Banking Reform in 
the United States: 
A Survey of Current Issues

I. INTRODUCTION

The purpose of this paper is to provide a broad overview of current banking reform issues and efforts in the United States. The next section discusses the author’s views on why there is a need for banking reform in the United States. Section III presents seven principles that, again in the author’s view, the Federal Reserve Board has developed for guiding reform efforts. The next section briefly describes where the author believes reform efforts seem to be going in the U.S. Congress. The primary goal of this section is to try to clarify a complex and dynamic situation for readers not familiar with the workings of the U.S. legislative process. Section V concludes.

II. WHY BANKING REFORM?

The need for banking reform in the United States derives from the sources of stress in the U.S. banking system. The causes of stress can be divided into three general areas: macroeconomic factors, forces that have increased competitive pressures, and safety net incentives to take excessive risk.

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Macroeconomic Factors

Adverse shocks to the international, national, and regional U.S. economies and markets have impaired the capital of many money center, regional, and community banks. These shocks have been a major cause of the increase in bank failures and other stresses in the banking industry. Well-known examples of such shocks include the sharp increases in inflation and interest rates in the late 1970s, the severe recessions of the early 1980s, volatility in oil, agricultural, and other commodity prices, the declining credit quality of many less developed nations, sharp drops in commercial real estate values, and the 1990-91 recession.

These adverse shocks, coupled with an increase in the volatility of financial asset prices (examples include the October 1987 stock market crash and the collapse of the junk bond market), have apparently led investors to demand higher risk premiums on bank debt and equity. Other factors, such as uncertainty regarding federal fiscal policy, have perhaps also played a role. The end results have been an increased cost-of-capital and other signs of stress at many U.S. banks.¹

Factors Increasing Competitive Pressures

The primary factors increasing competitive pressures in U.S. banking have been partial deregulation, technological change, internationalization of financial markets, the existence of substantial cost inefficiencies, and certain macroeconomic effects. Each of these is discussed below.

Partial deregulation, while providing benefits and opportunities to banks, has also increased competitive pressures. The primary examples here are the deregulation of deposit interest rates, the limited expansion of powers that may be exercised by banking organizations, and the advent of regional interstate banking through bank holding companies (BHCs). At the same time, key laws and regulations that impose significant costs on banks have been retained. The most important examples are the Glass-Steagall Act's restrictions on combinations of commercial and investment banking, the McFadden Act's limitations on interstate branching, and the prohibition against the Federal Reserve paying interest on required reserves that are held by depository institutions at the central bank.

In some cases, the ways that have been found to relax these laws and regulations are themselves relatively high cost. For example, beginning in

¹ A secondary effect has been increased demand for low-cost hedging vehicles by all financial market participants. While the creation of such vehicles has helped banks adjust to a riskier environment, such demand has further stimulated the technological change discussed below. As will be suggested, such technological change has not always worked to the advantage of banks.
mid-1988 the Federal Reserve began to allow some bank holding companies to establish so-called "Section 20 subsidiaries." These subsidiaries may be allowed to engage in expanded investment banking activities, such as underwriting stocks and bonds, within limits that are set so as to conform with the constraints of the Glass-Steagall Act. Unfortunately, the limits are such that the expanded securities activities are really only available to fairly large banking organizations. And even large bank holding companies may need to reorganize extensively their operations to establish a Section 20 subsidiary. Both of these results limit the public benefits of this partial deregulation, and raise unnecessarily banking organization costs.

A perhaps more important example is the manner in which interstate banking is evolving in the United States. Beginning in the early 1980s, groups of states began to form "regional compacts" whereby banks chartered in states that were part of a given compact could expand across state lines via separate holding company subsidiary banks. Today, all states except Montana and Hawaii have enacted legislation permitting entry by banks from some—but not necessarily all—other states. Still, there are fewer than 200 interstate banking organizations, and only two bank holding companies have subsidiary banks in as many as ten states. Use of the holding company organizational form is, at least in some cases, a relatively expensive means of conducting interstate operations, since considerable duplication of effort is required. Examples of such duplication include separate boards of directors, senior management, and certain types of asset/liability management. In addition, the need to deal with a multiplicity of state laws, rather than a single national law, surely imposes extra costs.

