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THE EVOLVING LEGAL FRAMEWORK FOR FINANCIAL SERVICES

by Walker F. Todd

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Abstract

If one searches for a rational legal framework for the financial services industry, derived from first principles consistently applied, one will be disappointed in reviewing the history of that legal structure in the United States. Only ambiguous conclusions may be drawn if one wishes to justify the kinds of liberalizing measures that generally have been favored in academic circles since the mid-1970s.

The United States started with a classically liberal/negative liberty framework regarding "monied corporations," but as early as the 1780s, policymakers began to make utilitarian/positive liberty compromises. Gradually, traditional legal structures designed to encourage managerial prudence (such as double liability for banks' shareholders) eroded, and subsidies that eventually led to a severe moral hazard problem (such as federal deposit insurance) were inserted in their place. Checks and balances that originally existed, such as a strong and competing role for the states in bank supervision and regulation, gradually collapsed into an increasingly centralized and synchronized federal regulatory system. Nevertheless, the current rhetoric of advocates of financial services industry reforms seems to have classically liberal pretensions, despite the supervisory and regulatory protections and subsidies now available to many parts of that industry.

Competition within a given class of firms (e.g., banks) for dominance in their market segment has become transformed into competition across industry sector lines (e.g., between banks and securities firms) for dominance largely determined by governmentally provided protections and subsidies. Rhetorical consistency and sound strategy for reform would appear to require reductions of these protections and subsidies, renewed and increased competition within industry sectors (not just between different classes of protected and subsidized industries), and increased levels of manager and shareholder accountability for the conduct of their financial institutions.

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I. Introduction

This paper summarizes both the history of financial services regulation in the United States and the conflicting models of political economy, or the legal framework, that lay behind that history. The principal supervisory intervention and closure options available to financial services regulators by the late 1980s are described briefly. Many of those options were modified or even extended by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA),1/ but numerous older supervisory tools that had fallen into disuse after the advent of federal deposit insurance and direct federal intervention in the capital markets affecting financial services institutions during the 1930s remain neglected.

The primary purpose of this paper is to review the legal framework for the supervision and regulation of financial services both as it has been and as it might be. Specific policy recommendations regarding expansion of the activities of one set of financial institutions across industrial sector lines into the domains of other financial institutions, or innovations in financial services supervision, are beyond the scope of this paper.

II. A Brief History of Financial Services Regulation in the United States

It is a common misconception that banks and trust companies, bank holding companies, thrift institutions, credit unions, securities firms, insurance companies, mutual funds, and the like,

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all of which are usually referred to as "financial services companies," have existed in more or less their present form throughout U.S. history or, even earlier, in British history.2/ But the present common legal form of large banking organizations in the United States, a bank holding company with many banking and nonbanking subsidiary corporations, was rare in the 19th century and became the generally accepted model only after World War II. The most frequently advocated alternative model for large banks, a universal bank with branches nationwide, has never existed in the United States, and the closest approximations, the First and Second Banks of the United States, were so limited in their asset powers that they could not properly be called universal banks.3/ Even in Great Britain, the model of the universal bank with nationwide branches has come into existence only since enactment of the Financial Services Act of 1986.4/

Prior to enactment of the National Bank Act (1863), most American banks did not have corporate charters, and even those that did still exposed their shareholders to double liability. Shareholders were liable to the bank regulator for assessments up to the par value of their shares, then a substantial amount, if the bank's assets were insufficient to satisfy liability holders' claims. Thus, there was a fair amount of personal liability on the part of directors and ordinary shareholders if their institutions failed. Also, before the National Bank Act, most bank charters were issued only for limited terms--20 years was the most common.

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Perpetually chartered, limited-liability, incorporated banks having as their principal liabilities deposit accounts instead of circulating notes were a novelty of the second half of the 19th century in the United States. The National Bank Act authorized "national associations" to obtain federal banking licenses in order to enable partnership and sole-proprietorship banks to join the bond-secured currency scheme, and state law also licensed banks but did not require them to incorporate.

Neither the Federal Reserve Act (1913) nor the Banking Acts of 1933 and 1935 required member banks to incorporate, and the double liability of national banks' shareholders was not eliminated until the Banking Act of 1935. Instead, the impetus for incorporation was provided by the Emergency Banking Act of 1933, which authorized the Reconstruction Finance Corporation (RFC) to assist the reorganization of troubled banks by purchasing their preferred shares (it was easier to obtain the RFC's assistance for incorporated banks). Private banks holding commercial bank or trust company licenses still exist under New York state law: Brown Brothers Harriman is one example, and even J.P. Morgan & Co. did not become a publicly traded corporation until the 1950s.

Investment companies, securities broker-dealers, investment banks, mutual funds, mutual thrift institutions, mutual insurance companies, and the like are not required to incorporate as a matter of law. It is possible to derive from this description of the prior legal framework the hypothesis that it was the personal liability of the principals of unincorporated financial services

institutions that used to encourage the prudent operation of their firms, and that it was governmental incentives like the prospect of RFC assistance that tempted those principals to incorporate (see analogous arguments in Kane [1987], pp. 104-105, and A. Smith [1976], book II, pp. 329-337).

More than just banks alone, financial services corporations were generally considered to create moral and legal difficulties that ordinary business corporations did not because, before the Free Banking Era (1838-1861), they depended on the favor of the state for their corporate charters and continued profitability. Adam Smith (1976) wrote disparagingly of the joint-stock trading companies of his day; the framers of the Constitution noted the American prejudices against corporations of any type, but especially against "monied corporations," and failed to include an incorporations clause in the Constitution; Andrew Jackson opposed banks primarily because they promoted the circulation of paper money; late 19th and early 20th century political rhetoric denounced the "money trust"; New York attorney Charles Evans Hughes became famous as legislative counsel investigating the misdeeds of insurance companies in 1905; and as late as 1913-14, Louis Brandeis wrote a series of articles (later compiled into a book) on the economic inefficiencies of large holding companies of the J.P. Morgan model, entitled <u>Other People's Money and How the Bankers Use It</u>.5/ Both Hughes and Brandeis later became justices of the U.S. Supreme Court.

