

TOWARD ENHANCED CONSUMER CHOICE IN BANKING: UNINSURED DEPOSIT FACILITIES AS FINANCIAL INTERMEDIARIES FOR THE 1990's

JONATHAN R. MACEY* AND GEOFFREY P. MILLER**

INTRODUCTION

The world of depository institutions today is undergoing a revolution of far-reaching significance, one that is fundamentally changing the ground rules under which financial services are provided to the American population. Like many revolutions, this one is fueled by a catastrophe: the spectacular failures of the Federal Savings and Loan Insurance Corporation's deposit insurance fund in the 1980s and the Federal Deposit Insurance Corporation's (FDIC's) Bank Insurance Fund in the early 1990s. The enormous cost of these fiascoes — more than \$500 billion by some measures¹ — has brought this formerly placid and unimaginative industry under intense political scrutiny, and generated important legislation, the effects of which are only beginning to be understood.²

At the root of the present crisis lie the perverse incentives implicit in federal deposit insurance. The system of flat deposit insurance premiums that prevailed throughout the life of the sys-

*J. DuPratt White, Professor, Cornell Law School.

**Kirkland & Ellis Professor, University of Chicago. We would like to thank Lissa Broome, Howell Jackson, George Kaufman, Michael Klausner, Craig Wasserman and Chuck Muckenfuss for very helpful comments and Erika Samuels for excellent research assistance on this article. The Lynde and Harry Bradley and Sarah Scaife Foundations provided financial assistance for Miller's work on this project.

1. The \$500 billion figure is one well-known estimate of the eventual costs of the thrift bailout, interest expenses included. See, e.g., Kleege, *The Thrift Bailout Law: 1 Year Later*, *Am. Banker*, Aug. 2, 1990. Economists James Barth, Dan Brambaugh and Robert Litan estimate the cost in present value terms at \$200 billion. J.R. Barth, R.D. Brambaugh & R.E. Litan, *The Future of American Banking* (manuscript 1992).

2. The most important recent statutes are the Competitive Equality Banking Act of 1987 ("CEBA") the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA") and the Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (1991) ("FDICIA").

tem, that is only now being replaced by risk-adjusted premiums,³ seems, in retrospect, to have virtually guaranteed the disaster. When banks pay the same insurance rates regardless of their level of risk, they are implicitly being subsidized for taking risks. And the normal inhibitors against risk-taking that would ordinarily counter this perverse incentive for risk-taking — the reputations of depository institution managers, the interest of shareholders in not losing their investments — disappear or become attenuated when a depository institution runs into serious financial problems, since at this point shareholders and managers have little to lose, and much to gain, from causing their institutions to engage in highly risky activities in hopes that their firms will return to solvency. Without a significant class of debtholders whose own interests would be impaired by this risk-taking strategy, all the incentives of deposit insurance committed shareholders and managers of depository institutions to engage in risky business strategies, especially as their institutions ran into financial difficulties.

This is exactly what happened during the 1980s, with cataclysmic effect. Bankers and (especially) savings and loan managers committed their institutions to increasingly risky investments, funded by the seemingly inexhaustible supply of cheap money which could be obtained through the brokered deposit market.⁴ It was inevitable that the system would fail. Like the O-rings in the Challenger space shuttle, the defective design of deposit insurance went unrecognized through years of apparently successful operation, only to manifest itself in sudden and unexpected — but, in retrospect, predictable — tragedy.

Today, Congress and the regulators are playing catch-up. Important and potentially valuable reforms have been implemented — especially in the underestimated Federal Deposit Insurance Corporation Improvement Act of 1991, which mandated the use of risk-adjusted deposit insurance premiums and required prompt regulatory intervention for undercapitalized depository institutions.⁵

Too often, however, the “reforms” have been backward-

3. Congress instructed the FDIC to implement a system of risk-adjusted deposit insurance premiums in FDICIA. See 12 U.S.C. § 1817(b)(1)(a) (1988).

4. For discussion of brokered deposits, see, e.g., U.S. Department of the Treasury, *Modernizing the Financial System: Recommendations for Safer, More Competitive Banks* IV.1-IV.15 (1991).

5. See 12 U.S.C. § 1817(b)(1)(a) (1988) (risk-adjusted premiums); FDICIA § 131 (prompt corrective action).

looking rather than forward-looking. Congress has failed to cut back even marginally on the preposterous insurance ceiling of \$100,000 per depositor per institution. And in the name of protecting the deposit insurance system against future losses, Congress has hamstrung the banking industry in its ability to compete with nonbank institutions in an increasingly integrated financial services marketplace — for example, by imposing draconian sanctions on bank officials for banking law violations,⁶ restricting the ability of banks to engage in price competition for deposits,⁷ increasing the costs of examination and regulatory compliance,⁸ and requiring depository institutions to make unprofitable and geographically nondiversified loans in the name of “community reinvestment.”⁹

In vowing not to repeat the mistakes of the past, Congress and the regulators have made new mistakes. By focusing blame on convenient scapegoats — the “savings and loan crooks” such as the archetypal Charles Keating, and the allegedly excessive deregulation of the Reagan Administration — the political system has deflected attention from the fundamental fact that the regulatory system of deposit insurance was defective from the start.