Technological change has been a powerful force that has increased competition in banking. Probably the single most important type of technological changes have been advances in computer and telecommunications that have so lowered the cost of information processing that it is increasingly possible for borrowers and lenders to contract directly, rather than going through a commercial bank. Thus the classic "information processing" and "transformers of assets" functions of banks have been lowered in value. The commercial paper and mortgage-backed securities markets are early examples here, but securitization of other financial assets is proceeding. Another aspect of how technological change has increased competition for banks is the increasing ability of many nonbank firms to provide banking services. Money market mutual funds, automobile finance subsidiaries of the automobile producers, and small business and consumer finance companies are but a few examples.

Banks have, of course, attempted to take advantage of technological change. And many banks have been quite successful in this regard. But

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2 Sixteen percent of assets in insured domestic banks is held by banks owned by out-of-state bank holding companies. In 17 states, out-of-state BHCs control over 30 percent of banking assets.
others have been much less skilled at adapting to technological change, and this has sometimes damaged their profitability.

A sometimes overlooked component of technological change is discoveries in economics and finance that have helped to lower the cost of pricing, issuing, trading, and otherwise exploiting a variety of financial assets. Many of these discoveries have created financial instruments and services that are close substitutes for traditional bank products. And again, while banks have been somewhat successful at using these developments to their own advantage, it is probably also true that the value of traditional bank intermediation has been lowered. Examples of such innovations include option pricing formula, the discovery that a complex security can often be expressed as a combination of a set of simple (or fundamental) securities, and the development of financial futures, options, and loan sales markets.

The increasing internationalization of U.S. and world financial markets, including the expansion of foreign bank activity in the U.S., has greatly intensified competitive pressures. To date, these pressures have been felt primarily by a relatively small number of large U.S. banks that are active in international markets. However, to the extent that such pressures have led to increased emphasis on the domestic middle market by large U.S. banks, internationalization has indirectly led to increased domestic competitive pressures on smaller U.S. banks. In addition, some domestic U.S. restrictions, such as the Glass-Steagall Act, have been particularly harmful to the "world" competitive position of the larger U.S. banks. For example, it is sometimes argued that the inability to underwrite equity securities at home has hurt the ability of U.S. banks to gain equity underwriting contracts abroad as issuers of equity have come to increasingly issue and trade their stock on exchanges in several nations. There is every reason to believe that internationalization will continue, and that more and more U.S. banks will be affected. 3

As the value of the banking franchise has declined, relatively inefficient banks have found it more and more difficult to survive. A number of studies have suggested that some banks, both large and small, are just a lot better than many others at using, or managing, their inputs in a productive way. 4 Estimates of these so-called cost inefficiencies suggest that they swamp any benefits from economies of scale, and perhaps any benefits from economies of scope. In addition, there is some evidence that cost inefficiencies play a role in the incidence of bank failure. It is estimated that over 50 percent of U.S. bank failures in the 1980s came from the highest (noninterest) cost

3 Europe 1992 will almost surely increase international competitive pressures on U.S. banks.
quartile of banks, while fewer than 10 percent are estimated to have occurred in the lowest cost quartile.

Finally, certain macroeconomic factors have also hurt the competitive position of U.S. banks. The effect of increased risk premiums on the cost-of-capital was discussed above. In addition, the relatively low U.S. savings rate, and continuing large federal government deficits have probably helped to increase the cost-of-capital of U.S. banks.\(^5\)

**Safety Net Incentives to Take Excessive Risk**

The existence and administration of the federal safety net, particularly deposit insurance, have no doubt deterred many banks from building the capital bases needed to succeed in a riskier, more competitive world.\(^6\) Indeed, it is widely agreed among observers of the U.S. banking system that an excessive degree of "moral hazard" has been allowed to develop in the U.S. insured depository (banks, thrifts, and credit unions) system.\(^7\) In brief, the argument is that the safety net has so lowered the risks perceived by depositors that many have become indifferent to the financial condition of the depository institutions where they keep their funds, except in unusual circumstances. With depositors exercising little discipline through the risk premium they demand on the interest rate they receive on their deposits, the incentive of some banks' owners to control risk-taking has been lowered.

