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REFORMS OF THE U.S. BANKING SYSTEM

BY

MONICA SHUN-OI LUN

A thesis submitted in partial fulfillment of the requirements for the degree Master of Science Major in Economics South Dakota State University 1988
This thesis is approved as a creditable and independent study by a candidate for the degree, Master of Science, and is acceptable for meeting the thesis requirements for this degree. Acceptance of this thesis does not imply that the conclusions reached by the candidate are necessarily the conclusions of the major department.

Dr. Charles E. Lamberton
Major and Thesis Advisor

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Date
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This thesis is dedicated to my family. I will always be indebted to them for their lifetime devotion and endless support throughout the duration of my study.

ML
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CHAPTER I

INTRODUCTION

The U.S. banking industry has encountered difficulties over the past two decades. The large number of bank failures in the recent years; the collapse of two state deposit insurance systems; the severe problems facing the Federal Savings and Loan Insurance Corporation; the increased burdens on the Federal Deposit Insurance Corporation (FDIC); and the heavy indebtedness by lesser developed countries (LDCs) all put tremendous stress on the system. In addition, there are also significant changes shaped by the interaction of economic, technological, legal, and regulatory forces. These forces have eroded the traditional rules of financial institutions and led to the development of innovative financial instruments and the globalization of world financial markets.

Due to these problems and changes, it becomes doubtful whether the existing regulations will preserve the safety and soundness of the system. Major areas for reforms are: the deposit insurance system; the linkage of banks to other financial activities and nonbank firms; the payments system; and, the policies towards LDCs' difficulties in servicing their debts.

Problem Statement

Deposit Insurance System

The deposit insurance system was established to protect the
small depositors from bank failures and an insurance limit was set to prevent high risk banks from taking large depositors from other banks. However, the FDIC's general use of purchase-and-assumption method in dealing with troubled large banks implies 100 percent insurance coverage and creates the problem of 'moral hazard.' Depositors are likely shifting funds to banks that offer the highest yield without considering the soundness of the bank and it likely encourages excessive bank risk taking. In the past decade, there have been numerous bank failures creating increased burdens for the FDIC.

Banks' Linkages to Other Financial Activities and Nonbank Firms

The major restrictions of banks' linkage to other financial activities and nonbank firms are imposed by the Bank Holding Company Acts of 1956 and 1970 and the Glass-Steagall Act of 1934. Banks were restricted from underwriting securities with the belief that such activities are too risky. Also, banks are restricted in affiliating with nonbank firms because of possible conflicts of interest and self dealing among affiliates. However, many scholars have argued that because of the cost advantages of economies of scope, and tremendous competitive pressure from other financial and nonbank firms under the deregulated environment, these restrictions should be eliminated or at least relaxed.

Evaluating the reform of these restrictions requires an analysis of a number of issues: (1) Can a bank be insulated from its affiliates so that the problems of conflicts of interests and the
abuse of the federal safety net can be ruled out? (2) Will new activities introduce economies of scope and enhance bank profitability and competitiveness? (3) Will new activities bring about new bank risk thus creating burdens for the FDIC and other financial insurance agencies? (4) What are the roles of supervision and regulation in a restructured banking system?

The Payments Systems

There are a number of payments systems in the U.S. These include Fedwire, Clearing House Interbank Payments System (CHIPS) and Automated Clearing House (ACH). Although the Federal Reserve administers only Fedwire and ACH, it might also have to rescue CHIPS as a creditor of last resort.

There have been concerns that some of the procedures adopted by these payments systems could impose risks on the systems. The first concern is the credit risk that these systems assume by allowing receivers to get funds immediately while senders can settle the net differences until the end of the day at no cost of these daylight overdrafts. The second concern is the system risk that these systems assume by guaranteeing transactions if a sender does not have enough reserves to cover its balance at the end of the day.

Furthermore, the increased linkages of international markets and increased access by nonbank firms to the systems also raised concerns about their risks to these payments systems.

Lesser Developed Countries' Debts

Since 1970, U.S. banks have been playing a major role in LDCs
lending. However, due to world recession and disinflation of the early 1980s, many LDCs have been having difficulty servicing their debts. Today, the fundamental question is how these loans are going to be paid back in the long run and how is the loss going to be shared among the lenders (U.S. bank stockholders), guarantors (U.S. taxpayers), and borrowers (LDC citizens).

Research Objectives

The purpose of this research is to investigate problems of the U.S. banking system and evaluate various reform proposals.

The specific objectives of this research are:

1. To review four fundamental factors that shape today's U.S. banking structure. These factors are bank chartering, branching, merging and group banking.

2. To examine the deposit insurance system and its shortcomings; review the effects of deregulation on the system; and evaluate proposals for reform.

3. To evaluate and compare opinions on the reform of the linkages of banking to other financial activities and nonbank firms.

4. To identify the various risks that the payments systems impose on the Federal Reserve System.

5. To examine the causes of LDC loan problems, and solutions that have been pursued.

6. To analyze the banking facilities and examine the financial standing of banks in South Dakota.
Chapter II

BANK STRUCTURE: CHARTERING, BRANCHING, MERGING AND GROUP BANKING

Introduction

The U.S. banking system is unusual in that it is made up of a very large number of independent banks. Most countries have a few large banks that are permitted to branch nationwide. Also, the U.S. Constitution granted powers of incorporation to the states, and each state, in turn, chartered banks that were authorized to operate within its borders (state banks). The National Banking Act of 1863 created the Office of the Comptroller of the Currency (OCC) with the authority to charter national banks. This existence of both national and state chartered banks is called the dual banking system.

The U.S. banking structure has been undergoing adjustments caused by factors such as changing laws and regulations, technological developments, and market forces. There are three basic vehicles through which banks may expand and change their organizational forms. These vehicles are branching, merging, and group banking. In this chapter, each of these vehicles, as well as the dual banking system, will be discussed. Furthermore, an analysis of the banking structure in South Dakota will be presented and discussed in Chapter VII.

Bank Chartering

During the early U.S. history, banking charters were granted
to banks on an individual basis by state legislatures. When the first commercial banks in the U.S. were founded in the 1780s, their chartering required special acts of a state legislature, a requirement that held until the free banking charter laws of various states were passed in 1837 and 1838.

By 1860, 18 of the then 32 existing states in the U.S. had passed free banking structures. Even though there were variations among the states, these laws essentially allowed banks to be chartered by any parties providing a prescribed amount of capital had been invested and the notes of the new bank were secured with a specified amount of bonds. The bonds were deposited with an agent of the state who could sell the bonds to satisfy calls for note redemption should the bank fail to redeem its outstanding notes (11, p. 46).

The free banking structure gave rise to the problem of fraudulent banking. Banks were formed to issue notes that the bank organizers never intended to redeem in specie. The notes were simply printed and circulated, and the bank would be closed after they had all been distributed. Few of the banks that opened for business under the free banking laws remained in operation by 1863. Those states that had few bank closings and maintained a stable banking system during this period had monitoring systems and more restrictive entry requirements.

The National Banking Act of 1863 was passed to sort out the problems of the state banking system by creating a national banking system and eliminating the state banking system as well as to help
finance the Civil War. The Act created the OCC to administer the law and supervise and examine national banks. Since bank chartering requirements were liberal and no specific authority to regulate bank entry was included in the act, the OCC took the responsibilities to approve or reject applications for national bank charters.

In addition, the Act set higher minimum standards for national banks than were required by the states. These standards included higher capital requirements, higher reserve requirements, bank notes backed by government bonds, restrictions on assets, stricter reporting requirements, and examinations with penalties. As a result, state banks had no inducement to become national banks and be subjected to higher standards. In 1865, an amendment to the Act placed a ten percent tax on the notes of state chartered banks. The intent was to make state bank notes unprofitable and force state banks to convert to national banks. The tax on state banks was initially effective. There were more than 1,600 national banks (and fewer than 400 state banks) by 1866.

However, a decade later, the growing use of checking account payments replaced the use of state bank notes and caused the tax to become increasingly irrelevant. Since that time state banks grew in number and the present dual banking system was in place (11, p. 48; 21, p. 7).

Branching

Throughout much of U.S. history, branching has been prohibited or severely restricted in most states because of the fear
of a banking monopoly by the large northern banks and the fact that most state banks were single office institutions (unit banks).

Branching by national banks was no easier than for state banks. Even though the National Banking Act of 1863 did not address the branching issue directly, two of its provisions were interpreted by officials as prohibiting branching by national banks. The first provision of the legislation specified that the founders of a national bank had to specify "the place" at which its lending and deposit-taking activities took place, designating the state, territory, or district as well as the particular county or city, town, or village. The second provision states that the usual business of a national bank shall be transacted at an office or banking house located in the place specified in its organization certificate. In addition, the Federal Reserve Act of 1913 did not authorize national banks to establish branches even though it did not prohibit the state banks that joined the system from operating existing branches.

With the enactment of the National Bank Consolidation Act in 1918, full service branching by national banks had been made a little easier by allowing them to keep the offices of the state banks that they acquired. In 1921, in order to meet the challenge of state branch banks, the OCC authorized national banks to open teller windows limited to accepting deposits and cashing checks where a state permitted its banks to branch.

The McFadden Act of 1927 explicitly empowered national banks to open full service branches, though that power was limited in two
ways. First, national banks could not branch interstate. Second, national bank branching was restricted to the limits of the city, town, or village in which the bank was located and then only if such branching was permitted by state law. The McFadden Act was later modified by the Banking Act of 1933, permitting intrastate branch banking by national banks on the same terms as state banks in the state in which the national bank was located.

The debate over unit versus branch banking has continued since the founding of the United States. Some of the reasons for restrictions on branching were: (1) Geographic expansion will lead to significant increases in market concentration. Over time, a relatively small number of institutions will gain control of the local marketplace. (2) Antitrust legislation is not effective in curtailing concentration increases in banking. (3) Banking organizations which compete with each other in a number of markets will, in effect, collude with one another by avoiding aggressive competition in one market, expecting similar behavior by rival firms in other markets (the mutual forbearance hypothesis). (4) Small banks are not able to compete with large banking organizations. Therefore, if increased geographic expansion is allowed, a significant number of bank failures will occur, and the number of small independent banks will significantly decline. (5) Removing restrictions on geographic expansion will lead to excessive market power resulting in an inferior level of banking services. (6) Allowing expansion will lead to higher bank service prices. (7) Service accessibility will decline if geographic expansion is
allowed. Additionally, the number of bank alternatives from which financial services can be obtained will decline. (8) Geographic expansion will not significantly aid, and may actually hinder, rural areas because expansion will take place only in more attractive urban markets.

On the other hand, many arguments have been made in support of branch banking. The main theme is that branching allows for better management because larger banks have more resources to invest in training and larger staffs make possible more specialization. The second argument relates to asset management. Larger banks can achieve greater diversification of assets, thus spreading risks and reducing the danger of failure. Further, a large bank with branches in several areas has more sizable resources and is therefore in a better position to meet the seasonal needs of one branch or of particular localities. Moreover, in case of emergency these resources can be more rapidly mobilized. The third argument refers to improved service to customers. Branch banks can be established in new areas more quickly than unit banks and the branches can offer services in areas that are not economically strong or active enough to support unit banks (17, 21, 52).

Although all these debates continue, a substantial number of states changed banking laws since World War II to permit branching. Several types of arrangements emerged which fall into three broad categories: (1) statewide branch banking (branches are permitted throughout the state); (2) limited branch banking (some branching is permitted but only within specified geographic limits); and (3) unit
banking (branching is not permitted).

In 1910, only 12 states permitted branching. In 1961, the states that permitted statewide branching increased to 19; 15 states permitted limited branching and 16 states permitted unit banking. In 1973, 17 states permitted statewide branching; 19 states permitted limited branching; and 14 states permitted unit banking. In 1976, 19 states permitted statewide branching; 16 permitted limited branch banking; and 15 states permitted unit banking. In 1982, 24 states permitted statewide branching; 16 states permitted limited branching; and 10 states permitted unit banking. More recently, there are also the regional branching laws allowing limited interstate branching (5, 13, 40, 52).

Rousakki (1984) believes that unit banking is gradually giving way to branch banking because of improved transportation and communication, the growth of business, the increased interdependence of communities, and the increased mobility of the population. These trends have caused an increased concern for banking convenience and the demand for branch banking.

Despite the existence of restrictions on geographical expansion, such restrictions have become less and less meaningful as banks have used Edge Act corporations, loan production offices (LPOs), nonbank subsidiaries of bank holding companies (BHCs), and other technological developments to serve customers over wide areas.

The earlier Edge Act of 1919 allowed banks to open Edge Act subsidiaries outside their home state to offer international banking services. These subsidiaries operate as commercial banks, accepting
deposits and making loans, but are restricted to foreign customers or those incidental to international business.

Due to the Bank Holding Company Act of 1956, banks are permitted to operate LPOs as long as the processing of any loan made or deposits taken is done within the bank's home state. Thus, banks have been able to solicit corporate business nationwide by setting up out of state LPOs which are charged with bringing in corporate business from their operating region.

The use of automatic teller machines (ATMs) has been gaining popularity. ATMs allow a bank to offer deposit-taking and check-cashing services without constructing and staffing a branch. Placing these machines across state lines is desirable where economic communities or metropolitan areas spread over state lines (33, 43, 52).

**Bank Merging**

A bank merger occurs when a bank ceases to exist as a distinct entity because of its acquisition by another bank. A variety of reasons has been responsible for bank mergers in U.S. First, a large bank can create a branch by merging with a smaller one and with the merged bank then functioning as a branch of the larger bank. As both individuals and businesses have moved from the city to the suburbs, city banks have wanted to follow their customers and merging with small suburban banks and maintaining them as branches have allowed city banks to do so. Second, if a bank wishes to offer a new form of service, it may be more economical to buy a going
Concern which has the desired area of expertise and an established market rather than to build such an area from scratch and recruit the necessary personnel. Third, economies of scale provide a motive for mergers. Spreading overhead costs over a larger volume of business reduces unit costs. Fourth, mergers allow banks to increase their capitalization and deposits. Because legal limits on the size of loans made to one borrower are based on the size of the bank's capital (15 percent to any single borrower on an unsecured basis and, under certain conditions, an extra ten percent on fully secured loans), merging allows a bank to enlarge its capital base and make larger loans. Fifth, mergers provide a way in which capital can flow more readily between regions. If a bank in a rapidly growing area merges with one in a more slowly growing locality, it can shift funds into the rapidly growing one. Sixth, mergers allow management to satisfy its preference for growth while allowing managers to diversify their assets. Finally, other factors motivating banks to merge include the desire to improve earnings and the need or desire to provide better service to existing business.