Abundant arguments existed on the other side, to be sure:

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Alexander Hamilton succeeded in obtaining a federal corporate charter for the First Bank of the United States; Chief Justice John Marshall sustained the constitutionality of the federal corporate charter of the Second Bank of the United States in McCulloch v. Maryland (4 Wheaton [17 U.S.] 316 [1819]); a whole system of federally chartered national banking associations was established under the National Bank Act; and incorporated Federal Reserve Banks were established nationwide under the Federal Reserve Act of 1913.6/ Financial services companies could and did exist in corporate form and even with federal charters, but the older, Jeffersonian, Madisonian, and Jacksonian notions of minimal federal interference in state regulation of financial services has prevailed to the extent that the chartering, licensing, and most forms of supervision of nonbank financial firms remain the exclusive domain of state law.7/

Reforms of the 1930s changed the legal framework for financial services significantly, but banks and, later, bank holding companies were more directly affected by federal centralization and regulation than were nonbank financial firms. For the most part, the latter were allowed to continue operating under state law, becoming subject only to federal registration and information disclosure laws in the 1930s and federal consumer protection legislation in the 1960s and 1970s. Federal deposit insurance was created in 1933 and was made available to state-chartered, nonmember banks as well as to Federal Reserve member banks, then considered a political triumph for proponents of state banking. A

serious attempt was made to nationalize all bank supervision as part of the Emergency Banking Act of 1933 (Wyatt [1933]), but that effort was abandoned in favor of the de facto nationalization of both financial and nonfinancial firms' capital structures between 1932 and 1947 under the Reconstruction Finance Corporation Act (see Todd [1992]). Bank branching activities, which became restricted in the early 1900s, were liberalized in 1927 but retrenched somewhat in 1933, and branch banking did not expand significantly again until the 1960s. Bank holding company expansion became a device for evading restrictive branch banking laws in the 1920s, but was retrenched between the 1930s and the early postwar years. The Bank Holding Company Act of 1956, its 1966 and 1970 amendments, and the International Banking Act of 1978 (for foreign banks) imposed federal restrictions on bank holding company and foreign bank expansion that have made the creation of nationwide branch or subsidiary banking networks legally and practically impossible, although the advent of automated teller machines has tended to undermine these restrictions.

On the whole, prior to the 1980s, the legal framework for financial services regulation in the United States was constructed roughly as follows:

- Banks and bank holding companies were regulated primarily at the federal level, but limited chartering and supervisory responsibilities were retained at the state level.

- After the 1960s, a gradual trend emerged pursuant to which investment banks, securities broker-dealers, and mutual thrift

institutions converted to corporate form. The securities firms retained their general independence from federal regulation other than the registration and disclosure type of requirements.

- Since the 1970s, it has generally been presumed in banking reform circles that financial services companies should be allowed to engage in all activities not specifically prohibited. Efforts to have federal bank regulators expand the range of permissible activities by administrative interpretation have tended to reflect that presumption. But the long-standing prior view under American and British law was that only activities specifically authorized or "so closely related to banking or managing or controlling banks as to be a proper incident thereto" should be permitted for member banks and bank holding companies.8/ In other words, the governing assumptions regarding the appropriate boundaries of the legal framework for financial services have changed within the last 20 years or so, but the reasons for that change remain somewhat unclear. In any case, the implementation of the altered assumptions through administrative decisions has had uneven success in the courts.9/

- Some authorities maintain that there is a type of "natural market segmentation" or compartmentalization in the financial services industry, to which a legal structure eventually returns, with commercial banks specializing in short-term loans to fund industrial, agricultural, and retail enterprises; thrift institutions specializing in home mortgage finance; insurance companies sticking closely to core insurance and annuity

activities; and securities firms and investment banks financing the medium- and longer-term credit requirements of commercial and industrial enterprises. Such segmented or compartmentalized systems have appeared, in fact, in America periodically from the time of Alexander Hamilton to the present moment, but most modern proponents of banking reform in academic circles have advocated reduction or elimination of geographic and activities restrictions on financial services companies.10/ Intra-industry and intra-regional consolidation tends to reduce the competition that is presumed in a free market, but the modern proponents of banking reform apparently prefer to have different industry sectors compete against each other to restore competitive balance. It is unclear how well grounded in historical analysis the current reform proposals are, but advocates of sectoral segmentation and compartmentalization usually base their arguments on historical analyses that, of course, the opponents contest.11/

III. Conflicting Models of Political Economy

Before drawing hard and fast conclusions about the appropriateness of different approaches to financial services reform, it is useful to review the principal attributes of the competing models of political economy that might be relevant. In the United States, socialist models have been disfavored, but strong centrally planned models like corporatism occasionally have been accepted in governing circles, during the First New Deal, for example (Phillips [1992]). Classical liberal or negative liberty

models have as their principal attributes preferences for the operation of free markets under the Rule of Law (see Hayek [1944]). Such free markets are usually characterized by the absence of protectionism (no artificial barriers to market entry) and the absence of subsidy, which might be negative (as with supervisory forbearance, for example; see Woodward [1992]). But utilitarian or positive liberty models, with attributes preferring limited governmental intervention or regulation in the operations of markets to correct for perceived "market failures," have adherents whose views might be described as the dominant world view in Washington since the 1930s. One way of explaining the 1930s' financial services reforms is as the product of a struggle between Brandeis antitrust liberals (utilitarians) and central planners of the left corporatist type (e.g., Rexford G. Tugwell and, perhaps, A.A. Berle) (see Phillips [1992], pp. 62-67 and Olson [1988], pp. 111-114).