In this paper we argue that the banking industry cannot easily sustain the costs of these backward-looking regulations, especially given the existence of powerful nonbank competitors not subject to similar regulatory burdens. The burdens of this regulatory system, moreover, fall disproportionately on consumers who have the least flexibility in structuring their financial affairs in order to avoid the increasingly uneconomic banking system. We propose a simple reform designed to remedy some, but not all, of these problems: the establishment of uninsured depository facilities — or, to use a more convenient if less exact terminology, consumer choice banks.

A consumer choice bank, as we envision it, is simply a bank chartered and regulated at the state level which is not insured by the FDIC or subject to most of the existing forms of federal bank regulation. Such a bank would be able to operate at lower costs, and with greater efficiency and more flexibility, than existing com-

6. See Macey & Miller, *Banking Law and Regulation* 616-19 (1992).

7. See 12 U.S.C. § 1831(f) (1988) (restricting use of brokered deposits by insured financial institutions).

8. See 12 U.S.C. § 1820(d)-(e) (1988) (annual full-scope, on-site examinations required for all insured depository institutions; costs may be assessed against the insured institution).

9. See 12 U.S.C. § 2901-2907 (1988) (Community Reinvestment Act).

mercial banks or thrift institutions. For this reason, it would be able to pay higher interest on deposits than banks which are federally regulated and insured. The consumer choice bank would thus be capable of competing with nonbank financial institutions on a more level playing field.

The benefits of the enhanced flexibility of operations would not be limited to depository institutions. Rather, these advantages would be substantially passed on to consumers of banking services, especially individuals and small businesses that are currently unable to take advantage of the sophisticated regulatory avoidance strategies available to larger corporate depositors. Thus, in addition to mitigating the existing competitive imbalance between depository and nondepository financial institutions, the consumer choice bank would also facilitate the establishment of a more level playing field as between large and small depositors.

In addition to evening the playing field on which banks and nonbanks now compete, and providing consumers with an option currently unavailable to them, the consumer choice bank offers additional advantages in terms of regulatory flexibility and capital formation. Because deposits in consumer choice banks would not be insured, the federal government's interest in regulating these banks would be much smaller than its interest in regulating traditional insured banks. Consumer choice banks could be allowed to take on levels of risk, or experiment with activities, that would be unacceptable for banks operating under federal deposit insurance, even under the forthcoming system of risk-adjusted premiums. Consumer choice banks could thus fill market niches that are inadequately served by existing depository institutions, and could act as innovators in the development of new banking products or services that, if successful, might be allowed for depository institutions operating under federal deposit insurance.

Consumer choice banks would also offer the opportunity, at the state level, for new capital to enter the banking system, since under existing federal law an uninsured consumer choice bank could be owned by all sorts of nonbanking firms so long as it stayed out of the business of making commercial loans.¹⁰ The influx of new capital into the banking system would appear desirable given the severe problems of undercapitalization which accompanied the disasters of recent years, and which are only now beginning to be rectified. Ownership of consumer choice

10. See text accompanying notes 61-70 *infra*.

banks by nonbank institutions would potentially increase competition in the banking industry, thus enhancing consumer benefits.

The principal argument against the consumer choice bank is that consumers could be confused into believing that a deposit at a consumer choice bank is federally insured. To the extent that this is a real danger, it could be considerably mitigated by relatively simple regulations. Consumer choice banks could be housed separately from traditional banks and called by a distinctive name in order to avoid the danger of consumer confusion between uninsured and insured accounts. Such banks would have to publicly disclose that their accounts are not insured, both in advertising and in written disclosure to depositors.¹¹ Moreover, states could require consumer choice banks to make regular disclosures of financial condition to depositors in order to facilitate an informed choice about whether the risks of banking with an uninsured depository facility outweigh the benefits. States could also impose minimum capital rules on these institutions. We believe that with such safeguards in place consumers could distinguish between insured and uninsured accounts. Most consumers would probably elect to keep their funds in an insured account; but for others who make an informed decision to take on a higher level of risk in exchange for a greater return, there seems to be no compelling reason of policy why they should be prohibited from doing so.

No federal legislation would be required to establish consumer choice banks within a state, although federal legislation would restrict the activities of consumer choice banks in certain ways, and would significantly restrict the ability of thrift institutions to operate without federal deposit insurance.¹² As regards state law, it would appear possible for banking institutions to establish or convert into consumer banks under existing law of states. For these states, consumer choice banks would become a reality without statutory amendment. Other states require their state-chartered banks to obtain federal deposit insurance.¹³ In these states, modest statutory amendments would be required to implement the consumer choice bank experiment.

We do not propose the consumer choice bank as any kind of panacea to the problems in the banking industry. These problems are extraordinarily deep-seated, and more fundamental

11. Such a requirement is present in existing federal law. See *infra* notes 18-20 and accompanying text.

12. See *infra* notes 18-48 and accompanying text.

13. See *infra* notes 23-24 and accompanying text.

reform than this may well be required in the long run if the industry is to remain viable as a provider of financial products and services in the years to come. We view incremental reform such as that represented by the consumer choice bank as merely moving the system in the direction of a more basic restructuring. For the time being, however, and in light of present political and economic conditions, the consumer choice bank may be well worth serious investigation by depository institutions, state legislators, and others concerned with the future of this troubled but vitally important industry.

