The Future of Banking: A Political Analysis for 1999 and Beyond

John Maffey

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THE FUTURE OF BANKING: A POLITICAL ANALYSIS FOR 1999 AND BEYOND

by

John Maffey

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The Future of Banking: A Political Analysis for 1999 and Beyond

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This study focuses on the cycle of politics and banking by analyzing the relationship amongst the three primary actors within the domestic financial sub-system; regulatory agencies, the banking industry, and members of Congress. The cycle consists of three stages; loosening or deregulatory behavior, tightening or re-regulatory activity, and re-loosening, which is a return to deregulation. Legislation does not distinguish the stages, rather it ratifies existing behavior. Prior to legislative action, regulators grant bankers similar authority in an effort to enhance profitability or fend off competitors. Regulatory agencies provide mostly objective, non-partisan advice to Congress and supervision of the industry, acting to reduce the effects of the exigencies which arise within a regulated industry operating in a free market system.

Technology has been the primary motivation for changes within the banking industry to include pressuring Congress and regulators to license more expansive banking powers, to maintain the viability of the industry. How the industry responds to newly authorized business lines shall determine congressional behavior going forward. Federally subsidized depositor insurance assures a continuation of federal regulation of the industry, and therefore sustains the cycle.
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CHAPTER I

INTRODUCTION

The Financial Industry Is Changing

Banks Don’t Look Like They Used To

Allstate Insurance Company, one of the largest insurance providers in the United States, has recently been awarded a charter to initiate banking operations as a thrift institution (Dugas, 1999). Citibank, one of the top money-center banks, has merged with Travelers Group, a multi-layered insurance and financial services company forming the first truly “one-stop shop” for financial and insurance services, with a global operating footprint. Numerous other money-center banks have purchased securities and brokerage firms, such as Fleet Bank’s acquisition of Quick & Reilly Securities, and NationsBank’s (now Bank of America) purchase of Montgomery Securities. Even at the regional level, banks are forming strategic alliances and making acquisitions under their holding company umbrella, to expand their products and services. Why?

What we are witnessing is the creation of financial services companies, the likes of which we have not seen before in modern times. This amalgamation is occurring at almost every stage in the vertical structure of the industry, thereby creating challenges for all actors that purportedly shall result in tremendous benefits
for the consumer and the shareholder. Congressional committees, the conduit through which all legislation passes, are engaged in redefining responsibilities to better reflect the realities of their oversight industries. Regulatory agencies, accustomed to mediating their respective relationships within the banking community are now engaged with sister agencies from the financial services world, attempting to define regulatory responsibilities in the future. Banks, insurance, and brokerage firms are retooling, merging, and investing in technology. The customer is changing as well; better educated, more likely to invest for his or her future, and readily adapting to technological advancements. Financial services companies must promote their comprehensive products and services in an ever intensifying “cross selling” effort, to expand their “share of wallet” and justify their investment in change.

Purpose of Study

That the banking industry is one of the most closely regulated is testament to its expansive role in the national economy. Commerce in all forms requires capital, and banks remain the primary source of these funds that initiate construction, research and development, working capital loans for local businesses, and other economic advantages. Political oversight, which determines scope, cause, and conditions for regulation, will be the focus of our study. Historical analysis of the previous twenty years of banking legislation, widely viewed as a period that saw partial deregulation of New Deal legislation and then re-regulation in response to both environmental and industry behavior issues, shall form the basis of this study’s conclusions. Federal
government oversight cannot authenticate this study on its own. Banking industry practices will play a large role as well, for I will attempt to demonstrate the existence of a pull – pull relationship between bankers and legislators. It is a uniquely dynamic relationship in which regulatory agencies quietly apply leverage in one camp or the other, to promote their policy preferences. In strong economic times, legislation accommodates industry initiatives that tend to expand business conditions or curtail government practices. Economic and performance issues however can raise the level of public salience towards banking, triggering legislation initiated by regulators or constituents that responds accordingly to the public’s concern.

Given the tumultuous change now underway in banking (As this paper is being prepared, the Senate has passed legislation that removes the final New Deal era restrictions on banking, thereby accrediting the merger activity discussed above.), this study will attempt to predict the cause and effect parameters, that will initiate the next identifiable shift in legislator behavior on the issue of banking and finance. The vehicle to accomplish this will be the cycle of politics and banking. It is a criterion of behavior patterns amongst primary actors, as they respond to environmental conditions, focused on the mutually shared outcomes of a stable industry and a satiated constituency. The cycle will demonstrate the intrinsic relationship that exists amongst the three primary actors, and how they must rely on one another to successfully fulfill their strategies, responsibilities, and relations with the general public.
Organization of the Study

Between the years 1980 and 1994, banking had been significantly altered by proactive and reactive legislative and regulatory actions. These changes represent the cyclical nature of markets and the commerce carried on within them. That banking had become more exposed to market conditions, and treated at the federal level more like other forms of commerce, suggests that it would be subject to market volatility. Chapter two provides an historical evaluation of legislation and the conditions in which it was enacted during these years. It is provided to buttress the discussion of the cycle of politics and banking with a fact based foundation, expanding the readers' knowledge of a lesser known subject; banking legislation.

Borrowing a common title from industry publications describing banking in the 1980s, what are the “lessons learned” from the experience? Certainly within industry and regulatory circles much has been discussed and debated. Industry groups through their publications and sponsorship of symposiums have engaged members in a review of actions and conditions attempting to share proven practices and avoid common pitfalls. Regulatory agencies have conducted extensive internal evaluations of their respective reactions to industry and therefore economic conditions. The most interesting inter-agency exchange was sponsored by the FDIC, reviewing both the causes and agencies’ reactions to the exceptional institutional failure rates in the 1980s (FDIC, 1997). But on the legislative front, with its constantly changing cast of actors, what has been learned? More to the point, what is proper legislative behavior
in carrying out oversight responsibilities of the banking industry? With all the changes we have already discussed, are the legislators up to the task?

In Chapters III through to the conclusion, the focus will shift to an analysis of the three broad, and I will argue cyclical stages we witnessed in the years 1980 – 1994 as marked by legislative action. The behavior of each of the three major actors involved; legislators, regulators and bankers, will be examined within each of these stages. As if on the Federal Reserve Board discussing money supply, the cycle is marked by stages of loosening, tightening, and then re-loosening of the primary industry influences; oversight, regulation, legislation and therefore banking behavior. This cycle is just beginning its second historical iteration, and therefore is most difficult to identify, and requires a fair amount of hypothesizing to validate. But it could prove a useful tool for all parties involved in the financial subsystem.
CHAPTER II

1980-1994 BANKING LEGISLATION

Historical Background and Assessment of Current Conditions

Overview

Both the political and financial sectors within the US have been intertwined since the earliest days of this nation, when their survival was questionable and hinged upon overcoming shared challenges. Since those early days, the financial sector, specifically commercial banks, have succeeded in maintaining a tenuous relationship with the federal government, largely through federal regulatory agencies. The federal government, specifically Congress, has promoted this arrangement and through their oversight responsibilities, maintained what can be considered an evenhanded policy towards the financial community. Laws and regulations are enacted and modified in response to market or industry conditions, with Congress and the Executive Branch shepherding a policy whose keystone has been and remains industry stability and a positive public perception.

The financial industry, like others that operate in an intensely regulated environment, attempts to interpret regulations for their competitive advantage, seek and exploit the loophole. Therefore, banking policy changes enacted at the federal
level often are reactionary, attempting to maintain a straight line of financial stability and therefore consumer confidence in the industry.

The typical financial industry consumer today may be unable to fully appreciate the banking evolution underway these last twenty years. Compared to the previous 200 years, legislation and mergers have altered the financial landscape. A great deal has been written discussing this evolution in the 1990s, both from the perspective of the consumer and the financial industry. With the exception of regulatory agency publications however, federal government forecasting of the future impact current legislative alternatives may cause is restricted largely to economic and demographic perspectives. Clearly these are strong indicators given reliance on trends and historical data. However, such drastic changes occurring so quickly, demonstrate the need for greater scrutiny and analysis of interaction between and amongst actors in both the political and financial sectors.

Legislation between 1980 and 1994 occurred at a pace considered to be more active than any other time since the 1930's. Regulators and bankers were forced to amend many of their previous practices. The former, initially extending privileges during periods of deregulation, gaining additional regulatory tools towards the end of the decade and the latter, accelerating the scope and pace of business while attempting to maintain profitability in spite of high interest rates and poor business practices by many financial institutions. Overall, the consumer benefited in expanded banking facilities, greater deposit insurance coverage, and through technological innovation, expanded banking hours and access.
Deregulation Legislation Begins in 1980

During the 1970's, the domestic economy was challenged by numerous circumstances, which led to a very tight money supply. With the authority to protect the safety and soundness of the banking system, regulators had expanded interpretations of existing statutes to enhance banks' competitive posture given challenging environmental business conditions. Consumers and banks also sought relief from legal restrictions, which were incompatible with the current business climate. For example, thrifts lobbied for removal of interest rate ceilings on time and savings accounts while legislator constituencies clamored for low-interest mortgages. That these demands were contrary demonstrates the challenge Banking committee legislators faced. Caught in the middle, legislators “split on the best course of action, for fear of alienating powerful constituents no matter what they did” (Worsham, 1997).

The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA)

Heralded as the first deregulatory act since the New Deal, DIDMCA moved incrementally in a full circle in an effort to provide something for each of the interest groups influencing legislators. In response to money supply issues, the Federal Reserve (FED) was granted increased control through reserve requirements. Interest rate ceilings were phased out and interest-bearing checking accounts (NOW Accounts) were authorized, steps that pleased consumers and attempted to slow the
disintermediation ongoing since the 1970's. Recognition of technological
advancement is demonstrated by the authorization of automatic transfers (known as
EDS) between accounts. DIDMCA also created conditions that would severely
impact the cause and resolution of commercial bank and thrift failures during the
crisis in the 1980s. In reducing the percent of asset restrictions on a wide variety of
loans and expanding the types of loans allowed by thrifts, instruments of competitive
parity were misapplied and significantly contributed to the Savings & Loan (thrift)
failures. Deposit insurance was raised from $40,000 to $100,000, significantly
increasing the cost to taxpayers a decade later as the Resolution Trust Company
distributed indemnities. DIDMCA demonstrates the straight-line approach legislators
take, splitting the competing demands of constituents, when confronted with mutually
adverse influences.

The Garn-St Germain Depository Institutions Act of 1982

Given the perilous condition of many thrifts by 1981, still caught between
below rate mortgage loans and ceilings on deposit rates, Garn-St Germain broadened
the powers of regulators to handle and prevent failing thrifts. (DIDMCA did address
rate ceilings but the Depository Institutions Deregulatory Committee (DIDC), staffed
with members who “clung to old beliefs”, failed to execute its policy mandate,
because the committee feared higher rate ceilings would contribute to the collapse of
the thrift industry) (Worsham, 1997). Interestingly, though preventing further
institution failures was paramount, legislators dealt with this industry condition by
continuing the deregulatory course first embarked upon in 1980. Market discipline became the guidon upon which the industry was assembling, very different from New Deal reforms, which viewed the market as unstable and insecure. Contributing to competitive parity while relying on market discipline, the act authorized money market accounts to compete with money market mutual funds. Thus, thrifts won concessions and saw their investment opportunities expanded, and loan limits for single borrowers increased anywhere from 5 to 10 percent.

As the legislation created and expanded profit-making opportunities for banks, it also granted the industry insurance funds expanded powers to assist failing institutions. These powers included purchasing stock, issuing loans, making a deposit in and even purchasing assets of a failing institution. The Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) were responsible for the two industry insurance funds. Bank lobbyists and some legislators, catching the deregulatory fervor of the time even sought to authorize interstate branching as well as insurance and securities products. Though this did not succeed, emergency interstate acquisitions of failed institutions by healthy banks were allowed, administered through the FDIC. Authorizing emergency interstate mergers of failing institutions though marginal, represents the first crack in the walls erected by the Glass-Steagall Act in the 1930’s. It should be noted that state chartered non-member banks were allowed to offer insurance and securities products by state regulators as early as 1982; although the small market share and rural presence of these banks did not have a real political impact.
Re-regulation Responds to the Crisis of the 1980s

The period of years just reviewed witnessed considerable deregulatory activity in many industries. Airline and trucking industries were granted comprehensive deregulation and quite literally leveraged their respective futures on market discipline. Banking influences all aspects of the economy thereby lending much resolve and pensive deliberation to any and all changes to the status quo. Much was accomplished in the above two acts and more was expected. However, the declining state of the banking industry, punctuated by the federal bailout (FDIC cash infusion) of Continental Bank in 1984, tarnished arguments for further loosening and ushered in a period of re-regulation of the banking industry.