On the other hand, there are a number of reasons why smaller banks may find it advantageous to be absorbed by larger ones. First, merger may provide the solution for a bank having difficulty in acquiring capital that it needs, or if it faces failure. This was illustrated by the takeover of failing banks by stronger ones during the Depression. Another very important reason for agreeing to be absorbed has been the problem of management. Small banks are often at a disadvantage in trying to attract highly trained and skilled
management personnel. As current executives reach retirement age, merger or absorption by a larger bank may seem the best way to secure top quality management skills. Also, stockholders of small banks may desire mergers in order to trade their shares for those of the larger banks, which often yield better earnings and sell for higher prices (38, 40, 44, 52).

Although acquisition of banks has been a recurring phenomenon in the banking history of the United States, the 1950s saw a wave of mergers, almost 1,600, that aroused Congressional concern over the preservation of competition in banking and this led to the Bank Merger Act of 1960. This Act requires prior approval of the OCC if the acquiring bank is a national bank, of the Board of Governors (BOG) of the Federal Reserve System (FRS) if the acquiring bank is a state member bank, and of the Federal Deposit Insurance Corporation (FDIC) if the acquiring bank is an insured nonmember bank. In deciding on merger requests, each agency is to consider the financial history and condition of each bank involved, the convenience and needs of the community served, the character of the bank management, and the effect of the merger on competition. Each agency is also required to consider the advisory opinions of the other two agencies and of the Justice Department on the effects of the merger on competition.

Not surprisingly, it soon became apparent that the situation led to differences of opinion among the government agencies as to the net effects on competition of particular proposed mergers and as to whether they should be approved. Certain provisions of the Bank
Merger Act of 1960 were criticized for a lack of clarity or being too general. For example, the act did not assign relative weights to the individual criteria that regulatory authorities were to apply to merger applications. As a result, federal banking agencies emphasized banking factors, convenience, and community needs. The Justice Department stressed competition, relying on the antitrust provisions of the Sherman Act of 1890 and the Clayton Act of 1914. This difference in emphasis led to conflicts in reaching merging decisions. These differences of opinion became an acute public embarrassment when the Justice Department in 1965 contested in court the merger of two large New York banks ( Manufacturers Trust Company and the Hanover Bank) that had been approved by the Board of Governors (13, p. 321).

The Justice Department won its case. In response to the resulting confusion, Congress passed the Bank Merger Act of 1966, an amendment to that of 1960. This Act states that the federal banking agencies could not approve a merger that would lessen competition or result in a monopoly, unless the anticompetitive effects were outweighed by the needs and convenience of the community. It instructed the agencies to apply common standards in judging whether a proposed merger would on balance be beneficial. Also, the Justice Department was to cease prosecution of cases where prior approval of a merger had been given by the relevant agency. From then on, the Justice Department was to have only 30 days in which to challenge in the courts any merger approved by the other agencies, after which the merger was exempted from such action (13, p. 322; 52, p. 50).
To understand the bank merging cases, the various types of mergers are listed as follows: A horizontal merger is the union of two or more direct competitors. A vertical merger links companies that operate at different stages of the production-distribution process. Conglomerate mergers are all those that are neither horizontal nor vertical. Among conglomerate mergers, there are three categories: (1) product extension, involving producers of two different but related products, (2) market extension, involving firms producing the same product but occupying different geographic markets, and (3) pure conglomerate, involving firms with nothing at all in common. The Bank Merger Act as amended allows horizontal mergers if anticompetitive effects are outweighed by community needs and convenience. Bank mergers which did not involve direct competitors could be viewed as market extensions and were generally acceptable (23, 33).

Mergers have led to much controversy and concern about their effects on competition. Even though laws had been set up to prohibit mergers that would substantially reduce competition, it is becoming increasingly difficult to determine if a merger would actually reduce competition because the concepts of "industry" and "market" with respect to banking have altered dramatically in recent decades. In the 1960s, the Court interpreted the concept of commercial banking very strictly, segmenting the financial services industry into rigid categories. However, banks today compete not only with each other but also with other financial institutions. To secure time deposits, they compete for a share of the savings market with such financial
institutions as savings and loan associations, mutual savings banks, and credit unions. In raising funds through negotiable certificates of deposit they compete with other participants in financial markets and, at times, even with Treasury securities. Banks also compete with other institutions in the granting of loans. Loans are of different types, each of which has different kinds of customers and hence is subject to a different degree of institutional competition.

In addition, commercial banks used to be the only producers of demand deposits, which made the Supreme Court contend that banking as a whole is a separate line of commerce. However, in 1976 Congress authorized all commercial banks and the thrift institutions in the New England States to begin offering negotiable order of withdrawal (NOW) accounts. Enactment of the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 authorized the offering of NOW accounts on a national scale. Furthermore, credit unions were allowed to issue demand deposits through share-draft accounts.

The concept of "markets" has changed dramatically over the years, too. Although real estate loans and passbook savings with banks remain typically local, legislation or innovations made possible the extending of some of the other bank products beyond the geographic boundaries of the local area. For example, business loans were allowed to extend across regional, state, or even national boundaries; consumer loans can no longer be classified as local because of the national and regional mailings of credit cards; and large negotiable certificates of deposit may be held by distant
individuals or businesses. These extensions of geographical boundaries generated a problem in working out a just measure of actual competition because competition is generally gauged by comparing a bank's assets or deposits with the total bank assets or deposits held in the area where it operates.

In short, today's banks in fact deal in a variety of products and compete directly with other financial institutions. Any accurate measure of competition in banking must take these factors into account. Because of the considerable change in the business environment of most U.S. communities since the 1960s and the gradual easing of regulatory restrictions, Rousakkis (1984) believed that the number of mergers will increase significantly in the years ahead.

Increasingly communities are served by businesses that are not locally owned. For example, the large retail chain stores, insurance companies, and other businesses serving the needs of the communities are owned by regional or national concerns. The emergence of larger businesses has led to a rise in corporate financing demands and an increase in the size of individual loan requests. This development and the widening scope of banking services demanded by the public are exerting important pressures on commercial banks, and will have substantial effects on banks' decisions on bank mergers.

The easing of regulatory restrictions in the 1980s has also made the different financial institutions more alike. The enactment of the DIDMCA and Garn-St Germain Act expanded the operating powers of thrift institutions, blurring their traditional distinctions from
commercial banks. Consequently, mergers will be easier to accomplish not only among banks but also between banks and thrifts. In addition, the Garn-St Germain Act introduced an important departure by permitting the in-state and out-of-state acquisition of failing institutions in emergency situations. In fact, as the trend to reduced regulation continues and the competition among financial institutions increases, those institutions not able to weather the challenge may be acquired by more successful ones. Institutions facing failure do not simply dissolve, but are absorbed by being merged with other institutions.

Group Banking

Ownership or control of two or more banks by an individual, group of individuals, or corporation is called group banking. A bank holding company (BHC), which is a popular device of group banking, is a corporation that owns one or more banks. There are generally two types of BHCs: (1) Multibank holding company (MBHC), a company that owns controlling interest in more than one bank; and (2) one-bank holding company (OBHC), one that controls a single bank. Subsidiary banks of a BHC are independently chartered banks which possess varying degrees of autonomy depending upon the organization and operating policies of the holding company.

Multibank Holding Companies

MBHCs are established primarily to get around state branching restrictions and the prohibition on interstate banking in states that limit or prohibit branch banking. MBHCs vary in terms of
how tightly they control the operations of the banks they own. The individual banks may function quite autonomously or they may be run as branches. In the latter case, subsidiary banks enable holding companies to extend throughout the state a full array of specialized banking services, such as trust and international services, that would be economically impossible to offer by individual banks even if there were a local demand for them.

Subsidiary banks can benefit from affiliation in basically three respects: First, they can enjoy certain operational efficiencies through their relationship with the holding company. The subsidiaries could obtain services such as centralized and computerized bookkeeping, auditing, advertising, marketing, purchasing of supplies, research, personnel recruitment, group insurance, investment counseling, and other advisory services that economies of scale would otherwise not have allowed them to realize.

Second, subsidiary banks benefit from the holding company's better access to capital markets for the raising of funds. Thirdly, holding companies facilitate the mobility of funds through loan participation among members of the organization. In this way, returns on the aggregate loans of the system are increased. In addition, the returns on bank assets can be spread over all members of the holding company.

One-Bank Holding Companies

There are two types of OBHC, bank originated and nonbank originated. The former occurs when an existing bank creates its own
holding company, thus placing itself in a subsidiary status. Such an office is also called a congeneric since it is formed by a bank to engage in related financial activities such as mortgage banking and factoring. The latter does not draw its origin from the bank that it owns and controls. OBHCs can be further divided into traditional and conglomerate. Traditional ones are corporations established to control a small bank, and may also be involved in real estate, insurance and finance. Conglomerate OBHCs are corporations that own a bank but engage in other activities or have subsidiaries that are nonfinancial. Among these OBHCs, congeneric is the most important because it enables a bank originated holding company to establish a nonbank subsidiary and enter product and geographic markets from which banks are barred.

Reasons for Growth of Bank Holding Companies

Besides the primary reasons mentioned above for the establishment of MBHCs and OBHCs, there are additional reasons for the growth of BHCs as a whole. One reason is to take advantage of the tax laws. The subsidiary banks of a BHC are legally independent banks with a common owner. Control of more than 25 percent of a bank's voting stock requires the company to register as a BHC. An absence of control is assumed if less than 5 percent of voting stock is held. The BOG determines in each case whether a stockholding of 5 to 25 percent of voting shares actually constitutes control of a bank. A major source of BHC income is dividends from stock held in subsidiary banks. Such income is almost 100 percent tax free to the
BHC. Under previous tax law 85 percent of dividends were not taxed; under the Tax Reform Act of 1986, 80 percent are not taxed. BHCs often have negative taxable income after operating and financing expenses are considered. This negative taxable income offsets positive taxable income of the banks when the BHC files a consolidated tax return. Thus, the costs of operating the BHC are deducted from bank income before taxes (53, p. 11).

Another major reason for forming a BHC is to recapture funds during a credit restraint period like that of the late 1960s. During the 1960s, banks turned to BHCs to supplement their funds. By forming BHCs, banks could gain greater flexibility in fund raising. A bank could recapture funds by having the holding company raise funds by issuing its own commercial paper and funneling these funds to the bank by purchasing loans from its portfolio or bank-issued stocks and bonds. In this way, because holding companies were not subjected to interest ceilings, they could pay returns higher than the bank could offer its depositors. Also, these funds were not subject to reserve requirements and did not have to be insured (40, p. 64; 52, p. 60; 53, p. 11).

Growth of Bank Holding Companies and Legislation

BHCs are a dominant U.S. banking industry feature. This form of bank ownership has evolved in response to the increasingly complex competitive environment in which banks operate and to increased public demand for varied banking and financial services.

BHCs have existed since the turn of the century, developing
originally in states that limited or prohibited branch banking. The early BHCs were generally informal organizations, and it was not until the mid-1920s that the BHC concept became well recognized in the financial community.

The beginnings of the BHC movement dates back to the mid-1920s. During this time period, agricultural problems and the trend toward urbanization created some financial difficulties for thousands of primarily small, agriculturally oriented banks. Consequently, some of the small bank owners favored acquisition by a holding company so that a bank could become part of a stronger banking organization. In addition, the great surge in stock prices in the late 1920s made it possible for the holding companies to obtain the needed funds for acquisitions. By 1929 there were approximately 287 holding companies of various types that controlled more than 10 percent of the banking offices in the nation and an estimated 23 percent of the dollar volume of all bank deposits (53, p. 7).

However, BHCs did not expand during the 1930s. Three of the possible reasons include (1) the economic difficulties of the 1930s and depressed stock values; (2) growing liberalization of state branching laws that let many organizations expand through branching rather than holding company acquisitions; and, (3) the BHC legislation of 1933.

The Banking Act of 1933 dealt only in a minor way with BHCs. This law covered only those BHCs that included a Federal Reserve member. Those organizations had to register with the Federal Reserve and obtain a permit in order to vote their stock. However, the
legislation did not have a great impact on the existing BHCs that owned member banks. It did little to control BHC expansion and it did not significantly control BHC investments in nonbanking enterprises.

The BHCs continued to decline in the 1940s, but in the 1950s they began to expand. This spread of BHCs led to concerns over the effect of this development on competition in banking and the potential misuse of bank resources by BHCs. In addition, federal legislation was prompted by the activities of a West Coast MBHC, the Transamerica Corporation. As early as 1948, the BOG of the FRS initiated antitrust proceedings against Transamerica, which controlled the Bank of America in addition to 46 other banks in a five state area. When the court ruled in favor of Transamerica, public pressure for regulation of BHCs began to mount (13, p. 320; 42, p. 58).

The primary purposes of the Bank Holding Company Act of 1956 were to prevent the undue concentration of bank assets in BHCs and to preserve the historical separation between banks and commerce. The Act defined a bank holding company as an organization owning 25 percent or more of the stock of two or more banks, thus excluding OBHCs. The Act required BHCs to register with the BOG, thus providing definite information on the number and importance of such organizations. The Act also required prior approval by the BOG before any BHC could acquire more than five percent of the voting stock of any bank, in this way bringing under control the further spread of group banking. A list of specific factors was enacted for
the Board to consider when evaluating a proposed acquisition of a
bank. These factors are summarized as follows: (1) the financial
history and condition of the BHC and the bank concerned; (2) the
earning prospects of the BHC and the bank concerned; (3) the
center of bank management; (4) the convenience and needs of the
communities to be served; and, (5) the preservation of competition in
the banking industry.

The Act further stated that BHCs may not acquire banks
outside of their home states without the permission of the state in
which they propose to make the acquisition. Since at that time no
states had laws authorizing this practice, the Act both prevented
expansion of BHCs across state lines and protected each state's
banking community from incursions by companies from other states.
Moreover, the Act prohibited BHCs from engaging in nonbanking
businesses, which limited the hazard of the misuse of funds by
controlling holding companies (13, p. 320; 21, p. 15; 11, p. 58).

Despite the 1956 legislation's intentions to halt interstate
banking expansion, to separate nonbanking activities from BHC
activities, and to avoid concentration of financial resources in
holding companies, it was found that this act actually encouraged
their formation and expansion as a means of overcoming geographical
and functional barriers.

The reason the BHC device was used less frequently prior to
the 1956 Act was the uncertainty of the status of BHCs. In 1954,
there were only 46 BHCs. The pressure from unit banking groups and
others for new restrictive legislation and the Fed's stated position
on regulation of BHCs made it clear that such legislation was likely. In addition, since severe restriction or even abolition were possible consequences of a new statute, bankers were hesitant about the holding company form of organization. However, the 1956 legislation was hardly draconian and mainly served to clarify the status of BHCs. At the end of 1957, there were 74 BHCs registered with the FRS. They controlled 603 commercial banks possessing 13 percent of all bank deposits (13, p. 320; 52, p. 56).

