

FDICIA AFTER FIVE YEARS: A REVIEW AND EVALUATION

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I. INTRODUCTION

At yearend 1990, U.S. banking was in its worst shape since 1933. Some 1,150 commercial and savings banks had failed since yearend 1983, almost double the number of failures since the introduction of the FDIC in 1934 up through 1983 and equal to 8 percent of the industry at yearend 1980. Another 1,500 banks were on the FDIC's problem bank list (rated in the lowest two examination categories). Some 600 banks which held 25 percent of the industry's assets (although only 5 percent of the number of banks) reported book-value capital of less than 4 percent of their on-balance-sheet assets. These banks would have been classified as undercapitalized by the regulations that were adopted in 1991.¹

The thrift industry was in even worse shape. More than 900 savings and loan associations (S&Ls) were resolved (closed or merged with FSLIC assistance) or placed in conservatorship in the same seven year period. But, because there were far fewer S&Ls

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¹The U.S. was not the only country to experience serious banking problems in recent years. A study by the IMF reported that over 130 of the 181 member countries reported banking crises since 1980 (Lindgren, Garcia, and Saal 1996).

than banks, this number represented 25 percent of the 4,000 associations operating at the beginning of the decade. Many more associations were economically insolvent, but were permitted to continue to operate. Nearly 400 S&Ls reported tangible book-value capital ratios of less than 3 percent in 1990, including more than 100 with negative ratios. The cumulative losses incurred by the failed institutions exceeded \$100 billion in 1990 dollars. These losses resulted in the insolvency and closure of the Federal Savings and Loan Insurance corporation (FSLIC) and its replacement by the Resolution Trust Corporation (RTC) and the Savings Association Insurance Fund (SAIF), which were capitalized primarily by taxpayer funds authorized in the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989. FIRREA provided some \$150 billion of taxpayer funds to resolve insolvent associations.

During 1991, the banking situation continued to deteriorate rapidly and there was widespread fear that the banks would go the way of the S&Ls, and the FDIC the way of FSLIC and require additional large taxpayer funding. In response, at yearend 1991, Congress enacted the FDIC Improvement Act (FDICIA). FDICIA represents fundamental deposit insurance and prudential regulatory reform and is the most important banking legislation in the United States since the Banking (Glass-Steagall) Act of 1933. It dramatically altered the banking and regulatory playing field.

By yearend 1995, banking had recovered significantly and was in its best financial health in decades. Commercial bank profitability was at record levels since the introduction of deposit insurance and almost no banks were classified as undercapitalized. The thrift

industry also rebounded but more slowly and experienced a decline in assets as many resolved institutions were acquired by commercial banks.

In the balance of the article we: (1) briefly review in section II the causes of the U.S. banking and thrift debacles of the 1980s; (2) describe in section III the major aspects of and rationale for the corrective legislation enacted in FDICIA;(3) summarize in section IV the recovery of banking in the early 1990s; and (4) evaluate in Section V the effectiveness of the new prudential regulatory structure to date and recommend additional changes to further improve the structure.

II. OVERVIEW OF THE DEBACLE

The Savings and Loan Debacle

Although the thrift and banking breakdowns in the 1980s are often lumped together, there are important differences as well as similarities. The details of the debacles have been frequently and extensively reviewed elsewhere (e.g., Barth 1991, Bartholomew 1994, Benston and Kaufman 1990, Congressional Budget Office 1993, Jaffee, White, and Kane 1989, Kane 1985 and 1989, Mayer 1990, and National Commission 1993). We provide a brief overview to help set the stage for the subsequent analysis.

The thrift breakdown preceded the banking breakdown and was initially and primarily caused by the S&Ls' large interest rate risk exposures in a period of unexpected large and abrupt increases in interest rates in the late 1970s. Both the duration mismatch and the interest rate increases can be blamed primarily on government policy. Since 1934 the federal government has attempted to stimulate home ownership by supporting long-

term, fixed-interest-rate mortgages. To encourage an inflow of savings to finance these mortgages, S&Ls' shares were through time insured against loss by the FSLIC on the same basis as bank deposits. This turned S&L shares into deposits, most of which were short-term. The net effect of these policies greatly increased the interest rate exposure of S&Ls and caused the industry to be an accident waiting to happen. And the accident happened in the late 1970s, when market rates of interest increased sharply. The increase reflected the equally sharp rise in the rate of inflation attributable largely to earlier excessive growth in the money supply fostered by the Federal Reserve.

These problems were exacerbated by the extant deposit insurance structure which caused two problems. One, it permitted S&Ls to engage in moral hazard behavior by supporting their high risk portfolios with insufficient capital. Two, it permitted the thrift regulators to be poor agents for their healthy institutions and taxpayer principals by delaying the imposition of adequate sanctions on troubled associations and failing to resolve economically and, at times, even book-value-insolvent, institutions in a timely fashion. Had it not been for credible federally provided deposit insurance, savers would have been less likely to have put their funds into financial institutions with such duration-unbalanced portfolios. Moreover, runs by depositors when interest rates increased and threatened the solvency of the institutions would have automatically forced their closure sooner. But, deposit insurance negated the need for runs by depositors and the need to act quickly by the S&Ls' regulator -- the Federal Home Loan Bank Board (FHLBB). Instead, the FHLBB was able to delay the day of reckoning in the early 1980s by, among other actions, reducing the thrifts' book-value capital requirements, which already did not

include capital losses from the interest rate increases, from six to three percent of assets and artificially puffing up even this amount of reported net worth by adopting “regulatory accounting practices” (RAP). RAP permitted such gimmicks as deferral of losses on asset sales and inclusion as an amortizing asset (misleadingly termed “goodwill”) of the negative net worth of insolvent S&Ls that were merged with other institutions.²

The FHLBB engaged in these time-gaining measures for a number of reasons, including:

- being overwhelmed by the sudden large number of troubled and insolvent institutions,
- having insufficient reserves to resolve the insolvencies (FSLIC was itself economically insolvent),
- concern that official recognition of the need for taxpayer funding would enlarge the federal government deficit,
- concern that official recognition would spread fear among depositors and ignite runs on all S&Ls and possibly even banks, and
- wishful thinking that, because many of the losses were “only” unrecognized paper losses, they would be reversed because “interest rates are cyclical and are bound to decline.”

²The Supreme Court recently ruled that the creation of such goodwill represented legal contracts that Congress did not have the authority to reverse in 1989 in FIRREA without appropriate compensation. Any damages awarded to the thrifts that have sued the government will add to the net cost of resolving the debacle.