The Competitive Equality Banking Act of 1987 (CEBA)

To fully appreciate the ineffectual banking environment in which CEBA was enacted, one can look to the CEBA provision which expanded emergency acquisition (including interstate as defined in Garn-St Germain) of failed institutions to now include those in danger of closing. CEBA was designed to limit the bleeding in the industry caused by an alarming number of failing and failed institutions. It provided an infusion of $10.874 billion into the FSLIC to recapitalize this fund, as well as made the discretionary behavior practiced by regulators, “forbearance” law. (FDIC I, 1997) When legislation engraves regulatory procedures into law, salience has already reached a very high level. Legislation that affirms corrective regulatory procedures signifies the intellectual weight regulatory agencies possess in their field, as well as
the timidity or downright fear members have of altering the status quo. Congress neglected to address the issue of failing or failed institutions with appropriate timeliness. Regulatory departments had been practicing forbearance for sometime, largely in response to the dwindling insurance funds. Agriculture loans formed the basis for most rural bank portfolios, and these institutions usually were not well diversified across geographic boundaries or industry types. CEBA allowed small banks to amortize agricultural loan losses incurred after December 31, 1983. Once again, protection of the insurance funds influenced this provision.

Banking committees, as we have established, ensure legislation provides marginal satisfaction for all prominent members of the sub-system. With few objections from regulators, Congress responded to constituent concerns as well. The consumer provisions dealt with expediting funds availability, changed operating and governing laws for Credit Unions, and mandated a number of consumer related studies by the General Accounting Office and the banking agencies. Deposits were backed by the full faith and credit of the United States. This was always assumed but never articulated within a statute until CEBA.

Expanding commercial bank powers was on the table during CEBA negotiations. The dwindling funds in the FSLIC assured action from Congress and lent urgency to the process. Legislators opposed to expanded powers would not be swayed given thrift and bank failure rates, but persistent lobbying by advocates for commercial banks instead succeeded in achieving some protection from the non-bank banks. These are companies which either accept deposits or issue loans, but not both
as a bank does. CEBA closed this loophole grandfathering about 55 non-bank banks and restricting their activities. CEBA is yet another example of how advantage within the political arena is attained not just by winning expanded powers or opportunities, but also by limiting the advance of competing organizations. For advocates of expanded powers for commercial banks, CEBA achieved the latter, and maintained the barriers between them and their infringing adversaries in securities and insurance.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)

By 1989, the rate of thrift failures had moved from an alarming to a critical level and had become a public crisis. FIRREA is the product of an angry Congress, embarrassed by the excessive drain on federal funds caused by both the thrift industry and their own failure to assess the scope of the crisis in 1987 with effective legislation. After two years, CEBA provisions could not sustain the FSLIC and it was abolished. In its place, the Savings Association Insurance Fund (SAIF) was created and placed under FDIC management, separate from the Bank Insurance Fund (BIF). Punitive measures were enacted preventing thrifts from transferring between funds, imposing stricter accounting and regulatory standards, limiting state chartered thrifts, restricting brokered deposits and eliminating junk bond investments. The Resolution Trust Company (RTC) was established to deal with the voluminous government controlled assets from failed thrifts. RTC was to become a retrospective salience indicator as it provided a convenient method of measuring the cost to taxpayers of (pick one) (a) government largess, (b) policy failure of the Congressional/Executive
Branches, (c) capitalist greed, (d) the need for regulation/deregulation in response to the thrift crisis.

FIRREA exemplifies the sensitivity legislators had developed toward insurance funds protection. Through this act, Congress spread the responsibility for losses incurred by the insurance funds. Bank holding companies and commonly controlled institutions became liable for repayment of funds disbursed to resolve failed or failing institutions under their legal domains. This was known as a cross-guarantee provision. In addition to increasing private responsibility, CEBA allowed the FDIC to terminate insured banks' insurance coverage more quickly than previously allowed and tied cease and desist actions to insurance fund coverage. It demonstrates government recognition of the political volatility of taxpayer funded private industry bailouts, such as occurred with Chrysler Corporation in 1979.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)

Once again recapitalization of insurance funds was the primary issue driving this legislation. Though the thrift crisis had moderated somewhat in terms of legislated resolution policies, bank failures continued to drain the BIF and by 1990, the fund was in need of replenishment. Stability and soundness were attributes no longer easily associated with the US financial system. Congress recognized this, and the corresponding need for proactive legislation muted historically consistent debate on expanded powers and further deregulation. The BIF was funded by loans from the Treasury, paid down through deposit insurance assessments which by 1994, were
required to fluctuate based on the measured risk of the insured institution. These risk-based assessments had been under consideration for a decade, but the industry lobby had until now, successfully avoided their enactment.

FDICIA stepped up supervision through more detailed and frequent reporting by financial institutions. Capitalization requirements were now to be closely regulated using the CAMEL scale. (CAMEL is an acronym identifying the five critical components of an institution’s level of capitalization; Capital adequacy, Asset quality, Management, Earnings, Liquidity. They are applied against loan types/volumes in determining state of health.) Discretionary evaluation criteria that had been the prevalent form of regulatory appraisal, yielded to Congressional demand for objectivity by and accountability of field agents. Critically suspicious that regulatory forbearance was to arbitrary, Congress defined the state of health conditions and, as relates to insurance fund applicability, the corresponding corrective measures regulators would employ. Annual on-site examinations were now required and off-site surveillance policies became far more comprehensive in terms of the information required of the banks. Interest rate risk was now to be considered by regulatory agencies in determining risk-based capital standards for each institution.

The magnitude of operational intrusion caused by the previously discussed legislation paled in comparison to the effects of FDICIA. Mortgage lending standards under FDICIA became uniform for all insured depository institutions. Insured state chartered banks could no longer disregard federal legislation and engage in activities not authorized under a federal charter, unless the bank met certain measurable
requirements. Undercapitalized institutions were no longer able to accept brokered deposits and they were now subject to interest rate caps (previously amended in 1980).

As with other legislation in the period under review that addressed amongst many things, capitalization of the insurance funds, FDICIA went even further by establishing capitalization requirements for the insured institutions as well.

Legislation Creeps Back Toward Deregulation as the Economy Improves

At no time during the period between 1980 – 1992 did advocates of deregulation retreat from the policy-making scene. As stated, environmental and political circumstances tended to mute the debate on deregulation, as the industry’s troubles grew more severe towards the end of the decade. However, recovery of the industry in the early 1990s with a return to profitability and a reduction in failure rates to perceived acceptable levels, sanctioned proponents of deregulation to once again move to the forefront in policy debates.

The 1980s were by no means a return to New Deal era banking regulation, as they were also not a reproach of regulating an industry of such economic importance. The forces of market regulated commerce essentially won the battle begun in the 1970’s, when the deregulatory push began. Winning in this case is also not losing. That the industry was decimated by poor performing institutions, reached levels of public debate and criticism not seen since the depression years, and required an
But deregulation did not advance simply by the efforts of policy advocates. It was a compelling argument against the status quo because technology had wrought change on the procedures of doing business; on inter-institution and institution/customer relationships. Even the means of regulating underwent changes inspired by computer software and hardware development, which increased the volume and availability of information. Off-site surveillance by regulators could in fact, provide much of the information needed to render, for example a capitalization assessment using the CAMEL scale. New Deal adherents were influenced by these changes and, as shall be discussed later in this work, some key legislators changed their philosophy towards banking to more closely resemble other forms of commerce (Worsham, 1997).

Industry wide recovery though, allowed the political debate to focus again on growing the banking industry. Regulators and lobbyists could recommend policies that would strengthen their clientele, as opposed to working to save them. Now, politicians entered the debate unencumbered by high levels of public discourse on the industry, and the Banking Committees reverted to interest group and to a lesser extent party politics. Influenced by recent failures but lacking public urgency, much was debated but little accomplished.
Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994

Banking legislation, this study will show, is an affirmation of existing practices when enacted in a low salience, strong economic environment. Both Riegle acts are testament to this fact. We have already discussed the improved environment and accompanying increase in calls for continuing deregulation. However, state legislatures and their regulators have often been well ahead of their federal counterparts during the decade of the eighties, in granting additional powers to banks. When state application of a given provision reaches a super-majority amongst states, Congress appears to be comfortable enough with the provision to enact it into law. Such was the case with interstate banking.

The Riegle–Neal Interstate Banking Act allowed adequately capitalized bank holding companies to acquire a bank in any state after September, 1995. federal law had prohibited this since the New Deal era with the exception of emergency acquisitions authorized under CEBA. However, state statutes, though they varied considerably, had been allowing interstate acquisitions since Maine first enacted such a law in 1975. At the time Riegle-Neal was passed, only Hawaii did not allow banks to be acquired by out of state bank holding companies.

Another main provision of the law was allowing, by June, 1997, the merger of adequately capitalized banks across state lines. States were given an opportunity to opt in or out of this program, and in some cases, states actually approved interstate bank mergers with the acquisition of a branch in lieu of a bank.
Some additional provisions can be found in this law; to limit deposit concentrations by region, set minimum periods before a bank could acquire or be acquired, existing state laws and limits would override Riegle-Neal provisions, and all acquiring institutions would be evaluated for compliance with the Community Reinvestment Act.

**Community Development and Regulatory Improvement Act of 1994 (CDRI)**

Without much effort, CDRI legislation was moved through the respective Banking Committees. It contained provisions that generally speaking, were acceptable to all parties. Considered in relation to the previous Riegle act, it appears CDRI was a concession by advocates of interstate banking. They recognized the concerns expressed regarding consolidation in the industry and the potential loss of localized decision making (as often occurs in large financial institutions). CDRI provided legislators the necessary cover to open the gates for banks to grow across state lines in a concerted and highly public manner. Such growth was inspired by aggressive expansion plans, not the situational acquisition of a failing institution.

CDRI contained essentially two broad provisions, a reduction in many duplicative or outdated regulations and creation of a national fund for local community economic development. Most of the other regulatory changes were of an administrative nature, far less than requested by the banks. Nonetheless, the act reduced at least some of the regulatory burdens placed on banks in the 80’s with provisions of the FDICIA being repealed or relaxed. Community development in
rural and economically depressed areas was encouraged by creating a liquidity assistance fund for loans within CDRI parameters, thereby encouraging the type of high risk lending behavior which contributed to the crises of the 80’s. The differences under CDRI are federal acquiescence to the needs of economically disadvantaged areas, as well as the backing of the notes by federal government.
CHAPTER III

THE CYCLE OF POLITICS AND BANKING

A Behavioral and Consequential Evaluation of Legislators, Regulators, and Bankers

How Did the Cycle Begin?

By its nature, a cycle can arguably have no beginning, as it is circular with neither a definable start or finish point. Descriptive terms, also cannot always be fully accurate. The cycle of politics and banking interaction is termed as such due to this author’s belief that the legislative behavior we have witnessed over the past 19 years shall be repeated again, largely because of the existence of intrinsic conditions. By maintaining a straight line of financial stability, which is the primary motivation regarding legislators’ behavior, they are indeed affirming the cycle’s existence for marketplace (economic) and industry conditions and responses to these conditions cause the cycles stages to unfold. Legislators are passive observers until they are forced to act. The public’s perception of the banking industry also motivates legislative behavior. Thus, legislative behavior in particular does have identifiable stages, and along with the actions of industry representatives and regulators, does clearly signal the cycle’s existence.

