

The Treasury Plan for Banking Reform

By William R. Keeton

The recent problems of the banking industry have prompted calls for major reform. The high rate of bank failures has nearly depleted the FDIC's reserves, arousing fears of a taxpayer bailout similar to that for S&Ls. And according to some critics, FDIC protection has encouraged banks to specialize in risky ventures like commercial real estate development, distorting the allocation of investment in the economy. Also, recent declines in bank profits and the shrinking role of banks in the financial system have sparked concern about the long-run health of the banking industry.

Responding to these concerns, Congress ordered the Treasury Department in August 1989 to undertake a comprehensive study of banking reform. This study was completed in February 1991 and has become the focus of an intense debate over banking reform. One part of the Treasury plan would reform deposit insurance by varying deposit insurance premiums with risk, reducing coverage, and enforcing capital requirements more strictly. A second part would restructure the financial system by allowing full interstate banking, permitting banks to affiliate with any financial company, and letting commercial firms own banks indirectly. According to Treasury, both sets of reforms are needed: the deposit insurance reforms to protect the taxpayer and allocate credit more efficiently, and the restructuring proposals to protect the taxpayer and restore the long-run health of the banking industry.

This article argues that the Treasury plan contains a number of useful proposals. However, the plan can be criticized for being too cautious in some respects and too bold in others. The first section reviews Treasury's justification for reform. The second section

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focuses on Treasury's proposals for deposit insurance reform, while the last section examines Treasury's proposals for financial restructuring.

The Need for Reform

Most observers agree that the system of deposit insurance and bank regulation established in the 1930s served the nation well for many years. But the banking industry and deposit insurance funds now face serious problems. To justify reform, the Treasury study describes these problems and then argues they have specific causes that can be corrected through new legislation.¹

The most obvious problem with the current system is that taxpayers may have to pay for deposit insurance losses. The failure of hundreds of S&Ls in the 1980s bankrupted the S&L insurance fund and forced Congress to pass a massive bailout bill. Although the banking industry has been healthier, the rate of bank failures in the nation has been high by historical standards, and a few states like Texas have been particularly hard hit. The high failure rate has raised the FDIC's costs above the premiums paid by banks. As a result, the bank insurance fund has declined from \$18 billion in 1987 to \$8 billion in 1990, with a further decline expected this year. Because the U.S. government stands behind federal deposit insurance, taxpayers may have to bail out the FDIC if it eventually becomes insolvent.²

A second problem with the current system is that investment is being misallocated toward unproductive uses. In a few highly publicized cases, banks and S&Ls have spent depositors' money on lavish perquisites for owners and managers. But even more important, many banks and S&Ls have invested too heavily in risky projects--projects with a high potential

payoff but also a high chance of failure. Critics often charge, for example, that the current excess supply of office space is partly due to banks and S&Ls investing too heavily in high-risk commercial real estate loans during the 1980s. According to this view, the nation's productive capacity would be higher if banks and S&Ls had used the same funds to finance safer projects.

A third problem with the current system, in Treasury's view, is that the long-run health of the banking industry has eroded. The average profitability of the industry has decreased noticeably since the mid-1980s. For example, bank profits fell from 0.77 percent of assets in the 1970s to 0.69 percent in 1980-84 and 0.55 percent in 1985-89 (Department of Treasury 1991a, Chapter I, Table 6). The share of total financial sector assets held by commercial banks has also shrunk over the last ten years. Finally, Treasury points out that U.S. banks have become less important internationally, with far fewer banks ranking among the largest in the world.

What accounts for these problems? One cause, Treasury believes, is increased competition from other financial firms and securities markets. Many borrowers that used to rely solely on banks for credit now borrow in the open market or from such nonbank intermediaries as finance companies. This loss of business has reduced bank profits. According to Treasury, one way banks might have made up for the loss of business was by offering new financial services, such as insurance and securities underwriting. But banks were prohibited by law from offering such services. Instead, banks shifted to commercial real estate lending and other risky activities that promised high payoffs if successful.³

Another cause of the current crisis, in Treasury's view, is the expansion in the scope of deposit insurance. This expansion has come

partly through an increase in de jure coverage, the protection to which depositors are legally entitled. In 1980, for example, Congress increased the statutory limit on each account from \$40,000 to \$100,000. But there has also been an increase in de facto coverage, the protection the FDIC provides uninsured depositors through its method of handling bank failures. In most recent bank failures, the FDIC has fully protected uninsured depositors—for example, by arranging a merger with a healthy bank. Indeed, at banks with over \$1 billion in assets, the FDIC has never allowed uninsured depositors to suffer a loss—a policy known as “too big to fail.” According to Treasury, the growth in de jure and de facto coverage has raised the cost to the FDIC of resolving each bank failure. And higher coverage has increased risk-taking by reducing depositors’ incentive to discipline risky banks by withdrawing their funds or demanding higher rates.

A third cause of the current banking problems is inadequate supervision and regulation by government. In Treasury’s view, increased competition and higher coverage induced banks to shift to riskier activities. But regulators could have done a better job of controlling bank risk-taking. For example, Treasury argues that regulators should have closed insolvent S&Ls more quickly and imposed more restrictions on banks and S&Ls that failed to meet minimum capital requirements. And the government could have improved upon the current system of flat-rate premiums, under which all banks pay the same premium regardless of how much risk they take.

Treasury proposes to solve the crisis in banking and deposit insurance by attacking all three causes. One set of proposals would reform the deposit insurance system by reversing the expansion in coverage and improving the regulation and supervision of banks. A

second set of proposals would restructure the financial system by making it easier for U.S. banks to compete with securities markets, other financial institutions, and foreign banks.⁴

Deposit Insurance Reform

Treasury proposes to reform the deposit insurance system in three principal ways. First, deposit insurance premiums would depend partly on banks’ estimated risk. Second, the scope of deposit insurance would be reduced by limiting the coverage to which depositors are legally entitled and by protecting uninsured depositors less often when banks fail. And third, current capital standards would be enforced more strictly through a program of prompt corrective action against undercapitalized banks. According to Treasury, all three reforms would help reduce taxpayer risk and prevent misallocation of investment to unproductive uses.

Risk-based premiums

Under the Treasury proposal, a bank’s deposit insurance premium would depend on its capital, credit risk, and interest rate risk. Because risk would be measured imperfectly, the new system would not solve all problems. However, it would improve upon the current system of flat-rate premiums.

