning of the phrase “so closely related to banking,” the Fed determined that “acting as insurance agent or broker in offices at which the holding company or its subsidiaries are otherwise engaged in business (or in an office adjacent thereto)” fell within the statute’s meaning and was therefore permissible (57 Fed. Res. Bull. 674-675, August 1971). This new regulation represented a very generous grant of powers, for it did not make the expansion of activities contingent upon operating out of a small community where one of the subsidiary banks conducted business.

Less than six months after Unity, the FDIC reused its newly discovered resolution tool to prevent the insolvency of Detroit’s Bank of the Commonwealth. The Detroit bank had been experiencing significant problems for some years now. Unlike Unity, Commonwealth had over a billion dollars worth assets, so its failure would be considerably more harmful. Federal regulators had earlier forced out top executives and directors, and in January 1971, Chase Manhattan Bank, Commonwealth’s largest creditor, took possession of the bank. Within a few

⁴¹ For nearly a decade afterwards, Unity Bank limped along without paying off its private sector creditors or the federal government. As a result, the state banking commissioner later closed the institution and the FDIC took it into receivership on June 30, 1982; this time the FDIC sold off the assets to another bank to facilitate a merger. The bank evidently was no longer “essential” to its community.

⁴²The FDIC does not refer to these transactions as “bailouts,” rather it labels them instances of “open-bank assistance.”

months Chase tired of its creditor position and approached the FDIC about a means of getting back its investment plus expenses. According to Sprague, agency officials at the agency initially balked at the proposal. After months of negotiations between Chase and the regulators, though, the issue that led Sprague to become the second vote for an “essentiality” finding was Chase’s agreement to suffer some loss (Sprague 1986: 71).⁴³ The FDIC and Fed announced their rescue plan January 18, 1972, which included a loan from the Corporation and limits on shareholders’ dividends. The FDIC’s legal counsel justified its action on two grounds, namely “Commonwealth’s service to the black community of Detroit and concentration” in the city (Sprague 1986: 72). This second federal bailout, though, even with its much larger size, still did not trigger much reaction from the public or elected officials.

Responding to the volatility of interest rates and consumer demands for alternative interest bearing deposit outlets, the Consumer Savings Bank of Worcester, Massachusetts in July 1970 proposed negotiable order of withdrawal (NOW) accounts (Gibson 1975: 19). The NOW account innovation was simply a savings account permitting withdrawals using drafts written to third parties, thereby providing a means of payment much like a checking account, but unlike a demand deposit, paying interest.⁴⁴ On September 28, 1970 the state banking commissioner denied Consumer Savings’ application. The mutual savings bank quickly filed suit in state court. In early May 1972, the Massachusetts Supreme Judicial Court ultimately decided the case for Consumer Savings, arguing “We do not agree with the commissioner that use of the negotiable withdrawal order create a new account” (*Consumer Savings Bank v. Commissioner of Banks* 361

⁴³ The FDIC employed the “essentiality” doctrine two more times before decade’s end. The next instance occurred on September 9, 1974, when the FDIC declared American Bank & Trust of Orangeburg, SC, “essential.” This finding lasted only four days, at which time the agency closed the bank. Then, on March 15, 1976, the FDIC declared Farmers Bank of the State of Delaware “essential” and provided assistance. Farmers Bank, however, was unusual in that DE owned nearly half the stock and was one of the bank’s largest depositors.

⁴⁴ Depository institutions offering NOW accounts reserved the right to require 30-90 days notice before permitting withdrawals, so technically speaking, these accounts differed from actual demand deposits in the eyes of the law.

Mass. 717 (1972)). About a month later Consumer Savings Bank began offering customers NOW accounts; ten other Massachusetts mutual savings banks followed suit the next month, and, in September New Hampshire mutual savings banks began offering them (Gibson 1975: 19). According to one Federal Reserve banking analyst, Massachusetts mutual savings banks were in a unusual position because so many of them were both state-chartered and state-insured that the federal government had little control over them (Gibson 1975: 19). Thus began the banking community's innovations in transaction services, innovations that would ultimately blur the distinctions between different types of depository institutions established by Glass-Steagall.

The banking industry, though, was also busy trying to expand through other means. Bankers Trust New York Corporation (BTNYC), for instance, tried expanding across state lines in Florida by establishing a new holding company nonbanking subsidiary providing investment advisory services. Before the Federal Reserve Board ruled on the application, Florida had enacted a law clearly targeting Bankers Trust by prohibiting out-of-state corporations from owning investment advisory firms unless they were operating before December 21, 1972. As a result, the entire Board rejected the proposal on April 19, 1973, concluding, “[T]he recently enacted legislation was intended to, and does, prohibit the performance of investment advisory services in Florida by non-Florida bank holding companies” (59 Fed. Res. Bull. 365, May 1973). Though Bankers Trust's interstate expansion plans were thwarted, the bank holding company still had other options available as the Board assumed the constitutionality of all Florida's actions.

With federal regulators' Regulation Q authority scheduled to expire June 1, Rep. Fernand St. Germain (D-RI) had introduced a bill (HR 6370) at the end of March extending the authority through the end of 1974. Nearly a month later the House easily approved the measure, but in so

doing, it attached a Banking Committee amendment prohibiting NOW accounts nationwide. On a vote of 76-0 nearly two weeks afterwards, the Senate passed similar legislation extending federal authority over rates, but unlike the House, it attached an amendment prohibiting mutual savings banks, except for those in Massachusetts and New Hampshire, from offering NOW accounts. The two differing amendments produced by the House and Senate surrounding the provision of NOW accounts tied up the conference committee for months even as rate ceiling authority was about to expire.

Because rate ceiling authority expired June 1, legislators warned depository institutions not to raise rates to meet market levels since they still planned to extend the authority. Toward this end, in late June both chambers hurriedly enacted measures to extend the authority temporarily until August 1, 1973, by which time they hoped to have resolved their conference differences on HR 6370. Then, on July 31, House and Senate conferees finally reached an agreement on HR 6370; President Nixon signed the legislation three days later. The compromise extended federal authority over interest rates until the end of 1974 and granted all federally chartered bank and thrift institutions located in New Hampshire and Massachusetts the authority to offer NOW accounts. Under this agreement, Massachusetts and New Hampshire depository institutions would provide an experimental laboratory for this new type of transaction accounts.

As the following year began, the President's Commission on Financial Structure and Regulation report attracted much of the attention of the policymaking community. The President's Commission, more commonly known as the Hunt Commission after its chairman Reed O. Hunt, had submitted its report following completion of its eighteen month study late last December, but Congress had all ready adjourned. The presidential commission was composed of twenty individuals a number of whom were corporate executives in the banking and finance

industries, though it also contained economists and even a representative from the AFL-CIO.⁴⁵ The Commission was especially concerned with “protecting financial institutions from disintermediation” (U.S. Senate 1973: 15).⁴⁶

To alleviate the strains on the banking system, the Hunt Commission put forth a number of policy recommendations for lawmakers’ consideration. On the regulation of interest rates, the commission suggested eliminating the controls on time and savings deposits, but not the one setting the rate at zero percent for demand deposits. The panel also suggested expanding the powers of depository institutions to engage in a wider array of activities, ranging from making other types of loans to investing in various types of securities. The Commission proposed making charter conversions easier for all types of depository institutions and lifting the branching limitation to allow intrastate branching. Another proposal sought to make Federal Reserve membership mandatory for all state-chartered commercial banks, S&Ls, and mutual savings banks that offer transaction accounts. The Commission also recognized the need to develop more uniform standards for how the FDIC handled bank failures and to consider criteria other than the least cost when determining how to handle bank failures. The panel advocated creating a new agency to oversee all the state-chartered depository institutions and renaming the OCC the Office of the National Bank Administrator and granting it the responsibility for overseeing all federally chartered banks.

Toward the end of the year, the failure of the United States National Bank (USNB) of San Diego, California startled the American public and the policymakers. There had been little warning from the OCC prior to its closure on October 18, 1972. USNB had assets of

⁴⁵ Alan Greenspan, the future Chairman of the Board of Governors of the Federal Reserve, was one of the twenty commissioners.

⁴⁶ The term “disintermediation” was a fairly new one tracing its origins back to a *New York Times* article that stated, “the refinancing got high marks from Wall Street because of the Government’s effort to lessen “disintermediation” – heavy withdrawals from savings institutions for direct investment in the securities market” (Allan 1968: 67).

approximately \$1.2 billion when it became insolvent, and its downfall marked the largest bank failure since the Great Depression. Since the late 1950s, USNB was engaged in questionable lending to insiders and firms affiliated with its directors; this behavior triggered repeated regulatory criticism, but the bank had always managed to satisfy the regulators' complaints. Rather than being a casualty of the recession and the economic times, however, U.S. National's failure ultimately resulted largely from "self-dealing" (White 1992: 26). Until November 1972, however, OCC examiners had not classified the bank in the problem category in danger of failure. The OCC then took another eleven months before finally placing the institution into receivership. As a result, the Comptroller's office received heavy criticism from the media and lawmakers in Washington for its apparent lack of thoroughness in the examining process and lack of promptness in taking action.

With U.S. National's failure fresh in the public consciousness, the House Banking Committee wasted little time in January 1974 reporting a banking bill (HR 11221). Most importantly, the measure raised deposit coverage limits from \$20,000 to \$50,000; in addition, it fully guaranteed the time and demand deposit accounts of governmental units without regard to the amount. The purpose of such increases in deposit insurance was not only to reassure the American public, but, more importantly, to entice more funds into the banking system during a time of high interest rates. Nearly two weeks afterwards on February 5, the full chamber approved HR 11221 by nearly a two hundred vote margin.

The Senate, however, was in little hurry to act on the measure, for not until June 4 did the Senate Banking Committee report its version of HR 11221. The Banking Committee made several changes from the House version. Chief among them concerned the deposit coverage limits on which it removed the unlimited federal guarantee on the time and demand deposits of

local governmental units and the \$50,000 limit for individuals that it lowered to \$25,000.

Against the wishes of Sen. William Proxmire (D-WI), the soon-to-be chairman, the committee attached an amendment allowing a limited number of federally chartered S&Ls, to demutualize and convert to stock corporations. In addition, the Senate Banking Committee included an amendment extending through 1975 federal banking agencies' authority to establish interest rate ceilings. Then, nine days later the Senate passed its version of HR 11221 by a margin of 89-0.

Because of the two HR 11221s, House and Senate members convened a conference. At the beginning of October, conferees reached an accord when House members accepted most of the Senate amendments added to HR 11221. Most notably, the two chambers diverged widely on the increased coverage limits of federal deposit insurance. Whereas the House wanted a limit of \$50,000, the Senate desired a limit of \$25,000; the conferees agreed to increase the coverage limit to \$40,000. The conference committee also increased coverage for governmental unit deposits to \$100,000. In addition, the conferees accepted the Senate's extension of federal authority to set rate ceilings. The committee also acquiesced in the Senate's attachment of the Equal Credit Opportunity Act amendment that essentially prohibited depository institutions from discriminating based on sex or marital status. On October 9 and 10, respectively, the House and Senate approved the conference report with only a single House member voting against the bill. President Gerald Ford, who had taken office August 9 following Richard Nixon's resignation over Watergate, signed the bill October 28.

Meanwhile, on the day the House approved the conference report for HR 11221, Franklin National Bank (FNB) of New York failed. This bank had been among the nation's twenty largest banks and had had nearly \$5 billion in assets at its height. At its height, FNB held approximately \$5 billion in assets and was among the nation's twenty largest banks. Unlike

USNB which collapsed largely due to insider dealing, FNB failed because of its overexposure to the international lending markets. Although Franklin National began on Long Island, it expanded into New York City in the sixties to compete with the money center banks. When American banks were squeezed by rate ceilings in the late sixties and seventies, FNB followed the other money center banks to Europe where it could pay market rates of interest. To meet the extremely high interest rates, the bank took to speculating in foreign exchange (FX) markets. When U.S. inflation surged in the mid seventies, though, Franklin National's bet on the American dollar cost the institution dearly. Following its holding company's May 1974 announcement that it would cease dividend payments, a run ensued. As a result, the bank lost over a billion dollars in a little over a month. The Federal Reserve reluctantly provided FNB advances to stem the panic, while the Comptroller decided how to handle the failing bank. The OCC did not close the institution for another four months. The failure of Franklin National raised the new specter for regulators of what to do when such a large bank verged on insolvency. Since they had never really faced such an issue before, they had no plans in place. For that matter, neither did elected officials as they were too busy with Watergate and the political fallout from the midterm elections to pay much attention at the time to the bank failure.

When the 94th Congress convened in January 1975, the political landscape had changed dramatically with the arrival to Capitol Hill of many freshman Democrats and the turnover of the House and Senate Banking Committee Chairmanships. In the upper chamber, Sen. William Proxmire (D-WI) became chairman of the Banking Committee when Sen. John J. Sparkman (D-AL) vacated the position to take the helm of the Foreign Relations Committee. In the lower chamber by contrast, freshmen Democrats revolted against the seniority system and deposed a handful of committee chairman, including Rep. Wright Patman; in his place, Rep. Henry S.

Reuss (D-WI) became Chairman of the Banking Committee. Even with this changed political landscape, though, both chambers pursued banking industry reform, having not tackled the problem late the prior year.

Because the House Banking Committee had begun its own comprehensive study of the nation's banking system, it did not participate in any comprehensive banking reform; instead, it focused on legislation narrowly tailored to reduce inflationary pressures. Out of this legislative effort in the spring, Chairman Reuss introduced a bill (HR 6676) requiring the credit allocation activities of the twenty largest American commercial banks be tracked by regulator. The measure required the group of banks to report the amount of loans they made to individuals in nine delineated categories. Fearing that such a bill would entangle the federal government in the credit allocation process, House members on June 23 defeated it in a floor vote.

Even though the House had deferred any comprehensive banking reform legislation until the completion of its study, the Senate pushed ahead with a bill (S 1267). By the time the Senate Banking Committee reported its measure on November 20, ten banks had all ready failed in the year to date, the first time bank failures had reached double-digits since WWII.⁴⁷ The Senate bill resembled the Hunt Commission's policy recommendations. The measure phased out Regulation Q ceilings within five and a half years, but in the interim, it did not eliminate the existing differential between banks and S&Ls. Unlike the Hunt Commission, however, S 1267 ended the prohibition against checking account interest. The bill also allowed thrifts to offer checking accounts and commercial banks and thrifts nationwide to offer NOW accounts, thereby eliminating many of the distinctions between the depository institutions. Furthermore, the measure expanded the investment and lending powers of banks and thrifts, not to mention permitting federal S&Ls to convert to stock corporations. On December 11, the Senate easily

⁴⁷ Two more banks failed in the latter half of December, bringing the annual failure total to twelve.

approved S 1267. In passing the bill, however, the chamber made some minor revisions, most notably postponing elimination of the prohibition against paying interest on checking accounts for a year. Because the House failed to act on the bill preferring to wait until the completion of its study in 1976, the proposed legislation went nowhere.

A few days before the Senate Banking Committee reported S 1267, Sen. Proxmire introduced some incremental banking reforms with another bill (S 2672) extending the existing prohibitions against instituting certain local taxes on out-of-state depository institutions. The Senate Banking Committee reported this more modest bill November 20. The full Senate then considered and approved the measure December 8; the full House followed suit eight days later, but, in the process amended it. Because of these amendments and the action occurred at the end of the congressional session, the bill lingered until early February when the Senate agreed to the House version and added amendments and the House concurred in the resulting legislation. On February 27, 1976, President Ford then signed S 1267. In addition to extending the prohibitions against taxing foreign banking institutions, PL 94-222 granted all federally chartered banks and thrifts in CT, ME, RI, and VT the ability to offer NOW accounts, thereby extending NOW account authority to all the New England states and creating an experimental laboratory in which to test the financial innovations.

With the two largest American bank failures having occurred within the last two years, the Senate was trying to deal with the nation's problem banks so that policymakers were not caught unaware again. Though the issue of troubled banks is typically too esoteric for the general public, a number of newspaper stories early in the year exposing the names of endangered depository institutions generated much concern and demand for legislative action. One of the first such instances appeared January 11 on the *Washington Post's* front page when

the paper ran a story titled “Citibank, Chase Manhattan on U.S. Problem List” in which it disclosed the “privileged” information (Kessler 1976).

In March the House Banking Committee proposed a number of bills, the most important of which imposed the system of federal banking regulation of foreign banks operating in the United States (HR 13876). Unlike American banks which were separated not only from other areas of commerce, but also from the other financial service industries, foreign banks were structured differently with no separation from these other industries. As a result, they had not been subjected to the bank regulatory system as domestic banks had. Foreign banks thus avoided deposit insurance, branching restrictions, and activity limitations. Instead, the individual states had taken sole responsibility for chartering and regulating foreign banking entities. By extending federal regulatory authority, legislators hoped to eliminate foreign banks’ competitive advantages. Although the House ultimately passed the measure in late July, the bill died in the Senate.

The month before the House approved HR 13876, the Banking Committee released the entirety of its long-awaited Financial Institutions in the Nation’s Economy (FINE) Study. The project originated in April 1975 when the House Banking Committee selected the economist James Pierce to lead a group of academic experts examining the banking system and suggesting possible reforms. The study, which was composed of individually authored papers, was intended to inform the committee and provide a starting point for reforms. The study provided Congress with a means of recapturing from the executive branch the issue of banking regulation.

The FINE Study presented its policy proposals in the first chapter titled “Discussion Principles.” Central to this study’s proposal was the notion that “the present system must give way to a single, strong Federal Depository Institutions Commission that will better serve the

public interest and the interest of the financial community here and abroad” (U.S. House 1976: 16). In this way, FINE sought to consolidate regulatory authority for all depository institutions, regardless of state or federal charter, in this one federal agency. This agency even received regulatory oversight of foreign banks operating in the United States, thereby extending the bank regulatory structure to foreign competitors. With the creation of this agency, the Federal Reserve relinquished its regulatory oversight of banks and bank holding companies, but it gain greater authority over the monetary system by the requirement that all depository institutions join the Federal Reserve System.

FINE focused not only on the architecture of the banking system, but also on providing depository institutions the requisite powers so that they could compete safely and effectively in the contemporary environment. One such power included interstate branching by all federally insured depository institutions provided that individual states did not prohibit it. The Federal Depository Institutions Commission, though, would regulate all interstate branching. The study recognized that fluctuating interest rates had a deleterious effect on depository institutions, for “artificial ceilings on interest rates paid to depositors reduce the incentive to save, discriminate against small savers, and have not succeeded in preventing disintermediation” (U.S. House 1976: 7). To position depository institutions to meet the challenges posed by fluctuating interest rates, it advocated eliminating all Regulation Q ceilings and the statutory prohibition against the payment of interest on checking accounts. The study proposed that the Federal Depository Institutions Commission handle the phasing out of these rate controls. FINE proposed expanding the list of powers available to depository institutions, such as authorizing thrifts to offer transaction accounts and make more commercial loans, thereby making them behave more like banks. It also suggested making the process easier for thrifts to convert to banks. This

conversion process entailed thrifts demutualizing, and, in so doing, gaining access to more capital. With the 1976 presidential election less than six months away, however, the legislative impetus for banking reform receded, and no action of any note occurred concerning FINE before year's end.

THE CARTER YEARS

With the federal government back under the Democrats' unified control, lawmakers returned to banking policy in 1977. The year's major legislative initiative, though, which took nearly six months to complete, did not begin as a bill having anything to do with banking. Instead, the measure originated as a housing and urban aid bill. In one of the Carter administration's earliest actions, the Housing and Urban Development Secretary Patricia Roberts Norris asked Congress in testimony February 24 to increase federal housing programs substantially and extend the community development block grant program for another three years.

In response to the HUD Secretary's request, House Banking Chair Reuss and several colleagues introduced a bill (HR 6655) in late April to redevelop urban areas by streamlining the urban grant process. The Banking Committee quickly passed the measure on May 2, and the House followed suit on May 11. Because the bill concerned large grants for urban renewal, the main area of dispute surrounded the funding formula. Throughout its legislative development in the House, the bill lacked any anti-discriminatory provisions applying to depository institutions and had nothing to do with banking regulation.

A mere five days after the House passed HR 6655, the Senate Banking Committee approved its own version of the bill (S 1523). In the process, Banking Chairman Proxmire attached a provision from an earlier anti-redlining bill (S 406) he had sponsored requiring federal

regulators to consider a depository institution's record of meeting its surrounding communities' credit needs when deciding on branching applications.⁴⁸ Following two days of debate in which disagreement surrounded the funding formula, the Senate on June 7 passed the bill (S 1523). Proxmire's redlining provision, however, elicited opposition from senators, such as Robert Morgan (D-NC), who feared it would lead to the allocation of credit and inefficiencies due to its additional paperwork.

Even though a conference convened on June 28, it did not reach a final agreement until late September. Continued disagreements over the block grant formula caused this delay. Nevertheless, the House conferees acquiesced in the Senate's anti-redlining measure. President Carter signed the bill (HR 6655) into law October 12. Though the CRA gave regulators up to 390 days to implement it, it "require[d] each appropriate Federal financial supervisory agency to use its authority when examining financial institutions, to encourage such institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions" (*U.S. Statutes at Large* 91 (1977): 1147). Thus, the Community Reinvestment Act (CRA) was born as Title VIII of the Housing and Community Development Act of 1977. Although this piece of social regulation ran only a page and a half in length and played a rather innocuous role during its first decade, it grew significantly during the nineties until it became another means of imposing regulatory burdens on the banking industry.