After the various financial crises of the late 1920’s and early 1930’s, banking was identified as an industry that so permeates the economy, that it was irresponsible
on the part of government to expose this industry to the disciplines of the market. Such was the thinking that caused New Deal era banking legislation to protect the industry from the market through supervisory vigilance and legal constraints. Though the Second World War interrupted this trend, bankers through managerial expertise, institutional forbearance, and a reasonable economy were able to grow their businesses extending the benefits of their trade throughout the economy. But one noteworthy result of New Deal legislation that had and shall continue to have significant influence over the behavior of all actors, was establishment of the FDIC and the Bank Insurance Fund (BIF).

The BIF influences banking in various ways: First, it provides customers a level of assurance which significantly increases banks’ ability to attract capital. Second, it presents bankers with the problem of moral hazard (occurs “when insurance induces the insured to take more risk than they would take if they were not insured”) (FDIC, II, 1997) in making business decisions, motivating regulators specifically the FDIC, to exercise forbearance and institute practices which reduce the fund’s exposure. Finally, the BIF induces reactionary and protective statutes enacted by legislators in response to industry performance issues and their effect on the federal budget. In relation to the legislative cycle, consideration of the BIF in policy planning and deliberation by Congress is comparable to the capabilities of enemies of the United States when debating military spending bills. All banking initiatives, whether introduced by industry representatives, regulatory agencies, or constituents, are considered in relation to their impact on the BIF. Depositor insurance is a self-
perpetuating condition because elimination of this coverage is not politically viable. Therefore, it is very unlikely that the banking industry will ever shed the regulatory requirements of the federal government. Our discussion moves forward acknowledging that deregulation will never be complete hence, the BIF reinforces the perpetual existence of the legislative cycle because it supports a general continuum and therefore estimation of actors' behavior.

The economic realities of the 1970's exposed banking industry weaknesses in a comprehensive manner and the legislative cycle began in response to these conditions (see Chapter II). For the first time since the New Deal era, issues affecting banking were not restricted to a handful of congressional districts or states. Senators and Representatives from almost all areas had constituents dealing with banking industry challenges. As well, negative performance was being reported from large sectors of the financial industry; commercial banks and thrifts were facing environmental issues they could not overcome on their own. Certainly some of their problems could only be redressed by legislative action as the institutions faced obstacles, which resulted from the unfortunately timed convergence of legislated and economic circumstances. This to was a first since the New Deal era, and added considerable credibility to industry representative groups’ efforts to influence legislative behavior. A third condition merging on the timeline of industry behavior in the 1970’s was the actions of regulators. Heretofore, regulatory influence on the legislative process was primarily advisory, often not unified amongst the agencies, and lacked the need for urgent legislative action. Recognition of an urgent problem
was shared by all regulatory agencies, even though their legislative advice and prescribed resolutions varied. It should also be noted that regulators had for the better part of the decade, practiced policy enhancement under their respective charters, to assist their banking organizations in dealing with the environmental issues of the time.

Three responsible and representative forces had converged on the Congress to raise the likelihood of legislative action to stem the deterioration within the financial industry: First, the declining economy permeated every state in the Union directly affecting constituencies of members of Congress. Second, previous banking legislation had coupled with the souring economy to lash financial institutions to what appeared to be a doomed vessel, prohibited from taking appropriate countermeasures against the weak economy. And finally, the voice of regulatory agencies urging Congress to act while at the same time, loosening the regulatory restrictions on their constituent institutions. These are the conditions which initiated the cycle of politics and banking.

The Three Stages of the Cycle

Although the primary actors involved in the cycle may not carry out their system responsibilities in a coordinated manner, as one stage comes to an end and another begins legislators, regulators, and bankers have reached consensus in accepted priorities, strategic initiatives, and most profoundly, the direction of the industry. In effect an agreement on inclination is reached. The manner in which
consensus is achieved forestalls recognition of discernable breaks in the cycle, which would identify the end of one phase and the beginning of the next. Analysis of existing legislation does not accurately mark cyclical phases because it is not consistently beginning nor ending phases. Rather, legislation is the culmination of the primary actors’ interaction. Regulatory agency behavior reveals a great deal regarding industry conditions however, the behavior may vary by agency and as often is the case with field work, may not be available for review when it is current. It is in their advisory role to Congress where regulatory agencies are most likely to reveal their policy preferences, identification of industry issues, and recommended courses of remedial action. Banking industry groups may be the most difficult to analyze yet, their influence in the policy process is considerable. Unless an issue has a high degree of salience, the trade groups may very well be the only non-governmental actor attempting to influence the legislative process. Trade group organizations represent large banks, small banks, thrifts, credit unions, and the largest banks may employ their own professionals as full time policy advocates. In relation to moving from one phase to the next, trade groups can provide insight into the content of issues to be addressed. In summation, all three primary actors must be analyzed to determine when a given phase of the cycle may be approaching closure, and what issues will be prevalent in the next stage.

Each stage in the cycle of politics and banking is identified by a structure of inclination, in which the current issues are patterned. The structure of inclination becomes the primary motivator of actors’ behavior in each stage, and represents the
process through which consensus for action is reached. This is rather similar to how the “straight line of financial stability” guides legislators’ actions. By describing the attributes of this structure, each of the three stages in the cycle can be identified. The loosening stage structure supports retraction of existing conditions in an effort to enhance industry profitability or reduce the level of insolvency within the industry. Loosening can occur in response to challenging economic, competitive, or consumer-related conditions. This stage may be initiated by any of the primary actors, and is likely to be rather durable in terms of longevity. It is a politically palatable stage because the resulting legislative actions usually result in an outward flow of political capital, either returning favors or creating political indebtedness. Finally, loosening is a market directed inclination.

Following a deterioration in existing conditions, the behavior of both the industry and economy will determine when the tightening stage is entered. Tightening is an implementation of constrictive policies in response to conditions that are causing concern amongst any or all of the primary actors. Corrective action best describes this stage. Generally, bankers see a reduction in privileges while regulators gain in responsibilities and legal protections designed to increase supervision over and inspire proper conduct within the industry. In enacting legislation to respond to this phase of the cycle, politicians are likely to pursue courses of remedial action that cause constituents the least consternation, while they put out the fires so to speak. Debate on legislation in this phase requires an intimate knowledge of banking to understand the causes and effects of issues. This may cause some Banking Committee
members to extensively rely on outside expertise or delay action. Of course tightening represents a shift away from market inclination instead toward a stronger supervisory control of the industry.

The difference between the stages of loosening and re-loosening is what motivates and precedes the legislative action. Re-loosening follows a period of enhanced supervisory actions after the primary actors have reached collective agreement that the conditions which inspired tightening have waned. This stage will likely occur in an environment with a low salience level and a generally sound, profitable industry. Like loosening, actions taken within this stage are more palatable to politicians, inclined toward market discipline, and potentially durable and long lasting if accompanied by appropriate economic conditions and industry behavior.

Political actors ultimately control movement between the financial sub-system stages, as it is difficult to comprehend how a collective inclination can be reached without the assurance of legislative action. Legislation protects industry and regulatory agency actors from themselves and each other, by creating statutes that outline procedures and policies to solidify the collective inclination. Focusing on legislator behavior through the prism of the cycle of politics and banking should reveal a great deal about the future of the industry for, as we have stated, banking will not be relieved of its regulatory burden as long as federal government depositor insurance for consumers is in place.
CHAPTER IV

THE LOOSENING STAGE

Changing the Status Quo

The historical analysis of banking industry legislation provided earlier neglects the period from the late 1930’s to the 1970’s. During this time, legislative and industry inclination ran parallel to economic conditions. Regulators were afforded almost 40 years in which to supervise the industry unhindered by major economic or political challenges within banking institutions. Many inspectors as well as their banking counterparts were old enough to recall the Depression years and positively acted to prevent another system collapse. A recognized change in actors’ thinking signaled banking’s entry into a new phase. The first federal acknowledgement of the degenerating compatibility between the financial system structure and economic conditions came in 1971 with the Hunt Commission (Cargill, Gillian, 1982). This commission questioned the New Deal based system of financial regulation concluding that is was inefficient and recommending reform of regulatory procedures and the corresponding agencies. If Hunt legitimizes structure related discussions in the Capital, Watergate derailed the chance of legislative action occurring in a timely manner. Hunt was a Nixon Administration initiative unable to see the light of day in such a politically divided environment.
Banks and thrifts were by no means in a terminal state in 1971. The issue was credit availability, and much of the focus was on the Federal Reserve’s monetary policies. Bankers were experiencing a reduction in loan volumes and as a result, profitability fell. These conditions signaled the beginning of the loosening phase.

By the late 1970’s, the circumstances for Congress and the financial industry had changed notably. Though no considerable banking legislation was enacted during the 1970’s, a predilection for change was evolving into a shared reality. Influencing factors within each of the primary actor groups and on occasion outside these groups, moved the parties from debate to action. Regulators and the industry identified the motivating factors behind the loosening stage; formidable fiscal constraints for thrifts and an increasing competitive desire on the part of commercial banks. Conciliating both parties as well as the various industry groups could only be accomplished by the United States Congress, with the assistance of non-banking issues.

**Industry Conditions**

Thrifts and commercial banks faced two different sets of circumstances. Thrifts were wounded in two vital areas; earnings were reduced because thrifts make less money off portfolios of low interest housing loans than they pay depositors on their savings. Additionally, liquidity was draining away because the cash strapped thrifts cannot compete for consumer’s dollars with high return investments such as money market accounts (Wines, 1982). Thrifts were severely hampered by institutional insolvency rates that regulators found alarming. They urgently sought
relief from these constricting regulatory conditions (interest rate caps on deposits), and vigorously lobbied to prevent commercial banks from encroaching on their primary business source, home mortgages.

Commercial banks were by no means vibrantly profitable as they were also impeded by the high cost of money. But they were not yet affected by unacceptable institutional failure rates. Lobbying efforts focused on preventing their financial industry rivals such as securities firms and foreign owned banks, from gaining advantages. Banks sought a moratorium to stall foreign bank takeovers of US banks because the laws favored foreign banks by providing rather liberal business opportunities involving combining securities and banking. Commercial banks further argued if the trend were to continue unabated, foreigners through their bank ownership, would have undo influence on US monetary policy because they would be participating in electing Federal Reserve Board members (Atkinson, 1980). On occasion, commercial bank and thrift lobbies would compromise to demonstrate to members that their recommended course of action would have the support of their constituent industries. A deal was cut between bank and thrift lobbyists offering expanded thrift powers in return for thrift support of bank securities and revenue bond powers. However, the bill came out of committee with just the thrift provisions because the strong lobbying efforts of the securities industry shot bank powers down (Wines, 1982).

The conduct exhibited by industry groups in attempting to influence the outcome of legislation reveals the sparring nature of influence driven politics.
Positions constantly shift in relation to the actions of other interest groups or to announced positions taken by legislators. Unfortunately, such positional bantering can result in an unexpected outcome, or delay action until environmental conditions move the debate outside the halls of Congress. In 1981 and 1982, legislation was held up for over 10 months while lobbyists from various financial industry interests “plied the Banking Committees offices” hoping to gain benefits from the banking deregulation being considered. As the delay approached the end of the 97th Congress, and with thrifts getting worse, the legislation suddenly began “lurching toward passage” (Wines, 1982, p.1498).

There are other controlling factors affecting this industry group interaction with Congress, issues that capture the public’s attention. Two such examples impacted banking legislation debate in the late 1970’s. They had a profound effect on the primary actors. Both situations were addressed in the Senate Banking Committee and had an extremely high salience rate. In September, 1980, the federal government underwrote $300 million in bonds to avoid the bankruptcy of New York City. This occurred in the midst of a presidential campaign, and clearly eased legislators’ minds in terms of federal assistance for the public’s benefit (Molotsky, 1980). In 1979, the federal government had “bailed out” the Chrysler Corporation further contributing to the public’s discernment of the role government could play in resolving private industry. Regarding the Chrysler loan, the head of the Senate Banking Committee Senator Proxmire, in a statement of supreme irony, claimed that money for Chrysler
was "politics and pious hope", a statement which would come to amply describe banking legislation towards the thrift crisis (Associated Press, 1980, p. D5).