Interest rates did decline after 1982 and the regulators partially won their bet. But it was only a pyrrhic victory. Many of the decapitalized associations quickly incurred substantial credit losses either because of sharp economic downturns in their market areas, starting with the energy belt in the southwest in the mid-1980s and then spreading to New England and the mid-Atlantic states in the late 1980s, or because they gambled for resurrection and lost. At the same time, regulators were both ill prepared to supervise adequately the new powers granted S&Ls in the legislative deregulation of the early 1980s and under pressure to reduce their personnel to conform with attempts to cut back on federal government spending. In addition, the disarray in the industry encouraged a sharp increase in fraud. As losses mounted, policy-makers increased their denials and forbearance, in part in response to political pressures, as many individual associations and their major trade association stepped up their contributions to members of Congress to keep troubled associations open and in part to delay a big hit to the budget deficit. As a result, instead of shrinking, S&L assets more than doubled between 1980 and 1988. But, the industry and the policy-makers found it increasingly difficult to conceal the truth. In 1987, Congress made one last attempt in the Competitive Equality Banking Act (CEBA) to fix the problem without resorting to public funds by borrowing against the FSLIC's projected future premium income.³

In 1989, shortly after the presidential elections (during which by implicit agreement little mention was made of the crisis), the regulators, Congress, and new Bush

³The bonds were issued by a specially established GSE-like financing corporation (FICO). Because actual premium revenues were far less than projected, legislation was enacted in 1996 to require commercial banks to contribute funding to avoid default and ease the burden on the S&Ls.

Administration finally acknowledged that some \$150 billion in public funding was needed to resolve thrift insolvencies. In exchange, FIRREA required the closure of the FHLBB and its replacement with the Office of Thrift Supervision (OTS). The FHLBB's deposit insurance subsidiary, the FSLIC, was also abolished and its insured functions were transferred to a new Savings Associations Insurance Fund (SAIF), administered by the FDIC. This is one of the very rare instances when Congress terminated a government agency. In truth, however, the termination was more fiction than fact. Almost all of the affected personnel were transferred to successor agencies.

Losses attributable to regulatory forbearance account for a substantial proportion of the total cost of recapitalizing the industry. Forbearance had a poor batting average in the 1980s, particularly after interest rates declined, and most institutions that did not attract additional private capital did not survive (Congressional Budget Office 1991, Kane and Yu 1996, and National Commission 1993). However, Benston and Carhill (1994) provide evidence that many institutions did recover when interest rates declined. Although FIRREA provided the necessary public funding to resolve the thrift insolvencies, it introduced only minor changes in the structure of deposit insurance or prudential regulation. Instead, it sought to lay the blame for the debacle on incompetent regulators and competent crooks.

The Commercial Bank Debacle

Because they had better duration balanced portfolios, commercial banks were not weakened greatly by the sharp increases in interest rates in 1979-1981. But they also were operating with record low capital ratios. Hence, many banks were unable to absorb the credit losses stemming predominantly from the regional recessions and commercial real

estate lending that also affected S&Ls. The effects of these adverse events were magnified by restrictions on banks operating across state lines that limited their ability to reduce risk through geographical diversification. Seven of the ten largest banks in Texas failed in the late 1980s and two were merged after significant losses. In the early 1990s, the largest bank in New England and some of the country's largest savings banks in New York failed. By 1991, losses to the FDIC from these failures effectively wiped out its reserves. Indeed, on the basis of accepted insurance accounting, the FDIC was insolvent (Barth, Brumbaugh and Litan 1992). Coming on the heels of the seemingly ever-expanding S&L problem and the 1984 failure of the Continental Illinois Bank, the eighth largest bank in the country, the increasing number of bank failures and deteriorating condition of the industry as a whole frightened the general public with images of the 1930s and gave rise to substantial public pressure on Congress to act swiftly and meaningfully to prevent the crisis from both growing and ever happening again.

III. DEVELOPMENT AND ENACTMENT OF FDICIA

Alternative Proposals

By the late 1980s, numerous studies had identified mispriced and misstructured federal deposit insurance as a primary cause of the banking and thrift crises. The widespread problems represented massive regulatory failure. Most of these studies emphasized moral hazard behavior by the institutions as the chief culprit, but, with rare exceptions (particularly by Kane 1985 and 1989), overlooked the poor agent behavior of

the regulators. From these studies, a large number of proposals for reform of deposit insurance were developed. Those receiving serious consideration include:

(1) terminating government insurance and replacing it with either private insurance or a system of cross-guarantees among banks;

(2) maintaining government insurance, but dramatically scaling back individual account coverage;

(3) reregulation of deposit interest rates and additional restrictions on bank loans and investments to control risk;

(4) narrow or "fail-safe" banking;

(5) risk-based deposit insurance premiums; and

(6) structured early intervention and resolution (SEIR).

Serious political obstacles developed to any plan that attempted to eliminate deposit insurance or even to scale it back moderately. Some form of explicit or implicit insurance was viewed in the United States as well as in almost every other country as a political fact of life (Benston 1995).⁴ Private insurance was viewed as not sufficiently credible and bank cross-guarantees as insufficient in an undercapitalized banking environment. Although deregulation was seen as an important cause of the debacle by some politicians, media commentators, and academics, little support developed for re-establishing deposit interest rate ceilings or rolling back the expansion of lending authority to consumer and commercial

⁴In his analysis of the reasons Argentina reinstated deposit insurance in 1995 only a few years after it had abolished it, Miller (1996) concluded that

[O]verwhelming political forces trumped the [economic] theory to which these individuals [those in charge of the government and who were "ideologically attuned to the dangers of socializing risk in the banking sector"] subscribed (Miller, pp. 229-230).

loans granted S&Ls in the early 1980s. Reregulation was viewed as too late and impractical. Technology had let the genie out of the bottle to stay. Narrow banking received support primarily from the academic and think-tank communities (Benston et al 1989, Bryan 1988, and Litan 1987). It would cause a substantial change in the way banking has been conducted, which Congress and the banking industry were reluctant to do.⁵ While risk-based insurance premiums partially addressed the moral hazard problem, how they would be determined was unclear and, by themselves, they did not address the regulatory agency problem. This left SEIR on the Congressional radar screen.