This article is structured as follows. Part I discusses the concept of consumer choice banks in general terms. Part II considers the legal regulation applicable to such institutions. Part III addresses the pros and cons of consumer choice banks. We end with a brief conclusion.

I.

THE CONCEPT OF CONSUMER CHOICE BANKS

A consumer choice bank is a state-chartered bank that is not insured by the FDIC. The name is intended to refer both to the fact that this type of institution would offer consumers a choice — between lower-interest, federally insured accounts at an insured depository institution, on the one hand, and higher interest, uninsured accounts at an uninsured depository facility, on the other — and to the fact that the principal beneficiaries of such uninsured depository facilities would include consumers, who, unlike the treasurers of large corporations, do not currently enjoy ready access to uninsured, higher-yield transaction accounts at financial institutions.

The structure and specific rules governing consumer choice banks would depend on the regulations adopted in each state. It is thus difficult to provide a detailed picture of what consumer choice banks would look like, other than to observe that they would not operate with federal deposit insurance. One appealing model, however, is as follows. The consumer choice bank would be established as a separate uninsured depository facility. It would have its own building or office, which would be kept separate from any banking facility offering insured deposit accounts. The name of the facility would be such as to minimize the danger of customer confusion with insured depository institutions. For example, the institution might be prohibited from calling itself a “bank” (without more), a “savings bank” or a “savings and loan.” The institution would be required to comply with the existing fed-

eral law, described below,¹⁴ which mandates extensive disclosure of the absence of deposit insurance. It would be permitted to offer a full-service deposit and lending business.¹⁵ Depending on the state, it might be permitted to engage in activities that differ (either by being broader or narrower) from the activities permitted to state-chartered institutions generally under state law. Because customers are informed that the bank is not insured, they are on notice that their funds are at risk, and the bank accordingly could be permitted to choose its own asset portfolio and fee-generating activities with less regulatory scrutiny from the state regulators than otherwise might be the case.

Consumer choice banks could display a variety of ownership structures. Entrepreneurs could establish such banks as start-up firms. Existing bank holding companies could establish such banks de novo, or could convert a bank or thrift subsidiary into a consumer choice bank by giving up its federal deposit insurance. If a consumer choice bank stayed out of the business of making commercial loans, or alternatively avoided offering demand deposit accounts, it might qualify as a nonbank bank, and could be owned or operated by a wide variety of nonbanking firms.¹⁶ The states would in the first instance be able to set the limits of the ownership structure of the consumer choice banks established under their authority.

II.

LEGAL REGULATION OF CONSUMER CHOICE BANKS

In this section we consider the legal regulations applicable to uninsured depository facilities. It should be noted at the outset that because these institutions, as we envisage them, would be chartered as banks, they would be subject to state regulations applicable to state-chartered banks.¹⁷ They might even be subject to more stringent regulations than ordinary state-chartered banks if a given state elected to adopt special statutory rules to govern their activities. The key distinction between consumer choice

14. See *infra* notes 18-20 and accompanying text.

15. If, however, the bank wished to be treated as a nonbank bank for purposes of the Bank Holding Company Act it would have to give up either its demand deposit business or its commercial loan business. See *infra* notes 61-70 and accompanying text.

16. See *infra* notes 61-70 and accompanying text.

17. It is possible, of course, that an uninsured depository facility could operate without obtaining a bank charter. We do not consider such institutions in the present article.

banks and other banks is that because they are not federally insured, they would avoid much of the regulatory regime applicable to institutions that do operate with federal insurance. It turns out that avoiding federal insurance would have significant regulatory consequences.

Restrictions on Relinquishing Federal Deposit Insurance. — Consumer choice banks would be permissible under existing federal law, subject to certain limitations. Nothing in federal law requires depository institutions to obtain federal deposit insurance; indeed, the Federal Deposit Insurance Act quite clearly contemplates that state-chartered institutions may elect to operate without federal deposit insurance, at least if doing so is permissible under the laws of their chartering state. However, federal law does impose certain restrictions on depository institutions that wish to operate without federal deposit insurance.

Under the 1991 FDICIA legislation, all non-federally insured depository institutions, whether operating under bank or thrift charter, must now comply with certain federal disclosure requirements. An uninsured institution must place on all periodic statements, signature cards, passbooks, and certificates of deposit a conspicuous notice to the effect that it is not federally insured and that the depositor stands to lose money if the institution fails.¹⁸ Similar notice must be included at the bank premises and on all advertising.¹⁹ Depositors must acknowledge in writing that the institution in which they are placing their funds is not federally insured and that their deposits are at risk in the event of bank failure.²⁰

In addition to these disclosure requirements applicable to all nonfederally insured depository institutions, the FDICIA contains special rules applicable to nonbank (i.e., thrift) institutions. Thrift institutions must meet all “eligibility requirements” for federal deposit insurance even if they are not insured.²¹ The effect of this provision is not entirely clear, and probably was not thought through carefully by its congressional drafters, but the

18. FDICIA § 151, adding new 40(b)(1) to the Federal Deposit Insurance Act.

19. *Id.* at § 40(b)(2).

20. *Id.* at § 40(b)(3). The Federal Trade Commission is instructed to promulgate rules governing the manner and content of the required disclosure. *Id.* at 40(c).