In 1966, the Bank Holding Company Act was amended. The 1966 amendments permitted the Federal Reserve Board to approve holding company acquisitions that might lessen competition, provided this effect was clearly outweighed by benefits to the public.

A primary reason for the failure of the Bank Holding Company Act of 1956 to achieve its purposes was the major loophole of excluding OBHCs. Prior to the mid 1960s, OBHCs were often situations where the bank was a junior subsidiary. For example, a large manufacturing company located in a small town might own a bank for the convenience of the firm and its employees but the bank was a minor business relative to the manufacturing company. Therefore, an OBHC was believed to be just a single bank and adequately regulated by the bank regulatory system.

However, between 1965 and 1970, there was an abrupt expansion of OBHCs. In 1965, banks subject to OBHCs accounted for less than five percent of the nation's deposits, and the banks involved were all small. By the 1970s, such banks accounted for more than one-third of the nation's deposits and included nine out of the ten
largest banks in the country and 43 out of the 100 largest banks.

One major reason for this expansion was the high interest rate environment of the 1965-1970 period, combined with the limitations on the interest rates payable by depository institutions to attract funds, Regulation Q ceilings. These circumstances caused funds to flow out of depository institutions into higher earning alternatives, such as the Money Market Mutual Funds. This process is called disintermediation. This made Certificates of Deposit (CDs) an unstable source of funds to the banks. In order to expand their power to raise funds, large banks formed OBHCs. The advantage of doing so was that holding companies can generate funds for the bank in ways not allowed the bank itself. For example, although a bank itself is not permitted to issue commercial paper, and thus borrow short term funds in this way, an OBHC can do so in its own name and then give these funds to its bank. Another reason for banks to form OBHCs is to diversify into new product lines and new geographic markets through the acquisition of a variety of nonbank businesses such as mortgage companies, leasing firms, finance companies, data processing firms, and many others (21, 40, 53).

The growth of OBHCs called for the Federal Reserve to regulate the activities of these companies, including placing limits on the nonbank activities in which these companies can engage thus leading to the 1970 amendment to the Bank Holding Company Act of 1956. The 1970 amendment had three main goals, each of which has significantly influenced the subsequent growth of U.S. BHCs. First, OBHCs were no longer excluded from registration requirements. They
were required to register with the Federal Reserve Board and were subject to approval when acquiring a bank or nonbank businesses.

Second, the definition of holding company control over individual banks was expanded. If a company was found to exercise controlling influence over a bank, it might be required to register with the Federal Reserve Board as a BHC, regardless of what proportion of bank stock the company held.

Third, nonbanking activities that a company could pursue were restricted to include only those "so closely related to banking or managing or controlling banks as to be a proper incident thereto." (21, p. 16)

The rulings on such activities through May 1, 1982, are shown in Tables 2.1, 2.2 and 2.3.

The BOG of the FRS is in charge of what activities can be engaged by OBHCs and MBHCs. The criteria used in approving or denying requests by BHCs to enter nonbanking activities are whether certain activities are closely related to banking and whether these activities are similar to bank lending or operationally integrated into the lending process. Other criteria such as public interest and convenience, efficiency of management, conflict of interest, and competition vs. concentration might also be considered.

The 1970 amendment gave the BOG increased responsibilities for regulating the BHCs. Its responsibilities are summed as follows:

1. granting prior approval for BHC formations
2. granting prior approval for BHC bank acquisitions
3. determining permissible nonbanking activities of BHCs
Table 2.1: Nonbank Activities Permitted by Regulation for Bank Holding Companies under Section 4(c)8 of Regulation Y, April 30, 1982

<p>| | |</p>
<table>
<thead>
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<tr>
<td>1.</td>
<td>Extensions of credit</td>
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<td></td>
<td>Mortgage banking</td>
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<td></td>
<td>Finance companies: consumer, sales and commercial</td>
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<td></td>
<td>Credit cards</td>
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<td></td>
<td>Factoring</td>
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<tr>
<td>2.</td>
<td>Industrial bank, Morris Plan bank, industrial loan company</td>
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<tr>
<td>3.</td>
<td>Servicing loans and other extensions of credit</td>
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<tr>
<td>4.</td>
<td>Trust company</td>
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<tr>
<td>5.</td>
<td>Investment or financial advising</td>
</tr>
<tr>
<td>6.</td>
<td>Full-payout leasing of personal or real property</td>
</tr>
<tr>
<td>7.</td>
<td>Investments in community welfare projects</td>
</tr>
<tr>
<td>8.</td>
<td>Providing bookkeeping or data-processing services</td>
</tr>
<tr>
<td>9.</td>
<td>Acting as insurance agent or broker primarily in connection with credit extensions</td>
</tr>
<tr>
<td>10.</td>
<td>Underwriting credit life, accident and health insurance</td>
</tr>
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<td>11.</td>
<td>Providing courier services</td>
</tr>
<tr>
<td>12.</td>
<td>Management consulting for unaffiliated banks</td>
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<tr>
<td>13.</td>
<td>Sale at retail of money orders with a face value of not more than $1,000, traveler’s checks, and savings bonds</td>
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<tr>
<td>14.</td>
<td>Performing appraisals of real estate</td>
</tr>
<tr>
<td>15.</td>
<td>Audit services for unaffiliated banks</td>
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<tr>
<td>16.</td>
<td>Issuance and sale of traveler’s checks</td>
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<tr>
<td>17.</td>
<td>Management consulting to nonbank depository institutions</td>
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</table>

Table 2.2: Nonbank Activities Permitted by Order for Bank Holding Companies under Section 4(c)8 of Regulation Y, April 30, 1982

<p>| | |</p>
<table>
<thead>
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<tbody>
<tr>
<td>1.</td>
<td>Issuance and sale of traveler’s checks</td>
</tr>
<tr>
<td>2.</td>
<td>Buying and selling gold and silver bullion and silver coin</td>
</tr>
<tr>
<td>3.</td>
<td>Issuing money orders and general-purpose, variable-denominated payment instruments</td>
</tr>
<tr>
<td>4.</td>
<td>Futures commission merchant to cover gold and silver bullion and coins</td>
</tr>
<tr>
<td>5.</td>
<td>Underwriting certain federal, state, and municipal securities</td>
</tr>
<tr>
<td>6.</td>
<td>Check verification</td>
</tr>
<tr>
<td>7.</td>
<td>Financial advice to consumers</td>
</tr>
<tr>
<td>8.</td>
<td>Issuance of small-denomination debt instruments</td>
</tr>
</tbody>
</table>

Table 2.3: Nonbank Activities Denied by Board for Bank Holding Companies under Section 4(c)8 of Regulation Y, April 30, 1982

<table>
<thead>
<tr>
<th>Activity</th>
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<tbody>
<tr>
<td>1. Insurance premium funding (combined sales of mutual funds and insurance)</td>
</tr>
<tr>
<td>2. Underwriting life insurance not related to credit extension</td>
</tr>
<tr>
<td>3. Real estate brokerage</td>
</tr>
<tr>
<td>4. Land development</td>
</tr>
<tr>
<td>5. Real estate syndication</td>
</tr>
<tr>
<td>6. General management consulting</td>
</tr>
<tr>
<td>7. Property management</td>
</tr>
<tr>
<td>8. Computer output microfilm services</td>
</tr>
<tr>
<td>9. Underwriting mortgage guaranty insurance</td>
</tr>
<tr>
<td>10. Operating a savings and loan association</td>
</tr>
<tr>
<td>11. Operating a travel agency</td>
</tr>
<tr>
<td>12. Underwriting property and casualty insurance</td>
</tr>
<tr>
<td>13. Underwriting home loan life mortgage insurance</td>
</tr>
<tr>
<td>14. Orbanco: investment note issue with transactional characteristics</td>
</tr>
</tbody>
</table>

4. granting prior approval for BHC nonbank acquisitions
5. granting prior approval and regulation of foreign bank and nonbank affiliates of BHCs
6. general supervision of BHCs and subsidiaries--examinations
7. restricting illegal ties between bank and nonbank affiliates in a BHC

Although the OBHC loophole was taken care of, the 1970 Act opened a new loophole by its definition of a bank as a firm which both accepts demand deposits and makes commercial loans. By engaging in only one of these activities, a nonbank financial services firm can, in effect, become a nonbank bank. This loophole has also allowed BHCs to extend their geographic reach by opening a nonbank bank in a new market. For example, the new nonbank subsidiary may accept demand deposits and offer all other financial services and products. As long as it refrains from making commercial loans it is not a bank under the law. Commercial loans can be made indirectly by referring such applications to an affiliate within the BHC.

On top of that, BHCs have also tried to go across state lines by taking advantage of the Douglas Amendment to the Bank Holding Company Act. Section 3(d) of this amendment allows BHCs to acquire out-of-state banks wherever state laws permit them to do so. For example, after South Dakota enacted legislation in 1980 permitting limited out-of-state BHC activity within its borders, Citicorp of New York moved its credit card division to the state (52, p. 64).

Consequently, the BHC trend continued to grow. From 1965 to 1978, the deposits controlled by BHCs exploded from 12.8 percent of
the total to over 70 percent. At the end of 1981, there were 3,702 BHCs, and they held 99 percent of all deposits in the nation (28, p. 88).
CHAPTER III

DEPOSIT INSURANCE

Structure of the Deposit Insurance System

The adoption of a deposit insurance system for the U.S. banking system started with the Banking Act of 1933. It was believed that the existence of deposit insurance coupled with a more extensive supervisory and regulatory system would limit bank failures to a manageable number and this proved to be true. Since 1934, the bank failure rate has been relatively low and 99 percent of the deposits in those failed institutions have been protected for depositors (11, p. 150).

First, the Federal Deposit Insurance Corporation (FDIC) was established to provide deposit insurance for commercial banks. Soon thereafter, the Federal Savings and Loan Insurance Corporation (FSLIC) was established to insure deposits at Savings and Loans (S & Ls). These two agencies have very similar functions and powers, although administrative procedures and organizational form differ. For example, the FDIC is an independent agency while the FSLIC is administered by the Federal Home Loan Bank Board (FHLBB). Also, the FSLIC relies on the FHLBB for the services of examiners and other staff personnel. The FSLIC's status as a part of the Federal Home Loan Bank system serves to consolidate the supervisory, regulatory, and insurance function in a single agency for all federally chartered S & Ls, unlike the multi-agency system for commercial banks.
The third deposit insurance fund, the National Credit Union Insurance Fund (NCUIF), was established in 1970. The NCUIF is administered by the National Credit Union Administration and insures deposits in credit unions in a fashion similar to the FDIC and FSLIC.

The 1933 Banking Act set FDIC premiums at one-twelfth of one percent of the deposits (less certain adjustments) of insured banks. These assessments at first had to be remitted semiannually to provide funds for operating costs as well as maintenance of an insurance fund but in 1962 the Congress mandated annual rebates to insured institutions of two-thirds of collected assessments, less agency expense. In 1981, this mandated rebate level was trimmed to 60 percent, with lesser or greater amounts being permitted according to the amount of the reserve fund relative to insured deposits. In 1982 the effective assessment rate to FDIC insured banks was one-thirteenth of one percent of assessable deposits, up from one-fourteenth of one percent in 1981. FSLIC premiums were similarly structured, however, in the last two years FSLIC premiums have been raised to cover failing S & Ls (11, pp. 152-154; 55).

The FDIC deposit insurance plan focused on the amount, not the type, of deposit. The ceiling amount was raised periodically. The original ceiling was $2,500, it was later raised to $5,000 where it remained until 1950. The current amount is $100,000 brought about by the DIDMCA of 1980. Demand, savings, and time deposits in commercial banks were covered up to the ceiling amount, with S & L association shares and deposits being similarly covered. Nondeposit liabilities of insured banks were not covered. The distinction in
favor of the amount of deposit, rather than the type of deposit, is significant in the sense that it suggests that protection of depositors is the primary purpose of deposit insurance. Prevention of bank failure due to deposit runs is a secondary purpose, and protection of the money supply (transactions accounts) is at best a tertiary objective.

The deposit insurance agencies (FDIC, FSLIC, NCUIF) are obliged to share their authority to examine insured banks with the OCC, the FRS, and the various state banking commissions. Approximately twice a year examiners arrive unannounced at a bank and spend days or weeks, depending on the size of the bank, going over its operations. To ensure the bank's sound condition and the compliance with all applicable laws and regulations, the bank examiners investigate the bank's assets, capital, liquidity, earnings and management. Since the loan portfolio is the area of greatest potential vulnerability for a bank, the bank examiners look at loans in considerable detail. Each loan above a minimum size is examined individually. Also, compliance with regulations regarding loan size and eligibility of the borrower is assured. Adequacy of the financial information on the borrower is also checked. Then loans are classified according to the level of risk they represent. Loans judged to be uncollectible are classified as a loss and must be charged off. "Doubtful" loans are those expected to involve partial loss. Loans considered unduly risky, and thus calling for careful supervision, are labelled "substandard." Furthermore, the examiners assess the quality of the management and ensure the absence of fraud.
After the above investigations, a formal report is submitted to the bank's directors. The report covers all problems or failings found during the examination and might comment on specific management practices that are considered unsound or problematic. According to the Financial Supervisory Act of 1966, bank directors are required to implement the recommendations. Otherwise, it might result in the removal of the officers or directors involved.

In 1974, after the failure of the Franklin National Bank, the Congress looked into the procedures of bank evaluation and found that these procedures varied considerably in terms of what aspects of banking activity were examined and how performance was rated. In fact, different standards were being applied to different banks. Due to this lack of uniformity, there was not a coherent assessment of the health of the banking system as a whole. Also, it was found that the examining agencies did not make more intensive and frequent evaluation efforts on banks with demonstrated weakness. In order to remedy these faults, the Uniform Interagency Bank Rating System was introduced in 1978. It identified five distinct areas of bank operation and evaluation: Capital adequacy, Asset quality, Management and administration, Earnings quality and quantity and Liquidity level. Each of these areas is rated on a scale of 1 ("strong") to 5 ("unsatisfactory and in need of immediate remedial attention"). Also, the bank as a whole receives a composite rating on this scale. Banks with composite ratings of 1 are examined relatively infrequently, while those with the 5 rating undergo continual scrutiny.
Another method of checking, the National Bank Surveillance System (NBSS), has been in operation since 1975. The NBSS is administered by the OCC and is used to assess the ongoing performance of national banks. The NBSS system has four basic components: (1) the Bank Performance Report (BPR) which is compiled from the bank's financial statements and the national bank examination reports; (2) the Anomaly Severity Rating System (ASRS) which assigns scores to various aspects of bank performance for the purpose of detecting problem areas and measuring their severity; (3) the NBSS specialists compile a report based on the BPR and the ASRS and submit it with recommendations to the Regional Administrator of National Banks. When actual or potential problems have been identified, the bank undergoes further scrutiny and a correction plan is devised in consultation with the bank's management; (4) the Action Control System monitors banks' progress in correcting identified problems.