Rationale. All banks now pay a premium equal to a fixed percentage of their domestic deposits. Treasury argues that premiums should also depend on banks’ estimated risk to the insurance fund. In theory, such a system would reduce each bank’s incentive to take risk and would make it harder for risky banks to outbid safe banks for deposits. Thus, bank failures would decline, reducing taxpayer exposure. At the same time, the allocation of investment would improve because banks

would choose safer investments.

Description. The specific measure of risk proposed by Treasury is one recently adopted by regulators to determine each bank's capital requirement. As of this year, banks must maintain a minimum ratio of capital to risk-adjusted assets, which are computed as a weighted sum of assets in four risk categories. Under the Treasury plan, banks would still have to satisfy this requirement, but those with higher ratios of capital to risk-adjusted assets would pay lower premiums. The weights assigned to the four risk categories now reflect only the relative default risk of different assets—for example, business and consumer loans have a weight of one, while Treasury securities have a weight of zero. However, another part of the Treasury plan would require regulators to come up with a new measure of risk-adjusted assets that also reflected banks' exposure to interest rate changes.

The Treasury proposal leaves it up to the FDIC to decide how much premiums should vary with risk-based capital ratios. However, Treasury notes that it would be counterproductive for the FDIC to charge a significantly higher premium to a bank whose risk-based capital ratio fell below the minimum requirement due to unexpected losses. Charging such a bank a significantly higher premium would impede its recovery and increase its chance of failure. Presumably, then, Treasury believes risk-based premiums should be used mainly to reward banks for holding more capital than required rather than to penalize banks for holding less.

Evaluation. Although risk-based premiums are no panacea, the Treasury proposal would be an improvement over the current system. An important strength of the proposal is that it would use an ex ante measure of risk rather than an ex post measure. But because that measure is highly imperfect, Treasury is wise

to recommend that risk-based premiums supplement minimum capital requirements rather than replace them.

Ex ante measures of risk are more effective in controlling risk-taking than ex post measures. Ex ante measures of risk reflect a bank's chance of suffering problems in the future, while ex post measures reflect problems that have already occurred. A bank whose loans and investments have performed poorly will have a high chance of failing, suggesting it should be charged a high premium to cover the FDIC's costs. But telling banks they will be charged a higher premium if they suffer heavy losses may do little to discourage them from making risky loans and investments. Suppose, for example, that a bank is considering a group of risky loans that will yield high profits if repaid but wipe out the bank's capital if not repaid. In this case, knowing the premium will increase if the loans default will not deter the bank from making the loans. Since the owners will lose their entire investment if the loans default and the bank fails, the owners will not care if the bank is charged a higher premium when the loans default. A more effective way to discourage risk-taking is to base premiums on ex ante measures of risk so that banks are penalized before they get into trouble.

The risk-adjusted capital ratio, the measure of risk proposed by Treasury, would reflect ex ante risk in three ways. First, the four categories used to compute risk-adjusted assets would measure an asset's inherent risk of default rather than its past performance. Second, risk-adjusted assets would be redefined under the Treasury plan to reflect a bank's exposure to future interest rate swings. Finally, capital would measure ex ante risk by indicating a bank's cushion against future losses and its incentive to make

risky investments.⁵

To be sure, the risk-adjusted capital ratio is far from perfect as a measure of ex ante risk. For example, the proposed measure of capital could hide declines in net worth due to bad interest rate gambles or unrecognized loan losses. And the four risk categories are very broad, lumping all business and consumer loans together regardless of the borrower's creditworthiness. Crude as the risk-adjusted capital ratio is, however, it is still preferable to the purely ex post measures in some other plans.⁶

Given the flaws in the risk-adjusted capital ratio, Treasury is wise to propose that risk-based premiums complement minimum capital requirements rather than replace them. If the FDIC were to rely solely on risk-based premiums to control risk-taking, some banks could hold less capital than they should to guard against failure. Suppose, for example, that a bank had unusually risky business loans. Such a bank would have more chance of failing than banks with safer business loans. As a result, the bank's owners would have more incentive than the owners of safer banks to protect their wealth by reducing their investment. With risk-based premiums, the risky bank would have to pay a higher premium as its capital declined. But because the Treasury proposal would treat all business loans the same in calculating premiums, the risky bank's premium would not increase any more than a safe bank's premium. Thus, without a minimum capital ratio, the bank with risky loans could end up holding less capital than banks with safer loans—the opposite of what is needed to limit the rate of bank failures.⁷ A more prudent approach is the one suggested by Treasury—retain a floor on capital and use risk-based premiums to reward banks for exceeding the floor.

Reduction in coverage

Treasury proposes to reduce both de jure and de facto coverage of bank deposits. But under the proposal, regulators could continue to provide de facto coverage whenever financial stability was threatened. Thus, the proposal does not resolve the crucial issue of whether it is more important to protect the taxpayer and prevent misallocation of investment to risky uses or to preserve financial stability.

Rationale. As noted earlier, depositors now enjoy two forms of protection—the de jure coverage to which they are entitled by law and the de facto coverage they enjoy due to the FDIC's method of handling bank failures. Treasury argues that reducing de jure and de facto coverage would yield two important benefits. The first would be to reduce the FDIC's total liability to depositors, thereby limiting taxpayer exposure. The second benefit would be to increase depositor discipline by giving depositors more reason to worry about the safety of their funds. Like risk-based premiums, an increase in depositor discipline would force banks to pay more of the cost of their risk-taking. For example, lower coverage would force risky banks to increase their deposit rates further above those of safe banks to avoid losing funds. Thus, bank risk-taking would decline, reducing taxpayer risk and improving the allocation of investment.

Treasury also argues that coverage could be significantly reduced without threatening financial stability. Treasury acknowledges that deposit insurance has promoted stability by discouraging bank runs and preventing bank failures from spilling over to other banks. But Treasury believes stability could be preserved at much less cost to the taxpayer by having regulators determine on a case-by-case basis when uninsured depositors need protection. In

this view, full de facto coverage is necessary only in exceptional cases, as when a failing bank has incurred large debts to other banks through interbank deposits or the payments system.

Description. The Treasury plan contains two proposals for reducing de jure coverage. The first is to limit each depositor to two insured accounts of \$100,000 or less per bank, with one of the two accounts for retirement. Under current rules, an individual can obtain more than \$200,000 in coverage at a single bank. For example, a family of three can obtain \$1.2 million in total coverage by opening 12 separate accounts at the same bank.⁸ Treasury would also require the FDIC to study the feasibility of a systemwide limit on coverage—a measure that would be much more effective in reducing total coverage but also costlier to administer.