Banking and thrift interest groups spent a great deal of time negotiating over the procedures and content of their efforts on the legislative front. They achieved certain victories however, failure to crystallize their concerns in members eyes, encroaching environmental issues which were lengthening the list of failed and failing institutions with an accompanying increase in the salience level, and staunch opposition from certain members as well as competing financial industry groups, prevented the banking and thrift lobbies from capitalizing on the gains. That they won concessions is clear. The timing of their victory and behavior amongst their constituency corrupted these legislated gains.

**Regulatory Concerns**

An illuminating perspective on banking regulation considers the complexity of three different federal regulatory agencies seeking to promote uniform regulation on commercial banks, each regulating different banks subject to different legal requirements. The reason for this conundrum is the three different types of financial institution charters. Through this tangle of regulatory oversight, the Congress must assess industry conditions, solicit opinions, and determine legislative priorities all in the hope of furthering the stability of the banking system. If regulators deliver a consistent message on the state of the industry, Congress is likely to act. By 1978, regulators were signaling agreement on the timing and need for legislative action.
Regulators stand between bankers and legislators rendering their respective opinions as they deem appropriate within the confines of their charters. Their actions can be categorized according to which actor they are attempting to influence; both bankers and legislators are publicly and privately pressured. Public forms of influence can be seen in the words of regulatory heads during appearances for industry groups or testifying in front of Congressional Committees. Private leveraging is far more complex and difficult to document. Regulators have access to senior management personnel at most banks and calls from agency heads are certainly received by Members. The public's perception of the banking industry is very important to regulators as the industry's customers possess considerable influence. All five banking regulatory agencies had "for weeks ... quietly sounded members of Congress's banking committees for support for emergency legislation ..., while at the same time, warning Congress not to arouse public concern over the health of the nations financial institutions" (The Administration.., 1980, p.35). Once the regulators went public, acknowledging amongst other things the vast number of problem and failed banks and thrifts, Congress was prepared to take swift action.

Consider the following examples of regulatory persuasion, and their effect on resulting legislation. In exercising their responsibility to maintain a sound financial system, regulators will make policy adjustments within the confines of their charter. In a move designed to motivate capital in the form of mortgage money flowing into thrifts, regulators raised by ¼ point the interest thrifts pay on deposits. This is an increase that places thrifts at an advantage over commercial banks in terms of
attracting deposits. This action took place well before legislative redress of the statute was undertaken. Call it private or public influence, but thrift regulators refused to stand fast while their insurance funds’ exposure grew as the rate of failed and failing institutions continued to rise.

John Heimann, the Comptroller of the Currency spoke before an audience of the Independent Bankers Association of America (IBAA) stating that the OCC’s position was to continue pushing for removal of geographic restraints upon bank expansion because they are “anticompetitive and impede the effectiveness and efficiency of the banking system”. The Comptroller went on to state “not withstanding the McFadden Act, in a very real sense, we already have national banking” (Battey, 1979, p.1). Mr. Heimann was directing his remarks toward Congressional Representatives when referring to actions taken by state regulators allowing in-state branching. In effect, the practice is already underway and working, let us make it national in application. It would take another 15 years before this happened. He also was certainly attempting to warn of impending disaster if legislation does not move quickly to accommodate the needs of the banking industry.

Many more accounts of regulatory agency influence towards Congress exist, than towards bankers. Consider the political capital being expended by regulatory heads in the struggle between thrift and commercial bank regulators. They defend their existing supervisory responsibilities while assuring the needs of their constituent institutions are well known to the legislators. Speaking of the Garn-St Germain thrift relief package, Thomas Vartanian, the General Counsel of the Federal Home Loan
Bank Board stated that the thrift package "will be enough to get them (thrifts) through the next five years," until new banking powers can be phased in (Wines, 1982, p.1498). At another appearance in 1980, he sought a moratorium on commercial banks merging with thrifts because commercial banks do not provide home mortgages at the same volumes as thrifts. Meanwhile, the Fed Governor, the Chairman of the FDIC, and the Comptroller of the Currency opposed the moratorium stating that questions surrounding merger policies should be decided by Congress, and besides, mergers could bring thrifts better management and sounder financial footing (Rubin, 1980). At times it appears as though the regulatory agencies are enjoined in the same efforts as their respective industry representative groups. At times they actually are, and this is an example of the shared inclination mentioned earlier.

At no time from the enactment of Garn-St Germain until the thrift crisis ended in the early 1990s did the thrift situation improve. The FHLBB was disbanded and absorbed into the FDIC. Mr. Vartanian should have realized that in the high salience environment primarily caused by the poor performance of the thrift industry, the federal government would not award expanded powers while paying out billions in insurance indemnities. Note the responses by heads of the commercial bank regulatory bodies. They chose to disarm the FHLBB's initiative by elevating the discussion to Congress thereby circumventing the issue of the thrift insurance fund. As well, their statements are a rather straightforward indictment of thrift management abilities and their precarious financial condition.
Towards the end of 1980, commercial bank regulatory agencies were forced to begin acknowledging that environmental challenges were having a negative impact on their constituent institutions. The 97th Congress was close to adjourning, thus raising the likelihood that legislation was forthcoming. Given this ninth hour atmosphere, more realistic assessments were being publicly pronounced. A Fed Governor testified to the Senate Banking Committee that banking was headed for a recession due to high debt ratios causing individual bankruptcies and high-energy prices. Governor J. Charles Partee urged Congress to permit interstate takeovers of failed banks and quick financial assistance to others. The Chairman of the FHLBB concurred with the Governor’s assessment stating they expected to advance considerable amounts of capital to their industry groups in the coming year (Ross, 1982). FDIC head William Isaac declared commercial banks are in “good shape” financially despite high interest rates. He stated only 210 out of 14,794 commercial banks were on a problem list compared to 360 S&L’s out of approximately 4000. Banks he said, kept enough money liquid to invest in instruments paying the high returns now possible (Jacobsen, 1980, p.1). By 1982, Chairman Isaac stated “commercial banking is generally good, but we are beginning to see some evidence of an increase in problems” (Jacobsen, 1982, p.1). This admission was not prompted by a substantial change in the number of problem banks but rather, by the fact that few of these banks were improving. DIDMCA was enacted at the end of 1980 and Garn-St Germain in 1982. It is possible to conclude that regulators avoid the concise truth on the state of their industry as long as it is
politically feasible. Faced with immanent legislation, their respective bottom lines are revealed and fortunately, addressed by Congress.

**Legislative Intentions**

Though industry groups and regulators were united in their inclination toward deregulation, they were allowing individual needs to cloud their messages to Congress. Therefore, the Banking Committees implemented solutions for various industry issues by inserting a quick fix to maintain as much as possible of status quo, instead of considering the economy over the next few years. With interest rates at exceptionally high levels in 1980, some committee members politicized debate by grabbing headlines prior to adjourning for Congressional elections. Though both banking committees acknowledged severe issues must be resolved in the financial industry, severe institutional paralysis has “stymied legislative action on all but a few issues,… where the possibility of immensely adverse financial consequences is the only thing that creates the economic and political imperative to do something” (Cohen, 1980, p. 769).

Banking committee members exhibit two interesting dynamics in executing their duty, reactionary and reform minded approaches to the issues. The reactive legislators saw primarily two conditions within the industry that influenced their positions, rising interest rates and the fear of recession. These were strong motivators because their resulting negative impact on the industry could be measured through institutional failure rates. They were also politically visible. Legislators reacted to
pressure more than they were able to set their own direction and strategy for the financial industry. The goal of their legislation is to return the industry to the pre-crisis status quo. Reactionary legislators can be quite visionary when not consumed by a crisis however, they tended toward regulatory solutions and feared banking would not remain stable if overexposed to the market. Chairman Proxmire was an example of this attitude. He routinely resisted reforms that encompassed expanded powers yet he saw the need for immediate supportive and corrective action. To Proxmire, banking was unlike other forms of commerce. The situation can be compared to congressional responses to flood emergencies; legislators may release emergency funds for the victims, but fail to direct the Army Corps of Engineers to correct the conditions which contributed to the flooding.

Besides the need for corrective action, some banking committee members were aware that reactive legislation unaccompanied by structural reform of the financial industry would not support long-term stability. This group of legislators tended to see the causes and effects and resolved to address the causes. They listened to the advice of regulators who were capable of defining industry stability in terms other than the solvency of depositor insurance funds. Senator Garn exemplified this group. When he assumed control of the Senate Banking Committee, replacing Senator Proxmire, it signaled a sea change in the types of legislated solutions under consideration in the chamber. Most of Senator Garn's initiatives were substantially different in scope and philosophy than the approaches led by Proxmire. Policies designed to expand banking powers usually result in greater involvement in non-
banking commerce. Therefore, proponents of structural change for the financial industry support greater market influence in banking.

Conclusion

The excessively high institutional insolvency rate of thrifts combined with the desire of commercial banks to increase profits by expanding their business opportunities, triggered the beginning of the loosening stage. Legislation was enacted which addressed the immediate concerns of the thrifts and partially satisfied the desires of commercial banks. Non-bank financial industry interest groups and their corresponding oversight agencies in government succeeded in keeping banks away from their areas of business, especially in the securities business.

Results conducive to an extensive deregulatory period were being achieved on the legislative front. Expanded powers were attained by thrifts and commercial banks in the midst of a financial crisis for the thrifts. It appeared the loosening stage would carry on for sometime. This did not happen. Deregulatory debate was stunted by the worsening thrift crisis and the newly emerging commercial bank crisis. The policies enacted during this first stage failed to stop the industry’s downward spiral. Reactionary legislators moved to the forefront of the debate in Congress. Regulatory heads warned of impending insolvency of the insurance funds, and bankers sought to stem losses by assuming higher profit business with accompanying greater levels of risk. Environmental circumstances and industry behavior worked to bring the deregulatory phase to closure, prematurely.
CHAPTER V

THE TIGHTENING STAGE

Responding to Crisis

Though the pace of financial institution failures had continued to increase through the early 1980s, the primary actors proceeded to look toward expansion of powers and further deregulation, believing these steps would abate the industry's worsening condition. In fact, the emerging consensus was that banks must have access to more products and services if they are to return to a healthy state. Liberalization of real estate lending standards had increased the pace and volume of business by thrift institutions. However, their inability to diversify loan portfolios, especially outside of real estate and agriculture, contributed to an ever expanding number of thrift failures and in so doing, handed commercial banks the first federally approved interstate mergers under the emergency acquisition provisions found in Garn-St Germain. Some nationally chartered banks began to look truly national as they grew their operating footprint, Citibank expanded its New York retail operation purchasing thrifts in Florida, California, and Illinois.

Previous banking legislation had spawned a new and more competitive financial service environment. Technology was continuing to affect the speed, efficiency, and accessibility to consumers of financial functions. Failing institutions
simply were unable to maintain their competitive edge in this changing world of financial services. Failures exhibited the industry was more closely tied to market driven realities and deregulation was in fact exposing the weak siblings. Banking was beginning to function as other industries within the economy. Deregulation proponents thought the spigot of expanded powers need only to be further opened, to unleash the industry’s significant resources in profit driven endeavors unencumbered by archaic regulatory burdens. This scenario certainly may have seen the light of day were it not for the Continental Bank of Illinois failure in 1984. Though regulatory agencies and Congress did express concern over institutional failure rates, it did little to dampen the industry’s enthusiasm.

The signal event that opened the tightening phase was the collapse of Continental Bank. This event did not curtail debate on expanded powers or give pause to the industry and congressional supporters of deregulation, so much as it provided those Members and regulators who questioned the appropriateness of deregulation a definable, high salience issue. Continental inspired the “too big to fail” theory. Its demise represented a potentially devastating claim against the FDIC’s insurance fund, a potential for rash, rumor driven intermediation actions by the public, and a realization by all primary actors of the consequences when financial resources are consolidated under inept institutional management.

