

ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

FDICIA's Discount Window Provisions

by Walker F. Todd

On December 19, 1991, President Bush signed into law the Federal Deposit Insurance Corporation Improvement Act (FDICIA), which Congress passed to address problems it saw in the supervision of federally insured banks. An important component of FDICIA that has already received substantial public attention is the set of provisions detailing a new process for prompt corrective supervisory action against undercapitalized banks. Much more obscure, though perhaps as innovative, are the sections of the legislation that modify the terms and conditions under which the Federal Reserve Banks may lend to troubled banks at the discount window.

Congress felt compelled to address discount window administration in FDICIA because of its concern that, under certain circumstances, discount window advances to troubled institutions could unnecessarily increase taxpayers' cost when the firms were eventually closed and liquidated, or sold by the FDIC. Implicitly, through the changes to discount window administration imposed by FDICIA, Congress sought not only to clarify the application of concepts like "too big to fail," "systemic risk," and "lender of last resort," but also to provide more explicit guidance to the Federal Reserve regarding the appropriate use of the discount window in failing bank situations. The aim of this *Economic Commentary* is to describe the evolution of supervisory policy toward failing banks over the last 20 years or so, with particular emphasis on the role of Federal Reserve Banks in their capacity as "lenders of last resort."

■ Background

A regulatory closing or other failure resolution effectively constitutes official recognition of a depository institution's economic insolvency. Typically, as many as three agencies could be involved in a bank shutdown: the chartering agency, the FDIC, and any Federal Reserve Bank from which the institution might have borrowed prior to closing.

Although the Federal Reserve's formal role in the closing is passive, it may precipitate this action by demanding repayment of its advances. If the borrower cannot repay the advances upon demand, the chartering agency (the Office of the Comptroller of the Currency [OCC] for national banks) declares the bank insolvent and appoints the FDIC either as a receiver outright or as operator of a bridge bank, a kind of conservatorship under the FDIC's control.¹ If there is a Federal Reserve advance, it is either repaid at once or arrangements are made for deferred payment by the FDIC. In a liquidation, the insured depositors are paid off in full, followed by the secured creditors. The uninsured depositors and other general and subordinated creditors are paid back in full if sufficient funds are available, but they are at risk of receiving only a partial payback. The stockholders stand last in line for the receipt of liquidation funds.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) made potentially the most significant statutory alterations in the Federal Reserve System's discount window lending regime in nearly 50 years. FDICIA restricts the Reserve Banks' authority to lend to undercapitalized depository institutions in order to address issues raised by the "too-big-to-fail" doctrine surrounding rescues of uninsured claimants on insolvent banks. In addition, the new legislation provides explicit guidance to the FDIC on the status of uninsured claims under the systemic risk doctrine.

This simplified model of a bank closing began to evolve into more complicated forms nearly 20 years ago, when the Federal Reserve Bank of New York made a large, prolonged advance to Franklin National Bank of New York to facilitate its orderly closing in 1974. In the Franklin case, the Reserve Bank acted as a lender of last resort because no other institution was willing to incur the risk of nonpayment at par by lending substantial sums to Franklin on an unsecured basis.²

Subsequently, the too-big-to-fail doctrine evolved from federal bank regulators' actions in dealing with large, troubled financial institutions, roughly since the failure and rescue of Continental Illinois of Chicago in 1984. This doctrine generally holds that some banks, because of either their size and correspondent banking relationships (the case for Continental) or their importance in key regional or international financial markets (possibly the case for both the Bank of New England of Boston [1991] and the National Bank of Washington [1990]), should not be liquidated with less than full payment of liabilities, including uninsured liabilities.³ Formally, too-big-to-fail decisions are made by the FDIC, not the Federal Reserve, but the Federal Reserve's participation in some large failure resolutions has allowed it to play a significant role in implementing this doctrine. In any case, neither "lender of last resort" nor "too big to fail" is a statutorily defined term guiding Federal Reserve policies — these phrases do not appear in the Federal Reserve Act.

In some instances, especially involving some recent failures of large banks, institutions do not have sufficient assets to cover both the repayment of their Federal Reserve advances and the liabilities owed to all other claimants (except stockholders and subordinated creditors). Some of the uninsured claimants might suffer losses if the too-big-to-fail doctrine were *not* invoked. If the doctrine were invoked, however, the FDIC might need to use its own resources to pay off the uninsured parties fully. It is easy to see that the larger

the failing bank's capital in proportion to its assets, and the more quickly the bank is closed upon recognition of its failure, the less likely it is that the FDIC would need to provide its own funds for a troubled bank resolution.