Soon after the start of 1978, the House followed up on its recent FINE Study when Banking Committee member St. Germain introduced a bill (HR 10899) extending the regulatory structure to cover foreign banks operating in the U.S. by assigning the Federal Reserve the oversight duties. The most controversial aspect of the bill in the House revolved around whether

⁴⁸ Redlining refers to the discriminatory practice by lenders of denying borrowing requests by homeowners and businesses based on race or ethnicity. The term originated from the practice whereby lenders would outline in red whole neighborhoods on a map in which they would not loan money, especially mortgages.

foreign banks branched across state lines. Because domestic banks were prohibited from branching across state lines, members of Congress ultimately decided upon limiting foreign banks' branching to their foreign operations only. Representatives also required foreign banks to subscribe to federal deposit insurance for all individual bank retail depositors. The House approved the proposed legislation in early April, but the Senate delayed consideration until August. When the Senate finally took up the bill, its principal action involved amending it to authorize the Federal Reserve to impose reserve requirements on foreign banks equal to what it imposed on domestic institutions. Given that HR 10899 focused on regulating foreign banks by subjecting them to regulation similar to domestic banks, it was rather non-controversial such that both Houses agreed to the alterations by mid August, clearing the way for the bill to become law in mid September as the International Banking Act of 1978. In addition, the legislation extended the BHCA's nonbanking restrictions to foreign banks.

With the 95th congressional session about to end in mid October, Reps. St. Germain, Reuss, and Annunzio (D-IL) co-sponsored a bill (HR 14279) a mere week beforehand containing a single title extending Regulation Q authority for another year. This measure was so non-controversial that the House approved it the next day. The bill arrived in the upper chamber October 12, at which point the Senate Banking Committee Chairman substituted a much longer bill with fifteen titles. Most of the provisions had all ready been passed by the Senate. The full Senate then approved the newly expanded bill the same day and returned it to the House. After attaching a few additional provisions it had approved earlier in the year, the House on October 15 agreed to the amended bill; the Senate concurred in the bill the same day. On November 10, President Carter signed the Financial Institutions Regulatory and Interest Rate Control Act (FIRIRCA) of 1978.

In addition to extending Regulation Q authority for another year, the legislation authorized federally chartered New York banks and thrifts to provide NOW accounts. The statute also authorized the Federal Home Loan Bank Board (FHLBB) to begin offering mutual savings banks the option of obtaining a federal charter. Moreover, those savings banks selecting the federal charter gained the option of converting from a mutual organization to a stock one. To aid regulatory agencies in handling problem banks, FIRIRCA permitted the federal regulators to issue bank executives and directors, rather than just the depository institutions themselves, cease-and-desist orders when engaging in unsound or illicit activities. The statute gave the FDIC additional powers to extend loans or purchase the assets of troubled federally insured banks and thrifts. Furthermore, Title X of the bill ordered the creation of an interagency body, the Federal Financial Institutions Examination Council (FFIEC), to establish uniform regulatory standards. The FFIEC included the Federal Reserve, the FDIC, the FHLBB, the FSLIC, the NCUA, and the OCC. The interagency council, though, did not commence operations until March 10, 1979.

By that time, several regulatory agencies had all ready issued rulings permitting their subjects to provide some new transaction services to customers. Needless to say, the agencies themselves instigated these legal challenges as they persuaded members to sue their regulatory counterparts. On April 20, 1979, in the consolidated case of *ABA v. Connell; IBAA v. FHLBB; USLSA v. Board of Governors of the Federal Reserve*, the D.C. Court of Appeals decided the fate of three financial product innovations: automatic transfer services from savings to checking accounts in commercial banks, share drafts in credit unions, and remote service units in savings and loan associations.⁴⁹ In a *per curiam* opinion, the court ruled that the respective federal

⁴⁹ An automatic transfer service (ATS) is a prearranged service that transfers funds from a savings to a checking account to maximize interest earnings or cover needed withdrawals as checks come in for clearing. Share drafts accounts are interest bearing transaction accounts provided through credit unions; they are akin to thrifts' negotiable

regulatory agencies lacked the statutory authority to approve these innovative financial products.⁵⁰ The court reasoned that

[t]he net result [of approving these innovations] has been that three separate and distinct types of financial institutions created by Congressional enactment to serve different public needs have now become, or are rapidly becoming, three separate but homogeneous types of financial institutions offering virtually identical services to the public, all without the benefit of Congressional consideration and statutory enactment. 686 F.2d 953 (D.C. App. Ct. 1979)

The Court of Appeals reversed the district courts' rulings upholding the financial product innovations and remanded the cases for further action. Because the court realized that American consumers had grown accustomed to these financial products, it delayed its order until January 1, 1980.

To avoid the ensuing disruptions caused by the court rulings taking effect, lawmakers had to act by year's end. In a congressional address on May 22, President Jimmy Carter advocated enactment of "comprehensive financial reform legislation" to repair "a system which has become increasingly unfair to the small saver" (Carter 1980: 928). The president sought to reform America's depository institution system which had suffered large outflows of money as depositors sought to avoid rate ceilings that prevented the intermediaries from meeting the market rates of interest. President Carter, however, advocated not only removing interest rate ceilings, but also expanding "new investment powers" so that depository institutions gained the ability to pay the high market rates of interest (Carter 1980: 929). Toward that end, he asked

order of withdrawal (NOW) accounts. A remote service unit is merely another name for an automated teller machine (ATM).

⁵⁰ The litigants included the American Bankers Association (ABA), Lawrence B. Connell, Jr. of the National Credit Union Administration, the Independent Bankers Association of America (IBAA), the Federal Home Loan Bank Board (FHLBB), and the United States League of Savings Associations (USLSA).

Congress to act on four particular items: the elimination of all interest rate ceilings, the authority of all federally insured depository institutions to provide interest-bearing transaction accounts, the ability of all federal thrift institutions to offer adjustable rate mortgages and to invest up to ten percent of their deposits in consumer loans (Carter 1980). The first two items applied to banks whereas the last two applied only to thrifts. Curiously absent was any mention of changes to federal deposit insurance.

Nearly four months elapsed before legislators seriously followed up on Carter's reform proposals. On September 11, the House easily passed a narrowly tailored bill (HR 4986) titled the "Consumer Equity Act." Besides overturning the D.C. Appeals Court ruling by authorizing the three new financial products, the proposed legislation extended NOW accounts to banks and thrifts across the U.S.

Not until mid October did the Senate Banking Committee report legislation. The Banking Committee version differed significantly from the House passed bill because it not only imposed reserve requirements on all banks offering NOW accounts, but also phased out interest rate ceilings. On November 1, the upper chamber with fewer than ten senators opposing easily approved its reform bill. During floor debate, NOW accounts proved to be the most controversial issue because they entailed mandatory reserve requirements and elimination of the thrift industry's quarter percent interest rate advantage.⁵¹ To resolve this controversy, the Senate stripped the reserve requirement extension from the bill. Then, to assuage his large constituency of thrifts, Sen. Alan Cranston (D-CA) amended the bill exempting California S&Ls from providing NOW accounts. Unrelated to this controversy, but undoubtedly beneficial to thrifts, Cranston also contributed a provision raising the federal deposit insurance limit from \$40,000 to

⁵¹ The thrift industry benefited from a quarter point interest rate differential over banks ever since the Interest Rate Control Act of 1966 extended Regulation Q ceilings to thrifts.

\$50,000 to allow the ailing industry to attract deposits more easily in the distressed economic times.

On November 7, the House Banking Committee amended the Senate bill by attaching a previously passed measure concerning Fed membership. If Fed defections ceased, the bill would permit reserve requirement reductions. Conversely, if Fed membership continued to decline, the measure would impose on all banks mandatory reserve requirements. The full chamber approved the revised bill later that day and requested a conference. The conference committee convened on December 5, but was unable to reach an accord. The principal disagreements surrounded the Senate's elimination of rate ceilings and the House's Fed membership provisions. Describing the impasse created by these two issues, the House Banking Committee Chairman Henry S. Reuss (D-WI) said "The irresistible force seems to have met the immovable object" (Congressional Quarterly 1980a). These disagreements remained through year's end and thwarted legislative passage.

Just as federal lawmakers were responding to a recent court order, the FRB also found itself responding to a court decision from earlier in the year. On March 19, 1979, the Fifth Circuit Court of Appeals decided *Florida Association of Insurance Agents v. Board of Governors*. The case was a class action lawsuit brought by an insurance agents' trade group against the FRB for a series of decisions permitting bank holding companies to enter the insurance agency business. The court overturned the Fed decisions on the grounds that the Board did not adequately consider the public benefits in each application. In the court's view, "The basic principle is clear that the Board cannot ignore the applicability and effect of state law inasmuch as it bears upon the public interest determination by the Act" (*Florida Association of Insurance Agents v. Board of Governors* 591 F.2d 334 (1979)). As a result of this federal court

decision, the Federal Reserve Board in November revised its Regulation Y. Effective December 5, the Board's revised Reg Y permitted "bank holding companies or their nonbank subsidiaries with a principal place of banking business in a community with a population of 5,000 or less to sell any type of insurance in such a community" (65 Fed. Res. Bull. 903, November 1979). Thus, the Fed constrained future insurance agency activities severely to small municipalities in which the bhcs all ready conducted their main banking business.

Since permanent legislation preempting the court ruling remained stuck in conference, Congress moved to authorize the services temporarily. Toward this end, both chambers passed an authorization right before Christmas, and, on December 28, President Carter signed the legislation. Public Law 96-161 temporarily authorized the three types of transaction services from December 31, 1979 until April 1, 1980. Although Congress bought another three months with P.L. 96-161 to delay a court order temporarily, it needed to complete long-term action when its next session resumed.

The temporary authorization of P.L. 96-161, however, failed to address the Federal Reserve or the circumstances that caused it to undertake its fundamental change in monetary policy targeting bank reserves. In early February 1980, Federal Reserve Chairman Paul Volcker testified before the Senate Banking Committee. According to him, the defection of banks from the system had become an "avalanche" (Congressional Quarterly 1981a). Given that the Federal Reserve paid no interest on required reserves balance, maintaining the interest-free balances at the Fed, especially in times of high interest rates, became very costly. Unless lawmakers addressed Fed membership, banks defecting threatened the effectiveness of the Fed's new monetary policy, not to mention unfairly burdening the remaining members.

With legislation fundamentally reforming the banking system held over in conference through the start of the next year, the conferees reconvened on March 5 and successfully resolved their differences. Sometime during the lengthy negotiating session that went deep into the night, the House Banking Committee Chairman Fernand St. Germain (D-RI) attached a provision raising the deposit insurance limit to \$100,000 (Liscio 1989; Wall Street Journal 1991).⁵² This \$60,000 increase far exceeded the one Cranston had attached to the Senate bill. With the differences between the two chambers worked out, the bill's final passage was rather a formality with the House approving the conference report easily March 27, the Senate following suit by voice vote the next day, and President Carter signing the legislation three days later. The bill's official title was the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 (P.L. 96-221).

In addition to the deposit insurance increase, the legislation had several other important provisions divided among seven subheadings. Among the more important of them were the first four. The first title concerned monetary control; it extended reserve requirements to all depository institutions, phased in the requirements for non-members over an eight year period, lower reserve requirements for existing members, extended reserve requirements to foreign branches and subsidiaries of U.S. banks, and extended Fed services, including the discount window, to all depository institutions, but required the central bank to charge for the use of its services. The second title possessed the label "Depository Institutions Deregulation."⁵³ This section provided for the phasing out of interest rate ceilings over six years by creating a

⁵² Curiously enough, news of St. Germain's culpability in raising the deposit insurance limit came to light nearly ten years afterwards when journalists disclosed it in their discussions of causes of the S&L crisis. St. Germain was notorious for his support of the thrift industry; the first job he took upon leaving public life involved lobbying for the USLSA.

⁵³ This section of the statute dealing with the withdrawal of the government from an area of activity was the only one to fall under the "Deregulation" heading.

Depository Institutions Deregulation Committee (DIDC), which was composed of the chairmen of the Federal Reserve, the FDIC, the FHLBB, the NCUA, the Treasury Secretary, and the Comptroller of the Currency, to handle the government's withdrawal from the sphere of dictating interest rates.⁵⁴ The third heading authorized not only NOW accounts on a nationwide basis, but also all three of the transaction service innovations overturned by the 1979 appeals court ruling. This section of the bill effectively eliminated one of the main distinctions separating commercial banks from other depository institutions. The fourth section expanded the powers of thrifts to make consumer loans, to make mortgage loans without regard to geographic constraints, to offer trust services, to offer credit card services, and to invest in a variety of securities such as corporate debt obligations and commercial paper.

As federal lawmakers were enacting the most far-reaching legislation affecting banking in nearly fifty years, the nation's twenty-third largest bank verged on insolvency; it had over \$9 billion in assets. Even though federal regulators were closely monitoring First Pennsylvania Bank, N.A. (First Pennsy) since at least 1979, its condition began spiraling downward in late March 1980.⁵⁵ To halt further deterioration and losses to the deposit insurance fund, the FDIC on April 28 declared the bank "essential" and offered it an assistance package rather than close it or sell off its assets. According to the FDIC's official history, "In this case, the FDIC's determination of "essentiality" was based mainly on size" (FDIC 1984: 95). Because of existing laws against interstate banking and branching and First Pennsy's large size, regulators could not find any buyers to assume the bank's deposits, so they had no alternative, in their view, to bail out the firm.

⁵⁴ The voting members of the DIDC included the Treasury Secretary, and chairmen of the Federal Reserve, the FDIC, the FHLBB, and the NCUA. The Comptroller of the Currency also was a member, but he lacked a vote.

⁵⁵ Notice the N.A. in the bank's name indicating it was a National Association and thereby regulated and chartered by the OCC.

According to FDIC Chairman Irvine Sprague, “There was strong pressure from the beginning not to let the bank fail. Besides hearing from the bank itself, the other large banks, and the [C]omptroller, we [the FDIC] heard frequently from the Fed” (Sprague 1986: 88). In spite of the intense lobbying efforts, in Sprague’s view, the FDIC Board did not decide on a bailout until it had exhausted all its other resolution options (Sprague 1986: 92). The bailout package provided \$500 million in loans with \$175 million from other banks and \$325 million from the FDIC. As a condition of its loan of \$325 million, the FDIC required the bank to issue it warrants that were convertible to bank stock; it received warrants equivalent to twenty million shares.⁵⁶

On June 9, 1980, the Supreme Court ruled that bank holding companies could expand across state lines through nonbanking subsidiaries. The controversy had originated with an April 1973 Board of Governors order rejecting BTNYC’s application to provide investment advisory services in Florida. Rather than sue the Board, though, the bank holding company sued the state for violating the Commerce Clause. In the case before it, the Court found that Florida violated the Commerce Clause. According to the majority opinion, “Under the Florida statute, discrimination against affected business organizations is not evenhanded because only banks, bank holding companies, and trust companies with principals operations outside Florida are prohibited from operate investment subsidiaries or giving investment advice within the State” (*Lewis, Comptroller of Florida v. BT Investment Managers, Inc.* 447 U.S. 27 (1980)). Thus, the Supreme Court signaled to bank holding companies wishing to expand across state boundaries that any state laws discriminating against out-of-state competition would be highly suspect. In

⁵⁶ The warrants led to a shareholder’s suit of the FDIC for lacking the authority to impose such conditions in its financial assistance package. The case of *Philip Zinman v. FDIC* 567 F. Supp. 243 (U.S. District Ct. 1983) is the only legal challenge to the agency’s “essentiality” power, but the District Court ruled solely that the liberal construction of the statute permitted the regulator to impose whatever conditions it desired.

the process, the Court strengthened the Federal Reserve as it approved expanded activities of holding companies.

CONCLUSION

This chapter recounted the 1969-1980 period of bank regulatory policy, a period that was marked by the appearance of significant turmoil affecting the industry. This turmoil, of course, was nothing compared to what struck the banking industry during the subsequent twelve years. Nonetheless, during this period regulators scrambled to resolve the mounting bank failures, particularly a handful of the nation's largest banks. These events led lawmakers to place mounting pressure on the regulators, but it was the largely unnoticed resolution mechanism developed by the FDIC during this era that had the largest impact on subsequent regulation. The FDIC employed its "essentiality" power to extend financial assistance to a number of banks and thus prevent them from closing. This process began with tiny Unity Bank and Trust and ran through First Pennsy, but would develop further in the next twelve years. This focus on resolutions, though, is not to say that the other two regulators were absent or uninvolved, rather they were simply restrained in their efforts to expand the activities available to banks. The Federal Reserve, though, did make some early attempts to expand the business activities open to banks by granting affiliations through the holding company structure, but these efforts were nothing like what followed over the next two decades.

Even though federal lawmakers played a prominent role in the events of these years, they responded retroactively to developments in the banking system. Both the White House and Congress conducted extensive studies of the banking system and its regulatory troubles, yet they failed to enact many of the proposals, thus leaving most regulatory policy change in the hands of regulators. Aside from 1970's BHCA Amendments and 1980's DIDMCA, most of the banking

legislation was rather limited in scope and merely updated the statutory code to accord with contemporary regulations. Elected officials, though, did enact regulatory statutes, such as the CRA, imposing new social responsibilities and objectives on banks and bank regulators. Though relatively innocuous at the time, later generations of lawmakers would seize upon them to influence the goals and operation of the banking system.

4. BANKING REGULATION'S TWELVE TUMULTUOUS YEARS: 1981-1992

This chapter investigates banking regulation during the administrations of Ronald Reagan and George H.W. Bush. The twelve years examined here include the most legislatively productive period as measured in terms of major banking statutes since FDR's administration. Seminal pieces of legislation included the Garn-St. Germain Act of 1982, which granted thrifts and banks additional powers and sped up the phase out of interest rate ceilings, the Competitive Equality Banking Act (CEBA) of 1987, which closed the nonbank bank loophole by redefining what constituted a bank and pledged the government's full faith and credit behind all insured deposits, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989, which granted the FDIC the right to increase premiums and to seize the assets of a healthy bank when any affiliated bank fails, and the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, which, among other things, allowed the FDIC to establish premiums accounting for a bank's risk level and to intervene promptly when a bank's capital fell below accepted levels.

Though the deregulatory period is considered to have begun in banking in 1980 with enactment of DIDMCA, it supposedly continued through the period here and the subsequent one under Clinton. Nevertheless, this characterization of this nearly twenty year period is quite misleading, for policymakers almost never repealed regulations without replacing them with some other type of regulations. Moreover, lawmakers instituted entirely new regulations relating to capital requirements and extended social regulations relating to consumer protection and extending credit to inner-cities and poorer communities.

Throughout this entire twelve year period, all three federal banking regulators were actively involved in the policymaking process. The FDIC was busy coping with increasing

numbers of bank failures. Though most of these resolutions elicited little attention from lawmakers or the public, the agency's extension of financial assistance to Continental Illinois in 1984 and to a handful of other large banks in the remaining years of this period triggered a loud outcry and charges that these banks had become too big to fail. Because the FDIC lacked both the means to alter premiums for much of this period and the inability to accurately monitor banks' assets, a moral hazard problem existed. This problem was only worsened, though, by actions of the OCC and Federal Reserve.

These two agencies employed their statutorily granted authority to expand the activities available to banks. The OCC, for instance, used its power to find securities brokerage and insurance agency as "incidental" to banking. Likewise, the Fed used its power to permit banks to affiliate through the holding company with firms that were engaged in prohibited securities activities provided that the revenue from these units remained less than 5 percent. The approval of such arrangements really began in 1984 when the Fed approved an application by a bhc to engage in commercial paper; it then quickly spread to other bhcs, then expanded to include other types of securities. Over the course of the period, the revenue limit doubled and the list of "ineligible" securities grew. Furthermore, the Fed in 1984 crafted a "source of strength" policy that it used to justify all these decisions. Interestingly enough, both the Fed and OCC rationalized their expansions of banks' powers as means of creating stronger depository institutions.

THE REAGAN YEARS

Because 1980's Depository Institutions Deregulation and Monetary Control Act (DIDMCA) failed to improve the banking and thrift industries enough, lawmakers needed additional banking legislation following President Reagan's inauguration. Not until October

1981, however, did members of Congress make significant progress on banking policy to address the industry's crisis. On the third day of the month, the House Banking Committee reported the Depository Insurance Flexibility Act (HR 4603). The bill, championed by House Banking Committee Chairman St. Germain, was an emergency measure granting the FDIC and FSLIC additional powers to aid to troubled banks and thrifts and to arrange acquisition partners for failing depository institutions. On October 28, the House approved the bill. In passing HR 4603, though, the House attached two amendments: one amendment limited the simplified acquisition procedure to troubled thrifts and the other amendment required federal regulators to follow an order of merger preference. This merger preference order sought acquisitions between similarly chartered institutions in the same state, then in a different state, then a depository institution of a different charter in the same state, and finally an institution with a different charter outside the state.

Meanwhile also in October, the Senate Banking Committee Chairman Jake Garn (R-UT) introduced the Financial Institutions Restructuring and Services Act of 1981 (S 1720). In addition to providing federal regulators with emergency powers to deal with failing depository institutions, Garn's bill extended the powers of commercial banks to thrifts so that they gained alternative means of revenue to make commercial loans, invest in real estate, invest in corporate debt, and offer checking accounts. Furthermore, S 1720 granted banks and thrifts entry into the mutual fund and insurance industries and granted national banks authority to underwrite and trade municipal revenue bonds. With the end of the year approaching, though, Sen. Garn decided to wait until the following year to accomplish major banking reform, so he put aside both his own legislative proposal and the House's Depository Insurance Flexibility Act. Thus, legislators achieved little progress in 1981 on the banking front.

Although Sen. Garn had prioritized banking reform with his far-reaching S 1720, his inability to garner enough committee support restrained him from passing anything. Instead, Chairman Fernand St. Germain and the House Banking Committee initiated legislative reform by approving a bill (HR 6267) May 11; the Net Worth Guarantee Act provided financial aid to the nation's troubled S&Ls. The measure authorized the Treasury to guarantee the net worth of thrifts whose equity to assets ratio fell below two percent. In committee debate, St. Germain defended his bill arguing, "This is a no-cost situation. It's not a bailout" (CQ Almanac 1983). He was not completely honest in his advocacy of the legislation, for the bill would entail large Treasury outlays if the federal government exercised its net worth guarantees in the event of thrift failures. Nevertheless, St. Germain carried the measure in a party line vote, and, in so doing, defeated a Republican alternative that guaranteed the troubled thrifts' net worth, but only up to two percent of their assets. The House approved HR 6267 on May 20. Rep. Frank Wylie (R-OH) put forth the Republican alternative guaranteeing only a portion of S&Ls' net worth using a sliding scale. Democrats, though, rallied around St. Germain's bill and defeated the Republican substitute. Thus there was a Democratic initiative to buttress the ailing thrift industry through a federal guarantee.