The drive toward further deregulation continued but no longer was debate occurring in an environment of shared inclination. Potentially large claims against the insurance fund provided reason enough for certain individuals in legislative and
regulatory groups to dig in their heels against further exposure of banking to the realities of the market. Accompanied by continuing poor trends within the industry, their resistance provided sufficient justification to enact restrictive legislation towards the middle years of the tightening phase. Deregulatory proponents remained somewhat prominent at the federal level, but achieved significant progress working with state banking regulators and state legislatures.

**Industry Conditions**

Thrift organizations continued to deteriorate during the tightening stage thereby assuming a more passive role in policy debates, much different than during the loosening stage. As they recovered from the 1970's interest rate cap issues, thrifts undertook increasingly precarious business initiatives to expand revenue-producing opportunities hoping to remain competitive and profitable against commercial banks. Their resulting overexposure to excessive default rates in real estate loans accompanied by regional market economy recessions, caused their industry group to become politically ambivalent by the end of the tightening phase. Unfortunately, thrift behavior in the marketplace resulted in politically volatile circumstances as their institutional failure rates spiraled causing the federal government to form a public corporation (Resolution Trust Company) to resolve failed institutions. Even their insurance fund (FSLIC) was bankrupted and ultimately consolidated and placed under FDIC stewardship. By the end of the tightening phase differences between thrifts and commercial banks were becoming blurred, both in operating regulations and lobbying
efforts. Commercial banks took the lobbying initiative and directed their efforts towards resisting and allying with other financial services industry groups.

After 1982’s legislation, large regional banks and some of the national organizations began to expand by taking advantage of the weak thrift acquisition statute at the federal level and the more liberal state banking laws. These early years saw the first out of state strides by some of today’s industry behemoths such as NCNB (Bank of America), First Union, and Chase buying into Florida and Texas. Industry groups retained their intensive lobbying efforts in the hopes of expanding their powers to include selling insurance, dealing in securities, and gaining unhindered access to branch across state lines. These aggressive efforts were not limited to dealings with Congress.

Banks knew that regulatory agencies were continuing to broadly interpret legislation to bolster their constituent industry’s long term viability and profitability. Growing impatient with the lack of federal legislation since 1982, banks doubled their efforts at finding legal loopholes through which additional products and services could be sold. Large numbers of non-bank banks had been forming, causing angst among commercial banks that Congress’s failure to act would render them competitively impotent. Some of the banks’ initiatives, supported by their regulatory agency, resulted in court cases. Congress’s failure to legislate moved the debate to another branch of government. US Bancorp’s foray into selling insurance provides an illuminating example of banking ingenuity. Utilizing a 1916 banking law which allowed insurance to be sold by national banks in towns with populations less than
5000, US Bancorp began selling insurance in 1986 with the consent of the OCC. Insurance industry groups immediately took US Bancorp and the OCC to court. After six years of legal battles, the insurance industry prevailed (Britta, 1992).

Some free marketers saw Congress’s inactivity or “legislative stagnation” as preferable to action because it supported free market economics and represented a benefit for both consumers and banks (Prager, 1984). No evidence could be found that any in the legislative or regulatory actor groups supported this position. However, some industry groups such as independent community bankers, feared expanded powers and interstate banking in the hands of larger banks would curtail the potential success of smaller banks. Though industry representative groups would merge their positions as this stage progressed, at no time would all members of the industry applaud legislative stagnation.

As Congress wrestled with banking legislation, particularly interstate banking, state legislatures saw the handwriting on the wall and moved regionally to protect their constituent banks from exposure to the large money center banks. Thus, regional regulations formed at the state level began to appear, containing certain elements of protectionism. Florida exhibited this close industry/government relationship. Joel Wells was president of Governor Graham’s advisory panel on banking as well as being president of Sun Banks (Stavro, 1984). The southeast and New England regions were the earliest and most progressive in creating regional banking alliances built upon reciprocal state banking laws.
In some cases state banking regulators acted unilaterally in extending state charters to out of state banks wanting to conduct business in their states. Certainly a great deal of legal confusion existed between and amongst state and federal banking regulators and their oversight bodies. Most looked to Congress to clear up the issues. But while clouds remained, banks moved as quickly as they could to take advantage of the fog, and expand their operations as they wished. The tightening phase could have been devastating to the banking industry; given the five year legislative drought from 1982-1987 and the subsequent reactionary-corrective action measures that Congress instituted. Had it not been for magnanimous interpretations of statutes by federal regulators and aggressive deregulatory actions by state regulators and legislatures, (spurred to beneficent action by states rights issues in anticipation of federal interstate banking legislation or protectionism of indigenous industry actors, or possibly to sustain the dual banking system so unique to this country) commercial banks likely would have been forced to comply with far more constricting legislation.

Regulatory Concerns

Regulatory agency conduct towards Congress during the tightening phase remained fairly consistent with their behavior in the previous phase. The FED, FDIC, and OCC all contributed a great deal of expert advice both privately and publicly to Members, and for the most part shared common ground in suggested solutions and initiatives for the industry. However, their relationship with constituent industry groups appeared to become more didactic as conditions deteriorated. This is so for
two reasons: First, many institutions were under performing or outright failing, creating a heightened salience level for the entire industry. In this environment, agencies come under increased congressional scrutiny, (questioning causes and seeking remedies, not necessarily assigning blame) accompanied by a corresponding rise in public awareness of the agency and its role in this salient issue. Bureaucratic agencies act quickly to change this situation, motivated by the interdependent goals of reducing political consequences and improving constituent performance. All three agencies endured some scrutiny; money supply issues dogged the FED, the OCC dealt with the foreign lending crisis involving national banks, and the FDIC managed the insurance fund during a time of substantial institutional failures. Second, the absence of federal legislation limited banks’ competitiveness against financial service companies not regulated by the three federal regulatory agencies. Whether the challenges came from state legislatures, state-chartered banks, or other industries, the federal agencies worked closely with their constituent banks to afford them every opportunity to gain the competitive product access they needed. Hence, we witnessed regulators granting powers and the subsequent legal battles.

Regulatory agencies gained and applied considerable powers during the tightening phase; all proclaimed in the latter half of the period, mostly to resolve current crisis or prevent their reoccurrence. All three agencies increased in size to carry out the additional taskings.

Frustrations with Congress extended to the heads of each of the agencies. FED Chairman Volcker called on Congress to recognize that vast changes in the banking
industry have affected public opinion of financial institutions. The FSLIC crisis and failure rates demanded that legislation be enacted to deal with these issues (Naylor, 1985). FDIC head William Isaac warned against the threat of nationalizing banks with fund bailouts of investors and argued against criticism that his agency’s support of Continental Bank constituted a federal bailout (Trigaux, 1984). Donald Regan, the Reagan Administration’s Treasury Secretary testified before Congress seeking an expansion in bank powers as a method to forestall the damaging effects of so many other industries on banking. This was doomed to failure with the Continental collapse. He further argued that St. Germain was insulating the security and insurance industries from competition by refusing to allow an expansion of banking powers (Carrington, 1984).

In terms of liberalizing statutes, the three agencies instituted some unique regulations in support of their banks. Always cognizant of Congress’s legislative agenda and timing, regulators would await Congress if they knew legislation was forthcoming. The FED waited through the 1987 legislative session for Congress to allow banks to underwrite corporate debt. At year’s end, the FED moved quickly to grant this authority as they had an obligation to respond to pending applications (Taylor, 1988). Two more examples are appropriate as they exhibit the momentum and urgency banks and regulators placed on expanding powers, following the ambivalent legislation from 1982. In 1984, the FDIC granted state chartered banks, not regulated by the FED, the authority to offer brokerage services. In the same year, the OCC granted additional charters for non-bank banks. This was an overt effort to
circumvent interstate banking and bank ownership prohibitions (Langley, 1984). The net result of these initiatives was to fuel the industry’s dash for expanded powers.

Congress and regulatory agencies share the mutual goal of a profitable and financially strong industry. Consider the implications if Congress had created the agencies without the flexible guidance of a charter, instead through strict statute guidelines. The result during this tightening phase would likely have been an industry upheaval of very public proportions. Lacking an associated government organization such as the regulatory agencies, industry groups would have been forced to move the debate to the public forum similar to the manner we see electric utility deregulation being debated today in media advertising. Were that to have occurred, Congress would be forced to address the issues almost exclusively in terms of their effect on constituencies.

Regarding states granting additional banking powers, this action initiated very interesting discussions on maintaining balance amongst regulatory agencies within the dual banking system. Chartering institutions has been a significant measure of regulatory agency authority. During the tightening phase, granting expanded powers may have superceded charter authority as an agency’s most puissant use of authority. Of course jurisdiction by state governments over commerce within their borders is at issue both in terms of jurisprudence and in relation to the regulatory boundary within the dual banking system. States rights are more likely to survive federal usurpation of authority if the state had previously enacted legislation. Hence, the federal version of
interstate banking legislation was instituted over a three-year period while each state was asked to opt in or out of participating.

The tightening phase demanded that regulators move to the forefront in shaping policy through both their traditional role as advisors to Congress, and as policy making agencies exercising discretionary powers. In the absence of congressional action, regulators implemented prompt corrective measures during the crises, thereby shouldering responsibility for the industry. Considering the economic, competitive, and operational issues at the time, regulatory agencies should be lauded for their successful creation as well as implementation of policies to redirect the industry towards financial stability. Congress’s inaction presented regulators with a unique opportunity to implement timely policies during a critical period in the evolution of the financial industry. Banks should be grateful they did.

**Legislative Intentions**

It was widely accepted after 1982 that thrifts had gained the benefits of recent legislation even though innovative leaders in the commercial bank industry were thought to have the competitive edge with their deep pockets and vast customer base. In fact many in the industry believed deregulation would continue unabated for sometime. In 1983, Senator Garn was expecting and the Deputy Secretary of the Treasury, R.T. McNamar was predicting that a bill was forthcoming to change the current Bank Holding Company Law to “provide a framework for financial institutions for the next 10 or 20 years” by allowing a holding company to engage in
any form of securities activity (Miller, 1983, p.54). Senator Garn enthused proponents of deregulation with his comprehensive legislative agenda while Representative St Germain not only refused to consider granting banks additional powers, but wanted to curtail existing regulations resulting in financial services companies being required to shed assets or business lines, such as Sears selling the Sears Savings Bank (WSJ, 9/17/84). Consumer groups joined the fray adding additional pressure by pushing for lower fees and more access, wanting basic low or no fee services for the poor and elderly. The chairmen of the Banking Committees stood poles apart on the question of what banks should be allowed to do. When the Democrats took back the Senate in 1987, agreement on banking bills between the houses became possible.

Loosening stage legislative actions combined corrective action and expanded powers for thrifts and banks. That those promoting corrective action were also against deregulation was not as important in 1982, as it became in 1984 and beyond. Loosening stage industry problems arose after an extended period of strict supervisory policy. Members such as Representative St Germain may have voted to address the current problems' effects in 1982, and thereby agree to expanded powers legislation. By 1984, industry problems had for the most part worsened. Factor the Continental collapse into the decision process followed by those favoring stricter supervision (regulation) and one can more clearly understand the resistance they displayed towards further powers expansion, towards viewing banking more as other forms of commerce, and towards non-banks offering banking services. Yet while the
agencies resisted, the industry continued to decline. St Germain’s Banking committee did not offer plausible solutions to industry issues instead wanting more time to study the potential effects on industry and consumers. The reality was that St Germain was a party stalwart who single-handedly blocked enactment of significant banking legislation until the Senate was taken by the Democrats and legislation from the Senate no longer contained language expanding banking's powers. This, even though Senate banking legislation between 1983-1985 was passed with overwhelming bi-partisan support.

Without passing significant banking legislation, the 98th Congress adjourned shifting the impetus for action to the industry and regulatory agencies. It was hoped that the actions of more aggressive banks and financial services companies would push Congress into action, (Holcomb, 1985) and that the body would ratify the changes already underway within the industry. Once again Congress relied upon the discretionary powers of regulators to maintain current policies - whilst Congress fiddled while Rome burns - unable to bridge the divide between two fundamentally opposed approaches to the industry.