In general, it was the classical liberals who lost out in those 1930s' policy debates.12/ Thus, classical liberals need to think carefully before defending 1930s' policy reforms.

Similarly, those whose reference points are earlier, the era of Alexander Hamilton and Thomas Jefferson, for example, should bear in mind comparable distinctions as to appropriate models. Hamilton was essentially a positive liberty thinker, while Jefferson's and, to a slightly lesser degree, Madison's ideas reflect negative liberty values. Utilitarian and corporatist methods often are inconsistent with classical liberal models--a

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principle that should be remembered as we evaluate the supervisory and regulatory structures described below.

IV. Regulatory Intervention and Closure Options in the 1980s

Banks, bank holding companies, and thrift institutions were subject to the supervisory and regulatory intervention and closure procedures described below during the 1980s. Some of these procedures evolved from specific supervisory experiences during the 1960s and 1970s, such as limitations on standby letters of credit (1974), but most were derived from statutory changes in the 1930s or even from long-standing banking customs. Not until enactment of the Competitive Equality Banking Act of 1987 (CEBA) for the thrift industry and the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) for federally insured institutions generally was there a statutory shift away from the long-term trend toward relaxation of examination and capital ratio standards, the low point of which was the Garn-St Germain Act of 1982. Garn-St Germain was perceived as having created perverse incentives for insured institutions, and CEBA and FIRREA generally were viewed as attempts to rein in some of the excesses attributed to those incentives (see generally Kane [1989] and Mayer [1992]). Basically, FIRREA was an attempt to reintegrate the legal and economic rationales for supervisory intervention, and FDICIA has carried that attempt somewhat further.

Most of the enforcement tools needed by supervisors and regulators already existed before FDICIA was enacted in 1991. The

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federal bank supervisory and regulatory agencies' powers to intervene in the affairs of banks and bank holding companies ordinarily were limited to such institutions in troubled or failing condition prior to enactment of FDICIA. Apart from filing periodic call reports or submitting to supervisory examinations or inspections, most banks and bank holding companies had, and after FDICIA still have, uncontentious relationships with their supervisors and regulators. Most banks are not required to restructure their liabilities in ways that affect the legal rights or financial returns of depositors and other claimants. This part of the paper ignores issues regarding the supervision and regulation of institutions that would be classified as adequately or well capitalized under FDICIA's standards and focuses instead on the supervisory regime for troubled and failing institutions before FDICIA. The next part of the paper focuses on changes to that regime made by FDICIA.

Enforcement Actions

The three principal federal bank supervisory and regulatory agencies (hereafter referred to simply as the Agencies) long have had at their disposal a variety of instruments to redirect a bank's affairs. Possibly the most significant is the cease-and-desist order.13/ Section 8(b) of the FDIC Act authorizes the Agencies to issue such orders against insured banks and institution-affiliated parties. Before initiating the action, however, an Agency must find that an unsafe or unsound practice has occurred, is occurring,

or is about to occur, or that a violation of law, regulation, written agreement, or other written condition imposed by the Agency has occurred, is occurring, or is about to occur. After making the required findings, an Agency must satisfy several procedural requirements, including giving notice to the named parties and providing the opportunity for a hearing, before it may issue an order. Once such an order becomes final, it is enforceable by the courts (see 12 U.S.C. Section 1818[i][1]). Violations of a cease-and-desist order may also result in the imposition of civil money penalties by the Agencies, which may reach $1 million per day (12 U.S.C. Section 1818[i][2]).

Cease-and-desist orders are flexible, multipurpose tools for requiring the affected party to take or to stop certain actions or to take certain actions only after Agency review and approval. They have been used by the Agencies to address a wide variety of banking problems, ranging from unsound loan administration to weak management and violations of law. Typical orders might restrict the payment of dividends, require improved capital ratios, or mandate the development of programs to improve earnings. Since 1989, the Agencies have been explicitly authorized to require the affected parties to take affirmative action to correct conditions resulting from the violation of law or from the unsafe or unsound practice that caused the order to be issued.14/

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Removal of Deposit Insurance

The FDIC may terminate a bank's federal deposit insurance pursuant to Section 8(a) of the FDI Act (12 U.S.C. Section 1818[a]). The statute generally provides that the FDIC may initiate a proceeding once it determines that there exist violations of law or unsafe or unsound practices that require the termination of insurance. Insurance also may be terminated if the FDIC determines that the institution is in such an unsafe and unsound condition that it may not continue operations as an insured bank. Once a final order terminating insurance becomes effective, following notice, hearing, and appeal, the insured deposits of the bank remain insured, less withdrawals, for a period of at least six months or for as long as two years, as the FDIC might decide. Additions to existing deposits and new deposits after final termination are not insured. In similar circumstances under Section 8(a), the FDIC may suspend deposit insurance if it has reason to believe that the insured bank has no tangible capital left under the capital guidelines or regulations of the appropriate Agency.

Forfeiture of Bank Charter

The Office of the Comptroller of the Currency (OCC) may initiate suit in federal court to determine whether directors of a national bank have knowingly violated the National Bank Act or the Federal Reserve Act. Upon judgment of such violation, the rights, privileges, and franchises of the bank are forfeited.15/ In such

circumstances, the bank probably would be liquidated, or a bridge bank might be created.