Since he still lacked the votes, Sen. Garn in late July abandoned the Financial Institutions Restructuring and Services Act of 1981 (S 1720). The Senate Banking Committee reported a revised bill (S 2879) on August 19 that was a cleansed version of Garn's S 1720. To attract support for S 2879, Garn removed the provisions granting banks access to mutual funds and insurance. Needless to say, the removal of these aspects disappointed members of the banking industry who now viewed the bill as little more than a handout for the thrift industry. The resulting bill mainly provided assistance to troubled thrifts. Rather than create a net worth

guarantee, the bill permitted thrifts to exchange their capital notes with the Federal Savings and Loan Insurance Corporation (FSLIC) and Federal Deposit Insurance Corporation (FDIC) for interest bearing promissory notes. The legislation also granted the FDIC and FSLIC greater powers for arranging mergers for failing depository institutions. It expanded the portfolio choices available to thrifts by expanding available asset categories and hastened the removal of Regulation Q interest rate ceilings. When the bill reached the floor in mid September, the Senate approved it without any dissent. To ease passage, the Senate amended the proposed legislation to eliminate the rate differential between banks and thrifts, limit thrifts' checking account authority, and broaden bank service corporations' powers.

While Sen. Garn was engrossed in redrafting a bill that would pass the Senate, the Comptroller of the Currency handed down an interpretive ruling that reverberated throughout the banking and securities industries. Back in April, Security Pacific National Bank of California (Security Pacific) had applied to establish a de novo subsidiary that would engage in discount brokerage. Though countless banks provided some form of brokerage activities for years, Security Pacific's proposal went much farther by offering the service to the general public rather than just its own customers, executing the trades itself, and submitting trades without first receiving payment from the customer. The Comptroller approved Security Pacific's application finding that it violated neither Glass-Steagall nor the McFadden Act. According to the Comptroller, the brokerage subsidiary did not violate Glass-Steagall's section 16 as long as it "maintain[ed] its agency" status in the transactions (OCC 1982: 42). In other words, the subsidiary could not buy securities for its own account. Likewise, the subsidiary acceded with section 32's affiliation prohibition against firms "principally engaged in" impermissible activities because securities brokerage was not on the list (OCC 1982: 42). In a speech before the ABA

nearly two months later, Comptroller Conover provided one of the few window's on his Office's views perspective on approving new banking powers, "Very simply, if a bank can make a strong case that a proposed activity is legal, our inclination is to approve it. We followed that policy this past year in approving...discount brokerage subsidiaries for two others" (Conover 1982).⁵⁷

With the midterm elections fast approaching, the two chambers convened a conference, and within five days, the conferees brokered an agreement. The House was the last of the two bodies to accept the conference report on October 1, and President Reagan signed the bill into law on October 15 as the Garn-St. Germain Depository Institutions Act of 1982. St. Germain's Net Worth Certificate Program found its way back into the bill. In addition, the legislation expanded S&Ls' lending powers in agricultural, commercial, and consumer loans; it permitted thrifts to offer checking accounts to private depositors and businesses which all ready conducted business with the institutions. Garn-St. Germain directed the DIDC to create a new type of insured account, a money market demand account (MMDA), to compete directly with money market mutual funds (MMMFS). The statute increased the available areas in which thrifts could invest. To benefit national banks, the legislation increased the amount they could lend to any individual or entity from ten to fifteen percent of their capital and surplus. Finally, the law gave state-chartered industrial banks the option of applying for federal deposit insurance.

While Congress was preoccupied with Garn-St. Germain, Mexico announced in August 1982 that it could no longer meet its debt service arrangements with international moneylenders.⁵⁸ Lending to less-developed countries (LDCs) increased significantly over the seventies as American banks escaped domestically imposed rate ceilings through the use of

⁵⁷ The two banks to which Conover was referring included Security Pacific and Union Planters National Bank of Memphis.

⁵⁸ Debt service refers to the payment of interest and principal on a loan or other borrowed funds.

Eurodollar accounts.⁵⁹ During the 1970s, of course, money center banks were especially flush with cash as the OPEC nations recycled petrodollars through them. Because of the rampant inflation afflicting the U.S. dollar, the LDCs actually borrowed at negative real interest rates. Repayment was easy so long as commodities, like their principal export of oil, were high and the dollar was weak. Because of the Fed's successful war against inflation, the borrowers lost the ability to repay their loans with inflated dollars. Making matters worse, as the dollar strengthened the loans' variable rates skyrocketed and the value of oil collapsed.

The federal regulators, however, had all ready begun preparing for the coming foreign debt crisis. Expressing their concern "about the secular declines in the capital ratios of the nation's largest banking organizations, particularly in view of increased risks both domestically and internationally," the three banking agencies in December 1981 announced capital adequacy guidelines (68 Fed. Res. Bull. 34, Jan. 1982). Whereas the FDIC established a minimum capital adequacy standard of 5 percent, the Fed and OCC adopted two standards: 6 percent for community banks (those with less than \$1 billion in assets) and 5 percent for regional banks (those with assets of \$1 billion or more).⁶⁰ The promulgation of these capital adequacy guidelines represented a new direction for banking regulation since capital was meaningless before this time other than as an initial requirement for obtaining a banking charter. After commencing operations, a bank would have no concern for its capital levels or ratios.

Although BankAmerica Corporation had announced its decision to acquire the discount brokerage Charles Schwab a few days before its competitor Security Pacific announced plans of

⁵⁹ Eurodollars were simply offshore dollar-denominated accounts and therefore not subject to rate ceilings.

⁶⁰ These guidelines did not apply to the seventeen American multinational banking organizations, which were also the most heavily exposed to the LDC debt crisis. Aware of this omission, the Federal Reserve and the OCC later amended the guidelines in June 1983 to apply to the seventeen multinationals (69 Fed. Res. Bull. 539, Jul. 1983). The regulators established a minimum standard of 5 percent capital to assets for these largest 17 banking organizations.

opening a brokerage subsidiary, the Board of Governors did not approve its application until January 7, 1983. Charles Schwab was a large discount brokerage having offices in 26 states and D.C. In approving the acquisition, the Fed relied upon the Comptroller's recent interpretation of Glass-Steagall's section 16 in accepting the Security Pacific proposal. The Board based its order on the grounds that "Schwab's brokerage functions do not constitute the "public sale" of securities (or any other proscribed activity) within the meaning of section 20 of the Glass-Steagall Act" (69 Fed. Res. Bull. 115, Feb. 1983).⁶¹

Not long after the Fed issued its brokerage order, the Fifth Circuit Appeals Court struck down the enforcement of capital adequacy guidelines with its February 1983 decision in *First National Bank of Bellaire v. Comptroller of the Currency* 697 F.2d 674 (1983). Although the court upheld the OCC's cease and desist orders against the bank for disregarding regulations on safe and sound banking, it reversed the order for inadequate capital levels finding that the "record as a whole does not provide support for the Comptroller's finding that the Bank's capital level was unsafe and unsound" (697 F.2d 674 (1983)). The Fifth Circuit took issue with the analysis used to determine the bank's inadequate capital level. As a result, the court's ruling cast doubt on future uses of capital guidelines by the regulators unless legislators provided explicit statutory authorization.

Because the LDCs received financial assistance from the IMF as their debt service worsened, the IMF's 146 member nations in early 1983 needed to make additional contributions. For its part, the U.S. owed \$8.4 billion, and it was through the IMF appropriation bill that lawmakers ultimately addressed the debt crisis and banking regulation. Largely following the

⁶¹ On August 10, 1983, the Fed approved Chase Manhattan Corp.'s acquisition of Rose & Company Investment Brokers (69 Fed. Res. Bull. 725, Sept. 1983). This marked the second bhc acquisition of a discount brokerage. Moreover, the Fed amended its Regulation Y to include discount brokerage activities, and the change took effect September 9, 1983 (69 Fed. Res. Bull. 696, Sept. 1983). The Board made the rule change following the Second Circuit Appeals Court upheld its approval of BankAmerica's application.

Reagan administration's wishes, the IMF funding measure originated in the Senate where the Foreign Relations Committee on March 15 passed a bill (S 695). On April 28, the Banking Committee approved the proposed legislation, but amended it at Sen. John Heinz's (R-PA) insistence directing regulators to set minimum capital levels for banks. On June 8, the full Senate passed the IMF funding bill. After defeating a number of ideologically charged amendments from Foreign Relations Committee Members Gordon Humphrey (R-NH) and Jesse Helms (R-NC) restricting the use of the IMF funds, the Senate on June 8 approved the legislation.

In the meantime, the House Banking Committee on May 16 passed its own IMF bill (HR 2957). The House version provided IMF funding, reauthorized the Ex-Im Bank, and provided development banks funding. At the request of Chairman St. Germain, the Banking Committee amended the proposed legislation imposing stricter requirements on banks by mandating the creation of special reserves to offset LDC loans. At Rep. Jim Leach's (R-IA) insistence, the committee amended the IMF provision by directing federal regulators to set adequate capital levels for all U.S. banks and to coordinate their efforts with their foreign counterparts.

Even though the House began considering its bill (HR 2957) July 25, it did not approve the legislation until August 3. The debate in the lower chamber was considerably more intense than in the Senate, where populist Democrats and conservative Republicans united in opposition. After accepting several amendments posited by this opposition coalition, including Rep. Ed R. Bethune's (R-AR) excess profits tax on large banks and Rep. Byron L. Dorgan's (D-ND) limitation large banks' fees for restructuring their LDC loans, the House passed its bill by the narrow margin of six votes. Following the House's action, however, the proposed legislation sat idle for nearly three months awaiting a conference. While the proposed legislation was lying

dormant, Rep. St. Germain wrote an August 8 letter to President Reagan threatening to block further action unless lawmakers joined the IMF bill (HR 2957) to a housing authorization bill (HR 1) that he had worked on earlier in the year.

After several weeks of negotiations between the Reagan administration, congressional leaders, and Rep. St. Germain, the conference committee combined the housing (HR 1) and IMF (HR 2957) bills and attached them to a non-controversial supplemental appropriations bill (HR 3959). The committee then approved its report November 15. Then, over the next three days, the two chambers approved and amended the bill sending it back and forth before the House completed final action on the last day of the session November 18. On the last day of November, President Reagan enacted the Supplemental Appropriations Act of 1984. The banking related portion of the legislation became Title IX, known as the International Lending Supervision Act (ILSA) of 1983. This act authorized the federal regulatory agencies to establish capital adequacy guidelines and to issue cease and desist orders to banks failing to comply. ILSA represented a significant shift in bank regulation as policymakers instituted a new form of “prudential” regulation that did not proscribe certain activities, rather it imposed costs depending on the types of activities engaged in.

At one time, Continental Illinois National Bank and Trust Company was the nation’s eighth largest bank, yet it was still a money-center bank at the heart of a vast correspondent network. Following wire reports on May 9 of Continental’s imminent failure, foreign depositors began hurriedly withdrawing their deposits; a global run had begun. This run forced Continental on May 11 to borrow \$3.6 billion from the Fed’s discount window. Needless to say, the bank’s position deteriorated further as the run continued. To stem the run, the FDIC on May 17 declared the bank “essential” and publicly informed all Continental’s creditors and depositors

that the agency would guarantee their claims against the bank in their entirety. The FDIC then announced a temporary assistance package of \$2 billion, with \$500 million in loans from other commercial banks and the remainder as a loan from it. Because the run on Continental persisted despite regulators' best efforts, they put forth a permanent solution on July 26 that entailed the FDIC purchasing \$4.5 billion worth of bad loans, the bank writing off another \$1 billion in bad loans, and the FDIC providing a \$1 billion capital infusion through the bank's holding company for which it received preferred stock. Additionally, the FDIC replaced the bank's board of directors and senior executives.

In the aftermath Continental Illinois' bailout, policymakers continued to pursue regulatory reform. The Federal Reserve Board, for instance, on July 30 approved an application from Manufacturers Hanover (Manny Hanny) Corporation's application for its subsidiary to engage in "underwriting, dealing in, brokering, and purchasing and selling obligations of the U.S. government and its agencies, general obligations of the various states...and such other obligations that state member banks...may be authorized to underwrite" (70 Fed. Res. Bull. 661, Aug. 1984). In approving the request, the Board reasoned that the subsidiary's clients would be sophisticated investors and that the firm would provide a public benefit by introducing more competition.

Such actions led one Senate Banking Committee aide to tell Congressional Quarterly, "People are saying, 'What are we doing offering new powers to these lunatics when they can't handle the powers they've got?'" (Congressional Quarterly 1985). Although some individuals on Capitol Hill may have been unable to articulate the rationale, regulators were more than willing to do so. Speaking to the American Bankers Association convention later in the year, Comptroller C.T. Conover would explain, "I've devised a simple equation to describe the

process [of how modernizing the laws will yield a stronger banking system]—“Strength = New Powers + Firm Supervision” (Conover 1984). In this way, regulators believed that the process was not one of simply removing pre-existing regulations and allowing banks to have a free-for-all, rather it entailed replacing the old rules with new ones better designed to foster a competitive and dynamic marketplace.

Since 1984 was an election year and the Continental Illinois bailout was dominating the banking policy agenda, Chairman St. Germain employed the House Banking Committee to investigate the matter more fully. Toward this end, the Financial Institutions Supervision, Regulation and Insurance Subcommittee, which St. Germain also chaired, held hearings on Continental Illinois over a three day span: September 18, 19, and October 4, 1984. Comptroller of the Currency C.T. Conover’s testimony September 19 was the most noteworthy since he admitted regulators were aware of Continental’s difficulties for a few years, but resorted to bailing out the institution because they failed to develop an alternative resolution plan. Chairman St. Germain employed some rather intense prodding, when he exclaimed to the Comptroller, “The fact of the matter is, as a practical matter, neither you nor your successors are ever going to let a big bank the size of Continental Illinois fail” (House Committee on Banking, Finance and Urban Affairs 1984: 300). Conover explained in response, “[I]t isn’t whether the bank fails or not. It is how it is handled subsequent to its failure that matters. And we have to find a way [to resolve large banking institutions]. I admit that we don’t have a way right now. And so, since we don’t have a way, your premise appears to be correct” (House Committee on Banking, Finance and Urban Affairs 1984: 300).⁶² The Comptroller ostensibly disclosed that

⁶² Interestingly enough, Comptroller Conover never used the phrase “too big to fail.” Instead, Rep. Stewart B. McKinney (R-CT) applied the term right after Conover’s disclosure. Rep. McKinney declared, “Mr. Chairman, let us not bandy words. We have a new kind of bank. It is called too big to fail. TBTF, and it is a wonderful bank” (House Committee on Banking, Finance and Urban Affairs 1984: 300).

federal regulators would not allow the nation's eleven largest multinational banks to fail, but he was actually referring to nationally chartered banks.

Although the balance of power in D.C. remained roughly the same in 1985 following the recent election where Reagan won a second term in dramatic fashion and Democrats and Republicans retained control over their respective chambers, the health of the banking system continued to deteriorate as failures of depository institutions mounted. Capitol Hill, however, remained stalemated on the matter of banking reform throughout the year. As a result, the agencies and the courts took a prominent role in bringing about regulatory change.

Drawing upon Garn-St. Germain's "thirty-mile rule," the Comptroller on February 21 approved an application from the Mark Twain Bank, N.A., a subsidiary of Mark Twain Bancshares, seeking to relocate its headquarters from Independence, Missouri to Overland Park, Kansas. The Comptroller began by reviewing the bank's rationale. According to the Comptroller, "The Bank, recognizing that its community, for Community Reinvestment Act purposes, includes locations on the Kansas side of the border, believes that the relocation will enable it to better serve those locations while still serving Missouri customers" (OCC 1985 38). Then, the Comptroller proceeded to consider the petition submitted by the Kansas Bankers Association (KBA), which questioned the OCC's authority to approve the application under Kansas state law pertaining to holding companies, the Douglas amendment, and the Commerce Clause. The Comptroller held that approving the relocation would not violate the Commerce Clause and that the Kansas law all ready discriminated against out-of-state bank holding companies. Furthermore, it ruled the Douglas Amendment inapplicable because the application did not entail an out-of-state acquisition by a holding company, thus avoiding the input of the

FRB. Consequently, in the first use of its kind to allow interstate banking, the Comptroller approved the relocation of Mark Twain's main office.

Nearly four months later on June 10, interstate banking received further legal backing when the Supreme Court ruled in favor of the Federal Reserve in the case of *Northeast Bancorp v. Board of Governors* (472 U.S. 159 (1985)). The case involved three New England based bhcs receiving FRB approval under the Douglas Amendment to consummate interstate acquisitions of banks located in other New England states having reciprocal acquisition statutes.⁶³ Because the Board approved the application, a handful of New York based bhcs that were excluded from the New England banking market sued in federal court.⁶⁴ After the D.C. Court of Appeals upheld the Board's approval of the application, the Supreme Court took the case and rendered an 8-0 decision affirming the previous court's ruling. The Justices found that the New England state statutes were within the Douglas Amendment, and furthermore, that "they do not violate the Commerce Clause, the Compact Clause, or the Equal Protection Clause" (*Northeast Bancorp v. Board of Governors* 472 U.S. 159 (1985)). Thus, interstate banking under the existing statutory framework received additional backing as the courts upheld the actions of one of the federal banking regulators.

The Supreme Court continued to hear banking cases the following term when it heard the case of *Board of Governors of the Federal Reserve System v. Dimension Financial Corporation* November 4. When the Court delivered its ruling early the following year on January 22, it gave lawmakers no alternative but to enact legislation prohibiting nonbank banks. The case revolved around the Federal Reserve's 1984 rule-making attempt under Regulation Y to amend the definition of a "bank" to expand the meaning of demand deposits to include NOW and other

⁶³ The New England bhcs included the Bank of New England Corporation, the Hartford National Corporation, and the Bank of Boston Corporation.

⁶⁴ In addition to Northeast Bancorp, the two other NY bhcs were the Union Trust Company and Citicorp.

transaction type accounts. Striking down the Federal Reserve's action and affirming the Tenth Circuit Appeals Court's ruling, an 8-0 majority stated, "If the Bank Holding Company Act falls short of providing safeguards desirable or necessary to protect the public interest, that is a problem for Congress, and not the Board or the courts, to address" (474 U.S. 361 (1986)). Thus, only Congress could redefine the meaning of the term "bank" to close the nonbank bank loophole.

While several banking bills were stalled on Capitol Hill in 1986, the Comptroller of the Currency issued the United States National Bank of Oregon (USNB OR) an interpretive letter that had far-reaching consequences on the financial services industries. In a letter dated August 18, the Comptroller broke from precedent by allowing this bank to "sell a full range of insurance products to customers of the bank and others from an office at the Bank's branch locations in Banks, Oregon, a town with a population of under 5,000" (OCC 1986: 20). This opinion departed from precedent because the Comptroller ruled that the bank may sell insurance to anyone regardless of whether he was a customer of the bank, thereby indicating insurance agency was no longer incidental to banking. Furthermore, the ruling permitted USNB OR to sell insurance to inhabitants of regions with populations greater than 5,000 provided that the underwriter for which it was agent had authorization to operate in that particular state. This ruling was exactly what banks seeking to enter the insurance industry needed.

Though Congress failed to complete statutory reform in 1986, regulators were more than willing to accomplish policy change. In an order written Christmas Eve, the Board of Governors approved Bankers Trust New York Corporation's (BTNY Corp.) application to place commercial paper. Commercial paper, which existed for many years, is basically a short-term

promissory note issued by a corporation with a maturity date of between 2 and 270 days.⁶⁵ Commercial paper provided a cheaper alternative to financing commercial activity through bank loans. The placement process was one of the two ways in which issuers of commercial paper marketed their indebtedness. More specifically, issuers of commercial paper typically had an entity use its connections to place its debt with a small group of sophisticated investors; this process is often referred to as a direct placement. In rendering its decision, the Fed developed two arguments. First, despite interpretations by the courts and other regulators to the contrary, the Board argued commercial paper was not a security. Second, the FRB developed another argument that took precedence irrespective of whether commercial paper was a security. Even if the Board was mistaken and commercial paper was actually a security, approving this activity did not violate Glass-Steagall because the FRB reinterpreted the “principally engaged” phrase. Using a revenue test to determine whether a firm was principally engaged in an impermissible securities activity, the Board concluded, “The conduct of the commercial paper placement activity at these less than 5 percent levels [of revenue] is consistent with the Board’s past practice” (73 Fed. Res. Bull. 146, Feb. 1987). The 5 percent revenue limit, though, was suggested by BTNY in its application. With this decision, the Federal Reserve inaugurated the section 20 revolution through which banks under the holding company structure could affiliate with firms engaging in impermissible nonbanking activities.

Resuming the chairmanship of the Banking Committee following the Democrats’ regaining control of the Senate in the 1986 midterms, William Proxmire on February 17, 1987 unveiled to fellow committee Democrats a bill addressing the worsening thrift crisis. Proxmire’s draft not only provided additional S&L funding, but also closed the nonbank bank loophole. According to Congressional Quarterly, Sen. William Proxmire believed that “the government

⁶⁵ A promissory note is nothing more than a legal evidence of debt.

would find it difficult to sell off ailing thrifts if prospective buyers could save money by entering the same financial market through the non-bank bank loophole” (Congressional Quarterly 1988a). The rise of mortgage securitization in the eighties, after all, had made the thrift model of generating mortgages and holding them to maturity outmoded.⁶⁶ As a result, if such nonbank banks were permitted to exist, the pool of potential thrift buyers would be much smaller. Nevertheless, such a policy stance expanding banks’ powers represented a dramatic change for the Wisconsin Democrat who had long opposed banks expanding into the other financial services industries.

