Fordham Law Review

Volume 59 | Issue 6 | Article 16

1991

A Note to Congress and the FDIC: After FIRREA, Where's the BIF?

David Andrew Segal

A NOTE TO CONGRESS AND THE FDIC: AFTER FIRREA, WHERE'S THE BIF?*

INTRODUCTION

ALTHOUGH the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA")[1] is widely recognized as the "savings and loan bailout bill,"[2] many of its provisions deal with commercial banks in addition to their savings-and-loan brethren.[3] Specifically, the bill was intended to place both the Savings Association Insurance Fund ("SAIF")[4] and Bank Insurance Fund ("BIF")[5] "on a sound financial footing."[6]

The clear theme of the House Banking, Finance and Urban Affairs Committee's deliberations was "never again."[7] That is, FIRREA was intended to provide for the "early detection of problems in financial institutions and the prevention of losses to the deposit insurance funds" and ultimately to the taxpayer.[8] Unfortunately, it appears that unless Congress acts prudently and quickly, "never again" could become "here we go again," and the taxpayers will be forced to bail out the commercial

* Due to publication constraints, the information in this Note is current only through March 1991.

1. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 [hereinafter FIRREA] (to be codified at various sections of 12 & 15 U.S.C.).

2. A purpose of the bill was "[t]o provide funds from public and private sources to deal expeditiously with failed depository institutions." *See id.* § 101(8), 103 Stat. at 187; *see also* Knight & Walsh, *S&L Bailout Set to Go Into High Gear; $20 Billion to Be Spent in 7 Weeks on Cleanup of Ailing Thrifts*, Wash. Post, Aug. 9, 1989, at A1, col. 3 ("the savings and loan bailout bill [FIRREA] . . . launch[es] a seven-week, $20 billion blitzkreig to clean up the sickest S&Ls"). *But see* White, *The S&L Debacle*, in Annual Survey of Financial Institutions and Regulation, The S&L Crisis: Death and Transfiguration, 59 Fordham L. Rev. S57, S61-62 (1991) (disputing that FIRREA was a "bailout").

3. Federal Deposit Insurance Corporation Chairman L. William Seidman stated that the effects of FIRREA "go well beyond the closing of insolvent thrifts[;] . . . a changed financial system is in the making." *Conferences Highlight Regulatory/Congressional Reactions to FIRREA*, [Bulletin 6] Control of Banking (P-H) ¶ 6.1, at 1 (Sept. 15, 1989); *see, e.g.*, FIRREA, *supra* note 1, tits. VIII, IX, XI, 103 Stat. at 441, 446, 511 (provisions dealing with powers applicable to savings and loans as well as commercial banks); *see also infra* notes 34-42, 47 and accompanying text (discussing some FIRREA provisions that apply to commercial banks).

4. SAIF insures the deposits of savings associations and was created under FIRREA. *See* FIRREA, *supra* note 1, §§ 205(1)(A)(a)(2), 211(3)(6), 103 Stat. at 194, 219 (to be codified at 12 U.S.C. §§ 1814(a)(2), 1821(a)(6)); *see also* Note, *The FDIC's Enhanced Powers over Saving Associations: Does FIRREA Make it SAIF?*, in Annual Survey of Financial Institutions and Regulation, The S&L Crisis: Death and Transfiguration, 59 Fordham L. Rev. S381, S387 (1991) (discussing the operation of SAIF).

5. For a discussion of the operation of BIF, see *infra* notes 30-45 and accompanying text.

6. FIRREA, *supra* note 1, § 101(5), 103 Stat. at 187.

7. *See* H.R. Rep. No. 101-54(I), 101st Cong., 1st Sess. 310 (1989), *reprinted in* 1989 U.S. Code Cong. & Admin. News 86, 106.

8. *Id.*

banking industry and its insurance fund.[9]

When FIRREA was enacted, Congress correctly viewed the legislation as only a first step.[10] Senate Banking Committee member Jake Garn warned, "The 'problem' isn't over . . . we still need more deregulation and modernization of our financial system that will require very careful oversight and changes."[11] It is likely, however, that "[c]oncentration on the thrift crisis distracted [Congress'] attention from another concern, the health of our nation's banking system, [specifically] the ability of the Bank Insurance Fund to withstand [a] sizeable drain upon its resources."[12]

In September 1989, Federal Deposit Insurance Corporation ("FDIC") Chairman L. William Seidman testified that he expected BIF "to break even or show a slight reduction for the full year and to show an increase in 1990."[13] Mr. Seidman further stated that "the worst of the problems in the banking industry are behind us."[14] Since these predictions were made, however, it has become apparent that "[t]he taxpayer is in serious jeopardy of being asked to bail out the [commercial] banks."[15]

In the aftermath of the savings-and-loan crisis, Congress has devoted

9. *But see* Considine, *A State Response to U.S. Treasury Department Proposals to Modernize the Nation's Banking System*, in Annual Survey of Financial Institutions and Regulation, The S&L Crisis: Death and Transfiguration, 59 Fordham L. Rev. S243, S252 (1991) (assessing state of commercial banks and comparing with state of S&Ls); Felsenfeld, *The Savings and Loan Crisis—Yet Another Analysis*, in Annual Survey of Financial Institutions and Regulation, The S&L Crisis: Death and Transfiguration, 59 Fordham L. Rev. S7 (1991) (same).

10. *See, e.g.*, FIRREA, *supra* note 1, § 1001, 103 Stat. at 507 (ordering various regulators to study federal deposit-insurance system); *id.* § 1003, 103 Stat. at 509 (ordering Comptroller General of the United States to study deposit insurance issues).

11. *Conferences Highlight Regulatory/Congressional Reactions to FIRREA*, [Bulletin 6] Control of Banking (P-H) ¶ 6.1, at 2 (Sept. 15, 1989).

House Banking Committee member John LaFalce similarly recognized that FIRREA "marks the beginning rather than the end of a long policy process . . . which will change the shape of the financial services industry." *Id.*

12. *Hearings on Deposit Insurance Before the Financial Institutions Subcomm. of the House Banking Comm.*, 101st Cong., 1st Sess. 1 (Sept. 19, 1989) (Panel one) [hereinafter *Deposit Insurance Hearings I*] (statement of Rep. Annunzio, Chairman) (LEXIS, Nexis library, Fednews file).

Apparently, Congress did not fully comprehend the extent of the problems facing the commercial banks because it created a structure for the savings and loans similar to that which existed for the commercial banks and placed control of the savings association's deposit-insurance fund with the deposit-insurance regulator of the commercial banks, the Federal Deposit Insurance Corporation. *See, e.g.*, FIRREA, *supra* note 1, § 202, 103 Stat. at 188 (adding "savings associations" as institutions subject to the Federal Deposit Insurance Corporation); Note, *The FDIC's Enhanced Powers over Saving Associations: Does FIRREA Make it SAIF?*, in Annual Survey of Financial Institutions and Regulation, The S&L Crisis: Death and Transfiguration, 59 Fordham L. Rev., at S387 (1991) (discussing FIRREA's regulatory restructuring of savings associations).

13. *Regulators Paint Rosy BIF Picture; Academics, GAO See Growing Problems*, 53 Banking Rep. (BNA) No. 12, at 415 (Sept. 25, 1989).

14. *Id.*

15. *A More Pessimistic View of Bank Deposit Insurance Fund*, N.Y. Times, Oct. 11, 1990, at D2, col. 2 (quoting Rep. Annunzio).

significant resources to exploring the problems of the banking industry, especially with respect to commercial banks. This Note examines the crisis facing the commercial banking industry. Part I reviews BIF's establishment and operation, including forecasts concerning the health of the fund and the banking industry. Part II analyzes many of the proposals for deposit insurance and industry reform, evaluating the benefits and drawbacks of each proposal in light of the overall goal of restoring the banking industry and the deposit-insurance fund to a sound financial footing. This Note concludes that Congress must act quickly and forcefully to prevent the need for a costly rescue of the banking industry.

I. The Crisis

A. *Background*

Banking institutions[16] are regulated by various federal and state agencies, including state bank supervisors, the Office of the Comptroller of the Currency, the Federal Reserve Board and the FDIC.[17] These regulatory bodies exercise overlapping levels of jurisdiction,[18] a structure that has been aptly described as a "bankers [sic] nightmare and a lawyer's dream."[19]

The bulk of the FDIC's regulatory authority stems from its mandate

16. Throughout this Note, the terms "banking institutions" and "banks" refer to commercial banks. A commercial bank is traditionally defined "as an institution whose business consists of discounting commercial paper, accepting deposits (particularly demand deposits), and making loans (particularly commercial loans)." M. Malloy, 1 The Corporate Law of Banks § 1.2.2, at 11 (1988) (footnotes omitted).

In contrast, for purposes of this Note, the terms "savings and loans ('S&Ls')," "savings banks," "savings associations" and "thrifts" refer to non-commercial institutions. For FIRREA's statutory definition of savings associations, see FIRREA, *supra* note 1, § 204(b), 103 Stat. at 190-91 (to be codified at 12 U.S.C. § 1813(b)); *see also* Malloy, *Nothing to Fear but FIRREA Itself: Revising and Reshaping the Enforcement Process of Federal Bank Regulation*, 50 Ohio St. L.J. 1117, 1117 n.2 (1989) (discussing the legal definitions of savings associations).

The term "depository institutions" is used to describe commercial banks, credit unions and savings associations. *See* 12 U.S.C. § 461(b)(1)(A) (1988); *see also* FIRREA, *supra* note 1, § 204(c)(c)(1), 103 Stat. at 191 (to be codified at 12 U.S.C. § 1813(c)(1)) (limiting definition of "depository institutions" to S&Ls and banks for purposes of the Federal Deposit Insurance Act).

17. *See generally* M. Malloy, 1 The Corporate Law of Banks § 1.3 (1988) (analyzing roles of the various banking regulators).

18. *See id.* at 23-25.

19. *Hearings, Oversight on the Financial Institutions Reform, Recovery and Enforcement Act Before the Financial Institutions Supervision, Regulation and Insurance Subcomm. of the House Banking, Finance, and Urban Affairs Comm.*, 101st Cong., 2d Sess. 25 (Mar. 14, 1990) [hereinafter *Oversight Hearings*] (statement of Rep. Parris) (LEXIS, Nexis library, Fednews file).

Representative Parris named over a dozen federal regulatory offices, in addition to the fifty state agencies, in a "laundry list" of regulators having some involvement with the banking and savings industries. *See id.*

to insure the deposits of all insured banks.[20] If an insured bank is closed after being declared insolvent, the FDIC is responsible for paying insured depositors.[21] Additionally, the FDIC can be appointed conservator by a bank's primary regulator[22] and can act as receiver of a bank in receivership.[23] The FDIC also has the authority to take remedial action to prevent the formal closing of an insured bank,[24] to organize bridge banks to assume the deposits, liabilities and assets of a bank that is in default or may default,[25] and to terminate the insurance of a bank whose current or anticipated activities are considered "unsafe or unsound"[26] or that present "a serious threat" to BIF.[27] To evaluate the need for such action, the FDIC has broad authority to conduct examinations of any insured bank.[28]

The FDIC administers two insurance funds, SAIF[29] and BIF.[30] The latter insures the deposits of approximately 13,000 institutions,[31] ninety-five percent of which are commercial banks.[32] The remainder of the insured banks are "federally and state-chartered savings banks and branches of foreign banks that conduct consumer business in this country."[33] BIF was established in 1989 by FIRREA[34] to replace the Perma-

---

20. *See* 12 U.S.C. § 1811 (1988) (amended by FIRREA, *supra* note 1, § 202(a), 103 Stat. at 188).

An insured bank is any bank "the deposits of which are insured in accordance with [the FDIC Act]." 12 U.S.C. § 1813(h) (1988).

While the FDIC is considered the primary regulator of both state non-member insured banks and foreign banks having an insured branch in this country (except for district banks), *see* 12 U.S.C. § 1813(q)(3) (1988), this Note will consider the FDIC's regulatory powers of the banking industry that exist through its protection of the insurance funds, specifically BIF.

21. *See* FIRREA, *supra* note 1, § 212(a)(f), 103 Stat. at 240 (to be codified at 12 U.S.C. § 1821(f)).

22. *See id.* § 212(a)(c)(2)(A)(i), 103 Stat. at 222 (to be codified at 12 U.S.C. § 1821(c)(2)(A)(i)).

23. *See id.* § 212(a)(c)(2)(A)(ii), 103 Stat. at 222 (to be codified at 12 U.S.C. § 1821(c)(2)(A)(ii)).

24. *See* 12 U.S.C. § 1823(c) (1988) (amended by FIRREA, *supra* note 1, §§ 201(a)(1), 217(3), 103 Stat. at 187, 255).

25. *See* FIRREA, *supra* note 1, § 214, 103 Stat. at 246 (to be codified at 12 U.S.C. § 1821(n)).

26. *Id.* at § 926(1)(a)(2), 103 Stat. at 489 (to be codified 12 U.S.C. § 1818(a)(2)).

27. *Id.* § 221(4)(m)(3)(C), 103 Stat. at 268 (to be codified at 12 U.S.C. § 1828(m)(3)(C)).

28. *See id.* § 210(a)(b), 103 Stat. at 217 (to be codified at 12 U.S.C. § 1820(b)).

29. *See* sources cited *supra* note 4.

30. *See id.* § 211(3)(4), 103 Stat. at 218 (to be codified at 12 U.S.C. § 1821(a)(4)); *see also infra* notes 37-42 and accompanying text (differentiating between the two insurance funds).

31. As of June 30, 1990, BIF insured 12,977 banks. *See* Federal Deposit Insurance Corporation, Board Briefing: Bank Insurance Fund Mid-Year Results 1990, 2 (June 30, 1990) [hereinafter Mid-Year Report].

32. *See* Statement of Robert D. Reischauer, Director, Congressional Budget Office, Before the Senate Comm. on Banking, Housing, and Urban Affairs 1 (Sept. 12, 1990) (Congressional Budget Office press release) [hereinafter Reischauer Senate Testimony].

33. *Id.* at 1-2.

nent Insurance Fund, which the FDIC had previously operated.[35] Pursuant to FIRREA, BIF assumed all the assets and liabilities of its predecessor.[36]

Despite concomitant administration of the insurance funds, BIF and SAIF are "maintained separately and not commingled."[37] All costs, expenses and receipts associated with savings associations insured by SAIF and banks insured by BIF are separately charged.[38] Additionally, for the five-year period following the passage of FIRREA,[39] a depository institution may not change its membership from BIF to SAIF or vice versa unless the FDIC approves the conversion.[40] To approve the conversion, the FDIC must determine that only an "insubstantial portion" of the total deposits are affected[41] or that the conversion is related to the acquisition of a troubled member of the alternate insurance fund.[42]

BIF derives its income "primarily from assessments on insured banks"[43] and "from the sale of assets of failed banks."[44] It also receives interest income from its cash balances, which are invested in Treasury

---

34. FIRREA, *supra* note 1, § 211(3)(5)(A), 103 Stat. at 219 (to be codified at 12 U.S.C. § 1821(a)(5)(A)).

35. *See id.* § 211(3)(5)(B), 103 Stat. at 219 (to be codified at 12 U.S.C. § 1821(a)(5)(B)).

36. *See id.*

37. *Id.* § 211(3)(4)(B), 103 Stat. at 219 (to be codified at 12 U.S.C. § 1821(a)(4)(B)).

38. *See id.* § 211(3)(7)(B)(iv), 103 Stat. at 221 (to be codified at 12 U.S.C. § 1821(a)(7)(B)(iv)); *see also id.* § 211(3)(7)(C), 103 Stat. at 221 (to be codified at 12 U.S.C. § 1821(a)(7)(C)) (allocating personnel, administrative or other overhead expenses to the fund from which the expenses were incurred).

39. *Id.* § 206(a)(7)(d)(2)(A)(ii), 103 Stat. at 197 (to be codified at 12 U.S.C. § 1815(d)(2)(A)(ii)).

40. *See id.* §§ 206(a)(7)(d)(2)(A)(i), 206(a)(7)(d)(2)(B)(i), 103 Stat. at 197, 197 (to be codified at 12 U.S.C. §§ 1815(d)(2)(A)(i), 1815(d)(2)(B)(i)).

Conversion is defined as "the change of status of an insured depository institution from a [BIF] member to a [SAIF] member or from a [SAIF] member to a [BIF] member," *id.* § 206(a)(7)(d)(2)(B)(i), 103 Stat. at 197 (to be codified at 12 U.S.C. § 1815(d)(2)(B)(i)), or "the merger or consolidation of a [BIF] member with a [SAIF] member." *Id.* § 206(a)(7)(d)(2)(B)(ii), 103 Stat. at 197 (to be codified at 12 U.S.C. § 1815(d)(2)(B)(ii)).

41. *Id.* § 206(a)(7)(d)(2)(C)(i), 103 Stat. at 197 (to be codified at 12 U.S.C. § 1815(d)(2)(C)(i)).

42. *See id.* §§ 206(a)(7)(d)(2)(C)(ii)-(iii), 103 Stat. at 197-98 (to be codified at 12 U.S.C. § 1815(d)(2)(C)(ii)-(iii)); *see also* Note, *The FDIC's Enhanced Powers over Saving Associations: Does FIRREA Make it SAIF?*, in Annual Survey of Financial Institutions and Regulation, The S&L Crisis: Death and Transfiguration, 59 Fordham L. Rev., at S388-89 (1991) (discussing membership transfer regulations).

43. Reischauer Senate Testimony, *supra* note 32, at 2; *see also* 12 U.S.C. 1817(c) (1988) (amended by FIRREA, *supra* note 1, §§ 201(a)(1), 208(7), 103 Stat. at 187, 213) (describing assessments).

The BIF assessment rate is a premium assessed on each $100 of a member bank's insured deposits. *See* FIRREA, *supra* note 1, § 208(4)(1)(C), 103 Stat. at 208 (to be codified at 12 U.S.C. § 1817(b)(1)(C)). The method of calculating deposits is provided by 12 U.S.C. § 1817(b)(4) (1988) (amended by FIRREA, *supra* note 1, § 208(6), 103 Stat. at 212-13).

Congress set BIF assessment rates at 8.5 cents for the remainder of 1989, *see* FIRREA, *supra* note 1, § 208(4)(1)(C)(i), 103 Stat. at 208 (to be codified at 12 U.S.C. § 1817(b)(1)(C)(i)), 12 cents for 1990, *see id.* § 208(4)(1)(C)(ii), 103 Stat. at 208 (to be securities.[45]

BIF's financial condition and viability are measured by two basic indicators. The first is the fund's balance on either an accrual or cash basis.[46] The second is the fund's "reserve ratio."[47]

If BIF were to become insolvent, the taxpayers, as insurers of last resort, would need to provide money to bail it out. Accordingly, because the banking industry dwarfs the thrift industry in size,[48] a banking crisis could have much greater consequences than did the savings-and-loan debacle.

---

codified at 12 U.S.C. § 1817(b)(1)(C)(ii)), and 15 cents on and after January 1, 1991. *See id.* § 208(4)(1)(C)(iii), 103 Stat. at 208 (to be codified at 12 U.S.C. § 1817(b)(1)(C)(iii)).

Additionally, Congress provided that if the FDIC determines that a higher assessment rate is warranted, it may increase the rates, *see id.* § 208(4)(1)(C)(iv), 103 Stat. at 208 (to be codified at 12 U.S.C. § 1817(b)(1)(C)(iv)), up to a maximum of 32.5 cents, *see id.* § 208(4)(1)(C)(iv)(II), 103 Stat. at 209 (to be codified at 12 U.S.C. § 1817(b)(1)(C)(iv)(II)), with the increase in any one year not to exceed 7.5 cents. *See id.* § 208(4)(1)(C)(iv)(III), 103 Stat. at 209 (to be codified at 12 U.S.C. § 1817(b)(1)(C)(iv)(III)). *But see infra* notes 138-142 and accompanying text (Congress considering legislation to remove ceilings on assessment rates).

For 1990, the FDIC has raised the BIF assessment rate to its statutory maximum of 19.5 cents. *See* Nash, *Banks' Payments to Insure Deposits May Jump By 30%*, N.Y. Times, Aug. 15, 1990, at A1, col. 3.

44. Reischauer Senate Testimony, *supra* note 32, at 2; *see* FIRREA, *supra* note 1, § 217(4)(d), 103 Stat. at 256 (to be codified at 12 U.S.C. 1823(d)).