Conservatorship

Prior to FDICIA, the OCC could, without notice or a prior hearing, appoint a guardian or caretaker for a national bank, called a "conservator," whenever the Comptroller determined that one or more of ten conditions listed in 12 U.S.C. Section 203(a) and (c) existed with respect to that bank. The conditions listed that were most directly relevant to this paper included:

(i) The bank is in an unsafe and unsound condition to transact business, including having substantially insufficient capital or otherwise, and

(ii) The bank has incurred or is likely to incur losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the bank's capital to be replenished without federal assistance.16/

Even when the listed conditions were satisfied, the language of the National Bank Act made it clear that the appointment of a conservator by the OCC is discretionary.

The OCC's objectives in appointing a conservator, who may be the FDIC, are to take possession of the bank and to take such actions as might be necessary to conserve its assets pending disposition of its business. The conservator acts with all the powers of the bank's shareholders, officers, and directors, and unless the OCC prohibits his doing so, he may continue to operate

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the bank as the same legal entity.17/ The conservator may receive new deposits and use them to satisfy the claims of previously existing depositors, which does not necessarily matter much if the grounds for his appointment do not include the bank's actual or prospective insolvency. However, the capacity to use new deposits to pay off old deposits is an important (albeit economically unsustainable) power if the bank actually is or is likely to become insolvent. (See Appendix A.) The bank may challenge the appointment of a conservator within 20 days (12 U.S.C. Section 203[b][1]), but conservatorship usually continues until the OCC (together with the FDIC, if it has been appointed as conservator) decides that the conservatorship may be ended safely and the bank either is permitted to resume business or is sold, merged, or liquidated (that is, a receiver is appointed), etc.18/

Receivership

Before FDICIA, the OCC could appoint a receiver for a national bank whenever "after due examination of its affairs," he found that 1) the bank had forfeited its charter for knowing violations of the National Bank Act,19/ 2) a creditor had obtained a judgment against the bank that remained unpaid for at least 30 days, or 3) the bank had become insolvent (12 U.S.C. Section 191). An additional ground for appointment of a national bank receiver before 1934 was failure to redeem circulating national bank notes--in fact, it was on this ground that most court cases involving national bank insolvencies were decided before 1934, when circulating notes were

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terminated.20/

Since 1933, the insolvency of a national bank has generally been determined by a "maturing obligations" test--that is, capacity to meet maturing obligations, rather than a mere excess of liabilities over assets. However, before 1933, occasionally since 1933, and again after FDICIA, insolvency has also been determined by what amounted to a balance-sheet test (an excess of liabilities other than capital over assets, at book value). That is, a national bank might dishonor maturing obligations or its own circulating notes (pre-1934), or close its doors (which often happened during panics, when circulating notes could not be redeemed in specie), but the final regulatory determination of insolvency, reflecting the condition of the bank's balance sheet, among other factors, would be made by the Comptroller. See Smith v. Witherow, 102 F.2d 638 (3d Cir. 1939).

It is worth noting that the balance-sheet test for insolvency could rely fairly safely on book-value accounting in the past (pre-1933) because national banks then held no long-term assets whose market value would have differed significantly from book value, or historic cost. Also, cash accounting principles were commonly used for banks prior to 1933, which meant that divergences in asset values due to the lags of accrual accounting usually did not exist. The general transition to historic-cost accounting principles for banks occurred pursuant to a supervisory agreement in 1938 (see Mengle [1991] and Simonson and Hempel [1992]).

Whichever test is applied for the appointment of a national

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bank receiver under 12 U.S.C. Section 191, the OCC's decision is entirely discretionary and cannot be compelled by the bank's creditors, although it may be attacked by the bank itself. Once appointed, the receiver (usually the FDIC for insured banks) ordinarily has no mandate other than to take control of the bank's assets and affairs, wind up its business, and close the bank (12 U.S.C. Sections 191 and 194). After all creditors have been paid in full, the OCC (or the FDIC, if acting as receiver) must call a shareholders' meeting to determine whether the receiver, or an agent elected by the shareholders, should complete the distribution of receivership assets to shareholders or should further manage affairs (12 U.S.C. Section 197).

Bridge Banks

Bridge banks share many common attributes with and serve many of the same economic objectives as national bank conservatorships. The principal difference is that bridge banks are organized and administered by the FDIC, while the OCC appoints national bank conservators. In effect, the bridge bank power enables the FDIC to take over failing banks even though the FDIC is not a charter-issuing agency.

Bridge banks were authorized under Section 503 of CEBA (1987)(now 12 U.S.C. Section 1821 [n]). Previously, in states without conservatorship statutes, there was no orderly way for the FDIC to encourage state regulators to close state-chartered banks while assuring those regulators that the banking operations of the

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closed banks would continue--occasionally an important factor in establishing political support for the closure. The CEBA provisions regarding bridge banks required actual closing of an insured bank before a bridge bank could be chartered to continue its operations (former 12 U.S.C. Section 1821[i][1]).

FIRREA (1989) amended the bridge bank provisions of the FDI Act to authorize the chartering of a bridge bank whenever it is determined by a court, the appropriate administrative body, or the appropriate Agency that one or more insured depository institutions are either "in default" (that is, a conservator, receiver, or other legal custodian is actually appointed) or "in danger of default" (that is, it is determined either that the insured institution cannot meet maturing demands or obligations without federal assistance or that the insured institution has incurred or is likely to incur losses that would substantially deplete all of its capital without federal assistance).21/ Thus, the creation of a bridge bank no longer need await a chartering authority's formal closing order and becomes largely discretionary on the part of the FDIC.

After the FDIC's board of directors authorizes the organization of a bridge bank, the OCC <u>must</u> charter it (12 U.S.C. Section 1821 [n][1][A]). A bridge bank is deemed a new, insured national bank from the time it is chartered, "in default" for the purpose of abridging certain contractual obligations of the former depository institution, operating without capital, and <u>not</u> an agency, establishment, or instrumentality of the U.S.