Structured Early Intervention and Resolution (SEIR)

Although various parts of SEIR had been proposed earlier, it was developed as a comprehensive package as part of a broader project on banking reform sponsored by the American Enterprise Institute (Benston and Kaufman 1988). The concept was subsequently modified and improved by a number of scholars and policy-makers (Benston et al. 1989 and Shadow Financial Regulatory Committee 1989). Although it recognized

⁵For example, institutions offering federally insured deposits would no longer be permitted to make or hold most types of loans. Their earning asset portfolios would be restricted to very high credit quality, very short-maturity securities or their deposits would have to be collateralized with virtually riskless securities. Proponents of these proposals claimed that the other services and products provided by banks could be freed of regulation. They did not consider as important four concerns. One is that the narrow banks would be more costly to depositors, since the banks would be restricted to low-yielding earning assets while incurring the considerable expense of processing checks. The second is that the narrow banks would lose economies of scope with respect to operating costs, customers' transactions costs, and risk reduction from diversification.

The third is that other providers of fund transfer services would be established. Using fractional reserves and investing in more profitable assets, these providers could outbid banks for similar services. It would be difficult, perhaps impossible, for government to forbear from rescuing "depositors" in these firms should they fail.

Hence, nothing substantial would have changed. Fourth, capital requirements, reporting, auditing, and a closure rule still would be required to prevent insolvent or near-insolvent narrow banks from engaging in moral-hazard behavior.

their flaws, SEIR had the advantages of basically maintaining the existing banking and deposit insurance structures, while correcting the primary flaws.

SEIR changes the structure of deposit insurance from incentive incompatible to incentive compatible. To deal with the moral hazard problem, regulatory sanctions on deposit-insured institutions, for which market discipline is weak, would mimic those the market imposes on similar enterprises that do not hold federally insured debt. Agency problems are dealt with by first allowing and then requiring specific intervention by the regulatory authorities on a timely basis. Thus, SEIR imposes on banks the same conditions that the banks impose on their own borrowers. Specifically, SEIR calls for:

- higher capital, with subordinated (explicitly uninsured) debt counted fully as capital;
- structured, prespecified, publicly announced responses by regulators triggered by decreases in a bank's performance (e.g., capital ratios) below established numbers;
- mandatory resolution of a capital-depleted bank at a prespecified point when capital still is positive; and
- market value accounting and reporting for capital.

In addition, the proposal called for maintaining government-provided deposit insurance ceilings at the existing \$100,000 per account. We discuss each one of these components.

For banks protected by the safety net (deposit insurance, central bank discount window, and central bank settlement finality), capital as a percentage of assets should be equivalent to the ratio maintained by uninsured nonbank competitors of banks. For

example, bank book-value capital/asset ratios had dropped to 6 percent in the 1980s, while insurance companies, finance companies, and similar financial companies generally maintained capital ratios of between 10 and 25 percent. Permitting banks to meet capital requirements with subordinated (explicitly uninsured) debt allows them the same income tax advantages as corporations generally.⁶ Consequently, higher capital requirements would not increase banks' cost of capital above that which the market would demand. Rather, the higher requirement would only decrease any extant deposit-insurance subsidy.

The original proposal specified four capital/asset ratio zones or tripwires. "Adequately-capitalized" banks, with ratios approximately equal to those of firms without government-provided deposit insurance (say, 10 percent or above with capital measured by market values) would be subjected to minimum prudential supervision and regulation. Supervision would be limited to determining that the bank was reporting correctly and was not being managed fraudulently or recklessly. Should a bank's capital ratio fall below this level, say below 10 percent but above 6 percent, it would fall into the "first level of supervisory concern." A bank in this zone would be subject to increased regulatory supervision and more frequent monitoring of its activities. The authorities could, at their discretion, impose such sanctions on the bank as restricting its growth, prohibiting it from paying dividends, and requiring a business plan for quick recapitalization. A bank falls into the "second level of supervisory concern" if its capital/asset ratio falls below the next prespecified ratio (e.g., 6 percent). The authorities then must impose additional and

⁶To be included in capital, subordinated debt must have a remaining maturity of perhaps two years so that it cannot be repaid before the authorities can act.

harsher sanctions, including restrictions on deposit rates, suspension of dividends, and prohibition of fund transfers to related entities. At or before this point, the bank would have considerable incentives to restore its capital ratio either by raising more capital or by shrinking its assets.

Finally, if the capital ratio fell below the third specified number, say 3 percent, the authorities must resolve the bank quickly through sale, merger, or liquidation. However, rather than permit this to happen and permit a government agency to take at least temporary control and possibly dissipate its remaining capital, a solvent bank most likely would voluntarily raise its capital ratio into compliance or sell out to or merge with another institution. Any losses incurred in resolution or from the authorities not acting quickly enough would be charged pro-rata to the insurance agency, uninsured depositors, and other creditors.

The structured, predetermined capital/asset ratios that trigger actions by the regulatory authorities have two purposes. One is to reduce a bank's moral hazard behavior. Similar to covenants that creditors impose on borrowers in most private loan and bond contracts, SEIR acts to turn troubled institutions around before insolvency. The several performance zones serve as "speed bumps" or "trip wires" to slow the deterioration of weak banks and reduce incentives and opportunities for them to increase their gambling as they approach the floor of a zone. Equally important, banks are encouraged to perform better by enticements, such as additional product and geographic powers and reduced monitoring in the highest zone. SEIR includes "carrots" as well as "sticks."

The second purpose is to reduce the regulators' agency problem. The regulators first have the opportunity of using their discretion to get banks to restore depleted capital. But, if the banks do not respond and their capital ratios continue to fall, appropriate sanctions, including resolution at least cost to the FDIC at a prespecified low but positive capital level, become mandatory. Requiring and enforcing resolution at such a predetermined and explicit minimum capital ratio represents a "closure" rule. Regulators can no longer delay closing the institution. Likewise, institutions can no longer effectively bring political pressure on regulators to forebear from closing them down. Nor would the institutions be given second and additional chances to gamble for resurrection. This form of resolution would not be a "taking" by the government; any remaining funds would be returned to the shareholders. Moreover, by specifying and permitting gradual increases in the strength of the sanctions, the multiple-performance-zone structure makes the imposition of sanctions by the regulators both more likely and credible.

Market value accounting for capital is desirable both to provide a more accurate picture of the financial condition of institutions and to increase the transparency and accountability of the regulatory agencies. Because banks frequently delay and underreserve for loan losses and changes in value from changes in interest rates are not included, reported book value capital tends to lag market value capital. Deposit insurance ceilings on individual accounts are maintained, but would be strictly enforced *de facto* as well as *de jure*. Uninsured depositors would lose the same proportion of their uninsured funds in resolutions as the FDIC loses, thereby encouraging market discipline to supplement regulatory discipline. However, if the closure rule were strictly enforced, it is

doubtful that the insurance would be required. In effect, all deposits would be collateralized by assets of at least the same market value and deposit insurance would be redundant except in cases of massive fraud, inadequate monitoring by the regulatory agencies, or large rapid declines in asset values across the board.