A record number of banks have failed since Continental Illinois, exhausting the capacity of the FDIC's bank insurance fund (BIF) to repay even the insured depositors beyond the reserves already provided for expected future losses. The BIF also has had to absorb losses suffered by an unusually large number of uninsured claimants who have received settlements under the too-big-to-fail doctrine.

Eventually, after Congress became faced with the need to provide financial backing for the BIF during 1991, it began to reconsider the process by which bank failures were handled by the supervisory agencies. As part of its inquiry, Congress questioned the role of discount window advances in failure resolutions. Supervisory forbearance regarding the closure of large banks was thought to have contributed to their ability to take greater risks and to operate with less capital than the market would have tolerated in the absence of the forbearance.⁴

Congress also was concerned about possible inequities in the availability of discount window borrowings in failing bank situations. Small banks have complained that reducing the coverage of deposit insurance would drive depositors away from them and into the largest banks, because generally only large banking organizations were thought to be too big to fail. Although there apparently had been a tendency for the FDIC to extend too-big-to-fail treatment to ever-smaller banks, eroding market discipline further, depositors and other uninsured creditors of the smallest banks have never really felt equally treated by the regulatory process of resolving bank failures.⁵

■ Discount Window Administration Prior to FDICIA

Loans to banks through the Federal Reserve Banks' discount windows generally take three forms: seasonal loans,

typically to small agricultural banks; short-term adjustment loans, when a temporary reserve deficiency cannot be met in the national funds market; and extended credit, when a bank no longer has normal access to the funds market and needs time to find alternative sources. Most of the academic and congressional concern that has been expressed about the appropriateness of discount window loans pertains to the use of extended credit, especially when advances are outstanding for prolonged periods.⁶

A traditional view of the lender-of-last-resort function, one that in fact prevailed at the Board of Governors before 1970 or so, would have avoided continuous borrowings by member banks from the Reserve Banks, even to provide liquidity to failing or insolvent banks prior to their resolutions. The reason is that such borrowings in effect would have constituted use of Federal Reserve credit as a substitute for the member banks' capital for the duration of the advances.⁷ A theoretically and traditionally appropriate provision of Reserve Bank credit in bank failures is the extension of advances to other solvent banks holding claims on the failing banks.⁸

Banking conditions changed somewhat during the 1970s from their post-Depression norms. Many banks, especially large ones, became more active internationally and developed extensive interbank correspondent relationships. Moreover, the economy suffered two strong recessions, inflation and interest rates spiraled, and bank capital positions deteriorated. When Franklin National Bank found itself unable to maintain prior funding sources in 1974, the FDIC and the Federal Reserve embarked on a sizable and protracted rescue operation. From that time forward, it could be said that federal banking regulators began to think of discount window extended credit as an essential tool to maintain the liquidity of insolvent or failing banks, though it was several more years before such a situation actually reemerged.

CAPITAL CATEGORIES DEFINED BY FDICIA

Group 1	Well capitalized	An insured depository institution significantly exceeds the required minimum level for each relevant capital measure
Group 2	Adequately capitalized	An insured depository institution meets the required minimum level for each relevant capital measure
Group 3	Under-capitalized	An insured depository institution fails to meet the required minimum for any relevant capital measure
Group 4	Significantly undercapitalized	An insured depository institution is significantly below the required minimum for any relevant capital measure
Group 5	Critically undercapitalized	An insured depository institution fails to meet any specified capital measure

Even before the failure of Continental Illinois in 1984 made bank rescue policy a matter of public debate, it was generally acknowledged that regulators behaved as though they either already were or properly ought to be authorized to rescue fully the uninsured claimants on banks whose failure would pose undue risks to the U.S. banking system.⁹ Although the FDIC Act was amended in 1982 to provide the agency with explicit authority to lend to open insured banks to prevent their defaults or "when severe financial conditions exist which threaten the stability of a significant number of insured depository institutions or of insured depository institutions possessing significant financial resources" and the loans are made "to lessen the risk to the [FDIC] . . . posed by such insured depository institution[s] under such threat of instability," the Federal Reserve Banks' comparable lending authority has never been codified specifically.¹⁰ Nevertheless, the Federal Reserve's participation in the resolution of large or "important" bank failures has been explained as an essential bulwark against the spread of this "systemic risk" in the banking system.¹¹