The NBSS is a useful tool for the bank directors and managers as well as for regulatory agencies because bank managers can use this information to judge their own performance. The FRS uses the same system in monitoring state chartered member banks, and the FDIC has developed a similar system of bank surveillance, the Integrated Monitoring System (52, pp. 64-68).

There are generally five approaches that the regulatory authorities can use to deal with failed or failing insured depository institutions. They are: (1) close and liquidate the institution and pay depositors the full value of their insured deposits up to the maximum insurance amount, sharing with uninsured depositors and
creditors any losses due to an excess of the amount of insured deposits over the proceeds of liquidated assets; (2) assist in the process of the failed institution being absorbed by another (new or existing) institution (purchase-and-assumption); (3) provide resources to keep the failing institution afloat; (4) reorganize the troubled institution which would ordinarily require nondepositor creditor cooperation and concessions; or, (5) temporarily (a maximum of two years is allowed) take over operations of the failed institution.

Traditionally bank regulators could not close a bank until its book value became negative. However, since the Competitive Equality Banking Act of 1987, chartering authorities can close a bank when book insolvency appears imminent. The FDIC and FSLIC employ the purchase-and-assumption approach in the majority of cases. It is often less costly to the insurer than the deposit payoff and it avoids the negative effect that liquidations of larger banks might have on public confidence in depository institutions in general. However, the financial assistance involved in the purchase-and-assumption actions in 1981 and 1982 ballooned for both the FDIC and FSLIC thus urging them to make increased use of noncash assistance and to increase the effective deposit insurance premiums (6, 7, 11).

**Effects of Deregulation on Depository Insurance System**

While many of the supporters of the current deposit insurance and regulatory system claim that the existence of the system was to protect the interests of the small depositors, Carlstrom (1988)
questions the need to insure depositors up to the current maximum of $100,000. He emphasizes that the protection should be provided in the most cost effective way and suggests that the federal government allow an income tax credit so that depositors could deduct their losses, up to a legislated maximum.

Title 1 of the Garn-St Germain Depository Institutions Act of 1982, the Deposit Insurance Flexibility Act, broadened the scope of deposit insurance agency powers to cope with failing and failed institutions. It expanded the circumstances and forms by which the FDIC and FSLIC can provide capital assistance to troubled, insured institutions and can use their funds to facilitate mergers with rescuing institutions. It also allowed out-of-state acquisitions of failing institutions in certain circumstances.

The 1982 legislation allows the regulators to make a loan to, deposit in, purchase assets from, purchase securities issued by, and assume liabilities of a failing institution. The main feature of this is a so-called net-worth certificate program. The issuance of net-worth certificates by the FDIC and FSLIC to troubled institutions are intended to improve their book net worth positions. For regulatory purposes these certificates issued to the floundering organizations are treated as capital and thereby improve the capital position which had been eroded by losses. The benefits of this program are the contributions to the maintenance of a competitive financial system; the reduction of the risk of failure for floundering institutions; the allowance of regulators to "gamble" that falling interest rates will allow their rescue efforts to
succeed without any cash outlay; and the assistance in the early
identification of nonviable institutions. On the other hand, Cooper
and Fraser (1984) commented that this program is only an artificial
expansion of the capital account because the promissory notes issued
by the deposit insurance agencies for the net-worth certificates
carry the same yield as the latter.

In addition to the broadened power in dealing with failing
institutions, depository insurance regulatory authorities were
allowed greater flexibility in the merging of failed institutions.
Because the new legislation relaxed the geographic and institutional
barriers which formerly constrained merging activities, the FDIC may
now allow the acquisition of a large commercial bank or mutual
savings bank (over $500 million in total assets) by another federally
insured institution whether the institution is in-state or out-of-
state. For a failing bank, bids may be taken only from federally
insured depository institutions. If the lowest bid comes from either
an out-of-state institution or from an institution of a type
different from the failing one, then bids may be taken again. The
following priorities guide the regulatory authorities in minimizing
their loss from the sale: (1) same type, in-state institutions; (2)
same type, out-of-state institutions; (3) different type, in-state
institutions; (4) different type, out-of-state institutions; (5) among
out-of-state bidders, priority is to be given to adjacent state
institutions; (6) the FSLIC, but not the FDIC, is to give priority to
minority controlled bidders when a minority controlled thrift fails
(11, pp. 132-3).
Problems of the Deposit Insurance System

The principal purpose of deposit insurance is to reduce the external effect of bank failures and protect small depositors, who cannot afford the cost of good information, from bank failures. The insurance limit is designed to prevent risk loving banks from taking large depositors from other banks by offering higher yields. Uninsured large depositors restrict bank risk taking and reduce failures. However, the DIDMCA of 1980 raised the insurance limit from $40,000 to $100,000.

In addition, the FDIC usually chooses purchase-and-assumption or payout to minimize cost to the FDIC but has used purchase-and-assumption for all large banks until 1982 to avoid bank runs. This implies 100 percent insurance and creates "moral hazard" in that it likely encourages excessive bank risk taking. Large depositors were shifting deposits through money brokers to risky banks without checking the bank's solvency because the deposits were believed to be 100 percent insured since the FDIC had always used the purchase-and-assumption method. Money brokers began dividing large deposits into $100,000 pieces and putting the pieces into different banks so the total amount was insured.

Payout has been used only for small banks which have few large depositors, but these few share losses with the FDIC. The FDIC used payout with Penn Square in 1982 to stop the use of brokered deposits by risky banks.

To reduce the moral hazard of bank risk taking, insurance should be limited and large depositors should expect losses from bank
failure. To eliminate any external effects of a failure, however, depositors should not take any losses and insurance should be unlimited. When brokers and large depositors realized that insurance, though limited by law, was unlimited in practice they behaved predictably.

Regulators have been faced with some unregulated risks: interest rate risk, foreign risk, technological risk, and off-balance sheet activity risk. The insuree (bank) has more knowledge of its exposure to such risks than the insurer (regulator--FDIC). This creates a problem of adverse selection where higher risk insureds are more likely to buy insurance than lower risk because the insurance price is not risk based.

Deposit insurance premiums are the product of a premium base and a premium rate so that there are questions about both the appropriate base and the appropriate rate. The base now used is total domestic bank deposits. Since large banks have a larger share of their total deposits held in large, uninsured accounts, they believe they are subsidizing small banks by paying an insurance premium on uninsured deposits. Large banks would like to reduce the premium base to include only insured deposits. An alternative solution for large banks would be to insure all domestic deposits. Either way the base of deposits on which premiums are assessed would match the amount of deposits covered by insurance. The counter argument is that the purchase-and-assumption method of handling large bank failures has meant that all deposits of large banks have been insured de facto if not de jure.
Using risk based premiums and 100 percent deposit insurance would eliminate the moral hazard problem. Banks choosing more risk would pay higher premiums and could not bid for deposits with higher deposit rates because their higher earnings on riskier assets would be offset by the higher premiums.

Although risk-based premiums may be difficult to measure and assess accurately, others argue that regulators already classify banks into risk categories in the bank examination process. The capital, asset and liability restrictions imposed on problem banks represent, in fact, risk-based premiums. An imperfect but direct method of charging risk-based premiums might be more efficient than the current implicit system of all-or-nothing restrictions imposed by an agency.

Since banks can adjust to changes in technology, markets, and regulations faster than regulators can adjust to such changes, there are usually some unregulated risky activities. These include interest rate risk due to asset and liability management practices, foreign activities risk, and off-balance sheet activities risks. These create an adverse selection problem for the insurer because the insured has more information about its own exposure to risk than does the insurer.

Proposed Changes in Depository Insurance

Due to deregulation, the financial institutions have to face a more competitive environment and are exposed to more risk. The elimination of the interest rate ceiling, the relaxation of branching
constraints, and the many innovations of financial products might expose financial institutions to a higher chance of failure. Thus, deposit insurance, which is a protection against bank failure, might call for adjustments to deal with the new environment.

**Risk-Based Insurance Premiums**

The current fixed-rate deposit insurance premium has been subject to criticism. Thomson (1986) and Carlstrom (1988) commented that mispriced deposit guarantees can generate many undesired effects. They include (1) the misallocation of resources; (2) an inequitable transfer of wealth between society and the insured industry; and (3) an inequitable transfer of wealth between institutions within the insured industry. Because fixed-rate deposit insurance premiums provide limited liability to the financial institutions, the owners of the financial institutions receive all the benefits from increased leverage and portfolio risk without having to pay the full costs associated with their actions.

Leverage risk can be increased by the reduction of capital the institution holds relative to its assets in either of two ways: (1) increase the size of the institution and finance its growth entirely with debt and (2) issue debt and distribute the proceeds of the debt issue to the stock holders as dividends, instead of purchasing additional assets. According to Carlstrom (1988), the capital/asset ratio among banks has been decreasing from the 1900's 20 percent to 1930's 15 percent to 1988's approximately seven percent.
Total portfolio risk can be increased by changing either the composition of assets, of liabilities used to fund the assets, or both. Changes in asset composition include (1) changing relative amounts of the portfolio’s low risk assets (securities) and high risk assets (loans); (2) increasing the credit risk of the portfolio’s high risk assets ending up with a decrease in asset quality; (3) decreasing the diversification of the portfolio, over concentrating assets in any one sector of the economy. The change in liability composition is involved with increasing the institution’s reliance on purchased funds. These tend to be a less stable source of funds than deposits and create a higher possibility of near term illiquidity and subsequent insolvency.

In addition, the deregulation of interest rates brings about an increase in the portfolio’s asset and liability interest sensitivity mismatch, thus increasing uncertainties about earnings and hence the total risk of the portfolio. This is the current problem of the thrift industry.

In order to maximize bank value, bank managers will maximize the combined value of the bank and the deposit insurance subsidy. The subsidy is the fair value of the deposit guarantee that exceeds the insurance premium. Thus, mispriced deposit insurance actually subsidizes the institution’s risk taking and thereby allows it to hold a riskier portfolio than it would if the subsidy were zero. Other than the problem of risk taking, this deposit insurance subsidy also gives insured institutions an unfair competitive advantage over uninsured institutions in raising funds and buying assets (6, 7, 37,
Charging risk-based deposit insurance premiums is one of the proposals for change. It was opposed in the past by the deposit insurance agencies and other regulators on the basis of practical difficulties of implementation and also for fear that the high-premium (riskier) banks could suffer from withdrawals by concerned and uninsured depositors once their risk was known to the public. Given the current level of disclosure, the problem of risk level exposure to the public is probably minimal.

The problems of implementation exist because there is not yet a credible, generally accepted, and reasonably accurate system of risk measurement and pricing. The FDIC stated that such an ideal system would require that the FDIC be given an extreme amount of authority. Moreover, it would entail unrealistic data requirements and much more advanced risk qualification techniques than are currently imaginable. In addition, it would be necessary to dismantle all existing geographic, portfolio, and capital adequacy restraints on depository institutions, while giving the deposit insurance agencies power to levy premiums up to 100 percent of deposits. However, if deregulation is to continue, risk-based deposit insurance pricing is an idea whose time may have come.

**Minimum Capital Requirement**

Due to the many difficulties faced by a risk-based deposit insurance premium system, there is increased interest in the feasibility of using higher minimum capital requirements to reduce
the deposit insurer's uncompensated liability from guaranteeing deposits.

The first minimum capital-to-asset ratios for banks and BHCs was imposed in December 1981, became effective in mid-1982, and was amended in 1983 and 1985. According to Furlong (1988), the capital-to-asset ratio for 98 of the largest publicly traded BHCs increased from about 4.75 percent in 1980 to about 6.5 percent in 1986.

The primary reason for a higher minimum capital requirement is that decreased leverage of a bank will lead to a reduction of default risk (overall risk), hence protecting the deposit insurance fund from risk exposure. Although this may be true, one should also note that default risk and the liability of the insurance system also depend on the degree of asset risk assumed by banks. Therefore, if the asset risk taking of banks were increased to a greater degree than the capital requirement, then part or all of the beneficial effects resulting from the higher minimum capital requirement could be offset by the greater asset risk. A higher minimum capital requirement alone may not serve the purpose as well as it should.

In addition, there is a worry that the requirement of higher minimum capital itself might indirectly lead to the undertaking of higher asset risk. The underlying logic is that banks that are required to increase capital will shift to higher yielding, riskier assets to increase the rate-of-return on equity.

James (1987) showed that higher capital requirements can worsen an underinvestment problem. That is, a bank that is faced with raising relatively more capital to fund new projects would tend
to give up certain low risk ventures in which it might otherwise invest. As a result, the bank’s portfolio will end up smaller and include relatively more risky assets than if capital requirements were lower. However, one should be cautioned about accepting this finding because, according to Furlong and Keeley (1987), with underpriced deposit insurance the marginal gain to a bank from increasing asset risk declines as its capital to deposit ratio increases. Therefore, banks may only increase their asset risk to a limited extent.

Another criticism of the present capital requirement is its inability to include off-balance sheet activities in calculating capital requirements. This may encourage banks to increase their leverage as a way to increase their bank value at the cost of a higher exposure of risk to the deposit insurance system (moral hazard problem).

The most popular off-balance sheet activities include commercial loan sales and Standby Letters of Credit (SLCs). Their volume has been increasing significantly in recent years. The current system does require that loans sold with recourse (i.e., with an issuing bank’s guarantee against default) be treated as assets when calculating capital requirements. However, commercial loans are seldom sold with recourse, very naturally because of the tendency of banks to avoid extra burden. On the other hand, unlike commercial loan sales, SLCs are not considered at all when calculating capital requirements. In order to serve the purpose of higher capital requirements without the side effects of off-balance sheet
activities, the regulatory agencies might consider encouraging the use of loan sales with recourse by regulation or incentive and/or including part or all of SLCs in capital requirement calculations.

Another criticism related to the present minimum capital requirement is its uniform standard for all banks. Without risk level taken into account, it is possible that some banks meeting the capital standards can now hold a riskier portfolio than they could previously hold with the same degree of leverage. Once again, because of the fixed-rate deposit insurance premium, it is very likely that bank asset risk will rise. Therefore, if possible, the depository insurance agencies should vary the minimum capital standard on a bank-by-bank basis. If a fixed minimum capital requirement is to be implemented, then they should vary the auditing frequency accordingly. Further research suggested that a single-audit guarantee is a much more effective method than perpetual guarantee when using a minimum capital standard to reduce the insurer's liability. Pyle (1986) carried out an option theoretic analysis of deposit insurance which was pioneered by Merton (1977, 1978). He studied the perpetual deposit insurance system (insurance is automatically renewed after each audit) and the single-audit deposit insurance (insurance contract is renegotiated after each audit), and compared both with the assumption of pay-as-you-go audit costs (audit costs are charged to the insured institution at the time of the audit). He confirmed that the insurer's liability due to a perpetual guarantee is greater than the liability from a single period guarantee. In addition, after comparing the elasticities of
these two insurer liabilities with respect to the insured's asset value to deposit ratio, he arrived at the above conclusion.