The 99th through the 101st Congresses successfully passed one major piece of legislation each session. Each piece was reactionary, addressing the crisis within the industry through corrective action while failing to resolve the debate over expanded powers. Congress did not however, offset the market directed legislative gains from the loosening period. Banking powers were not tightened or restricted so much as regulators were given more objective direction on regulatory procedure and less
discretionary authority. Once again, protection of the insurance funds played a critical role. The BIF “establishes a continuing legitimacy for further regulatory legislation” due to the government’s role in underwriting the industry’s safety net (Prager, 1984, p.14). In addressing industry problems through their oversight agencies instead of directing their legislation primarily at the industry, Congress acquiesced to and placed their trust in the expertise and reliable intentions of the regulatory agencies.

Conflicting political ideologies spanned the entire tightening phase. Yet banking legislation evolved through the learned assessments of each individual elected official, thereby enhancing the posture of the three regulatory agencies through Congress’s reliance on their expertise. Contrast banking legislation with the politics of environmental legislation. Both issues have powerful government agencies and affect almost all areas and aspects of the economy. Unlike banking, the environmental debate has been forged into party platforms because it is not so convoluted an issue that the average voter cannot comprehend the ramifications of various legislative approaches. Salience rates in banking lack the endurance of those in environmental issues. Legislating through government agencies is not uncommon. Congress often legislates through Executive office agencies implying on the one hand, a government inclined to guide agendas not set them, and on the other, a Congress incapable of performing its constitutional role to render legislation directed at the voting public. Agency centered legislation during the tightening phase resulted from neither of these because the rationales of the crisis were unfamiliar to legislators
and the costs of pursuing an impractical policy to great. Regulators took the initiative in 1985 to sustain the industry providing Congress more time to choose not to act.

**Conclusion**

Regulators moved to the forefront of the industry during the tightening stage in response to Congress’s inability to enact comprehensive banking legislation addressing the competitive and inter-industry issues within the financial industry. Banks and to a far lesser extent thrifts developed more intimate relations with regulators; the former to foster approval of and support in expanding banking powers through the application of legal loopholes and regulator discretionary powers. The latter to fend off impending economic disaster through continued and liberal application of depositors’ insurance fund indemnities hoping to avoid what would ultimately become a costly, well-publicized debacle.

State legislatures and state banking regulators also played a significant role. Like Federal regulatory agencies, states nurtured their financial industries to become as profitable and stable as possible. They moved to expand banking powers and acted to secure their position against federal encroachment on states rights.

Constricting legislation was realized through expanded regulatory oversight with more objective institutional evaluation criteria, not through direct limitations on banking activities. Most all of the industry’s legislative achievements from the loosening phase remained in place, a testament to Members reluctance or fear of making the wrong legislative adjustment to the industry. The phase concluded as it
began, with public indicators of industry performance dictating the sobriety, scope, and timing of banking legislative debate. The industry returned to profitability once again towards the mid-1990s.
Deregulation never left the stage, it simply had moved out of the light while recovery and resolution took center stage. Measured by profits, the industry was beginning to show signs of stability in 1992, emboldening proponents of deregulation. The state of shared inclination amongst actors began shifting from ensuring the survival of the industry to defining the means through which it could again thrive. A predilection existed amongst the three primary actors on the instrumentality by which the industry could return to and maintain stability. Non-bank competitors along with their oversight committees and regulatory bodies would prove to be the most formidable obstacle. A macro perspective reveals that the debate had transferred from within the banking industry outward to congressional committees, their agencies, and industry groups in securities, insurance, real estate, and credit unions. The extreme insolvency rates amongst thrifts during the earlier crisis years, resulted in the smaller institutions losing credibility leaving community bankers alone in representing their interests within the banking triad. Debate had quieted.
All actors knew strength of the industry must “come first” before legislation designed to bring strength to the system could be successfully enacted (Anonymous, 1991). Yet, the financial structure they operated within remained generally similar to that found in the 1930’s when the gross domestic product (GDP) was $609 billion and the population was 130 million. This aged structure was required to support an industry serving a population of 260 million with a national GDP of $5.2 trillion. The economy was “light years removed from that of the 1930’s” (Szabo, 1994, p.26). Technology, demographics and consumer expectations (which grew parallel with technology, quieting consumer groups in the process) were impelling the industry to change. Technology affected two principal areas: the speed with which buying decisions of financial products are made and the service convenience levels heretofore unavailable to the consumer. Further, it fueled globalization of financial services. These changes were accompanied by a degree of market innovation, also referred to as “regulatory erosion”, effectively demanding the structure of the industry change to accommodate the new financial industry barons, large and small (Greenspan, 1995).

While the signaling circumstances for the previous two phases occurred within either the industry or government actor groups, the re-loosening phase was initiated by events within both. In 1994 two significant occurrences heralded the stage’s arrival: the 1994 congressional elections which “caused the most sweeping changes in the nation’s political landscape in a half century”, and the enactment of federal legislation authorizing interstate banking (Olson, 1995, p.74). The
rationalizations for these two events have distinct origins. Republicans rolled to victory in 1994 in response to voters’ concern that the Democratic Party had shifted the debate on the role of government in private lives far to the left, led by President Clinton’s attempt at nationalizing health care. Interstate banking occurred due to a far more permissive environment than during the loosening stage. Three predominate reasons for the timing of this expanded power: first, emergency acquisitions across state lines and regional reciprocal branching agreements had paved the way for national legislation. Second, banks succeeded in convincing their primary audience, Congress, that their core business lines were being pirated by specialized non-bank financial service providers, peeling income from banks and contributing to their instability. Ironically, the legislation was enacted as banks rolled to record profit levels in 1993-1994. Finally, branching prohibitions during the crisis years magnified the structural weakness of preventing institutions to geographically diversify their business. Failure rates were extremely high in states which had restrictive branching laws such as Texas (Nadler, 1995).

Once interstate banking became Federal law, work continued on overturning Glass-Steagall (barriers to insurance and securities), and the industry launched into an impressive period of mergers and acquisitions while regulators construed additional powers from their charters, in the event Congress would not act promptly. The new financial services industry – banking, securities, and insurance - was rapidly evolving and no one could define the resulting structure with certainty.
Industry Conditions

An improving economy fueled by reduced interest rates contributed to recovery across all industry segments by the end of 1994. Banking had once again assumed a public image of strength and stability and succeeded in retreating from the front pages and public debate, to the familiar environment of banking committee rooms and professional publications. Salience had been reduced. Consumer groups were quieted as consumers warmed to the convenience and flexibility now being delivered by the industry, through services related to demand deposit accounts, even though dissatisfaction with fees associated with ATMs and credit cards was growing. Although the number of banks in the United States had declined to about 8,300 by 1993, rather significantly from 1983 when 11,000 institutions were operating under charters, more products were available to customers at more locations than ever before (Szabo, 1994).

Loopholes exploited by banks in recent years were in litigation as competing industries moved, in the absence of action by Congress, to limit banking’s expansion. Insurance agents sued Citibank over the State of Delaware’s insurance authorization and the courts continued to wrestle with the 5,000-population town loophole. Sale of insurance by banks dominated this inter-industry debate. Powerful organizations on each side of the issue battled over House Banking Committee Chairman Leach’s proposals to extend insurance sales to banks, which was supported by the FED (within the holding company structure). Though insurance products had been offered
at state chartered institutions and through some national banks, Congress was by no means being asked to ratify an accepted industry practice.

Securities products were quite different. State and federal regulators had previously authorized their sale through banks or bank subsidiaries. This compelled investment banking and brokerage organizations to lament their lack of deposit and loan products, citing the branch network maintained by most banks would place securities companies at a disadvantage (Szabo, 1994). Reality proved to be quite different. Technology had transformed the banks “brick and mortar” networks from an advantage for banks to what some consider an albatross, sustaining banks inability to generate profit revenue from the spread between deposits and loans, measured by-location, due to the high costs of maintaining the branch network systems and buildings.

Banks sensed the circumstances causing high profitability would not last (McDermott, Berry, 1995). Compared to their numerous non-bank competitors, their balance sheets were weighted with the physical branch liabilities replicated within each institution. Mergers between banking institutions began to occur at an ever-increasing pace. In consolidating operations, banks believed they could reduce operating expenses by spreading fixed costs over more revenue, leverage technology investment across more customers thereby meeting their preferences, and encounter the threat posed by non-bank competitors which remains very real indeed. Consider at this time that private pension plans represent 45 percent of insurance companies’ assets and individual holdings in mutual funds exceed total deposits in bank savings
accounts (Szabo, 1994). Banks were losing customers as their core business products became available in different forms, from different sources. Of greatest import, these competing financial services companies did not operate under the regulatory restrictions and compliance standards affecting banking. They enjoyed distinct advantages including various methods of raising capital. When banks lose customers in their core business products, such as the flood of money out of savings accounts into mutual funds, they also lose lending capital. Funding deficits provoked banks to question the importance of their charters, viewing the accompanying operational restrictions as too great a price to pay for the benefit of depositor insurance. With the exception of a foreign bank moving into insurance sales, no financial institution voluntarily relinquished their charter during this period (Cocheo, 1996). Therefore, the industry continued to believe they could compete against non-bank financial services companies, by extracting concessions from regulators and Congress without altering a fundamental element of their industry structure.

**Regulatory Concerns**

Having successfully guided the industry through the crises years resulting in a stable, profitable industry operating within a strengthening economy, regulatory agencies relinquished the leadership role to banks and returned to manipulating the debate from their advisory role. Their operating tenets did not change but instead were adapted to confront the emerging economic conditions of a stronger industry and the continued encroachment into the sphere of banking by non-bank commercial
organizations and their respective regulatory bodies. Declining insolvency rates amongst institutions and passage of interstate banking legislation fostered this shift in influencing behavior. For the first time since the devastating losses incurred during the 80’s, the FDIC reduced premiums on insured investments from 24 cents on every $100 of insured deposits to 8 cents by the end of 1995. This significantly added to banks overall profits (McTague, 1994). The OCC granted banks numerous concessions to include the right to sell insurance under certain conditions. In 1995, the OCC’s Comptroller of the Currency Eugene Ludwig authorized the first Internet bank to open under a thrift charter. In doing so, Chairman Ludwig challenged the banks to look towards the Internet and leverage their expertise before non-bank competitors moved in (McTague, 1994). Regulators at the FED were nearly as liberal, granting amongst other privileges, the right to broker securities within the holding company structure.

Neither the FED nor the OCC were constrained by maintenance of the fund or excessive resolution responsibilities. The FDIC however, was responsible for both as the fund remained their primary justification for participating in the banking system. Having done the majority of heavy lifting through the crises years by directing the Resolution Trust Company and managing distribution of indemnities from the BIF, the FDIC recognized the need to re-tool and restructure their organization to meet the changing needs of their clientele. Reorganization encompassed a culture change within the agency to apply their traditional behavior of fund guardianship in a manner conducive to the dynamic supervisory atmosphere. Loosening their grip on the reins
Congress provided during the crises to maintain the viability of the BIF and therefore the agency itself, necessitated a shift in attitude and management style. As the industry grew profitable once again, FDIC regulators were challenged to “regulate in the morning and .. deregulate in the afternoon” (Khademian, 1995, p.19), in enforcing legislated statutes while attempting to remain in step with their sister agencies in this permissive regulatory environment. The FDIC recognized their future as a regulator was contingent on tempering the conservatism of the insurance provider and initiating a partnership with their constituent banks, fostering an entrepreneurial and dynamic culture within their constituent institutions.

Interstate banking legislation encouraged a review of regulatory agency responsibilities. Discussions began on consolidating the agencies motivated by the rather excessive amount of agencies’ involvement in a bank holding company exercising expanded powers. Besides various state banking agencies in its operating region, the holding company faces regulation from the SEC, FED, FDIC, and the OCC (Nadler, 1995). The consolidation initiative never appeared to develop into a formidable issue, testament to the interlocking alliances amongst and between the primary actors, as well as acknowledgement of substantial external threats.