The second way the plan would reduce de jure coverage is by eliminating coverage for brokered deposits and most deposits of employee pension plans. Under current law, wealthy investors can fully insure large amounts of money by using deposit brokers to spread their money among different banks in lots of \$100,000. Such deposits are fully insured because coverage “passes through” to each of the deposit broker’s customers, no matter how large the broker’s total investment in a bank. Pension plans also benefit from such pass-through coverage. No matter how much a pension plan invests in a bank, each member of the plan enjoys full coverage as long as his own share of the total does not exceed \$100,000. The Treasury plan would prohibit all coverage of brokered deposits and most coverage of pension plan investments.⁹

The Treasury plan also contains several proposals for reducing de facto coverage. To understand these proposals, it is necessary to know how the FDIC resolves bank failures.

The FDIC uses four methods: purchase and assumption (P&A), open-bank assistance, payoffs, and insured deposit transfers. The main difference is that uninsured depositors suffer no loss under a P&A or open-bank assistance but at least a partial loss under a payoff or insured deposit transfer. In a P&A, the FDIC pays a healthy bank to take over all the failed bank’s deposits and some or all of the assets. With open-bank assistance, the FDIC injects enough new funds to keep the bank open. In a payoff, the FDIC pays the bank’s insured depositors and then shares the proceeds from the bank’s assets with uninsured depositors. Finally, an insured deposit transfer is the same as a P&A except that the acquiring bank takes over the insured deposits only.

The first proposal for reducing de facto coverage would require the FDIC to resolve failures in the least costly manner whenever financial stability was not at stake. To protect uninsured depositors through a P&A or open-bank assistance, the FDIC now has to show only that these methods are cheaper than a payoff; it does not have to show they are cheaper than an insured deposit transfer. But an insured deposit transfer is usually the cheapest way to resolve a bank failure. Unlike a P&A or open-bank assistance, an insured deposit transfer forces uninsured depositors to bear some of the bank’s losses, reducing the cost to the FDIC. And unlike a payoff, it preserves the bank’s customer relationships, helping the FDIC extract favorable terms from the acquiring bank. Thus, under Treasury’s revised cost test, the FDIC would find it harder to justify transactions that protected uninsured depositors.

The second proposal is to let the Fed and Treasury decide when to waive the cost test. Under current law, the FDIC can waive the cost test if it believes the failing bank’s unin-

sured depositors must be protected to preserve financial stability. Under the Treasury plan, the cost test could be waived only if the Treasury and Fed jointly determined that failing to protect uninsured depositors would have a "severe adverse impact on the financial system." In theory, giving Treasury more say in the decision would help limit protection of uninsured deposits because Treasury is directly accountable to taxpayers.¹⁰

The last proposal is for the FDIC to make a "final settlement payment" to uninsured depositors whenever it resolves a failure through a payoff or insured deposit transfer. This measure is designed to make the reduction in de facto coverage more palatable by reducing disruption to uninsured depositors. As soon as the bank was closed, each uninsured depositor would receive a one-time payment based on the FDIC's average recovery rate on assets of failed banks. Thus, uninsured depositors would have immediate access to their funds. And they would not have to worry about losing their entire investment if the bank's assets turned out to be worthless. Treasury notes that, based on the FDIC's recent recovery rate, the final settlement payment would be about 80 percent of the uninsured portion of the deposit.

Evaluation. The main problem with the Treasury proposals is that they assume the benefits of reduced coverage can be achieved without any decrease in financial stability. Despite Treasury's hopes, the risk of a banking panic could increase if regulators rarely protected uninsured depositors of failed banks. To prevent such instability, it would suffice to provide full de facto coverage at large banks, since they are the banks that rely heavily on uninsured deposits. But then nothing would be achieved except a further shift in uninsured deposits from small banks to large banks.

Could financial stability be preserved by

protecting uninsured depositors only in isolated cases, as Treasury suggests? This approach would make sense if the main way depositor losses could disrupt the financial system were by spilling over to other banks. In some cases, for example, a failing bank might owe large amounts of money to other banks in the form of interbank deposits or overdrafts on the large-dollar payments network. Allowing these creditor banks to suffer losses could set off a chain reaction of failures and disrupt the payments system. Thus, full de facto coverage might be justified to preserve financial stability. But other times, a failing bank might owe little to other banks. In these cases, it could be argued, full de facto coverage would be unnecessary because depositor losses would have no adverse effect on the financial system as a whole.¹¹

The problem with this view is that it ignores an even more important source of financial instability than spillover effects—a general loss of confidence by all uninsured depositors. If regulators seldom protected uninsured depositors of failed banks, all uninsured depositors would have more reason to worry about the safety of their funds. This greater exposure would increase depositor discipline—a major goal of the Treasury proposal. At the same time, however, the increased exposure would make the banking system more vulnerable to a "flight to quality" that could severely disrupt the economy.

To see how such a panic could occur, suppose some uninsured depositors came to doubt the condition of many bank loan customers. For example, the economy could show signs of slipping into recession. Or many businesses and households could appear overextended. At banks with large amounts of suspect loans, some uninsured depositors would withdraw their funds out of fear the loans would never be repaid. Other depositors might

then withdraw their funds in the belief the first group had received unfavorable news about the banks' loans. And still other depositors might join the panic, not because they doubted the underlying quality of the banks' loans, but because they knew the loans were illiquid and could be sold to meet withdrawals only at a heavy loss.¹²

A flight to quality would not only inconvenience depositors but also hurt the economy. The funds withdrawn from banks with suspect loans would be invested in safer assets like Treasury bills or shifted to banks that invested heavily in such assets themselves. Rather than switch into safer assets, some banks might try to stem the outflow by raising interest rates on uninsured deposits. But to the extent banks raised their deposit rates, they would also have to increase their loan rates or tighten their credit standards. As that happened, fewer borrowers would be willing and able to obtain loans, forcing banks to shift to other assets. Sooner or later, therefore, the flight to quality would lead to a decline in total bank lending. If severe enough, such a contraction in bank lending could push the economy into recession, justifying depositors' initial doubts about the quality of bank loans.¹³

Given the threat to financial stability from a flight to quality, the Fed and Treasury could make a strong case under the Treasury plan for retaining the too-big-to-fail policy—that is, for continuing to protect uninsured depositors whenever a large bank failed. The regulators could argue that a loss of confidence by uninsured depositors of large banks would be especially harmful to the financial system because large banks rely heavily on uninsured deposits for funds. In 1990, for example, uninsured deposits accounted for 56 percent of total deposits at banks over \$10 billion, versus 13 percent at banks under \$1 billion (GAO, p. 158). And the two regulators could argue that

the only way to prevent a loss of confidence by uninsured depositors of large banks would be to provide them full de facto coverage.