Another problem cited is the continued use of book values for capital regulation which may lead to the failure to close economically insolvent firms on a timely basis. This can jeopardize the long-run effectiveness of the deposit insurance system. The use of book values has led to insurance renewal at fixed rates despite deterioration in the economic condition of the bank and has supported the lack of timeliness in closing failed institutions. A more realistic and practical approach would be the monitoring of capital on a market value basis (22, 30, 48).

One Hundred Percent Deposit Insurance Coverage

Another proposal on deposit insurance is the one hundred percent deposit insurance coverage. The reasons supporting this proposal are basically on the grounds of greater efficiency and equity. The efficiency argument is based on the fact that limited deposit insurance leaves depository institutions unprotected against runs by uninsured depositors, and the greater the degree of public disclosure of the problems of problem banks, the more likely are such runs to occur. The equity argument for 100 percent deposit insurance is based on the evident preference of the deposit insurance agencies to employ the purchase-and-assumption method, rather than deposit payoff, whenever possible in the case of failures of large institutions. This leaves large institutions with an unfair advantage in competing for uninsured deposits.
On the other hand, 100 percent insurance might reduce the incentive of depositors in evaluating the soundness and safety of the depository institutions thus encouraging them to undertake larger risk. Another argument against this proposal centers on the increase in risk to insurance funds. It is likely that it will lead to the virtual termination of deposit payoffs in favor of other approaches and more importantly, affect or retard the pace of deregulation due to the increased risk to the deposit insurance agencies.

Other Coverage Proposals

There are other proposed changes in coverage. They include 100 percent insurance of demand deposits but limited or no insurance of time deposits. The major problem here is that due to deregulation and the innovations of many new varieties of accounts such as NOW and Super-NOW, it is becoming more difficult to distinguish between transaction and nontransaction accounts.

Other than proposals on the change of coverage, there is also a proposal to give depositors an option to purchase additional deposit insurance covering deposits in excess of the general limit of $100,000. It was argued by Carlstrom (1988) that there is little incentive for depositors to do so because of the possible extension of the limit to different accounts held by each individual. Also, Cooper and Fraser (1984) argued that because of the dominance of the purchase-and-assumption approach in handling bank failures, 100 percent deposit insurance is virtually in effect. The present problem is not one of inadequate deposit protection, but rather one
of reconciling such protection with an increasingly deregulated and risky banking environment.

Merging of Regulatory Agencies

Another proposal is the merging of the deposit insurance agencies. Arguments for this proposals are basically: (1) due to deregulation, different financial institutions are getting much more alike, thus centralization of regulatory authority seems appropriate as a means of promulgating consistent rules; (2) mergers of firms regulated by different agencies require that each agency review and approve the combination which can lead to interagency disputes which impose costs on society; (3) the regulatory gaps and overlaps generate unnecessary problems; (4) differing goals of the regulatory agencies might halt compromise solutions; and (5) regulatory consolidation will result in reduced administrative expenses.

Arguments against this proposal include: (1) the likelihood that shared supervision can avoid regulatory capture (the identification of the regulator with the regulated); (2) since the current system allows a depository institution to choose among several different types of state and federal charters and with each goes a different primary regulator and insurer, there is a possibility of beneficial competition among agencies; and (3) the banking, thrift, and credit union industries developed for separate purposes and with specialized regulators. Despite the innovations of recent years, firms and agencies today still look quite different. Although the variation will fade with time, it may be difficult to
reconcile initially (8, 15, 54).

Summary

The focus of the problems of the deposit insurance system is placed on the moral hazard problem created by the present deposit insurance system. The adoption of risk based premiums can discourage banks from taking excessive risks. The implementation of this policy, however, will require better programs for risk measurement and pricing. The regulatory agencies can establish a stringent bank minimum capital requirement even before these programs can be well developed. When calculating required capital, assets should be valued at market, rather than book value and off-balance sheet activities should be included.
CHAPTER IV

BANK POWERS

Introduction

Restrictions on bank ownership and powers are imposed primarily by the Glass-Steagall and Bank Holding Company Acts. The former restricts affiliation of member banks with firms involved in securities underwriting, and the latter regulates the association of banks with other financial and nonfinancial firms. There are various state laws that restrict affiliations between banks and nonbank enterprises.

The reasons supporting the elimination of these restrictions are generally as follows: First, banks cannot compete with nonbanks in the current domestic regulatory environment and also the conflict between economic forces and regulation extends beyond domestic markets. Second, the primary concerns that led to restrictions in the 1930s are not prevalent today, i.e. concentration of resources and the potential for self dealing have been constrained by antitrust laws and Securities and Exchange Commission regulations and surveillance. Third, there has been a declining trend in bank profitability in recent years. If banks are allowed to diversify into such activities as underwriting and other investment banking activities, bank profitability and risk management might improve and thus enhance the stability of the banking system. Finally, there is a cost advantage in the form of economies of scope in allowing banks
firms.

The main argument against eliminating the restrictions is that banks play special roles in the economy that requires more protection through regulation. Banks provide public access to the payments system. They provide a source of liquidity to the economy. They play a critical role in stabilizing the economy through the transmission of monetary policy and, more importantly, they are the public connection to the safety net provided by deposit insurance and the Federal Reserve's source of ultimate liquidity. The extension of banks into nonbank activities may also be undesirable because of the comparative advantages that the implicit subsidy of the safety net provides to them, and the greater potential exposure of the insurance funds or taxpayers to the financial problems of these firms (3, 15, 27, 36, 37, 45).

**Major Concerns**

**Bank Insulation from its Affiliates**

The insulation question is crucial. If banks can be insulated from their affiliates, there is no need to restrict the activities in which the affiliates of a bank may engage. On the other hand, if banks cannot be insulated from their affiliates, it might be necessary to restrict the activities of bank affiliates so that the safety net will not be abused.

Seidman (1987) believes that insulation is possible and that direct regulatory and supervisory authority over nonbanking affiliates or even bank owners is unnecessary. Seidman's approach
includes the retaining of the existing legislation of Sections 23A and 23B of the Federal Reserve Act (FRA) and a few supplements.

Section 23A of the FRA restricts a bank's credit extension to any single nonbank affiliate and to all of its nonbank affiliates taken together to 10 percent and 20 percent, respectively, of the bank's capital and surplus. Such extensions of credit incur stringent collateral requirements. In addition, it requires that all bank transactions with affiliates be on terms and conditions consistent with safe and sound banking practices. This has been interpreted to mean that any transaction between a bank and its affiliates must be on terms and conditions that are at least as favorable to the bank as those prevailing in similar transactions between the bank and unaffiliated third parties. Seidman further suggests that it should be expanded to cover nonbanking subsidiaries of banks.

Section 23B of FRA specifies that all bank transactions with affiliates must be conducted at an "arm's length" distance. This section also prohibits any action which would suggest the bank is responsible for any action of the nonbank affiliates or stating or implying that their obligations are covered by federal deposit insurance.

Additional policies that Seidman suggests include: (1) authority to audit both sides of any transaction between a bank and its subsidiaries or affiliates; (2) authorized collection of certain financial data from bank affiliates, where needed; (3) clearly defined regulatory authority to require, from either a practical or
risk standpoint, that any nonbanking activity be housed outside the
bank in either a subsidiary or affiliate; and (4) exclusion from the
bank's supervisory capital computation any equity investments in such
nonbanking business.

In sum, Seidman believes that effective insulation is
possible. Banks can be protected against legal risks if appropriate
procedures are followed to ensure that the operations of their
affiliates are conducted in truly separate corporate entities.
Although there are economic incentives to treat different units as
part of an integrated entity, these incentives can be controlled
largely through existing legislation such as Sections 23A and 23B of
the FRA and proper supervision of the bank itself, with appropriate
penalties for abuses. By doing so, the marketplace will view
different units within an organization as distinct corporate entities
if they are, in fact, treated accordingly by the supervisory
agencies. However, this approach will call for more FDIC supervisory
staff to accomplish this task.

Huertas (1987) also believes that insulation is possible. He
emphasized that when examining whether banks can be insulated from
their affiliates, the standard to employ is that interaffiliate
transactions be done on substantially the same terms and conditions
as transactions with unaffiliated third parties. Such a standard
safeguards the bank, but allows the bank to benefit from being part
of a broader integrated enterprise.

Huertas believes that the existing legislation, Section 23A
and 23B of the FRA, has already insulated banks from their affiliates
in credit transactions and has been quite effective in preventing failures of banks due to transactions with affiliates. In addition, after studying five other proposals for regulatory design, he found that all of them also keep in place the existing legislation. Furthermore, some plans provide for additional insulation of the bank. They are:

(1) Antifraud provision. This would reinforce the antifraud provisions of the securities law by prohibiting affiliates of banks from stating or implying that their liabilities are obligations of an insured bank or insured thrift and from stating or implying that either obligations are covered by federal deposit insurance.

(2) Stand-alone requirement. This prohibits a bank from directly or indirectly guaranteeing the obligations of its affiliates and requires the affiliate to disclose this to investors.

(3) Arm's length requirement. This makes explicit the interpretation of current law and regulation requiring that all interaffiliate transactions be on terms at least as favorable to the bank as those prevailing in similar transactions between the bank and unaffiliated third parties.

(4) Limit on daylight overdrafts of an affiliate of the bank. This will take care of the missing part of the FRA's credit extension requirement providing more protection to the bank.

(5) Bear-down provision. This requires the bank to maintain adequate capital at all times, and it empowers the bank's primary federal regulator to force the owner of the bank to divest the bank if the bank's capital falls below the minimum required level. This
is an extremely powerful provision, for it enables the regulator to step in well before the net worth of the bank is exhausted. It will fully protect the deposits of the bank and the deposit insurance funds from all risk, including any risk that might arise as a result of the bank's transactions with its affiliates.

(6) Back-stop provision. This would require each parent in the corporate chain above the bank to assume unlimited liabilities for the bank subsidiary. However, the effectiveness of this provision is doubtful because the guarantee of the holding company of unlimited liability is only as good as the company that gives it.

Also, Huertas has two additional provisions:

(1) Plenipotentiary provision. This would grant the bank's primary federal regulator the authority to write rules and regulations regarding interaffiliate transactions so as to protect the safety and soundness of the bank. There would be severe civil and criminal sanctions for violations of such regulations. This would allow the regulator to address in a flexible manner the concerns that prompted the provisions cited above. Regulators can also address quickly other concerns that may arise as a result of changes in market conditions.

(2) Enforcement provision. This would grant the primary federal regulator of a bank controlled by a financial services holding company the authority to seek an immediate court injunction against any unsafe and unsound practice engaged in by such a bank. This would allow the regulator to take prompt action against banks with unsafe practice and bypass cumbersome and time consuming cease-
and-desist procedures.

Huertas believes that the various proposals and the existing regulations can be combined in a way that yields a higher level of effectiveness in insulation.

However, Litan (1987) criticizes the bear-down provision because regulators may simply not be able to catch serious problems in time. Even if they can, another problem arises. Although a target bank's capital for regulatory purposes may be positive (but below the threshold minimum), by forcing divestiture, regulators signal to potential buyers that the bank may have serious problems, which can dramatically lower its resale value. Litan also questions the implementation of the bear-down requirement if banks were permitted to diversify directly or through subsidiaries. In that case, if bank capital falls below the required minimum, regulators could separate the bank only by selling off each of the nonbank activities—an operation potentially far more difficult and disruptive to complete than merely divesting a bank from its holding company affiliates.

On the other hand, Corrigan (1988) emphasizes that separation of banking from commerce should be preserved. He believes that in reality financial conglomerates and commercial-financial firms are managed in an integrated manner, and it is rare that one would go its own way if the other is faced with adversity.

Concentration of Resources

Huertas (1987) believes that as the geographic barriers break
down, there will not be a problem of concentration. Even if there is, when excess profit exists, competition will eliminate it. He believes that barriers to entry produce concentration. However, in the field of finance, there do not appear to be any significant natural barriers to entry. Hence, he concluded that removing the artificial barriers to affiliation between banks and nonbank firms will only reduce concentration, not increase it.

Litan (1987), on the other hand, expresses his concern that if banking organizations were left totally unconstrained, economic power and asset ownership will become too concentrated. Excessive asset concentration might also bring about adverse effects to the U.S. political system.

**Economies of Scope**

There are two types of economies of scope, global and product-specific. Global economies of scope are present if, for a given product mix, the total costs from joint production of all products in the product mix are less than the sum of the costs of producing each product independently. Product-specific economies of scope refer to economies that arise from the joint production of a particular product with one or more other products. A cost complementarity exists between two products if the marginal cost of producing one product declines when it is produced jointly with the other.

An argument supporting the elimination of restrictions is that there are cost advantages in the form of economies of scope in
allowing banks to associate with other financial and nonfinancial firms. Joint production of financial services or joint production of financial and nonfinancial services might increase economic efficiency and potentially lower consumer costs.

Many studies have been conducted to estimate economies of scope for depository financial institutions. After reviewing 13 of these studies, Clark (1988) found that they do not support a conclusion of global economies of scope from joint production. However, many of the studies report some evidence of cost complementarities between pairs of products. For example, Lawrence and Shay (1982) reported cost complementarities between nonbank activity and total loans as well as between nonbank activity and investments. Diseconomies of joint production were reported between nonbank activity and total deposits.

Litan (1987) and Huertas (1987) both agree that technology advancements that started about 20 years ago had important impacts on economies of scope. Advances in technology are important because they substantially reduce communication and information costs. They make it easier and cheaper for financial institutions to perform their functions as intermediaries. Banks, insurance companies and other financial service companies are all essentially in the same business of providing and transferring information. Therefore, any financial corporation doing business today should be capable of using the computer stored data that lie at the core of one financial service to deliver other services and lowers the costs of providing them all. In short, the cheaper information and communication cost
and the integration of financial and nonfinancial services will result in increased economies of scope and firms that produce products jointly will be more profitable than those more specialized.

On the other hand, Tobin (1987) feels that the importance of economies of scope, especially for the economy at large, remains small.

**Competitiveness**

In general, some researchers argue that the present system is anti-competitive so restructuring will promote competition and reduce the costs of financial services. Others were concerned about the possibility of increased concentration of economic power if a revised regulatory structure allowed the development of large financial and commercial conglomerates.

The problem cited for the current restrictions on bank powers is that financial activities will continue to shift away from banks to nonbanks, thrifts, and investment banks because of the trend towards functional realignment in the provision of financial services. Also, nonbank depository institutions have been invading the profitable activities that were formerly carried out by banks only and consequently reducing bank profitability.