45. *See* 12 U.S.C. § 1823(a) (1988) (amended by FIRREA, *supra* note 1, § 217(1)(a), 103 Stat. at 254-55); Reischauer Senate Testimony, *supra* note 32, at 2.

46. The FDIC uses an accrual basis to report its net income. The fund's accrual balance represents the "accumulated net worth of the fund." Reischauer Senate Testimony, *supra* note 32, at 2. Under this accounting method, the FDIC subtracts its expenses and provisions for expected losses from the fund's balance and revenue. *See id.*; *see also* Mid-Year Report, *supra* note 31, at 4 (showing the calculation of the fund's unaudited accrual balance as of June 30, 1990). The estimated loss figure is reduced by expected future income from asset dispositions. *See* Reischauer Senate Testimony, *supra* note 32, at 2.

In contrast, the federal budget records the FDIC balance on a cash basis, that is, reflecting the receipts and payouts as they occur. *See id.* at 3. In the short term, a shortage of cash could hinder the FDIC's ability to finance the acquisition of assets. *See id.*

47. The BIF reserve ratio is defined as "the ratio of the net worth of [BIF] to the value of the aggregate estimated insured deposits held in all [BIF] members." FIRREA, *supra* note 1, § 208(14)(l)(6), 103 Stat. at 214 (to be codified at 12 U.S.C. § 1817(*l*)(6)). The net worth of the fund represents the fund's accrual balance. *See id.* § 208(4)(*l*)(C)(iv), 103 Stat. at 208 (to be codified at 12 U.S.C. § 1817(b)(1)(C)(iv); *supra* note 46; *see also* Mid-Year Report, *supra* note 31, at 1 (indicating $1,988 billion in deposits are insured by $11,375 million, the fund's accrual balance, for a ratio of 0.60%).

In FIRREA, Congress designated that the fund's target reserve ratio shall be 1.25%, or $1.25 for every $100 in bank deposits. *See id.* § 208(4)(1)(B)(i)(I), 103 Stat. at 207 (to be codified at 12 U.S.C. § 1817(b)(1)(B)(i)(I)).

FIRREA also provided for the maximum reserve ratio of BIF to be 1.50%. *See id.* § 208(4)(1)(B)(i)(II), 103 Stat. at 207 (to be codified at 12 U.S.C. § 1817(b)(1)(B)(i)(II)). There are, however, proposals that would remove BIF's maximum reserve ratio. *See infra* text accompanying notes 151-153.

48. The BIF-member banks have over three trillion dollars in assets, which is two and one-half times the assets held by the thrift industry. *See Deposit Insurance Hearings I*, *supra* note 12, at 1 (statement of Rep. Annunzio, Chairman).

B. *Financial Condition*

Until recent years, the FDIC bank-insurance operations consistently generated more revenue than expenses.[49] This growth occurred even though the FDIC regularly rebated a portion of the banks' assessment payments[50] and resolved an average of twenty-four failing banks per year.[51]

The increasing number of bank failures indicates the escalating problems of the insurance fund. During the forty-six-year period from the 1934 creation of the FDIC[52] through 1979, a *total* of 558 FDIC-insured banks failed.[53] In contrast, during the nine-year period from 1980 through 1988, 879 banks failed or needed assistance, including over four hundred in the last two years alone.[54] Furthermore, as of June 30, 1990, the FDIC considered over one thousand banks to be "problem banks,"[55] that is, "banks that are perceived as unusually weak" and in danger of failing or requiring assistance.[56]

In 1988, the FDIC insurance fund experienced the first loss in its history[57] when it paid out over seven billion dollars resulting in a net loss of $4.2 billion.[58] The losses continued into 1989, when the fund recorded a net loss of $851 million.[59] At the end of 1989, BIF had an accrual bal-

49. From 1970 to 1985, the FDIC fund's accrual balance grew from $3.9 billion to $19.5 billion as the FDIC generated net income each year, including $2.8 billion in 1985. *See* Reischauer Senate Testimony, *supra* note 32, at 3.

50. *See id.*; *see also* 12 U.S.C. § 1817(e) (1988) (amended by FIRREA, *supra* note 1, § 201(a)(1), 103 Stat. at 187) (authorizing the FDIC to issue rebates to insured banks).

51. *See* Reischauer Senate Testimony, *supra* note 32, at 3.

52. *See* Banking Act of 1933, ch. 89, § 8, 48 Stat. 162, 168 (1933).

53. *See Hearings on Deposit Insurance Before The Financial Institutions Subcomm. of the House Banking Comm.*, 101st Cong., 1st Sess. 2 (Sept. 19, 1989) (Panel two) [hereinafter *Deposit Insurance Hearings II*] (statement of Robert Gramling, Director, Corporate Financial Audits, Accounting and Financial Management Division of the United States GAO) (LEXIS, Nexis library, Fednews file); *see also* Testimony of L. William Seidman, Chairman, Federal Deposit Insurance Corporation, on Deposit Insurance Revision and Financial Services Restructuring Before the Senate Committee on Banking, Housing, and Urban Affairs, app. I at fig. 1 (July 31, 1990) (Federal Deposit Insurance Corporation press release) [hereinafter Seidman I] (graph depicting number of failed banks per year from 1934 to 1989).

54. *See Deposit Insurance Hearings II*, *supra* note 53, at 2 (statement of Robert Gramling, Director, Corporate Financial Audits, Accounting and Financial Management Division of the United States GAO); *see also* Seidman I, *supra* note 53, app. I at fig. 1 (graph of number of failed banks per year including the years 1985 to 1989).

55. *See* Mid-Year Report, *supra* note 31, at 2.

56. Flannery, *Can State Bank Examination Data Replace FDIC Examination Visits?*, J. Bank Res., at 312 (Winter 1983).

57. *See* Reischauer Senate Testimony, *supra* note 32, at 5 table 2.

58. *See* Mid-Year Report, *supra* note 31, at 2.

59. *See id.*

Recognizing problems seems to be difficult for the regulators. For example, in early December 1989, BIF was expected to show losses between $250 million and $500 million for the year. *See BIF Reserves Will Drop By $250 Million in 1989, FDIC Chairman Seidman Predicts*, 53 Banking Rep. (BNA) No. 23, at 868 (Dec. 11, 1989). Chairman ance of $13.2 billion[60] and a cash balance of $15.1 billion.[61]

In addition to the continued declining balances, the insurance fund's

BANK INSURANCE FUND

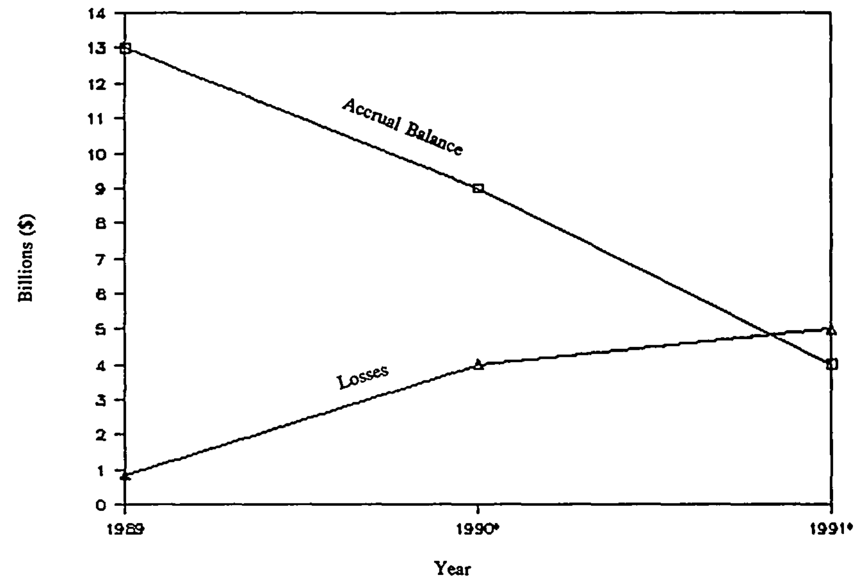

FIG. 1

* Indicates figures are estimates.

Sources: Federal Deposit Insurance Corporation, Board Briefing: Bank Insurance Fund Mid-Year Results 1990 (June 30, 1990); N.Y. Times, Dec. 17, 1990, at A1, col. 6; Wall St. J., Dec. 12, 1990, at A2, col. 2.

reserve ratio has also been falling steadily. The ratio peaked at 1.3% in 1985[62] and fell to 0.70% by the end of 1989.[63]

The FDIC estimated that during 1990 BIF would continue to incur losses totalling three billion dollars[64] despite significantly increased assessments.[65] These estimates were based on losses experienced by BIF through June 30, 1990.[66] Moreover, the FDIC's mid-year report indi-

Seidman characterized this loss as "slight," to which Representative Annunzio replied, "Only in Washington could someone term a half billion dollar loss 'slight.' " *Id.*

60. *See* Mid-Year Report, *supra* note 31, at 2.

61. *See* Reischauer Senate Testimony, *supra* note 32, at 3; *see also* figure 1.

62. *See* Reischauer Senate Testimony, *supra* note 32, at 5.

63. *See* Mid-Year Report, *supra* note 31, at 2.

64. *See* Labaton, *Deposit Fund Condition is Worsening*, N.Y. Times, Sept. 29, 1990, at D1, col. 6; Thomas, *FDIC Increases Loss Projection to $3 Billion*, Wall St. J., Sept. 28, 1990, at A2, col. 1.

65. *See supra* note 43.

66. Up to that point in 1990, the FDIC had handled 103 bank failures and had $3.7 billion in expenses. *See* Mid-Year Report, *supra* note 31, at 2.

cated that BIF's reserve ratio had reached an all-time low of 0.60%.[67] The FDIC expected the ratio to continue to fall and, by year's end, to reach a balance of only fifty cents for every one hundred dollars in deposits, a ratio of 0.50%.[68]

Indicative of the continuing deterioration of BIF, in December 1990, the FDIC was again forced to revise its estimates and predicted that BIF would lose four billion dollars or more during 1990.[69] Losses of this magnitude would lower BIF's accrual balance to about nine billion dollars and its cash balance to about seven billion dollars.[70] Since BIF insures $2.3 trillion in deposits,[71] its reserve ratio would fall to 0.39%. BIF is expected to face these record losses despite a decreasing number of bank failures.[72]

The FDIC has preliminarily estimated that BIF will lose five billion dollars in 1991.[73] These loses would be incurred in dealing with 170 to 200 failing banks[74] and result in BIF's reserve ratio falling to eighteen cents for every hundred dollars in deposits.[75] If these estimates are accurate, BIF will have a loss for the fourth consecutive year and the worst in the fund's history.[76] Such a loss, combined with the expected 1990 losses, would leave BIF with an accrual balance of about four billion dollars.[77]

---

67. *See id.*

68. *See* Labaton, *Deposit Fund Condition is Worsening*, N.Y. Times, Sept. 29, 1990, at D6, col. 6.

69. *See* Bacon, *Bank Insurance Fund '90 Losses Put at $4 Billion*, Wall St. J., Dec. 12, 1990, at A2, col. 2; Labaton, *$4 Billion Loss Seen by F.D.I.C.*, N.Y. Times, Dec. 12, 1990, at D1, col. 3. This represents a one billion dollar increase from the FDIC's June projections, *see supra* note 64 and accompanying text, and double its early September predictions. *See* Bacon, *Bank Insurance Fund '90 Losses Put at $4 Billion*, Wall St. J., Dec. 12, 1990, at A2, col. 2.

70. *See* Bacon, *Bank Insurance Fund '90 Losses Put at $4 Billion*, Wall St. J., Dec. 12, 1990, at A2, col. 2; Labaton, *$4 Billion Loss Seen by F.D.I.C.*, N.Y. Times, Dec. 12, 1990, at D1, col. 3; *see also* figure 1.

71. *See* Bacon, *Bank Insurance Fund '90 Losses Put at $4 Billion*, Wall St. J., Dec. 12, 1990, at A2, col. 2.

72. In 1990, 169 banks failed, *see Bank Failures, Dip for Now*, N.Y. Times, Jan. 1, 1991, at 42, col. 4, with assets totalling $16 billion. *See* Bacon, *As Deposit Insurance Dwindles, FDIC Wonders if it Should Start Running the Banks it Seizes*, Wall St. J., Dec. 31, 1990, at 30, col. 3. This represents a 29% drop from 1989. *See Bank Failures, Dip for Now*, N.Y. Times, Jan. 1, 1991, at 42, col. 4.

73. *See* Labaton, *$5 Billion '91 Loss Seen for U.S. Fund Insuring Deposits*, N.Y. Times, Dec. 17, 1990, at A1, col. 6.

74. *See id.*; *see also* Bacon, *As Deposit Insurance Dwindles, FDIC Wonders if it Should Start Running the Banks it Seizes*, Wall St. J., Dec. 31, 1990, at 30, col. 3 (it is expected that the average failed bank will be larger than it was in 1990).

75. *See* Labaton, *$5 Billion '91 Loss Seen for U.S. Fund Insuring Deposits*, N.Y. Times, Dec. 17, 1990, at D4, col. 1.

76. *See id.*

77. *See* Bacon, *FDIC Says Insurance Fund Will Shrink to $4 Billion in '91 Without an Infusion*, Wall St. J., Dec. 17, 1990, at A4, col. 1; Labaton, *$5 Billion '91 Loss Seen for U.S. Fund Insuring Deposits*, N.Y. Times, Dec. 17, 1990, at A1, col. 6.

Subsequently, the FDIC acknowledged that it may need to borrow $10 billion this year, *see* Labaton, *U.S. Seeks Much Bigger Amount to Shore Up Bank Deposit Fund*, N.Y.

While the FDIC has not made forecasts for BIF beyond the year's end, the Office of Management and Budget ("OMB"), the Congressional Budget Office ("CBO"), the General Accounting Office ("GAO") and a House subcommittee have made projections that raise serious questions regarding BIF's health.

The OMB estimated that BIF will lose $6.1 billion through 1993,[78] even if bank premiums continue to rise.[79] Under these projections, BIF will show an accrual balance of $5.3 billion by September 30, 1993 and have a reserve ratio of only 0.22%.[80] While the FDIC views these figures as "pessimistic" and "possible, but not likely,"[81] the "projections are doubly alarming when you realize that they are based on economic assumptions that do not include a recession."[82]

The CBO's estimates are slightly more optimistic. Assuming that BIF's premiums remain at their 1991 level, the CBO estimated that BIF would show twelve billion dollars in net income by 1993 and would have both a twelve billion dollar accrual balance and a 0.50% reserve ratio by 1995.[83] BIF's cash on hand, however, would decrease to about seven billion dollars. The low cash balance reflects the increasing amount of assets that the FDIC would acquire from case resolutions.[84] Furthermore, the CBO estimates do not include "additional potential liabilities . . . that could result from previous case resolutions."[85] The CBO report indicates that these commitments, which stem from FDIC guarantees made when transferring assets to acquiring institutions, could require additional cash outlays of about eight billion dollars.[86] Additionally, like the OMB's estimates, the CBO's figures do not account for the slower economic growth that the CBO itself admitted seemed likely[87] and has in

Times, Mar. 22, 1991, at D6, col. 1, indicating that it may be predicting that BIF will have a zero or negative cash balance by the end of the year. *See* Labaton, *Big Loan Is Proposed For F.D.I.C.*, N.Y. Times, Feb. 26, 1991, at D1, col. 6.

78. *See A More Pessimistic View of Bank Deposit Insurance Fund*, N.Y. Times, Oct. 11, 1990, at D2, col. 1.

79. The OMB assumed that the premium would rise from the 19.5 cents scheduled for 1991 to 23 cents in 1992 and 1993. *See id.* at D2, col. 4.

80. *See id.* at D2, col. 3.

81. *Id.* at D2, col. 2 (quoting Mr. Roger Watson, research director of FDIC).

82. *Id.* at D2, col. 3 (quoting Rep. Annunzio, the chairman of the House Banking Financial Institutions Subcommittee).

83. *See* Reischauer Senate Testimony, *supra* note 32, at 7.

84. *See id*; *see also* figure 2.

The CBO is predicting that the amount of asset acquisitions will continue to rise. *See* Reischauer Senate Testimony, *supra* note 32, at 7. When the FDIC manages a failed bank, it acquires assets other than cash from its liquidation. While these assets are not part of the FDIC's available cash resources, they are included in BIF's balance. *See* Mid-Year Report, *supra* note 31, at 5. For example, the FDIC owns 12% of the Dallas Cowboys, *see Deposit Insurance Hearings I*, *supra* note 12, at 17 (statement of Rep. Annunzio), and, although the team is probably not generating much income, the value of the asset is included in BIF's balance.

85. Reischauer Senate Testimony, *supra* note 32, at 14.

86. *See id.*; *see also* figure 2.

87. *See* Reischauer Senate Testimony, *supra* note 32, at 13.

CBO ESTIMATES OF 1995 BIF CONDITION

FIG. 2

* Based on additional liabilities CBO believes BIF might incur.
Sources: Statement of Robert D. Reischauer, Director, Congressional Budget Office Before the Senate Comm. on Banking, Housing, and Urban Affairs (Sept. 12, 1990) (Congressional Budget Office press release).

fact occurred.[88] Finally, the CBO warned that the failure of a single large bank[89] or any loss greater than one percent of insured deposits[90] could exhaust the fund's cash resources.[91]

The GAO indicated that while BIF was not technically insolvent, under a " 'more realistic [accounting] standard,' " several billion dollars should have been reserved as liabilities.[92] Such a reserve would have depleted BIF's 1989 accrual balance.[93] The GAO's study noted that the FDIC's calculations did not reflect the eight billion dollars that may be needed to repurchase assets from the acquisitions of southwestern

88. *See* Murray, *White House's Forecast Admits U.S. is in Recession*, Wall St. J., Jan. 2, 1991, at A3, col. 1; Rosenbaum, *The White House Agrees: It's a Recession*, N.Y. Times, Jan. 3, 1991, at D1, col. 3.

89. *See* Reischauer Senate Testimony, *supra* note 32, at 17.

90. *See* Statement of Robert D. Reischauer, Director, Congressional Budget Office, Before the House Comm. on Banking, Finance and Urban Affairs 5 (Sept. 26, 1990) (Congressional Budget Office press release) [hereinafter Reischauer House Testimony].

91. *See id.*; Reischauer Senate Testimony, *supra* note 32, at 17.

92. *See* Labaton, *A Bleaker Forecast Made For U.S. Fund That Insures Banks*, N.Y. Times, Sept. 12, 1990, at A1, D4, col. 1, 4 (quoting testimony by Comptroller General Bowsher).

93. *See id.* at A1, col. 1.

banks.[94] Nor did the calculations include the $4.4 billion to $6.3 billion that will be required to cover claims on deposits in thirty-five large banks that have failed, are likely to fail, or will require assistance in the next year.[95] Disagreeing with the GAO's forecast, Mr. Seidman, the FDIC chairman, said that "[t]he G.A.O. figures had looked at potential losses without considering the income [BIF] would be getting from the sale of assets at failed institutions and the rise in premiums."[96] Mr. Seidman further asserted that BIF "will be able to meet its obligations."[97]

By far the gloomiest forecast was presented in a May 1990 study commissioned by the House Financial Institutions Supervision, Regulation and Insurance Subcommittee.[98] The study estimated that if bank premiums remained at their current level of 19.5 cents per $100 in deposits, BIF would have approximately twenty-eight billion dollars to resolve failed banks over the next three years.[99] If the premiums rise to twenty-three cents, BIF would have thirty-one billion dollars in resources over the next three years.[100] Using these estimates, the study explored whether this amount of money would be sufficient to cover the costs of expected failures.[101]

Three possible three-year scenarios, each based on a different level of recession, were simulated.[102] Under the "highest" level, the researchers assumed that all the banks in the country would suffer the same level of deterioration as the Texas banks experienced and determined that BIF would face costs between twenty-eight and sixty-three billion dollars.[103] Under the "middle" scenario, all banks would suffer the same deterioration level as the New England banks experienced through June 30,

94. *Hearings on the Bank Industry Condition Before the Senate Comm. on Banking, Housing and Urban Affairs*, 101st Cong., 2d Sess. 7-8 (Sept. 11, 1990) [hereinafter *Industry Condition Hearings*] (statement of Mr. Bowsher, United States Comptroller General) (LEXIS, Nexis library, Fednews file).

95. *See id.* at 7.