While the Senate Banking Committee rewrote Proxmire’s bill, the Board of Governors issued an order on March 18 authorizing the Chase Manhattan Corporation through a commercial finance subsidiary to conduct limited dealing and underwriting in commercial paper. Dealing entails a firm acting as a principal by buying and selling securities for its own account and then turning a profit by reselling the securities to customers afterwards at higher prices.⁶⁷ Closely related to dealing, underwriting also involves a firm buying and selling of securities for its own account, yet it often includes the underwriting firm guaranteeing the issuing party a certain minimum value for the securities. As a result, both dealing and underwriting involve significant risk.

In this application, Chase sought to underwrite the commercial paper, and in so doing, take upon itself greater risk. The Board, though, upheld the request as closely related to banking reasoning that the “activity is functionally and operationally similar to the role of a bank that arranges a loan participation, and banks are particularly well suited to assume this role” (73 Fed. Res. Bull. 369, May 1987). This order followed upon the previous December’s authorizing BTNY Corp.’s

⁶⁶ This method of mortgage financing is also known as the originate to hold model.

⁶⁷ Dealing and placements represent the two methods by which commercial paper is distributed.

commercial paper placement. To avoid Chase Manhattan Bank from becoming affiliated with a firm principally engaged in impermissible activities, the FRB limited the Chase Manhattan Corp. to deriving less than five percent of its total revenue from the activities of its commercial finance subsidiary.

The day after the Board of Governors issued its order, Sen. Proxmire introduced S 790, which was broader than his February draft. This bill contained three main components: regulatory authorizations, regulatory restraints, and consumer protections. On the authorization front, S 790 provided the FSLIC with another \$7.5 billion and granted the FDIC emergency powers and new resolution tools to handle problem banks. Perhaps equally important, though, it imposed one-year moratoria on regulator approved expansions into the real estate, securities, and insurance industries, and on regulator approved formations of nonbank banks. The moratorium on expanded insurance powers resulted from committee members John Heinz and Christopher Dodd (D-CT). Although Dodd had previously sought to impose a permanent moratorium on banks entering the insurance sector, the panel rejected and opted instead for the one year version. Finally, the bill contained disclosure requirements concerning the length of time for check holds on deposited items.

The Senate debated S 790 March 25-27. The principal controversy surrounded the moratoria on federal regulators' expansions of bank powers. The moratoria on expanded powers also applied to foreign banks. The moratoria, however, did not impinge on state regulators' authority to grant state-chartered banks additional powers. During this process, the chamber rejected Sen. Garn's attempts to remove the moratoria on nonbank banks and expansions of bank powers. Freshman Sen. John Breaux (D-LA), though, notched a major victory for moratoria opponents by making them retroactive to the beginning of March 1987 regardless of the bill's

enactment date. Finally, the bill directed President Reagan to appoint a commission to study overhauling the banking regulatory system. The Senate approved S 790 March 27 by a margin of 79-11 with all eleven nay votes coming from Republicans.

Although Chairman St. Germain had introduced a bill (HR 27) on the first day of the new session, the House was slow to act. Compared to its Senate counterpart, HR 27 focused solely on funding the FSLIC. The House Banking Committee approved St. Germain's bill on April 1. HR 27 ignored regulatory matters of expanded powers or nonbank banks. The bill's main contents included \$5 billion worth of FSLIC funding. Needless to say, this amount was one third that requested by the Reagan administration and approved March 31 by the House Financial Institutions Subcommittee.

Meanwhile during the spring, the Board of Governors issued other significant decisions affecting the regulatory structure. On April 24, the Board announced a "source of strength" policy concerning bank holding companies' duties to their subsidiary banks, stating it is "the responsibility of bank holding companies to act as sources of financial and managerial strength to their subsidiary banks" (73 Fed. Res. Bull., 441, Jun. 1987). Though Fed officials previously articulated the policy in testimony and speeches, the FRB had never officially issued a written statement on it. Hereafter, the Federal Reserve employed this legal rationale to justify its decisions expanding bank holding companies' activities through subsidiaries. According to this line of reasoning, nonbanking affiliates of banks would not endanger federal deposit insurance or the Fed's discount window, rather they would aid the banking system by providing additional revenue streams to their parent banking organizations.⁶⁸

⁶⁸ To date, the federal court system still has not ruled on the "source of strength" doctrine. There was one line of cases, known as MCorp, during the early 1990s that challenged the policy that went through the Appeals Circuit before reaching the Supreme Court, but the Court ultimately decided that the district and appeals courts erred by

The Fed did not stop there when six days later it approved joint applications by Citicorp, J.P. Morgan & Co., and BTNY Corp. to engage in limited underwriting and dealing in certain securities. The securities included municipal revenue bonds, mortgage backed securities, consumer-receivable-related securities, and commercial paper, all of which the Board referred to as “ineligible securities.” Because this case entailed bank holding companies proposing to underwrite securities in subsidiaries all ready engaged in underwriting certain types of securities, the Board “concluded that the U.S. government and other securities specifically made eligible for underwriting and dealing by member banks in section 16 should not be viewed as the kind of activity proscribed by section 20” (73 Fed. Res. Bull. 476, Jun 1987). Once again, the Fed limited the section 20 subsidiaries to less than 5 percent of their revenue from the impermissible activities. Interestingly enough, Board Chairman Paul A. Volcker and Governor Wayne D. Angell dissented from the ruling. Though they supported the policy result, they disagreed with the method taken to reach it. Because of this ruling, Angell and Volcker argued, member banks would no longer be affiliated with corporations “principally engaged” in underwriting or dealing in securities, rather they would be affiliated with corporations “wholly engaged in such activities” (73 Fed. Res. Bull. 505, Jun 1987).⁶⁹

When HR 27 reached the House floor May 5, the main controversy surrounded the FSLIC funding package’s size. The Reagan administration was advocating a \$15 billion funding plan spread out over five years whereas many lawmakers, including St. Germain, believed a \$5 billion package was sufficiently adequate. To aid its cause, the administration even successfully lobbied Speaker Jim Wright (D-TX) into supporting its funding plan. As a result, Wright

concluding they had jurisdiction to rule on the regulation 900 F.2d 852 (5th Cir. 1990), reversed, 502 U.S. 32 (1991). As a result, there still is no official federal court ruling on the FRB’s “source of strength” doctrine.

⁶⁹ The Board approved a similar application in mid May from the Chase Manhattan Corp. to underwrite and deal in the same types of securities. Once again, Chairman Volcker and Governor Angell dissented and referred to their statement in the Citicorp, Morgan, BTNY Corp. order (73 Fed. Res. Bull. 609, Jul 1987).

prevailed upon St. Germain to amend his committee's \$5 billion funding provision with the administration's one. This amendment caused many members of both parties to revolt; it failed 258-153. After defeating the \$15 billion FSLIC amendment, the House returned to the original HR 27 with its \$5 billion provision spread over two years; this version overwhelmingly passed with only six members voting against it.

Even though both chambers easily passed bills, wrangling between them over whose bill they would negotiate delayed the convening of a conference. When the conference began on June 22, Rep. St. Germain agreed to negotiate all the Senate bills' provisions. According to St. Germain's aides, "it was clear that senators were adamant about taking up their entire bill, and...a compromise on FSLIC would be impossible without first working on the other Senate provisions" (Congressional Quarterly 1988a). Over the next week and a half, the conferees agreed to \$8.5 billion for the FSLIC, a redefinition of the term "bank," and a moratorium on regulators' expansion of bank powers expiring one year from S 790's introduction. The redefinition of a bank, which closed the nonbank bank loophole that had existed since the BHCA Amendments of 1970, amounted to a permanent moratorium on further nonbank banks.

After some last minute veto threats from the administration which successfully extracted more FSLIC funding from the conference, President Reagan signed the Competitive Equality Banking Act (CEBA) of 1987 on August 10. Though the statute focused primarily on the thrift industry, it also contained several important elements pertaining to the banking industry. Since the FSLIC was then insolvent, the law sought to recapitalize the fund. CEBA reaffirmed that the United States government, and the U.S. taxpayer, stood behind not only the FSLIC, but also the FDIC. It also granted the FSLIC the authority to borrow up to \$10.825 billion by issuing bonds and to impose additional assessments on member thrifts given the exceptional circumstances.

Second, CEBA enacted key changes to the banking system. The statute ended the nonbank bank by redefining the meaning of “bank” contained in the Bank Holding Company Act. CEBA added to this definition any institution insured by the FDIC, regardless of its loan making or deposit taking. Because numerous nonbank banks had arisen since 1970, it grandfathered the operations of those ones operating before March 1987. It attached a condition relating to the grandfathering that limited the annual growth rate of such limited service banks’ assets. Perhaps even more important than closing the loophole, CEBA imposed a one-year moratorium on federal regulators approving any bank applications seeking expansions into the insurance, securities, or real estate industries. The moratorium expired March 1, 1988.

The law also required the FHLBB and the FSLIC, the two federal thrift regulators, to adopt generally accepted accounting principles (GAAP). These other accounting guidelines replaced the previous standard employed by the agencies known as regulatory accounting principles. This change required the use of mark-to-market accounting methods and brought thrifts in line with the accounting rules employed by banking regulators. Connected with the change in accounting principles, legislators permitted regulators to grant thrifts located in economically depressed regions forbearance. The FDIC gained another resolution mechanism with the “bridge bank” that allowed it to create a new, sound bank and operate it in place of a failed bank for up to three years while looking for a buyer. To curtail moral hazard and minimize insurance fund losses, the FDIC received the authority to overrule state banking commissioners, who chartered state banks, when they refused to close their insolvent institutions.

CEBA unfortunately failed to stem the mounting bank and thrift failures. Soon after the start of 1988, officials from the FSLIC and the GAO released reports indicating that the costs of resolving the thrift failures were much higher than policymakers previously anticipated.

CEBA's FSLIC funding provisions suddenly became insufficient. The new estimates revealed the costs increased significantly over the last four months of 1987. With President Reagan in his final year in the White House, Sen. Proxmire planning to retire at the end of the congressional session, and elected officials focusing on the upcoming presidential election, lawmakers were rather preoccupied with matters other than banking reform. Sen. Proxmire spent his last year in elective office attempting major legislative reform of the banking industry, but his efforts failed to produce any tangible results.

Nevertheless, two days before President Reagan left office, the Board of Governors of the Federal Reserve approved the proposal from J.P. Morgan & Co. Inc., Chase Manhattan Corp., BTNY Corp., Citicorp, and Security Pacific Corp. to underwrite and deal in a whole host of different debt and equity securities. The Board approved the activities which would be conducted within bank holding companies' section 20 subsidiaries; it still subjected the subsidiaries to less than the 5 percent revenue limit. The importance of this order, however, was not so much that the Fed approved the application, but that in doing so, it provided a list of firewalls that would prevent the spread of contagion to any of the affiliated banks. The protections included items such as requiring separate names and logos for the banks and affiliates, limiting the concentration of resources, and increasing capital adequacy requirements (75 Fed. Res. Bull. 202-210, Mar. 1989).

THE BUSH YEARS

As President George H.W. Bush took office in the midst of worsening bank and thrift crises, he attempted to tackle the problems of these crises in one of his earliest actions. During its first week in office, the Bush administration leaked the idea of funding resolution of the thrift crisis a "depositors' fee" on all depository institutions, thereby contradicting President Bush's

“no new taxes” pledge (Boyd 1989). Rep. Henry Gonzalez (D-TX), who became House Banking Committee Chairman following Rep. St. Germain’s loss in a 1988 Democratic primary, best summarized the political reaction of most elected officials to the Bush administration’s proposal, “I don’t see any difference between raising the premium and exacting a tax, a fee” (Boyd 1989). Even though the adverse political reaction caused the administration to relinquish the tax proposal and increase deposit insurance premiums instead, the damage was still done as the Bush White House committed its earliest mistake.

Nearly a week after policymakers reacted harshly toward the bank tax idea, President Bush formally announced his legislative plan addressing the banking and thrift crises. The Bush proposal contained the following components: placing insolvent thrifts under the FDIC-FSLIC’s joint management, overhauling the nation’s regulatory framework for depository institutions, establishing a corporation to finance the cost of resolving the numerous insolvent thrifts, and increasing the Department of Justice’s budget to pursue those bank executives guilty of fraud and other wrongdoings. Bush defended his plan, arguing that “the taxpayers will not be called on to rescue it [i.e. the FDIC] a few years from now” (Bush 1990: 61).

Although both the House and Senate Banking Committees worked on the proposed legislation during February and March, the Senate Banking Committee completed work on the bill first. Sen. Don W. Riegle Jr. (D-MI), who became Banking Committee Chairman upon Sen. Proxmire’s retirement, took the leading role in redrafting the Bush administration’s plan with fellow committee members behind closed doors, the Banking Committee on April 12 approved a bill (S 774) strongly resembling the White House’s one. As requested by President Bush, S 774 contained a \$50 billion appropriation to fund resolution of the insolvent thrifts. The Senate Banking Committee’s bill, however, differed from the administration’s bill in three significant

areas: it strengthened capital adequacy requirements for thrifts; it further restricted state-chartered thrifts' activities; and, it removed chartering authority from the FHLBB.

Exactly a week later, the Senate easily passed S 774. Though the upper chamber debated the proposed legislation for three days, it changed few elements in the bill. The Senate left the appropriation amount unchanged, although Sens. Riegle and Bob Graham (D-FL) tried but failed to circumvent Gramm-Rudman by placing the funding on budget. The alterations of greatest significance, however, revolved around increasing thrifts' capital standards, which only strengthened the bill. Sen. Howard M. Metzenbaum (D-OH) was instrumental in getting the chamber to toughen capital requirements requiring thrifts to have a specified minimum amount of tangible capital; the Metzenbaum amendment set the level at three percent capital to assets. Additionally, his amendment required thrifts to amortize any goodwill they were carrying as capital over a twenty-five year period. Sens. Garn and Riegle also amended S 774 allowing the FDIC to continue charging banks the maximum premium until its fund was replenished to at least 1.65 percent of total deposits, an amount greater than that sought by the Bush administration.

Unlike the Senate, the House had a more difficult time completing work on the administration's proposed banking legislation. Having received Chairman Gonzalez's draft of the administration's proposal HR 1278 on referral, the Subcommittee on Financial Institutions approved a version of HR 1278 on March 13 following some heated mark ups. The most contentious aspect of HR 1278 within the panel, though, concerned capital standards and the subcommittee's decision to set them lower than the administration requested. The panel, however, amended the bill requiring thrifts meet the capital requirement based on their assets' riskiness. The House Banking Committee began work on HR 1278 nearly two weeks afterwards,

and, just like its subcommittee, experienced the most disagreement over capital standards. Although the committee kept the Financial Institution Subcommittee's risk-based measure of capital, it increased the amount of capital regulators required thrifts to have. It required thrifts have tangible net worth of at least 1.5 percent of assets by the following June and to have core capital, which included goodwill, of 3 percent by the same date. Both requirements were stricter than those of the Senate or Bush administration. The committee also limited thrifts' activities. On May 2 the Banking Committee approved HR 1278 with only two votes in the negative.

In light of the controversy encountered in committee, the House had a surprisingly easy time June 15 passing HR 1278. The Banking Committee's capital standards remained, though a number of Congressmen, most notably Rep. Henry Hyde (R-IL), attempted to amend the bill lowering the standards. Nonetheless, the Bush administration and its congressional allies successfully defeated all such amendments reducing the capital requirements. During the debate, the House adopted Rep. Byron L. Dorgan's (D-ND) amendment banning thrifts from investing in junk bonds. The House also defeated amendments taking the funding for thrift resolutions off budget.

Following its selection in late June, the conference committee did not convene until after the Fourth of July recess. While the capital standard issue fomented much controversy within the House, it became a non-issue in conference. Instead, conferees argued the most about the financing method of the \$50 billion appropriation. The committee became deadlocked on whether the appropriation should be on-budget or off-budget. The Bush administration and Republicans espoused putting the funding off-budget given the size of the deficit, whereas Democrats were split between the two options. Ultimately Sen. Alan Cranston (D-CA) switched his vote from the off-budget to the on-budget plan to move the legislation. In return, he

extracted some concessions from Chairman Gonzalez and other House members retaining the bill's anti-discrimination provisions. As a result, the conferees reached final agreement on a bill and submitted their report July 27.

President Bush signed HR 1278 on August 9, thereby enacting the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) of 1989. The law abolished the bankrupt FSLIC and stripped the FHLBB of its regulatory role; it then created the Office of Thrift Supervision (OTS) as a new bureau within the Treasury to regulate federally chartered thrifts and transferred the FHLBB's chartering and regulatory authority to the OTS. Second, FIRREA established two new deposit insurance funds under the FDIC's management: the Savings Insurance Fund (SAIF) and the Bank Insurance Fund (BIF). To aid the thrift cleanup, the statute created the Resolution Trust Corporation (RTC), a new agency to resolve the assets of failed S&Ls.⁷⁰ Fourth, to make it more difficult for the FDIC to invoke its authority under Section 13(c)(4), the law expanded the size of the agency's board of directors by adding the OTS director and two other presidentially selected appointees.⁷¹

FIRREA also changed the bank and thrift regulatory structure. First, it rewrote the minimum capital standards for S&Ls, and further defined what constituted capital. In particular, it prohibited regulators after 1994 from using their discretionary authority to include "goodwill" as capital. FIRREA also increased bank capital standards on thrifts. Second, to fund the SAIF and the BIF, the measure increased the deposit insurance premium, which was a fixed, flat rate that banks and S&Ls paid. Third, to aid in the resolution process, financially sound banks and thrifts were allowed to purchase failed thrifts across state lines. Fourth, the statute officially

⁷⁰ Basically, lawmakers created the RTC to perform one half of the FDIC's function; it served as the resolution authority but not the insurance authority.

⁷¹ Section 13c(4) refers, of course, to the "essentiality doctrine" the FDIC employed to bail out failed depository institutions, especially under the infamous too big to fail moniker.

sanctioned the FDIC's cross-guarantee policy by which the agency seized the assets of healthy banks affiliated with failing banks. Fifth, because thrift premium rates exceeded bank ones, FIRREA prohibited healthy S&Ls from converting to banks to join the BIF and reap its lower premium rates. Sixth, it applied banks' investment guidelines to S&Ls, and, more specifically, required S&Ls to divest any junk bond holdings by July 1994.

Although FIRREA marked the completion of lawmakers' banking legislation for the year, bank regulatory policy continued to evolve through other venues. The most important development occurred on September 21, when the Federal Reserve Board announced that it was modifying its section 20 rule. This rule allowed subsidiaries of bhcs to deal in and underwrite "bank-ineligible securities."⁷² In addition, the newly generated rule "raise[d] from 5 to 10 percent the revenue limit on the amount of total revenues a section 20 subsidiary may derive from ineligible securities underwriting and dealing activities" (75 Fed. Res. Bull. 751, Nov. 1989). The rule further expanded the category of "bank-eligible securities" to include securities "rated by a nonaffiliated, nationally recognized rating organization or...issued or guaranteed by the Federal National Mortgage Association [Fannie Mae], the Federal Home Loan Mortgage Corporation [Freddie Mac], or the Government National Mortgage Association [Ginnie Mae]" (75 Fed. Res. Bull. 751, Nov. 1989). Thus, certain asset-backed securities became eligible for purchase by bank holding companies and their subsidiaries.

By the start of 1990, it was becoming increasingly evident that FIRREA and its provisions to fund the thrift cleanup were insufficient for solving the S&L problem. The number of failing thrifts was climbing far beyond the amount that FIRREA was designed to resolve, and, as a result, regulatory officials began warning Congress early about the need for additional

⁷² "Bank-eligible securities" included federal government bonds or Treasuries, but, in recent decades expanded to include municipal bonds and general revenue bonds.

action. Needless to say, members of Congress were angered over this discovery and did not want to be seen passing another government bailout.

Meanwhile, President Bush and his advisers remained silent on the increasing failures and the failures' effect on the costs of federal deposit insurance. The executive branch's silence, however, only worsened relations with Capitol Hill as legislators refused to act on such a politically unpopular issue without having the president as an equal participant. Treasury Secretary Brady eventually testified before the Senate Banking Committee in late May and told senators that conditions had worsened tremendously with between 700 and 1000 thrifts having failed or verging on failure. He predicted losses to the federal government could exceed \$100 billion, but that this amount could easily change as the number of troubled banks and thrifts increased.

Both chambers in October finally crafted bills providing additional money for the RTC. Because of the Bush administration's silence and the intense hostility such bailouts generated, congressional leaders did not bring any of the measures to the floor. The final attempt to pass a funding bill died early in the morning of October 28, when Rep. Gonzalez's unanimous consent attempt to consider H.R. 5891 failed.

The following year, Capitol Hill lawmakers accomplished little except for passage of a bill in October authorizing the FDIC to raise its insurance premiums. At the time, FDIC premiums were at their highest level permitted under the law; the statutorily capped rate was 12 cents per \$100 of deposits. On October 16, the House approved a budget reconciliation bill HR 5835 containing a provision eliminating altogether the cap on premiums. The provision resulted from a bill (HR 5610) the House had approved a month earlier. On October 18, the Senate passed HR 5835. Although the both chambers' votes on HR 5835 were rather close, the deposit

insurance premium increase attracted little attention during debate (Congressional Quarterly 1991b). President Bush eventually signed the spending bill the day before the midterm elections; the deposit insurance provision did not cause the delay (Congressional Quarterly 1991b).