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government.22/ In order to organize a bridge bank, the FDIC's directors must determine that at least one of the following conditions exists:

(i) The costs of operating the bridge bank would not exceed the costs to the FDIC of liquidation;

(ii) The continued operation of an insured bank is essential to provide adequate banking services in the community; or

(iii) The continued operation of the former bank is in the best interest of its depositors (12 U.S.C. Section 1821 [n][2][A]).

A bridge bank may assume only the deposits and other liabilities and purchase only the assets of the defaulting insured bank that the FDIC determines to be appropriate.23/ A bridge bank generally can exercise all the corporate powers of a national bank, without having to observe national banks' capital adequacy requirements. Its existence is limited to two years, but this may be extended by the FDIC for up to three additional one-year periods (12 U.S.C. Section 1821 [n][4] and [9]). The statute anticipates that any bridge bank will be merged, sold, or otherwise disposed of during its existence (12 U.S.C. Section 1821 [n][10]-[11]). If not, the FDIC is to dissolve it and commence liquidation, with the OCC appointing the FDIC as receiver (12 U.S.C. Section 1821 [n][12]). Hortative language in the statute (12 U.S.C. Section 1821 [n][3][B]) apparently contemplates that existing borrowers and depositors continue to be accommodated.

V. Changes Effected by FDICIA

FDICIA changed the supervisory intervention and closure regimes described above only minimally, but added a new set of intervention powers: capital-based prompt corrective action (Sections 131-133 of FDICIA), designed to impose a supervisory duty to avoid or minimize loss to the deposit insurance funds and, ultimately, to the taxpayer. Under prompt corrective action, there is essentially an increasing degree of supervisory intervention in an insured institution's affairs as the leverage capital ratio (capital vs. total assets) or the risk-based capital ratio (capital vs. risk-adjusted or weighted assets) declines.

Five capital ranges are established for open depository institutions, ranging from well-capitalized to critically undercapitalized. The Agencies are authorized to define the capital adequacy ratios for those ranges. Only the first two ranges (well-capitalized and adequately capitalized) may be exempted from prompt corrective action as capital adequacy declines. Once capital reaches the critically undercapitalized level, currently defined as a Tier 1 leverage capital ratio of 2 percent or less, the institution must be closed within 90 days, unless the Agency grants an extension that can be renewed only once (conservatorships and bridge banks are exempted from this rule). While Agency discretion played an important role in the pre-FDICIA supervisory regimes, that discretion has been severely limited by the prompt corrective action provisions in order to mandate the abandonment of supervisory forbearance by the Agencies. Rightly or

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wrongly, Congress believed that it was forbearance that either caused or increased the losses incurred by the Resolution Trust Corporation and the Bank Insurance Fund during the 1980s.24/

Other relevant changes made by FDICIA include:

Enforcement Actions. The criteria for issuance of cease-and-desist orders were amended by adding the receipt in an institution's most recent report of examination of a less-than-satisfactory rating for asset quality, management, earnings, or liquidity. If the deficiency goes uncorrected, the appropriate Agency may deem the continuance of the deficiency an unsafe or unsound banking practice (12 U.S.C. Section 1818 [b][8]).

Conservatorship. The standards for appointment of conservators of national banks were unified with those for appointment of the FDIC as conservator of insured state-chartered depository institutions (12 U.S.C. Section 1821 [c][5], effective December 19, 1992). The principal new feature of these revised standards is the explicit authorization of a balance-sheet test (an excess of liabilities over assets) as grounds for appointment of a conservator, as distinguished from the mere inability to satisfy claims as they mature.

Receivership. The receivership section of the National Bank Act (12 U.S.C. Section 191) was modified, effective December 19, 1992, to provide for the appointment of the FDIC as receiver of national banks without prior notice or hearings on the same unified grounds as for the appointment of the FDIC as conservator, including the explicit authorization of a balance-sheet test.

Also, a receiver or conservator may be appointed if a national bank has fewer than five directors. No prior examination is required for the OCC to be authorized to appoint a receiver.

* *

FDICIA made no other substantive changes in the bank supervisory intervention and closure regime. Of all these changes, it is reasonable to predict that the capital-based intervention standards and the procedures for prompt corrective action will prove to be the most far-reaching. FDICIA also contains language aimed at encouraging studies of market-value accounting and limiting the use of the Federal Reserve Banks' discount windows, but the risk-adjusted FDIC assessments probably will prove to be the most significant supervisory change other than the supervisory interventions foreseen under prompt corrective action. In general, it is fair to characterize FDICIA as a market-oriented attempt to realign the legal and economic incentives underlying supervisors' and bankers' behavior in the same taxpayer-cost-reducing direction and away from forbearance.25/

VI. After FDICIA: The Evolving Legal Agenda

The enactment of FDICIA essentially reflected congressional frustration and disappointment regarding the performance of depository institutions' supervisors and regulators over the prior decade. Only the national credit union industry, among depository institutions, has managed to avoid (thus far) the same degree of congressional scrutiny and mandate for supervisory intervention.

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However, it is reasonable to expect that the emergence of problems in that industry, albeit unlikely, also would give rise to FDICIA-like legislation.

Insurance companies remain almost entirely regulated by the states, but it is conceivable that high-profile failures of large insurers would generate enough political pressure to cause Congress to attempt to mandate uniform nationwide supervision. Under existing economic conditions, however, very few, if any, large insurance companies are likely to fail. In early 1993, press reports indicated that Representative Joseph Kennedy 2d (D.-Mass.) had introduced a bill to require insurance companies to comply with federal standards analogous to those for banks regarding disclosure of data on racial and demographic characteristics of customers, an anti-redlining measure. It appeared that the Kennedy bill contemplated offering increased access to the Federal Reserve Banks' discount windows in exchange for compliance with federal anti-redlining standards (Garsson [1993]).