Another innovation in Federal Reserve lending practice since the mid-1970s is that, as with Franklin National (1974), Continental Illinois (1984), a few large Texas bank failures in 1988-89, and the failures of the Bank of New England and James Madison Limited of Washington, D.C. (both in early 1991), the Federal Reserve Banks also refrained from

demanding that the FDIC, in its corporate capacity, repay outstanding advances, even after the failed entities were seized.¹² In those cases, the FDIC eventually repaid the Federal Reserve's advances, including \$3.5 billion repaid over five years for Continental Illinois (the largest amount and the longest forbearance). Federal Reserve credit to the FDIC enabled that agency to conserve its cash at the time, but it did not reduce or cancel the FDIC's obligation to repay the advance ultimately.

The Reserve Banks' forbearances for the FDIC or advances to the FDIC's bridge banks (a type of successor entity occasionally administered by the FDIC when there is no acquiring bank at the time of seizure of a failing bank) apparently have not increased the final amount of advances outstanding at failure. In principle, bridge banks can be created in which uninsured depositors are not made whole, and the FDIC's assumptions of outstanding Reserve Bank advances need not influence the agency's decisions regarding the standing of uninsured depositors in a failure resolution. But defenders of the more restrictive, traditional view of discount window lending argue that lender-of-last-resort advances to support the solvency (capital replacement) of, or to delay the closing of, insolvent banks are simply another way for regulators to extend de facto guarantees to uninsured depositors and other creditors of the firm.

In effect, these advances allow such claimants to get their money out of the bank at full value, thereby increasing the

ultimate cost of liquidating or selling the bank to the FDIC. The loss arises because discount window advances could be used repeatedly to replace withdrawn private funds, leaving an insufficient pool of sound collateral to cover eventual payments to the insured and uninsured claimants who remain in the bank. Arguably, a faster closure, prompted by a refusal of Federal Reserve discount window credit, would make more of the bank's good assets available at the time of liquidation or sale.¹³

Determining whether the Federal Reserve's use of extended credit in failing bank cases materially aided or harmed the public good is problematic, because there are no clear efficiency standards against which the effort can be evaluated. Studying the history of the Federal Reserve's advances during June 1991, the House Banking Committee concluded that, during the six years covered (1985-90), the Reserve Banks had made advances of extended credit to approximately 500 banks, with roughly 90 percent of those institutions eventually failing during that period.¹⁴ During May and June 1991, Congress began to consider measures to provide more specific guidance regarding regulators' attempts to provide full coverage of uninsured claimants on failed banks, with particular attention paid to the too-big-to-fail and systemic risk doctrines.

■ FDICIA's Discount Window Provisions

The discount window provisions of FDICIA are particularly significant when considered in the context of the Act's other provisions, especially those pertaining to prompt corrective action. FDICIA mandates a set of capital strength categories for banks and requires bank supervisors to take progressively stricter actions against banks as their capital positions deteriorate (see box). These actions are designed to encourage management and policy changes at banks before failure becomes imminent. As the federal bank supervisory agencies implement prompt corrective action, the risk of eventual

loss to either the Federal Reserve or the FDIC should be reduced even if the bank is subsequently closed and liquidated or merged. Some observers, for good reason, consider the specifications of prompt corrective action to be FDICIA's heart and soul, although it remains to be seen how the statute's language is actually put into practice.

FDICIA's discount window reforms, in Congress' view, add another layer of taxpayer protection in troubled bank resolutions by restricting the terms and conditions under which advances may be used to assist banks with weak capital positions and by forcing more public accountability on all of the regulators involved in such operations. Formally, the new discount window provisions do not become effective until December 19, 1993, two years after enactment. However, at the time FDICIA was passed, the House Banking Committee observed that the Federal Reserve had already altered its practices regarding extended credit.¹⁵

Section 141 of FDICIA essentially limits the too-big-to-fail doctrine and also formalizes procedures for recognizing systemic risk exceptions to those limits. Effective January 1, 1995, the FDIC is explicitly prohibited from using its funds to pay off more than the insured amount of deposits and from paying creditors other than depositors.¹⁶ Section 312 of FDICIA immediately prohibits the use of FDIC funds to repay at par depositors at foreign offices of U.S. banks, subject to exceptions for systemic risk and the early resolution provisions of Section 143. However, Section 312 (c) also explicitly permits Reserve Banks to make advances that might be used to repay such foreign depositors as long as other applicable requirements of Section 142 are satisfied.