96. Labaton, *A Bleaker Forecast Made For U.S. Fund That Insures Banks*, N.Y. Times, Sept. 12, 1990, at D4, cols. 4-5.

97. *Id.* at D4, col. 5; *see also* Bacon, *Bank Insurance Fund '90 Losses Put at $4 Billion*, Wall St. J., Dec. 12, 1990, at A2, col. 2 (despite increased loss estimates, Seidman continues to assert that BIF has adequate assets).

98. *See Hearings on the Bank Insurance Fund Before the Financial Institutions Supervision, Regulation and Insurance Subcomm. of the House Banking Committee*, 101st Cong., 2d Sess. 3 (Dec. 17, 1990) [hereinafter *Bank Insurance Fund Hearings*] (statement by Rep. Annunzio) (LEXIS, Nexis library, Fednews file).

The study was completed by Dr. R. Dan Brumbaugh, Jr., Dr. Robert E. Litan, and Professor James Barth, all of whom correctly forecast the problems currently being faced by the savings-and-loan industry. *See id.* at 4, 11 (statement by Rep. Annunzio).

99. *See id.* at 14 (statement by Mr. Litan).

100. *See id.*

101. *See id.*

102. *See id.* at 17.

103. *See Bank Insurance Fund Hearings*, *supra* note 98, at 17 (statement by Mr. Litan).

1990,[104] and BIF would require twenty-five to fifty billion dollars to resolve failures.[105] Finally, under the "mildest" scenario, which assumes a slight recession,[106] BIF would face expenses in the range of twenty to forty-three billion dollars.[107]

Because the authors believe that their calculations are conservative,[108] they estimate that BIF's actual expenses will likely fall in the "midpoint to high range" of their calculations.[109] This means that BIF would require revenue of thirty-one to forty-three billion dollars to cover its expenses adequately.[110] Several factors support this contention that BIF's costs will be at the high end of the estimates. First, one of the study's authors noted that the estimates were based on "reported accounting data, recent FDIC closure rates and recent FDIC closure costs"[111] even though experience with the savings-and-loan crisis indicates that these figures underestimate actual costs.[112] Second, at least two large banks have recently been able to raise their capital to levels considered healthy by regulators by improving their earnings with "one-time extraordinary gains"[113] that only serve "to obscure deterioration through accounting."[114] Third, the authors used data from June 30, 1990 and the "numbers seem to be getting worse since then."[115] Fourth, because the country has entered a recession, the discrepancy between the true market value and the book value of assets is probably growing.[116] Finally, unlike the late 1980s when most of the failed banks were small, today's problems are "heavily concentrated"[117] in the large banks, and therefore it is likely that more failures will occur in these larger banks than indicated in the scenarios.[118] Thus, the combined effect of these factors on the models supports the conclusion that the true costs to BIF over the next three years will likely be towards the higher end of the ranges.

Thus, the House-commissioned study concluded that even if the assessments were to rise, "bank resolution costs . . . would clearly exhaust [BIF's] resources."[119] Because BIF "will be out of cash,"[120] the authors

---

104. *See id.* This scenario assumes a deterioration of the industry approximately one-third less severe than was experienced in Texas. *See id.*

105. *See id.*

106. This scenario assumes that the recession will be half as severe as experienced in New England. *See id.*

107. *See id.*

108. *See id.* at 12 (statement by Mr. Brumbaugh); *id.* at 16 (statement by Mr. Litan).

109. *Id.*

110. *See id.* at 17.

111. *Id.* at 12 (statement by Mr. Brumbaugh).

112. *See id.*

113. *Id.*

114. *Id.* at 13.

115. *Id.* at 16 (statement by Mr. Litan).

116. *See id.*

117. *Id.*

118. *See id.* at 16-17.

119. *Id.* at 19 (statement by Mr. Barth). *Compare supra* note 110 and accompanying

suggest that BIF is already insolvent.[121]

While the eulogies for BIF may be premature, the present state of the commercial banking industry serves only to amplify concerns that BIF will be depleted and require taxpayer assistance, rather than to assuage those concerns.[122] The news from individual large banks, for example, has been grim.[123] Although the failure of just one large bank could pose

text (BIF expected to incur $31 to $43 billion in expenses) *with supra* note 100 and accompanying text (BIF would have $31 billion in available resources).

120. *Bank Insurance Fund Hearings, supra* note 98, at 34 (statement by Mr. Litan).

121. *See id.* at 11 (statement by Mr. Brumbaugh).

122. Nothing brings the state of the banking industry "closer to home" than trying to find a cash machine in the formerly "branch-rich" Pennsylvania Station in New York City. Of the three banks that had branches in the Long Island Railroad pavilion, no branches remained open in October 1990.

123. For example, in October 1990, one of the nation's large banking companies, the Bank of New England, announced losses of $123.2 million in the third quarter of 1990. *See* Quint, *Bad Loans Up in New England Bank Loss*, N.Y. Times, Oct. 20, 1990, at 29, col. 3. These losses raised the company's total losses over the last year to $1.44 billion and lowered its shareholder capital to about 1.1% of its assets. *See id.*

In December 1990, reports began to circulate that the Treasury was helping the Bank of New England by placing more than one billion dollars in the bank. *See* Gerth, *Treasury Helping New England Bank With Big Deposits: Over $1 Billion in Cash*, N.Y. Times, Dec. 13, 1990, at A1, col. 2. *But see* Bacon, *U.S. Denies Report It's Propping Up Big Boston Bank*, Wall St. J., Dec. 13, 1990, at A9, col. 3. In early January, the bank announced that it expected a large fourth quarter loss and would have no funds to absorb future loan losses. *See* Quint, *Bank of New England Sees Loss, Pushing it to the Brink of Failure*, N.Y. Times, Jan. 5, 1991, at 1, col. 4. The losses totalled $450 million, resulting in total losses of $653 million for the year. *See* Bacon & Suskind, *U.S. Recession Claims Bank of New England as First Big Victim*, Wall St. J., Jan. 7, 1991, at A6, col. 4. The bank's nonperforming assets totalled over three billion dollars. *See id.* On January 6, 1991, to stem a run of over one billion dollars in withdrawals, *see* Labaton, *U.S. is Taking Over a Group of Banks to Head off a Run*, N.Y. Times, Jan. 7, 1991, at A1, col. 6, the FDIC announced the seizure of the bank and stated that all deposits, including those over $100,000, would be covered. *See F.D.I.C. Statement on Bank of New England*, N.Y. Times, Jan. 7, 1991, at D8, cols. 5-6; *see also* Ravo, *No Lines Before 9 A.M. Outside Hartford Bank*, N.Y. Times, Jan. 8, 1991, at D8, col. 5 (run apparently halted with FDIC seizure).

Meanwhile, Chase Manhattan Bank, one of the New York money-center banks, was forced to cut five thousand jobs, trim its dividend by more than 50% and add one billion dollars to its reserves to cover its mounting loan losses. *See* Bleakley, *Chase Manhattan Cuts Dividend, Staff, Presaging More Bad News in Banking*, Wall St. J., Sept. 24, 1990, at A3, cols. 2-3; Feder, *Chase Manhattan to Cut 5,000 Jobs and Trim Dividend*, N.Y. Times, Sept. 22, 1990, at 1, col. 4; *see also* Hilder, *Chase May Take Big Charge-offs of Its Loans*, Wall St. J., Nov. 19, 1990, at C9, cols. 1-2 (indicating that Chase continues to experience problems with its loan portfolio); Quint, *Chase Says Its Losses Will Rise*, N.Y. Times, Nov. 17, 1990, at 31, col. 3 (same).

In the fourth quarter of 1990, Chase's earnings increased by 10%. *See* Hilder & Pulliam, *Loan Weakness Hinders Profit at 3 Big Banks*, Wall St. J., Jan. 15, 1991, at A4, col. 1. This gain was boosted by a six billion dollar asset sale, however. *See id.* Furthermore, Chase's non-performing loans, *excluding* loans to less developed countries and foreclosed real estate, increased 18.3% in the quarter, and Chase charged off $230 million against its domestic loans, nearly double that of the year earlier. *See id.*

Citicorp, the nation's largest banking company, announced a 38% decline in earnings and set aside $283 million for possible losses on its commercial loans, up from only $59 million a year ago. *See Citicorp, Big Banks Post Modest Profits; Wells Fargo and Banc a serious threat to BIF's solvency,[124] the woes of the banking industry are not limited to a few banks.[125] There are over one thousand banks on the government's problem bank list, representing about twelve percent of the industry.[126] Other indicators similarly demonstrate the industry's

---

One Stand Out, Wall St. J., Oct. 17, 1990, at A2, cols. 3-4; Quint, *Citicorp Earnings Drop 38%*, N.Y. Times, Oct. 17, 1990, at D1, col. 6.

Furthermore, in October 1990, a Citicorp auction of 49-day securities nearly failed. *See* Bleakley, *Citicorp Forced To Boost Rate On Share Issue*, Wall St. J., Oct. 23, 1990, at A4, col. 3; Gilpin, *Citicorp's Debt Auction Nearly Fails*, N.Y. Times, Oct. 23, 1990, at D1, col. 6. Under Citicorp's variable-rate preferred issues, there must be sufficient bids at auction to yield at or below 120% of the rate of double-A commercial paper to match the offers to sell; otherwise, the auction is considered failed and all the existing holders are paid the maximum rate. *See* Bleakley, *Citicorp Forced To Boost Rate On Share Issue*, Wall St. J., Oct. 23, 1990, at A4, col. 3; Gilpin, *Citicorp's Debt Auction Nearly Fails*, N.Y. Times, Oct. 23, 1990, at D1, col. 6. To prevent a recurrence of a near failure, Citicorp changed its rules to permit payments of up to 16.25% interest on its preferred stock. *See* Bleakley, *Citicorp Again Raises Issue's Rate*, Wall St. J., Oct. 25, 1990, at C1, col. 2; Norris, *A Costly Citicorp Move to Win Over Investors*, N.Y. Times, Oct. 25, 1990, at D1, cols. 4-5. To this end, in its October 24, 1990 auction, Citicorp paid 12.5% interest, which is two times the double-A commercial paper rate. *See* Bleakley, *Citicorp Again Raises Issue's Rate*, Wall St. J., Oct. 25, 1990, at C1, col. 1; Norris, *A Costly Citicorp Move to Win Over Investors*, N.Y. Times, Oct. 25, 1990, at D1, cols. 4-5. The following week, the rate continued to rise, reaching 13%. *See* Bleakley, *Citicorp's Rate on Preferred Stock Increases Again*, Wall St. J., Nov. 1, 1990, at C18, col. 3. Rather than continue paying high rates, Citicorp decided to redeem some shares. *See* Bleakley, *Citicorp to Redeem Preferred Shares Amid Talk it Seeks $1 Billion in Capital*, Wall St. J., Nov. 8, 1990, at A3, col. 2; Quint, *Citicorp to Redeem Some Stock*, N.Y. Times, Nov. 8, 1990, at D1, col. 6. In addition, Citicorp has sought foreign capital. *See* Hylton, *Citicorp to Offer Shares Abroad*, N.Y. Times, Nov. 12, 1990, at D5, cols. 4-6; Bleakley, *Citicorp to Redeem Preferred Shares Amid Talk it Seeks $1 Billion in Capital*, Wall St. J., Nov. 8, 1990, at A3, col. 2.

As a result of anticipated continued problems with Citicorp's real estate and leveraged loan portfolio, Standard and Poor's Company downgraded the bank's debt one notch. *See* Bleakley, *S&P Lowers Debt for Citicorp*, Wall St. J., Nov. 6, 1990, at A8, col. 1. Citicorp subsequently posted "a fourth quarter loss of $300 million to $400 million stemming largely from increased commercial loan loss reserves." Hilder, *Citicorp to Post 4th-Quarter Loss of Over $300 Million, Cut Payout*, Wall St. J., Dec. 19, 1990, at A3, col. 1-3; *see* Quint, *Biggest U.S. Bank Retrenches Again*, N.Y. Times, Dec. 19, 1990, at A1, col. 5. During this period, Citicorp increased its loan-loss reserves by $979 million, *see* Hilder, *Loan Provisions Spur Losses at Citicorp, 2 Other Banks*, Wall St. J., Jan. 16, 1991, at A2, col. 1-2, including a 31% increase in its consumer loan-loss provisions. *See id.* at A2, col. 2.

124. The $11.4 billion in BIF would not be enough to cover the deposits of a failed bank one sixth the size of Chase Manhattan. *See* Byron, *The Bad-News Banks*, N.Y. Mag., Oct. 8, 1990, at 16.

125. In December 1990, a management consultant from McKinsey & Company contended that 1.5% of the banks are so weak that the FDIC should close them. *See* Quint, *Experts Suggest Cures for an Ailing Bank System*, N.Y. Times, Jan. 1, 1991, at 42, col. 3. He further calculated that nine percent of the industry, holding $300 billion in assets, would need assistance to prevent its failure during a recession and that the next twelve percent of the industry, with $400 billion in assets, has been severely weakened by bad loans. *See id.* at 42, cols. 3-4.

126. The FDIC mid-year report indicated that there were 1,034 problem banks, or 12.5% of all BIF-insured banks. *See* Mid-Year Report, *supra* note 31, at 2; *see also*

decline.[127]

Industry Condition Hearings, *supra* note 94, at 8 (statement by Mr. Bowsher) (indicating concern regarding the number of problem banks).

Additionally, some troubled banks are not included on the problem list. For example, the Bank of New England, *see supra* note 123, received assistance without ever appearing on the problem bank list. *See Industry Condition Hearings*, *supra* note 94, at 25 (statement by Mr. Bowsher).

Authorities apparently take comfort in the fact that the industry is not facing the widespread failures that were seen during the S&L crisis. *See, e.g.*, Felsenfeld, *The Savings and Loan Crisis—Yet Another Analysis*, in Annual Survey of Financial Institutions and Regulation, The S&L Crisis: Death and Transfiguration, 59 Fordham L. Rev. S7, S40 (1991) (commercial banks, in contrast to savings associations, are healthy); Labaton, *Banking's Limited Crisis*, N.Y. Times, Dec. 27, 1990, at A1, col. 1 (authorities reject crisis in commercial banks because fewer banks in jeopardy); Quint, *Four Formulas for Avoiding the Mess in Banking*, N.Y. Times, Dec. 23, 1990, § 3, at 4, col. 1 ("[b]ut only" about 1,000 of the commercial banks are in enough trouble to be labeled by regulators as "problems"). The problem, however, may be that although there is not the widespread collapse of an industry as was seen in the S&L crisis, both the size of the average failed banking institution and the cost of resolution may be greater. *See supra* note 74; *see also Bank Insurance Fund Hearings*, *supra* note 98, at 3 (statement by Rep. Annunzio) ("While the causes of the bank and savings and loan insurance fund troubles may be different, the results could be exactly the same. Namely, a taxpayer bail out . . ."); *id.* at 4 (statement by Rep. Wylie) ("there is sufficient evidence that [BIF] is in the same position as FSLIC was in [the] mid-1980s"); Schmitt, *Brumbaugh Returns to Bedevil Bank Regulators with New Study*, Wall St. J., Dec. 17, 1990, at B6, cols. 2-3 (research director for the U.S. League of Savings Institutions sees "eerie similarities" between the S&Ls and banks).

127. In the second quarter of 1990, banks earned a total of $5.3 billion, $1.7 billion less than in the second quarter of 1989, and provisions for loan losses were two billion dollars above 1989's second quarter totals, reaching $6.4 billion. *See* Sandy, *'Quarterly Banking Profile' Released by FDIC*, [Bulletin 6] Control of Banking (P-H) ¶ 6.4, at 9 (Sept. 14, 1990). Additionally, the commercial bank industry's return on assets was 0.64% in the second quarter, compared with the 0.88% return in the second quarter of 1989. *See id.*

It also appears that the real estate problems that plagued the banks in the Northeast have spread to the mid-Atlantic states. *See id.* Overall, the industry's total non-current real estate loans increased by $3.2 billion over last year, representing a 13% increase. *See id.* at 10. Furthermore, there are indications that the real estate market will continue to worsen. *See* Hylton, *Real Estate Woes Seen Worsening*, N.Y. Times, Nov. 19, 1990, at D1, col. 6. This downturn has and will continue to hurt bank loan portfolios. *See* Pacelle, *Citicorp Says Delinquent Home Loans Rose to $1.1 Billion in Third Quarter*, Wall St. J., Nov. 21, 1990, at A6, cols. 1-3; Quint, *Mortgage Woes Rise At Citicorp*, N.Y. Times, Nov. 21, 1990, at D1, col. 6; Hylton, *Real Estate Woes Seen Worsening*, N.Y. Times, Nov. 19, 1990, at D1, col. 6; *see also* Quint, *A Crystal Ball for Banking's Ills*, N.Y. Times, Jan. 12, 1991, at 33, col. 4 (" 'The commercial real estate market is in a free fall, and in the past few weeks it appears that the rate of decline has actually accelerated' . . . . 'It does not bode well for the banks . . . .' ") (quoting Thomas Hanely, banking analyst at Salomon Brothers). These predictions were borne out in the third quarter of 1990.

During the third quarter of 1990, banks reported that they had earned $3.75 billion, down 29% from the second quarter. *See* Bacon, *Bank Insurance Fund '90 Losses Put at $4 Billion*, Wall St. J., Dec. 12, 1990, at A2, col. 2; Labaton, *$4 Billion Loss Seen by F.D.I.C.*, N.Y. Times, Dec. 12, 1990, at D1, col. 3. The outlook for the fourth quarter remains bleak, with real estate loans remaining the main problem. *See* Bacon, *Bank Insurance Fund '90 Losses Put at $4 Billion*, Wall St. J., Dec. 12, 1990, at A2, col. 2; Labaton, *$4 Billion Loss Seen by F.D.I.C.*, N.Y. Times, Dec. 12, 1990, at D1, col. 3.

In addition to the real estate problems, the bank industry's consumer lending portfolios are also weakening. *See* Lowenstein, *Consumers May Not Cure Banks' Woes*, Wall St. J., Dec. 21, 1990, at C1, col. 3. Not only is the growth of these profit-rich loans slowing, *see*

For example, the banking industry's loan portfolios are worse now than when the country was coming out of its last major recession.[128] The FDIC reported that the industry's non-performing loans grew to over sixty billion dollars by mid-1990.[129] By September 1990, non-current bank loans had reached $89.6 billion, which represents 2.65% of total bank assets.[130] This level of non-current loans is the highest since 1982, when such data was first reported.[131] Further, a bank analyst for Salomon Brothers estimated that "problem loans"[132] at the end of 1989 represented 2.6% of total loans and would rise to 3.5% by the end of 1990.[133] Although a non-performing loan will not necessarily prove to be a bad loan, the dramatic rise in the value of non-performing assets does present questions about the industry's well-being and the potential costs to BIF.

These sobering statistics concerning the health of the banking industry, combined with the gloomy estimates of the fund's current solvency, have spurred Congress to consider numerous proposals for deposit-insurance reform in order to prevent further BIF decreases and a potential taxpayer bailout.

II. PROPOSALS FOR REFORM

Various authorities have proposed over a dozen reforms to ease the financial stress on the banking industry and BIF.[134] The proposals range

id. at C1, cols. 3-4, but the charge-offs for consumer loans have also been increasing. *See id.* at C2, cols. 3-4; *see also* Pacelle & Castro, *Banks Scrutinize Some Consumer Debt*, Wall St. J., Dec. 14, 1990, at A2, cols. 2-4 (rising delinquencies on consumer loans causing banks to be more cautious).

128. *See* Norris, *Can Banks Survive a Recession?*, N.Y. Times, Sept. 26, 1990, at D1, col. 4; *see also* Seidman I, *supra* note 53, app. I at fig. 2 (graph of net charge-offs of total loans of insured commercial banks, 1961 through 1989, inclusive); Lohr, *Banking's Real Estate Miseries*, N.Y. Times, Jan. 13, 1991, § 3, at 1, col. 2 (" 'Our banks are going into this recession weaker than they have been since the 1930's.' ") (quoting James Barth, finance professor).

129. *See* Byron, *The Bad-News Banks*, N.Y. Mag., Oct. 8, 1990, at 16 (chart).

130. *See* Bacon, *Bank Insurance Fund '90 Losses Put at $4 Billion*, Wall St. J., Dec. 12, 1990, at A10, col. 1.

131. *See id.*

Additionally, banks appear less able to deal with increasing loan losses as their reserves have fallen to 73 cents, a 10 cent decrease from a year ago, for each dollar of non-current loans. *See id.*

132. "Problem loans include those listed as nonperforming, which normally means payments are overdue or likely to become so, and loans renegotiated to provide breaks for the borrower, as well as real estate loans on foreclosed property." Norris, *Can Banks Survive a Recession?*, N.Y. Times, Sept. 26, 1990, at D1, col. 4.