Furthermore, the conflict between economic forces and regulations extends beyond domestic markets. Regulatory discrepancies among nations have caused increasing shifts of activities from the U.S. to the less regulated international markets. There have been attempts to coordinate international regulation of
the world's three most important financial centers (New York, London and Tokyo) such as the recent U.S.-U.K. accord on capital standards. As long as there are restrictions of domestic banking powers, there remain strong incentives to shift toward a less regulated environment.

This idea is further affirmed by Greenspan, the current chairman of the BOG, who believes that deregulation is the only way to strengthen the U.S. banking system and increase the competitiveness of the U.S. banks in globally integrated markets. At the same time, deregulation would eliminate many inefficient financial institutions. Banks would gain access to new sources of capital and the opening up of new profit opportunities would make it easier for banks to cover losses on old investments (24).

Litan (1987) believes that certain nonbanking industries, especially investment banking, could generate greater competition for banks. He stated that in securities markets where banks can underwrite securities such as general obligation municipal bonds, market concentration is lower, competition is more vigorous, and underwriting fees are lower than in the corporate securities markets from which banks are precluded.

Guttmann (1987) worries that deregulation may not ultimately strengthen many financial institutions. It may cause more failures in the finance industry in the near future. New competitive pressure will push many insufficient financial institutions out of business, there is a possibility that such failures might do immense damage to the state of consumer confidence and trigger destructive financial
Volcker (1987) worries that further deregulation will undermine an already fragile banking system by unleashing excessive competitive pressures thus accelerating the already considerable rush into potentially risky innovations.

Lovett (1984) believes that insurance companies and banks are strong competitors in managing pension funds, along with some independent union and association pension plans. In addition, securities marketing has been for the most part properly segregated from commercial banking and insurance. As a separate industry, it has brought helpful competition to the financial sector. In short, commercial banks, thrift institutions, and securities firms have ample competition within their own ranks and it still makes sense to separate commercial banking from the distribution and marketing of securities and to preserve inter-industry competition.

Role of Supervision and Regulation

The general concerns related to the role of supervision and regulation in a restructured financial system are whether supervision should be consolidated, the use of functional supervision and regulation; whether each part of a BHC should be supervised by its appropriate regulatory agency, what should be the responsibilities of FRS, FDIC, and OCC in the revised financial structure, and the international coordination in financial regulation.

Guttmann (1987) suggests a streamlining of the present complex web of overlapping and often competing regulatory authorities
for better coordination. Furthermore, because of the current vulnerable exposure of the U.S. financial system to globally integrated and short term capital flows, measures ensuring stability, including the standardization of national regulations, are urgently needed.

Kaufman (1987) suggests that an official central authority should be established to oversee all major financial institutions and markets. He criticizes the present system of diverse and overlapping official supervision for lacking a coherent overview and failing to meet the realities of the financial world today. Furthermore, he would establish an official international authority to oversee major financial institutions and markets, regardless of their location.

Corrigan (1987) emphasizes that banking and financial supervisory policies should move in the direction of international convergence. He recommends that like activities be subject to the same capital and other prudential standards, regardless of where in a corporate entity those activities are conducted or booked. In addition, he favors the consolidated supervision of diversified financial firms which would narrow a major gap in the present official supervisory network.

Huertas (1987) feels that there is no need for consolidated official supervision of the entity owning the bank. Banks should be able to affiliate with any other type of firm, including a commercial firm. He emphasized that it is more important to protect a bank through insulation rather than consolidated official supervision of the entity owning the bank.
Conflicts of Interests

Edwards (1987) argues that the potential abuse related to perceived conflicts of interests and to the transferring of profits or assets from a bank to its associated entities, thereby weakening the bank is related more to the corporate form employed (the holding company entity) than to the mixing of banking and securities activities. However, he suspects that by permitting more open competition among banks and securities firms, there would be less abuse of conflict situations in the future.

According to Seidman (1987), another benefit of allowing banks to affiliate with other firms is that affiliates can be sold to raise capital for the bank in times of financial difficulty. This would provide a buffer for the FDIC and help to maintain a stable financial system. He generally concludes that there is not likely to be a problem of conflict of interest, and even there is, it can be fixed. For example, with respect to an information problem, Seidman claims that this would be handled by policies that encourage or require greater disclosure of costs, alternatives, and other pertinent facts. In addition, problems of insider information will be taken care of by additional safeguards and stiffer penalties rather than prohibiting efficiency enhancing combinations of activities.

Volcker (1987) feels that conflicts of interest are likely to occur when banks and their commercial affiliates deal with each other as both owners and creditors (debtors). Recognizing the rich history of financial market manipulation and the recent epidemic of white-
collar crime in financial institutions, he is concerned about the new
sources of fraud and interest conflicts in a less regulated
environment.

Corrigan (1987) stresses the possibility of self dealing when
nonbank firms are given access to the public’s money and the unique
government support mechanism (such as deposit insurance) through
their banking subsidiaries.

Kaufman (1987) believes that conflicts of interest run such
serious risk of undermining the efficient functioning of the
financial system and the economy that lending, underwriting of
securities and equity investing activities should be kept apart.
Conflicts of interests are bound to arise if these activities are
joined.

New Activities and Additional Risk

Another concern is the effect of new activities on bank
risks. A general consensus is that risk varies from activity to
activity and from organization to organization, and depends on the
relative size of the new activities to the existing activities. Some
new activities might pose few risks and could benefit the bank, while
others might increase the overall level of risk of the bank. Some
activities may only be desirable when adequate safeguards exist to
ensure that the bank is protected against excessive risks.

A banking organization can reduce its risk by offering
services that help smooth out the earnings fluctuations of bank
activities. Although diversification is generally believed to reduce
risk, institutions could diversify in a risk enhancing fashion.
Managers of some institutions may deliberately seek more risk,
particularly in view of the incentives for risk-taking created by the
current system of federal deposit insurance, which charges banks the
same insurance premium regardless of their risk of failure. In
addition, given their inexperience in other lines of business,
certain depository organizations may find their diversification
efforts to be less than successful. Therefore, it is not easy to
draw a conclusion as to the impact of diversification.

However, if banks adopt new activities conducted outside the
reach of bank supervision, it is important that these activities are
not funded with insured deposits because underpriced deposit
insurance offers an incentive for banks to take excess risk (3, 36,
54).

Conclusion

It is not certain whether the barriers between banking and
other financial and nonfinancial activities can safely be removed.
If banks can be insulated from their nonbank affiliates, there will
not be problems of self dealing and conflicts of interest. However,
it is likely that different units of a corporation will be managed as
a whole and there is no guarantee that even very strict regulations
can stop interactions between a bank and its affiliates. Hence, it
may not be wise to eliminate the restrictions on the linkages of
banks to nonbank firms.

There is evidence that certain nonbank activities can
generate product-specific economies of scope. There is also evidence that certain currently restricted activities do not increase a bank's risk while some that are allowed do. The proportion of a bank's new activities among its total activities also affects the risk level. Because economies of scope and risk factors vary from activity to activity, one should not generalize whether banks should or should not be allowed to undertake other financial activities, rather one should ask which activities and the extent of the linkages which should be allowed.
CHAPTER V

THE PAYMENTS SYSTEM

There have been changes in the financial system since the introduction of the Federal Reserve System (FRS). Financial innovations, coupled with increased linkages with international markets, have significantly increased the volume of the payments system. Today's payments system has many components and is subject to different kinds of risks. Failure of the payments system would impose large costs to the U.S. and the other countries because as transactions cease, many other economic activities would also cease. Since there is always some risk of failure, there are concerns for reducing the risk to which the system is exposed and putting in place procedures which will prevent failure and protect the FRS and the economy.

Today's U.S. payments system features numerous instruments and ways that payments can be made. Other than the two traditional instruments for payments, checks and currency, there are debit cards (the technological equivalent of a check), credit cards, and travel and entertainment cards. The major ways that payments are made today, however, are Fedwire, Clearing House Interbank Payments System (CHIPS), and Automated Clearing House (ACH).

Among the three payments systems, Fedwire and CHIPS account for 85 percent of the transactions made today in terms of dollar volume. Fedwire and ACH are administered by the Federal Reserve.
The CHIPS, privately owned by the New York Clearing House, handles both domestic and foreign payments. Both Fedwire and CHIPS handle large volumes each day, averaging 200,000 transactions totaling $500 billion, and 114,000 transactions totaling $425 billion, respectively. Unlike Fedwire and CHIPS, ACH has relatively smaller volume and fewer transactions. All three rely heavily on advanced computer and electronic technology. This has raised the concern that if there are computer malfunctions, the system could incur large losses (16).

The major problem of the Fedwire system is that it allows the receivers to get funds immediately while the senders do not have to settle the net differences until the end of each day by transferring ownership of reserve balances held at the FRS. The FRS does not charge for most daylight overdrafts, but this delayed settlement encourages senders to send early, creating large daylight overdrafts to obtain free credit from the FRS. During the 1980s the amount of daylight overdrafts has been rising, averaging about $40 billion per day.

A second Fedwire problem is that the FRS interposes itself between the sending and receiving bank to guarantee the transactions. If a sender does not have enough reserves to cover its balance at the end of a day, the FRS will extend credit to the sender while the receivers remain unaffected. This leaves the FRS bearing the credit risk that it is not supposed to.

In past years, the FRS has made a couple of attempts to reduce these daylight overdrafts. These included the establishment
in March 1986 of a bilateral ceiling (caps) for a set maximum overdraft exposure for institutions. In July 1987, the caps were reduced by 25 percent.

However, the problem remains unsolved unless the daylight overdrafts can be eliminated. To do so the FRS may consider the repricing of Fed credit with the time value of funds and adopting the real time settlement of transactions by monitoring bank positions and matching payment flows on a continuous basis. Being forced to pay the real cost of credit, institutions would no longer be able to take advantage of the daylight overdraft loophole. The real time settlement of transactions which is becoming feasible with advanced communications and electronic accounting techniques, would leave little room for daylight overdrafts.

For the FRS to eliminate its direct bearing of credit risk, it could also include in its pricing scheme the actuarial value of the default risk it implicitly assumes in guaranteeing final payment. Ruling out daylight overdrafts will encourage market discipline to reduce the risks of failure of the payments system. As private parties realize that those institutions with more adequate clearing balances would have transactions that clear more rapidly and certainly, they would have to manage their payments more carefully. At the same time the regulatory authorities should be aware that as free daylight overdrafts are eliminated, it is likely that more payment activities will be switched to the private credit market thus increasing the private market’s risk exposure. Consequently, more stringent regulations such as higher capital or liquid reserve...
requirements may be needed.

Another problem that the FRS has to encounter is the derivative risk when customers initiating transactions suddenly are not able to pay, and the systemic risk that the removal of one failed institution from the system will affect the position of other institutions in the system making payments settlement impossible. All three, Fedwire, CHIPS, and ACH, are exposed to these risks. Even though the FRS administers only Fedwire and ACH, it might also have to rescue CHIPS as part of its lender of last resort responsibility. CHIPS is the system that is most vulnerable to these risks because of its international character. As today's U.S. banks are becoming more involved with international activities, the linkage between the domestic payments system and foreign banking organizations is significant. The failure of a non-US bank to settle can lead to the collapse of CHIPS thus affecting the domestic payments system as well. The Fed is not able to control the risk imposed by foreign institutions because they are out of the jurisdiction or control of U.S. authorities. Therefore, there are increasing concerns that the U.S. be allowed to regulate the flow of foreign funds to protect the domestic payments system from these disturbances. International supervision and regulation is one of the possibilities (12, 45).

Another concern is the increasing access to the payments system by nonbank firms. Nonbank firms are usually denied direct access to the payments system, and especially to Fedwire, because of concerns of increased payments system risk. However, due to the increasing integration of payments and securities activities, the
trend towards direct placement, and the more sophisticated cash management technology employed by many nonbank firms, direct access to the payments system becomes more valuable. To get access to the payments system many nonbank firms have used approaches such as ownership of thrifts or bank holding companies.

In sum, there is a general consensus that those that impose risks on the payments system should pay the costs of the risks they create. Proposals for risk reduction include charging for FRS credit, the FRS’s assumption of credit risk, and the benefits received by nonbank firms, as well as eliminating the free credit of daylight overdrafts and reaching international agreements on central banks’ responsibilities to act in case of failure.
CHAPTER VI

LESSER DEVELOPED COUNTRIES LENDING

Introduction

Due importantly to the world recession and disinflation of the early 1980s, many lesser developed countries (LDCs) have been having difficulty servicing their debts. Because of the large volume of lending by U.S. banks to LDCs, often exceeding the total capital of a bank, and the increasing concentration of LDC loan exposure to the largest banks, there are increased concerns about the safety of the banking system. The underlying issue today among the LDC citizens, U.S. bank stockholders and U.S. taxpayers, is who will pay and how will the loss be shared. If the LDC citizens were forced to pay, they would have to expect lower living standards by using proceeds of export sales to repay loans rather than for domestic consumption and investment. If U.S. bank stockholders were forced to pay by taking losses on the loans, stock dividends would be reduced causing stock prices to fall and banks to fail. If the U.S. Treasury accepts the loss or if the FDIC guarantees payment in banking costs, then the U.S. taxpayers would have to pay (2, 37, 54, 58).

Causes of the Problem

Prior to the 1970s commercial banks in America played only a small role in LDC lending. The lending grew rapidly from 1970 to about 1982, and the growth contributed to the oil price shock that led many oil importing LDCs to borrow to cope with the capital
outflow needed for the purchase of oil.

After the debt crisis in 1982, when Mexico and other LDCs began having difficulties servicing their debts, voluntary bank lending decreased significantly. One reason cited for the debt crisis was the sharp recession from July 1981 to November 1982 coupled with the unexpected worldwide disinflation in 1982. The recession jeopardized the LDCs exports to developed countries, reduced their planned foreign exchange receipts, and increased their demand for credit to maintain their living standards. The long term debt obligations had been contracted with the assumption of continued economic expansion. The disinflation made them increasingly costly in real terms.

In addition, a large proportion of the LDC loans were negotiated at floating interest rates with frequent interest rate fixing dates. The U.S. government attempted to reduce inflation in the 1980s by tightening credit and increasing short term interest rates to as high as 20.5 percent in August 1981. This increased LDCs borrowing costs under the floating rate agreements as well as contributed to the disinflation. Finally, the value of the dollar rose relative to that of the LDC currencies making repayment of dollar denominated debt more difficult.