Legislative Adoption of SEIR in FDICIA

Although SEIR was not the first choice of most academics, it appealed to both Congress and the Administration in the early 1990s as a politically feasible, quickly implementable, and effective solution to minimize both the future costs of the ongoing banking debacle and the recurrence of future such debacles (Benston and Kaufman 1994a and Carnell 1992). What could appeal to Congress more than passing a law that promised to outlaw future losses at insolvent institutions without a radical change in the banking or deposit insurance structures?

A modified form of SEIR was first introduced in the Senate in 1990 as part of a larger banking bill, but failed to be adopted. After it was recommended in a major study of the deposit insurance system by the Treasury Department that was mandated by FIRREA, it was reintroduced in the Senate and introduced in the House of Representatives in early 1991. The bills also included wider product and geographic powers for banks, but these were deleted before final passage. The greatest opposition to SEIR, which was incorporated in the prompt corrective action (PCA) and least-cost resolution (LCR) provisions of the bill, came from bank regulators, who correctly perceived it as a reduction

in their power, visibility, and freedom to micromanage banks (Horvitz 1995).⁷ Although the regulators' own credibility had been weakened greatly by the magnitude of the banking debacle and criticism of their response, they still were able to weaken many of the provisions that reduced their discretionary powers during the legislative process before FDICIA was passed by Congress and signed by the president at yearend 1991.⁸

The regulators further weakened the potential effectiveness of the Act by drafting weak regulations to implement it (Benston and Kaufman 1994b). For example, the Act specifies five capital/asset ratios, but largely delegates the setting of the numerical values for the zones to the banking agencies. (The sanctions and the numerical values established by the regulators for the five capital zones required by FDICIA are summarized in Table 1.) The regulators set the threshold values for the zones so low that almost all banks were classified "adequately-capitalized" or better, even before the industry had fully recovered. Moreover, after full recovery, when the capital ratios of most banks easily exceeded the required minimums for "well-capitalized", the regulators still opposed even small increases in the threshold values although these would have demoted only a few banks. At year-end 1996, only 1.5 percent of all commercial banks were not classified as "well-capitalized." Studies completed after enactment of the legislation conclude that had these low capital tripwires been in place in the 1980s, the required PCA sanctions would

⁷The PCA provisions of FDICIA are more specific than those proposed in SEIR and reflect the understanding of the role of economic incentives by staff drafters of the House and Senate Banking Committees.

⁸Although, unlike the FSLIC, the FDIC did not require permanent taxpayer funding to validate its deposit guarantee, FDICIA did make such funds available if necessary and provided temporary funds for working capital, which the FDIC and RTC did use and repaid in full.

likely have been ineffective (Jones and King 1995 and 1997, and FDIC 1966 and Peek and Rosengren 1996). Indeed, a recent study by the GAO (1996) reported that less than 20 percent of the banks and thrifts classified by the FDIC as problem institutions between 1992 and 1995 were also classified as undercapitalized.

The Act specifies three definitions of capital -- one "plain vanilla" leverage ratio and two risk-based ratios -- and differentiates between equity (tier 1) and nonequity (tier 2) capital accounts. This basically follows the capital guidelines developed earlier by the Basle Accord for international banks in industrial countries. Little if any empirical support has been found for these risk weights (Williams 1995). Rather, they operate as a form of credit allocation. Nor is the division of capital into the two tiers supported by economic or financial theory.

FDICIA also requires the regulators to develop a means for estimating market values to the "extent feasible and practical." However, the agencies quickly viewed market-value accounting as neither feasible nor practical and did not even fully implement the Financial Accounting Standards Board's (FASB) standards with respect to marking securities to market for purposes of computing capital. During the Congressional hearings, the time delay permitted for mandatory resolution of undercapitalized institutions was lengthened and limited waivers were permitted. Implementation of the Act's requirement to include interest-rate risk in risk-based capital by the regulators was postponed a number of times beyond its scheduled June 1993 deadline and finally left up to supervisory discretion on a case-by-case basis. Restrictions on permitting banks to maintain interbank balances at and extend credit to weak banks, which were included to protect against

systemic risk, were weakened. Also weakened substantially were first-time-ever penalties on the Federal Reserve for lending through the discount window to banks that subsequently failed. This provision was introduced after a Congressional study found that 90 percent of the banks that had received extended credit through the discount window in the late 1980s later failed. The penalty to the Fed for such lending was reduced from sharing in any loss resulting from the bank's failure -- thereby putting the Fed's own funds at risk -- to a small loss of interest income received from a failed bank.

Some who claim that the prompt correction and resolution tripwires would have been ineffective in the 1980s blame this on the provisions of FDICIA (e.g. Peek and Rosengren 1996 and FDIC 1996). Unfortunately, this reflects their failure to read the Act carefully. The only numerical value specified in the Act is one defining critically undercapitalized banks. As noted above, the Act delegates setting all the other numerical values for the tripwires to the regulatory agencies. Moreover, the sole number specified -- 2 percent tangible equity to total assets -- is a minimum, which can both be exceeded and be superseded by other definitions of capital. These studies also argue that the use of capital, per se, as an indicator of bank performance is flawed as it is only a lagging indicator of performance and less informative than examiner evaluations. But, as already noted, the Act encourages the regulators to move towards market value accounting which would make capital a more accurate and timely indicator. In addition, it permits the regulators to downgrade banks and impose harsher sanctions on the basis of examination reports and other information. Thus, the regulators can both increase the numerical values

of the capital tripwires and enhance the definition of capital to make the tripwires more effective. Failure to do so represents regulatory failure, not legislative failure.

As is true for much federal legislation, FDICIA is long and complex and contains much more than deposit insurance reform. In part, this contributed to widespread misunderstanding of both the purpose and contents of the Act. There are numerous provisions that deal only marginally with prudential matters and some that appear to have been motivated more by bank bashing and the personal agendas of individual members of Congress. The latter included restrictions on employee compensation and minimum ratios of book to market values of a bank's stock. Although for the most part these provisions were harmless and possibly even useful, particularly if interpreted wisely by the regulators, and some were repealed, the regulators as well as many bankers used them as examples of counterproductive and costly regulatory micro-management of banks in order to impugn the overall Act and encourage its weakening or even repeal. In the process, they were, at least, temporarily successful in giving it a bad name.