In an attempt to soften the appearance of these problems, some banks have been reclassifying renegotiated loans as performing, *see* Suskind, *Some Banks Use Accounting Techniques That Conceal Loan Woes, Regulators Say*, Wall St. J., Nov. 29, 1990, at A4, cols. 2-3, although such loans may still cause a drain on earnings. *See id.* at A4, col. 3.

133. *See* Norris, *Can Banks Survive a Recession?*, N.Y. Times, Sept. 26, 1990, at D1, col. 4.

134. *See infra* notes 138-389 and accompanying text; *see, e.g.*, Labaton, *Congress Takes First Step to Buoy Deposit Insurance*, N.Y. Times, Jan. 4, 1991, at D1, col. 1 (legislators

from minor modifications to major structural changes in both the industry and the federal deposit-insurance system and include drastically reducing the insurance coverage and overhauling the entire banking industry.[135] Each option has advantages and disadvantages and none

---

introduced "flurry" of legislation to overhaul BIF and banking industry); Anders, *Here's How Banks Just Might Recover*. . ., Wall St. J., Nov. 12, 1990, at B7C, cols. 1-3 (various opinions on reforming banking system); Wayne, *Key Man at Banking's Crossroads*, N.Y. Times, Nov. 8, 1990, at D9, cols. 3-6 (administration considering proposals for bank reform); Chernow, *The Menace of the Small Bank*, Wall St. J., Oct. 31, 1990, at A14, cols. 3-6 (urging reform of bank system); Atkinson, *Pressure Mounts for International Deposit Insurance Coverage*, Am. Banker, Sept. 27, 1990, at 2 (reporting budget office citing 20 proposals for reform).

The following bills are some of those introduced during the first month of the 1991 Congressional session:

Bill Number	Description	Citation
H.R. 6	separate chartering and regulatory functions, unify regulatory functions under a single agency, limit discretion of regulators, eliminate "too-big-to-fail," and authorize risk-based premiums	*See* 137 Cong. Rec. H43-45 (daily ed. Jan. 3, 1991) (statement by Rep. Gonzalez).
H.R. 15	recapitalize BIF, restructure regulatory system and reform the industry	*See* 137 Cong. Rec. H54 (daily ed. Jan. 3, 1991) (statement by Rep. Wylie).
H.R. 31	recapitalize BIF	*See* 137 Cong. Rec. H758 (daily ed. Jan. 29, 1991) (statement by Rep. Annunzio).
H.R. 679	limit insurance to $100,000 per-person for any 36-month period	*See* 137 Cong. Rec. H780 (daily ed. Jan. 29, 1991) (statement by Rep. Conte).
S. 261	permit risk-based premiums, require annual examinations of every bank, and eliminate "too-big-to-fail"	*See* 137 Cong. Rec. S1159, S1160 (daily ed. Jan. 24, 1991) (statement by Sen. Dixon).
S. 263	modernize and reform financial services and strengthen enforcement authority of regulators	*See* 137 Cong. Rec. S1160, S1161 (daily ed. Jan. 24, 1991) (statement by Sen. Dixon).
S. 274	modify procedures for approving deposit insurance and require implementation of risk-based premiums	*See* 137 Cong. Rec. S1220 (daily ed. Jan. 29, 1991) (statement by Sen. Graham).
S. 280	include foreign deposits in assessment base, require risk-based premiums and curtail regulatory discretion	*See* 137 Cong. Rec. S1235 (daily ed. Jan. 29, 1991) (statement by Sen. Dole).

On March 20, 1991, the Treasury Department introduced its "sweeping proposal to overhaul the banking system." Labaton, *Congress Gets Bush Bank Plan*, N.Y. Times, Mar. 21, 1991, at D6, col. 6. The bill is 317 pages long, *see id.*, and proposes "to reform the Federal deposit insurance system, to improve the supervision and regulation to federally insured depository institutions, to reform the financial services industry as to the activities in which that industry may engage, to consolidate the regulatory structure for depository institutions, to recapitalize [BIF], and for other purposes." 137 Cong. Rec. H1912 (daily ed. Mar. 20, 1991) (statement by Rep. Gonzalez).

135. As an indication that any valid proposal was open for discussion, Representative Gonzalez, chairman of the House Banking Committee, declared, while announcing the

solves all of the problems. For this reason, some of the options have been introduced in varying combinations as well as by themselves.[136]

To facilitate analysis of these options, the proposals have been grouped into three categories based upon the particular goal of the reform.[137] The proposals attempt either to replenish BIF, to reduce the potential liability of BIF or to initiate structural reform of either the deposit-insurance system or the banking industry. All the proposals have the ultimate goal of preventing the need for a taxpayer bailout of BIF and the banking industry.

A. *Replenishing the Insurance Fund*

The aim of the reforms within this category is to provide BIF with sufficient funds to deal with whatever bank failures occur.

1. Increased Premium Flexibility

The first proposal focuses on increasing the FDIC's discretion in determining BIF assessments. All variants of this proposal are based on lifting the ceilings on the assessment premiums that the FDIC charges insured banks.[138] For instance, during the last Congressional session, both the House of Representatives[139] and the Senate[140] considered legislation to give the FDIC greater discretion to raise premiums and to permit the FDIC to set assessments twice a year[141] rather than annually.[142]

The passage of premium reform would not necessarily mean that premiums would be raised.[143] In fact, FDIC Chairman Seidman has indi-

---

opening of hearings on the deposit-insurance system, that "Congress should not regard the $100,000-per-account insurance as a divine right." *Panel to Consider Deposit Insurance Overhaul*, L.A. Times, Feb. 15, 1990, at D2, col. 3. A reform of the scope of deposit insurance was previously considered "too hot to handle." *Id.*

136. For example, see bills cited *supra* note 134.

137. This will cause artificial problems because, for the most part, suggestions for reform include several of the proposals working together. An analysis of every possible combination, however, would be impossible given the scope of this Note.

The regulators have urged Congress to restructure the industry and the deposit insurance system simultaneously, arguing that the two are "inextricably linked." Congress, however, points only to the urgent need for deposit-insurance reform, apparently believing that industry reform is not as pressing. *FDIC Endorses Administration Proposal to Let Agency Hike Insurance Premiums*, 55 Banking Rep. (BNA) No. 13, at 521 (Oct. 1, 1990).

138. *See* FIRREA, *supra* note 1, § 208, 103 Stat. at 206-09 (to be codified at 12 U.S.C. § 1817).

139. *See* H.R. 5610, 101st Cong., 2d Sess., 136 Cong. Rec. 7653, 7658 (1990).

140. *See* S. 3045, 101st Cong., 2d Sess., 136 Cong. Rec. 13099 (1990); *see also FDIC Endorses Administration Proposal to Let Agency Hike Insurance Premiums*, 55 Banking Rep. (BNA) No. 13, at 520 (Oct. 1, 1990) (noting that S. 3045 is similar to the House legislation).

141. *See* H.R. 5610 § 2, 101st Cong., 2d Sess., 136 Cong. Rec. 7653, 7653 (1990).

142. *See* FIRREA, *supra* note 1, § 208(4)(1)(A)(i), 103 Stat. at 207 (to be codified at 12 U.S.C. § 1817(b)(1)(A)(i)).

143. *See* 136 Cong. Rec. H7654 (daily ed. Sept. 17, 1990) (statement of Rep. Gonzalez).

cated that he does not believe that premiums will need to be raised for the time being.[144] Nonetheless, the enactment of such legislation would provide the FDIC with immediate flexibility to increase premiums, presumably increasing BIF's revenue, replenishing BIF and covering the expenses of more failures before needing to tax the public.[145] In addition, the proposal's proponents argue that premium ceilings should be lifted because "[t]he existence of the premium ceiling creates false expectations that deposit insurance will be cheap, regardless of the underlying risks."[146]

There is strong concern, however, that pressures to increase BIF's net worth, combined with the proposals' added flexibility, would lead to a large premium increase, thereby potentially causing even more bank failures. Federal Reserve Chairman Alan Greenspan, for example, has warned that the FDIC "can create problems for the American taxpayer by having premiums that are . . . too high . . . . If we set the premiums too high, we can induce more bankruptcies. The banks would then fall back on the F.D.I.C. and the taxpayers would be worse off."[147] Similarly, a study released by the CBO concluded that while premiums would have to rise to forty-three cents[148] to get BIF to the level considered "safe" by Congress,[149] a premium this high could cause forty large banks to fail.[150]

A White House proposal goes further than the aforementioned Congressional plan and includes two additional key provisions.[151] First, the plan would amend the laws requiring the FDIC to rebate a portion of a

144. *See* Labaton, *Lawmakers Rushing to Lift Caps on F.D.I.C. Premiums*, N.Y. Times, Sept. 13, 1990, at D8, col. 4.

Roger Watson, an FDIC official, indicated that although the FDIC has no increase currently planned, if the pace of bank failures escalates, the FDIC would consider raising the premium for one year to as high as 50 cents. *See* Bleakley, *FDIC May Assess One-Time Premium If the Pace of Bank Failures Increases*, Wall St. J., Nov. 5, 1990, at A2, cols. 3-4.

145. *See* Reischauer House Testimony, *supra* note 90, at 12.

146. 136 Cong. Rec. H7182 (daily ed. Sept. 5, 1990) (statement of Rep. Gonzalez); *see also Bank Insurance In S.E.C. Study*, N.Y. Times, Mar. 30, 1991, at 26, col. 4 (SEC study concluded that the value of bank deposit insurance is worth three to five times current premiums).

147. Labaton, *Greenspan Urges Cautious Moves to Shore Up the Banking System*, N.Y. Times, Sept. 14, 1990, at D2, cols. 5-6 (quoting Greenspan).

148. *See* Labaton, *Treasury Urges Restrictions on Bank Deposit Insurance*, N.Y. Times, Sept. 27, 1990, at D2, col. 1.

149. This assumes that Congress considers the "target" level of the FIRREA legislation as the "safe" level of the fund. *See* FIRREA, *supra* note 1, § 208(4)(1)(B)(i), 103 Stat. at 207 (to be codified at 12 U.S.C. § 1817(b)(1)(B)(i)).

150. *See* Labaton, *Treasury Urges Restrictions on Bank Deposit Insurance*, N.Y. Times, Sept. 27, 1990, at D2, cols. 1-2.

151. *Compare supra* notes 139-142 and accompanying text (discussing House version of the proposal) *with infra* notes 152-155 and accompanying text (discussing key additions in the White House plan). *See also FDIC Endorses Administration Proposal To Let Agency Hike Insurance Premiums*, 55 Banking Rep. (BNA) No. 13, at 520 (Oct. 1, 1990) (discussing Administration's proposal).

bank's assessment,[152] leaving rebate determinations to the FDIC's discretion. This proposal would permit the FDIC to consider the need to build up BIF's reserves to "withstand future periods of unusual stress."[153] Additionally, the Administration proposal would authorize the FDIC to obtain loans from the Federal Financing Bank ("FFB")[154] in order to provide cheaper, short-term working capital for the fund.[155] This provision would give the FDIC the flexibility *not* to raise premiums in a particular year as long as the fund's long-term prospects were positive.

The Administration proposal provides increased protection for BIF. Chairman Seidman expressed his approval for the provision removing mandatory rebates and noted that BIF would have thirty billion dollars in reserves and "would clearly not be under stress today" if rebates had not previously been required.[156] Also, the provision permitting BIF to be replenished by FFB loans is advantageous because it permits the fund to experience short-term losses without increasing fees and needlessly saddling an industry experiencing temporary difficulties with additional problems.

Despite the merits of the above proposals, FDIC Chairman Seidman stressed that flexibility to increase premiums is not the sole answer to all of the insurance fund's problems because the higher assessments that such flexibility allows would further weaken the banking industry.[157] Because banks pass higher premiums on to their customers through higher fees for services,[158] higher premiums may threaten the industry's ability to compete against nondepository institutions, such as money markets and mutual funds, and further strain the viability of the industry.[159] Additionally, if BIF is truly in crisis, simply increasing rate-setting discretion may raise future revenue, but will not provide the necessary

152. Current law requires that rebates be issued if the insurance fund maintains certain ratio levels. *See* FIRREA, *supra* note 1, § 208(5)(d)(2)(A)-(B), 103 Stat. at 210-11 (to be codified at 12 U.S.C. § 1817(d)(2)(A)-(B)).

153. *FDIC Endorses Administration Proposal to Let Agency Hike Insurance Premiums*, 55 Banking Rep. (BNA) No. 13, at 520 (Oct. 1, 1990).

This action would also increase BIF's interest income because the fund's balances would be larger. *See supra* note 45 and accompanying text.

154. The FFB purchases and sells obligations on behalf of federal agencies. *See* 12 U.S.C. § 2285 (1988).

The Administration's banking reform bill, *see supra* note 134, calls for an increase in the FDIC's borrowing authority to seventy billion dollars. *See* Labaton, *U.S. Seeks Much Bigger Amount to Shore Up Bank Deposit Fund: Plans to Authorize Borrowing Up to $70 Billion*, N.Y. Times, Mar. 22, 1991, at A1, cols. 1, 2.

155. *See FDIC Endorses Administration Proposal to Let Agency Hike Insurance Premiums*, 55 Banking Rep. (BNA) No. 13, at 520 (Oct. 1, 1990).

156. *Id.*

157. *See Hearings on Deposit Insurance Reform Before the House Banking Comm.*, 101st Cong., 2d Sess. 8 (Sept. 25, 1990) [hereinafter *Reform Hearings*] (statement of Mr. Seidman) (LEXIS, Nexis library, Fednews file).

158. *See* Reischauer House Testimony, *supra* note 90, at 10.

159. *See id.* at 12.

immediate cash infusion.[160] Finally, no matter how much insurance premiums increase, the nature of insurance makes it inevitable that BIF cannot be healthy unless the insured industry is healthy. Therefore, while granting premium discretion to the FDIC may be part of the answer, it is only one step towards appropriate reform.

2. Recapitalization

Responding to concerns that BIF "is teetering on the brink of insolvency. . . . [and] too thinly capitalized to deal with potential bank failures,"[161] Representative Annunzio has suggested that every FDIC-insured bank be required to pay an amount equal to one percent of its deposits into the fund.[162] The plan would immediately raise twenty-five billion dollars for BIF.[163] Representative Annunzio hopes that this would prevent the taxpayers from having to bail out BIF. He predicts that under the plan, BIF's reserve ratio immediately would rise to

160. The Administration proposal, however, handles this problem by permitting the FDIC to get FFB financing. *See supra* note 155 and accompanying text.

161. *See* 136 Cong. Rec. H7655-56 (daily ed. Sept. 17, 1990) (statement of Rep. Annunzio).

162. *See id.*; *see also* H.R. 5590, 101st Cong., 2d Sess., 136 Cong. Rec. 7502 (1990) (introduction of bill).

The Bush administration initially considered a similar plan that would require banks to purchase preferred stock from the FDIC. *See* Bacon, *Administration Weighs Plan on FDIC Stock*, Wall St. J., Nov. 28, 1990, at A3, col. 1. The plan involved requiring the banks to purchase FDIC stock in an amount equivalent to one-half to one percent of their total deposits. *See id.* Although using a different mechanism, the Annunzio and Administration plans are functionally equivalent and the following analysis applies to both.

A recapitalization plan was also under consideration by the Treasury as part of its banking package and included levying a one-time special assessment on the industry of $25 billion. *See* Bacon, *Treasury Mulls Charging Banks Additional Fee*, Wall St. J., Jan. 3, 1991, at C8, col. 6. Apparently, the final Treasury proposal was not expected to address how to recapitalize the deposit-insurance funds. *See* Bacon, *Big Banks Would Get Vastly Broader Powers Under Treasury's Plan*, Wall St. J., Feb. 6, 1991, at A6, col. 1; Labaton, *Administration Presents its Plan for Broad Overhaul of Banking*, N.Y. Times, Feb. 6, 1991, at D6, col. 4. Instead, the Treasury expected the FDIC and bankers to formulate their own plan. *See id.*; *see also* Labaton, *Bankers Offer Their Plan to Bolster Insurance Fund*, N.Y. Times, Feb. 12, 1991, at D1, col. 1 (bankers offer proposal to borrow money from industry through sale of bonds). The final version of the Treasury's bill, however, does include a provision to recapitalize BIF by granting the FDIC the authority to borrow up to twenty-five billion dollars from the FFB. *See* Thomas, *New Banking Rules to Provide Means to Bolster FDIC*, Wall St. J., Mar. 19, 1991, at A26, col. 1; *see also* Labaton, *U.S. Seeks Much Bigger Amount to Shore Up Bank Deposit Fund*, N.Y. Times, Mar. 22, 1991, at A1, col. 1 (FDIC Chairman Seidman states that the Administration's plan actually permits the FDIC to borrow $70 billion). This borrowing proposal is very similar to a plan that was originally proposed as part of an Administration plan increasing premium flexibility. *See supra* notes 154-155 and accompanying text.

163. *See* 136 Cong. Rec. H7656 (daily ed. Sept. 17, 1990) (statement of Rep. Annunzio).

The Administration's stock purchase plan, *see supra* note 162, had it been implemented, was expected to produce $14 to $28 billion. *See* Bacon, *Administration Weighs Plan on FDIC Stock*, Wall St. J., Nov. 28, 1990, at A3, col. 1.

1.70%.[164] Such a cash inflow would clearly improve the fund's financial condition without the need to resort to the taxpayers.

Of major concern to the regulators, however, is how the recapitalization payment would be treated from an accounting standpoint.[165] If the payments to BIF were carried as an asset,[166] the banks would in effect be making an equity investment in the FDIC.[167] Thus, if the fund lost money, the value of bank assets would be reduced accordingly. This result might discourage risky activities because deposit insurance losses would be reflected directly on the banking industry's books.[168]

This approach, however, is nothing more than a clever system of permitting the banks to count the same money twice: once on their own books and again in computing BIF's balance.[169] Treating the payment as an asset might also have negative implications as to the FDIC's ability to control BIF.[170] The Federal Savings and Loan Insurance Corporation ("FSLIC") accrued a secondary reserve consisting of premium prepayments between 1961 and 1973.[171] The secondary reserve was treated as an asset on the industry's books.[172] Even after FSLIC recognized the increasing costs it was facing and accordingly ordered a write-off of the reserve fund,[173] Congress nevertheless ordered the recapitalized fund to issue rebates to the thrifts, shifting the costs of the industry's collapse from the industry to the taxpayers.[174] Thus, the possibility exists that long after the present crisis has passed, a banking industry facing increasing financial difficulties could successfully lobby Congress to order the

---

164. *See Panel Warned to Wait on Annunzio BIF Bill, But Seidman Says it Has Some Merit*, 55 Banking Rep. (BNA) No. 13, at 526 (Oct. 1, 1990).

165. Chairman Seidman stated, "One of the important issues raised by [the proposal] is the accounting treatment [of the assessment]." Statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation, on H.R. 5590, Bank Account Safety and Soundness Act Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs 3 (Sept. 27, 1990) (Federal Deposit Insurance Corporation press release) [hereinafter Seidman II]; *see also Panel Warned to Wait on Annunzio BIF Bill, But Seidman Says it Has Some Merit*, 55 Banking Rep. (BNA) No. 13, at 526 (Oct. 1, 1990) (discussing concern of regulators about the accounting standard).

Under the Administration's proposed stock purchase plan, *see supra* note 162, it was never resolved whether the stock would have been treated as part of the banks' capital. *See* Bacon, *Administration Weighs Plan on FDIC Stock*, Wall St. J., Nov. 28, 1990, at A10, col. 3.

166. Thus, the payment would also be considered part of a bank's capital.

167. *See* Seidman II, *supra* note 165, at 3.

168. *See id.*

169. Lawrence White suggests that this would permit the banks to "have their cake and eat it too." White, *How Not to Save the FDIC*, Wall St. J., Jan. 8, 1991, at A14, col. 4. He argues that the plan is "outright double-counting," *id.*, and merely a "smoke-and-mirrors approach" for dealing with a serious financial problem. *Id.* at A14, col. 5.

170. *See* Seidman II, *supra* note 165, at 3-4.

171. *See House Panel Probes Depletion, Possible Restoration of FSLIC Secondary Reserve*, Daily Rep. for Executives (BNA) No. 114, at A-1 (June 16, 1987).

172. *See id.*

173. *See id.*

174. *See* Seidman II, *supra* note 165, at 3-4.