In contrast, the Fed and Treasury would have a hard time arguing that uninsured depositors of small banks had to be protected to preserve financial stability. Without blanket protection, uninsured depositors of small banks would be just as likely to lose confidence as uninsured depositors of large banks. But since small banks rely mostly on insured deposits, a loss of confidence by their uninsured depositors would cause little disruption to the financial system.

Thus, if the Fed and Treasury strictly interpreted their mandate to preserve financial stability, total coverage would not change. De facto coverage would remain unchanged at large banks but fall at small banks. Given this increased disparity in coverage, uninsured depositors at small banks would have even more reason than now to shift their funds to large banks. As a result, the Treasury proposal would encourage a further shift in uninsured deposits to large banks without reducing total coverage at all.¹⁴

The reason the Treasury plan does not resolve the coverage issue is that it avoids choosing between two competing goals of bank regulation. The first goal is to limit taxpayer exposure and prevent misallocation of investment to risky uses. The second goal is to preserve financial stability. Ultimately, policymakers will have to decide which goal is more important. If protecting the taxpayer and preventing excessive risk-taking are the overriding concern, then uninsured depositors should always be allowed to suffer a loss regardless of the size of the bank or the effect on other banks. That is, no exception should be made for systemic risk. On the other hand, if preserving financial stability is the first priority, deposits should enjoy full de jure

coverage at all banks.¹⁵ The two approaches are very different. But both would make the rules of the game clear and ensure that banks competed on the same terms.¹⁶

Stricter enforcement of capital requirements

The Treasury plan would enforce existing capital requirements more strictly. Treasury is correct to emphasize the benefits of high capital. But stricter enforcement would likely have more benefits and fewer costs if combined with a gradual increase in capital requirements.

Rationale. Treasury proposes to enforce capital requirements more strictly by reducing forbearance—the practice of allowing a bank to operate below the minimum. Few would advocate zero forbearance—immediately shutting down a bank when its capital falls below the minimum. But Treasury believes the system has gone too far in the other direction. One way Treasury believes forbearance should be reduced is by closing banks before their capital is totally depleted. Under the current system, banks are usually not closed until their reported capital falls below zero. But a bank's true capital may be highly negative by that point, requiring the FDIC to incur large losses. If banks were closed earlier, when their reported capital was still positive, their true capital would be less likely to be negative. Thus, FDIC losses would decline, reducing taxpayer exposure.

A second way Treasury believes forbearance should be reduced is by regulating undercapitalized banks more strictly and making them restore their capital faster. According to Treasury, the current system gives banks that fall below the minimum too much opportunity to go for broke by taking big risks. Forcing banks to recapitalize more quickly would

reduce the number of banks that face this temptation to gamble their way out of trouble. And tightly restricting the activities of undercapitalized banks would make it harder for them to act on the temptation. Thus, undercapitalized banks would take fewer risks, decreasing taxpayer exposure and improving the allocation of investment.

Description. Under the Treasury plan, the regulation and supervision of banks would vary with their capital. Specifically, the plan would establish five zones based on banks' ratios of capital to risk-adjusted assets and capital to total assets. Zones 1 and 2 would include banks with capital higher than the minimum, while Zones 3-5 would include banks with capital below the minimum.

Banks in Zones 1 and 2 would include all those that meet minimum capital requirements. Banks in Zone 1 would have significantly more capital than required and would be allowed to undertake new activities through affiliates (these activities are spelled out in the financial restructuring proposals of the plan). Banks in Zone 2 would be treated the same as currently.

Banks in Zones 3-5 would include all those failing to meet minimum requirements. These banks would face prompt corrective action in the form of progressively stricter supervision and regulation. Banks in Zone 3 would have to file a recapitalization plan, and the parent company would have to satisfy minimum capital requirements. Other measures, such as restricting dividend payments, would be at the discretion of regulators. Banks in Zone 4 would face the same restrictions as banks in Zone 3 and also would not be allowed to pay any dividends. Finally, Zone 5 would include all banks with capital below a critical level specified by regulators. These banks would be put into receivership or conservatorship even if they still had positive capital. It should be

noted that all these sanctions, including the early closure requirement for banks in Zone 5, would be presumptive rather than mandatory. That is, the requirements could be waived if the FDIC and the bank's primary regulator agreed.¹⁷

Evaluation. While reduced forbearance would have important benefits, it would also have a cost--regulators could close some banks that would be viable if given enough time to recover. This cost could be reduced by raising minimum capital requirements in addition to closing banks early. Combining early closure with higher capital requirements would also help protect the taxpayer and curb excessive risk-taking.

Why might the early closure rule prove costly? In a world of perfect information, banks suffering only temporary losses would never be forced out of business by an early closure rule. They could always raise enough capital from outside investors to meet the minimum requirements. In reality, however, outside investors may refuse to invest in a bank suffering temporary losses because they cannot determine whether the losses are temporary or permanent. If regulators allowed a bank suffering only temporary losses to remain open, the bank could gradually rebuild its capital through retained earnings and meet the minimum capital requirement again. If instead regulators forced the bank to close, some of the bank's intangible assets could be permanently lost, such as its long-term relationships with borrowers. To be sure, closing troubled banks early might reduce the FDIC's losses and protect the taxpayer. But society as a whole could still be worse off through the loss of the bank's intangible assets.

Given this cost, the Treasury's early closure proposal could have the perverse effect of increasing government ownership of banks.

Even under the current system, concern about the premature closing of banks has led to calls for greater government assistance. The FDIC can already invest in troubled banks through its open-bank assistance program. And many observers are now advocating a new fund for investment in weak banks along the lines of the Depression-era Reconstruction Finance Corporation. Under the Treasury plan, pressure for such government intervention would likely increase. Thus, instead of troubled banks being closed earlier, more banks could end up being partly owned by the government—an outcome most people would find distasteful.