The establishment of the capital zones and the mandatory regulatory responses by FDICIA represent partial replacement of regulatory discretion by rules. As such, it resembles the partial replacement of Federal Reserve discretion by FDIC insurance rules following the Fed's failure to prevent the banking crisis of the early 1930s. But, the sanctions become mandatory only after the discretionary sanctions applied are ineffective in improving a bank's performance and restoring its capital to a satisfactory percentage of assets. Thus, the mandatory sanctions serve as credible backup that should strengthen rather than weaken the regulators' discretionary powers. Moreover, because both the

discretionary and the mandated sanctions and other rules are explicit and known a priori, they will help shape the future behavior of the banks so that the regulators have stronger ex-ante influence and are not faced as often with unexpected fiat accompli.

In addition to the prompt corrective action sanctions specified, FDICIA requires the FDIC to inaugurate risk-based deposit insurance premiums, which it did promptly. The risk classifications are based on the FDICIA capital categories and the regulatory agencies' examination ratings. In the first years, the spread between the premiums charged to the safest and riskiest banks were considerably narrower than those assigned by the market to the noninsured debt of these banks. Through time, the premium spreads were widened, although almost all banks qualified for the safest bank category. In 1995, the Bank Insurance Fund (BIF) was recapitalized to the maximum 1.25 percent of insured deposits specified in FDICIA and premiums for all but a few banks were effectively reduced to zero. Legislation adopted in late 1996 increased the banks' premiums slightly by requiring them to contribute to meeting the payments on the FICO bonds, which were in danger of default from insufficient premium revenues from S&Ls only. The legislation also required S&Ls to make a one-time payment to recapitalize SAIF to the required 1.25 percent level and reduced their future insurance premiums to the same level as that of the banks.

FDICIA also attempts to increase the accountability of the regulators in carrying out their delegated responsibilities. The FDIC is required to compute and document the costs of resolving a troubled institution in alternative ways, justify its selection of the option used as the least-cost one, and have a report prepared by the agency's inspector general if it incurs a material loss. This documentation must be provided to the Administration and

Congress and is audited annually by the General Accounting Office (GAO) for compliance with the provisions of the Act. The first GAO annual reviews were critical of both the FDIC's and the RTC's PCA and LCR procedures (GAO 1994a and b). Likewise, the FDIC's Inspector General was critical of the agency's early implementation of PCA in 1993 and the first half of 1994 (FDIC 1994). In response, both organizations changed their procedures and received better evaluations in subsequent GAO reviews, although a more recent GAO report, reviewed later, still includes criticisms of the agencies' PCA directives through 1995.

Effective January 1, 1995, the FDIC is prohibited from protecting uninsured depositors or creditors at a failed bank if it would result in an increased loss to the deposit insurance fund. However, an exemption from least-cost resolution is provided for banks that regulators judge as "too-big-to-fail" and where not protecting their uninsured depositors or creditors from loss "would have serious adverse effects on economic conditions or financial stability." But this exemption requires a determination that the country's financial security is threatened by the Secretary of the Treasury upon the written recommendation of two-thirds of both the FDIC Board of Directors and the Board of Governors of the Federal Reserve System and after consultation with the President of the United States. Moreover, any loss incurred by the FDIC from protecting insured claimants must be recovered with a special assessment on all insured banks based on their total assets, rather than only domestic deposits, the current base for insurance premiums. Thus, this assessment impacts large banks proportionately more and makes it less likely that the protected bank's competitors would be overly supportive of such a rescue. Finally, the

GAO must review the basis for the decision. The requirement to justify violations of the Act, even ex-post, is likely to improve the regulators' accountability and make them think twice before taking actions that are outside the spirit of the Act. Thus, compared to the pre-FDICIA situation, "too-big-to-fail" is likely to be used rarely, if at all.

IV. THE RECOVERY OF BANKING IN THE EARLY 1990S

As we note in the introduction, banking recovered dramatically in the early 1990s. The number of bank failures declined steadily from 221 in 1988, to 127 in 1991, to 41 in 1993, and to only 6 in 1995. As is shown in Table 2, at yearend 1990, 5 percent of all BIF-insured banks holding fully 25 percent of all bank assets would have been classified as "undercapitalized" (the lowest three of the five FDICIA zones). By yearend 1993, only 0.5 percent of the number holding 0.3 percent of bank assets would have been so classified. At yearend 1996, there were almost no "undercapitalized" banks. Over the same period, the percent of banking assets at "well-capitalized" banks increased from 37 to 99 percent. This improvement is somewhat overstated as it reflects, in part, the resolution and therefore disappearance of insolvent institutions that existed in the early years of the period. As shown in Figure 1, the return on both assets and equity for the remaining commercial banks rose to record levels. Except for consumer loans, nonperforming loan rates, which were high through the 1980s, declined sharply, as did loan charge-offs.

The industry's book-value equity capital/assets ratio climbed above 8 percent at yearend 1993 for the first time since 1963, after having declined to near 6 percent. This increase reflects both high retained earnings from profits and record sales of new capital. From 1991 through 1993, sales of new stock issues by large bank holding companies

totaled nearly \$20 billion, an amount 33 percent greater than the amount of equity capital raised in the previous 15 years and approximately 10 percent of their book-value equity capital at yearend 1990. The increase in the industry's market-value capital/asset ratio is even greater than the increase in the book-value capital/asset ratios. In 1990, stocks of publicly traded banks sold at about 80 percent of their book value. In 1995, they traded at nearly 150 percent of book value.

As a result of resolutions and improved profits and capital positions, there are fewer "problem" commercial banks that require special supervision. Problem banks peaked at more than 1,500 in number at yearend 1987 and at over \$500 billion in assets (held by over 1,000 banks) at yearend 1991, which represented 15 percent of the industry. These numbers and amounts declined continuously to less than 500 banks holding \$250 billion in assets by yearend 1993 and to only 150 banks holding \$17 billion in assets by yearend 1995. Much of this decline reflects bank resolutions rather than recoveries, particularly in the early years.

The thrift industry also recovered, but at a slower rate, and proportionately more of the industry's better performance reflects the disappearance of insolvent institutions. Between 1989, after the enactment of FIRREA, and 1995, the number of OTS regulated institutions declined by 50 percent from nearly 3,000 to about 1,400 and S&L assets by 45 percent. At yearend 1990, 32 percent of the institutions, holding nearly 50 percent of total assets, would have been classified as "undercapitalized." By yearend 1992, only 4 percent of the remaining institutions holding 8 percent of the total assets were so classified. At mid-year 1996, only 0.5 percent of the 1,397 associations holding even a

smaller percentage of industry assets were “undercapitalized.” Their return on assets and equity also improved sharply from negative values in 1990 to near 1 percent on assets and 12 percent on capital in early 1996. At the same time, the corresponding values for commercial banks were 1.3 percent and near 15 percent, respectively.