FDIC to return "the banks' money,"[175] claiming that the funds are needed to prevent the failure of individual organizations. Chairman Seidman warned that if asset accounting was adopted, the possibility of this scenario would lead to increased uncertainty about the availability of the insurance fund's resources in critical times.[176]

On the other hand, if the BIF recapitalization was treated as an expense, like current premium payments, the deposits in BIF would have the advantage of not being attachable by bank creditors in the event of a bankruptcy.[177] This approach, however, would cause an immediate decrease in bank capital. The FDIC fears that banks "subject to a large one-time loss . . . may have difficulty restoring capital levels."[178]

Apart from the accounting dispute, it is unlikely that the weakened banking industry could support Annunzio's recapitalization plan. The assessment would be expected to produce twenty-five billion dollars, nearly double the total bank earnings of 1989.[179] This comparison strongly suggests that the industry may not have the resources to handle a one-year recapitalization.[180] Chairman Seidman indicated that Annunzio's plan "would drive 28 additional banks into insolvency, and [make another] 241 banks . . . capital-deficient."[181] Although he deems the bill to have " 'great merit,' " he said it should be enacted only as a " 'drastic step' " because it " 'would throw the entire industry into a loss.' "[182]

175. This argument was exactly the one that the thrifts used. *See House Panel Probes Depletion, Possible Restoration of FSLIC Secondary Reserve*, Daily Rep. for Executives (BNA) No. 114, at A-2 (June 16, 1987). In 1987, an officer of the Association of Thrift Holding Companies stated, "The bank board has stolen our money." *Id.*

176. *See* Seidman II, *supra* note 165, at 3-4.

177. *See Panel Warned to Wait on Annunzio BIF Bill, But Seidman Says it Has Some Merit*, 55 Banking Rep. (BNA) No. 13, at 526-27 (Oct. 1, 1990).

178. Seidman II, *supra* note 165, at 4.

179. Bank earnings in 1989 were $15.7 billion. *See id.* at 5.

180. *See id*; *see also* White, *How Not to Save the FDIC*, Wall St. J., Jan. 8, 1991, at A14, col. 5 (current credit crunch makes it a bad time to ask banks to contract their assets).

Additionally, the industry earned only about 60 cents per $100 of deposits during the first three quarters of 1990. *See* Labaton, *Added Bank Fees Suggested to Aid Insurance System*, N.Y. Times, Dec. 18, 1990, at A1, col. 3.

In an attempt to soften the impact of the proposal, the Treasury's recapitalization plan includes the possibility for payments and write-offs to be stretched over a five-year period. *See* Bacon, *Treasury Mulls Charging Banks Additional Fee*, Wall St. J., Jan. 3, 1991, at C8, col. 6.

181. Seidman II, *supra* note 165, at 4-5.

182. *Panel Warned to Wait on Annunzio BIF Bill, But Seidman Says it Has Some Merit*, 55 Banking Rep. (BNA) No. 13, at 526 (Oct. 1, 1990) (quoting FDIC Chairman Seidman).

Recently, Chairman Seidman has decided the time for drastic measures has arrived. He acknowledged that BIF is " 'so weak that it needs to be recapitalized.' " Labaton, *$5 Billion '91 Loss Seen for U.S. Fund Insuring Deposits*, N.Y. Times, Dec. 17, 1990, at A1, col. 6; *see* Labaton, *Added Bank Fees Suggested to Aid Insurance System*, N.Y. Times, Dec. 18, 1990, at A1, col. 3. Furthermore, Chairman Seidman has decided that the assessment " 'would add only marginally to bank failures and failure-resolution costs.' " *Id.*

GAO Assistant Comptroller General Richard L. Fogel similarly voiced doubts about how much money the industry could be asked to pay.[183] While Comptroller of the Currency Robert Clarke opined that the plan was a "constructive effort to maintain the strength of the deposit insurance fund," he expressed apprehension about the plan, stating that it should only be considered as a part of broad deposit-insurance reforms.[184] In sum, placing a significant cost on the banking industry when banks are under considerable stress could have unpredictable, even disastrous, consequences.

B. *Reducing BIF's Potential Liability*

The objective of proposals in this category is to reduce the level of BIF's potential liability by decreasing the level of insured deposits. Thus, for any particular bank failure, the FDIC and the insurance fund would have to pay out less money. Any such reform, however, must neither destabilize the industry nor induce bank runs.

1. Eliminating "Too-big-to-fail"

"Too-big-to-fail," a concept identified and labelled during the 1984 rescue package arranged for Continental Illinois National Bank and Trust Company,[185] refers to troubled banks that are allegedly too large for the FDIC to close. When a bank fails, the FDIC may rescue the bank by arranging for another institution to acquire the bank's liabilities, both insured and uninsured,[186] or by providing direct financial assistance.[187] Despite the express $100,000 limit on deposit insurance,[188] all the bank's deposits are protected under the too-big-to-fail approach. It is currently estimated that "better than 99 percent of all deposits are effectively insured" by too-big-to-fail.[189] Thus, many proposals to lower BIF's potential liability call for the elimination of too-big-to-fail.[190]

The FDIC claims, however, that it does not have a too-big-to-fail pol-

---

183. *See Panel Warned to Wait on Annunzio BIF Bill, But Seidman Says it Has Some Merit*, 55 Banking Rep. (BNA) No. 13, at 526, 527 (Oct. 1, 1990).

184. *Id.* at 526.

185. *See* 136 Cong. Rec. H7656 (daily ed. Sept. 17, 1990) (statement of Rep. Annunzio).

Because of the assistance package, the FDIC never officially considered Continental Illinois "failed." *See id.*

186. The account may be uninsured because of the nature of the account or because it is greater than the $100,000 insurance limit.

187. *See* Seidman I, *supra* note 53, at 9.

188. *See* 12 U.S.C. § 1821(a)(1) (1988).

189. 136 Cong. Rec. H7183 (daily ed. Sept. 5, 1990) (statement of Rep. Annunzio); *see also* Bacon, *Treasury Plan to Favor Easing Bank Oversight*, Wall St. J., Dec. 7, 1990, at A4, col. 1 ("The FDIC has covered 99.5% of the deposits of banks that have failed since 1985.").

190. *See* Bacon, *White House Plan Seeks to Reduce Scope of 'Too Big to Fail' Protection for Banks*, Wall St. J., Dec. 20, 1990, at A18, col. 5.

In most cases, the only depositors that are limited by the $100,000 ceiling are those in icy.[191] Rather, Chairman Seidman explained that "the FDIC has a belief that the possible failure of a large financial organization presents macroeconomic issues of considerable significance, and that these macroeconomic considerations cannot be legislated away."[192] Unfortunately, this explanation appears to be a distinction without a difference.[193] In essence, while there may not be a de jure too-big-to-fail policy, there is a de facto one.[194]

Chairman Seidman justified his position that reform legislation should not explicitly prohibit a too-big-to-fail approach on three grounds. First, he contended that the government has a duty to consider the economy-wide ramifications of a large bank failure.[195] Second, he argued that adhering to too-big-to-fail is actually cheaper than permitting an institution to fail and paying off the depositors.[196] Therefore, a proposal to prevent

---

small banks that the Government liquidates rather than sells. *See* Duke, *S&L Mess May Spark A Thorough Overhaul of Deposit Insurance*, Wall St. J., July 3, 1990, at A5, col. 1.

When the FDIC closed Freedom National Bank, a small community bank in Harlem, New York, it initially covered only deposits up to the $100,000 insurance level. In closing the Bank of New England, however, the FDIC fully covered all depositors. This led the New York State Attorney General to complain about the disparity of treatment between depositors at the two banks. *See Abrams Faults F.D.I.C. Action*, N.Y. Times, Jan. 8, 1991, at D8, col. 1. Subsequently, the FDIC announced it may consider making *full* reimbursement to the uninsured depositors, suggesting that even depositors at small banks would not face an insurance limit. *See* Castro, *FDIC May Cover Freedom National Deposits in Full*, Wall St. J., Jan. 11, 1991, at A5C, col. 3.

One of the major points of contention concerning the Treasury Department's banking proposal is that the plan does not eliminate too-big-to-fail. *See* Bacon, *Banking Industry Attacks Bush Plan to Reform Deposit Insurance System*, Wall. St. J., Feb. 13, 1991, at A2, col. 3; Bacon, *Big Banks Would Get Vastly Broader Powers Under Treasury's Plan*, Wall St. J., Feb. 6, 1991, at A6, col. 2. The proposal, however, would place the "too-big-to-fail" decision in the hands of the Treasury Department and Federal Reserve Board instead of the FDIC. *See* Labaton, *White House Proposes Curbs on Insured Deposits*, N.Y. Times, Feb. 3, 1991, § 1, at 28, col. 6.

191. *See* Seidman I, *supra* note 53, at 8.

192. *Reform Hearings*, *supra* note 157, at 8 (statement of Rep. Wylie quoting FDIC Chairman Seidman).

193. *Compare* Testimony, L. William Seidman, Chairman, Federal Deposit Insurance Corporation, on Deposit Insurance Revision and Financial Services Restructuring Before the House Comm. on Banking, Finance and Urban Affairs 15 (Sept. 25, 1990) (Federal Deposit Insurance Corporation press release) [hereinafter Seidman III] ("the FDIC does not in fact have a Too Big To Fail policy") *with* Seidman I, *supra* note 53, at 10 ("Too Big To Fail as an issue would exist even in the absence of an explicit deposit insurance program.").

194. Chairman Seidman indicated that "[p]ast experience in all major countries supports the contention that a Too Big To Fail policy exists, de facto if not de jure." Seidman I, *supra* note 53, at 11.

195. *See id.* at 10.

196. *See Reform Hearings*, *supra* note 157, at 8-9 (statement of Chairman Seidman). Chairman Seidman explained that the FDIC

> make[s] a calculation of what it will cost [the FDIC to] close the institution down, fail it, pay off depositors, and . . . the alternative too-big-to-fail transaction with someone buying out whatever parts of the institution they want. And that calculation comes to a bottom line . . . . In almost all cases it's been found cheaper to cover all depositors, and that's why we cover all depositors in almost all bank failures.

the use of too-big-to-fail could actually cause a larger drain on BIF.[197] Finally, the absence of such a policy could cause massive withdrawals of uninsured deposits, further straining the solvency of a troubled bank.[198]

By recognizing the reality that some banks are simply too big to fail, this policy protects the economy from severe disturbances. Thus, too-big-to-fail cannot be eliminated and any deposit insurance reform aimed at reducing the coverage of federal deposit insurance must acknowledge this reality.

2. Reducing the $100,000 Per Account Coverage

The "most prominent proposals"[199] for reducing BIF's potential liability suggest lowering the insurance ceiling below the current $100,000 per account[200] or restricting coverage to the individual as opposed to the account.[201]

Representative Gonzalez suggested that the $100,000 deposit insurance ceiling[202] is not a "divine right"[203] and that Congress should consider reducing the coverage.[204] First, Representative Gonzalez suggested that there was little justification for increasing the insurance ceiling from $40,000 to $100,000:[205] he recalled the proposal to increase the ceiling being passed in less than fifteen minutes, with fewer than fifteen members present and with no discussion, debate or hearings at any time.[206] Addi-

---

Id. at 9.

197. The Treasury Department backs the FDIC position, agreeing that regulators should continue to have discretion in handling bank collapses that jeopardize the entire financial system. *See* Labaton, *Treasury Urges Restrictions on Bank Deposit Insurance*, N.Y. Times, Sept. 27, 1990, at D2, col. 3.

198. For example, prior to the FDIC's seizure of the Bank of New England and its announcement that it was going to cover all deposits, *see F.D.I.C. Statement on Bank of New England*, N.Y. Times, Jan. 7, 1991, at D8, col. 6, over one billion dollars was withdrawn in a two-day period. *See* Labaton, *U.S. Is Taking Over a Group of Banks to Head Off a Run*, N.Y. Times, Jan. 7, 1991, at A1, col. 6.

199. Reischauer House Testimony, *supra* note 90, at 11.

200. *See* 12 U.S.C. § 1821(a)(1) (1988) (amended by FIRREA, *supra* note 1, §§ 201(a)(1), 211, 103 Stat. at 187, 218-22).

201. It is questionable whether there is a limit at all, given "too-big-to-fail." *See supra* notes 185-198 and accompanying text.

The Treasury Department has decided not to propose that Congress lower the $100,000 insurance limit, but would probably propose limits on the number of accounts that can be insured. *See* Labaton, *Shifts in Deposit Insurance Weighed*, N.Y. Times, Nov. 29, 1990, at D8, col. 6.

202. *See* 12 U.S.C. § 1821(a)(1) (1988) (amended by FIRREA, *supra* note 1, §§ 201(a)(1), 211, 103 Stat. at 187, 218-22).

203. *Panel To Consider Deposit Overhaul*, L.A. Times, Feb. 15, 1990, at D2, col. 3.

204. *See* 136 Cong. Rec. H7183 (daily ed. Sept. 5, 1990) (statement of Rep. Gonzalez).

205. The insurance limit was raised by the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 308(a)(1), 94 Stat. 132, 147.

206. *See* 136 Cong. Rec. H7183 (daily ed. Sept. 5, 1990) (statement of Rep. Gonzalez); *see also* Note, *Causes of the Savings and Loan Debacle*, in Annual Survey of Financial Institutions and Regulation, The S&L Crisis: Death and Transfiguration, 59 Fordham L. Rev. S301, S307-08 (1991) (discussing problems with deposit insurance).

tionally, because the average account balance is only about $8,700[207] and eighty to eighty-five percent of account holders have less than ten thousand dollars in a bank,[208] the goal of deposit insurance to protect the small depositor who does not have the means to investigate the soundness of the institution would be maintained with a lower ceiling.[209] A system of lower coverage would encourage banks to be more prudent because large account investors would only deposit their funds at financially sound institutions.

Chairman Greenspan agreed that the $100,000 level of coverage may not be justifiable, but maintains that "whatever the merits of the 1980 increase in the deposit insurance level . . . the higher level of depositor protection has been in place long enough to be . . . incorporated into the financial decisions of millions of households [and] . . . a wide variety of bank . . . decisions."[210] Therefore, lowering coverage would reduce the banks' market values and involve large transaction costs. Thus, if Congress lowers the limits, it must also provide "a meaningful transition period."[211]

On the other hand, Mr. Greenspan testified that a decision to leave the limit at $100,000 would not "preclude other reforms that would reduce current inequities in, and abuses of" deposit insurance, such as limiting insurance coverage to $100,000 per individual.[212] As the system currently stands, it is possible for an individual to be insured in excess of the $100,000 limit by keeping several different accounts[213] or as the beneficiary of a large account.[214] The major concern with proposals to limit

207. *See* 136 Cong. Rec. H7183 (daily ed. Sept. 5, 1990) (statement of Rep. Gonzalez).

208. *See id.*

209. *Id.*

210. Testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, Before the House Comm. on Banking, Finance and Urban Affairs 4 (Sept. 13, 1990) (Board of Governors of the Federal Reserve System press release) [hereinafter Greenspan Testimony].

211. *Id.* at 4-5.

212. *Id.* at 5-6.

213. *See* 136 Cong. Rec. H7183 (daily ed. Sept. 5, 1990) (statement of Rep. Gonzalez). In the Freedom National Bank failure, however, the FDIC treated multiple accounts of a single depositor as a single account. *See* Strom, *Charities Face Large Losses in Failed Bank*, N.Y. Times, Nov. 19, 1990, at B1, col. 6. This was contrary to the expectations of many depositors, *see id.*, and apparently of Representative Gonzalez. While the FDIC may consider covering some, *see* Bacon, *FDIC Might Pay Freedom National Charity Depositor*, Wall St. J., Jan. 17, 1991, at B8, cols. 2-3, or all of the Freedom National Bank depositors, *see* Castro, *FDIC May Cover Freedom National Deposits in Full*, Wall St. J., Jan. 11, 1991, at A5C, col. 3, several groups have filed a lawsuit against the FDIC claiming that they were never told that the insurance limit was per-depositor rather than per-account. *See* Lambert & Stevens, *Charity, Religious Groups Sue FDIC Over Freedom National Accounts*, Wall St. J., Jan. 21, 1991, at B6, col. 2.

214. *See* Greenspan Testimony, *supra* note 210, at 6. In determining the coverage of an account held in trust, *each* beneficiary of the account is insured up to $100,000.

The Treasury Department's banking reform plans propose a per-individual, per-bank $100,000 account plus one retirement account (for a total of $200,000) limit on insurance. *See* Labaton, *A Proposal to Limit F.D.I.C.*, N.Y. Times, Feb. 5, 1991, at D23, col. 6; Labaton, *White House Proposes Curbs on Insured Deposits*, N.Y. Times, Feb. 3, 1991, § 1, insurance by individual rather than by account is whether such a system could be effectively implemented and policed.[215] Specifically, any per-individual proposal would have to consider the extra reporting burdens placed on individual institutions, the extensive record-keeping imposed on the FDIC, and the privacy and security issues raised by maintaining records necessary to police per-individual limits.[216]

More importantly, any form of insurance coverage reduction, whether the imposition of a lower ceiling or the imposition of a per-individual limit, may lead to "increased instability in banking markets."[217] These proposals might, for example, encourage large depositors to withdraw their money from banks, thus causing runs of uninsured deposits.[218] The overall cost of financial services to the economy would then increase[219] and United States banks would correspondingly compete less favorably in the international market.[220] Additionally, the existence of too-big-to-fail[221] prompts small banks to oppose most plans to reduce deposit-insurance coverage.[222] They argue that depositors would believe that deposits in large banks would continue to be fully protected regardless of the rules. This would cause small banks to lose depositors[223] and would erode the competitive balance between the two groups of institutions.[224]

3. "Haircut" Coverage

The American Bankers Association ("ABA") has presented a deposit-insurance reform proposal that gives depositors a "haircut."[225] Under

at 28, col. 5. The plan also includes a proposal to study implementing a nationwide limit over five years. *See* Labaton, *A Proposal to Limit F.D.I.C.*, N.Y. Times, Feb. 5, 1991, at D23, col. 6; Labaton, *White House Proposes Curbs on Insured Deposits*, N.Y. Times, Feb. 3, 1991, § 1, at 28, col. 5.

215. *See, e.g.*, Greenspan Testimony, *supra* note 210, at 6 (Federal Reserve Board's concerns about the costs and complexity of the proposal); Reischauer House Testimony, *supra* note 90, at 11 (expressing CBO's concerns about implementing a per individual limit).

216. *See* Seidman III, *supra* note 193, at 15.

217. *Id.*

218. *See* Greenspan Testimony, *supra* note 210, at 6; Reischauer House Testimony, *supra* note 90, at 11.

There might even be runs on insured deposits based solely on rumor. For example, the Old Stone Corporation was subject to a run on deposits, even though it was perfectly healthy, after a CNN story on Rhode Island bank failures used a branch of Old Stone as a backdrop. *See* Lohr, *Troubled Banks and the Role of the Press*, N.Y. Times, Feb. 18, 1991, at 33, col. 2.

219. *See* Reischauer House Testimony, *supra* note 90, at 12.

220. *See* Seidman III, *supra* note 193, at 15.

221. *See supra* notes 185-198 and accompanying text.

222. *See Panel to Consider Deposit Insurance Overhaul*, L.A. Times, Feb. 15, 1990, at D2, col. 4.

223. *See* Duke, *S&L Mess May Spark A Thorough Overhaul of Deposit Insurance*, Wall St. J., July 3, 1990, at A5, col. 1; *Panel to Consider Deposit Insurance Overhaul*, L.A. Times, Feb. 15, 1990, at D2, col. 4.

224. *See* Seidman III, *supra* note 193, at 15.