Securities firms and investment banks also continue to be chartered under state, not federal, law. Federal supervision of the securities industry, however, has been a fact of life since 1933, though state supervision continues to play an important role with respect to small companies, securities issues not registered with the Securities and Exchange Commission, and the like. It is conceivable that a few high-profile failures in the securities industry might trigger a congressional movement toward uniform, federal supervision. Mutual funds essentially are subject to the

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same kinds of supervision and chartering authority as securities firms and investment banks, but they currently experience a fairly high degree of federal supervision.

Comparatively few new powers are likely to be granted to federally insured depository institutions, given the prevailing mood in Congress. Interstate branching opportunities might arrive soon for well-capitalized banks, but increased insurance underwriting powers seem unlikely. It is fair to state that, currently, there is some support in Congress for regulatory relaxation tied to relief of the "credit crunch," but little support for wholesale expansion of banks into new business lines.

The rising importance of mutual funds seems to make them outstanding candidates for the next round of increased federal regulation of financial services companies. In my opinion, such increased regulation is unnecessary and would be unwise because of the implicit guarantee that federal supervision and regulation might carry for mutual fund activities.

For the 103rd Congress, at least, it appears that the principal legal agenda items regarding financial services are reform and restructuring proposals covering the federal bank supervisory authorities. Regarding the Federal Reserve, bills introduced in both houses of Congress during January 1993 would tend to centralize control in Washington of monetary policy deliberations that have been left until now in the hands of Reserve Bank presidents, whose selection is largely determined by directors elected by private-sector member banks.26/

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In the House of Representatives, two bills would restructure the supervisory functions of the Agencies. Under the Gonzalez plan, a new Federal Banking Commission would be created as an independent regulator, and all supervisory responsibilities of the Agencies (except the National Credit Union Administration, or NCUA) would be transferred to it.27/ Under the Leach plan, a new Federal Banking Agency would be created as an independent regulator, with the OCC and the Office of Thrift Supervision combined into it. The new Agency would acquire jurisdiction over bank holding companies with federally insured subsidiaries whose assets are less than $25 billion and whose principal subsidiary is a federally chartered depository institution, together with all stand-alone federally chartered banks and thrift institutions. The FDIC would be the federal supervisor for stand-alone state-chartered banks and thrifts as well as for bank and savings and loan holding companies with assets less than $25 billion and whose principal subsidiary is a state-chartered institution. The NCUA's jurisdiction would remain unaffected. Thus, the Federal Reserve would be left as the principal supervisor of bank holding companies with insured banks as their principal depository institution subsidiaries and with total assets in excess of $25 billion. The Federal Reserve's supervisory jurisdiction would extend to all such bank holding companies' subsidiaries, regardless of the type of charter held. The Fed would also be the principal supervisor for all foreign banking activities and for U.S. activities of foreign banks with worldwide assets in excess of $25 billion.28/

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Whatever further legal reforms are attempted, it might prove useful when analyzing them to bear in mind the principles articulated above regarding competing models of political economy. For example, if we intend to achieve classically liberal results (market-determined outcomes) consistent with a least-government model, it might make more sense to leave the regulation and subsidy of insurance companies at the state, not the federal, level. In matters affecting the expansion of banks' powers, it might prove helpful to consider whether German universal banking models, for example, have anything useful to communicate to U.S. policymakers if the policymakers really intend to follow a classical liberal model of banking structure and regulation in the long run. It just might be the case that German-style universal banking works as it does because of a radically different set of accumulated customs, laws, and assumptions about the optimal method for organizing society than the set that has applied in the United States.29/ After all, one of Hayek's points in The Fatal Conceit (1988) is that the evolution of the structure of markets and institutions in capitalist societies is not independent of the societies' moral and ethical codes. If that proposition is true, then it ought to be necessary to change the German universal banking model to fit U.S. society, or to change U.S. society toward Germanic norms, if we set about to accommodate German-style universal banking.30/

If the optimal structure for the central bank or for the Agencies (federal bank supervisors) becomes the principal agenda item after FDICIA, it would be useful to apply the same principles

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described above to the analysis. An increased tendency to centralize monetary policy or supervisory powers in Washington might be consistent with centrally planned political economy models and with some varieties of utilitarianism, even though at first glance this would seem to be repugnant to classically liberal or mildly utilitarian principles. It is unclear that a rhetoric of free markets and free trade could be easily reconciled with the practice of strongly utilitarian or central planning methods in any logically rigorous way.31/

VII. Conclusion

The legal and theoretical history of financial institution structure in the United States carries an ambiguous message for present-day policymakers trying to devise an optimal framework for financial services. At the inception, the dominant political economy model was classically liberal, but strong policymakers like Alexander Hamilton and, later, Nicholas Biddle strove constantly and with increasing success to introduce utilitarian attributes into that framework. A central bank was created, barriers to perpetual corporate charters for financial institutions became eroded, double liability for shareholders was dropped, federal deposit insurance was introduced, and what appears to be an inexorable tendency toward centralization of supervision in Washington has developed.

The recent policy debate has been dominated by questions regarding supervisors' powers to intervene, while the better

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question might have been whether it would be possible to return to a structure that reduced the role of federal supervisors and left a greater role for the states and for market discipline of financial institutions. If our methods and methodologies increasingly become strongly utilitarian or mildly corporatist, it is fair to ask whether it is logically correct or morally responsible to continue to use free-market (classical liberal) rhetoric to describe what we do. I would prefer to dismantle the structures that ensure increasing levels of centralization of the financial services supervisory framework and to return to the original, classical liberal model. Dismantling federal deposit insurance, separating solvency-support (capital-replacement) lending from the central bank and placing it on-budget at the Treasury, and restoring increased levels of manager and shareholder accountability for the conduct of their financial institutions would seem to be useful places to begin this process.