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\(^5\) The increasing internationalization of capital and product markets continues to soften these impacts by allowing U.S. firms increased access to foreign savings. Indeed, if current developments continue (e.g. financial market liberalization in Japan), it is quite possible that differences in the "home country" cost-of-capital will become less and less important. But the adverse competitive effects of a "legacy" of both implicit and explicit constraints on international capital movements, and trade in goods and services, no doubt continue today.

\(^6\) The U.S. federal safety net for depository institutions consists of deposit insurance, access to the Federal Reserve's discount window, and guarantees of the payments system provided by the central bank.

\(^7\) Moral hazard refers to the economic incentives created when two parties agree to share risk, but one party has greater control over how much risk is actually taken. Moral hazard is endemic to all kinds of insurance, including deposit insurance. More specifically, insurance creates an incentive for the insured party to take on extra, or excessive, risks because part of the cost of taking those risks is shared with the insuring institution. That there is too much moral hazard in the U.S. banking system is argued in, for example, Testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Subcommittee on Commerce, Consumer, and Monetary Affairs of the Committee on Government Operations, U.S. House of Representatives, October 3, 1990. The idea that moral hazard has increased in recent years is developed in Keeley, Michael C. "Deposit Insurance, Risk, and Market Power in Banking," *American Economic Review*, Vol. 80, No. 5 (December 1990), pp. 1183-1200.
Profits associated with risk-taking accrue to owners, while losses in excess of bank capital that would otherwise fall on depositors are absorbed by the deposit insurance fund. The end results have been the growth of excessively risky assets at many banks, and the substitution of insured deposits for private capital in funding those assets.

The exploitation of moral hazard, along with other sources of stress in the U.S. insured depository system, have led to huge losses in the thrift and bank deposit insurance funds. While estimates of the total expected losses vary widely, everyone agrees they run into the tens of billions of dollars. The U.S. Congress is currently struggling with how to finance upwards of $200 billion to provide for both losses and working capital to resolve failed and failing banks and thrifts. The need for such massive amounts has led to sharp increases in the deposit insurance premiums paid by both banks and thrifts. For example, the deposit insurance premium paid by banks was .083 percent of total domestic deposits as recently as 1989, but today stands at .23 percent, an increase of almost 300 percent. Obviously, such huge losses, large increases in premiums, and calls for even larger increases have contributed greatly to stress in the U.S. banking industry. In addition, they are probably the single most important set of reasons for the intensity of current reform efforts.

Many aspects of the administration of the federal safety net have come under severe criticism. Among the more important objects of criticism are (1) the tendency of regulators to sometimes delay the resolution of deeply troubled depository institutions (a practice known as regulatory forbearance), (2) the tendency for regulators to fully insure all deposits at banks deemed “too-big-to-fail,” (3) the fact that deposit insurance premiums do not fluctuate with the level of bank risk, (4) the fact that many bank assets and liabilities are not “marked to market,” (5) the assertion that deposit insurance coverage limits are too high, and (6) the feeling that regulatory monitoring and examination efforts generally slackened during much of the 1980s, thereby making it more difficult to detect excessive risk taking in a timely manner.8

III. FEDERAL RESERVE PRINCIPLES FOR BANKING REFORM

The Federal Reserve has consistently supported broad, or comprehensive, reform of the U.S. banking system.9 The purposes of this broad reform are to relieve, to the extent possible, the causes of stress in the U.S. banking

8 These and many other issues are reviewed extensively in U.S. Department of the Treasury, Modernizing the Financial System: Recommendations for Safer, More Competitive Banks, (February 1991).