225. The ABA's proposal actually includes many provisions in addition to the

the proposal, which contemplates too-big-to-fail as a foregone conclusion, *all* uninsured depositors, i.e., depositors with accounts over $100,000, would be forced to suffer a loss, whether or not the bank was too big to fail.[226] The proposal calls for approximately five to fifteen percent[227] to be shaved off[228] FDIC reimbursements of any amount over $100,000.[229] Thus, if the haircut percentage was ten percent, a person with $200,000 in an account would recover only $190,000.[230]

This proposal has several benefits. First, it recognizes political realities. Congress is fearful of alienating the politically strong bankers' lobby, yet is eager to limit BIF's liability.[231] Even assuming the existence of too-big-to-fail, this proposal would accomplish these goals because the FDIC would no longer fully insure large deposits and all banks would be treated equally. The FDIC has commented that the proposal "resolves many of the administrative hurdles that reduce the likelihood that losses will be imposed on uninsured depositors in major banks."[232] The proposal also encourages increased depositor discipline at a relatively modest potential depositor loss. This, in turn, should encourage prudent banking practices and discourage excessive risk.[233] Further, imposing a haircut reduces the risk of a large bank failure and helps equalize the treatment of large and small banks.[234] Finally, the proposal would minimize the costs of deposit insurance in terms of both BIF liability and the fees charged to the banking institutions.[235]

The FDIC warns, however, that the haircut proposal has serious drawbacks.[236] The first concern deals with the provision's effects on correspondent banks.[237] Banks, often as part of check-cashing arrange-

mandatory haircut. *See* Seidman I, *supra* note 53, app. II at 2. For the purposes of this Note, however, only the haircut provisions are considered.

226. *See id.* at 3.

227. The proposal calls for the percentage to be based on the FDIC's average rate of losses in past resolutions. *See id.* at 2.

228. Hence the term "haircut."

229. *See id.*; Duke, *S&L Mess May Spark A Thorough Overhaul of Deposit Insurance*, Wall St. J., July 3, 1990, at A5, col. 1.

230. This is similar to the guarantees that the Italian deposit insurance program provides. The Italian Government fully insures accounts of 200 million lira, and 75% of the next 800 million lira. *See* Sibley, *How the Europeans Do It*, Wall St. J., Aug. 29, 1990, at A6 (table); *see also id.* (discussion of European countries' deposit insurance systems).

231. *See* Duke, *S&L Mess May Spark A Thorough Overhaul of Deposit Insurance*, Wall St. J., July 3, 1990, at A1, col. 6.

232. Seidman I, *supra* note 53, app. II at 3.

233. *See* Greenspan Testimony, *supra* note 210, at 7; Seidman I, *supra* note 53, app. II at 3.

234. *See* Seidman I, *supra* note 53, app. II at 3.

235. *See id.*

236. *See id.* at app. II at 4-5, 15-18.

237. A correspondent bank is "[a] larger bank that sells its service(s) to other, smaller respondent banks or financial institutions from which it receives fees or compensating balances." American Bankers Ass'n, Banking Terminology 27 (2d ed. 1985) (emphasis omitted).

ments, have accounts at other banks.[238] This is especially true of smaller banks that usually hold correspondent balances at the large banks in their district in order to clear checks.[239] The FDIC predicts that if the haircut proposal is adopted, the smaller banks would potentially face losses that could cause bank runs, liquidity crises or insolvency.[240]

The ABA counters that because banks only incur losses that are a percentage of their total uninsured balance, the actual impact on the net worth of a depositing bank would be de minimis.[241] The ABA contends that if a ten percent haircut had been in place at the time of the Continental Illinois resolution,[242] only two banks would have suffered losses exceeding fifty percent of their capital and none would have been rendered insolvent.[243] The FDIC refutes this contention, however, noting that check-clearing systems involve large amounts of money and that if an economic downturn affected a region, a small bank might not be able to find a completely safe bank for its check-clearing services.[244] Furthermore, the agency argues that a small community bank could be rendered insolvent if it were forced to move its check-clearing business from one failing bank to another, each time taking a mandatory haircut.[245]

Both the FDIC and the Federal Reserve contend that the ABA plan creates incentives for runs on uninsured depositors.[246] If a particular bank fails in a distressed region, depositors at other regional banks might fear that their banks are in danger of failing, perhaps based solely on rumor, and withdraw their monies.[247] Thus, the FDIC claims that while the ABA system would protect runs of small depositors, which are not threatening to an institution, it would expose the industry to runs on healthy institutions by large uninsured depositors.[248] The ABA, on the

---

238. *See* Seidman I, *supra* note 53, app. II at 4.

239. *See id.*

240. *See id.*

241. *See id.*

242. The ABA suggests that one reason the FDIC implemented "too-big-to-fail" in resolving Continental Illinois was because a large number of banks, 976, had deposits over $100,000. *See id.*

243. *See id.*

244. *See id.* app. II at 4-5.

The FDIC acknowledges, in a footnote, that small banks could utilize the Federal Reserve for check clearing. *See id.* app. II at 5 n.2. The FDIC argues, however, that check clearing is a profitable business for the larger banks and that it is inappropriate to further weaken a distressed regional bank by eliminating such business. *See id.*

245. The FDIC report notes that during a three-year period, nine of the ten largest banks in Texas were closed or assisted. *See id.* app. II at 5. Thus, its scenario of a bank being rendered insolvent by taking haircuts in numerous shifts of its check processing is not unfathomable. *See id.*

246. *See* Seidman I, *supra* note 53, app. II at 6; *see also* Greenspan Testimony, *supra* note 210, at 7 (discussing the consequences of an ABA-type plan).

This point seems even more forceful in light of depositors' willingness to withdraw their funds based solely on unfounded conjecture. *See, e.g.*, *supra* note 218 (discussing run on Old Stone Bank in Rhode Island).

247. *See* Seidman I, *supra* note 53, app. II at 6.

248. *See id.*

other hand, assumes that there would be greater stability among uninsured depositors because these depositors would be certain of their potential losses.[249] The FDIC and Federal Reserve question this assumption and argue that a depositor would join a bank run so long as the transaction costs of moving funds are less than the potential losses.[250]

Thus, the haircut proposal is attractive and should remain open for discussion.[251] The potential increased instability, however, might undermine the overall goal of deposit insurance.

C. *Structural Reforms*

The six proposals included in this final category call for some structural reform in the banking industry. The first two proposals relate to operation of the insurance fund, the second two relate to the operation of the regulators and the final two relate to the operation of the banks.

1. BIF's Structure

a. *Risk-Based Assessments*

FIRREA requires federal regulators to study a system of risk-based premiums.[252] If established, risk-based premiums would establish a premium structure "that would consider asset quality risk, interest rate risk and the quality of management, profitability as well as capital" of an insured bank.[253] Unlike private insurers, who determine what level of risk to insure in setting premiums,[254] federal deposit insurance is currently unconditional;[255] that is, every insured member pays the same premium regardless of risk.[256] Thus, bankers who might otherwise be prudent are encouraged to take risks in order to remain competitive with other, more reckless, banks. Also, under the current system, all members of the banking industry pay for the risky members, rather than the risky parties paying for themselves.[257]

---

249. *See id.*

250. *See id.*; *see also* Greenspan Testimony, *supra* note 210, at 7 (arguing that similar approach would lead to increased instability).

251. Although the Treasury Department stated that it found the ABA proposal attractive and considered the idea, *see* Bacon, *Treasury Plan to Favor Easing Bank Oversight*, Wall St. J., Dec. 7, 1990, at A4, col. 2, it was not included as part of the reform proposal. *Cf.* Labaton, *Administration Presents its Plan for Broad Overhaul of Banking*, N.Y. Times, Feb. 6, 1991, at D6, col. 2-4 (table) (outlining major parts of Treasury plan).

252. *See* FIRREA, *supra* note 1, § 1001(b)(1)(A)-(B), 103 Stat. at 507 (to be codified at 12 U.S.C. § 1811(b)(1)(A)-(B)).

253. H.R. Rep. No. 54(I), 101st Cong., 1st Sess. 475, *reprinted in* 1989 U.S. Code Cong. & Admin. News 86, 271.

254. Additionally, a private insurer reviews the policy periodically to determine premium adjustments to reflect a change in insured risk. *See* Reischauer House Testimony, *supra* note 90, at 9.

255. *See id.* at 11.

256. *See* 12 U.S.C. § 1817(b) (1988) (amended by FIRREA, *supra* note 1, §§ 201(a)(1), 208(4), 208(6), 103 Stat. at 187, 207-12, 212-13).

257. In contrast, many states have an "assigned risk pool" of motor vehicle drivers.

At first glance, risk-based premiums are extremely attractive. Overly aggressive institutions would pay higher premiums commensurate with the risks they take much in the way a private insurer would charge a reckless venture higher premiums. On the other hand, a prudent operation would be able to remain competitive with risky banks because it would have lower expenses.[258]

The current risk-based premium proposals, however, have numerous drawbacks. First, they would not encourage banks to diversify their portfolios, which could lead a number of banks to invest only in a limited number of assets. If one of the limited markets collapses, the lack of diversification that risk-based premiums encourage could result in increased bank failures. In addition, Lawrence White has noted that "the science of rating investment risks [is] quite primitive."[259] Therefore, it is possible for risky investments to avoid being penalized because they are located within a broad category that is considered safe, such as commercial real estate.[260] Furthermore, if troubled institutions are charged higher premiums, their deterioration would only increase.[261]

Additionally, for such a plan to be effective, regulators must be able to evaluate various bank loan portfolios accurately, a task that even proponents of the system recognize as problematic.[262] In today's "more volatile"[263] markets, it is difficult for regulators even to determine which banks are in danger of complete failure.[264] Thus, regulators would face

The purpose of this fund is for drivers that are considered higher risks to pay higher premiums and for all drivers in this category to pay for each other's carelessness.

258. *Cf.* Reischauer House Testimony, *supra* note 90, at 10 (insurance premiums are "pass[ed] on to customers through higher fees for financial services").

259. Passell, *Banking's Reins: Too Tight and Too Loose*, N.Y. Times, Dec. 17, 1990, at D4, col. 3.

260. *See id.* at D4, cols. 3-4.

261. *See* Labaton, *Shift Asked on Bank Insurance*, N.Y. Times, Dec. 19, 1990, at D6, col. 5.

262. The proponents recognize that " 'not every risk can be quantified and that risks can change over time.' " Sandy, *Wide-Ranging Reforms Proposed to Repair Deposit Insurance*, [Bulletin 6] Control of Banking (P-H) ¶ 6.1, at 2 (Sept. 14, 1990) (quoting Rep. Henry Gonzalez, Chairman, House Banking Committee); *see also* Labaton, *Shift Asked on Bank Insurance*, N.Y. Times, Dec. 19, 1990, at D6, col. 5 (FDIC issued study in 1983 "particularly critical" of Government's ability to figure out efficient way of setting risk-based premiums); Labaton, *Treasury Urges Restrictions on Bank Deposit Insurance*, N.Y. Times, Sept. 27, 1990, at D2, col. 2 (Robert Glauber, the Under Secretary of the Treasury, acknowledging the difficulty in determining levels of risk).

263. *Deposit Insurance Hearings II*, *supra* note 53, at 17 (statement of R. Dan Brumbaugh, Jr., Senior Fellow, Stanford University Center for Economic Growth); *see also* Seidman I, *supra* note 53, app. I at 5 (volatility is on the increase).

264. *See Industry Condition Hearings*, *supra* note 94, at 12 (statement of Mr. Bowsher, United States Comptroller General).

For example, the GAO uncovered instances in which twenty-two banks failed without ever being placed on the problem list, while another nine banks were placed on the list only shortly before they failed. *See id.* at 18 (statement of Sen. Heinz).

Perhaps the regulators could take a lesson from television's David Letterman, who suggests the following guidelines:

Top Ten Signs That Your Bank is Failing

serious difficulties in gauging portfolio risks accurately in order for risk-based premiums to be successful.[265]

In an attempt to answer this particular criticism, Senator Alan Dixon introduced a bill[266] during the last Congressional session that would create a system of risk-based insurance with premiums set by private insurers.[267] Under the proposal, the FDIC would sell ten percent of the insurance risk to private insurers,[268] who would then assess the risk and set the premiums.[269] Senator Dixon hoped that the proposal would " 'guarantee that federal deposit insurance rates reflect marketplace realities.' "[270] This proposal, however, also has limitations. First, it is not clear that private insurers would participate in the program.[271] Second, the proposal assumes that private insurers are better than the regulators at assessing risk and would accurately assess risk in the banking industry. Theoretically, however, regulators are experts in banking and it is unwise to assume that private industry could successfully assess a risk better than the regulators.[272]

Overall, while the idea of risk-based assessments is appealing, there are

---

10. Free handful of Cheetos with every new account.
9. They hand out calendars one month at a time.
8. Security guard offers to walk you back to your office for five bucks.
7. Overhear branch manager muttering to himself, "I wonder if you can eat squirrel?"
6. Free giveaway toaster is made by G.E.
5. Teller machine replaced by fat guy with carton of twenties.
4. You glimpse inside the vault and notice it's stacked with empty soda bottles.
3. You deposit cash: an officer runs over, sticks it in pocket and dances around yelling, "Lordy, we're having biscuits tonight!"
2. You recognize some of the tellers as carnival people.
1. They can't change a twenty.

Late Night With David Letterman (NBC television broadcast, Jan. 9, 1990).

265. The inability of regulators to recognize *failing* banks raises serious questions about their ability to recognize risks in profitable banks.

Even experts have difficulty analyzing risks. For example, in the 1980s, many experts were positive that the oil boom would continue. The bubble burst, however, causing many Texas banks to fail. *See* Duke, *S&L Mess May Spark Thorough Overhaul of Deposit Insurance*, Wall St. J., July 3, 1990, at A5, col. 3.

266. S. 3040, 101st Cong., 2d Sess., 136 Cong. Rec. 13076-13082 (1990).

267. *See Seidman Calls For Study of Bank Investments in BIF; Bills Planned*, 55 Banking Rep. (BNA) No. 11, at 431 (Sept. 17, 1990).

268. *See id.* There are also proposals that call for restructuring the insurance system by having private insurers assume some of the FDIC's potential liability. *See infra* notes 273-293 and accompanying text. Senator Dixon's bill is one such proposal. For the purposes of this section, however, Dixon's proposal is analyzed only with respect to the use of private insurers to set the level of premium payments.

269. *See Seidman Calls For Study of Bank Investments in BIF; Bills Planned*, 55 Banking Rep. (BNA) No. 11, at 431 (Sept. 17, 1990).

270. *Id.*

271. In an attempt to solve this problem, Senator Dixon's bill includes a provision that if after eight years there are not enough participating insurers, the FDIC would loan money to the private banking industry to create a for-profit reinsurance subsidiary. *See id.*

272. *See supra* notes 262-265 and accompanying text.

serious questions about whether such proposals can be implemented productively and whether such proposals are financially sound.

b. *Private Insurers*

Some proposals would modify BIF's structure by placing some or all of the responsibility for insuring deposits in the private sector, either by supplementing or completely replacing BIF's insurance guarantee with private insurance policies.[273] The proponents argue that the proposals "preserve[] the best feature of the current insurance system—the high confidence it gives depositors in the stability of our banking system—while providing real marketplace discipline."[274] This discipline would presumably further discourage imprudent banking practices and limit BIF's potential liability.

The drawbacks of the private insurance plans, aside from pricing and administrative difficulties,[275] are numerous. The underlying problem is that "[p]rivate insurance and public responsibility unfortunately are not always compatible."[276] First, a program of private underwriters:

> would require, of course, that all relevant supervisory information—much of which is now held confidential—be shared with private insurers who would be obligated to use that information only to evaluate the risk of depositor insurance and not for the purposes of adjusting any of their own portfolio options.[277]

In addition to this potential conflict of interest, it is possible that such an extensive sharing of records could invade the right of privacy of the individual depositors or creditors.[278]

Second, the CBO warns that despite the hopes of the proponents of private deposit insurance, increased market discipline could cause withdrawals and effect bank runs.[279] This would result because market forces, while creating a more effective level of supervision, are also less forgiving in reacting to imprudent practices.[280] Moreover, the GAO suggests that private systems of insurance "have not generally been successful, because they have not had sufficient financial resources to convince the public that the insured banks were safe."[281] The recent failure of the

273. *See, e.g.*, S. 3040, 101st Cong., 2d Sess., 136 Cong. Rec. 13076-82 (bill requiring 10% of large banks' deposits be insured by private insurance); Seidman I, *supra* note 53, at 26-27 (discussing three private insurance proposals).

274. 136 Cong. Rec. S13075 (daily ed. Sept. 13, 1990) (statement of Sen. Dixon).

Other proponents even suggest that "anything short of a private insurance mechanism is doomed to fail." *Consultant Calls for Private Insurance Mechanism to Replace Federal Deposit Insurance*, 54 Banking Rep. (BNA) No. 20, at 864 (May 21, 1990).

275. *See* Seidman I, *supra* note 53, at 27.

276. Greenspan Testimony, *supra* note 210, at 8.

277. *Id.* at 7-8.

278. *See* Seidman III, *supra* note 193, at 15.

279. *See* Reischauer House Testimony, *supra* note 90, at 14.

280. *See id.*

281. Statement of Richard L. Fogel, Assistant Comptroller General, General Accounting Office, Deposit Insurance and Related Reforms Before the House Comm. on Bank-

Rhode Island private insurance system[282] amplifies this last concern[283] and has resulted in numerous bills to bar private insurance.[284]

Furthermore, it is unlikely and unreasonable to expect that private insurers would consider those macroeconomic factors that are the proper focus of deposit insurance.[285] For example, it may be more prudent, in some circumstances, to assist a troubled institution than to liquidate it. Private insurers, however, are not likely to consider this alternative.[286] Also, while "public good"[287] would sometimes suggest that all deposits should be fully reimbursed,[288] private insurers would probably pay depositors only up to the explicitly stated insurance limit.[289] Finally, although withdrawing from a distressed market would be reasonable for a private insurance company, such withdrawal would be "counterproductive" in the deposit insurance context.[290]

In short, private insurance is unlikely to relieve the Government, and consequently the taxpayer, from potential liability.[291] An underwriting error or a systematic industry failure would cripple insurance companies' ability to pay their policies and ultimately taxpayers would continue to remain liable.[292] The proposals would fail to lessen the Government's supervisory role as well: to continue to control improper activity, any decreased supervision of the banks would be counterbalanced by increased supervision of the private insurers.[293]

---

ing, Finance and Urban Affairs 20 (Sept. 19, 1990) (General Accounting Office press release) [hereinafter Fogel Testimony]; *see also Hearings on Deposit Insurance Reform Before the House Banking, Finance, and Urban Affairs Comm.*, 101st Cong., 2d Sess. 8 (Feb. 21, 1990) (commenting that the Ohio attempt at private deposit insurance failed and that no system of private insurance has been successful).

282. *See* Bradsher, *45 Credit Unions and Banks Shut by Rhode Island*, N.Y. Times, Jan. 2, 1991, at A1, col. 3; Ingrassia, *Rhode Island Governor Closes 45 Institutions*, Wall St. J., Jan. 2, 1991, at A3, col. 4.

283. *See* Bradsher, *45 Credit Unions and Banks Shut by Rhode Island*, N.Y. Times, Jan. 2, 1991, at D2, col. 5.

284. *See* Pulliam, *U.S. and States Beginning to Draft Bills Barring Private Credit Union Insurance*, Wall St. J., Jan. 11, 1991, at A4, col. 1; *see also* Rubens, *Private Deposit Insurance Isn't the Answer*, Wall St. J., Jan. 16, 1991, at A14, cols. 3-5 (privatization of federal deposit insurance will not solve banking problems).

285. *See* Greenspan Testimony, *supra* note 210, at 8.

286. *See* Reischauer House Testimony, *supra* note 90, at 14.

287. *Id.* at 11.

288. Full protection of deposits is one of the consequences of "too-big-to-fail." *See supra* notes 185-198 and accompanying text.

289. *See* Reischauer House Testimony, *supra* note 90, at 11.

290. *See* Greenspan Testimony, *supra* note 210, at 8.

291. The failure of the Rhode Island Share and Deposit Indemnity Corporation, *see supra* notes 282-284 and accompanying text, reinforced this proposition. *See* Rubens, *Private Deposit Insurance Isn't the Answer*, Wall St. J., Jan. 16, 1991, at A14, col. 3.

292. *See id.*; Seidman I, *supra* note 53, at 27. This is likely to be the outcome in the Rhode Island private insurance failure. *See* Rubens, *Private Deposit Insurance Isn't the Answer*, Wall St. J., Jan. 16, 1991, at A14, col. 3.

293. *See* Seidman I, *supra* note 53, at 27-28.