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FOOTNOTES

1. FDICIA, enacted December 19, 1991, is Public Law No. 102-242.

2. Other nations' histories either are or have been somewhat relevant to (and are often cited as possible models for) the restructuring of American legal and financial services institutions. Although those histories are interesting and often instructive, the hard fact remains that, as a matter of legal history, only the English and Scottish experiences are directly relevant to the actual evolution of the framework for the American financial services industry. The future, of course, might be different, but the past is less mutable on this point than proponents of universal banking or expanded governmental subsidies of the financial services industry might wish to acknowledge. For detailed analysis of this issue, see Roe (1993).

3. Useful summary descriptions of the legal structures of the First and Second Banks of the United States appear in Judge Harold Greene's supplemental opinion in Melcher v. Federal Open Market Committee, 644 F.Supp. 510 (District Court D.C. 1986). Subsequently, Melcher was affirmed on other grounds, 836 F.2d 561 (D.C. Cir. 1987); certiorari denied, 486 U.S. 1042 (1988).

4. Good descriptions of the legal forms and structural organizations found among large banks in early American history appear in Hammond (1957) and Gibbons (1859). A comparable description for Britain, especially for Scotland, is in L. White (1984), pp. 23-49.

5. See A. Smith (1976), book V, chapter 1, pp. 245-282; Tansill (1965), pp. 563, 724-725; Schlesinger (1945), pp. 76-77; Mowry (1958), p. 79; and Brandeis (1914), esp. pp. 135-223.

6. See Hamilton (1790, 1791); Hart (1899), pp. 230-252, 274-288; and Smith and Beasley (1972), pp. 90-94.

7. See Jefferson (1791); Madison (1791); James (1938), pp. 556-558; and Schlesinger (1945), pp. 76-77.

8. This phraseology appears in Section 4(c)(8) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. Section 1843).

9. See, for example, Board of Governors v. Dimension Financial Corporation, 474 U.S. 361 (1986), in which the Supreme Court decided, 8-0, that the Board lacked the authority to reinterpret the statutory definitions of terms like "bank" or "commercial loan" in Section 2(c) of the Bank Holding Company Act (12 U.S.C. Section 1841) so as to extend the Board's regulatory authority to nonbank banks. Such banks generally remain outside Federal Reserve regulation unless they are owned or controlled by

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banks or bank holding companies. On the other hand, most of the Board's orders liberalizing securities powers of the affiliates of member banks, reversing prior, limited interpretations of Section 20 of the Banking Act of 1933 (12 U.S.C. Section 377), have withstood court challenges since the early 1980s.

10. The idea of "natural market segmentation" is discussed favorably by, among others, Stevens (1898), p. 264, and, nearly 100 years later, Minsky (1993), who in turn credits Kregel (1992) for this idea. On the other hand, the idea of dismantling segmented or compartmentalized financial services institutions is discussed favorably by, among others, England (1993), Kaufman (1993), and U.S. Treasury (1991).

11. The best-known historical analyses in favor of segmentation and compartmentalization of financial services are Brandeis (1914) and Pecora (1939). Among the better-known recent critiques of those analyses are E. White (1986) and Benston (1990). For a good current restatement of the recent critiques, see Wheelock (1993).

12. Herbert Hoover and Carter Glass were, I suppose, the leading illustrations of this proposition. See generally Hoover (1952) and Smith and Beasley (1972).

13. Other similar enforcement actions employed by the Agencies are the written agreement and the memorandum of understanding. Like the cease-and-desist order, the written agreement is a formal supervisory action. The memorandum of understanding, however, is informal. The Agencies, with respect to commercial banks, are the Federal Reserve, the Office of the Comptroller of the Currency, and the FDIC.

14. 12 U.S.C. Section 1818(b)(6). This section specifically lists the following types of affirmative action that affected institutions may be required to take: 1) restitution for certain losses, 2) restrictions on asset growth, 3) disposal of any loan or other asset, 4) rescission of agreements or contracts, and 5) employment of qualified officers and employees who may be subject to approval by the Agency. It should be self-evident that not all onerous banking regulations proceeded from FDICIA alone.

15. 12 U.S.C. Sections 93(a) and 501(a). Directors of national banks may be personally liable for damages caused to the banks or to others because of their consensual violations of the National Bank Act or the Federal Reserve Act.

16. 12 U.S.C. Section 203 was completely rewritten by FIRREA in 1989. The general counsel of the Federal Reserve Board, Walter Wyatt, drafted the original Bank Conservation Act (12 U.S.C. Sections 201-211) as Title II of the Emergency Banking Act of March 9, 1933. (Federal Reserve Bulletin, vol. 19 [1933], p. 115. See

also, Jones [1951], pp. 21-22.) The former condition for appointment of a conservator under Wyatt's version of Section 203 was "whenever [the OCC] shall deem it necessary in order to conserve the assets of any bank for the benefit of the depositors and other creditors thereof. . . ." In other words, no explicit finding of actual or potential insolvency was required, but former Section 203 provided explicitly that a conservator was to have all the powers of a receiver, in addition to powers necessary to operate the bank. Jones (1951), p. 22, notes that the title "conservator" was "akin to receiver but less harsh on the public ear." The original object of conservatorship "was to stave off creditors long enough to rehabilitate a bank rather than let it go into receivership." (Ibid.)