21. FDICIA § 151, adding new § 40(e)(1) to the Federal Deposit Insurance Act. The Federal Trade Commission, in consultation with the FDIC, can make exceptions to this requirement. *Id.*

rule would appear to mean, at least, that any uninsured thrift institution must meet the factors for insurability under section 6 of the Federal Deposit Insurance Act.²² To a significant, although uncertain, extent, therefore, it would appear that an uninsured thrift institution would be subject to regulations similar to those applicable to federally insured institutions.

On the other hand, the statute does not prohibit state-chartered thrift institutions from operating without federal deposit insurance, provided they comply with the substantive eligibility standards that apply to insured institutions, and to this extent a consumer choice bank could operate under thrift institution charter. Moreover, since the obligation of complying with the FDIC's eligibility requirements does not extend to institutions operating under bank charter, a banking firm would presumably have the option of converting an existing thrift subsidiary over to bank charter, or of obtaining a *de novo* bank charter for a start-up institution, in order to operate a consumer choice bank free of the FDIC's eligibility requirements.

Turning to state law, it appears that consumer choice banks would not be possible under the existing law in a significant number of states. Although the traditional rule is that state-chartered banks are permitted, but not required, to obtain federal deposit insurance, the problem of bank failures during the 1980s stimulated a spate of state laws requiring state-chartered institutions to obtain federal deposit insurance. Such legislation is in effect in more than half the states.²³ Moreover, even without such

22. 12 U.S.C. § 1816. The relevant factors include the financial history and condition of the institution, the adequacy of the institution's capital structure, the future earnings prospects of the institution, the general character and fitness of the management of the depository institution, the convenience and needs of the community to be served by the institution, and whether the institution's corporate powers are consistent with the purposes of the Act. *Id.*

23. See Ala. Code § 5-5A-12 (1991); Alaska Stat. 06.05.355(a) (1991) (bank must be a member of the FDIC to begin business, but can voluntarily relinquish membership with the consent of the state banking department); Ariz. Rev. Stat. Ann. § 6-204 (1992); Colo. Rev. Stat. § 11-3-110(6) (1991); Conn. Gen. Stat. § 36-1421(l) (1990); D.C. Code Ann. 26-807.1 (1991); Ill. Rev. Stat. ch. 17, ¶ 320 (1991); Iowa Code §§ 524.802, 524.816 (1989) (all state-chartered banks must acquire deposit insurance effective July 1, 1992); La. Rev. Stat. Ann. §§ 6:216, 6:1135 (West 1991); Mich. Code Ann. § 487.358 (1991) (banks must be insured by the FDIC unless commissioner waives requirement for good cause shown); Minn. Stat. § 46.045 (1991); Nev. Rev. Stat. Ann. § 659.085 (Michie 1991) N.H. Rev. Stat. Ann. 386-A:19a (1990); N.M. Stat. Ann. § 58-1-70 (1991); N.C. Gen. Stat. § 53-9.1 (1991); N.D. Cent. Code § 6-02-03 (1991); Ohio Rev. Code Ann. § 1101.061 (1987)(newly chartered banks must obtain federal de-

legislation on the books, in some states, as a practical matter, a proposed depository institution must promise to seek FDIC insurance in order to obtain a charter from the state regulator, and a decision to relinquish the status of a federally insured institution would be viewed with dismay or even rejected by the responsible official.²⁴ In states where FDIC insurance is required either as a matter of statute law or by administrative discretion, the establishment of consumer choice banks would require a change in existing practice.

In some states, however, it appears that a consumer choice bank could be established without a change in existing practice. This should be no surprise: the consumer choice bank concept is merely a modern variant of a traditional form of depository institution, the state-chartered bank or thrift institution that elected for whatever reason to operate without federal deposit insurance.

Even if the law of a given state permitted the establishment of a consumer choice bank, however, we would expect that state banking regulators would use their discretionary authority over the activities of such banks as necessary to ensure that the dangers of consumer confusion are minimized, subject to the need to allow the bank a reasonable flexibility in operations.

Activities Restrictions. — We now consider the activities restrictions applicable to consumer choice banks. It turns out that uninsured depository facilities operating under bank charter could, depending on applicable state law, engage in a wide range of activities not permitted to similarly situated insured institutions. Uninsured deposit facilities operating as savings institutions, however, would be considerably more circumscribed in their operations.

The general rule, in the absence of federal pre-emption, is that a state-chartered depository institution can engage in any activity permissible under state law, even if similarly situated nationally chartered institutions could not engage in such activities. The states have used their powers to allow state-chartered banks

posit insurance; existing uninsured banks may continue in business but must post notice); Ore. Rev. Stat. § 708.026 (1989); Pa. Stat. § 7:105(A) (1991); R.I. Gen. Laws § 19-11-9 (1991); Tenn. Code Ann. § 45-14-103 (1991); Utah Code Ann. § 7-3-3 (1991); Va. Code Ann. § 6.1-2.9:4 (1991); W.V. Code § 31A-1-6 (1991); Wyo. Stat. Ann. § 13-2-103 (1991).

24. In Georgia, for example, although FDIC insurance is apparently not required under the statute, it is necessary for every state-chartered bank to obtain some form of deposit insurance satisfactory to the state banking department. Ga. Code Ann. § 7-1-244 (1991).

or thrift institutions to enter a variety of nontraditional activities, including underwriting insurance,²⁵ underwriting securities,²⁶ operating travel agencies,²⁷ investing in real estate equities,²⁸ and more.