Although U.S. banks’ total LDC loan exposure and exposure relative to assets and capital have declined since 1982, their exposure to troubled LDCs has not fallen as much as their exposure to more creditworthy borrowers. The total LDC loan exposure has also become increasingly concentrated at the largest U.S. banks.
There are several reasons for the continuing large, and increasingly concentrated, bank exposure to LDC debt. One is involuntary lending. Generally, there are three choices for a bank if a debtor cannot service its debt: (1) forbearance and rescheduling the loan; (2) selling the claim and recognizing a loss in the form of a discount; and (3) recognizing the loan as a loss by declaring the borrower to be in default. Except for lenders with relatively small outstanding exposure, most banks prefer the first approach because of the large losses that they might incur with the other two. The International Money Fund (IMF) offers short term funding, with the conditions that the debtor government agree to make economic reforms to improve the long term outlook for repayment and that its bank reach an agreement with the debtor to reschedule their loans. The bank's agreement can help the debtor to obtain funds from the IMF and the IMF loan enhances the debtor's chances of repaying the bank. Therefore the bank usually reaches an agreement to forebear and reschedule the loan to protect the bank's own well being.

Of the two general sources of funds that a debtor can obtain, bank loans and bonds, bank loans become relatively more important as the debtor's credit rating declines. This is due to the belief that banks have advantages over bondholders in assessing the creditworthiness of borrowers, monitoring borrowers, and working through repayment problems. As default risk increases banks also have superior ability and flexibility to work with troubled debtors and ultimately to seize assets (2, 37).
The U.S. government's implicit guarantee also contributed to the increased loan exposure to troubled LDCs. The U.S. government helped LDCs with policies to stimulate the U.S. economy and encouraged other industrialized countries to stimulate their economic growth to increase their imports from LDCs. Governments in major industrialized countries also informally encouraged banks to lend to LDCs on the implicit understanding that central banks would fulfill the lender-of-last-resort function. With the implicit guarantee from the government, a bank's liability is limited. Hence, banks will tend to accept greater loan risk attempting to increase the net value of the bank. That is, they might lend to or continue to support certain LDCs loans relying on an implicit U.S. government guarantee rather than LDC repayment ability. Another similar guarantee of limited liability is offered by the present deposit insurance system that does not charge premiums according to risk.

The inability of regulators in today's system to close troubled banks until well after they are actually insolvent also contributed to this problem. According to Furlong and Keeley (1987), the closer a lender is to being insolvent, the greater is the incentive to hold risky assets. A possible solution to this is to eliminate the capital forbearance of banks. Based on current regulation, banks can maintain as an asset the book value of a loan as long as there are "reasonable" prospects to collect the principal, even though the market value of the loan is much lower than its book value. If this regulation is removed, a much more precise market value bank asset position will be reported.
Finally, the FDIC has been choosing to use the purchase-and-assumption method in dealing with troubled large banks. The perception by the market that large banks would not be allowed to fail contributed to the concentration of the risk exposure in nine of the largest banks.

**Solutions that Have Been Pursued**

**Loan Writeoffs by Lenders**

In 1987, banks have written off a substantial portion of their LDC loan exposure resulting in a large reduction in their equity. Despite the large profits and additions to equity from other business that offset the writeoffs that year, three large bank holding companies announced new common equity issues during 1987 and other large bank holding companies were considering the same policy or a reduction in dividend payout to build up their equity accounts.

**Debt-for-Equity Swaps**

Debt-for-equity swaps include the exchange of LDC debt, usually at discounts from par value, for equal value of shares or other equity investments in enterprises operating within the debtor country. U.S. regulators have been liberalizing the regulations related to this area. However, in many LDCs the number of enterprises suitable for debt-for-equity conversion is quite limited.

**Debt Securitization**

Securitization means banks package their debt with a payment guarantee of fractional shares of the packaged debt. This approach
is speculative in nature and would not likely lead to a long run
solution.

Debt Dealing

Dealing LDC debt in a secondary market has been in practice
since the debt crisis in 1982. This is not an ultimate solution
because the market is so small that any offer of a large quantity of
a country's debt depresses bid prices dramatically. The sales are at
market value, so the seller usually incurs substantial losses.
Furthermore, since the discount from par value may not be captured by
the debtors, their strains still cannot be eased.

The Baker Plan

In October 1985, U.S. Treasury Secretary James A. Baker
announced a plan for the LDC debt crisis. Baker urged U.S. banks to
continue providing enough new-money loans to stimulate real economic
growth in 15 heavily indebted LDCs. In return, these LDC debtors
were to strengthen the foundation for long-term growth and eventual
debt service by adopting market oriented reforms of domestic
policies, including extensive privatization of state owned
enterprises, and elimination of some producer and consumer subsidies.

Exchange Debt for Bonds

This significant arrangement that allowed LDCs to exchange
their debts held by banks and government for bonds through an auction
arrangement was developed by J.P. Morgan & Company, the U.S.
Treasury, and the Mexican government in late December 1987. This
approach is still in an experimental stage and there is no certainty about the net effect. It is also not certain that this approach could apply to other LDCs because they do not have the foreign currency reserves required to purchase the U.S. Treasury or other similar securities that would support any new bond issue.

Fundamental Issues of the Problem

The LDC debt issue is fundamentally a question of how loans are going to be paid back in the long run and how is the loss going to be shared among the lenders (U.S. bank stockholders), guarantors (U.S. taxpayers), and borrowers (LDC citizens).

If the borrowers are forced to repay the loans on schedule, it can only be done if they sell their products to other countries (export for dollars), cease importing from others, and use the export earnings to pay off debt. This means they cannot consume the things they produce and they cannot import consumer goods. Thus their living standard must fall sharply to pay debt. Also, they cannot import capital goods to keep producing exportables. There is probably a limit to how poor such people are willing to be before they throw out their governments and default on government debts. Thus, LDC governments and U.S. banks cannot push this solution too far.

By rescheduling the debt the banks hope to recover all of their loans but over a longer period. Supposedly this will not reduce LDC living standards as sharply but for a longer period and thus keep the revolt and default option at bay. Rescheduling also
allows the bank to ignore, for regulatory purposes, the reality of an asset which has declined sharply in market value. This means that bank stockholders do not have to be told openly that their equity in the banks has decreased. Since the financial markets have long recognized the risk of these LDC loan assets by trading down the price of bank stocks to reflect the loan losses, stockholders are well aware of the losses.

By writing off 25 percent to 50 percent of their LDC loan exposure in 1987, banks recognized a large reduction in equity on their financial statements. This occurred in 1987 because the banks had large profits and additions to equity from other business that year to offset the writeoffs. These actions in the stock market and loan writeoffs are a recognition that bank stockholders are sharing the real losses with the LDC citizens.

The proposals and negotiations are efforts to shift the shares of the losses to others. Banks want to shift more of the loss onto the LDC citizens through lower living standards. LDC governments want to shift the loss onto bank stockholders (and lower their wealth and living standard). Both bank management and LDC governments would like to shift a bigger share of any loss to a third party--the U.S. citizens--and lower their living standard.

The U.S. government could buy the loans from the banks saving their stockholders and forgive the loans due from LDCs to protect their living standard. Funds would be raised from U.S. taxpayers or bank customers through deposit insurance premiums, and lower their living standard.
Reasons why U.S. taxpayers might wish to subsidize LDCs are (1) U.S. taxpayers feel morally obligated to help the LDC’s to avoid facing the unpleasant consequences of their earlier borrowing decisions or (2) if too large a share of the losses is placed on bank stockholders, large banks will fail, the insurance fund will fail, and U.S. taxpayers will have to pay to keep the payments system in the U.S. functioning. Either way taxpayers would share the losses.

The U.S. government must therefore measure how much the bank stockholders can lose before taxpayers have to pick up too large a problem at the FDIC, how much LDC citizens can and will lose in their living standard before defaulting on the loans and what can the U.S. gain from all this. The Baker Plan was intended to yield a gain for the U.S. by saying that the U.S. would help those LDCs which converted to the U.S. ideology. That is, if they freed their markets, allowed competition, and sold government businesses.
CHAPTER VII

BANK STRUCTURE IN SOUTH DAKOTA

Banking Facilities in South Dakota

This section describes the banking facilities available in South Dakota as of June, 1988. Data was supplied by the South Dakota Department of Commerce and Regulation, Division of Banking.

Banks and Banking Offices

The number of banks in South Dakota is dramatically smaller today than in the past four decades. Some reasons for this decrease are (1) independent banks were sold to become branches of other banks and (2) due to deregulation in the early 1980s and advances in technology, many investment substitutes available out of the state are now within reach of the local population hence reducing the demand for local banking services.

The number of branches, on the contrary, has increased significantly from the past. One possible reason is that as communication and transportation methods improve, urban populations spreads out and banks have to establish branches to capture customers. The situation for 1988 is depicted in Table 7.1.

Unit and Branch Banking

As shown in Table 7.2, there are significantly fewer branch banks than unit banks: 81 unit banks compared to 54 branch banks. Most of the National banks with branches tend to have more branches
Table 7.1

Commercial Banks and Banking Offices in South Dakota, June 1988

<table>
<thead>
<tr>
<th>Charter</th>
<th>Banks</th>
<th>Branches</th>
<th>Total Offices</th>
</tr>
</thead>
<tbody>
<tr>
<td>National</td>
<td>24</td>
<td>70</td>
<td>94</td>
</tr>
<tr>
<td>State</td>
<td>111</td>
<td>90</td>
<td>201</td>
</tr>
<tr>
<td>Total</td>
<td>135</td>
<td>160</td>
<td>295</td>
</tr>
</tbody>
</table>

Table 7.2

Unit Banking and Branch Banking in South Dakota, June 1988

<table>
<thead>
<tr>
<th>Charter</th>
<th>Unit Banks</th>
<th>Branch Banks</th>
<th>Total Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>National</td>
<td>15</td>
<td>9</td>
<td>24</td>
</tr>
<tr>
<td>State</td>
<td>66</td>
<td>45</td>
<td>111</td>
</tr>
<tr>
<td>Total</td>
<td>81</td>
<td>54</td>
<td>135</td>
</tr>
</tbody>
</table>
than do state banks. Of the nine National banks with branches, one has 32 branches or nearly half of the total National bank branches. The others have from one to eight branches. Of the 45 state banks with branches, 36 have only one or two branches. The maximum number of branches a bank in this category has is eight. The situation for 1988 is depicted in Table 7.2.

Population per Bank and Office

From the 1940s to the 1960s, the average ratios of population per bank was about 3,900, as of June, 1988 the ratio is 5,252. Both a growing population and a decrease in the number of banks contributed to this change.

Since the 1940s, population per office decreased from 3,180 to 2,835 in 1962. By 1988 this ratio had fallen to 2,403. The situation for 1988 is depicted in Table 7.3.

Bank Holding Companies

There are 73 bank holding companies in South Dakota of which 62 are one-bank holding companies and 11 are multibank holding companies. Bank holding companies are a dominant feature of the U.S. banking industry and it should not be surprising that the majority of South Dakota banks are owned by holding companies. See Table 7.4.

Financial Summary of South Dakota Banks

This section summarizes the analysis of the financial data of banks in South Dakota. Data of 137 banks were obtained from the 1987 and 1988 editions of the Commercial West Bank Directory of the Upper
Table 7.3

Population per Bank and per Banking Office in South Dakota, June 1988

<table>
<thead>
<tr>
<th></th>
<th>Bank</th>
<th>Office</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population</td>
<td>709,000</td>
<td>709,000</td>
</tr>
<tr>
<td>Number</td>
<td>135</td>
<td>295</td>
</tr>
<tr>
<td>Population/Number</td>
<td>5,252</td>
<td>2,403</td>
</tr>
</tbody>
</table>

Table 7.4

Bank Holding Companies in South Dakota, June 1988

<table>
<thead>
<tr>
<th>Banks Owned</th>
<th>Bank Holding Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>62</td>
</tr>
<tr>
<td>2</td>
<td>8</td>
</tr>
<tr>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>4</td>
<td>0</td>
</tr>
<tr>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>6</td>
<td>1</td>
</tr>
<tr>
<td>7</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>94</td>
</tr>
</tbody>
</table>
Midwest. Two banks are primarily involved with a credit card business and were not included in this analysis. In addition, although the data for the majority of the banks are dated 1987, 12 banks' data were not available for that year and 1986 data were substituted.

Definitions

**Cash and due.** Cash and amounts due from depository institutions include: non-interest bearing balances, currency and coin, and interest-bearing due from depository institutions whether in the form of savings or time balances.


**Other securities.** Securities issued by states and political subdivisions in the U.S. and all other debt and equity securities (including Federal Reserve Stock) and holdings of private certificates of participation in pools of residential mortgages issued by others that are not guaranteed by the U.S. Government and are not held in trading accounts.

**Federal funds sold.** Includes federal funds sold and securities purchased under agreements to resell.

**Loans and leases.** Loans and leases net of unearned income, but before allowance for loan and lease losses.

**Total assets.** Includes cash and due from banks, securities, federal funds sold, loans and leases, fixed assets and all other assets.
**Time deposits.** Deposits that are payable on a specified date, after a specified period of time from the date of deposit or after a specified notice period, which in all cases may not be less than seven days from the date of deposit.

**Total deposits.** Included all demand, savings and time deposits.

**Equity capital.** Includes perpetual preferred stock, common stock, surplus, undivided profits and capital reserves, and cumulative foreign currency translation adjustments.

**Net income.** Net Income after applicable income taxes and extraordinary items and other adjustments.

**Classifications of Banks**

Group I: Total assets of less than $10 million

Group II: Total assets of more than $10 million but less than $25 million

Group III: Total assets of more than $25 million but less than $75 million

Group IV: Total assets of more than $75 million but less than $150 million

Group V: Total assets of more than $150 million but less than $300 million

Group VI: Total assets of more than $1 billion

**Cash and Due/Total Assets**

Although the cash accounts of banks cannot produce income, banks are required to maintain a relatively high percentage of their
total assets as cash and due to meet the needs for liquidity. Since the 1940s bank liquidity has been decreasing. As shown in Table 7.5, cash and due amounted to 7.42 percent of bank assets in 1987. One of the reasons cited is that as competition from other financial institutions increases, banks have to transfer more of their assets to incoming producing assets in order to remain profitable.

**U.S. Securities/Total Assets**

Marketable securities provide banks with both liquidity and income. U.S. securities can be long-term or short-term. Long-term securities usually earn higher interest rates than the short-term ones. However, if interest rates rise sharply, there is a risk the prices of long-term securities may be considerably below their purchase price. Therefore, banks usually prefer using longer term securities for their investment portfolio. Banks usually rely on short-term securities for secondary reserves because they can be sold to provide cash without incurring serious loss.