As the following year began, the failure of the Bank of New England Corporation (BNEC) and its three subsidiary banks reminded policymakers yet again of reforming the banking statutes to prevent future uses of TBTF.⁷³ Although BNEC and BNE were publicly reporting losses in the hundreds of millions throughout the previous year, it was not until the holding company's announcement on Friday, January 4, 1991 that a run began on the BNE in which depositors withdrew nearly \$1 billion. As a result, the OCC declared BNE insolvent on Sunday, January 4 and appointed the FDIC receiver. The FDIC then immediately charged the other two banks in the group with the anticipated insurance fund loss, but because they were unable to pay the capital deficiency, the agency seized them as well.⁷⁴ To stem the run, the FDIC announced that it would protect all deposits of the three banks, even those above the \$100,000 statutorily guaranteed limit. The FDIC's blanket guarantee of all deposits turned attention back to the too big to fail doctrine.⁷⁵

Lawmakers received additional impetus on February 5 when the Treasury Department released its 700 page FIRREA-ordered policy study *Modernizing the Financial System: Recommendations for Safer, More Competitive Banks*. The Treasury described the predicament facing American banks in the following way:

⁷³ The three banks composing the BNEC included Bank of New England, N.A. (BNE), Connecticut Bank and Trust Company, N.A. (BCT), and Maine National Bank (MNB). All three banks combined had assets totaling nearly \$21 billion, making the BNEC one of the nation's largest banking organizations.

⁷⁴ This action marked the FDIC's first official use of its cross-guarantee policy as it forced two solvent banks into receivership.

⁷⁵ Incidentally, the BNE failure was the last time in the twentieth century the FDIC employed its "essentiality" authority. There were, of course, three other instances in which the agency invoked this power between Continental Illinois and BND. These three instances included First National Bank and Trust Company of Oklahoma City (Oklahoma City, OK 1986), First Republicbank of Dallas (Dallas, TX 1988), and MBank Houston, N.A. (Houston, TX 1989).

In short, unable to adapt and follow their best customers into related lines of businesses, banks have become steadily less competitive in their traditional activity of lending....Losses have increased and capital has decreased. Taxpayers have become more exposed. (Department of the Treasury 1991: 7)

To alleviate the situation, the Treasury proposed allowing banks to affiliate with a host of other financial services firms, including nonfinancial companies, authorizing banks to expand into the other financial services industries, and removing restrictions on interstate branching. Although the study recommended altering deposit insurance to limit coverage and thereby lower the federal government's contingent liability, anything addressing federal deposit insurance's funding shortfall was conspicuously absent.

The House Financial Institutions Subcommittee began the lawmaking process May 7 when it easily approved a narrow bill (HR 2094) that provided the FDIC a \$30 billion Treasury line of credit, capped deposit insurance coverage at \$100,000 total per depositor throughout the country, and improved banking regulation by among other things, requiring regulators to act more promptly with insolvent institutions. Thirteen days later without dissent, it passed a broader banking bill resembling the Treasury' proposed plan. This second bill, which remained unnumbered, basically provided everything the administration advocated such as removing the prohibitions against interstate branching, removing statutory restrictions on expanded bank activities, permitting nonfinancial corporations to own banks, and allowing banks to affiliate with insurance and real estate firms. The unnumbered bill, however, did not limit deposit insurance as the Bush White House wished to \$100,000 per person nationally.

A month after the House Financial Institutions Subcommittee passed the broader banking bill (HR 2094), the House Banking Committee began marking up bills. Following several days

of markup, the committee June 28 approved a narrow banking bill (HR 6), which Chairman Gonzalez had introduced on the first day of the session. As introduced, HR 6 replenished the deposit insurance fund by raising an existing Treasury line of credit to \$30 billion. Then, in something of a turnabout, the committee attached its subcommittee's entire unnumbered broader bill and sent both to the floor together.

Since the House Banking Committee finished working on HR 6, the bill proceeded to Commerce where it sat idle until Congress returned from the August recess. Upon resuming, Commerce's Finance Subcommittee soon approved HR 6, but before doing so it attached two amendments. One amendment thwarted the mixing of banking and commerce by prohibiting banks from affiliating with nonfinancial companies whereas the other one restricted the affiliations between banks and securities firms by limiting their cross-selling. As this subcommittee worked on HR 6, Commerce's Competitiveness Subcommittee considered the proposed legislation. It too passed and amended the bill restricting banks' entry into insurance, thereby curtailing some regulator approved activities. Then, on September 25 the Energy and Commerce Committee easily approved HR 6 in a form nearly identical to that passed by its two subcommittees.

Meanwhile, the Senate Banking Committee held nomination hearings on September 26 and October 3 for Robert L. Clarke's second term as Comptroller of the Currency. President Bush had nominated Mr. Clarke for a second five-year term back in January, but the Senate delayed action on the appointment for over nine months. At the two day affair, Democratic Senators blamed Clarke for the hundreds of bank failures occurring under his tenure. Banking Committee Chairman Riegle went so far as to claim, "During his tenure, national banks failed in numbers not seen since the Great Depression" (Congressional Quarterly 1992a). It was not only

the large number of bank failures that troubled Democrats, but also Comptroller Clarke's role in the resolution of BNE at the start of the year that stirred opposition from Democratic Senators. In particular, he had been uncooperative with congressional requests for documentation concerning OCC examinations and actions taken to stem the unsafe and unsound practices at BNE. As a result, the committee defeated Clarke's reappointment in two party-line votes: one recommending confirmation and another merely forwarding his nomination to the floor without any recommendation.⁷⁶ Though Clarke failed to win a second term as Comptroller, he remained in office as a recess appointment through the following February.

These two rather different bills reported by the House Banking and Commerce Committees created an impasse that thwarted further action. By the third week of October, however, Rep. Gonzalez relented and agreed with Commerce Chairman Dingell on a compromise version. The agreement involved prohibiting nonfinancial companies from owning banks, limiting banks' insurance activities, and erecting more stringent firewalls separating banks from their affiliates. In return, Dingell abandoned his demands for the SEC to regulate securities activities conducted in banks, thus relinquishing the Commerce Committee's clear move to gain jurisdiction over one area of banks' activities. The two chairmen left the interstate branching provisions alone. In response to the Gonzalez-Dingell compromise, President Bush issued a veto threat on October 29. House leaders persisted in bringing the revised bill to the floor, so legislators utterly rejected it on November 4 by over a three to one margin.

Two days after the House defeated HR 6, the Banking Committee returned to HR 2094, a narrower banking bill it passed earlier in the year, and approved it once again for floor action. The committee maintained the bill's earlier form and contents. Unfortunately, once HR 2094

⁷⁶ Sen. Al D'Amato (R-NY) was the only senator to cross-party lines in these two committee votes and join Banking Committee Democrats.

reached the floor November 13 members added two amendments: one reattached non-controversial banking law reforms discarded from the earlier HR 6 whereas the other one permitted interstate branch banking while curtailing the banking industry's ability to enter real estate and insurance. As a result, a rather odd political coalition of banks, securities firms, and consumer rights groups coalesced against the insurance and real estate interests supporting it; this second banking bill was defeated November 13 by a 227-191 margin.

While the House spent much of the year crafting banking legislation in the open, the Senate did so but behind closed doors. In fact, Banking Chairman Don Riegle spent much of the year privately drafting a bill (S 543) that permitted banks to affiliate with securities firms, prohibited banks from affiliating with nonfinancial companies, provided the FDIC with a \$30 billion line of credit, required regulators act promptly to close insolvent banks, provided lender liability protection for banks foreclosing on contaminated property, and provided consumer protections for bank customers. The Banking Committee passed the bill August 2, but delayed Senate action by failing to file a report on the proposed legislation until October 1. In narrowly approving S 543, the committee altered Riegle's bill somewhat through the amendment process. The changes included: altering the special premiums to cover the line of credit so that they applied only on domestic deposits, creating new resolution procedures for the FDIC and ending too big to fail by permitting the FDIC to cover uninsured depositors but to also impose a ten percent loss on them, dropping Riegle's provision for a new bank regulatory agency outside the Treasury, and permitting both interstate branching and consolidation within three years. The Senate considered S 543 for several days during mid November. Before passing the bill November 21, however, senators made three other amendments of significance. First, the chamber removed the provisions allowing banks to affiliate with securities firms. Then, the

Senate added a provision permitting national banks to serve as insurance agents in states granting the same ability to state-chartered banks. Finally, the chamber changed the interstate branching provision so that banks could only cross state lines by purchasing another bank.

The House Banking Committee marked up its third banking bill on November 19. The third incarnation was HR 3768; it closely resembled HR 2094 except for it lacked the interstate banking provisions. The House debated HR 3768 two days later without permitting any amendments whatsoever. Insurance industry ally Rep. Solomon strenuously opposed the bill, but was prevented from offering any amendments. The chamber then approved the measure overwhelmingly, if unenthusiastically, 344-84.

With November nearly over, the two chambers hastily assembled a conference. To complete the legislation before session's end, conferees settled on approving a narrow bill. They achieved this goal by authorizing a line of credit of \$30 billion to the FDIC, instituting higher deposit insurance premiums on banks to replenish the insurance fund, and granting the FDIC short-term borrowing authority. The conferees from both Houses adopted the report November 27.

On December 19, President Bush signed S 543 into law, thereby enacting the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. First, FDICIA raised the FDIC's Treasury line of credit to \$30 billion. Second, it authorized the FDIC to set risk-based deposit insurance premiums. Until this time, the FDIC charged all banks the same rate, regardless of risk, thereby creating a moral hazard problem. Third, the law required bank regulators to intervene immediately before a bank failed, practicing what the statute labeled "prompt corrective action," to limit losses to the insurance fund. Fourth, it instituted consumer protections such as the Truth-in-Savings Act requiring depository institutions to make certain

disclosures to depositors about interest rates. Fifth, the statute limited executive compensation at troubled banks and instituted safeguards insider lending. Sixth, though by no means all, the law necessitated regulators develop a new formula for calculating whether a bank had adequate capital. This law, along with 1983's ILSA, composed the two sources from which regulators derived their ability to set capital requirements.

The banking system, however, continued to have problems the following year as hundreds of depository institutions failed. Needless to say, FDICIA did not immediately turn around the industry. Furthermore, the cost of resolving the thrift crisis continued to increase, thereby necessitating additional action from legislators. Though Congress attempted to extend last December's RTC appropriation early in the spring, the efforts failed and the RTC had to return much of the funding to the Treasury. With George Bush's first term about to expire, lawmakers were so focused on the upcoming election that they wanted to avoid the unpleasant choices entailed in tackling the banking system's woes. As a result, 1992 witnessed no further progress on banking reform legislation.

CONCLUSION

This chapter examined bank regulation during the Reagan-Bush years. As evidenced by the amount of major banking statutes, this twelve year period proved to be one of the most productive for lawmakers in the realm of banking policy in decades. Some of this legislation eliminated New Deal era interest rate controls. Legislators eliminated the New Deal interest rate ceilings, authorized the federal regulators to establish capital requirements for banks due to international lending, redefined what constituted a bank and thereby brought more firms within the purview of regulators, granted the FDIC the right to increase premiums and then the right to establish risk-weighted premiums, and, unlike in previous times, ordered federal regulators to

take prompt corrective action whenever a bank's capital fell below specified levels. Additionally, they extended previously enacted social regulations such as community reinvestment requirements and instituted entirely new ones aimed at disclosure and consumer protection. In this way, lawmakers significantly revised not only the various tools available to the agencies, but also the relationships between them.

Federal lawmakers, however, were not the only ones busy during this period. As revealed by this chapter, the regulatory agencies were also very involved in the policymaking process. The FDIC continued experimenting with its "essentiality" provision as a way to provide financial assistance to failing depository institutions. It extended financial assistance to organizations such as First Pennsy, Continental Illinois, and the Bank of New England. By this time, though, this resolution mechanism was all ready falling into disfavor; Continental Illinois won it the too big to fail epithet whereas Bank of New England proved to be the last use of it until the 2007-2009 financial crisis.

While the OCC and Fed were coordinating with the FDIC over resolving bank failures, they were also approving expansions of activities. The OCC approved expansions by national banks into securities brokerage and insurance agency, not to mention permitting a bank to move its headquarters across state lines. Not to be outdone, the Fed used its authority to permit affiliations between banks and firms engaged in nonbanking activities through the holding company structure. Nearly a year after the OCC's brokerage decision, the Federal Reserve approved Bank of America Corporation's application to acquire the securities brokerage Charles Schwab. Then, nearly a year later, the Fed began approving affiliations between banks and firms engaging in "ineligible" securities activities. Both agencies justified their rulings as means of strengthening the banking system, yet neither really considered at the time the implications such

expansions might pose on deposit insurance system. Nevertheless, the implications of how such expansions into other financial services sectors could one day channel governmental aid to those industries rather than the banking one was largely ignored for a later date.

5. BANK REGULATION DURING THE CLINTON ADMINISTRATION

This chapter presents bank regulation during President Clinton's first seven years in office. The narrative begins the March 1993 initiative that revealed Clinton's interest in streamlining regulatory reviews of banks and extending additional credit to poor communities. Because the nation was still recovering from the bank and thrift crises of the preceding period, though, policymakers soon turned their attention to funding the remaining cost of the resolutions. In the process of completing legislative action on this matter, administration officials clearly communicated to Capitol Hill their interest in serious reforms of the nation's antiquated branching laws. Lawmakers remembered this interest in Clinton's second year when they successfully pushed through the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 that phased out existing restrictions on intrastate and interstate branching within a few years.

Shortly after the Democrats completed this major reform of the country banking laws concerning branching, however, the Democrats lost control of both congressional chambers in the midterm for the first time in forty years. On the surface, at least, such a return to divided government threatened to block any further reforms of the banking statutes. Nonetheless, the change in party control brought about significant changes both in terms of committee jurisdictions and personnel running those committees that new opportunities of statutory reform quickly appeared.

In February 1995, not long after the 105th Congress convened, House Banking Committee Chairman Jim Leach (R-IA) began his quest to complete modernization of the nation's outmoded bank regulatory laws that would ultimately produce the Financial Services Modernization Act of 1999. Over the next few years, however, Leach's efforts are stymied by

opposition mainly from the insurance industry and its opposition to further expansion by banks into insurance. Not until Citicorp and Travelers announced their merger in April 1998 did hope for real legislative reform return. Late this particular year, though, Sen. Phil Gramm (R-TX) killed the proposed legislation in the Banking Committee. With Gramm slotted to takeover the chairmanship of the Banking Committee in 1999, Needless to say, the possibility for legislative reform appeared to lessen with Sen. Gramm taking over the Banking Committee chair, but he proved himself to be quite the legislator over the course of the year as he and his counterpart in the House, Rep. Leach, successfully guided the Financial Services Modernization Act of 1999 to enactment. In so doing, lawmakers repealed a few vestiges of “Glass-Steagall.”

Though much of the activity during this period occurred at the legislative level, the federal regulatory agencies were still actively influencing the course of regulation with their various activities. Since the problems associated with resolving the bank and thrift crises soon disappeared, the FDIC took on a lesser role vis-à-vis its two counterparts. The Comptroller of the Currency, for instance, continued to permit national banks to expand into activities deemed “incidental” to banking. In June 1993, the Supreme Court upheld the Comptroller’s decision to allow national banks sell insurance in the case involving the United States National Bank of Oregon. A few years later in early 1996, the Supreme Court upheld the right of a bank holding company subsidiary to sell insurance in Florida. Thus, banks managed to consolidate their regulator approved entry into the insurance industry. Likewise, the Federal Reserve continued to approve applications from bhcs engaging in “ineligible” securities activities through their section 20 subsidiaries. In December 1996, the Fed raised the limit from 10 to 25 percent on revenue for section 20 subsidiaries; then two months later, it announced a major streamlining of its review procedures for bhcs expansion, which was made possible by a recent statutory reform. Thus, two

of the three federal banking regulators were crucially involved in the development of bank regulatory policy. This involvement continued through the passage of Gramm-Leach-Bliley as they fought over the structure of the newly sanctioned activities.

THE CLINTON YEARS

Nearly two months after taking office, President Bill Clinton delivered a March 10 speech on the nation's credit crunch and outlined a means to "speed the economic recovery" through "increasing access to credit" for small businesses and other community members (Clinton 1994). To accomplish this goal, the president announced that the federal bank regulatory agencies would issue directives without any statutory changes streamlining the examination process and reduce burdensome paperwork requirements. Implementing these changes, though, he stressed would "not reduce attention to important regulation" (Clinton 1994). Community reinvestment was one such regulation that regulators would not slight in the process. As Clinton explained,

Through a proper allocation of our regulatory resources, we will be able to focus more on examination procedures to further meaningful compliance with the Community Reinvestment Act and to promote fair opportunities for all our people while reducing the hassles for all creditworthy loans. (Clinton 1994)

This marked perhaps one of the earliest instances of a White House emphasizing the duty of banks lending to members of their own communities.

Although ideas such as these concerning the importance of micro-lending and fairness might seem out of the blue to someone not familiar with President Clinton, they were not at all out of line with his worldview. After all, Bill Clinton had expressed a rather different conception of the American banking system's operation when he gave one of his earliest national interviews

the previous September right after having received the Democratic nomination. He stated, “I think every major urban area and every poor rural area ought to have access to a bank that operates on the radical idea that they ought to make loans to people who deposit in their bank” (Greider et al. 1992). Clinton elaborated upon this idea saying, “It’s not happening today. A certain percentage of the bank assets of this country have to be devoted to community banking” (Greider et al. 1992). The CRA became one of the principal ways in which the administration did so. Writing in his autobiography, Bill Clinton argued,

One of the most effective things we did [for the economy] was to reform the regulations governing financial institutions under the 1977 Community Reinvestment Act....before 1993 it had never had much impact. After the changes we made...banks would offer more than \$800 million in home mortgage, small-business, and community development loans” (Clinton 1994: 517-518).

Though it is debatable to what extent such initiatives aided the economic recovery, it certainly is undeniably that the administration, unlike its predecessors, emphasized lenders’ social responsibilities in the realm of banking regulation.

In congressional testimony before both Houses during mid March, Treasury Secretary Lloyd Bentsen requested \$45 billion to fund the RTC and the Savings Association Insurance Fund (SAIF). He stressed that this politically unpopular appropriation, which Congress failed to complete the previous year, would hopefully be the last one needed to resolve the thrift crisis. The Senate Banking Committee approved a funding bill (S 714) in late March appropriating \$42 billion, but when it reached the floor in mid May, senators reduced the appropriation to \$29 billion and amended it requiring the RTC to revise its operating procedures to limit waste and improve recovery rates. A few days before the full Senate vote, the House Banking Committee

passed its own bill (HR 1340) providing \$18.3 billion solely for the RTC. Under this bill, the FDIC funded the SAIF through the \$30 billion Treasury credit line it received in 1991. The cost of the RTC and the SAIF's funding method, though, troubled Republican members who succeeded in delaying any further action on the measure until the fall.

While legislation addressing the RTC was stalled in Congress, the Supreme Court ruled in the case of *USNB OR v. Independent Insurance Agents of America* (508 U.S. 439 (1993)). The cases surrounded the Comptroller's 1986 interpretive ruling allowing the United States National Bank of Oregon to act as an insurance agent out of one of its branches. This interpretive ruling had drawn upon a section within the Federal Reserve Act Amendments of 1916 authorizing national banks to sell insurance out of their offices in towns with populations under 5,000. The novel aspect of the 1986 ruling, though, was that the Comptroller interpreted the statute's text to allow national banks to sell insurance not only to residents of the small towns in which they were located, but also to customers outside of those locales irrespective of population. Consequently, a trade group representing insurance agents sued the Comptroller in federal court. Although the district court upheld the Comptroller's ruling, it raised the issue of whether or not the insurance agency provision was still on the statutory books. When the case arrived in the D.C. Appeals Court, the court seized upon the provision from the 1916 statute and overturned the Comptroller's ruling on the grounds that subsequent editions of the U.S. Code had omitted the section. When the Supreme Court unanimously ruled on the case in early June 1993, the Court upheld the OCC's ruling on the grounds that the provision's disappearance from the statutory code was "a simple scrivener's error" (*USNB OR v. Ind. Insurance Agents of America* 508 U.S. 439 (1993)). Thus, the Comptroller had won a significant victory for banks wishing to enter the insurance industry as agents.

It was ultimately a compromise crafted by four Banking Committee members setting aside \$8 billion for the SAIF helped free the proposed legislation for passage. On September 14, the House narrowly passed HR 1340. The bill then waited another two months before a conference convened and passed a version resembling HR 1340. Both chambers quickly approved the conference report along partisan lines, and President Clinton enacted the Resolution Trust Company Act of 1993 less than ten days before Christmas. Although the RTC Completion Act concentrated on funding resolution of thrift insolvencies, it contained provisions on federal deposit insurance and the use of those funds. In particular, it limited the use of federal deposit insurance such that “the Bank Insurance Fund and the Savings Association Insurance Fund shall not be used in any manner to benefit any shareholder” (*U.S. Statutes at Large* 107 (1993): 2390). The effect of this provision, of course, was to prevent a repeat of the Continental Illinois case in which regulators used FDIC funds to backstop a bank holding company’s shareholders.

Further bank regulatory changes began anew after the start of 1994. Congress had not forgotten the Clinton administration’s interstate banking reform proposals from the previous year. Toward this end on February 3, the House Financial Institutions Subcommittee unanimously passed a branch banking bill (HR 3841). Then a week later, the Financial Institutions Subcommittee Chairman Stephen Neal (D-NC) introduced the bill on the floor. Rep. Neal’s bill permitted interstate banking everywhere one year after its enactment. It allowed bhcs owning bank networks across state lines prior to its enactment to consolidate them after eighteen months. After three years, it permitted bhcs to purchase out-of-state banks and consolidate them. Provided that states “opted in,” the bill allowed banks to open new branches across state lines without acquiring any in-state banks, so-called *de novo* branching. To assuage consumer rights

advocates, the proposed legislation subjected federally chartered out-of-state banks to state consumer protection and fair lending laws. The bill also expanded community reinvestment requirements so that banks wishing to branch across state lines needed to meet them. Because foreign banks operating in the U.S. were free from deposit insurance and community reinvestment requirements, HR 3841 advantaged any of them seeking to branch nationwide.