The best way to avoid these problems would be to combine the Treasury plan with a substantial increase in minimum capital requirements. The higher a bank's initial capital, the bigger and more sustained the losses the bank would have to suffer before its capital reached the critical closure level. Thus, with higher capital requirements, the banks shut down under the early closure rule would be more likely to be inefficient or reckless rather than just temporarily troubled due to bad luck.¹⁸

Higher capital requirements would also help protect the FDIC against losses by insolvent banks and discourage excessive risk-taking by banks that exceed current requirements. Because capital is measured imperfectly, Treasury's early closure rule would not ensure that troubled banks were closed before they became a burden to the FDIC. If banks had to meet higher capital requirements, banks could not become insolvent as quickly. Thus, regulators would have more chance of identifying reckless and badly managed banks in time to prevent them from running up big losses. Furthermore, while the Treasury plan would curb risk-taking by undercapitalized banks, it would have little effect on banks that satisfy current requirements. While these

banks have less reason to gamble than insolvent or undercapitalized banks, deposit insurance still encourages them to gamble more than they should. With higher capital requirements, many of these banks would have to hold more capital, reducing their incentive to take risk.

To be sure, higher capital requirements would also have costs. Some experts believe bank deposits have unique transactions features that make them cheaper than equity. For example, by combining NOW and money market accounts with check-clearing services, banks may be able to attract such funds at a relatively low interest rate. If this argument is correct, forcing banks to substitute capital for deposits could increase their cost of funds, making it harder for them to compete with securities markets, other financial firms, and foreign banks.¹⁹ Also, with the economy in recession and bank profits low, now would be an especially difficult time for banks to raise more capital. Nevertheless, given the study's emphasis on the benefits of capital, it is surprising Treasury did not recommend at least a gradual move to higher capital standards rather than rely solely on stricter enforcement of current standards.

Financial Restructuring

The Treasury plan contains three sets of proposals for restructuring the financial system. The first set would allow full interstate banking. The second would allow banks to affiliate with other financial companies such as securities firms and insurance firms. The last set would end the separation of banking and commerce by allowing commercial firms to own banks indirectly. The main purpose of these proposals is to protect the taxpayer and increase bank profitability. Treasury believes the proposals would also improve the allocation of investment by reducing pressure on

banks to shift into risky activities and by helping banks attract new capital.

Interstate banking

Treasury proposes that banks have complete freedom to expand across state lines, including the right to establish branches. By helping banks diversify their loan portfolios, this proposal could significantly reduce FDIC losses from bank failures.

Rationale. Along with other banking experts, Treasury believes full interstate banking would protect the taxpayer by sharply reducing the rate of bank failures. According to this view, nationwide banking organizations would be less vulnerable to regional economic downturns because such organizations could offset losses in depressed regions with profits in prosperous regions.

Treasury also argues that full interstate banking would increase bank profitability. Some bank holding companies (BHCs) have already expanded to a limited degree by establishing subsidiaries in other states. According to Treasury, allowing BHCs to replace these subsidiaries with branches would boost profits by eliminating costly duplication of management and overhead.

Description. The Treasury plan contains two interstate banking proposals. The first proposal would repeal the Douglas Amendment to the Bank Holding Company Act, which prohibits bank holding companies from acquiring banks in another state unless explicitly authorized by that state. Most states have already acted on their own to allow some kind of entry by outside holding companies. However, some of these states allow entry only from neighboring states or from states with reciprocal agreements. The Treasury plan would hasten the day when BHCs can establish subsidiaries anywhere in the nation.

The second, and more important, proposal would repeal the prohibition against interstate branching in the McFadden Act. National banks would be allowed to open branches in any state. Also, state-chartered banks would be allowed to open branches in any state as long as they were authorized to do so by their home states. Although interstate branching would be allowed, states could continue to restrict branching within their boundaries, as a few do now.

Evaluation. To the extent the industry moved to full interstate banking, Treasury's proposals could do more to protect taxpayers than any other part of the plan. In the 1980s, most bank failures occurred in states specializing in energy or agriculture. More recently, banking problems have shifted to states in the Northeast with sluggish growth and slumping real estate markets. A nationwide banking organization that avoided concentrating all its loans in a single region would have a much greater chance of surviving such downturns. Thus, many banks would find it in their interest either to merge with a nationwide organization or to expand on their own. As that happened, bank failures would decline.²⁰

Some might argue that the Treasury proposals would not cause a dramatic change because most states already allow entry by BHCs from other states. But as noted above, not all these states allow entry by holding companies from anywhere in the nation. Even more important, allowing interstate branching should make geographic expansion more attractive because opening a branch is often less costly than setting up a subsidiary. Finally, even if no new expansion occurred, the Treasury plan could still increase bank profits by allowing BHCs that had already expanded to replace subsidiaries with branches.

Affiliation with financial companies

The Treasury plan would allow well-capitalized banks to affiliate with any financial company. While this proposal would not be as harmful as some critics believe, it would be unlikely to achieve the benefits Treasury suggests.

Rationale. Current law generally prohibits banks from offering services like insurance and securities underwriting. The law also severely restricts BHCs from offering such services through separate subsidiaries. Although Treasury opposes letting banks offer new financial services directly, it believes well-capitalized banks should be allowed to affiliate with any company offering financial services. In other words, BHCs should be allowed to offer a full range of financial services, provided their banks are well capitalized and the new activities are conducted in nonbank subsidiaries. And any financial company should be allowed to own and operate well-capitalized banks.

Treasury believes affiliation with financial companies would increase bank profits due to synergies between banking and other financial services. According to this argument, affiliation with financial companies would make it easier for banks to sell their traditional products. For example, a large firm that had been raising its short-term funds on the open market would be more willing to borrow from a bank if the bank's affiliates could help the firm meet its other financial needs, such as selling equity or buying insurance. Such one-stop shopping could save the firm considerable time and effort. And because the bank and its affiliates could share information about the firm's financial condition and future prospects, they could provide the needed services at lower total cost.

Treasury believes its proposal would also reduce taxpayer risk by attracting new capital to banks. Treasury argues that BHCs would be willing to inject more capital in their banks in order to qualify for the new financial powers. Also, some insurance and securities firms would acquire poorly capitalized banks and inject capital into them in order to get into banking. Finally, even if insurance and securities firms purchased only well-capitalized banks, the price of bank stocks would rise, making it cheaper for poorly capitalized banks to raise additional capital. The extra capital would cushion banks against failure and reduce their incentive to gamble. Thus, the rate of bank failures would fall, reducing taxpayer risk.

Finally, Treasury argues that new financial powers would reduce taxpayer risk by helping BHCs diversify. According to this argument, a BHC offering new financial services would be unlikely to suffer simultaneous losses on its bank and nonbank operations. Thus, if the BHC's banks fell on hard times, the BHC could use the profits from its nonbank operations to cover the banks' losses and keep them from failing.