The systemic risk doctrine is a comparatively recent concern of regulators and is linked in most discussions to inter-bank exposure and the too-big-to-fail doctrine.¹⁷ An exception to the FDIC's least-cost resolution procedures that might affect the discount window limitations of FDICIA was included in Section 141 for "systemic risk." In this

context, a regulatory determination that failure to repay uninsured claims of insured institutions at par "would have serious adverse effects on economic conditions or financial stability" is required to suspend the specified procedures for least-cost resolution. This determination is based on criteria that reflect but are potentially broader than the prior criteria for FDIC open-bank assistance.

The systemic risk exception—Section 141(a)(1)(G)—was included in the least-cost resolution section of FDICIA to provide regulatory flexibility to avoid redemption of uninsured claims at less than par in cases that the regulators believe might cause generalized financial instability. Congress restricted the exercise of this discretion by requiring that the Secretary of the Treasury (in consultation with the President) determine that "action or assistance" under this exception "would avoid or mitigate" the "adverse effects" of the failure of each institution for which the exception is invoked. Requests for the systemic risk exception may be initiated by either the FDIC or the Board, but they must be approved by two-thirds of the FDIC's Board of Directors and two-thirds of the Board of Governors.

Section 141 also requires the FDIC to recover losses arising from the use of the systemic risk exception by a special assessment against all members of the appropriate fund (either the BIF or the Savings Association Insurance Fund). Thus, BIF members will have an interest in preventing unwarranted use of the exception because each surviving insured bank must pay for supervisors' decisions to guarantee the claims of uninsured creditors at par. The Secretary of the Treasury is required to document the regulators' decisions on systemic risk and to submit detailed reports to both the Senate and House Banking Committees.

FDICIA extensively revised and renumbered former Section 10(b) of the Federal Reserve Act.¹⁸ The new section limits Reserve Bank advances to undercapitalized institutions to no more than 60

days in any 120-day period. This restriction may be overridden only if the Reserve Bank receives advance written certification of the borrower's viability from the head of its principal federal supervisory authority or if, following an examination of the borrower by the Federal Reserve, the Chairman of the Board certifies in writing to the Reserve Bank that the borrower is viable.¹⁹

Section 142 of FDICIA alters the borrowing regime for undercapitalized institutions (Groups 3–5; see box) as follows: Group 3 or 4 institutions may borrow from Reserve Banks for only 60 days in any 120-day period. Group 5 institutions may borrow for only five days. The Board of Governors may authorize advances in excess of the 60-day limit for Group 3 or 4 institutions by treating them like Group 5 institutions and by agreeing to bear any excess loss arising from continuation of the advances beyond the five-day limit that applies to Group 5 institutions. The Board (not the Reserve Banks—at least, not directly) must repay losses arising from advances to Group 5 institutions beyond the five-day limit to the FDIC, with its liability calculated as the lesser of the incremental amount advanced after the five-day period and the interest received by the Reserve Banks on those advances. The Board must report its losses under new Section 10B(b) to Congress within six months after they are incurred.²⁰

■ Concluding Observations

The discount window provisions of FDICIA elaborated a new design for the Federal Reserve's part of the bank failure resolution process by providing explicit guidance and limits on the use of Reserve Banks' advances. The general thrust of these provisions is to tighten the lending criteria for undercapitalized institutions and to specify procedures that must be used for advances to these institutions.²¹

If regulators wish to invoke systemic risk exceptions to the new least-cost resolutions regime, FDICIA has established exacting and publicly accountable procedures for those exceptions, which previously were only remotely

accountable to the political process. FDICIA did not settle definitively the policy debate on the too-big-to-fail and systemic risk doctrines, together with other aspects of the theory of the lender of last resort, but it certainly has narrowed the scope of actions that regulators may take solely within their own discretion.

■ Footnotes

1. Most failing banks do not have Reserve Banks' advances outstanding at the closing; thus, Reserve Banks are not necessary parties at most closings.

2. See generally Spero (1980) and *In re Franklin National Bank*, 381 F. Supp. 1390 (E.D.N.Y.), 1974.

3. The uncertainty surrounding the role of the too-big-to-fail doctrine in the failure resolution process for the Bank of New England and National Bank of Washington arises from the fact that, at the time (1990–91), regulators were not required officially to announce that they were invoking it.