While Chairman Neal's subcommittee was approving its interstate branching bill, the longtime insurance industry proponent Sen. Chris Dodd (D-CT) announced on the Senate floor in a sudden about-face that he no longer insisted upon amending a branching bill to limit banks' insurance activities. As a result on February 23, the Senate Banking Committee unanimously approved a bill (S 1963). The Banking Committee bill closely resembled its House counterpart. It had a similar "opt in" provision for *de novo* branching and updated the community reinvestment requirements to keep pace with changes brought by this law. There were, however, a few significant differences between the two chambers' bills. Unlike its House counterpart, S 1963 permitted consolidation of preexisting interstate banking networks and any networks acquired after the bill's enactment no sooner than two years after passage. The Senate version also preempted state consumer protection laws federally chartered depository institutions and permitted nationwide branching to foreign banks only if they established banks in the U.S. subject to deposit insurance.

On March 9 the House Banking Committee passed HR 3841 with only a single nay vote. The committee rejected all but a bipartisan amendment requiring federal regulators to consider the opinions of community groups when approving branch closures. Then, the House approved HR 3841 thirteen days later with little controversy using a voice vote. On April 26, the Senate followed suit by approving S 1963 using a voice vote; the only audible nay came from Sen.

Byron Dorgan (D-ND). To bring S 1963 closer to the House version, the Senate increased the consolidation provision from two to three years following enactment; it then requested a conference.

When the conference convened in mid July, conferees had to resolve differences over foreign banks and the applicability of state banking laws. Although the conference dropped the Senate bill's more stringent provision imposing deposit insurance on foreign banks wishing to branch across state lines, it imposed community reinvestment requirements on them. The conferees decided that state laws regarding consumer protection and branching would apply equally irrespective of a bank's charter. The OCC, though, gained preemption authority over state laws disadvantaging national banks vis-à-vis their state-chartered competitors. Once the committee reached agreement on July 25, the House quickly approved the conference report in early August, but the Senate delayed doing so until September 13. President Clinton signed the Riegle-Neal Interstate Banking and Branching Efficiency Act September 29.

The statute contained several notable provisions. On the matter of interstate banking, it essentially repealed the Douglas Amendment requiring reciprocal laws between states and instead permitted bhcs to acquire banks in any state as of September 1, 1995. Toward that end, however, Riegle-Neal imposed concentration limits barring acquisitions leading to a bhc controlling more than thirty percent of the deposits in a particular state or more than ten percent of all domestic bank and thrift deposits. The statute extended the CRA to bank holding companies by requiring the Board of Governors to evaluate bhcs and their bank subsidiaries before approving any interstate acquisitions. Though the Fed had considered CRA evaluations when reviewing holding company applications for expansion, preexisting statutory law did not require it to do so. In extending the CRA, Riegle-Neal created new categories for CRA

evaluation beyond the single, annual bank evaluation; it established new categories including state level ones, state by state comparisons, and metropolitan area ones. The law allowed banks to merge with out of state banks and to consolidate them as branches under the resulting bank's title as of June 1, 1997. It contained concentration limits similar to those for acquisitions. It also authorized banks to open branches across state lines without first acquiring another bank, so-called de novo branching, provided that states enacted laws permitting the practice. To confine banks to expanding across state lines in the manner it outlined, Riegle-Neal prohibited national banks from employing the thirty mile rule to branch into states that chose not to participate in interstate branching.

With Republicans having won control of both Houses of Congress for the first time since 1954 in the 1994 midterms, the GOP instituted a handful of reforms impinging on bank regulatory legislation. For instance, House Republicans altered the committee system. On December 2, they announced a redesigned committee system. In addition to eliminating three committees altogether, Republicans significantly curtailed the jurisdiction of the House Energy and Commerce Committee. They not only reallocated much of its jurisdiction to other committees, but also shortened its name to simply the Commerce Committee to reflect these changes. Of particular note for banking and financial legislation, Republicans stripped Commerce of its jurisdiction over securities matters and reassigned the jurisdiction to the House Banking Committee, thereby combining jurisdiction over the banking and securities industries in one panel. The newly formed Commerce Committee, though, managed to keep its primary jurisdiction over the insurance industry.

On February 27, 1995, the new House Banking Committee Chairman Jim Leach (R-IA), introduced a bill (HR 1062) designed “[t]o enhance competition in the financial services industry

by providing a prudential framework for the affiliation of banks, securities firms, and other financial service providers.” He drafted a bill narrowly focused on the banking and securities industries to minimize the controversy it would foment. Leach’s bill eliminated the bank holding company model under whose umbrella banks had long organized their activities and instead replaced it with a financial services holding company model in which holding companies offered a wide range of banking and securities services, including brokerage and underwriting. A financial services holding company (fshc) is merely bank holding company that is permitted to engage in a wider variety of financial activities. Because the structure proposed was a variant on the bhc one, the Federal Reserve Board gained regulatory responsibility over the new entities. The bill erected firewalls separating the banking and securities subsidiaries of the fshcs and imposed strict capital standards on the subsidiaries. The House Banking Committee officially approved HR 1062 May 11. Even though large New York securities firms and money center banks supported the measure, small banks were less than enthusiastic as they stood to gain the least from this new structure and added powers. Although committee passage of HR 1062 represented an apparent victory for Chairman Leach, Rep. Charles E. Schumer (D-NY) pointed out, “No one is that strongly for this bill, and no one is that strongly against the bill” (CQ Almanac 1995a).

Strong opposition to the bill, however, materialized immediately following committee approval when the insurance agents’ lobby abandoned its neutrality and announced its opposition to the measure unless Congress imposed a moratorium on the OCC granting national banks the ability to sell insurance. Aware that the measure raised issues relating to the insurance industry and seeking to protect his committee’s remaining jurisdiction, Chairman Thomas J. Bliley (R-VA), announced his committee wanted to examine the bill and was considering broadening it to

permit affiliations between banks and insurance companies. Aware of the controversy brewing among the three financial services industries, House leaders intervened to negotiate a compromise between the principal legislators. Needless to say, Speaker Newt Gingrich's (R-GA) comments that Republicans planned to address the insurance industry's concerns when legislators debated HR 1062 did not help matters (Congressional Quarterly 1995a).

Republican leaders nonetheless brokered a deal between the two committees. Under the accord, the Commerce Committee would approve the same version of HR 1062 that Banking had in May, and the Banking Committee would amend its bill by placing a permanent moratorium on the OCC's authority to approve national banks' insurance agency activities. Then, working in conjunction with Rules Committee, Republicans would merge HR 1062 with HR 1362, a regulatory relief bill moving through the Banking Committee in May and June. Upholding its portion of the agreement, Chairman Bliley's Commerce Committee approved HR 1062 on June 16.

Even though Rep. Doug K. Bereuter (R-NE) had introduced HR 1362 on March 30 "[t]o reduce paperwork and additional regulatory burdens for depository institutions," it lay idle until mid May when the House Banking Committee finally referred it to the relevant subcommittee. After hearings in late May and June, the House Financial Institutions and Consumer Credit Subcommittee crafted a bill (HR 1362) exempting ninety percent of American banks from the CRA, curtailing the Truth in Lending Act (TILA) by preventing borrowers from initiating lawsuits even when lenders incorrectly disclosed loan fees, and rolling back the Truth-in-Savings Act requirements. Voting along party lines, the subcommittee curtailed the Department of Justice's authority to litigate discriminatory lending cases. On June 15, the subcommittee approved HR 1362 with the support of only one Democrat.

Regulatory relief proceeded to the House Banking Committee as Chairman Leach introduced a new bill (HR 1858) to replace the partisan-tinged HR 1362. The committee devoted four days to hearings and markup in the last half of June. Attempting to follow the stipulations of their earlier policy compromise, GOP leaders sought to attach a provision instituting a moratorium on the OCC granting banks additional insurance powers, but Republican committee members disobeyed the compromise and discarded the provision. They did so by approving Rep. Richard H. Baker's (R-LA) amendment permitting affiliations between banks and insurance companies; the amendment passed 36-12 with nineteen Democrats joining seventeen Republicans. The discarding of the moratorium, however, was not the only objectionable item to arise in this venue. The Banking Committee also weakened the regulatory mechanism for enforcing community reinvestment requirements, exempted banks with less than \$100 million in assets from those requirements, and provided banks with a "safe harbor" period between CRA examinations. Neither committee Democrats nor the White House were pleased with these CRA changes. As a result, Treasury Secretary Robert Rubin wrote the Banking Committee two letters; the first one was dated June 20 and expressed the administration's concerns over the weakened consumer protection whereas the second one dated June 29 conveyed his recommendation for the president to veto the bill (Congressional Quarterly 1995b). Despite the differences between the committee members and the White House, the Banking Committee narrowly passed the bill June 29.

While the lower chamber was embroiled in disputes over expanding insurance powers and weakening CRA requirements, the Senate was working on its own regulatory relief bill, though its version was much milder than the House ones. On March 30 Sen. Richard Shelby (R-AL), who had switched parties the day after the 1994 midterm elections, introduced a regulatory

relief bill (S 650); the measure attracted twenty-eight co-sponsors from both parties. The full Senate Banking Committee, however, did not proceed with the legislation until late September. The committee delayed acting on the bill because Chairman Alfonse D'Amato (R-NY) wanted the House to complete its bill first. Even though he chaired the Whitewater investigative panel, he went out of his way on S 650 working with Democratic Senators and the Clinton White House by removing amendments limiting the CRA that he gained the president's support for the bill. In fact, D'Amato explained jettisoning the CRA limitations because President Clinton had threatened a veto (Congressional Quarterly 1995b). Moreover, S 650 actually imposed additional consumer regulations due to committee added provisions authorizing consumers to alter and repair their damaged credit reports. The Senate Banking Committee approved the bill September 27.

House leaders intended to bring HR 1858 and HR 1062 to the floor as a package before summer's end, but the Banking Committee's removal of the moratorium on national banks' continued expansion into insurance agency violated the agreement they had brokered, thereby delaying floor action. Not content to abandon the proposed legislation, Chairman Leach applied repeated pressure to House leaders, which ultimately caused them to relent and devise a new plan for passage. As part of this plan, the Rules Committee combined HR 1062 and HR 1858 into a single bill to receive floor consideration before the end of 1995; the merger of these two bills yielded HR 2520, which Rules introduced in late October. The new bill removed Baker's amendment permitting affiliations between banks and insurance companies and instead replaced it with the original moratorium prohibiting any further affiliations for another five years. To appease Democrats, community reinvestment exemptions disappeared from the new bill. Finally, HR 2520 assigned the House Banking and Commerce Committees the task of structuring

the location of banks' new securities activities. This task was necessarily explosive since any decision affected who would regulate the new activities and who would benefit from formulating those regulations. This issue created an impasse between bank-friendly committee members and insurance-friendly party leaders. Because of this deadlock, Majority Leader Dick Armey (R-TX) postponed the new bill indefinitely (Congressional Quarterly 1995b). Likewise, the Supreme Court's announcement the previous month that it would hear *Barnett Bank v. Nelson* involving Florida's prohibition bank affiliates of holding companies selling insurance undeniably made the banking industry reluctant to compromise with the insurance industry. Consequently, the proposed banking legislation failed to receive floor action in the House.

Although the year began inauspiciously enough with the federal government shutdown and banking legislation postponed for the first several months, bank regulatory change was still occurring. Having heard arguments in January for *Barnett Bank of Marion County, N.A. v. Bill Nelson, FL Insurance Commissioner*, the Supreme Court rendered a unanimous verdict in March (517 U.S. 25 (1996)). The case entailed a Florida statute prohibiting banks from selling insurance unless they were located in a town of less than 5,000 people and did not belong to a bank holding company. Barnett Bank was a subsidiary national bank operating a branch in a town with less than 5000 people that bought an insurance agency and sued the state of Florida claiming federal law preempted the state's action. The Court decided the case on the grounds that federal law granting national banks or their subsidiaries the authority to sell insurance in towns with populations less than 5000 people preempted the Florida statute. Interestingly enough, the Supreme Court did not consider how the state's prohibition unfairly discriminated against banks that were bhc subsidiaries, yet bank subsidiaries tend to be larger and have access to more capital by the very nature of their corporate structures. The Comptroller may not have

been directly involved in the case, but the ruling upholding federal preemption of state regulations effectively empowered the OCC vis-à-vis the states.

Needless to say, the *Barnett* decision only complicated Rep. Leach's attempt at banking legislation during the 104th Congress' second session since banks were much less willing to compromise given their recent legal victory. He spent the three months following *Barnett* redrafting his bill. Chief among his priorities were codifying the Court's *Barnett* standard, removing the OCC moratorium, and permitting affiliations between national banks and insurance companies under the financial services holding company model. In early June, Leach tried bringing the bill to his committee for a revote, but some of the members refused to reconsider the proposal. Consequently, he publicly abandoned the revised version of HR 2520.

Within a month of Leach's latest setback, House Rules Committee Chairman Gerald Solomon attempted an end run to bar the OCC permanently from approving further expansions of insurance activities. Solomon tried to amend the 1997 Treasury-Postal Service appropriations bill (HR 3756) requiring the Treasury Department to withhold funding if the OCC authorized any more insurance powers. On July 17, bankers, the Clinton administration, and allies in the House came together and overwhelmingly killed the amendment 312-107. This action represented the last ditch effort by a leading supporter of the insurance industry to curtail banks' expansion.

By September Chairman Leach was cobbling together a modest banking bill by combining the least controversial elements of HR 2520 with the regulatory relief bill (HR 1858) and provisions funding the deposit insurance fund for thrift institutions (SAIF). With the House leadership's consent, Leach planned to bring the newest bill to the floor September 18. The rewritten bill no longer restricted banks' expansion into the insurance industry, but it prevented

federal preemption on matters of insurance regulation. Bankers, of course, disliked the provision, for it curtailed their recently achieved regulatory and judicial victories. The combination of the September arrival of an omnibus spending bill and bankers' opposition to eliminating federal preemption on insurance activities torpedoed Leach's latest attempt to receive floor action.

In a September 16 meeting with Republican leaders, White House Chief of Staff Leon Panetta suggested attaching the SAIF measure to the omnibus spending bill as a way of using its revenues to offset the additional spending sought by the Clinton administration (CQ Almanac 1996a). Over the course of the next week and a half, Republican congressional leaders scrambled to attach banking legislation to the catchall fiscal appropriations bill (HR 3610). Though Reps. DeLay and Solomon tried reinserting provisions restricting banks' expansion into insurance, Senate Majority Leader Trent Lott (R-MS) sought to keep the banking legislation as non-controversial as possible and thwarted such attempts. By the end of September, congressional leaders successfully crafted an appropriations bill that included banking measures; President Clinton signed the Omnibus Consolidated Appropriations Act of 1997 the last day of the month.

The statute's banking provisions strongly resembled S 650, the modest regulatory relief bill Sen. D'Amato produced. The final legislation funded the SAIF by raising premiums on banks and thrifts and even increased the regulatory burden on depository institutions by strengthening the Fair Credit Reporting Act requirements, but it also relieved banks of some lender liability issues associated with properties containing hazardous materials. The most significant element for the expansion of banking, though, amended the BHCA by streamlining the Board of Governors' approval process for bhcs seeking either to engage in previously

approved section 20 subsidiary nonbanking activities or to acquire nonbanking financial services companies. Furthermore, the law permitted well-managed and well-capitalized bhcs to enter any activity that the Fed's Regulation Y permitted without prior notice or approval. Conversely, if a bhc wished to conduct an activity presently not allowed, it simply needed to notify the Board within ten days of doing so.

The following year began with the Federal Reserve initiating key regulatory rule changes concerning bank holding companies and their subsidiaries. Though the Board had announced on December 20, 1996 that it was increasing the amount of revenue that "a section 20 subsidiary [of a BHC] may derive from underwriting and dealing in [ineligible] securities from 10 percent to 25 percent of its total revenue," the rule change did not take effect until March 6, 1997 (83 Fed. Res. Bull. 98, Feb. 1997). Just before the revenue increase took effect on February 20, 1997, the Board significantly revised its Regulation Y "intended to improve the competitiveness of bank holding companies by eliminating unnecessary regulatory burden and operating restrictions and by streamlining the application and notice process" (83 Fed. Res. Bull. 260, April 1997). These Regulation Y revisions resulted from the Omnibus Consolidated Appropriations Act of 1997 and took effect April 21, 1997. Not only did they streamline the application process, but they also removed the remaining firewalls separating nonbank and bank affiliates within the holding company structure.

Although the Federal Reserve's rule changes did not become effective until March and April respectively, the 107th Congress began legislative attempts to modernize the nation's banking system almost immediately. On the first day of the new Congress, Banking Committee Chairman Leach introduced the Financial Services Competitiveness Act of 1997 (HR 10) to "enhance competition in the financial services industry by providing a prudential framework for

the affiliation of banks, securities firms, and other financial services providers.” Beginning in February and running through June, the Banking Committee and its subcommittees held hearings on the proposed legislation. Through the course of these proceedings, Federal Reserve Chairman Alan Greenspan was one of the most frequent visitors, journeying to Capitol Hill three times to testify.

In his testimony, Greenspan expressed his support for legislative efforts modernizing the nation’s financial system that led to increased competitiveness and efficiency, and, in the process, benefited American consumers. His overriding concern, however, revolved around structuring banks’ new activities and the possible harms that could befall the deposit insurance system. In particular, he feared that HR 10’s provision allowing banks to broaden their activities through operating subsidiaries (op-subs) rather than through holding company subsidiaries affiliated with the banks imperiled federal deposit insurance. Greenspan instead suggested that any expansion of bank activities occur through the bank holding company structure, so that any losses caused by the new activities would not expose the deposit insurance fund. By expanding through holding company subsidiaries rather than through operating subsidiaries of banks, the Fed expanded its regulatory responsibilities at the expense of the OCC.

While the Federal Reserve Chairman was making his case for structuring banks’ expanded activities to give his agency a greater regulatory role, the Comptroller of the Currency said very little on the matter before Congress. Moreover, the Treasury Department remained silent for several months on the bank regulatory legislative proposals. As a result, the Clinton administration’s position on the matter was in doubt to lawmakers. Treasury Secretary Robert Rubin finally unveiled the administration’s plans for financial system modernization in late May. The Clinton administration proposed allowing federally insured depository institutions to engage

in a full range of securities, insurance, and investment advisory activities through operating subsidiaries. The op-subs, however, would not be permitted to develop real estate. Holding companies owning federally insured depository institutions, on the other hand, would be allowed to engage in the full gamut of insurance, investment advisory, merchant banking, and securities activities. In addition, Secretary Rubin presented two alternative proposals for bank holding companies to mix banking and commerce. Alternative A, as Rubin described it, entailed bank holding companies devoting some significant portion of their revenue as defined by Congress to nonfinancial activities. Alternative B, on the other hand, maintained the existing system in which bank holding companies could not engage in any nonfinancial activities. In other words, Option A permitted a mixing of banking and commerce whereas Option B maintained the preexisting separation of banking and commerce.

Nearly four weeks after Rubin presented the Clinton administration's financial modernization proposal, the House Banking Committee narrowly approved HR 10 on June 20. In the process, the committee attached two provisions that gave Chairman Leach reservations; one allowed a mixing of banking and commerce whereas the other eliminated the federal thrift charter within two years. Rep. Roukema (R-NJ) posited the amendment mixing banking and commerce by permitting bank holding companies the ability to invest up to 15 percent of their revenues in nonfinancial companies whereas Rep. Bill McCollum (R-FL) introduced the amendment ending the federal thrift charter within two years. The committee adopted both amendments by wide margins prompting Rep. Leach to state, "I supported the committee approval of the bill as a steward of the committee, but like all members I will reserve final judgment on the bill, particularly in light of how the banking and commerce issue is resolved" (Congressional Quarterly 1997: 2-76).

With the House Banking Committee having passed HR 10, the bill proceeded to the Commerce Committee for consideration. Commerce Chairman Thomas Bliley (R-VA) had intended to consider the bill in early September, but the passage of HR 10 triggered a barrage of insurance industry lobbying. Insurance agents were particularly incensed over the proposed legislation because it allowed banks to offer insurance products under the supervision of banking regulators rather than under the existing set of state insurance commissions. As a result of the ensuing hysteria among insurance agents, Chairman Bliley postponed considering the bill indefinitely.

After weeks of inaction on HR 10, the Finance and Hazardous Materials Subcommittee on October 24 eventually held a markup session lasting only a few hours and easily approved HR 10 by a vote of 23-2. Subcommittee Chairman Michael Oxley (R-OH) had the difficult task of maintaining the tenuous balance between the banking and insurance industries, a task made all the more difficult by the presence of the longtime insurance industry champion Rep. John Dingell (D-MI). Even though Rep. Oxley sought to reassure bankers that the committee would not simply bow to insurance industry demands that banks compete under the same regulatory structure, he ultimately permitted an amendment from Rep. Dingell curtailing the OCC's regulatory power over banks' insurance activities. In addition, the subcommittee amended HR 10 to maintain the unitary thrift charter by allowing commercial firms to enter banking by opening or acquiring savings and loan associations. Given the jurisdiction of the Commerce Committee and the various personalities involved, it was not surprising in the least that the subcommittee produced a bill more in line with the desires of the insurance industry than the banking industry.

In a *Wall Street Journal* Op-Ed piece on October 30, three prominent financial services industry CEOs argued “Today banks, insurance companies and securities firms that want to meet the demands of their customers have to be able to offer every type of financial product, across all markets, in every part of the world...U.S. financial corporations cannot do that unless Congress sweeps aside our antiquated banking laws” (Komansky, Purcell & Weill 1997: 1). These three chief executives were David Komansky of Merrill Lynch, Philip Purcell of Morgan Stanley Dean Witter, and Sanford Weill of Travelers. The three men proceeded to argue, “Regulations imposed since [the Great Depression] have only made matters more confusing: For example, a commercial bank may acquire a securities firm, but not the other way around” (Komansky, Purcell & Weill 1997: 1). In this way, three prominent financial services industry CEOs publicly appealed policymakers to permit their financial institutions and American banks compete on the same playing as foreign competitors.

The same day as the *Journal* article appeared, the Commerce Committee approved HR 10 by a 33-11 margin. This measure largely resembled the one the Rep. Oxley’s subcommittee had reported except for adding one amendment permitting banks to gain as much as five percent of their revenue from a commercial enterprise, thereby mixing banking and commerce.