9 For recent statements of this position see Testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System before the
system in ways that promote a safe, sound, competitive, and profitable banking industry that exposes the deposit insurance system, and therefore the U.S. taxpayer, to minimum risk of loss. While the specific elements of proposed reforms are often numerous and complex, in the author's view, the fundamental elements of the Board's proposals and expressed views on bank reform can be summarized in seven principles.

First, all banks should be required to maintain strong capital. A strong capital ratio has many benefits. Capital provides a cushion against unexpected losses, thereby protecting both stockholders from losing control of the firm, and the deposit insurance fund from loss. A solid capital ratio reduces a bank's incentive to exploit moral hazard, because a substantial amount of the bank's owners' funds are at stake. High capital ratios lower the probability of bank failure, and likely improve the long-run competitiveness of the bank. Finally, since strong capital essentially lowers the degree of subsidy provided by the federal safety net, the distortions in the economy's allocation of resources implied by that subsidy are reduced. These arguments have led the Federal Reserve to strongly advocate that all banks maintain adequate capital, including suggesting that in the long-run this may mean that the Basle Accord's minimum capital ratios may need to be raised.

Second, the Board has endorsed the concept of prompt corrective action (PCA). The goals of a policy of PCA are to give insured banks strong incentives not to take excessive risks (that is, not to exploit moral hazard). Under a policy of prompt corrective action, regulatory actions would become increasingly severe, and less discretionary, as a bank’s financial condition deteriorated. Banks that are in strong condition would have relatively few constraints on their activities. As a bank’s condition began to decline, initial regulatory actions might include relatively painless requirements such as increased monitoring by and reporting to the regulatory authority, and submission of a recapitalization plan. At lower levels of financial health, more severe restrictions would apply, such as prohibitions on dividend payments and the expansion of assets. Ultimately, senior management would be replaced, and the bank sold or closed before substantial losses were imposed on the deposit insurance fund. In short, a PCA policy is designed to make regulatory costs mimic what the free market would do—as risk to the deposit insurance fund rises, so would the marginal

Committee on Banking, Housing, and Urban Affairs, United States Senate, April 23, 1991; and Testimony by Alan Greenspan before the Financial Institutions Subcommittee of the Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives, April 30, 1991.

In other words, capital is a “deductible” that must be exhausted before the insurance fund suffers a loss. Deductibles are a common means by which private insurance funds seek to control moral hazard.
cost to the bank of regulation. In this sense, PCA may be viewed as a form of risk-based regulatory discipline.

Third, the Board has supported timely, on-site examinations of insured banks. A crucial requirement for the successful implementation of any regulatory policy is the availability of timely, accurate information on the financial condition of an insured bank. In the Board's view and experience, such information is acquired in large part through timely examination of a bank's books and activities by regulatory personnel actually visiting the bank.

Fourth, the Board strongly supports full interstate branching powers for banks operating in the United States. As suggested earlier in this paper, interstate branching has the potential to reduce the costs to banks of operating interstate. An important result of these lowered costs would be the facilitation of geographic diversification by U.S. banking organizations. Greater geographic diversification of risk would virtually without doubt increase the safety and soundness of the U.S. banking system. Equally important, greater interstate branching would increase competition in the affected parts of the banking industry, thereby making consumers better off.

Fifth, the Board has strongly supported increasing the range of allowable activities for banking organizations. In particular, it has argued that activities should be expanded in ways consistent with the evolution of banking and financial markets. Particularly important reforms include repeal of the Glass-Steagall Act's restrictions on combinations of commercial and investment banking, and expansion of the insurance activities of U.S. banks.