4. See, for example, U.S. House of Representatives (1991b), pp. 29–39.

5. See analogous remarks of Senate Banking Committee Chairman Donald Riegle upon introducing the first Senate version of FDICIA, S. 543, on March 5, 1991 (*Congressional Record* [1991], p. S2639). Comparable statements also appear in U.S. House of Representatives (1991a), pp. 15–18, 22–23, and (1991b), pp. 29–39.

6. See Schwartz (1992), U.S. House of Representatives (1991c), p. 94, and Garsson (1991).

7. Both Schwartz (1992), pp. 61–65, and Hackley (1973), p. 194, discuss such historical operation of the discount window. Hackley notes, citing language then in Regulation A (but later dropped in 1980), that "ordinary" unavailability of Federal Reserve credit for extended periods would not preclude such credit "to assist member banks in emergency situations," but that language was not demonstrated to have been aimed solely or primarily at loans in situations where the borrower's eventual failure was probable or certain. See also footnote 8, below.

8. See the discussions in Todd (1988, 1992), Hetzel (1991), Schwartz (1992), and Mayer (1992), pp. 260–325. Federal Reserve Regulation A, 12 C.F.R. Section 201.5(a) (1992), provides as follows: "Credit for Capital Purposes. Federal Reserve credit is not a substitute for capital." Schwartz (1992), p. 59, describes the increased use of Reserve Banks' advances of extended credit to failing banks as a blurring of the distinction between liquidity and solvency. See also, on this point, U.S. House of Representatives (1991c), p. 94, and Garsson (1991).

9. See Zweig (1985), pp. 373, 396, and Sprague (1986), pp. 252–55.

10. 12 U.S.C. Section 1823 (c)(1)(1992). These two conditions on FDIC open-bank assistance ("significant number" and "significant financial resources") apparently are embryonic forms of the systemic risk and too-big-to-fail rationales, respectively.

11. In regard to regulators' emerging systemic risk or contagion concerns, see Spero (1980), Sprague (1986), pp. 77–106, Todd and Thomson (1990), and Kaufman (1992).

12. See Schwartz (1992), pp. 63–64, and *In re Franklin National Bank*, 381 F. Supp. 1390 (E.D.N.Y.), 1974.

13. See Thomson (1990), p. 34. For a similar view of FDIC failure resolution policies prior to the implementation of prompt corrective action under FDICIA, see Caliguire and Thomson (1987). However, for a thorough explanation and sympathetic view of the FDIC's procedures for deciding whether and how to close failing banks prior to FDICIA, see Bovenzi and Muldoon (1990). For a description of how the FDIC's procedures were applied in the Penn Square case (1982), until recently the largest payoff of an insured bank, see Zweig (1985), pp. 371–74.

14. U.S. House of Representatives (1991c), p. 94, Garsson (1991), and Schwartz (1992), pp. 58–59, 65.

15. The House Banking Committee's legislative history report on FDICIA notes that "The Federal Reserve currently [written in November 1991] maintains a policy of not extending credit to nonviable depository institutions. The Committee expects the Federal Reserve to adhere to this policy and refrain from making advances to institutions in situations where the Federal Reserve would likely suffer a loss on the loan." (U.S. House of Representatives [1991c], p. 105).

16. This general rule gives rise, however, to some significant logical inferences. An anonymous referee of this *Commentary* paraphrased those inferences quite well, as follows:

In instances where critically undercapitalized institutions are resolved without loss to the FDIC, all general creditors obviously will receive full value. Moreover, where losses are experienced, [Section 141 (a)(1)(E)(iii)] ... gives the FDIC latitude to fully protect uninsured depositors in resolutions that take the form of [purchase and assumption transactions] ... which cost the FDIC no more than if the institution had been liquidated.

17. See, for example, Greenspan (1991), pp. 433–34, Todd and Thomson (1990), and Kaufman (1992) for discussions on these topics. I have been unable to find explicit references to "systemic risk" in the pre-Continental Illinois (1984) period.

18. The new section was renumbered 10B(b) under Section 142 of FDICIA.

19. These certifications are renewable for additional 60-day periods, but the authority to do so cannot be delegated by the head of the appropriate supervisory authority.

20. In practice, the Board would repay those losses by special assessments for its expenses on the Reserve Banks. See Section 10(3) of the Federal Reserve Act.

21. The House Banking Committee's legislative history report (U.S. House of Representatives [1991c], p. 105) states explicitly that Section 141 of FDICIA "abolished" the too-big-to-fail doctrine, but perhaps this is too strong a conclusion.

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