After Commerce passed HR 10, Rep. John Boehner (R-OH) whom Republican leaders selected to serve as banking reform point man held bipartisan meetings with the Rules Committee and the two committees that had reported the bill. Boehner hoped to move the bill to the House floor as quickly as possible, but differences between the Banking and Commerce Committees differed on key issues such as the mixing of banking and commerce, ending the thrift charter, and regulating bank insurance and securities activities, not to mention the joint insistence by Reps. Solomon and Dingell to place further restrictions on banks’ insurance

activities, made the task quite challenging. His efforts collapsed on November 8, when Commerce members, neglected to appear for a meeting with him and the Banking Committee. As a result, the proposed banking legislation never reached the House floor in 1997.

Hoping to learn from 1997's failed legislative attempt, Rep. Boehner, according to Congressional Quarterly, met countless members of the banking, insurance, and securities industries between November 1997 and March 1998 (Congressional Quarterly 1998: 5-11). Based on these meetings, Rep. Boehner and other Republican leaders developed another version of HR 10 which they unveiled on March 10. First, the 1998 version permitted securities firms and insurance companies to own banks and the other way around. The inequities of permitting banks to own other financial services companies but prohibiting other financial services companies from owning banks were one of the complaints of financial services industry members, such as Komansky, Purcell, and Weill. Second, the bill authorized national banks to sell insurance, but to do so in subsidiaries overseen by state insurance commissioners. Third, the bill gradually ended the unitary thrift charter through which commercial companies entered the banking industry. Fourth, proposed legislation created a new type of corporate organizational structure, namely the financial holding company, through which the firms wishing to offer the assortment of financial services products would do so. The Securities and Exchange Commission (SEC), though, would have regulatory oversight of these subsidiaries' securities activities. Finally, the new HR 10 linked a statutory repair of federal credit union law to banking reform.

By the week of March 23, though, the various sectors of the financial services industry were once again battling one another. On the last day of March, Rules Chairman Solomon removed the measure from floor consideration because members failed to agree on the rules for

debate. The Rules Committee's efforts to achieve agreement were likely hampered by the rule it created just before the bill went down preventing the House from eliminating the unitary thrift charter. Chairman Solomon, nonetheless, explained the bill's death as the result of a lobbying effort unlike any he had ever seen that kept his and colleagues office telephones "ringing off the hook" (Congressional Quarterly 1998: 5-7). Although this legislative reform effort was stymied in the House because members could not agree on the rules for debate, a merger creating the largest banking and financial services company occurred a week later that altered the landscape altogether.

On April 6, 1998, Travelers Group and Citicorp announced plans for their two firms to merge, thereby creating Citigroup. Travelers Group was a financial services company run by Sandy Weill that provided asset management, brokerage, consumer financing, investment banking, and insurance underwriting whereas Citicorp was a bank holding company owning nonbank subsidiaries and bank subsidiaries, most notably Citibank, N.A. The merger of these two very different firms created a financial conglomerate capable of providing customers an assortment of financial products.

Because Travelers engaged in activities prohibited by the BHCA, Citicorp could not legally acquire it. According to the BHCA, though, Travelers could petition the Board of Governors to form a bank holding company and acquire Citicorp. To facilitate the creation of a bank holding company under such circumstances and aid in the divestiture of prohibited nonbanking activities, section 4(a) of the BHCA authorized the Board "to extend the period [mandating divestiture within two years of becoming a bhc]... for not more than one year at a time...but no such extensions shall extend beyond a date...five years after the date as of which a company becomes a bank holding company" (*U.S. Statutes at Large* 70 (1956): 135-136).

Therefore, Travelers applied to the FRB to become a bhc and acquire Citicorp. A few months later on September 23, 1998, the Board conditionally approved the acquisition and Travelers' request to form a bank holding company named Citigroup and granted the new company a two-year exemption to divest its prohibited nonbanking activities.⁷⁷ Because the BHCA provided for a two year exemption with three additional one year exemptions possible thereafter, Citigroup had at most five years before it would have to divest its nonbanking businesses unless lawmakers significantly altered the banking statutes.

When the GOP leadership removed HR 10 on March 31, Rep. Boehner pledged to bring the bill back to the floor during the first week of May. The Travelers-Citicorp merger certainly added pressure for legislative action. After all, Citicorp had opposed the legislative reform efforts up until its merger when it suddenly changed policy positions. Citicorp had opposed regulatory reform largely because it had achieved many of the expanded activities it sought through the existing regulatory structure and did not want to lose the protection it afforded.

On May 13, the chamber passed HR 10 by a single vote with Speaker Gingrich and other GOP leaders twisting members' arms to obtain the necessary support. In the process of narrowly approving the bill, the House defeated two amendments allowing banks to expand their activities through operating subsidiaries. The first of these amendments permitted national banks to conduct all financial activities except for real estate investment or insurance underwriting in subsidiaries whereas the second allowed national banks to expand into all activities then permissible for bank holding companies but not for national banks themselves. The chamber then also amended HR 10 to prohibit holding companies from engaging in nonfinancial

⁷⁷ As one of its conditions for approving the acquisition, the Board required a fifteen day waiting period before the merger became official. The waiting period notwithstanding, receiving the Board's conditional approval meant the two firms would complete their merger.

commercial activities, thereby preventing a mixing of banking and commerce. The proposed legislation proceeded to the Senate where it sat idle until after the summer recess.

Though the Senate Banking Committee scheduled a markup of HR 10 for September 3, it postponed the hearing a week because of immediate opposition from Sens. Gramm and Shelby. The Republican Senators wanted to exempt financial services companies and financial holding companies from the CRA's requirements and refused to consider any other alterations to the bill until the committee resolved the CRA issue. To proceed the following week, the committee amended the bill by eliminating the requirement that banks with poor community reinvestment records divest holdings and exempting securities firms and insurance companies unaffiliated with banks from community reinvestment requirements. Neither Sen. Gramm nor Sen. Shelby participated in this compromise, for both men wanted further limitations placed on community reinvestment requirements so that community groups were less able to extort contributions from banks to avoid protesting expansions. Gramm offered an amendment allowing banks to use preexisting CRA ratings rather than requiring new ones when seeking regulatory approval for activity or branching expansions. The Texan, however, withdrew his provision when other Republican members indicated they were unwilling to torpedo the proposed legislation over community reinvestment issues. As a result, the Banking Committee September 11 passed HR 10 with only Sens. Gramm and Shelby voting against it.

Before the Senate debated the bill in early October, though, legislators negotiated solutions to two longstanding disagreements among the industries touched by the proposed legislation. First, they successfully gained an agreement from the insurance and banking industries granting state insurance commissioners regulatory responsibility for insurance activities, but with the understanding that these authorities could generate different rules for

banks and insurance agents under thirteen different scenarios. Word of this agreement became public the last day of September. Second, the chairmen of the Senate Banking and House Commerce Committees agreed on handling banks' entry into the securities business. Based on their agreement, the Securities and Exchange Commission (SEC) classified banks' products as securities and regulated them whereas the Federal Reserve served as a check on the SEC and the federal court system gain an expedited judicial review process to resolve any disagreements.

On October 5, the Senate began debating HR 10. Significant roadblocks, however, still thwarted the bill's path to enactment. For instance, the Clinton administration's threatened veto of any bill excluding bank expansion through operating subsidiaries remained. More importantly, Sen. Gramm still objected to the bill's extension of community reinvestment requirements into other financial services sectors. Although he supported modernizing financial services and allowing banks to offer other financial products, he detested the CRA's burdensome requirements on banks and the bill's extension of the act to nonbank affiliates and to banks seeking branching expansions. As a result, Gramm masterfully employed parliamentary procedure to block the legislation, causing it to die on the floor October 9 without a final vote. Banking legislation remained in limbo through the midterm elections and into the next year.

Congress recognized the persistence of bank regulatory legislation, for lawmakers began working on bills early in 1999. Now under Sen. Gramm's chairmanship due to Sen. D'Amato's recent electoral defeat, the Senate Banking Committee began drafting a bill in late February. During the committee's hearings, community reinvestment requirements proved to be the major issue dividing the parties. Chairman Gramm, once again, sought to rollback the CRA's reach. Toward this end, Sen. Richard Shelby submitted an amendment exempting rural banks with less than \$250 million in assets. This provision focused the reinvestment requirements on large

urban banks. Democratic senators, though, vehemently opposed the move arguing that small, rural banks were the worst community reinvestment offenders by investing their money and assets outside of their localities. To approve a banking bill, Sen. Gramm ultimately convinced Sen. Shelby to lower the value of the exempted financial institutions by \$150 million. Then, on March 4 the Banking Committee approved its bill (S 900) by a party-line vote of 11-9 with one Democrat and one Republican switching sides.

The Banking Committee's bill permitted banks with less than \$1 billion in assets to conduct their nonbanking activities through operating subsidiaries, but required larger banks to do so within the holding company structure. In breaking with the American tradition dating back to the McCarran-Ferguson Act, the proposed legislation gave the federal banking regulators oversight of banks' insurance agency activities. S 900, however, prohibited operating subsidiaries from underwriting insurance or developing real estate. The measure also strictly forbade affiliations between banks and commercial businesses. On the contentious community reinvestment issue, S 900 exempted small, rural banks with less than \$100 million in assets. The bill did not address financial privacy issues.

While the Senate Banking Committee worked on S 900, Chairman Leach and the House Banking Committee held a three-day markup session during the first half of March.⁷⁸ On the third day of markup March 11, the committee approved another version of HR 10 by a margin of 51-8. In the approval process, two issues raised particular challenges. Community reinvestment once again proved to be a contentious and partisan issue. Generally, this issue divided legislators along party lines, with Democrats espousing reinvestment and Republicans opposing it. Their majority notwithstanding, Republicans failed to alter the reinvestment requirements. During the

⁷⁸ Because of Republican caucus rules enacted following the 1994 midterms, Rep. Leach was entering the final two years of his six-year term as committee chairman.

markup, privacy was the other troublesome issue. To avoid further challenges over privacy matters by permitting consumers to opt-out of information sharing, Rep. Leach co-authored a provision which the committee adopted requiring banks to disclose their privacy policies. In addition to these consumer issues, the Banking Committee's HR 10 gave banks with less than \$10 billion the option of organizing their nonbanking activities within operating subsidiaries or holding companies. HR 10, however, prohibited operating subsidiaries from developing real estate or underwriting insurance. The House Banking bill also limited the authority of state insurance commissioners to regulate banks' insurance activities.

In early May the Senate devoted three days to debating S 900. As occurred at the committee level, community reinvestment was the most contentious and partisan issue. Sen. Gramm defended the bill's present form, but Democratic Senators challenged its reinvestment requirement reductions by offering two amendments to remove Gramm's provisions. Although the two Democratic amendments failed on May 5, Democratic lawmakers continued to press for toughening CRA.

The other issue generating disagreement among senators concerned structuring of the banking industry. Except for allowing banks with under \$1 billion in assets to organize most of their activities within an operating subsidiary, S 900 required all other banks to organize their new activities in holding companies. Since Sen. Shelby held a position more in line with the Treasury's on matters of organizational structure, he put forth an amendment giving banks undertaking the newly approved activities the option of choosing which structure to use. In response, Gramm threatened to remove the entire bill from the Senate floor if the chamber

adopted Shelby's amendment. The Senate ultimately rejected Shelby's amendment 53-46. Finally, on May 6 the Senate approved Gramm's S 900 along partisan lines by a 54-44 vote.⁷⁹

To a significant extent, the bill Gramm shepherded through committee resembled the Senate approved one. The Senate bill required banks with more than \$1 billion in assets to organize their nonbanking financial activities through holding company subsidiaries. Banks below the \$1 billion limit, on the other hand, received the option of organizing their new activities either within a holding company or an operating subsidiary. In a change from the committee approved version, this one delegated state insurance regulators significant authority over banks' insurance activities, including those involving insurance agency, but it prohibited them from discriminating between federally and state chartered depository institutions. For securities activities, S 900 permitted banks to conduct these activities within the bank while barring the SEC's oversight. Unlike its House counterpart, the Senate bill exempted rural banks under \$100 million in assets from meeting community reinvestment requirements and required disclosure of the agreements settling disputes between banks and community groups. On the matter of privacy issues, S 900 was silent.

Once the Senate passed a banking bill, the House Commerce Committee in late May began consideration of HR 10. Unlike the two Banking Committees, Commerce's markup of HR 10 proceeded smoothly in a bipartisan fashion. The main issues of concern to this committee were privacy and financial industry structure. On June 10, the Commerce Committee easily approved HR 10 without dissent. Unlike the House Banking's version, Commerce's prohibited banks from conducting any nonbanking financial activities within operating subsidiaries, instead requiring them to do so within affiliates under the bank holding company. The committee's HR 10 also granted states more authority to oversee banks' insurance activities with little in the way

⁷⁹ Sen. Ernest Hollings (D-SC) was the only Democrat to cross party lines and support the bill.

of protections from states discriminating against federally chartered banks. Third, Commerce's bill contained privacy measures such as its provision allowing people to opt-out of information sharing between third-party unaffiliated companies.

Once both House committees approved HR 10, GOP leaders in late June selected the Banking Committee's version, which contained the subsidiary structure and more lenient privacy language, and used it for the floor debate. Right before July fourth, the House debated and approved HR 10. Unlike 1998's narrow passage of HR 10, this time the chamber passed the bill with a bipartisan margin of 343-86. The House passed bill granted banks the option of structuring their activities as either operating subsidiaries or holding companies, but required banks with more than \$10 billion in assets to enter any of the new nonbanking financial activities through holding company subsidiaries. It also granted the SEC a larger role in overseeing banks' securities activities and imposed tougher restrictions on those activities. The House bill resembled its Senate counterpart on insurance regulation by granting state regulators broad powers yet protecting national banks from discrimination by the states. Other than by increasing existing penalties for non-compliance, HR 10 hardly altered the CRA. Also unlike its Senate counterpart, it required financial institutions to disclose their privacy policies and to allow customers to opt out of information sharing with third parties.

Following House passage of a banking bill, a conference convened for a single day on August 3 before Congress' late summer recess. In addition to naming Rep. Leach as chairman, this meeting produced two other notable developments. First, Sen. Gramm demanded a resolution concerning the counting of House conferees' votes since the committee contained twenty House Republicans compared to twenty-two House Democrats. To resolve the problem, House leaders arranged the votes by section so that House Republicans always outnumbered

their Democratic counterparts. Second, Sen. Shelby publicly announced the need for the final bill to contain much stronger privacy protections. This announcement represented a significant Republican defection, especially since the Senate bill was silent on privacy issues.

When the conference reconvened in mid September, Chairman Leach attempted to operate in good-faith and in a bipartisan manner, by holding open debate and allowing all conferees to negotiate over the bill. Doing so, though, quickly impeded progress as members could not agree on issues involving organizational structure, community reinvestment, or privacy. At month's end, Sen. Gramm requested GOP leadership intervene and devise a new strategy for crafting the conference report. On September 30, House Speaker Dennis Hastert (R-IL) and Senate Majority Leader Trent Lott met privately with the three committee chairmen. This meeting yielded a new backroom approach involving the three chairmen privately negotiating a working draft of the bill and then returning with the draft for members to amend. The three committee chairmen unveiled a revised draft of the bill on October 12. Behind closed doors, Gramm had successfully convinced the other two men to scale back community reinvestment requirements by making exams less frequent, exempting small rural banks, and prohibiting banks and community groups from striking confidential deals.

Even though the conference now had a new *modus operandi*, the matter of structuring the banking industry and its new financial activities remained. According to Federal Reserve Chairman Alan Greenspan, "After endless efforts to reconcile the two versions [i.e. the House and Senate bills], Congress threw up its hands and gave our institutions [i.e. the Fed and Treasury] until October 14 to settle it ourselves" (Greenspan 2007: 199). When the fourteenth arrived, Chairman Greenspan and Treasury Secretary Lawrence Summers spent the afternoon in the Treasury working out a compromise. Greenspan described the negotiations as "a textbook

case of policymaking by rational compromise. We sat and argued point by point” (Greenspan 2007: 199). Upon emerging from Summers’ office, they produced an agreement concerning their two respective regulatory agencies. The accord involved structuring banks’ new activities and the division of regulatory oversight resulting from it. The two men agreed to support legislation permitting banks, regardless of size, to structure their new activities, within operating subsidiaries rather than bank affiliates in the holding company structure. Because Summers and Greenspan considered insurance underwriting and real estate development considerably more risky than the other new activities, they categorized them as exceptions and agreed upon insisting that lawmakers mandate that banks conduct them within affiliates under the parent holding companies. In the process, the Secretary Summers increased the Comptroller’s jurisdiction whereas Chairman Greenspan expanded the Federal Reserve’s regulatory jurisdiction.

Though resolution of the Treasury Fed disagreement over the structuring of new activities marked progress, the revised bill unveiled by the three chairmen on October 12 angered many Democrats because of its community reinvestment changes. To further the proposed legislation, Treasury Secretary Summers appeared unexpectedly on the evening of October 18 to assist Democrats in their negotiations with Senator Gramm. Over the next two days, Summers and Gramm conducted extensive discussions, eventually leading Summers to depart from their meeting on the night of October 20 believing they had negotiated something acceptable to the White House. The Clinton administration, however, was not ready to accede to the bill’s reinvestment provisions. Negotiations between congressional Democrats, Republicans, and the White House carried on for nearly two more days, before the parties finally reached an accord early on the morning of October 22. Interviewed by *National Journal* a few days after reaching the agreement, Gramm explained his logic behind negotiations over the CRA, “Quite frankly, I

concluded Wednesday [Oct. 20], that the Administration had taken a hostage—by threatening to veto the bill—that they weren't willing to shoot" (Victor 1999: 3127). In exchange for letting Gramm's reinvestment provisions stand, the White House demanded that expansion by banks into new activities be made contingent upon satisfactory reinvestment ratings.

The conferees from both Houses then quickly adopted the report. The House and Senate both adopted the conference report on November 4th; the Senate approved the overhaul conference report 90-8 whereas the House approved it 362-57. On November 12, President Clinton signed the Financial Services Modernization Act (FSMA) of 1999, also known as the Gramm-Leach-Bliley Act, before a crowd that included legislators, congressional staffers, and bureaucrats. Members of the banking and financial services industries were conspicuously absent from the ceremony.

The Gramm-Leach-Bliley Act's most notable component was its partial repeal of Glass-Steagall. In particular, it repealed two of the sections separating commercial banks from investment banks (i.e. sections 20 and 32), but left the other two sections separating the banking industry (i.e. sections 16 and 21) intact. GLBA repealed the prohibitions against banks affiliating with securities firms and having the same directors as securities firm, yet it left the prohibition against securities firms accepting deposits and the limitations on banks directly engaging in securities activities. Aside from that, the statute left Glass-Steagall's other components alone. In addition, the FSMA repealed amendments added to the BHCA of 1956 in the Garn-St. Germain Act severely limiting bank holding companies' insurance activities.

Even though it created a new type of corporate structure, namely the financial holding company, that was basically a notch above a bank holding company, it did not allow banks to affiliate with commercial enterprises. As for regulating new areas of financial activity entered

into by subsidiaries of the fshcs, the law apportioned regulatory responsibility among the existing banking and financial regulators according to the function of the activity. In other words, the federal banking regulators would regulate banking units, the SEC would regulate any securities units, and state insurance commissioners would regulate the insurance units. The law authorized federal regulators to establish safeguards within the new holding companies separating banks from the other nonbank subsidiaries.

On the matter of overseeing the banking system, the law largely maintained the status quo by leaving the OCC to regulate national banks and the Fed to regulate holding companies. The GLBA allowed national banks to establish subsidiaries for new activities financial in nature, provided the bank was well-managed, well-capitalized, and all the subsidiaries assets totaled less than \$50 billion. The statute, however, did not authorize banks subsidiaries to conduct merchant banking, insurance underwriting, or real estate development; if a bank wanted to enter those areas, it had to form a financial holding company and do so through a holding company subsidiary. Conversely, the FSMA permitted financial holding companies to engage in banking, insurance, securities, and any other activities the Board determined to be “financial in nature.” In this way, the law significantly liberalized the BHCA’s “so closely related to banking” phrase. GLBA also limited the Fed’s oversight and enforcement of nonbank affiliates, requiring it to defer to functional regulators unless the affiliates posed a material risk.

The law also had implications for consumer protection issues. Although it generally preserved the existing community reinvestment requirements for banks, it conditioned bank affiliation with insurance or securities firms on having at least satisfactory reinvestment ratings. To appease the more conservative legislators, FSMA required community groups to disclose the manner in which they spent any funds received from banks under the CRA and lessened the

frequency of reviews for banks having under \$250 million in assets. The law required financial services companies and banks to disclose their privacy policies and to give customers the right to opt out of information sharing with third party firms. The GLBA, however, did not permit customers to opt out of information sharing among related firms within the same holding company. Finally, the statute contained some other relatively minor consumer protection features such as requiring automated teller machines to disclose to their fees.

CONCLUSION

This chapter began with a newly elected Democratic president with a unified federal government showing an early interest in banking regulation with an early initiative streamlining loan reviews while also pushing credit availability to the poorer members of society. This interest in banking policy carried over to the following year as the White House and Capitol Hill worked together and easily passed major legislation permitting nationwide banking and branching and also expanding the provisions requiring banks reinvest in their local communities. Though the matter of branching had proven contentious for years, the Riegle-Neal Act passed both Houses with opposition numbering in the single-digits.