Sixth, the Board has argued that the expansion of bank activities should occur within the holding company organizational form. There are at least two advantages of the holding company organization. First, it facilitates the separation of the insured bank from other, noninsured parts of the organization. This insulation, known as the concept of "corporate separateness," helps both to ensure that safety net subsidies are not extended beyond the insured bank, and that risks residing in uninsured subsidiaries are not passed onto the insured bank and hence onto the taxpayer. Of course, the legal protections of the holding company form are unlikely to be complete, but they do provide some insulation of the insured bank. Second, the holding company form facilitates regulation of a given activity by the regulatory agency responsible for that activity. For example, in the United States securities firms are primarily regulated by the Securities and Exchange Commission, while banks are primarily regulated by the Federal Reserve, the Comptroller of the Currency, or the Federal Deposit Insurance Corporation. Because each subsidiary of a holding company is a separate

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11 Such uninsured parts would include holding company subsidiaries engaging in securities and insurance activities.

12 This only refers to federal regulation. Individual states can and do also regulate banks and securities firms doing business in their state.
legal entity, the holding company organizational form facilitates “functional regulation” by the appropriate agency.

However, because the legal protections provided by the holding company are unlikely to be complete, there is a need for one regulator to have overall responsibility for making sure that the taxpayers’ interests in the insured bank are protected. Thus the Board has argued that there is a need for an “umbrella regulator” that has this responsibility.

Seventh, and last but certainly not least, the Federal Reserve has argued that any reform package must maintain the ability of the central bank to protect the economy against systemic risk.\textsuperscript{13} Systemic risk refers to the chance that financial difficulties at one bank, or possibly a small number of banks, may spill over to many more banks and perhaps the entire financial and economic system. In situations of true systemic risk, the Board has argued that the authorities must have the flexibility to respond quickly and perhaps in ways that would not be used in normal circumstances. The primary example of an unusual response would be the protection of uninsured depositors so as to prevent destructive bank runs or other systemic effects. While the Board has agreed that full protection of uninsured depositors has been provided too often in the past, and that therefore some restriction of this power is appropriate, it has urged that the ability to protect uninsured depositors not be completely proscribed.

IV. STATUS OF REFORM EFFORTS

As of this writing (early October 1991), the state of banking reform efforts in the United States is highly dynamic and extraordinarily complex. There are literally a dozen or more separate reform proposals being discussed in Congress, not to mention continuing debate among and within trade groups, academics, and others. This section attempts to clarify the current situation, but should obviously be viewed as solely the opinions of the author.

Background and Timing

In February 1991 the United States Treasury released its long-awaited study of banking reform entitled, \textit{Modernizing the Financial System: Recommendations for Safer, More Competitive Banks}. This study, and subsequent proposed legislation, advocated a comprehensive plan for reforming

\textsuperscript{13} The Board’s most comprehensive statement of this view is contained in Testimony by John P. LaWare, Member, Board of Governors of the Federal Reserve System before the Subcommittee on Economic Stabilization of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, May 9, 1991.
and modernizing the U.S. banking system. Examples of major reforms included in the Treasury’s proposal were changes in the regulatory system to include prompt corrective action, more frequent on-site bank examinations, full interstate banking, repeal of the Glass-Steagall Act, and allowing expanded combinations of banking and commercial firms. While it did not initially include proposals for recapitalizing the federal Bank Insurance Fund (BIF), the plan eventually included such a proposal.

Throughout the first half of 1991 many observers remained skeptical that a broad reform package had any chance of success in Congress. Indeed, many argued that only a BIF recapitalization was likely to pass. However, contrary to these expectations, by the end of the summer both the Senate and House Banking Committees had approved comprehensive reform proposals that incorporated many, but not all, of the Treasury’s proposals.

The driving force behind the timing of current reform efforts is the urgent need to recapitalize the Bank Insurance Fund. The FDIC estimates that the fund will be insolvent by late 1992, as does the Executive Branch’s Office of Management and Budget, and some private estimates are even more pessimistic. Equally important is the need to provide working capital for the BIF, so that the FDIC can resolve troubled banks in a timely manner at minimum cost to the fund.

To date, broader reforms of the banking system have remained legislatively tied to proposals to recapitalize the BIF. In my view if, and this is a very big if, this linkage continues to hold, then the probability is quite high that some form of comprehensive banking reform will pass the U.S. Congress before the end of 1991. If comprehensive reform becomes “decoupled” from BIF recapitalization, I would say there is very little chance that broad reforms will be enacted this year.