17. 12 U.S.C. Section 206, as amended in 1989 by FIRREA. Previously, Section 203 provided that a conservator had all the rights and powers of a receiver and that the rights of all parties with respect to a conservator were "the same as if a receiver had been appointed," which limited the conservator's capacity to maintain uninterrupted banking services (for example, claimants against conservatorships could not have obtained full satisfaction of their claims--to the possible prejudice of other claimants--without judicial approval). Now, a judicial order might be necessary to <u>prevent</u> the conservator from satisfying some claims in full, to the potential detriment of other claimants.

18. 12 U.S.C. Section 205. Former Section 205 provided for termination (other than by "reorganization" under Section 207 [repealed in 1989] or conversion into receivership) whenever the OCC decided that it could safely be done and would be in the public interest.

19. The knowing violations of the National Bank Act prohibited under 12 U.S.C. Section 93 were not amended by Title IX of FIRREA, which established civil money penalties for violations of the Act. Those knowing violations include the acceptance of deposits after the commission of an act of insolvency, or in contemplation of such an act. 12 U.S.C. Section 91. This prohibition against the acceptance of new deposits while knowingly insolvent was enforced frequently until 1934 (when federal deposit insurance commenced), but has been enforced only rarely since then and not, to the author's knowledge, within the last 20 years.

20. See 12 U.S.C. Section 192 and cases cited thereunder. Many lawyers are deceived by looking only under Section 191 for cases involving insolvent national banks.

21. FIRREA Sections 204 and 214; 12 U.S.C. Sections 1813(x) and 1821(n). These criteria are essentially the same as those for appointment of a receiver or conservator of a national bank, except for the new balance-sheet test and having fewer than five directors, added by FDICIA.

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22. 12 U.S.C. Section 1821(n)(1)(E), (n)(2)(A)-(C), and (n)(5)(A).

23. 12 U.S.C. Section 1821(n)(1)(B) and (n)(3)(A). Thus, the FDIC has virtually complete discretion to determine the composition of the liabilities and assets of a bridge bank.

24. Most of the relevant statutory amendments made by FDICIA are in the FDI Act. See generally Carnell (1992) on prompt corrective action under FDICIA and on other legal issues related to FDICIA. On the costs of forbearance, see Woodward (1992) and Thomson (1993).

25. See Thomson (1993), Woodward (1992), and Carnell (1992).

26. See, for example, in the Senate, S. 212, introduced by Senator Dorgan, and S. 219, introduced by Senators Sarbanes, Sasser, Riegle, and Dorgan, both on January 26, 1993. In the House of Representatives, see H.R. 28, introduced by Representative Gonzalez on January 5, 1993, and H.R. 586 and 587, introduced by Representatives Hamilton and Obey on January 26, 1993.

27. See H.R. 1214, introduced by Representative Gonzalez on March 4, 1993.

28. See H.R. 1227, introduced by Representative Leach on March 4, 1993.

29. Minsky (1993), citing Kregel (1992), observes that "the supervision of the German banks [which is located outside the Deutsche Bundesbank, the central bank] is much closer than anything contemplated in the States." Universal banking performs as it does in Germany, I argue, principally because of a greater and more long-standing tolerance for corporatist ideas in German society and under German law than has been the case in the United States. Many important German financial and industrial combinations would not have been allowed under U.S. antitrust laws and doctrines that have prevailed here for the greater part of a century.

30. An important new article on this topic is Roe (1993).

31. See Neier (1993).

* * *

NOTE ON FURTHER READINGS ON FDICIA

The best recently prepared sources of information on the economic and theoretical evolution of FDICIA of which I am aware are Benston and Kaufman (1992 and 1993). For the legal and theoretical evolution of FDICIA, see Carnell (1992), Pike and Thomson (1992), Todd (1993), and Wall (1993). The most thorough

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statement of Federal Reserve positions on the bills that subsequently became FDICIA is Greenspan (1991).

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APPENDIX A

FROM CONSERVATORSHIP TO PONZI FINANCE

Before FIRREA (1989), the conservatorship statute (former 12 U.S.C. Section 206) explicitly required conservators of national banks to segregate new deposits (those received after their appointment) from previously existing deposits, to make such prior deposits available for withdrawal only on a ratable basis (which could be estimated), and not to use new deposits to liquidate any indebtedness of the bank existing prior to their appointment. After FIRREA, Section 206(c) provides that the OCC may require the conservator to set aside amounts that may be withdrawn safely, in the OCC's judgment, by all depositors and creditors who are similarly situated. Thus, the OCC still might require a conservator to segregate old from new deposits, but the former statutory requirement has been made discretionary and therefore is subject to political pressures not to segregate. In fact, in the conservatorships created for banks and thrifts since FIRREA, new deposits have not been segregated from old deposits.

The economic effect of failure to segregate deposits in an insolvent or prospectively insolvent institution is to spread uninsured claimants' losses among all funders of the federal safety net instead of limiting those claimants' recoveries to the amounts reasonably estimated to be realized from the eventual liquidation of the conservatorship assets. The FDIC's bridge banks are also susceptible to this criticism because, while they function more or less like conservatorships, they do not segregate old from new deposits.

Failure to segregate deposits in conservatorships effectively creates a Ponzi scheme*/ in which the existing shortfall between book and market asset values is merely rolled forward into the new asset pool supporting the mixture of both old and new deposits. In the economic modeling literature, this problem is addressed in formulaic terms by McCulloch and Yu (1990).

*/A Ponzi scheme is a fraudulent pyramid scheme in which funds placed by new investors are used to meet demands for withdrawals or returns on investments of earlier investors. Such schemes are so named because they first became famous when one of them was unmasked in Massachusetts in 1920. The operator of that scheme was named Charles Ponzi, who died penniless in Brazil in 1949. See Marcia Grodsky, "Charles Ponzi," in Encyclopedia of American Business History and Biography: Banking and Finance, 1913-1989, pp. 355-59. New York: Facts on File, Inc., 1989.