Not only were discussions on regulatory agency consolidation disconcerting to all agencies in terms of relinquishing authority, but for the FDIC, concern grew over the increasing size of national and super-regional banks being created through aggressive merger activity. Without acknowledging the “too big to fail” policy initiated in 1984 with Continental Bank’s resolution, the FDIC was very disturbed
with the fund’s exposure to the deposit base of these large institutions. Furthermore, other actors knew even non-insured deposits would be covered based on precedent. “Large corporate depositors and borrowers have the unwritten assurance that if they are at a large institution, it will be bailed out no matter what; however, if they work with a smaller one, they have no assurance” (Nadler, 1995, p.84). That the industry and consumers were accepting large institutions and Congress was actually encouraging their growth, indicates the assumed protections grounded in precedent within “too big to fail” were in fact real. It is therefore within the realm of possibility that institutional failure in the future may result in a Chrysler style “bailout” by the taxpayer or an industry upheaval and nationalization as occurred with the railroads and Conrail.

While the FDIC was compelled to redefine their role within the industry and the OCC was operating on the fringe of discretionary authority and therefore in the courtroom as well, the FED was growing its influence across the spectrum of actors within the national economy. In doing so, the FED and primarily its long serving chairman, became a well recognized agency within the business world. Through two administrations, FED Chairman Alan Greenspan has been credited with administering an effective money supply policy. Due to his leadership and the agency’s broad responsibilities within financial commerce, the FED is the agency least likely to relinquish supervisory or regulatory powers over the banking industry in the future. Chairman Greenspan has the figurative authority to lead industry wide debate. He believed technology had single-handedly demanded Congress change the structure of
the industry. The spread of and advancements in telecommunications and computers had "lowered the cost and broadened the scope of financial services, making possible new products that would have been inconceivable a short time ago. In the process, challenging the institutional and market boundaries that in an earlier day had seemed so well defined" (Greenspan, 1995, p.779).

Greenspan represents the public face of an agency that has distanced itself from its peers by building an independent, politically neutral image at a time when a larger percentage of the population than ever before is invested in the financial community. Amongst regulatory agency issues, this is the most compelling result of the re-loosening phase. The dual banking system is likely to survive on the strength of states rights however, three regulatory agencies at the national level may appear redundant to Congress in the future.

**Legislative Intentions**

An undercurrent ran through all congressional interaction amongst the primary actors during this stage, protection against competition. It can be observed within each of the groups and very likely is the ultimate obstacle standing between reforming the banking industry and its current structure. Competition existed during the loosening stage of course. But unlike twenty years before, technology had reduced or eliminated burdens and obstacles and the political and business environment was highly conducive to change. Members knew many of the barriers were reduced but could not overcome their greatest fear in expanding banking powers, offending all the
affected industries as Congress was controlled by the pro-business Republicans. Interstate banking legislation was Federal government ratification of existing states’ behavior, expended relatively little political capital in passage, and could be sold as a benefit to constituents back home. However, reforming Glass-Steagall was proving to be a far more contentious challenge.

Members are in the difficult position of being forced to choose between government agencies, an un-envious task for elected officials. The OCC and FED proposed antagonistic plans on the approved structure through which banks could exercise their expanded powers, when authorized. Through the bank itself or bank owned affiliates is how the OCC proposed, while the FED wanted the bank holding company to manage expanded products, not the bank. Survival of the agencies and the struggle against marginalization were the real issues as the OCC regulated national banks and the FED, bank holding companies.

Amongst competing groups representing banking, securities and insurance, Members are challenged by the vast leverage each was applying in relentless fashion. There was little posturing between these industry representative groups as each was cognizant that failure would either bring a new competitor into their industry or prevent their entry into a new field. Members contended with a vigorous grassroots campaign sponsored by the insurance industry as well as a newly formed coalition, the Alliance for Financial Modernization, representing the joint views of bankers and the securities industry (Brostoff, 1996).
Within Congress, Members began an internal evaluation of their structure in relation to changes occurring in the industry. They were assessing the segmentation of responsibilities at the committee level, and analyzing their constituents' needs and their own power bases within the Congress, their parties, and the committee system. Security industry issues were administered in the Energy and Commerce Committee (now Energy Committee) separate from the Banking Committee. Split jurisdiction was considered to be one of the major impediments to new legislation (Olson, 1995). The House recognized this was counterproductive yet expended no effort in reconciling jurisdiction as legislation had not ratified the industry change. Inter-committee challenges to bills affecting the industry came about as banking legislation addressed insurance sales. House Rules Committee Chairman Gerald Solomon acting in the interest of the insurance industry, sought to prevent the OCC from allowing banks to expand into insurance sales by attaching an amendment to a Treasury Department appropriations bill. The amendment was soundly defeated not because of content, but because many Members objected to the procedure (Brostoff, 1996). The Senate Banking Committee has jurisdiction over both the securities and banking industries. Rules of the Senate prevent split jurisdiction amongst committees. Senate rules should resolve the issue of insurance industry regulatory oversight if authorization to offer the product is given to banks.

Bankers were enthused with the changes election results wrought in 1994, as the environment which fostered an “absence of menace” within legislative affairs was believed to have been degraded (Olson, 1995, p.51). With the change in political
party control in Congress, a striking difference in philosophy and methodology became obvious at the House Banking Committee level. Chairman Gonzalez, the outgoing Democratic Chairman was a liberal populist who advocated tougher and more stringent rules for the industry. In contrast to his mercurial temper, Chairman Leach the incoming Republican Chairman, brought a tempered leadership attitude and a more cerebral approach to the position. Leach was considered far less partisan than his predecessor and quickly gained industry support for bringing the "most single-minded willingness ... to modernize banking" than any chairman in decades (Olson, 1995, p.76).

In the Senate, personality and philosophical differences were not nearly as extreme. Chairman Reigle retired at the end of the 103rd Congress. The Republican Party victory gave the chair to longtime Banking committee Member Senator D’Amato. He had demonstrated the ability to support varying positions and parties on contentious issues: consumer groups on credit card interest rate caps, the securities industry in battling against banks in the 1980s, and commercial bank involvement in insurance and securities under the holding company structure (Olson, 1995).

Legislative intentions in the re-loosening phase are likely the most clear and unanimous, of the three stages. Yet, they are likely the most difficult to achieve because the debate forces Members to make significant political decisions the results of which effect their most important constituencies.
Conclusion

What is so unique regarding the attitudes of the primary actors at this time of renewed profitability, is that almost all members of the groups agree that banking as an industry must change or go the way of the buggy whip manufacturer. The industry and regulators had won the engagement concerning banks' execution of their fundamental role in the economy. Now, Congress once again was being asked to ratify their initiatives. Where salience and ideological differences hindered legislative progress before, during the re-loosening stage political alliances with powerful interest groups detailed the ramifications for Members failing to appreciate their support. Banking committees wrangled with interest groups and the struggle over expanded powers for banking.

Though these same struggles occurred during the loosening phase, little doubt existed amongst the current actor groups about what would be done. Reform of Glass-Steagall laws will likely result when the various actors realize that preventing competition is no longer good for business. Members differ over the degree of expansion and reform, seeking progress through incremental change where only comprehensive reform is an option. They remain engaged in this process today.
CHAPTER VII

POLITICS AND BANKING: CONCLUSIONS

What Lies in the Future for Legislators, Regulators, and Bankers

Protectionism and Ideology: Reasons Not to Change

Throughout the period of time under review, the industry has been adaptive and proactive in exploiting business practices from the world of commerce. In applying these to the financial industry, bankers have simultaneously prolonged and initiated two distinct characteristics of debate amongst the primary actors: first, the ideological differences between the big bank little bank camps have been present in the political sphere since the country’s founding. Those following Alexander Hamilton’s view espouse “faith in large elite institutions and believe banks should be free to expand at will”. While others look to Jefferson’s “agrarian vision of small banks serving local communities” (Wilson, 1991, p.55).

These diverse perspectives on the industry can be observed within all three actors. Infighting amongst industry representative groups such as the ABA and the IBAA often slowed or outright halted legislative initiatives favorable to the industry. Regulatory agencies tended to prefer benefits primarily to those institutions they supervise. For example, community banks fearing amongst other things, the lack of resources to simply offer the product, vigorously resisted the OCC’s deference
towards national banks regarding insurance sales. Security sales authorized by the
FED initially benefited large banks with the resources to acquire trading firms.
Within the last few years we now are seeing community banks offer brokerage
services through allied partners. Amongst legislators, beyond the geographic loyalties
of legislators from states containing national bank headquarters, constituent demands
to ensure the autonomy and survival of small, homegrown banks, as in other
industries, create a tremendous impediment to legislative progress. Congress has
attempted to overcome this issue for years through a mix of concessions and promises
however, the characteristics of the debate may be unreconcilable.

Where theoretical debate on the peculiarity of the industry has been carried on
for years, only recently has the second obstacle to inclination become visible,
protectionist tendencies. They are evident in many other areas of commerce and
government as well. Yet during these last twenty years, technological advancements
have decreased the product differences and therefore boundaries within the financial
industry. No longer are there significant economic or technological barriers to
entering new product or service fields and each industry actor, across the financial
services spectrum, is fully aware that advantages held today can be quickly overcome.
By virtue of the homogeneous nature of financial products and services, protectionists
are concerned with keeping their customers. Therefore, the final barrier to free,
unprotected financial industry commerce is the utilization of the legislative process to
block industry peers from accessing customers or, to enhance products offered to
retain customers.
Each congressional election cycle voters send their legislators back into this cauldron of competing interests. If they could, Congress may be pleased to let banking legislation lie dormant, unacted upon until such time as regulators can provide unanimous direction with accompanying industry support. But like other contentious issues addressed at the federal level, salience, production and delivery revisions, and changing consumer preferences force Members to address issues that estrange actors at all levels of the financial sub-system.

**BIF – Subordination of Debt – Nationalized Banking**

Although this work is not intended to discuss the ramifications of federally mandated insurance for bank depositors and the subsequent moral hazard for bank management, it is appropriate to share observations on the BIF because it is the constant which supports the cycle. Depositor insurance provides banks with two operational subsidies: it reduces the cost of bank liabilities by providing banks access to funds at lower rates than uninsured companies that take deposits. It allows banks to leverage greater levels of risk i.e. operate with less of a capital requirement (Burstein, 1995). Depositors are affected by the moral hazard element because virtually, (assuming continuation of the unstated “too big to fail” policy) 100% of deposits are insured freeing them to search for the highest interest rate, and pay little heed to the stability of the institution. Regulation and supervision have been the price bankers pay for the privilege of insurance which provides a lower cost of funds in their core business. Members, empowered by the taxpayers’ investment in the industry, have
piled consumer laws and lending regulations onto the industry. Banks are burdened by such voluminous regulatory requirements, they want us to believe that they can barely compete. The reality of course is that they are partly correct, yet no other industry operates with a government safety net for its customers. Therefore as banking powers expand, banks assume a far more advantageous position verse their new competitors in comprehensive financial services, because banks provide a $100,000 insured consumer product, and the image of government protection unmatched in investment banking, securities, or insurance.

Under the scenario of a faltering national bank, raising the specter of a fund bailout of depositors, what conditions would be prevalent, what attitudes would have changed, to forecast that regulators and Congress would not once again respond as they did in 1984 with Continental Bank? The argument could be made that conditions were bad all over in 1984, and others were faltering as well. But why could this not again occur? The answer of course is that although national banking does reduce the future effects of 1984’s economic conditions, actors cannot be certain conditions will change in the domestic market, or in the international arena where many national banks carry on significant operations. And everyday the boundaries between these markets are further blurred by the new technology of distribution channels.

Much debate transpires over the funding of the bank insurance fund, as well as over how an alternative from state government or private insurance, possibly along with banks voluntarily raising reserve capital levels, may change the Federal government’s participation levels and jar the three primary actors from their operating
axis. Should this occur, a complete reevaluation of the industry, the regulators and of course Congress would be required. This author cannot foresee government leaving the deposit insurance business, nor depositors assuming greater risk.