The recovery of banks and S&Ls following passage of FDICIA appears due to several factors. Many reflect economic factors. The national and regional economies recovered at a low inflationary rate, the residential and particularly the commercial real estate markets bottomed out and recovered, interest rates declined as monetary policy eased during the recession that started in mid-1990 and as inflationary expectations receded, and the yield curve turned steeply upward, generating at least temporary profits to asset-long institutions.⁹ In addition, the funding provided by FIRREA permitted the resolution of insolvent “zombie” institutions that were making profitability difficult for solvent institutions by frequently paying higher-than-market interest rates to attract deposits and charging lower-than-market rates on their loans. And FDICIA also contributed.

V. EVALUATION OF DEPOSIT INSURANCE REFORM IN FDICIA

How well has the deposit insurance reform enacted as part of FDICIA worked to date? Despite the early efforts of some regulators to undercut the reforms and intent of the Act, the PCA and LCR provisions, even in their weakened form, appear to have been

⁹Among its easing actions, the Federal Reserve reduced reserve requirements on time deposits from 3 to 0 percent at yearend 1990 and on demand deposits from 12 to 10 percent in February 1992. Both actions should have increased bank profitability and the 1992 reduction was specifically implemented "to reduce funding costs for depository institutions...[and] strengthen banks' financial condition" (Board of Governors, 1992, p. 95).

effective in reducing the moral hazard and agency problems previously associated with deposit insurance and to have contributed to the strengthening of the industry. Three aspects of the SEIR provisions of FDICIA are particularly important. One is the improved, but still less-than-prompt, actions of the regulatory authorities in penalizing poorly performing institutions and resolving institutions that do not meet FDICIA's minimum capital requirements. The second is actions of banks and thrifts to more than meet the law's minimum requirements by raising additional capital, which made them much less prone to fail and to take excessive risks. The third factor is the ending of the FDIC's protection of uninsured deposits at insolvent institutions and its imposition on these deposits of a pro-rata share of any losses incurred. This gave other uninsured depositors reason to monitor their institutions and the institutions reason to increase their capital to assuage depositors' concerns.

Prompt Actions by the Agencies to Correct Institutions with Inadequate Capital and Resolve Undercapitalized Banks at Least Cost

Despite the large number of resolutions, the regulatory agencies did not always initiate prompt corrections as promptly or as firmly as FDICIA requires. As noted earlier, the FDIC's Inspector General (1994) found that the agency, for various reasons, had not used these tools in about one-third of a sample of 43 undercapitalized banks between December 1992 and July 1994. Likewise, the GAO (1996) found that through 1995 the Comptroller of the Currency and the Federal Reserve initiated prompt corrective action directives against only eight of a sample of 61 banks identified as undercapitalized at some time in 1993 and 1994, although the agencies generally closed critically

undercapitalized (the lowest capital zone) banks within the specified 90 day time frame. Moreover, from yearend 1992 through mid-1996, the two agencies used their authority to either downgrade banks from well-capitalized to adequately-capitalized or treat a bank as if it were in a lower zone on the basis of their own evaluation that the bank was “engaging in an unsafe or unsound practice” only twice. This small number occurred despite frequent criticisms by the agencies that PCA zones based solely on capital are too rigid and do not make full use of the more current information the agencies possess on the financial and risk condition of banks through their supervisory activities.

In addition, the GAO (1994a) found that the FDIC may not have marketed large failed banks effectively in 1992 and thus may have solicited either too few bidders or the type of bid not likely to lead to least cost resolution. A follow-up study (GAO 1995), however, reported that the FDIC had improved its marketing practices in 1993. Nevertheless, the GAO still found that in a number of instances in 1995 the FDIC had failed to document its decisions on least cost resolution as completely as required. Thus, despite the cries by the agencies that PCA and LCR would severely limit if not eliminate their discretion, the GAO concluded that to date “the subjective nature of the standards continues the wide discretion that regulators had in the 1980s over the timing and severity of enforcement actions” (GAO 1996a, p. 57).

Likewise, the FDIC's average loss rate has not declined significantly since the enactment of FDICIA. In part, this likely reflects the greater decline in large bank failures, which generally result in proportionately smaller losses. Nevertheless, it would appear that the regulatory agencies might still be able to move faster both to impose sanctions and to

resolve undercapitalized institutions and reduce FDIC losses. Indeed, a review by the banking agencies' own IGs and the GAO of resolutions that involved material losses to the FDIC (basically, losses that exceed \$25 million) that FDICIA requires annually found that in 1995 three of the four cases that required such a review the "bank regulators either did not take sufficiently aggressive enforcement actions to correct identified safety and soundness deficiencies or to ensure that troubled banks complied with existing enforcement actions" (GAO 1996b, p. 5).

For large banks, FDIC losses might also be reduced by the depositor preference legislation, which was enacted in 1993 as part of the Omnibus Budget Reconciliation Act, although the complex dynamic implications of the Act remain to be sorted out (Kaufman 1997). This legislation gives the FDIC and uninsured depositors at domestic insured bank offices priority in failure resolution to depositors at overseas branches of insured U.S. banks and general creditors of banks, e.g., Fed funds sellers. Previously, all these claimants had equal standing with each other. Moody's responded to this change by quickly downgrading the newly subordinated obligations of some then poorly capitalized banks below the rating of the bank's domestic deposits. Statistically, this provision effectively gives major U.S. money center banks, like Citibank, who have large foreign deposits and are large buyers of Fed funds, a near 50 percent capital ratio from the FDIC's vantage point. Thus, the FDIC should expect to suffer no losses in resolving such banks. Dynamically, however, this could change as the subordinated claimants act to protect themselves by running or collateralizing their claims. As a consequence, the FDIC could

become more vulnerable than before. Ironically, this important piece of banking legislation was enacted as part of a nonbanking bill without much publicity and only minimal analysis.