Status of Legislation

What is the current status of legislation in each House of the Congress? In the Senate, the Senate Banking Committee’s bill will (hopefully) be voted on by the full Senate sometime in November. In the House of Representatives, the situation is more complex. The bill passed by the House Banking Committee also had to be considered by four other House committees, each of which had some overlapping jurisdiction with the House Banking Committee. These committees have proposed revisions, and in some cases substantial reductions in the scope of the Banking Committee’s bill. For example, the committee with jurisdiction over securities firms has, in my opinion, adopted amendments that, if they became law, would severely limit the ability of banks to engage in securities activities. Another committee is attempting to constrict the degree of interstate banking allowed in the Banking Committee’s bill. At this point, no one really knows what will happen when these conflicting proposals come to a vote by the full House of Representatives. Assuming that each House of Congress does pass some
form of banking reform, any differences between each House’s bill would have to be reconciled in a conference committee of the two Houses. The conference committee bill would then have to be approved by each House. Finally, for the bill to become law, it would have to be signed by the President. Clearly, banking reform still has a considerable way to go.

Likely Reforms

Assuming that “comprehensive” banking reform is enacted this year, what reforms are likely? The answer to this question is, of course, highly speculative. However, I will attempt a few predictions. First, I think that the Bank Insurance Fund will definitely be recapitalized. The government cannot default on its guarantees of insured deposits, and money must be provided to resolve troubled banks. Second, I think it is quite likely that regulatory reforms that embody the principles of prompt corrective action and timely on-site bank examinations will be enacted. Both concepts are contained in the bills passed by the House and Senate Banking Committees. Third, I believe that increased interstate banking has a good chance of becoming law. In many ways interstate banking is already a substantial reality for many banks, and removing existing restrictions would merely lower the cost of much existing behavior. Fourth, I think that it is almost certain that if bank powers are expanded, the holding company form will be the vehicle for such expansion, and that there will be an “umbrella” regulator for the entire organization.

Reforms beyond these, with the exception of certain “consumer” provisions, are, in my view, very much less certain. In particular, repeal of the Glass-Steagall Act’s restrictions on commercial and investment banking, while in the bills passed by both Banking Committees, seems very much in doubt. The current scandals in the investment banking industry, and other portions of the financial sector, have certainly not helped the chances for repeal of Glass-Steagall. In addition, relaxation of the barriers between banking and commerce, proposed by the Treasury, seems to have no chance. On balance, then, I think there is still a reasonable chance that broad banking reforms will be enacted in the United States this year, but the reforms will not be as broad as those proposed by the Treasury in February.

V. CONCLUSION

The pressures for banking reform in the United States derive from the sources of stress in the U.S. banking industry. These sources are complex, and are not always amenable to legislative relief. However, many of them

14 Or, if the President vetoed the bill, the President’s veto would have to be overridden by both Houses of Congress in order for the bill to become law.
are, all have shown through in massive losses to the deposit insurance funds, and hence the current intensity of effort in the U.S. Congress.

The Federal Reserve's principles for guiding banking reform focus on the perceived fundamental causes of stress deriving from regulatory, statutory, technological, and market practices and developments. In addition, the Federal Reserve has argued that no matter how short or far reaching any reforms are, the central bank should continue to have the flexibility needed to protect the economy from systemic risk.

The probability that comprehensive banking reform will be enacted in the United States this year is highly uncertain. The urgent need to recapitalize the Bank Insurance Fund will almost surely result in legislation that addresses this narrow goal. But whether BIF recapitalization will be accompanied by broader reforms is unknown. In the author's view, there is some hope that a substantial number of Congress people will see that the deposit insurance funds' losses are a reflection of deeper structural problems in the U.S. banking system; and that therefore they will vote to enact a relatively broad set of reforms. However, these changes would almost surely not be as sweeping as those proposed in February by the U.S. Treasury.