2. Regulatory Structure

a. *Increased Supervision and Regulation*

Business people will always make bad loans and investments; nothing can prevent them from making these unwise judgments. While banking regulations may proscribe certain activities, it is only through appropriate supervision that regulations can be enforced, unsound activities restrained and losses to BIF limited. Several proposals to reform the regulatory and supervisory powers of banking regulators have been proposed, including: introduction of required annual on-site examinations, creation of a uniform dividend policy that would apply to all troubled institutions, development of a common test for evaluating loans and assigning resident examiners to all large banks.[294] Additionally, plans to streamline the current "overlapping and redundant" regulatory structure have been proposed.[295]

There is a general consensus[296] that these proposals would improve the banking regulatory structure by enhancing detection of potential problems. A conflict arises, however, in determining the level of discretion the bank regulator may exercise. There appear to be two approaches: (1) statutorily defined actions and procedures, with some regulatory flexibility or (2) maintenance of the regulator's discretion.[297]

As for the first approach, the Federal Reserve ("Fed") has stated that

---

294. *See* Testimony of L. William Seidman, Chairman, Federal Deposit Insurance Corporation, on Deposit Insurance Reform Before the House Subcomm. on Commerce, Consumer, and Monetary Affairs of the Comm. on Government Operations 6 (Oct. 3, 1990) (Federal Deposit Insurance Corporation press release) [hereinafter Seidman IV]; *see also Deposit Insurance Hearings II*, *supra* note 53, at 4 (statement of Mr. Gramling, Director, Corporate Financial Audits, Accounting and Financial Management, United States GAO) (supporting on-site examinations); Fogel Testimony, *supra* note 281, at 13 (same); Wayne, *Key Man at Banking Crossroads*, N.Y. Times, Nov. 8, 1990, at D9, cols. 4-5 (supporting examinations and dividend policy).

295. Seidman III, *supra* note 193, at 17; *see, e.g.*, Labaton, *Plan to Pare Financial Supervision*, N.Y. Times, Jan. 7, 1991, at D1, col. 6 (Treasury proposal for "super regulator"); *id.* at D8, col. 6 (Representative Gonzalez introduced bill to create "super regulator"); *see also supra* notes 16-19 and accompanying text (describing current regulatory structure).

296. The Treasury expected that its proposed plan for a "super regulator" would be backed by a consensus of the regulators. *See* Labaton, *Plan to Pare Financial Supervision*, N.Y. Times, Jan. 7, 1991, at D8, col. 2. The final plan calls for two regulatory agencies, one for state banks and one for national banks, and the removal of the FDIC as regulator. *See* Bacon, *Big Banks Would Get Vastly Broader Powers Under Treasury's Plan*, Wall St. J., Feb. 6, 1991, at D6, col. 3-4 (table). The FDIC has expressed its opposition to the removal of all its "powers to protect the insurance fund." Bacon, *Treasury's Plan to Overhaul Banking Could Diminish Fed's Regulatory Role*, Wall St. J., Feb. 8, 1991, at A4, col. 1 (quoting Chairman Seidman).

297. *See infra* notes 298-310 and accompanying text.

Compare Greenspan Testimony, *supra* note 210, at 15-17 (advocating limitation of regulatory discretion) *with* Seidman III, *supra* note 193, at 19 (discouraging reduced discretion).

supervisory responses must occur "promptly and firmly."[298] Chairman Greenspan argues that, while "some flexibility" is required, there "must be a prescribed set of responses and a presumption that these responses will be applied . . . [e]ven though prompt corrective action implies some limit on the discretion of supervisors to delay for reasons that they perceive to be in the public interest."[299] For example, the Fed suggested that, absent an affirmative act by the regulator, some statutorily dictated remedial action should be imposed when a bank fails to meet minimum required capital levels.[300] Specifically, Chairman Greenspan proposed that Congress design a system that would require regulators to initiate forced mergers, divestitures and conservatorships of inadequately capitalized institutions.[301] While current law authorizes regulators to take these actions, the power is "discretionary and dependent" upon a showing of an illegal act or some unsafe or unsound condition.[302] The Fed argues that removal of this discretion would introduce greater consistency into the banking industry and provide management with clearer notice.[303] Overall, by requiring specified standard actions, the proposal would limit the regulators' ability to allow sagging bank positions to deteriorate further.[304]

The FDIC, on the other hand, while supporting enhanced supervision,[305] argues that the savings-and-loan crisis has wrongly resulted in a "bad name" for discretion.[306] Chairman Seidman commented that the

---

298. Greenspan Testimony, *supra* note 210, at 15.

This view, explicitly defining corrective action, is also supported by Robert E. Litan of the Brookings Institution. *See* Quint, *Experts Suggest Cures for an Ailing Bank System*, N.Y. Times, Jan. 1, 1991, at 42, col. 4.

299. Greenspan Testimony, *supra* note 210, at 15; *see also* Fogel Testimony, *supra* note 281, at 12 ("To achieve earlier, more forceful intervention, the discretion available to regulators in taking actions . . . should be narrowed."); Bacon, *Quicker Regulatory Action to Combat Risky Banking Practices Urged by GAO*, Wall St. J., Mar. 5, 1991, at A18, col. 1 (GAO suggests " 'trip-wire' approach to regulation").

300. *See* Greenspan Testimony, *supra* note 210, at 15-16.

301. *See id.* at 16; *see also Regulate Banks: Less, and More*, N.Y. Times, Dec. 10, 1990, at A18, col. 2 (Treasury considering options in which *requiring* regulatory action in certain circumstances is essential).

Senator Riegle similarly proposes that "if a bank falls below its required level of capital . . . it *must* suspend dividend payments, limit its growth and file a plan to restore its financial condition. If it fails to follow the plan, then it *must* suspend bonuses to executives." Labaton, *New Banking Restrictions Are Proposed*, N.Y. Times, Mar. 6, 1991, at D1, col. 6 (emphasis added).

302. Greenspan Testimony, *supra* note 210, at 16-17.

303. *See id.* at 17.

304. *See id.* at 15; *see also* Bacon, *Bruised by the S&L Fiasco, Lawmakers Now Try to Show They are Born Again Bank Guardians*, Wall St. J., Mar. 19, 1991, at A26, col. 1 (" 'We wouldn't be facing a deposit-insurance crisis if the regulators had acted promptly to prevent bank failures, rather than allowing problem banks to fester into catastrophic failures.' " (quoting Rep. Annunzio)); *Regulate Banks: Less, and More*, N.Y. Times, Dec. 10, 1990, at A18, col. 2 ("[m]andatory intervention was missing during the 1980's," permitting savings associations to get into deeper trouble).

305. *See* Seidman III, *supra* note 193, at 18.

306. *Id.* at 19.

savings-and-loan crisis was not induced by excessive discretion, but rather by savings-and-loan regulators who acted as "cheerleaders" of the industry and abandoned their independence.[307] Chairman Seidman argued that reducing discretion would "curtail the ability of the bank supervisors to seek the least costly or least disruptive way of handling bank difficulties."[308] He believes that "supervisory discretion has contributed enormously to the stability of the financial system."[309] Additionally, the FDIC states that promptness and decisiveness can be effectively achieved in a system that permits the regulators to maintain their current level of discretion.[310]

The first approach appears to be the better alternative. It permits some flexibility while simultaneously mandating prompt action through explicitly described corrective measures. Therefore, this approach avoids the pitfalls of discretion, such as imprudently delaying action.

b. *Cross-Guarantee Provisions*

The cross-guarantee provisions,[311] originally enacted under FIRREA,[312] provide that an insured financial institution may be liable for the losses of its failed or failing affiliates. The provisions effectively indemnify the FDIC for the costs incurred in assisting or seizing the "commonly controlled"[313] insured institution.[314] This liability is expressly superior to any obligations or liabilities owed to shareholders[315] or affiliates.[316] Congress is now considering proposals to reinforce and clarify

---

307. *Id.*

308. *Id.*

309. *Id.*

310. *See id.* at 18-19.

311. The cross-guarantee provisions relate to "[a]ny insured depository institution," that is, to insured members of both SAIF and BIF. FIRREA, *supra* note 1, § 206(a)(7)(e)(1)(A), 103 Stat. at 201 (to be codified at 12 U.S.C. § 1815(e)(1)(A)).

312. *See id.* § 206(a)(7)(e), 103 Stat. at 201 (to be codified at 12 U.S.C. 1815(e)).

313. Two depository institutions are "commonly controlled" if they are controlled by the same holding company or if one institution controls the other institution. *See id.* § 206(a)(7)(e)(9), 103 Stat. at 205 (to be codified at 12 U.S.C. § 1815(e)(9)). The conditions for "control" are defined in 12 U.S.C. § 1843(f) (1988)(amended by FIRREA, *supra* note 1, §§ 603(b), 604(b), 1219, 103 Stat. at 410, 411, 546).

314. *See id.* § 206(a)(7)(e)(1)(A)(i), 103 Stat. at 201 (to be codified at 12 U.S.C. § 1815(e)(1)(A)(i)).

For example, if Banks A and B are owned by holding company C and the FDIC provides assistance to A to prevent it from failing, the FDIC may, under the cross-guarantee provisions, "bill" B for its costs. In addition, the FDIC's claims are superior to C's. *See infra* notes 315-316.

Effective May 30, 1990, the FDIC adopted a policy statement setting out guidelines that it will use in assessing liability. *See* 55 Fed. Reg. 21,935 (1990); *see also Liability Policy Set By FDIC Board on Institutions with Common Control*, 54 Banking Rep. (BNA) No. 21, at 900 (May 28, 1990) (discussing liability guidelines).

315. *See* FIRREA, *supra* note 1, § 206(a)(7)(e)(2)(C)(i)(I), 103 Stat. at 202 (to be codified at 12 U.S.C. § 1815(e)(2)(C)(i)(I)).

316. *See id.* § 206(a)(7)(e)(2)(C)(i)(II), 103 Stat. at 202 (to be codified at 12 U.S.C. § 1815(e)(2)(C)(i)(II)).

the cross-guarantee provisions, hoping to prevent a holding company from "loot[ing]" its bank operation, leaving the Government to foot the bill.[317]

FDIC Chairman Seidman expressed concern that the cross-guarantee provisions could be avoided through:

> [t]he ingenuity of lawyers . . . in that people can wait until a bank is about to fail, sell it just before it fails, and then the cross-guarantee provisions don't apply. Or they can have transactions between the holding company and the bank which have the effect of penalizing [BIF]. . . . [W]e need some loophole closing in that area.[318]

Similarly, the GAO argues that laws making a bank holding company liable for deposit-insurance costs associated with its bank entities "should definitely be implemented."[319]

Despite the concerns over loopholes in the current law, more fundamental problems with the cross-guarantee provisions exist: the current law is inherently unfair and not clearly constitutional.[320] The law permits the FDIC to impose liability on healthy institutions without regard to whether they were operated independently of the failed bank and notwithstanding the absence of fraudulent transactions.[321] This bright-line approach may lead to inequitable results in certain situations in which the law applies.

For example, the FDIC may waive cross-guarantee liability only where "the Corporation determines that such exemption is in the best interests of [BIF]."[322] A literal interpretation of the statute[323] could conceivably make a waiver based on a finding of an entity's good faith impermissible because good faith is not a permitted exception.[324] Furthermore, if an assessment of liability would only weaken, not bankrupt, a sister bank, the FDIC could easily impose cross-guarantee liability. Accordingly, the entity would be liable for a failure of a separate legal entity, without having acted to cause that failure.

Theoretically, because the FDIC waiver authority is discretionary,[325] the Corporation could cause the failure of otherwise healthy banks, as long as the FDIC finds that not waiving liability would serve the best interests of BIF.[326] In light of the tremendous political pressure caused

317. 136 Cong. Rec. H7185 (daily ed. Sept. 5, 1990) (statement of Rep. Gonzalez).
318. *Oversight Hearings*, *supra* note 19, at 9 (statement of FDIC Chairman Seidman).
319. Fogel Testimony, *supra* note 281, at 21.
320. *See infra* notes 322-337 and accompanying text.
321. *See infra* notes 322-329 and accompanying text.
322. FIRREA, *supra* note 1, § 206(7)(e)(5)(A), 103 Stat. at 203 (to be codified at 12 U.S.C. § 1815(e)(5)(A)).
323. For the moment, any constitutional challenges are ignored, but they are discussed *infra* notes 330-337 and accompanying text.
324. Accordingly, the guidelines for liability adopted by the FDIC permit waivers only if "the exemption is in the best [financial] interests of either of the insurance funds." 55 Fed. Reg. 21,934, 21,935 (1990).
325. *See supra* note 322 and accompanying text.
326. *See id.*

by the savings-and-loan bailout, the FDIC is more likely to assert cross-guarantees even where such action could ultimately result in the failure of additional banks.[327] Even if the sister bank would not fail, the guarantee provisions create a contingent risk to healthy institutions that is difficult to monitor or measure. This risk would undoubtedly lower the bank's market value.[328]

Finally, if the FDIC could show that the entities were not operated independently or that fraudulent transfers occurred, no court would have difficulty in holding the affiliate liable under traditional principles of law.[329] Absent this finding, however, the logic of cross-guarantees is elusive.

Aside from the asserted inequity of cross-guarantees, these provisions are also open to constitutional challenge. Enforcement of the cross-guarantee may constitute a taking of property without just compensation[330] in violation of the fifth amendment.[331] To date, no court has confronted this issue, apparently because the FDIC dropped the one case in which it asserted its cross-guarantee power.[332] Although the constitutional issue is implicated in cases in which the FDIC attempts to force affiliates to support an ailing bank,[333] the courts in these cases have based their decisions on statutory grounds.[334] Now that Congress has explicitly pro-

327. *See, e.g.*, Gifford, *NBW's Rescue May Be Charged to Sister Banks*, Legal Times, Sept. 24, 1990, at 11, col. 4 (suggesting the provision does not make sense when another bank is forced into insolvency).

The FDIC waiver guidelines require that an institution "must demonstrate that its viability would be *seriously* jeopardized by such liability and that the loss to the FDIC funds would be greater than the loss from the one failure." 55 Fed. Reg. 21,934, 21,936 (1990) (emphasis added).

328. This assertion rests on an economic theory that a rational purchaser carefully factors all contingencies into the value of an institution. Thus, a contingent liability would lower the price such a purchaser would be willing to pay for such an institution.

329. *See, e.g.*, Gentry v. Credit Plan Corp., 528 S.W.2d 571, 573 (Tex. 1975) ("[T]he corporate fiction may be disregarded to prevent fraud or injustice."); Zaist v. Olson, 154 Conn. 563, 573, 227 A.2d 552, 557 (1967) ("Courts will disregard the fiction of separate legal entity when a corporation 'is a mere instrumentality or agent of another corporation or individual owning all or most of its stock.' ") (quoting Hoffman Wall Paper Co. v. Hartford, 114 Conn. 531, 535, 159 A. 346, 348 (1932)).

330. *Compare* Glass, *Cross-Guarantee Is Seen as Risk to Holding Companies*, Am. Banker, July 19, 1990, at 25, cols. 2-4 (suggesting regulation may be unconstitutional) *with* Curtis, *The Takings Clause and Regulatory Takeovers of Banks and Thrifts*, 27 Harv. J. on Legis. 367, 389 (1990) (suggesting regulation is not unconstitutional).

331. *See* U.S. Const. amend. V.

332. *See* Gifford, *NBW's Rescue May Be Charged to Sister Banks*, Legal Times, Sept. 24, 1990, at 11, col. 4.

333. *See, e.g.*, Senior Unsecured Creditors' Comm. of First RepublicBank Corp. v. Federal Deposit Ins. Corp., 749 F. Supp. 758, 760 (N.D. Tex. 1990) (plaintiffs claim FDIC's action violated the United States Constitution); Curtis, *The Takings Clause and Regulatory Takeovers of Banks and Thrifts*, 27 Harv. J. on Legis. 367, 389 (1990) (noting plaintiffs in another case also raised taking issue).

334. *See, e.g.*, Mcorp Fin., Inc. v. Board of Governors Fed. Reserve Sys., 900 F.2d 852, 863 (5th Cir. 1990), *cert. granted*, 111 S.Ct. 1101 (1991) (Nos. 90-913, 90-914) (requiring a holding company to transfer assets to a troubled subsidiary is beyond the Board's statutory authority); Senior Unsecured Creditors' Comm. of First RepublicBank Corp. v. Fed-

vided for cross-guarantees, however, the Constitution provides the only basis upon which parties may challenge the FDIC.[335] There are several tests for determining whether a taking is constitutional[336] but it is unclear which one a court would apply and what result the court would reach.[337]

In short, the cross-guarantees need to be amended to rectify their inequity and their possible unconstitutionality. The law should at least require a finding of fraud or collusion before imposing liability.

3. Banking Industry Structure

a. *Capital Requirements*

Capital is the cushion that forces a banker to exercise caution because it places the owner's own money, rather than just the Government's, at risk.[338] Regulators and Congress have endorsed varying proposals[339] aimed at increasing the capital requirements for banks beyond those set by international regulatory agreements that take effect in 1992.[340] These

eral Deposit Ins. Corp., 749 F. Supp. 758, 775-776 (N.D. Tex. 1990) (refusing to dismiss creditor's claims against FDIC despite claims that obtaining guarantees from affiliates was within scope of FDIC's regulatory authority); Texas Am. Bancshares, Inc. v. Clarke, 740 F. Supp. 1243, 1254 (N.D. Tex. 1990) (summary judgment against FDIC, finding actions violated 12 U.S.C. § 194).

The FDIC and RepublicBank subsequently settled their litigation. *See* Lancaster, *First RepublicBank and FDIC Reach Accord on Claims*, Wall St. J., Dec. 12, 1990, at A10, col. 1. The FDIC was seeking over one billion dollars to reimburse it for assistance provided to sister banks. *See Senior Unsecured Creditors*, 749 F. Supp. at 761. The settlement would call for RepublicBank to pay $158.2 million. *See* Lancaster, *First RepublicBank and FDIC Reach Accord on Claims*, Wall St. J., Dec. 12, 1990, at A10, col. 1.

335. *See* Curtis, *The Takings Clause and Regulatory Takeovers of Banks and Thrifts*, 27 Harv. J. on Legis. 367, 370 (1990).

336. *See, e.g.*, Connolly v. Pension Ben. Guaranty Corp., 475 U.S. 211, 224 (1986) (upholding the constitutionality of amendments that increased the liability of employers who withdraw from multi-employer pension plans); Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419, 426 (1982) ("permanent physical occupation authorized by government is taking without regard to the public interests that it may serve").

337. Generally, the Supreme Court has "eschewed the development of any set formula for identifying a 'taking' forbidden by the Fifth Amendment, and ha[s] relied instead on ad hoc, factual inquiries into the circumstances of each particular case." *See Connolly*, 475 U.S. at 224; *see also id.* at 225 (identifying three factors of "particular significance" to the taking inquiry); Curtis, *The Takings Clause and Regulatory Takeovers of Banks and Thrifts*, 27 Harv. J. on Legis. 367, 370-75 (1990) (discussing applicability of various regulatory taking precedents).

338. *See Deposit Insurance Hearings I*, *supra* note 12, at 2 (statement of Rep. Annunzio).

339. *See, e.g.*, Seidman I, *supra* note 53, at 25 ("Capital serves to protect both individual banks and the deposit insurance system."); *Hearings on the Regulators' Report on Capital Standards Before the Senate Comm. on Banking, Housing and Urban Affairs*, 101st Cong., 2d Sess. 12 (Sept. 10, 1990) [hereinafter *Capital Standards Hearings*] (statement by Gov. Angell, Federal Reserve Board) (LEXIS, Nexis library, Fednews file) ("important benefits . . . would result from stronger capital requirements"); 136 Cong. Rec. H7181 (daily ed. Sept. 5, 1990) (statement of Rep. Gonzalez) ("it is fatal to permit insured institutions to operate with little or no capital").

340. The Basle Accord requires banks to have risk-based capital of 8% by 1992. *See*

parties, recognizing the decline of equity capital from fifteen to six percent of assets,[341] claim that "too many banking organizations . . . have travelled too far down the road of operating with modest capital levels."[342]

There are numerous justifications for increasing capital guidelines. First, the owners and managers would have greater incentive to act prudently because their own money would be at risk.[343] This curtailment of risk would result in a healthier banking industry and thus a healthier insurance fund.[344] Second, higher levels of capital would provide a larger buffer between a bank's losses and BIF.[345] Third, with stricter capital requirements, banks would face an additional "market test" in convincing potential investors that their operation and practices are sound.[346] Fourth, increased capital standards might counter the subsidy effect of the deposit guarantee,[347] which allows poorly capitalized or high-risk institutions to attract deposits and thus raises the costs of funds to all banks,[348] resulting in a more efficient pricing of bank services. Fifth, as Chairman Greenspan suggests, "[w]ell-capitalized banks are best positioned to be successful."[349] Finally, because today's markets are much more volatile, there should be higher capital standards "as a matter of bank policy."[350] Thus, "[c]apital provides the best means of *both* ensuring the continued stability of the banking system and limiting the liability of the government from losses in failed financial institutions."[351]

Because of the increased difficulty banks are experiencing in attracting capital, an increase in capital requirements would present problems for

---

Capatides, Madara & Chan, *Understanding the Risk-Based Capital Guidelines*, 2 Banking L. Rev. 5, 8 (1990).