At first glance, it would seem the benefits claimed by Treasury could be achieved more simply by letting banks offer new financial services directly. This system is common in Europe, where so-called universal banks offer a wide variety of financial products. However, Treasury believes the FDIC and the taxpayer would be better protected by confining the new services to affiliates and restricting transactions between banks and affiliates. That way, the federal safety net would not be extended to new activities. In particular, a BHC's banks would be less likely to be dragged down at FDIC expense if the company suffered heavy losses on new financial services.²¹

Description. The Treasury proposal

would create a new type of company that could engage in both banking and other financial activities. BHCs whose banks significantly exceeded minimum capital requirements would be allowed to offer new financial services through nonbank subsidiaries. And companies that already offered these services could acquire banks as long as they added whatever capital was needed to make the banks well capitalized. The new activities would include selling and underwriting insurance, underwriting securities, and establishing mutual funds. For most banks, these activities have either been banned or confined to nonbank affiliates whose primary business is closely related to banking.²²

The definition of "well capitalized" would be based on the same zones as in Treasury's proposal for stricter enforcement of capital standards. Specifically, a BHC's banks would qualify as well capitalized if at least 80 percent of the company's banking assets were held by banks in Zone 1 and the rest by banks in Zone 2. If a BHC's banks suffered losses that ceased to qualify them as well capitalized, the BHC would have to recapitalize the banks or terminate the new financial activities.²³

To insulate banks from losses by their new affiliates, all existing "firewalls" between banks and affiliates would be maintained. These firewalls include strict quantitative limits on loans from banks to affiliates and a requirement that all business deals between banks and affiliates be at arm's length. The Treasury plan would also allow regulators to impose any special restrictions on interaffiliate transactions they deemed necessary to prevent abuse of deposit insurance.

Despite the strong firewalls in the plan, regulation of BHCs would be relaxed in one important sense. BHCs must now satisfy consolidated capital requirements for the whole

organization in addition to individual capital requirements for each bank. The Treasury plan would eliminate consolidated capital requirements for any BHC whose banks satisfied the individual capital requirements.

Evaluation. Letting banks affiliate with financial companies would be unlikely to boost bank profits or significantly protect the taxpayer. Exploiting synergies between banking and financial services would not address the main cause of the decline in bank profitability. Also, little capital would be injected into banks because BHCs would have too little incentive to offer new financial services and because insurance and securities firms would have too little incentive to get into banking. Finally, while new powers would make BHCs safer, they could still refuse to aid their troubled banks, leaving the taxpayer at significant risk.

Why might affiliation with financial companies do little to boost bank profits? While some synergies between banking and other financial activities undoubtedly exist, there is little empirical evidence that these synergies are large (Litan). More importantly, the Treasury proposal would not attack the primary cause of the decline in bank profitability. According to Treasury, the main cause is overcapacity—too many banks chasing too few good lending opportunities. The proposal would neither expand banks' investment opportunities nor allow them to lend freely to their new financial affiliates. Thus, banks would continue to lack an adequate outlet for their funds.²⁴

It is also doubtful that the Treasury proposal would induce companies to inject large amounts of new capital into banks to earn the right to diversify. Until banking becomes more profitable, insurance and securities firms are unlikely to be interested in acquiring banks. Furthermore, the insurance and securities industries have experienced

problems of their own in recent years, suggesting BHCs would have little to gain by expanding into those areas (Dudley). To be sure, both BHCs and other financial companies could still profit from offering a wider array of services if synergies were large. But there is little evidence synergies are large enough to make companies willing to accept Treasury's terms for diversification.

Finally, Treasury overstates the extent to which BHC diversification would reduce FDIC losses. Most studies have found that returns to new financial services are neither highly correlated with the returns to banking nor exceptionally risky by themselves (Saunders). Thus, Treasury is probably correct that expansion into new services would make BHCs safer, in the sense of reducing the variability of their profits. It does not follow, however, that the risk of bank failures would fall. Treasury assumes diversified BHCs would use their profits on new financial services to cover the losses of their troubled banks. But a BHC might well prefer to let its troubled banks fail. To be sure, the company would have to give up its right to offer both banking and other financial services. But on the positive side, the company could saddle the FDIC with the banks' losses and keep all the profits from other financial services to itself. Thus, if the losses were big enough, a BHC might choose to abandon its troubled banks.²⁵

While new financial powers would do little to reduce FDIC losses, it is only fair to note that new powers would probably not increase FDIC losses as much as some critics claim. These critics worry that new powers would expand opportunities for risk-prone BHCs to gamble, just as product deregulation in the early 1980s made it easier for undercapitalized S&Ls to gamble. But a key difference between the two situations is that BHCs would have to exercise new powers outside their banks and

with strict firewalls, whereas S&Ls were allowed to pursue new activities directly. Also, under the Treasury proposal, only BHCs with well-capitalized banks could pursue new activities. In contrast, many of the S&Ls that took advantage of product deregulation in the 1980s were severely undercapitalized.

The Treasury proposal could still increase the risk of FDIC losses in another way—by eliminating consolidated capital requirements for most BHCs. A BHC that suffered heavy losses on its nonbank operations might be tempted to gamble in its traditional banking operations to stay alive. By forcing a BHC to maintain a cushion against nonbank losses, consolidated capital requirements would reduce the chance of the BHC's net worth falling to the point where it faced this temptation. Thus, if new powers are granted, consolidated capital requirements should be retained.²⁶

Indirect ownership of banks by commercial firms

The last of Treasury's restructuring proposals would allow commercial firms to acquire BHCs with well-capitalized banks. Like new financial powers, commercial ownership of BHCs would be unlikely to help banks. At the same time, commercial ownership of BHCs would be more likely than new financial powers to increase taxpayer risk.

Rationale. Under current law, banks and BHCs can neither engage in commercial activities nor affiliate with commercial firms. While opposing a complete end to the separation of banking and commerce, Treasury believes commercial firms should be allowed to own BHCs with well-capitalized banks. According to Treasury, this change in ownership rules would decrease taxpayer risk by attracting new capital to banks. Some commer-

cial firms would acquire BHCs with poorly capitalized banks and inject enough capital in the banks to qualify them for commercial ownership. More generally, efforts by commercial firms to acquire BHCs would drive up the price of BHC stock, making it cheaper for all BHCs to raise capital to channel to their banks.