Despite the Democrats' loss of Congress in the 1994 midterms, bank regulatory policy continued to evolve through statutory initiatives and agency ones. While the insurance industry stymied Republican congressional efforts at a modernization of the banking system and overhaul of the regulatory system, the regulators and courts played major roles in granting banks new powers, solidifying them, and then expanding upon them afterwards. With bank failures having almost disappeared, the FDIC's role diminished, leaving the Fed and OCC to dominate the regulatory arena. Both agencies through their rulings were instrumental in bringing about nationwide banking and branching. The Federal Reserve, in particular, was crucial in issuing

rulings allowing holding companies to expand into “ineligible” securities activities through their section 20 subsidiaries. Then, in late 1996 and early 1997, the Fed made pivotal changes when it increased revenue limits of section 20 subsidiaries and streamlined the approval process of bhc expansions, including granting holding companies the authority to begin activities without any prior notice provided the Fed had all ready issued rules concerning the matters. This pattern of Fed rulings doubtless contributed to the decision by Travelers and Citicorp to follow through with their merger, which, in turn, prodded lawmakers finally to act and update the nation’s outdated regulatory law. The result of this effort, of course, was the Gramm-Leach-Bliley Act which was not the massive repeal of Glass-Steagall that its opponents would have people believe. Instead, Gramm-Leach-Bliley basically updated the banking statutes so that they according with the regulatory decisions that occurred over the last few decades.

6. U.S. BANK REGULATION EVOLVING:

GLASS-STEAGALL, GRAMM-LEACH-BLILEY, DODD-FRANK, AND BEYOND

My dissertation investigated the development of bank regulation over the twentieth century through a case study focusing on what lawmakers enact, how regulators implement it, and how it subsequently evolves. As I have shown, this pluralist process entailed interdependent multiple actors, especially multiple federal regulators, who are able to act consequentially and exert influence upon one another whenever they choose to do so. The case study covered four of the more eventful periods of interaction among the federal regulators, including 1914-1933, 1969-1980, 1981-1992, and 1993-1999. Given the narrative presented in the previous four chapters, this chapter begins by reviewing the process by which the United States transitioned from Glass-Steagall to Gramm-Leach-Bliley. Then, this concluding chapter examines what role, if any, Gramm-Leach-Bliley played in the recent financial crisis of 2007-2009. Finally, this chapter employs my explanation of bank regulatory change to speculate on what possible developments we may expect in the wake of the recent Dodd-Frank Wall Street Reform and Consumer Protection Act.

During the first period of the case study, the Comptroller of the Currency and the Federal Reserve, failed to coordinate their actions to avert the series of banking failures from the twenties onwards that culminated in the Great Depression. The events of the early 1930s led to the establishment of the Federal Deposit Insurance Corporation to resolve bank failures and guarantee the deposits of banks, thereby preventing future depositor panics. Instabilities in the banking system persisted through the remainder of the Depression and into the early 1940s. From WWII onwards, though, the banking system stabilized as bank failures virtually

disappeared. This stability, which also was marked by significant continuity in the legal and regulatory realms of banking policy, lasted for nearly thirty years.

When banking crises returned in the late 1960s, the federal regulators had grown more interconnected and interdependent. Regulatory responsibilities had increased since the Depression era banking reforms, yet they had not done so in ways that allowed the regulators to act without affecting the responses available to their counterparts. Though the OCC's statutory powers remained largely unchanged with respect to its authority over the definition and powers of nationally chartered banks, the FDIC and Fed both gained significant regulatory powers through statutory reforms.

The FDIC received a third policy option in 1950 with which to handle bank resolutions. This new "tool" was known as the "essentiality" provision and allowed the agency to extend financial assistance to failing banks, thereby preventing closures.⁸⁰ Though the FDIC did not employ this provision until the 1971 failure of Unity Bank and Trust Company, it quickly employed this tool six months later to resolve the Bank of the Commonwealth, which was the nation's largest failure to that date. During the 1970s and early 1980s, the FDIC experimented with this resolution mechanism several more times before using it to resolve Continental Illinois. In bailing out the depositors and shareholders of Continental Illinois, the agency gave birth to the infamous Too Big to Fail (TBTF) doctrine.⁸¹ This policy change effectively divided the banking industry into two camps: a select few of very large, money-center banks which regulators would not allow to fail and everyone else. Before the recent financial crises, the FDIC last employed this policy option in early 1991 when the Bank of New England failed. Because this resolution

⁸⁰ The FDIC temporarily gained such a power through the Banking Act of 1935, but the statute established a sunset date of July 1, 1936, so the power was never invoked.

⁸¹ As discussed in Chapter 4, the TBTF label was given by a congressional opponent of the regulatory development in House Banking Committee hearings on Continental Illinois in late 1984.

method extended protection beyond the existing statutorily defined deposit levels, Fed or OCC regulatory actions widening banks' powers potentially expanded the federal government's liabilities. Moreover, lawmakers enacted several statutory increases in deposit insurance coverage limits from 1950 through 1980 which only compounded the federal government's potential liabilities.

Of far greater importance for the evolution of banking regulation, however, were the statutes assigning regulatory authority over bank holding companies to the Federal Reserve.⁸² These legislative changes enlarged the Fed's regulatory powers and constituency significantly. As my case study recounted, these statutory revisions occurred over a fifteen year span beginning with enactment of the Bank Holding Company Act (BHCA) of 1956 and concluding with the Bank Holding Company Act Amendments of 1970. In the 1956 statute, the Fed gained responsibility over multi-bank holding companies. According to the BHCA, the Fed was to define the powers and activities in which multi bank holding companies and their subsidiary units could engage, thereby gaining significant control over the affiliations that banks may form. To close the loophole in the BHCA exempting holding companies owning a single bank (obhcs), lawmakers later enacted the BHCA Amendments of 1970 to include one bank holding companies in the Fed's regulatory jurisdiction and to redefine what constituted a bank. Though the Federal Reserve did not immediately use these regulatory powers fully, lawmakers' conferral of them gave the Fed a powerful tool by which it could influence the subsequent development and structure of the banking system, not to mention the actions of other actors within the policy realm.

⁸² The statutes, of course, technically located this regulatory power within the Board of Governors of the Federal Reserve System.

Not until Paul Volcker's final year as chair, however, did the Fed significantly turn down the pathway of granting affiliations between banks and other financial services firms within the holding company structure. In March 1987, the Fed ruled that irrespective of whether commercial paper was actually a security, holding company subsidiaries could deal and underwrite such debt provided that the parent companies generated less than five percent of their revenue from these activities. Almost a month later, the FRB announced its "source of strength" policy concerning bhcs' duties to act as sources of revenue for their subsidiary banks when these insured depository institutions encountered financial distress. Thereafter, the Fed employed this policy as its chief rationale for granting affiliations between banks and firms engaged in other financial services industries. A week after officially announcing this policy statement, the Board approved joint applications from several of the nation's largest bhcs to engage in limited underwriting and dealing in certain prohibited securities, which it referred to as "ineligible securities," provided that the parent companies generate less than five percent of their revenue from such activities. Two weeks afterwards, the FRB approved a similar application from the Chase Manhattan Corporation. In two of his final actions as chairman, Paul Volcker dissented from both Board decisions. Thus, the Federal Reserve was clearly heading in this direction of expanding affiliations between banks and other financial service providers before Alan Greenspan joined the Board.

During Chairman Greenspan's tenure, the Board of Governors of the Federal Reserve continued down this pathway. The next major development in this series of regulatory rulings, though, did not occur until mid January 1989 when the Board widely extended the list of bank ineligible securities activities provided the parent companies stayed below the five percent revenue limit. Nearly nine months afterwards, the Board issued another ruling doubling the

revenue limit to ten percent and expanding the category of “bank-eligible securities” to encompass securities issued by government sponsored enterprises or rated by industry recognized ratings agencies. The Greenspan Fed eventually raised the revenue limit in December 1996 to twenty-five percent, thereby significantly increasing the size of financial services firms that could be acquired by holding companies and affiliate with banks. Two months later, the FRB streamlined its review procedures for approving bhc activity applications, including shortening the timeline and permitting holding companies to enter certain areas with preexisting Board rulings without prior notice. In September 1998, the Board approved Travelers’ acquisition of Citicorp, a merger which had been announced six months earlier, and exempted the new corporation from the BHCA’s activity restrictions for its first two years. Unless lawmakers finally accomplished reform of the banking statutes, the newly established Citigroup would have to divest itself of many of its nonbanking units. With the exception of the FRB’s action streamlining its review process for bhc nonbanking activity applications in February 1997, all the other regulatory changes were conducted without any changes in statutory authority.⁸³

Even though the Federal Reserve arguably became the dominant player among the three federal banking regulators during the eighties and nineties, the Comptroller of the Currency still played a major role in the evolving structure of the banking system. After all, it was the OCC which was perhaps the earliest of the three regulators to employ its statutory powers, especially the “incidental” powers clause of the National Bank Act, to expand the list of permissible activities and allow national banks to expand into these other lines of business.⁸⁴ Deriving

⁸³ The streamlining of the Board’s review procedure resulted from the Omnibus Consolidated Appropriations Act of 1997 from September 30, 1996.

⁸⁴ When national banks expanded into these other activities, they organized these other lines of business either as divisions of the bank itself or as separate operating subsidiaries of the bank.

authority from this clause, the Comptroller in late August 1982 was the first federal agency to rule that a bank could operate a securities brokerage. In late February 1985, the OCC invoked Garn-St. Germain's thirty-mile provision to allow a national bank to relocate its main office from Independence, Missouri to Overland Park, Kansas, thereby facilitating interstate branching. The OCC also facilitated interstate branching in February 1985 when it drew upon Garn-St. Germain's thirty-mile provision to allow a national bank to cross state lines by relocating its main office from Kansas to Missouri. Drawing its authority on a WWI era statutory revision, the Comptroller's Office ruled in August 1986 that a national bank could sell insurance to its customers, but, more importantly, that it could do so to individuals who were not currently customers and in locales with populations greater than 5,000. This ruling marked a significant departure from previous approvals of insurance activities, and it presented a means for banks wishing to enter this line of business ever since lawmakers had closed the holding company route. Though the OCC continued issuing rulings allowing national banks to expand through the remainder of the eighties and nineties, it was not quite able to counter the Federal Reserve's expansions of bank holding companies.

Given the various crises experienced by the American banking system at the end of the twentieth century, federal agencies were by no means the only governmental actors operating in the policy realm. The twentieth century's final two decades arguably produced the most significant amount of banking legislation since the New Deal. Unlike the regulators, however, federal lawmakers typically responded to crises in the system and independent actions of the agencies in their statutory work. DIDMCA, for instance, extended the Fed's reserve requirements authority to all depository institutions, allowed all depository institutions to offer transaction accounts, and increased deposit insurance levels to \$100,000. Within two years,

federal lawmakers recognized the need for more statutory change and enacted Garn-St. Germain which immediately phased out interest rate ceilings, granted thrifts more powers to operate as banks, and instituted the thirty-mile rule for national banks. Five years later with the thrift crisis exploding, Washington enacted CEBA to reassure depositors by pledging the federal government's full faith and credit, not to mention closing the nonbank bank loophole by redefining what constituted a bank.

Because lawmakers failed to stem the bank and thrift crises before President Reagan left office, President George H.W. Bush entered the White House facing a worsening banking system. The Bush administration then set out to enact major statutes reforming the banking system, but especially reforming the FDIC so that the agency would be better able to resolve the bank and thrift failures. As a result, in President Bush's first and third years in office, lawmakers completed work on FIRREA and FDICIA. Though the administration sought more far-reaching reform and modernization of the nation's banking system from both measures, it ultimately settled for reforms that dealt principally with the FDIC. Among other things, these statutes established another temporary agency to resolve the failed thrifts, altered organization and leadership of the FDIC, granted the FDIC more procedures for handling resolutions, imposed more procedures when seeking to use the TBTF doctrine, gave the agency more ways to raise funds through rate changes on member banks, and allowed for capital requirements.

Despite these major statutory revisions of the federal system of deposit insurance, President Clinton entered office in 1993 facing additional clean-up of the bank and thrift sectors. After completing work on these tasks during his first year in office, including legislation prohibiting the federal agencies from providing financial assistance to the shareholders of any failing depository institution, Washington in 1994 finally accomplished major revision of the

nation's outmoded laws prohibiting interstate banking and branching with the Riegle-Neal Act. Following years of regulatory rulings expanding banks' activities and judicial verdicts upholding most of those agency decisions, the Clinton White House and the Republican controlled Congress enacted the Financial Services Modernization Act of 1999. This legislation basically updated the statutory code so that it was in accord with the existing body of regulatory rules; in so doing, it marked a partial repeal of Glass-Steagall. Though Gramm-Leach-Bliley contained an agreement reached between the OCC and Fed dividing regulatory authority over the banking industry's structure, the Fed appeared to gain an advantage since the largest financial services firms were required conduct their activities through the holding company structure.⁸⁵ The Financial Services Modernization Act neither erected additional regulatory agencies nor required much, if any, restructuring and redistribution of authority among the various banking and financial services regulators.

Since the onslaught of the 2007-2009 financial crisis, public officials and others in the policymaking community frequently blamed the Gramm-Leach-Bliley Act, especially its repeal of Glass-Steagall, for creating the environment for free-wheeling financiers. According to this perspective, the United States would have averted the crisis, or at least the brunt of its severity, had President Clinton and congressional Republicans not enacted Gramm-Leach-Bliley. As my case shows, however, such a belief could not be further from reality as evidenced by changes to the banking statutes, the regulators actions and rulings, and responses to the crisis made possible by Financial Services Modernization. First, much of the Banking Act of 1933 remains, most notably the deposit insurance components the coverage limits of which have increased a number of times over the last seventy plus years. Second, statutory reforms of the eighties and nineties

⁸⁵ Gramm-Leach-Bliley, it may be recalled, created a new type of holding company known as a financial holding company.

repealed other major aspects of the Banking Act including the ceilings on interest rates, prohibitions against transaction accounts by nonbank depository institutions, and the branching limitations. Third, in terms of Glass-Steagall's specific provisions separating commercial and investment banking, Gramm-Leach-Bliley only repealed two of the four provisions. The GLBA repealed sections 20 and 32, which prohibited affiliations between banks and securities firms and prohibited common directors respectively, but it left section 16 that limited banks' securities activities and section 21 that outlawed securities firms accepting deposits. Fourth, rather than being in the class of social regulation, the Banking Act was quintessentially within the category of economic regulation since it focused on the banking system's safety-and-soundness. The 1933 statute would have done nothing to prevent predatory lending or abuses of consumers by mortgage lenders.

Over the course of the last few decades of the twentieth century, the Comptroller of Currency and the Federal Reserve revised and replaced many of the rules created under Glass-Steagall restricting banks to the narrow services of taking deposits and making loans. Banks were able to engage in the brokerage business through subsidiaries or affiliates as of the early eighties. By the middle of the decade, holding company affiliates could be involved in a host of different types of securities prohibited to banks themselves. Around the same time, national banks obtained permission to sell insurance products to existing customers and potential customers from any of their offices regardless of where the clients were located. Thus, rather than suddenly provide banks with a host of new powers or activities, Gramm-Leach-Bliley essentially provided statutory authorizations for a number of the regulatory rules bankers had won from the OCC and Fed over the last few decades.

Moreover, the Financial Services Modernization Act even facilitated policymakers' responses to the financial crisis. One such policy option made possible by the 1999 statute included greater latitude for regulators in permitting affiliations between banks and other nonbank financial services firms. As President Bill Clinton explained to Maria Bartiromo in an October 2008 issue of *BusinessWeek*,

[I]t wasn't a complete deregulation at all. We still have heavy regulations and insurance on bank deposits, requirements on banks for capital and for disclosure....Indeed, one of the things that has helped stabilize the current situation as much as it has is the purchase of Merrill Lynch by Bank of America, which was much smoother than it would have been if I hadn't signed that bill. (Bartiromo 2008: 19)

This statutory power proved important for several of the Federal Reserve's decisions during the crisis permitting acquisitions of major financial services companies by existing bank holding companies or making it much easier to approve conversions of firms to holding companies under the Fed's supervision.

Having shown that Gramm-Leach-Bliley and its "repeal" of Glass-Steagall did not cause the financial crisis, it is valuable to apply my explanation of bank regulation's evolution to the regulatory environment after Dodd-Frank's enactment. After all, it is my dissertation's contention that the interplay of the actors in the policymaking process can explain a great deal about the regulation to emerge from it. For our purposes, however, I will focus on three of them.

First, lawmakers in Dodd-Frank stripped the regulatory agencies of their consumer protection responsibilities and established a new agency to monitor these items instead. This new regulatory agency was largely the intellectual progeny of the bankruptcy scholar Elizabeth Warren. She viewed the recent financial crisis as resulting from unscrupulous lenders taking

advantage of consumers on mortgages and other extensions of credit and wanted to create another agency modeled after the Consumer Product Safety Commission to prevent this behavior. The result of Warren's lobbying efforts was the Consumer Financial Protection Bureau (CFPB). The CFPB was situated within the Federal Reserve and received its funding from the revenue generated by the Fed in conducting its monetary and regulatory activities. Supporters of the agency hoped to protect it against de-funding efforts by future Congresses.

Establishing the CFPB with its own unique consumer protection mission necessarily adds further complexity and interdependencies to the existing regulatory structure, yet locating it within the Fed complicates matters even more. The Fed previously had consumer protection responsibilities over matters such as credit cards and bank holding companies, yet it experienced the same consumer protection shortfalls as the other banking regulators. Unlike other financial regulatory agencies, the Fed all ready had multiple responsibilities including regulating the money supply, member banks, foreign banks and holding companies. Unfortunately for the Fed, regulating the money supply is vastly different from regulating banks, a task that is concerned with safety-and-soundness. Moreover, Dodd-Frank added new responsibilities to the Federal Reserve such as supervising the largest, most complex financial holding companies and serving as the systemic risk regulator. The systemic risk authority, of course, assumes that regulators will be able to define clearly what poses a systemic risk, something they have been unable to accomplish to date. Although the Fed had several regulatory failings in the recent crisis, it still managed to garner additional roles and responsibilities in the subsequent legislative reforms. Given that the Federal Reserve all ready has difficulty resolving differences between its various responsibilities, adding a consumer protection component only creates further difficulties and potential conflicts. Likewise, the CFPB's pro-consumer attitude will necessarily generate

conflicts with the other banking regulators as one looks out for consumers whereas the others protect the safety of the banking system.

Second, as deposit insurance coverage limits increase, so too does the federal government's accompanying liability. Since the financial crisis broke and infected the U.S. banking system, federal lawmakers have twice enacted statutes temporarily raising deposit insurance coverage. Washington enacted the first such measure on October 3, 2008 as part of the Emergency Economic Stabilization Act; this statute increased coverage to \$250,000 through December 31, 2009. Then, on May 20, 2009, as part of the Helping Families Save Their Homes Act lawmakers extended the increase through the last day of 2013. Given the existence of a moral hazard problem inherent in the pricing of deposit insurance, though such increases in coverage may alleviate potential depositor runs, they impose an enormous cost on the system.

As the banking system grew and increased in complexity, there occurred certain circumstances in which the federal banking regulators determined that it was less costly for the government to extend financial assistance than to meet its posted deposit coverage limits. These are the cases in which a failing bank is deemed Too Big to Fail. Though lawmakers enacted several statutory provisions during the eighties and nineties to prevent any future use of the doctrine, TBTF reappeared in recent financial crisis as a host of federal banking and financial industry regulators met and agreed to offer assistance to some of the nation's largest banks, securities firms, nondepository lenders, and insurance companies. The Federal Reserve, in fact, was one of the worst offenders in the crisis as it extended credit to faltering banks and nonbanks. Dodd-Frank, however, neither changes the incentives for large firms to engage in such activities that might cause their failure nor does it prohibit the resolution of those failing banks and nonbanks. The legislation requires the creation of a \$50 billion fund to cover the resolution of

financial services firms deemed TBTF, an act which will surely invite future bailouts and corporate welfare. Moreover, the law creates a financial stability council and expands the decision-making group to encompass other governmental officials such as those from the Treasury Department. The inclusion of additional personnel in this decision-making process will surely create more opportunities for interested parties wishing to lobby the government and prevent the formulation of clear rules of operation.

Third, as President Clinton's response to *BusinessWeek* indicated, the Federal Reserve approved applications from the largest bank holding companies to acquire major nonbank financial services companies. Applications within this category included JPMorgan Chase's acquisition of Bear Stearns, Bank of America's acquisition of Countrywide Financial Corporation, Wells Fargo and Company's acquisition of Wachovia Corporation, and BofA's acquisition of Merrill Lynch.⁸⁶ The former president's statement, however, failed to note the more important development that occurred during the crisis as the Fed approved applications from nonbank financial services companies to convert to bank or financial holding companies. Requests and approvals for such conversions included American Express, Discover Financial Services, CIT Group, and GMAC.

For the purposes of Wall Street and the securities industry, requests by Goldman Sachs and Morgan Stanley to convert from investment banks to bank holding companies were the most significant. The FRB hurriedly approved these requests on the evening of Sunday, September 21, 2008.⁸⁷ The Federal Reserve's decisions on these two cases led financial journalists to

⁸⁶ At the time of the crisis, Bear Stearns and Merrill Lynch were two of the five large investment banks headquartered on Wall Street. The FRB formally approved the sale of Bear Stearns on April 1, 2008 whereas it formally approved the sale of Merrill November 26, 2008.

⁸⁷ That same weekend, federal banking and securities regulators failed to find a merger partner or white knight for the beleaguered investment bank Lehman Brothers. As a result, Lehman Brothers was allowed to fail and begin the bankruptcy process the following day.

remark memorably, albeit incorrectly, “The steps effectively mark *the end of Wall Street* as it’s been known for decades” (Hilsenrath, Paletta, & Lucchetti 2008)(Italics added). The weekend’s events, which saw the conversion of two of the three major remaining investment banks and the failure of the third one, however, were not the end of Wall Street, for Goldman, Morgan Stanley, and Merrill Lynch continued to exist, but they did so subsumed within the bank holding company structure. More importantly, these acquisitions and conversions altered the balance of power among the federal regulatory agencies. By approving these actions which gave the nonbanks access to the discount window and the steadier funding source of insured deposits, the Federal Reserve completely perverted its “source of strength” doctrine. Needless to say, neither Dodd-Frank nor other proposed legislative reforms addressed this doctrine or the dangers it poses to the entire banking system.

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