**Agency Consolidation and the Dual Banking System**

We are likely just beginning to witness serious discussions on reducing the number of federal regulatory agencies. Initiated by industry consolidation both within traditional banking and the broader financial services arena, it is conceivable that some of the existing regulatory agencies as well as their accompanying oversight committees may become redundant. Predominance within the regulatory agencies, exemplified by the moral authority to shepherd the industry or legislators, has shifted between state and Federal levels. During the tightening phase, state regulators led the initiative to expand powers while at the federal level, regulators were dealing with a reactionary Congress. However, re-loosening phase activity appears to be changing this situation. Take insurance for example, where the authority to establish rate structures has always resided at the state level, it is likely to become federalized as national banks push for standardization across states. It appears as though banking regulators at the federal level are gaining the advantage over their peers from the states. This is due primarily to the realities wrought by technology i.e., reduced boundaries. What is occurring today between states and the national government could be repeated in the coming years between nation states and the global economy,
represented by any number of potential organizations; trade blocs, the United Nations or World Bank, amongst others.

Should the shift in regulatory dominance from states to the national government lose its temporal character either through past practices or statutes, the nation’s dual banking system would be curtailed and implicitly eliminated. Look to the bank charter authorization authority as the leading indicator of change. The dual banking system may retain its dual nature but lose its character of equivalence. Dual banking may signify in the future the structure of industry participants instead of the nature of the industry’s supervision, charter authorization, and regulation. The industry may evolve to contain primarily two levels of participants, the national supermarkets of financial services and the more product specific, local community banks, similar to the Canadian banking system. Were it not for depositor insurance and access to the FED’s lending window on the one hand, and the strength of states rights on the other, an agency consolidation and fundamental change in regulatory responsibilities may have already transpired.

Consider non-banking regulatory bodies within the financial services industry, how will they conduct business in the future? Conflict amongst agencies over responsibilities in the new expanded powers environment have already begun, well in advance of legislative action. Today, banking regulatory agencies are sparring with the SEC over who will regulate securities in the environment of expanded banking powers. Little trust exists between these two camps as they each think the other is unqualified in their respective specialty areas (Schroeder, 1999). It is likely national
banks, upon reform of Glass-Steagall, will orient their lobbying efforts towards conducting "clean-up legislation" aimed at amongst other things, creating shared standards across states in areas such as insurance regulation and information privacy laws (Citibank interview, 1999).

Agency consolidation and the dual banking system are essentially related. Legislative action on financial industry issues almost always includes a significant leadership role for regulatory agencies. Consolidation may occur in the number of agencies however, the breadth and capabilities of those remaining would assuredly emulate current regulatory capacity. A shell game with resources may result, extending legislators' advisory base and the industry's regulatory capacity, while curtailing redundancies either within or between levels of government. A counter argument could be legitimately proffered claiming that because the industry will actually grow in complexity, additional regulatory resources will be required. This however, is an unlikely result.

**Technology & Fees: Ambassadors of Change**

Reference has been made to the impact of technology advancements on financial services throughout this study. A brief description of these changes is appropriate. By far, two advances stand out as primary change agents, both because they expand capabilities and because they represent the reduced costs of doing business associated with technology. First, the personal or small computer has fueled growth in desktop information heretofore unavailable except at mainframe terminals.
Small and inexpensive, computers today power the ATM machines that have fostered a reengineering of branching strategies. Even business customers are beginning to benefit from these advances as basic transactions such as deposits and change requests can now be conducted at self-service machines. The second change agent clearly has been the Internet. Today, there are over 79 million adults who are regular Internet users, 63 percent of them own stocks and bonds, and 10.5 million investors now trade online (Kudlow, 1999). A number of banks have initiated chartered operations without the need for retail brick and mortar facilities. The transfer of wealth amongst and between institutions and account holders has evolved with such speed, that governing regulations barely keep up with the pace of changes. The New York Stock Exchange had to install emergency trading halt coordinates in response to the volumes of wholesale trading often executed by computer generated models.

Retail and business financial services consumers can bank, trade securities, and make insurance and other purchases without entering institution facilities except through the mail, phone, or data connection. Such activity is not limited by boundaries between states or nations. Some industry experts believe the Internet hangs over Congress as Damocles' sword, reminding them that the old ways of conducting legislative and regulatory responsibilities are no longer applicable in today's climate. Congress feels irrelevant and they can see change is inevitable (Citibank interview, 1999).

Globalization trends certainly add to that feeling of inevitability amongst actors. Consider recent events such as the mergers of Deutsche Bank and Bankers
Trust and Daimler-Benz and Chrysler. Any nation is at risk of losing its leading private financial organizations through international merger activity; lending credence to the severity of change technology has inspired. Once all the issues surrounding online security and appropriate barriers against fraud and mischief have been constructed, growth in online financial services commerce is expected to explode. International banking, through either a curtailment of or enhancement in authorized activity by the Congress, may develop into a stage-changing agent within the cycle in future years.

Technology has affected all types of financial transactions inducing industry actors to invest in sizable networks. Charging for transactions and other services through use based fees has come to represent a considerable portion of banks’ operating revenues. Consider that fees are a huge source of income for banks, generating more than $2 billion a year (Gianz, 1999). Consumers have, by and large expressed through their quiescence, a willingness to pay the fees in return for greater convenience. In the future, as banks gain an ever-increasing percentage of their income through fees, salience may take over and inspire regulatory measures capping fees, as previously done with deposit interest rates. As a result of technology, fees may trigger a transition within the cycle towards a tightening period, prompted by consumer rebellion.

A final consideration must be made regarding fees; banks have a funding problem. The traditional source of banking income, interest-based revenue, is likely to be surpassed by fee-based revenues by 2003 (Fee based .., 1999). This may come
to pass because modeling risk-reward for fee based services is more favorable than that of the loan marketplace. Bank funding and fees are inter-related. If fee income in fact generates returns to meet shareholder expectations, securing funds for their lending business may diminish in importance. Having battled to hold deposits, barely withstanding a direct assault by investment vehicles such as mutual funds and money market accounts, banks may choose to seek other sources of capital as their expanding powers will allow. (That banks have not to date fled en masse from the FDIC insured deposit account is testament to the influence of the BIF.) Therefore, the consumer may be forced to utilize non-bank funding which would not be subject to the lending and regulatory standards of chartered banking institutions. It is too early to speculate if the consumer will benefit or rise up against the trend toward fee for service in banking. Either way, banks stand to gain as fees have become a second primary revenue stream.

**The Cycle – Beyond the First Iteration**

The nature of banking’s relationship with government remains unique due to the shared objectives amongst the three primary actors, foremost represented by industry stability and expanded access to services, justifying a distinctive structure of government/private industry interaction. It is exemplified by substantial layers of government-sponsored regulation and supervision, and justified by both the federally subsidized insurance fund and the singular role banking retains in the economy. Though goals are shared, the methodology to attain them generates intense debate.
Legislators and bankers remain engaged in a political struggle, fought in committee rooms, through regulatory agencies, and on occasion in the public arena. Bankers entice the political establishment with their remedies and blueprints for sustained industry stabilization. Legislators look to their advisors in the regulatory agencies to assist in deciphering industry requests, placing them in context with current economic and industry circumstances. Consumers, through their behavior provide a reliable criterion from which primary actors appraise their progress. Available evidence suggests that these interdependent relationships shall continue for the foreseeable future.

Regulatory agencies have carried out their duties within the cycle of banking and politics by and large, in an exemplary manner during the previous twenty years. Agencies figuratively discriminate amongst varying concepts from Congress and bankers, in determining the direction of the industry. This is exhibited by which end of the rope they choose to pull from, in the policy struggles between industry and legislators. Whether Congress is reacting and the industry is recuperating during a tightening phase; or industry is charging ahead into new and different business sectors during either of the loosening phases, regulatory agencies have consented to the direction pursued by applying their influence toward creating a shared inclination for action. Most impressively, influence has been and continues to be administered in a visibly objective manner, with only a marginal scent of political contact, found mostly in the OCC. Spanning administrations, committee chairs, and congressional election cycles, regulators have succeeded in educating elected representatives on the
issues while they keep the industry at heel, performing with admirable objectivity through the cycles' stages.

Thus, the cycle of banking and politics is likely to begin a second iteration sometime in the future, contingent upon the protracted interdependent relationship amongst the primary actors. Identifying stages, as stated earlier, is an ambiguous endeavor, far less complex of a task when done from an historical perspective. Though future change agents for moving from one stage to the next have been discussed above, the current dilemma is determining what characteristics signal transition from re-loosening, to the loosening stage. Also, is it possible to transition from re-loosening directly to tightening? Consider the former condition first.

Re-loosening stage activity follows a period of constrictive regulatory and legislative actions implemented in response to existing industry and economic conditions. Whereas responding to challenging economic, competitive, or consumer-related conditions initiates the loosening stage. Furthermore, re-loosening stage legislation (or regulatory agency authorization) is enacted with an inclination to prevent reoccurrence of tightening stage conditions. Thus, re-loosening is marked by substantive market directed changes as compared to incremental market oriented change in the loosening phase. Regardless of the fact that legislation belatedly ratifies agency policies, the transition from re-loosening to loosening likely will be the enactment of substantial legislation, for example reform of Glass-Steagall.

Once actors' shared inclination is validated by Congress in the re-loosening phase: industry representatives will return to seeking incremental assistance to clean
up issues. Regulators shall intensify supervision fearing industry members may lack forbearance in administering new powers. And legislators will certainly allow for a considerable period of time to pass, to analyze industry behavior, prepared to make only minor legislative adjustments. Therefore, it is most likely that noteworthy legislative success will bring the re-loosening stage to a close, ushering in a period of activity that can be identified with the loosening stage. Consider the current Glass-Steagall reform effort, it is being pushed along by competitive and consumer related issues.

What are the chances a period of re-loosening could move directly into a tightening phase?, marginal. Certainly nation state political struggles, regional economic failure, or fraudulent behavior by individuals or institutions could instigate the primary actors to revert to protectionist tendencies, thereby limiting the damage which could accrue to the domestic financial system. It is therefore possible, that re-loosening activity could come to an abrupt end, and shift directly into tightening. But the likelihood of such occurrences, as well as their being coordinated with re-loosening activity, are rather low. However, when the next tightening stage does occur, could it not be considered a re-tightening phase? In semantic terms yes, but not in actuality. Recall that tightening activity occurs in response to industry behavior and economic performance, and consists of corrective measures. Actions by the primary actors within this stage do not appear to be part of an integrated strategy, seeking advancement through persuasive interaction with other actors, such as is visible in either of the loosening stages. Though consecutive tightening phases may share
similarities, this author believes each tightening phase is uniquely defined by its own behavior and performance conditions.

The cycle of politics and banking is a means of conveyance through the rather exclusive domain occupied by industry, regulatory agency, and legislator actors. It contributes to understanding an industry/government relationship involving numerous professional disciplines, it permeates all aspects of the economy, and it exposes some of the strengths and weaknesses of representative governments at the state and federal levels. The primary actors have been individually studied in great detail, providing many worthwhile contributions to this study. Yet, comprehensive understanding of financial services must include knowledge of the interdependency amongst these primary actors.

Banking and government rely upon each other to foster, through their uncoordinated actions, a perception by the public of mutual legitimacy. Banking generates resources to fuel the market economy, which produces assets and services that are not provided by government. As the defense industry sustains the government in carrying out its obligation to protect the nation, so to does the banking industry sustain the economy, upholding the government’s ability to provide citizens the opportunity to achieve a standard of living commensurate with their abilities. Regulatory agencies carry forward government’s unique concern for banking by integrating themselves into the operations of financial institutions, to provide a window through which government can assess the level of strength and stability, and determine if corrective actions are required.
Regardless of the future shape or structure of the financial services industry, government will remain ingrained within the operational structure, at the institutional level. The cycle of politics and banking identifies a recurring set of behavioral standards, providing a means to foresee the industry structure in a dynamic, economic and political environment. To remain a competent instrument for assessment, the cycle will require revision moving forward. Facts will stubbornly overrule assumptions as historical analysis of the more recent stages grows in detail. The cycle’s second iteration will generate additional information to aid in recognizing conditions which cause shifts between stages. Most importantly, the cycle may allow actors to see that unilateral thinking can lead to the implementation of destabilizing strategies. Better to employ the cycle in anticipation of the actions and reactions of other actor’s, instead of jeopardizing the soundness of the system.
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