Description. Under the Treasury plan, a commercial firm could acquire any BHC that was strong enough to qualify for new financial services. Thus, any BHC with at least 80 percent of its banking assets held by banks in Zone 1 and the rest held by banks in Zone 2 would be eligible.²⁷ To avoid extending the federal safety net, the plan would also impose especially strong firewalls to insulate banks and BHCs from losses by their commercial parents. A BHC and its subsidiaries would be prohibited from extending any form of credit or financial guarantee to the commercial firm and from purchasing any financial asset from the firm. Other transactions between the commercial firm and the BHC or its subsidiaries would be subject to the same firewalls as between banks and affiliated financial companies.

Evaluation. Allowing commercial ownership would probably do little to attract new capital to the banking industry. At the same time, commercial ownership could increase taxpayer risk due to the difficulty of enforcing firewalls.

While Treasury is correct that many banks need to attract more capital, allowing commercial ownership would be unlikely to help. Like financial firms, commercial firms would be deterred from investing in banks by the low level of bank profits. And commercial firms would have even less reason than financial firms to invest in banks because banking has fewer synergies with commercial activities than with financial services. Investment in

banks will become more attractive only if profitability increases. But in that case, commercial ownership of BHCs will be unnecessary because plenty of funds will be available from other investors.²⁸

Compared to new financial powers, commercial ownership would also pose a greater risk of extending the federal safety net outside banking by exposing banks to losses by their affiliates (Corrigan 1991b; Volcker). In theory, the strong firewalls proposed by Treasury would make it hard for a bank to assist a troubled commercial parent. However, firewalls could be much more difficult to enforce for commercial firms than for securities and insurance firms, most of which are already subject to some form of regulation and engaged in activities familiar to banking regulators. For example, one way a bank could aid a troubled affiliate is by lending to the affiliate's customers at preferential terms. Such transactions could be very difficult to spot if the affiliate were an unregulated commercial firm involved in a wide variety of businesses.²⁹ Thus, if banks are to be allowed to affiliate with other firms, a good case can be made for starting with financial firms and allowing commercial ownership only later, if at all.

Conclusions

Citing recent banking difficulties and the precarious state of the insurance fund, Treasury has issued a comprehensive plan for reforming deposit insurance and restructuring the financial system. This plan has three goals—to protect the taxpayer, improve the allocation of investment, and restore the long-run health of the banking industry. Treasury deserves credit for identifying these important goals and coming up with a concrete plan to achieve them. However, while useful as a

starting point for debate, the plan has some shortcomings.

The main limitation of Treasury's deposit insurance reforms is that they are too cautious. Using risk-based premiums to complement minimum capital requirements would improve on the current system by rewarding banks for safe behavior. But Treasury's other deposit insurance proposals fail to resolve underlying problems. Treasury argues that deposit insurance coverage should be reduced to limit the FDIC's liability and increase depositor discipline. But because the plan might not eliminate de facto coverage of deposits at large banks, it could merely shift deposits from small banks to large banks without reducing coverage. Similarly, Treasury emphasizes the benefits of capital as a cushion against failure and an incentive against risk-taking. But rather than push for higher capital requirements, Treasury only advocates stricter enforcement of existing standards.

On the whole, Treasury's financial restructuring proposals err in the opposite direction, going further than necessary. As Treasury suggests, full interstate banking would reduce bank failures due to regional downturns. However, there is little reason to believe affiliation with financial firms would make banks safer or more profitable. The securities and insurance industries have been having their own problems. And even if BHCs diversified their operations, they would not necessarily come to the aid of their troubled banks. Finally, opening ownership of banks to commercial firms would achieve few synergies and attract little capital to the banking industry. Given the lack of benefits, commercial ownership does not seem worth the risk, however small, that losses by commercial firms could spill over to their banks.

Endnotes

¹ The Treasury study is divided into two parts (Department of Treasury 1991a). The first 74 pages give Treasury's justification for reform and explain the details of the plan. The rest of the study consists of 21 discussion chapters written with the help of staff from other government agencies. Soon after publishing the study, Treasury issued a detailed legislative proposal that departed in only minor ways from the recommendations of the study (Department of Treasury 1991b).

² If the FDIC becomes insolvent, it may not be possible to cover the deficit by raising insurance premiums for banks. Beyond a point, increasing the premium rate may reduce total revenue by reducing total deposits. And even if it were feasible, raising premiums enough to cover all FDIC losses might be undesirable because it could cripple the banking industry and curtail financial intermediation.

³ It should be noted that increased competition could have encouraged bank risk-taking in other ways. For example, some economists argue that increased competition reduced the value of a bank charter, making banks more willing to take gambles that could result in failure and loss of the charter. This possibility is not mentioned in the first part of the study but is cited in one of the discussion chapters (Department of Treasury 1991a, p. I-16) and in other Administration analyses of the deposit insurance crisis (Council of Economic Advisers).

⁴ The Treasury study and legislative proposal include many other recommendations besides those discussed in this article. The most important of these are proposals for simplifying bank regulatory structure and recapitalizing the bank insurance fund.

⁵ To be useful as a measure of ex ante risk, capital must also be subject to the bank's control. A bank that has low capital due to heavy losses may be unable to raise capital from outside investors and unable to build up capital quickly through retained earnings. In such cases, capital serves more as an ex post measure of risk, which is why Treasury suggests it may be unwise to charge higher premiums to severely undercapitalized banks.

⁶ Several years ago, for example, the FDIC issued a formal proposal to base premiums on ex post measures of risk such as loan delinquencies and loan chargeoffs (Hirschhorn).

⁷ This potential disadvantage of pure "price regulation" is discussed further in Keeton.

⁸ The 12 accounts would consist of three individual accounts, three joint accounts, two IRA accounts, and four revocable trust accounts (Department of Treasury

1991a, p. 19).

⁹ Pass-through coverage would still be available for self-directed and defined-contribution pension plans. In contrast to defined-benefit plans, members of these plans control their own investments.

¹⁰ The Treasury study also recommends that the Fed lend the FDIC enough money to cover the extra cost of protecting uninsured deposits. In theory, this provision could also limit coverage of uninsured deposits, because the Fed might be reluctant to lend to the FDIC on a regular basis. However, the provision was dropped from the Administration's legislative proposal.

¹¹ Some experts believe that allowing uninsured depositors to suffer losses would cause little harm to the financial system even when the failing bank owes large amounts to other banks. According to this argument, the main risk is that the creditor banks would temporarily lose access to their funds—a problem that would be alleviated by Treasury's final settlement plan and by recent reforms in the large-dollar payments network (American Bankers Association).

¹² The recent literature on bank runs assigns key roles to the illiquidity of bank loans and the fact that some depositors are less informed than others (Jacklin). Even without these factors, however, a flight to quality could occur if enough uninsured depositors came to doubt the ability of borrowers to repay their bank loans.