In the case of thrift institutions, these advantages of state chartering have been considerably undercut by FIRREA. Under section 222 of FIRREA, state-chartered savings associations — whether or not they operate with federal deposit insurance — may not engage as principal in activities not permitted to federally-chartered savings associations, unless the FDIC has determined that the activity in question would pose no significant risk to the federal deposit insurance fund and the savings association is in compliance with federal capital adequacy guidelines.²⁹ State chartered savings institutions are also barred from engaging in an activity *permitted* to a federal savings association in an *amount* that is not permissible for a federal association if either (a) the FDIC has determined that engaging in that amount of activity poses a significant risk to the deposit insurance fund, or (b) the state-chartered institution is not in compliance with federal capital adequacy guidelines.³⁰ And state-chartered savings associations are generally prohibited from acquiring or retaining any equity investment of a type or in an amount that is not permissible for a federal savings association; this would prohibit most direct investments in real estate (other than premises or property held as collateral), as well as most partnership interests, corporate stock, or other miscellaneous equity investments.³¹ The net effect of these provisions is to leave only a narrow window for state-chartered thrift institutions to act in ways not permitted to their federal counterparts. Significantly, moreover, a state-chartered savings association would not escape these preemptive federal rules by giving up federal deposit insurance.

State chartered banks, on the other hand, do gain potentially enhanced activities powers if they relinquish federal deposit insurance. Section 303 of FDICIA provides that insured state banks

25. See, e.g., Conference of State Bank Supervisors, *State Authorization of Selected Expanded Activities for State-Chartered Banks* (1989).

26. See, e.g., Conference of State Bank Supervisors, *State Authorization of Selected Expanded Activities for State-Chartered Banks* (1989).

27. See, e.g., S.D. Codified Laws § 51-18-1.2 (1991).

28. See Conference of State Bank Supervisors, *State Authorization of Selected Expanded Activities for State-Chartered Banks* (1989).

29. FIRREA § 222, adding 28 to the Federal Deposit Insurance Act.

30. FIRREA § 222, adding 28 to the Federal Deposit Insurance Act.

31. FIRREA § 222, adding 28(c) to the Federal Deposit Insurance Act.

may not engage as a principal in any activity that is not permitted for a national bank unless the FDIC has determined that the activity would pose no significant risk to the appropriate deposit insurance fund and the state bank complies with federal capital adequacy guidelines.³² Apparently insured state chartered banks may engage in activities permitted to national banks in amounts beyond those authorized for national banks; thus the pre-emption of state bank activities is less severe than that of state savings association activities. The new statute also generally restricts equity investments by insured state banks and their subsidiaries to those investments that would be permitted to a national bank.³³

These new preemptive rules apply *only* to state-chartered banks that operate with federal deposit insurance. Thus, it would appear that an *uninsured* depository facility chartered as a state bank would continue to operate free of any general federal pre-emption on the type or amount of its activities. In this respect the 1991 legislation, by restricting the activities of *insured* state-chartered banks, has significantly enhanced the degree to which *uninsured* state-chartered banks can operate free of the restrictions that apply to other financial institutions.

In addition to these general rules, uninsured depository facilities could also enjoy certain securities powers beyond those available to insured institutions. The only provision of the Glass-Steagall Act applicable to the securities activities of an uninsured depository facility is § 21, which prohibits institutions engaged "to any extent whatever" in the business of deposit banking from engaging in the business of "issuing, underwriting, selling, or distributing . . . stocks, bonds, debentures, notes or other securities."³⁴ Section 21 generally bars banks, including state-

32. FDICIA § 303. State-chartered institutions may continue to act as agents without federal pre-emption, so long as they restrict themselves to this role and do not become principals in the enterprise. *Id.*

33. FDICIA § 303. National banks have only very limited powers to invest in real estate equities, see 12 U.S.C. § 29 (1988) (providing limited authorization to own premises and related properties and to hold real estate obtained in satisfaction of debts or purchased at foreclosure sales); 12 U.S.C. § 371(d) (1988) (investment in premises may not exceed the amount of a bank's capital stock). National bank powers to invest in equity securities are severely circumscribed under 12 U.S.C. § 24(7) (1988). National banks can invest up to 10% of capital and surplus in bank service corporations, which are allowed to engage in activities permissible to bank holding companies. See 12 U.S.C. § 1864(f) (1988). National banks may also acquire stock in small business investment companies in an amount up to 5% of the bank's capital and surplus. See 15 U.S.C. § 682(b) (1988).

34. 12 U.S.C. § 378 (1988).

chartered nonmember banks, from the business of securities underwriting. Section 21, however, does not apply to the activities of nonbank *subsidiaries* of state-chartered banks.³⁵ Insured nonmember banks can, accordingly, engage in a range of securities activities through a wholly-owned subsidiary.