South Dakota banks have traditionally held a high proportion of total assets in U.S. securities. Table 7.6 shows that banks in Group I, II, and IV are still concentrating a great deal in U.S. securities as earning assets. However, taking banks as a whole, the average ratio of other securities/total assets is almost 5 percent higher than the average ratio of U.S. securities/total assets. This means that banks are placing more of their assets in other securities rather than U.S. securities.
Table 7.5

Cash and Due as Percentage of Total Assets of Banks in South Dakota as of December 31, 1987

<table>
<thead>
<tr>
<th>Group</th>
<th>Number of Observations</th>
<th>Average</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>10</td>
<td>7.72</td>
<td>7.52</td>
</tr>
<tr>
<td>II</td>
<td>55</td>
<td>7.07</td>
<td>5.31</td>
</tr>
<tr>
<td>III</td>
<td>42</td>
<td>7.77</td>
<td>5.62</td>
</tr>
<tr>
<td>VI</td>
<td>12</td>
<td>5.91</td>
<td>2.57</td>
</tr>
<tr>
<td>V</td>
<td>2</td>
<td>9.45</td>
<td>-</td>
</tr>
<tr>
<td>VI</td>
<td>2</td>
<td>14.99</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>123</td>
<td>7.42</td>
<td>5.59</td>
</tr>
</tbody>
</table>
Table 7.6

U.S. Securities as Percentage of Total Assets of Banks in South Dakota as of December 31, 1987

<table>
<thead>
<tr>
<th>Group</th>
<th>Number of Observations</th>
<th>Average</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>14</td>
<td>32.52</td>
<td>19.90</td>
</tr>
<tr>
<td>II</td>
<td>58</td>
<td>28.60</td>
<td>15.10</td>
</tr>
<tr>
<td>III</td>
<td>43</td>
<td>23.22</td>
<td>15.51</td>
</tr>
<tr>
<td>IV</td>
<td>14</td>
<td>29.41</td>
<td>14.19</td>
</tr>
<tr>
<td>V</td>
<td>2</td>
<td>22.54</td>
<td>-</td>
</tr>
<tr>
<td>VI</td>
<td>1</td>
<td>22.29</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>132</td>
<td>27.21</td>
<td>15.93</td>
</tr>
</tbody>
</table>
In addition, this may also reflect the increasing number and variety of other securities available for investment. Those securities that have higher interest earnings than U.S. securities became more attractive because of banks' drive for earnings in a deregulated environment.

Other Securities/Total Assets

Most of the other securities that South Dakota banks hold are securities issued by state and local governments. These securities do not contribute to a bank's liquidity as do short-term U.S. securities because they are generally not traded in active markets. However, since the interest earned on these municipal securities is not subject to Federal income taxation, they are attractive to banks. As noted above, South Dakota banks hold a higher percentage of total assets in other securities than in U.S. securities. See Table 7.7.

Loans and Leases/Total Assets

Granting loans to businesses and individuals is an important function of a bank because loans are its most profitable asset. However, they also require a greater degree of administrative skill than do the other bank earning assets. A bank's loan-asset ratio is determined by the demand for loans and the degree of risk which a bank is willing to assume in granting loans. As shown in Table 7.8, South Dakota banks, particularly larger ones, are placing significantly higher portions of their total assets in loans than in other assets discussed above. This is encouraged by the availability of deposit insurance.
Table 7.7

Other Securities as Percentage of Total Assets of Banks in South Dakota as of December 31, 1987

<table>
<thead>
<tr>
<th>Group</th>
<th>Number of Observations</th>
<th>Average</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>14</td>
<td>25.40</td>
<td>25.91</td>
</tr>
<tr>
<td>II</td>
<td>58</td>
<td>32.19</td>
<td>35.84</td>
</tr>
<tr>
<td>III</td>
<td>44</td>
<td>40.00</td>
<td>36.73</td>
</tr>
<tr>
<td>IV</td>
<td>14</td>
<td>22.74</td>
<td>13.77</td>
</tr>
<tr>
<td>V</td>
<td>2</td>
<td>11.72</td>
<td>-</td>
</tr>
<tr>
<td>VI</td>
<td>2</td>
<td>15.77</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>134</td>
<td>32.49</td>
<td>33.67</td>
</tr>
</tbody>
</table>
Table 7.8

Loans and Leases as Percentage of Total Assets of Banks in South Dakota as of December 31, 1987

<table>
<thead>
<tr>
<th>Group</th>
<th>Number of Observations</th>
<th>Average</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>14</td>
<td>42.46</td>
<td>14.16</td>
</tr>
<tr>
<td>II</td>
<td>59</td>
<td>42.93</td>
<td>12.62</td>
</tr>
<tr>
<td>III</td>
<td>44</td>
<td>46.25</td>
<td>12.80</td>
</tr>
<tr>
<td>VI</td>
<td>14</td>
<td>45.78</td>
<td>11.76</td>
</tr>
<tr>
<td>V</td>
<td>2</td>
<td>51.60</td>
<td>-</td>
</tr>
<tr>
<td>VI</td>
<td>2</td>
<td>50.59</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>135</td>
<td>44.50</td>
<td>12.80</td>
</tr>
</tbody>
</table>
Loans and Leases/Total Deposits

The Loans and Leases-Total Deposits ratio explains the extent to which funds collected from the community as deposits are made available to meet the community’s credit needs. Table 7.9 shows a higher than 50 percent average for all banks. Considering Group VI alone, the average of the two largest banks’ ratio is as high as 89 percent. These indicate that the banks in South Dakota use a large portion of their total deposits to make loans.

Time Deposits/Total Deposits

Total deposits include all demand, time and savings deposits. Time and savings deposits are a more costly source of funds to banks. Even though by law banks have the right to withhold payments of savings deposits up to 30 days, the period is universally waived. Time deposits, especially Certificates of Deposits, however, can only be cashed in before their maturity dates if an interest penalty of some significance is paid. Because time deposits have predictable maturities, they constitute slightly less of a withdrawal threat. However, retention of matured deposits is sensitive to competitive conditions.

Since the 1950s, time deposits have been an increasing proportion of total deposits in South Dakota banks. Table 7.10 shows that on average, banks’ time deposits account for more than 60 percent of total deposits. One reason cited for the growth of time deposits is that with increased competition with other financial and nonbank institutions, banks have had to increase interest rates being
Table 7.9

Loans and Leases as Percentage of Total Deposits of Banks in South Dakota as of December 31, 1987

<table>
<thead>
<tr>
<th>Group</th>
<th>Number of Observations</th>
<th>Average</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>14</td>
<td>47.36</td>
<td>15.78</td>
</tr>
<tr>
<td>II</td>
<td>59</td>
<td>48.04</td>
<td>13.74</td>
</tr>
<tr>
<td>III</td>
<td>44</td>
<td>52.19</td>
<td>14.19</td>
</tr>
<tr>
<td>IV</td>
<td>14</td>
<td>50.97</td>
<td>13.16</td>
</tr>
<tr>
<td>V</td>
<td>2</td>
<td>58.95</td>
<td>-</td>
</tr>
<tr>
<td>VI</td>
<td>2</td>
<td>89.04</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>135</td>
<td>50.39</td>
<td>15.00</td>
</tr>
</tbody>
</table>
Table 7.10

Time Deposits as Percentage of Total Deposits
of Banks in South Dakota
as of December 31, 1987

<table>
<thead>
<tr>
<th>Group</th>
<th>Number of Observations</th>
<th>Average</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>11</td>
<td>68.97</td>
<td>15.06</td>
</tr>
<tr>
<td>II</td>
<td>54</td>
<td>62.20</td>
<td>17.71</td>
</tr>
<tr>
<td>III</td>
<td>38</td>
<td>59.18</td>
<td>16.66</td>
</tr>
<tr>
<td>IV</td>
<td>13</td>
<td>53.49</td>
<td>15.34</td>
</tr>
<tr>
<td>V</td>
<td>1</td>
<td>38.92</td>
<td>-</td>
</tr>
<tr>
<td>VI</td>
<td>2</td>
<td>50.32</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>119</td>
<td>60.51</td>
<td>17.24</td>
</tr>
</tbody>
</table>
offered on time deposits to attract funds that would otherwise have been invested elsewhere. Therefore, depositors have shifted from demand to time deposits in response to these higher interest rates.

**Equity Capital/Total Assets**

The Equity Capital/Total Assets ratio measures the leverage position of a bank. As shown in Table 7.11, except for Group V and Group VI, the average Equity Capital/Total Assets ratios are rather high. In addition, when comparing asset size and the average of the ratios among the six groups, it indicates that the ratio is negatively related to bank size.

Since July 1, 1982 both National and state banks in South Dakota are required to maintain a minimum Equity Capital/Total Assets ratio of six percent. In this analysis, 12 banks were found failing to comply with this requirement. There are two in Group I, five in Group II, two in Group III, one in Group IV and two in Group VI. It is possible that banks with relatively lower Equity Capital/Total Assets ratios are disproportionately represented among those banks which did not report.

**Net Income**

As shown in Tables 7.12 and 7.13, bank net income is small when related to total assets but considerably higher when related to equity capital due to the high degree of leverage resulting from the small percentage of capital to total assets.

A return on assets of approximately one percent is lower than many would like, i.e. about two percent. However, for banks coming
Table 7.11

Equity Capital as Percentage of Total Assets
of Banks in South Dakota
as of December 31, 1987

<table>
<thead>
<tr>
<th>Group</th>
<th>Number of Observations</th>
<th>Average</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>14</td>
<td>11.00</td>
<td>4.44</td>
</tr>
<tr>
<td>II</td>
<td>59</td>
<td>9.57</td>
<td>3.17</td>
</tr>
<tr>
<td>III</td>
<td>44</td>
<td>9.23</td>
<td>2.58</td>
</tr>
<tr>
<td>IV</td>
<td>14</td>
<td>8.63</td>
<td>1.84</td>
</tr>
<tr>
<td>V</td>
<td>2</td>
<td>6.96</td>
<td>-</td>
</tr>
<tr>
<td>VI</td>
<td>2</td>
<td>5.14</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>135</td>
<td>9.40</td>
<td>3.11</td>
</tr>
</tbody>
</table>
Table 7.12

Net Income as Percentage of Total Assets of Banks in South Dakota as of December 31, 1987

<table>
<thead>
<tr>
<th>Group</th>
<th>Number of Observations</th>
<th>Average</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>6</td>
<td>1.18</td>
<td>0.29</td>
</tr>
<tr>
<td>II</td>
<td>23</td>
<td>0.79</td>
<td>0.47</td>
</tr>
<tr>
<td>III</td>
<td>23</td>
<td>1.04</td>
<td>0.48</td>
</tr>
<tr>
<td>IV</td>
<td>8</td>
<td>0.84</td>
<td>0.50</td>
</tr>
<tr>
<td>V</td>
<td>1</td>
<td>0.99</td>
<td>-</td>
</tr>
<tr>
<td>VI</td>
<td>2</td>
<td>0.67</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>63</td>
<td>0.93</td>
<td>0.48</td>
</tr>
</tbody>
</table>
Table 7.13

Net Income as Percentage of Equity Capital
of Banks in South Dakota
as of December 31, 1987

<table>
<thead>
<tr>
<th>Group</th>
<th>Number of Observations</th>
<th>Average</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>6</td>
<td>10.56</td>
<td>3.77</td>
</tr>
<tr>
<td>II</td>
<td>23</td>
<td>15.94</td>
<td>36.69</td>
</tr>
<tr>
<td>III</td>
<td>23</td>
<td>10.77</td>
<td>4.17</td>
</tr>
<tr>
<td>IV</td>
<td>8</td>
<td>11.06</td>
<td>6.41</td>
</tr>
<tr>
<td>V</td>
<td>1</td>
<td>12.85</td>
<td>-</td>
</tr>
<tr>
<td>VI</td>
<td>2</td>
<td>12.96</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>63</td>
<td>12.77</td>
<td>22.59</td>
</tr>
</tbody>
</table>
out of the agricultural loan crisis of the mid-1980s, it is probably satisfactory. Considering the fact that only 63 of the 135 banks in study supply net income data, the results may be biased and a conclusion should not be drawn without caution.
CHAPTER VIII

SUMMARY AND CONCLUSIONS

Summary

Due to various economic, technological, legal and regulatory forces, the U.S. banking industry has been undergoing changes and encountering problems in the past two decades. This research considered such difficulties in four major areas: (1) the deposit insurance system; (2) the banks' linkages with other financial and nonbank firms; (3) the payments systems and (4) the LDC debts.

The major criticism of the FDIC is that it creates a problem of moral hazard. The FDIC's general use of the purchase-and-assumption approach in dealing with troubled large banks implies 100 percent insurance coverage and discourages market discipline for banks that take excess risks. This has created an increased burden for the FDIC.

Banks have been restricted by legislation as to the extent of their involvement with securities underwriting and affiliations with nonbank firms. This legislation was designed to protect the safety and soundness of the banking industry. According to some scholars, however, the legislation has hindered the profitability and competitiveness of commercial banks.

Because of the procedures adopted by some of the payments systems, both potential credit and system risks are imposed upon the Federal Reserve. In addition, the increased access of nonbank firms
to the payments system and the increased linkages with international markets also create risks. These risks can lead to failure of the payments systems. Furthermore, the failure of the payments system can cause transactions and other economic activities to cease.

Since the early 1980s, the LDCs have been having difficulties servicing their debts mainly due to world recession and disinflation. In the U.S., the LDC debts are concentrated in the nine largest banks. In 1987 some of the debts were written off, incurring losses to the banks' stockholders.

Conclusions

With respect to the moral hazard problem that the deposit insurance system created, one solution would be the adoption of risk-based insurance premiums which would encourage market discipline by risky banks. However, due to the difficulties in implementing this method, a more feasible approach would be to implement stricter policies on banks' minimum capital requirements. By including off-balance sheet activities in calculating required capital, this proposal is believed to be capable of controlling banks' excess risk-taking to a substantial extent. In addition, the consolidation of various federal insurance agencies can also improve regulatory efficiency.

Evaluating the reform of the banks' linkages to other financial and nonbank firms required an analysis of a number of issues. Some of these issues are conflicts of interest and abuse of the safety net related to affiliates, the possibility of insulating
banks from their nonbank affiliates, economies of scope and bank risks introduced by new activities and banks' profitability and competitiveness. Because these issues are controversial, it is still too early to draw a conclusion.

In order to minimize the potential credit and system risks that the Federal Reserve is facing today, many scholars and this author conclude that the Federal Reserve should charge those who impose the risks on the payments system for the costs of the risks that they create. In addition, an international agreement on central banks' responsibilities to act in case of crisis would also be helpful.

The U.S. government might be able to minimize its losses on LDC debts if it measures carefully how much the bank stockholders can lose and how much LDC citizens can and will lose in their living standard before defaulting on the loans and draw its policies accordingly. This would leave less of a problem at the FDIC and to the taxpayers.

Recommendations for Future Research

In light of issues and problems raised in this research, there is ample room for more research. Future efforts should address questions like these: Should the federal depository insurance agencies be phased out and let the Federal Reserve have more responsibilities in the safety and soundness of the system? How can a more efficient vendor-payments system be put in place in the U.S. to substitute for today's expensive check based payments system?
What can the U.S. government do to minimize the cost involved in the LDC debt problem? And, as new powers are granted to banks, how will this affect their productive efficiency and competitiveness?
BIBLIOGRAPHY