Quicker FDIC response is also desirable because the agencies have defined "critically undercapitalized" as an institution having only 2 percent or less of book-value-tangible equity to capital, which is the minimum ratio specified in the Act. Although little research has been done on the appropriate capital/asset cutoff level, two percent appears much too low, particularly in light of increasing use by banks of derivatives with which they can change their risk exposures quickly and greatly and for which even effective internal control and monitoring systems are difficult to construct. It is likely that in many, if not most, instances this level will be breached only after an institution's market value capital is already negative. This lessens the likelihood that insolvencies will be resolved without loss to depositors and that deposit insurance will truly be redundant. However, with fewer insolvencies, the regulators should be able to act faster to resolve insolvencies.

Additional Capital Raised by Banks

The record amounts of new equity and subordinated debt sold by the industry in the early 1990s attests to the greater fears of bank management and shareholders that the era of liberal forbearance was over and that painful and costly sanctions would be imposed quickly if their banks did not satisfy the capital ratio performance criteria. By 1995, the capital ratios of nearly all banks exceeded the required minimum for even the "well-capitalized" classification and suggests that the market place encouraged banks, even after share repurchases, to maintain noticeable "excess" capital above their requirements to absorb reasonable margins of error. That is, the market views the regulatory

requirements as too low and, at best, as minimums. Although still far below the capital held by most of their noninsured competitors, the maintained higher capital base should both serve to absorb a higher level of losses than before and reduce any incentive of banks to engage in moral hazard behavior. Nevertheless, Standard and Poor's states that "without this regulatory support [that boosts its creditworthiness], the [banking] industry's high leverage ratio alone would rank it lower than the current assessment" (Standard and Poor's 1996, p. 1).

Subordinated debt with remaining maturity of, say, at least two years is an inexpensive and effective way of increasing capital requirements, particularly for larger banks. Unlike equity, interest on such debt is tax deductible. Moreover, such debt would represent little new as large banks already effectively have considerable shorter-term subordinated debt outstanding, particularly under depositor preference, in the form of Fed funds and deposits at overseas branches. Because their losses occur only after a bank's equity is depleted, these bond holders may be expected to carefully monitor the bank's equity position and begin to impose discipline as soon as they perceive serious financial problems. Thus, private market discipline will supplement, if not precede, regulatory discipline. The current capital requirements can be strengthened significantly at little if any additional cost by requiring large banks to maintain an additional margin of, say, 2 percent subordinated debt. Indeed, in 1985, the FDIC had requested comment on a proposal to increase capital requirements on insured banks to 9 percent, 3 percent of which could be satisfied by subordinated debt (FDIC 1985). Unfortunately, this proposal was not implemented.

Imposition of Resolution Costs on Uninsured Depositors

To satisfy the least cost resolution provisions of the Act, the FDIC dramatically changed its resolution procedures to leave more uninsured depositors (depositors whose deposits in excess of \$100,000 are at risk) unprotected, even before the yearend 1994 requirement to do so. Before FDICIA, the FDIC almost always arranged for the purchase and assumption of all liabilities of resolved insolvent institutions, particularly larger banks, thereby protecting depositors with uninsured funds at these institutions from loss. Table 3 presents the number and total assets of banks resolved by the FDIC from 1986 through 1995. In 1991, for example, the FDIC imposed losses on uninsured depositors in only 17 percent of the 127 resolved BIF-insured banks that were costly to it. The unprotected depositors were at basically small banks, holding only 3 percent of all resolved bank assets. Uninsured depositors at all large banks, including the Bank of New England, were fully protected.

In 1992, the unprotected percentages increased sharply to depositors at 54 percent of all 122 resolved banks, holding 45 percent of all resolved bank assets. Uninsured depositors at the relatively large First City Bank (Texas) and American Savings Bank (Connecticut) were left unprotected. However, uninsured depositors at four other large institutions -- CrossLands Savings (New York) and three other savings banks, which generally have proportionately fewer uninsured deposit accounts than commercial banks -- were protected. In 1993, the pendulum completed its swing. Uninsured depositors at 85 percent of the 41 resolved institutions holding 94 percent of the assets were left

unprotected, including the uninsured depositors at all of the largest of the relatively small banks that failed.

The results for 1994 appear mixed at first. In part, this reflects the small number of resolutions -- only 13 BIF insured banks were resolved -- and, in part, the relative importance of savings banks among the banks resolved. Of the 13 banks resolved, uninsured depositors were unprotected in 8 (62 percent) of these banks, holding 55 percent of the dollar assets of all resolved banks. But two of the five banks at which uninsured depositors were protected were savings banks and were by far the largest of these banks. Indeed, they were the two largest banks resolved during the year, even though the largest had assets of only \$337 million. Moreover, the FDIC did not expect to suffer any losses in these resolutions, as well as in two others in which uninsured depositors were protected, including one bank that was only a trust company and had no deposits. Excluding these two savings banks and the two other banks in which the FDIC did not expect to suffer losses shows a different picture. Uninsured depositors were unprotected at eight of the nine (89 percent) commercial banks resolved, holding 96 percent of assets at all resolved commercial banks.

In 1995, only six banks were resolved and uninsured depositors were protected in none. As in the earlier years, all were small banks, the largest having less than \$300 million of assets at the time of its resolution. In 1996, only five even smaller banks were resolved and losses imposed on the very few uninsured depositors at three. Thus, in contrast to its pre-FDICIA policies, it appears that the FDIC did not favor depositors at larger banks in its 1992 through 1996 resolutions.

Because no large money center bank has been critically undercapitalized since the enactment of FDICIA, "too big to fail" provisions of the Act have not yet been tested. But to the extent that the ex-ante incentives and sanctions in FDICIA prevent concurrent widescale failures, such as occurred in the 1980s, ahead of time, so that only a few banks are troubled at once, and, considering the multiple sign-offs required by FDICIA for the authorities to protect uninsured depositors at large banks, the regulators might be expected to be reluctant to use the exemption. It should be noted that the Bank of England, which had also earlier pursued a too big to fail policy, did not protect uninsured depositors in its most recent two large failures, that of the Bank of Credit and Commerce International (BCCI) in 1991 and Barings in 1995.