As state-chartered, nonmember banks, consumer choice banks would have the same option available to all such banks of establishing securities subsidiaries free of the strictures of § 21 of the Glass-Steagall Act.³⁶ In addition, however, it would appear that by eschewing deposit insurance, a consumer choice bank could also avoid the FDIC's regulations otherwise applicable to such securities activities.³⁷ Among other things, these regulations generally limit the underwriting activities of subsidiaries of insured nonmember banks, which have not been in continuous operation for five years, to the underwriting of "investment quality" debt and equity securities³⁸ and high-grade investment company securities.³⁹ Thus, a newly formed subsidiary of an insured nonmember bank could not underwrite high-yield debt, initial public offerings of securities, limited partnership interests, and other investments not included on the FDIC's list.⁴⁰ The regulations

35. See *Investment Company Institute v. Federal Deposit Insurance Corp.*, 815 F.2d 1540 (D.C. Cir.), cert. denied, 484 U.S. 847 (1987); *National Council of Savings Institutions v. Federal Deposit Insurance Corp.*, 664 F.Supp. 572 (D.D.C. 1987).

36. However, if the state-chartered bank was part of a bank holding company that included national or state member banks, the rule in § 20 of the Glass-Steagall Act, 12 U.S.C. § 377 (1988), governing affiliations between banking and securities firms might come into play. A banking organization could presumably avoid this problem by relinquishing its membership in the Federal Reserve System, since § 20 does not apply to state-chartered, nonmember banks whether or not insured. See M. Fein, *Securities Activities of Banks* 2.01[C](looseleaf).

37. The FDIC's regulations are codified at 12 C.F.R. 337.4.

38. 12 C.F.R. 337.4(b)(1). Investment quality debt securities are "marketable" obligations rated in the top four rating categories by a nationally recognized rating service or marketable obligations with investment characteristics equivalent to such top-rated obligations. *Id.* 337.4(a)(7). Investment quality equity securities are marketable common or preferred stock ranked or graded in the top four categories or equivalent by a nationally recognized rating service, or marketable preferred corporate stock with investment characteristics equivalent to the investment characteristics of top rated preferred corporate stock. *Id.* 337.4(a)(8).

39. I.e., investment companies not more than 25% of whose assets consist of investments other than investment quality debt or equity securities, or not more than 25% of which consist of investments other than instruments normally associated with a money market fund. 12 C.F.R. 337.4(b)(1)(ii)(C)-(D).

40. Once the subsidiary has been in continuous operation for five years, it is permitted to underwrite securities not on the FDIC's list if it is a member in

also impose significant limitations on transactions between insured nonmember banks and their securities subsidiaries or affiliates.⁴¹ In most cases the subsidiary or affiliate must also disclose to customers that their investments are not insured by the FDIC.⁴²

These limitations on the securities activities of subsidiaries of *insured* nonmember banks would not apply to the insurance activities of consumer choice banks, since the FDIC's rules are explicitly tied to the bank's insured status.⁴³ Thus a consumer choice bank could engage in securities activities with more flexibility of operations than a similarly situated insured bank, subject of course to whatever rules the bank's chartering state elected to impose.

Consumer choice banks would also have significantly greater powers than insured banks and bank holding companies in the area of insurance underwriting. National banks have traditionally been barred from most forms of insurance underwriting.⁴⁴ As of 1991, insured state banks are also prohibited from engaging in insurance underwriting "except to the extent that activity is permissible for national banks."⁴⁵ Restrictive rules also apply at the holding company level: most forms of insurance underwriting are prohibited for bank holding companies and their nonbank subsidiaries under Section 4(c)(8) of the Bank Holding Company Act.⁴⁶

good standing of the National Association of Securities Dealers and meets certain other conditions. 12 C.F.R. 337.4(b)(2).

41. See 12 C.F.R. 337.4(e).

42. See 12 C.F.R. 337.4(h).

43. If a consumer choice bank were chartered as a subsidiary of a holding company that also included an FDIC-insured bank in its organization, the FDIC's affiliate rules might require separation of the facilities and management of the consumer choice bank's securities subsidiary and those of the insured bank. See 12 C.F.R. 337.4(c).

44. National banks have traditionally been restricted, under § 92 of the National Bank Act, to acting as insurance agents in towns of 5,000 or less. See *Saxon v. Georgia Association of Independent Insurance Agents*, 399 F.2d 1010 (5th Cir. 1968) (rejecting Comptroller's attempt to allow national banks to act as agents in towns of more than 5,000). Even this authority is now in jeopardy as a result of a recent appeals court ruling that § 92 was repealed in 1918. See *Independent Insurance Agents of America, Inc. v. Clarke*, 955 F.2d 731 (D.C. Cir. 1992). In addition to their now-questionable agency powers, national banks have also been permitted to engage in limited forms of insurance underwriting related to their lending function. See 1 H. Pitt, D. Miles, & A. Ain, *The Law of Financial Services* 3[B][2] (1988).

45. FDICIA § 303, adding 24(b)(1) to the Federal Deposit Insurance Act.

46. 12 U.S.C. § 1843(c)(8) (1988). The limitations on insurance underwriting were introduced by Title VI of the Garn-St Germain Act of 1982, Pub. L. No.