¹³ The argument that reduced coverage could disrupt the economy by causing flights to quality can be found in Government Operations Committee, pp. 66-73. The original proponents of federal deposit insurance were also concerned about flights to quality. They believed deposit insurance would help end the Depression by reversing the flight from bank deposits to safer assets and stimulating bank lending (Committee on Banking and Currency). Critics of the flight-to-quality argument agree total bank lending might decline as banks shifted out of loans into safer assets but argue that the decline would not be large enough to hurt the economy (Benston and others).

¹⁴ Treasury's proposal for full interstate banking would also encourage the shift in uninsured deposits to large banks by making it easier for large banks to compete with small banks for funds.

¹⁵ Members of the Board of Governors have expressed differing views on the issue of de facto coverage. Chairman Greenspan and Governor LaWare have supported the Treasury view that uninsured depositors should be protected in some circumstances but not others

(Greenspan; LaWare). On the other hand, Governor Angell has argued for fully insuring all deposits (Angell).

¹⁶ Some observers, including Treasury, argue that large banks do not enjoy an unfair advantage over small banks (Department of Treasury 1991a, pp. 30-31 and VI-7). According to this view, large banks have been overcharged for deposit insurance relative to small banks because they fail less often and have assets that can be liquidated more easily when they do fail. This view is highly controversial (Barth and others). But even if it were correct, it would make more sense to provide small and large banks the same coverage and charge them different premiums per dollar of coverage to reflect the difference in their risk.

¹⁷ Treasury's legislative proposal added a provision prohibiting banks that fail to meet minimum capital requirements from offering significantly higher deposit rates than other banks in the same market (Department of Treasury 1991b, p. 8).

¹⁸ With a higher minimum, it would still make sense to require banks falling even slightly below the minimum to submit a recapitalization plan and cut dividends. However, regulators could afford to let banks drop further below the minimum before severely restricting their activities.

¹⁹ This advantage of deposits over equity is emphasized in Orgler and Taggart. Other experts dispute this view, arguing that transactions services can be "unbundled" from deposits. Deposits could also be cheaper to a bank than equity because of the tax deductibility of interest or underpriced deposit insurance. But in this case, there would be no net cost to society from forcing banks to hold higher capital because the increase in banks' cost of funds would be offset by an increase in tax revenues or decrease in FDIC losses.

²⁰ The possibility cannot be ruled out that some banking organizations would take advantage of interstate banking to increase their risk. In particular, a nationwide banking organization eager to gamble on high-risk loans could divert deposits from stable regions to regions experiencing speculative booms. An example of such behavior is the case of midwestern S&Ls that made speculative real estate loans in Texas and Arizona during the 1980s.

²¹ To see why controls on interaffiliate transactions might be needed to insulate banks, suppose a BHC has an implicit understanding with investors that it will use all its resources to back the debt of its nonbank subsidiaries. Allowing a troubled nonbank subsidiary to fail could cause investors to question that guarantee, raising the cost of debt to the BHC's remaining subsidiaries. Thus, without controls, a BHC might use its banks to bail out

its nonbank subsidiaries, even though the bailout would reduce the profits the BHC earned from its banks (Flannery 1986, pp. 220-23). Another situation in which controls may be needed is when a BHC suffers such heavy losses on its nonbank operations that it cannot service its debt. In this case, the only way for the BHC itself to avoid bankruptcy may be to siphon resources out of the banks to make payments on the debt.

²² Under the Treasury plan, all BHCs would be called Financial Service Holding Companies (FSHCs), whether or not they offered the new financial services.

²³ The legislative proposal also requires the BHC to post a bond with the FDIC for the amount of the capital shortfall (Department of Treasury 1991b, pp. 61-62). This bond would be used to reimburse the FDIC for any loss it suffered if the banks failed. If the BHC refused to post the bond or failed to submit a recapitalization plan, regulators could take over those banks not in Zone 1.

²⁴ Some experts argue that allowing affiliation with financial companies could relieve overcapacity in a different way—by enabling BHCs to employ their excess managerial and human capital in other lines of business besides traditional banking (Government Operations Committee, pp. 23-30). This argument assumes that BHCs' managerial and human capital is relatively immobile and would not quickly exit the banking industry in the absence of new powers.

²⁵ The Federal Reserve has long argued that BHCs should act as a "source of strength" to their banks by using the profits from their nonbank operations to prop up their failing banks. But the Fed has had little luck enforcing this doctrine, and its legality has recently been thrown into doubt. Some policymakers have proposed that the source-of-strength doctrine be legalized by making BHCs liable for any losses incurred by the FDIC on their failing banks (GAO, pp. 115-18, Government Operations Committee, p. 48). By discouraging BHCs from walking away from their troubled banks, this proposal would ensure that taxpayers shared in any benefits of expanded powers to BHCs. The question remains, however, whether many companies would be interested in exercising the new powers.

²⁶ A further modification of the Treasury proposal would be to extend controls on interaffiliate transactions to daylight overdrafts, a reform many experts consider long overdue (Flannery 1988). When a bank allows an affiliate to incur overdrafts on its account during the course of the day, the bank extends intraday credit to the affiliate. This form of credit is now exempt from controls on interaffiliate loans, even though default by the affiliate could have serious consequences for the bank.

Some critics worry that even with consolidated capital requirements and controls on daylight overdrafts, losses on nonbank operations could spill over to a BHC's banks through "guilt by association." According to this argument, a bank's uninsured depositors could interpret the losses as evidence that the BHC's entire management was incompetent or risk-loving, causing the depositors to lose confidence in the safety of their funds (Flannery 1986, pp. 217-18).

²⁷ Commercial firms that acquired BHCs would be known as Diversified Holding Companies (DHCs).

²⁸ Some critics have also attacked the Treasury proposal on the grounds that the banking industry suffers from overcapacity and therefore needs no additional capital

(Corrigan 1991a, CBO). This criticism seems overstated. It may be true that the industry as a whole needs to shrink to return to profitability. It may also be true that after such an adjustment, the \$200 billion in capital the industry now holds would be adequate. In the meantime, however, an infusion of outside capital would still help protect the taxpayer and discourage wasteful risk-taking. ²⁹ As in the case of new financial powers, it would be inadvisable to let commercial firms own BHCs without imposing consolidated capital requirements on the owner. But determining the appropriate consolidated capital requirement for a large industrial firm with many different businesses would be no easy matter.

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