Summing Up

It appears that the first five years of FDICIA were successful in helping to strengthen the financial condition of the banking and thrift industries.¹⁰ Deposit insurance appears to have been placed on a workable incentive-compatible foundation. Whether it will continue to work well depends on a number of factors, including importantly the political will of bank regulators to carry out the intent of the legislation, even at the cost of reducing their own discretionary powers. The regulators could signal their intent to do so by, among other strengthening actions, stopping their foot dragging and complaining about the difficulty of implementing market or current value accounting and allocating part of their large research budget and staff to improving the reporting and disclosure process and by raising the thresholds for all capital categories to levels more consistent with those the market imposes on the bank's nonbank competitors. Because of the current good health of the industry, a moderate move in this direction would cause only a few institutions to be downgraded to "undercapitalized" if they did not raise additional capital. Such an increase would also increase capital to levels more sufficient to absorb future losses from the existing instability in the regional and national economies and reduce the probability of bank failures. The failure rate should also be reduced by recent Congressional removal of most restrictions on interstate banking and by regulatory agency actions increasing the ability of banks to engage in insurance and securities activities. As a result, banks will be

¹⁰The apparent success of FDICIA is also reflected in the progressively increasing number of recommendations to introduce PCA and LCR provisions in other countries (e.g., Goldstein and Turner 1996).

able to diversify more effectively both geographically and across product lines. May the banking and thrift debacles of the 1980s rest in peace!

Table 1

**SUMMARY OF PROMPT CORRECTIVE ACTION PROVISIONS OF THE
FEDERAL DEPOSIT INSURANCE CORPORATION IMPROVEMENT ACT OF 1991**

Zone	Mandatory Provisions	Discretionary Provisions	Capital Ratios (percent)		
			Risk Based Total	Leverage Tier 1	Leverage Tier 1
1. Well capitalized			>10	>6	>5
2. Adequately capitalized	1. No brokered deposits, except with FDIC approval		>8	>4	>4
3. Undercapitalized	1. Suspend dividends and management fees 2. Require capital restoration plan 3. Restrict asset growth 4. Approval required for acquisitions, branching, and new activities 5. No brokered deposits	1. Order recapitalization 2. Restrict inter-affiliate transactions 3. Restrict deposit interest rates 4. Restrict certain other activities 5. Any other action that would better carry out prompt corrective action	<8	<4	<4
4. Significantly undercapitalized	1. Same as for Zone 3 2. Order recapitalization* 3. Restrict inter-affiliate transactions* 4. Restrict deposit interest rates* 5. Pay of officers restricted	1. Any Zone 3 discretionary actions 2. Conservatorship or receivership if fails to submit or implement plan or recapitalize pursuant to order 3. Any other Zone 5 provision, if such action is necessary to carry out prompt corrective action	<6	<3	<3
5. Critically undercapitalized	1. Same as for Zone 4 2. Receiver/conservator within 90 days* 3. Receiver if still in Zone 5 four quarters after becoming critically under-capitalized 4. Suspend payments on subordinated debt* 5. Restrict certain other activities				<2

* Not required if primary supervisor determines action would not serve purpose of prompt corrective action or if certain other conditions are met.

SOURCE: Board of Governors of the Federal Reserve System.

TABLE 2
FDICIA CAPITAL STATUS OF BIF INSTITUTIONS
1990-1996

FDICIA CAPITAL CLASSIFICATION	YEAREND								
	1990		1991		1993		1996		
	<u>Number</u>	<u>Total Assets</u> (\$B)	<u>Number</u>	<u>Total Assets</u> (\$B)	<u>Number</u>	<u>Total Assets</u> (\$B)	<u>Number</u>	<u>Total Assets</u> (\$B)	
				(percent of total)					
Well and adequately capitalized (2 zones)	95	75	97	92	99.5	99.7	99.8	99.9	
Undercapitalized (3 zones)	<u>5</u>	<u>25</u>	<u>3</u>	<u>8</u>	<u>0.5</u>	<u>0.3</u>	<u>0.2</u>	<u>0.1</u>	
TOTAL	100	100	100	100	100	100	100	100	

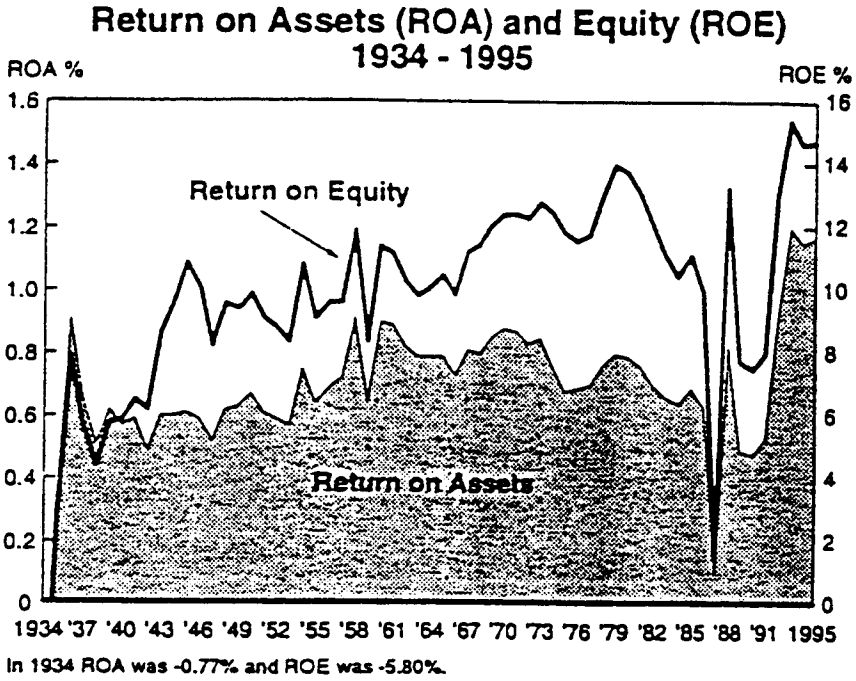
Source: Federal Deposit Insurance Corporation

TABLE 3
FDIC RESOLUTIONS OF BANKS, 1986-1996
BY PROTECTION OF LOSS OF UNINSURED DEPOSITORS

YEAR	NUMBER OF BANKS				TOTAL ASSETS (Billions \$)			
	Total	Protected	Not Protected	Percentage Not Protected	Total	Protected	Not Protected	Percentage Not Protected
1986	145	105	40	28	7.6	6.3	1.3	17
1987	203	152	51	25	9.2	6.7	2.5	27
1988	221	185	36	16	52.6	51.3	1.3	3
1989	207	176	31	15	29.4	27.2	2.2	8
1990	169	149	20	12	15.8	13.3	2.5	16
1991	127	106	21	17	62.5	60.9	1.6	3
1992	122	56	66	54	45.5	25.0	20.5	45
1993	41	6	35	85	3.5	0.2	3.3	94
1994	13	5	8	62	1.4	0.6	0.8	57
1995	6	0	6	100	0.8	0.00	0.8	100
1996	5	2	3	60	0.2	0.10	0.1	63

Source: Federal Deposit Insurance Corporation

FIGURE 1



Source: Federal Deposit Insurance Corporation

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