Consumer choice banks, however, would not be subject to these limitations on insurance activities. Accordingly, they could continue to take advantage of the powers, afforded by Delaware, South Dakota and other states, to engage in general insurance underwriting business.⁴⁷ They may apparently do so, moreover, even if the consumer choice bank is chartered as a subsidiary of a bank holding company which includes insured depository institutions. Nothing in the Bank Holding Company Act permits the Federal Reserve Board to regulate the activities of a state-chartered bank subsidiary of a bank holding company, including a subsidiary that is operating without federal deposit insurance.⁴⁸

Capital Structure. — Consumer choice banks would operate with a potentially different capital structure than that applicable to insured depository institutions. Such institutions would not be required to comply with federal capital adequacy guidelines, which apply only to federally insured depository institutions. They would, accordingly, have more freedom to arrange their capital structure as demanded by market conditions, rather than under the binding constraints of federal guidelines. States, however, would be free to impose their own capital adequacy guidelines on these institutions, which could be more stringent, less stringent, or identical to the federal guidelines.⁴⁹

Consumer choice banks would also be free of certain existing regulations of insured institutions that impose liability on affiliates of insured depository institutions. Bank holding companies that own or control consumer choice banks might be subject to the Federal Reserve Board's "source of strength" policy, which

97-320, 96 Stat. 1536 (1982). The statute contains a number of exemptions, including one, tracking 92 of the National Bank Act, for general insurance activities in towns of 5,000 or less, or other locations that the bank holding company can demonstrate have inadequate insurance agency facilities. 12 U.S.C. § 1843(c)(8)(C).

47. See generally 1 H. Pitt, D. Miles & A. Ain, *The Law of Financial Services* 3[B][4](1988).

48. See *Ind. Ins. Agents of Am. v. Bd. of Governors*, 890 F.2d 1275 (2d Cir. 1989), cert. denied, 111 S.Ct. 44 (1990). This is not to say that the Board could not find ways to make life difficult for a bank holding company that chose to flout the Board's will or undermine its regulatory authority.

49. Even without regulation, it is probable that consumer choice banks would operate with significantly higher capital ratios than those characterizing insured depository institutions today. Prior to the institution of deposit insurance capital ratios were, in general, much higher than they have been since deposit insurance became effective. See Kaufman, *Capital in Banking: Past, Present and Future* (manuscript 1992); Macey & Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 *Wake Forest L. Rev.* 31 (1992).

ostensibly requires bank holding companies to provide capital infusions to failed or failing subsidiary banks.⁵⁰ It is not clear, however, whether, even if it is good law,⁵¹ the source of strength policy would apply to uninsured depository institutions. Arguably, a transfer of funds to an uninsured institution from a holding company controlling both insured and uninsured depository institutions would not fall within the purposes of the source of strength policy. In addition to their possible regulation under the source of strength policy, consumer choice banks held in holding company form would presumably be subject to the limitations under the Federal Reserve Act on transactions among affiliated institutions.⁵²

Consumer choice banks would not be subject to the cross-guarantee rule of FIRREA,⁵³ which subjects the assets of insured depository institutions to the FDIC's claim for its losses in resolving any commonly controlled insured depository institution. Because the consumer choice bank is not federally insured, its assets would not be reachable under the cross-guarantee rule in the event of the failure of an insured bank under common ownership or control. Conversely, the cross-guarantee rule would not place the assets of any commonly controlled institution, insured or uninsured, at risk in the event that a consumer choice bank becomes insolvent, since the insolvency of a consumer choice bank would involve no costs to the FDIC.

Enforcement Rules. — The freedom from federal regulation enjoyed by consumer choice banks would be mirrored by their apparent exemption from most federal enforcement powers. Consumer choice banks would, for example, appear to be exempt from cease-and-desist orders, both temporary⁵⁴ and final;⁵⁵ from orders of suspension, removal or prohibition directed at person-

50. See 12 C.F.R. 225.4(a)(1)(providing that "a bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner.").

51. The Fifth Circuit rejected the Board's source of strength policy in *MCorp Financial, Inc. v. Bd. of Governors*, 900 F.2d 852 (5th Cir. 1990), but the Supreme Court reversed on technical grounds, 112 S.Ct. 459 (1991), leaving the substantive issue undecided.

52. See Federal Reserve Act 23A, 23B, codified at 12 U.S.C. § 371c, 371c-1.

53. 12 U.S.C. § 1815(e).

54. See 12 U.S.C. § 1818(c) (1988)(temporary cease-and-desist power provided, but apparently limited to federally insured institutions).

55. See 12 U.S.C. § 1818(b)(final cease-and-desist power provided, but apparently limited to federally insured institutions).

nel;⁵⁶ and from emergency prohibition and suspension orders.⁵⁷ Consumer choice banks would be exempt from most, if not all, of the draconian civil monetary penalties which, under FIRREA, can reach levels as high as \$1 million per day per offense.⁵⁸ Consumer choice banks would be exempt from most of the criminal prohibitions under the federal law.⁵⁹ In short, because consumer choice banks would not be federally regulated for most purposes, they would be outside the scope of many federal enforcement mechanisms that implement substantive federal regulations.⁶⁰

Ownership Restrictions. — A final distinction between consumer choice banks and similarly situated insured institutions would be that, with suitable modifications to their operations, the former can be structured so as to avoid federal restrictions on ownership of banks by nonbanking firms. The legal mechanism for avoiding such ownership restrictions would be a new form of the fabled nonbank bank. In this section we argue that the nonbank bank, widely believed to have been executed by Congress in 1987 for the crime of deregulating the banking industry, may not be dead, but only sleeping.

The nonbank bank arose as a means for avoiding the restrictions on geographic and product expansion that apply to bank holding companies under the Bank Holding Company Act.⁶¹ The key was the definition of the term "bank" under the Bank Holding Company Act. Prior to 1987 the statute defined "bank" to mean an institution that both accepted demand deposits *and*

56. See 12 U.S.C. § 1818(e)(powers over personnel apparently limited to persons serving at insured depository institutions).