Risk-based capital requirements factor various risk groups of assets to determine a bank's capital adequacy. *See* T. Fitch, Dictionary of Banking Terms 532-33 (1990); *see also Capital Standards Hearings*, *supra* note 339, at 12-13 (statement by Gov. Angell, Federal Reserve) (discussing principles to be considered to best factor interest rates and capital adequacy); Capatides, Madara & Chan, *Understanding the Risk-Based Capital Guidelines*, 2 Banking L. Rev. 5, 10-11 (table) (1990) (explaining how interest rate risks fit into the various weighted categories).

341. *See* Fogel Testimony, *supra* note 281, at 7; Benston, *Radical Surgery for Dying Banks*, N.Y. Times, Dec. 14, 1990, at A39, cols. 2-3.

342. Greenspan Testimony, *supra* note 210, at 11.

343. *See Capital Standards Hearings*, *supra* note 339, at 12 (statement by Gov. Angell, Federal Reserve Board).

344. Seidman I, *supra* note 53, at 25.

345. *See Capital Standards Hearings*, *supra* note 339, at 12 (statement by Gov. Angell, Federal Reserve Board).

346. *See id.*

347. *See* Seidman I, *supra* note 53, at 25.

348. *See* Fogel Testimony, *supra* note 281, at 7.

349. *Higher Capital Would Make Banks Less Competitive Initially, Greenspan Says*, 55 Banking Rep. (BNA) No. 8, at 291 (Aug. 20, 1990) (quoting Chairman Greenspan).

350. *Deposit Insurance Hearings II*, *supra* note 53, at 17 (statement of Mr. Litan, Senior Fellow, Economic Studies, Brookings Institution).

351. Fogel Testimony, *supra* note 281, at 15-16 (emphasis in original).

the industry.[352] A combination of bad debts and increasingly stringent regulator examinations has forced banks to increase their loan loss reserves;[353] these reserves, however, will no longer be allowed to be a significant part of the bank's capital under the capital requirements implementing the Basle Accord.[354] These changes have caused investors to become wary and curtail investment until it is determined how badly the industry will suffer.[355] The industry's increase of its loan reserves has also caused the value of bank stocks to dissipate.[356] No one supporting the increases in capital, however, expects banks to be able to raise funds cheaply or easily,[357] nor do they expect increased capital standards to be implemented in isolation of other changes.[358] Furthermore, because the capital requirement is a capital-*assets* ratio, a bank may curtail assets, e.g. loans, in order to meet the requirement, rather than raise capital. Thus, there is concern that increasing capital requirements would curtail lending activity, which is already experiencing a slowdown.[359] Such a slowdown could launch or lengthen a recession.[360]

---

352. *See* Bleakley, *Banks Find Their Sources of Capital are Drying Up*, Wall St. J., Oct. 19, 1990, at C1, col. 4; *see also supra* note 123 (discussing Citicorp's difficulties in raising capital).

In an attempt to meet the new capital guidelines, Chase, along with other banks, has been forced to sell off profitable operations. *See* White & Sesit, *Bank Company Places a Unit on the Block: Chase Manhattan is Seeking to Sell Investment Arm in a Bid to Boost Capital*, Wall St. J., Nov. 26, 1990, at A4, col. 1.

353. *See* Bleakley, *Banks Find Their Sources of Capital are Drying Up*, Wall St. J., Oct. 19, 1990, at C1, col. 4.

354. *See id.*; *Deposit Insurance Hearings I*, *supra* note 12, at 19-20 (statement of Comptroller of the Currency Clarke).

355. *See* Bleakley, *Banks Find Their Sources of Capital are Drying Up*, Wall St. J., Oct. 19, 1990, at C1, col. 4; Sease, *Bank Stocks Sink on Fears Loan Problems Understated*, Wall St. J., Sept. 28, 1990, at C1, cols. 5-6; *see also* Hilder, *Bank Stocks Soar in Wake of Fed Action*, Wall St. J., Dec. 6, 1990, at C1, col. 3 ("bank stocks have been among the stock market's worst performers")

356. *See* Sease, *Investors Expect to See Answers in 1991*, Wall St. J., Jan. 2, 1991, at R3, cols. 5-6 (table); Bleakley, *Banks Find Their Sources of Capital are Drying Up*, Wall St. J., Oct. 19, 1990, at C1, col. 4; *see also* Hilder, *Bank Stocks Soar in Wake of Fed Action*, Wall St. J., Dec. 6, 1990, at C5, col. 5 (recent increases in bank stocks probably temporary since they are still fundamentally poor).

357. *See, e.g.*, *Higher Capital Would Make Banks Less Competitive Initially, Greenspan Says*, 55 Banking Rep. (BNA) No. 8, at 291 (Aug. 20, 1990) (it "will be neither easy nor cheap" to meet higher capital requirements).

358. "Higher capital requirements should be accompanied by industry structural reforms." Seidman IV, *supra* note 294, at 7.

359. *See* Rosenbaum, *Federal Reserve Acts to Increase Lending by Banks*, N.Y. Times, Dec. 5, 1990, at A1, col. 6; *Bank Credit Tighter, Survey by Fed Finds*, N.Y. Times, Nov. 20, 1990, at D2, col. 5; Quint, *Banks Cut Business Lending, Hurting Weakened Economy*, N.Y. Times, Oct. 16, 1990, at A1, col. 5.

The Federal Reserve reports that existing loans to business by banks have fallen almost $5.2 billion in 1990. *See id.*

360. *See* Duke, *Banks Toughen Loan Standards Even Further*, Wall St. J., Nov. 20, 1990, at A2, col. 2; Quint, *Few Buffers to a Slump Are Seen*, N.Y. Times, Nov. 5, 1990, at D1, col. 6; Quint, *Banks Cut Business Lending, Hurting Weakened Economy*, N.Y. Times, Oct. 16, 1990, at A1, col. 5.

The Administration believes that tightening credit is contributing to the economic

Despite these problems, a gradual phase-in of higher capital requirements[361] would give banks sufficient time to raise their capital levels. Once in place, the requirements would benefit both BIF and the individual banks. BIF would no longer face the possibility of a large number of failing banks, and the industry would be better able to meet new opportunities and changing circumstances.

b. *Financial Deregulation*

Bank regulators are urging Congress to make major changes in the industry's structure that would enable banks to function and remain competitive in a changing financial environment.[362] Specifically, regulators propose ending the various ownership and product limitations as well as the geographic restraints currently placed on commercial banks.[363] Ending these limitations would hopefully lead to increased bank profitability.[364] Because "[a] healthy deposit insurance system de-

slowdown, *see* Rosenbaum, *Brady Warns Regulators About Credit*, N.Y. Times, Nov. 21, 1990, at D1, col. 6, and has acknowledged that the country is in a recession. *See* Rosenbaum, *The White House Agrees: It's a Recession*, N.Y. Times, Jan. 3, 1991, at D1, col. 3; Murray, *White House's Forecast Admits U.S. is in Recession*, Wall St. J., Jan. 2, 1991, at A3, col. 1.

361. Several regulators have proposed this gradual phase-in. *See, e.g.*, Greenspan Testimony, *supra* note 210, at 11 (proposing gradual phase-in); Seidman I, *supra* note 53, at 25 (same); Bacon, *FDIC Says Insurance Fund Will Shrink to $4 Billion in '91 Without an Infusion*, Wall St. J., Dec. 17, 1990, at A4, col. 1 (discussing proposals).

362. *See, e.g.*, Oral Statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation, on Deposit Insurance Revision and Financial Services Restructuring, Before the Senate Committee on Banking, Housing, and Urban Affairs 3 (July 31, 1990) (press release of the Federal Deposit Insurance Corporation) (urging repeal of numerous banking laws); Greenspan Testimony, *supra* note 210, at 22 (recommending that permissible range of activities for banks be broadened); Labaton, *Administration Presents its Plan for Broad Overhaul of Banking*, N.Y. Times, Feb. 6, 1991, at A1, col. 1 (Treasury proposes "sweeping overhaul" of banking system); Stein, *Who Needs the Banks?*, Wall St. J., Jan. 3, 1991, at A8, col. 4 (recommending that banks be given opportunity to make more money by permitting them to enter new activities); Bacon, *Bush Promises to Take Lead in Pushing for Restructuring of Bank Regulations*, Wall St. J., Nov. 30, 1990, at A16, col. 2 (President "pledge[s] to take 'a leadership role' in revamping bank laws in order to strengthen the nation's financial system").

363. *See* Labaton, *Administration Presents its Plan for Broad Overhaul of Banking*, N.Y. Times, Feb. 6, 1991, at D6, col. 1.

The banking regulations were basically formed by the passage of three acts. The Glass-Steagall Act provided for separate commercial and investment banking structures. *See* Banking Act of 1933, ch. 89, 48 Stat. 162 (1933). *See generally* M. Malloy, 2 The Corporate Law of Banks § 7.2 (1988) (explaining the reforms of the Act). The Bank Holding Company Act generally mandated a broader separation of banking from commerce. *See* 12 U.S.C. § 1843. *See generally* M. Malloy, 2 The Corporate Law of Banks § 8.2.1 (1988) (discussing legislative history of the BHCA). Finally, the McFadden Act restricted national banks from having branches that cross state lines. *See* McFadden Act of 1956, ch. 191, 44 Stat. 1224 (codified as amended in scattered sections of 12 U.S.C.).

The major thrust of the Treasury Department's reform proposal is to undo these regulations. *See* Labaton, *Congress Gets Bush Bank Plan*, N.Y. Times, Mar. 21, 1991, at D6, col. 6; Labaton, *Administration Presents its Plan for Broad Overhaul of Banking*, N.Y. Times, Feb. 6, 1991, at A1, col. 1.

364. *See infra* notes 370-373 and accompanying text.

pends ultimately on the existence of a healthy banking system,"[365] industry reform is vital to keeping BIF solvent. The FDIC even suggests that "deposit insurance reform should *start* with reform of [the] banking industry structure."[366]

Currently, the commercial banking industry is not healthy.[367] If the industry were healthy, individual banks would be more profitable, fewer banks would fail and BIF would face lower costs. The rising number of bank failures,[368] even before a slowdown in the economy, indicates that structural reform is needed to correct a problem with the industry's basic structure. To this end, Chairman Seidman warned Congress that the FDIC "can only hold the fort [in keeping BIF solvent] if we do substantial restructuring of the industry."[369]

The FDIC generally believes that the restrictions mandated by current law may "not only [be] unnecessary but also actually harmful to the banking industry. . . . [and that] the financial environment has been changing to the detriment of the traditional banking business."[370] The FDIC concludes that eliminating the current restrictions on banking would help diversify risk and boost overall profitability.[371] Moreover, proponents of structural reform submit that their proposals would improve the industry's ability to compete internationally.[372] For example, an indication of the significant lost opportunities under the current system is the "notable absence" of United States banks in the European and Japanese markets.[373]

Additionally, proponents of these proposals believe that reform can be implemented without impairing BIF's viability. There are two bases for this optimism. First, there is a general belief that the changes would improve the industry's overall profitability and thus "in the long run [may] reduce risks to the banks and, therefore, to [BIF]."[374] A House of

365. Seidman I, *supra* note 53, at 11.

366. *Id.* at 18 (emphasis added).

367. *See generally supra* notes 123-133 and accompanying text (discussing various indications of the industry's health). *See also* Task Force of The House Banking Comm. on the International Competitiveness of U.S. Financial Institutions, 101st Cong., 2d Sess. 5 (Press Release 1990) [hereinafter Competitiveness Report] ("banking industry is under substantial pressure and its general condition is weak").

368. *See supra* notes 51-55 and accompanying text.

369. Labaton, *Bank Law Overhaul Proposed*, N.Y. Times, Sept. 26, 1990. at D1, col. 6.

370. Seidman I, *supra* note 53, at 12; *see also Regulate Banks: Less, and More*, N.Y. Times, Dec. 10, 1990, at A18, col. 1 ("[Current banking laws] are suppose to make banks safe. In fact, they do the opposite.").

371. *See* Seidman I, *supra* note 53, at 13.

372. *See, e.g., id.* (urging deregulation to make banks more competitive internationally); *Regulate Banks: Less, and More*, N.Y. Times, Dec. 10, 1990, at A18, cols. 1-2 (same).

373. Competitiveness Report, *supra* note 367, at 8; *see also* Seidman I, *supra* note 53, at 13 (commenting that European market has nothing comparable to the Bank Holding Act); Greenspan Testimony, *supra* note 210, at 11 (commenting on increasingly competitive international environment).

374. Competitiveness Report, *supra* note 367, at 32.

Representatives Task Force Report, although acknowledging the possibility that reform could expose BIF to excessive liability in the short-term, concluded that "the status quo carries clear risks of its own"[375] and that "the lack of diversification in the industry has imposed costs on [BIF]."[376] Further, the FDIC suggests that there is "no valid reason" to continue to limit the type of entities that can be bank affiliates.[377] The only effect of such a limitation is to exclude an important source of capital—corporate business capital—from the banking industry.[378] The FDIC also argues that the current laws deprive banks of the opportunity to engage in "unfettered nationwide banking" through branching, which is not only the free-market ideal but often the most economical way to expand.[379] Such interstate restrictions have "hampered [the banks' ability] to lower risk through diversification."[380]

Second, supporters of the reforms emphasize that banks wishing to expand their operations could be forced to form separate affiliate entities,[381] which would ensure that BIF funds are adequately insulated from the enhanced risks of the new activities.[382] To enforce the separateness, the FDIC has suggested that Congress give the bank supervisors enhanced powers to audit both sides of a transaction between a bank and its affiliates that engage in the new activities.[383] The separateness of the banking entity would also be "fully disclosed and criminally

375. *Id.* at 33.

376. *Id.*

377. Seidman I, *supra* note 53, at 13.

378. *See Reform Hearings*, *supra* note 157, at 18 (statement of Mr. Seidman, FDIC Chairman). *But see* Bacon, *Bank Reforms From Treasury Faulted by CBO*, Wall St. J., Mar. 6, 1991, at A10, col. 2 ("no convincing arguments have been advanced to indicate that there are major advantages to be achieved by ownership that combines banking and nonfinancial activities.") (quoting CBO Director Robert Reischauer).

379. Seidman I, *supra* note 53, at 16.

The Treasury Department estimates that banks in several states would save five to ten billion dollars by using a single computer system. *See* Rosenbaum, *Bank Plan's Gains Are All Long Term*, N.Y. Times, Feb. 6, 1991, at D6, col. 2.

380. Seidman I, *supra* note 53, at 18.

The effect of these proposals on the dual banking system is unclear. *See* Considine, *A State Response to U.S. Treasury Department Proposals to Modernize the Nation's Banking System*, in Annual Survey of Financial Institutions and Regulation, The S&L Crisis: Death and Transfiguration, 59 Fordham L. Rev. S243 (1991). There are persuasive arguments that the current proposals would result in the elimination of the state system, a change that would ultimately be detrimental to banking in general. *See id.* These arguments may resolve themselves, however, by allocating the manner of state control over branches operating within its borders rather than by denying the branching of banks. *See id.*

381. *See, e.g.*, Seidman I, *supra* note 53, at 15 (separation can be achieved by extending existing safeguards to protect banks); Wayne, *Key Man at Banking Crossroads*, N.Y. Times, Nov. 8, 1990, at D9, col. 4 (suggestion by Treasury Under Secretary that "banks be allowed to engage in a broad range of financial activities" as long as they are "separately capitalized subsidiaries").

382. *See* Rosenbaum, *Plan to Revamp Banking Laws Faces Obstacles*, N.Y. Times, Dec. 26, 1990, at D6, col. 5.

383. *See* Seidman I, *supra* note 53, at 14.

enforced."[384]

The arguments against expanding bank powers take two forms. For convenience, these can be denominated the "paranoid" and "entitlement" approaches. The "paranoid" argument, which Congress made, suggests that deregulation of the savings-and-loan industry created the need for a bailout.[385] This argument confuses financial deregulation, which permits banks to expand geographically and to offer new financial devices, with supervisory deregulation, which frees the banks from the regulator's control. The two are not inextricably intertwined. When Congress implements financial deregulation, which is essential for the commercial banking industry to return to profitability, it should simultaneously increase the regulator's supervisory powers, which would minimize the potential for abuse.

The entitlement argument suggests that those advocating change should have the burden of proving the need to eliminate the current legal structure because "[b]anks are special."[386] This argument contends that the present banking structure has been successful in protecting the United States economy from disruption and that the proposed changes would merely add risk.[387] Therefore, there is no justification for reforming the system.[388] The burden of the argument for change has been met, however. Although the present structure has prevented bank runs, the industry is unhealthy.[389] The tremendous cost of the savings-and-loan crisis has shown that an unhealthy banking industry can impose an

384. *Id.*

385. *See* Note, *Causes of the Savings and Loan Debacle*, in Annual Survey of Financial Institutions and Regulation, The S&L Crisis: Death and Transfiguration, 59 Fordham L. Rev. S301, S316-17 (1991); *see also Regulate Banks: Less, and More*, N.Y. Times, Dec. 10, 1990, at A18, col. 1 (deregulation is "sure to be ridiculed by members of Congress" because of S&L bailout).

> [P]oliticians are so gun-shy after the savings and loan experience that . . . promises [claiming that deregulation can be implemented safely] may be insufficient. Representative Charles E. Schumer, an influential Democrat on the House Banking Committee, believes this could be the legislation's Achilles' heel. A liberal from Brooklyn, Mr. Schumer is normally an Administration antagonist, but he expects to be a strong supporter of the banking legislation. "Even if it's carefully structured," he said, "even if it avoids all the problems of the S.&L.'s, someone gets up on the floor and says this is the S.&L. crisis all over. You have shivers down the spine of Congress people, and they run for the doors."

Rosenbaum, *Plan to Revamp Banking Laws Faces Obstacles*, N.Y. Times, Dec. 26, 1990, at D6, col. 5; *see also* Case, *Deregulation: Invitation to Disaster in the S&L Industry*, in Annual Survey of Financial Institutions and Regulation, The S&L Crisis: Death and Transfiguration, 59 Fordham L. Rev. S93 (1991) (suggesting that deregulation was in fact the cause of the S&L crisis).

386. Burstein, *Banking System Safeguards Should Not Be Dismantled*, Am. Banker, June 7, 1990, at 4, col. 2.

387. *See id.* at 15, col. 5.

388. *See id.*

389. *See supra* notes 123-133 and accompanying text; *see also* Quint, *Experts Suggest Laws for an Ailing Bank System*, N.Y. Times, Jan. 1, 1991, at 42, col. 1 ("We have more than enough evidence that the banking system is breaking down . . . .").

enormous cost on the economy. Further, changes that make the financial services industry healthier would presumably lead to more efficient availability of funds for future economic growth. Finally, because these changes would be implemented without increasing the risks on the banking entity, the industry would continue to be free from bank runs.

The ability to offer a wider range of products, combined with stronger regulatory oversight, would permit the banks to be more competitive without necessarily imposing greater risks on the banking entity. Therefore, structural reform of the industry is essential to the industry's health, and correspondingly to the viability of the insurance fund.

CONCLUSION

To answer the question posed by this Note's title, BIF is in serious financial trouble, and Congress may be facing the very real danger that it will have to compel the taxpayers to make yet another rescue, this time of the commercial banking industry.

While the painful experience of the savings-and-loan debacle must be remembered, Congress must act swiftly to correct the structural problems of the banking industry. In order to survive in today's world economy, banks must be permitted to diversify their portfolios and offer innovative financial devices. Thus, Congress must free the banks from the shackles of the Depression-era laws.

Permitting this much-needed industry expansion, however, should not affect the insurance fund adversely as these freedoms would be implemented with significant safeguards. To gain the benefits, the banks will face stricter supervision from regulators and be required to increase their capital.

Additionally, while Congress must reform the deposit-insurance system, its changes will be in vain if the industry that BIF insures is not permitted to regain its profitability. Deregulation, not to be confused with lack of supervision, should give the banks the strength to return to health. If Congress refuses to act, a future Note will probably need to be written on the Commercial Bank Bailout Bill of 1992.

David Andrew Segal