57. See 12 U.S.C. § 1818(e)(3)(emergency suspension or removal power apparently limited to insured depository institutions).

58. See 12 U.S.C. § 1818(i)(2)(setting forth "general provisions for depository institutions insured by the FDIC").

59. See, e.g., 18 U.S.C. §§ 656-657 (prohibiting embezzlement or misapplication of funds from federally insured depository institutions); 18 U.S.C. § 1818(j)(violation of removal or suspension order against FDIC-insured depository institution).

60. Again, however, we emphasize that their exemption from federal regulation is not a licence to act free of all government supervision, since consumer choice banks would be subject to plenary state regulation.

61. Section 4(c)(8) of the Bank Holding Company Act requires that the activities of bank holding companies and their nonbank subsidiaries be "so closely related to banking or managing or controlling banks as to be a proper incident thereto." 12 U.S.C. § 1843(c)(8) (1988). The Douglas Amendment to the Bank Holding Company Act, 12 U.S.C. § 1842(d) (1988), prohibits interstate bank holding company acquisitions of subsidiary banks unless the acquisition is "specifically authorized by the laws of the State in which [the proposed subsidiary bank] is located, by language to that effect and not merely by implication."

made commercial loans.⁶² Under this definition, it was perfectly possible for an institution to do nearly everything that a traditional commercial bank does, and yet still not be classified as a “bank” under the Bank Holding Company Act.⁶³ An institution could, for example, operate as a federally insured national or state-chartered bank — thus acting as a bank for most practical purposes — yet avoid being classified as a bank under the Bank Holding Company Act by the simple device of eschewing commercial loans. It could make home mortgage and consumer loans without risking its status as a nonbank bank; and if it wished to extend credit to businesses, it could engage in the functional equivalent of commercial lending by purchasing the commercial paper issued by major corporations.⁶⁴ Alternatively, an institution could avoid being classified as a bank under the Bank Holding Company Act by limiting its depository activities to NOW accounts on which the bank retained a purely formal right to insist that the depositor give notice before making a withdrawal. Such a bank could make an unlimited amount of commercial loans and still avoid being classed as a bank so long as it avoided offering checking accounts.

In 1987, after the Federal Reserve Board had tried unsuccessfully to plug the loophole by regulation,⁶⁵ Congress scrapped the old, troublesome definition of “bank.” The new statute defines a bank for purposes of the Bank Holding Company Act as an institution that (1) is an “insured bank” under the Federal De-

62. 12 U.S.C. § 1841(c)(1982). The original Bank Holding Company Act of 1956 had defined “bank” quite broadly to include all national banks and all state-chartered banks, savings banks, and trust companies. Act of May 9, 1956, Pub. L. No. 84-511, 2, 70 Stat. 133 (1956). In 1966 Congress excluded savings banks, trust companies, and industrial banks from the statute by redefining “bank” to mean “any institution that accepts deposits that the depositor has a legal right to withdraw on demand.” Act of July 1, 1966, Pub. L. No. 89-485, 3, 80 Stat. 236 (1966). Congress added the additional requirement that the institution also be “engaged in the business of making commercial loans” in the 1970 amendments to the Act. Act of Dec. 31, 1970, Pub. L. No. 91-607, 101(c), 84 Stat. 1760, 1762.

63. See generally Felsenfeld, *Nonbank Banks—An Issue in Need of a Policy*, 41 *Bus. Law.* 99 (1985)(discussing regulatory avoidance potential of non-bank banks).

64. On commercial paper as the functional equivalent of commercial loans, see Litt, Macey, Miller & Rubin, *Politics, Bureaucracies, and Financial Markets: Bank Entry into Commercial Paper Underwriting in the United States and Japan*, 139 *University of Penn. L. Rev.* 369 (1990).

65. See *Bd. of Governors v. Dimension Fin. Corp.*, 474 U.S. 361, 364 (1986).

posit Insurance Act, *or* that (2) both (a) accepts demand deposits or deposits that the depositor may withdraw by check or similar means of payment to third parties or others; and (b) is engaged in the business of making commercial loans.⁶⁶ A bank is an "insured bank" if its deposits are insured by the Federal Deposit Insurance Corporation.⁶⁷ This includes all national banks, all member banks of the Federal Reserve System, and state-chartered, non-member banks that apply for and obtain federal insurance. Existing nonbank banks were grandfathered, but severe restrictions were placed on their ability to expand beyond their existing operations.⁶⁸

Although Congress tightened up the nonbank bank option, it did not prohibit such institutions altogether. Even under the new definition it remained technically possible for an institution to operate as a bank without being classified as a bank under the Bank Holding Company Act. A state-chartered bank could still qualify as a nonbank bank if it did two things: (1) give up its federal deposit insurance coverage; and (2) either get out of the business of offering demand deposit accounts or avoid making commercial loans.⁶⁹

The principal legal implication for the nonbank bank is that such an institution may be owned by any sort of firm, including firms outside the banking industry. Because the subsidiary institution would not come within the definition of a "bank" for purposes of the Bank Holding Company Act, the parent organization would not be, by reason of that ownership, a bank holding company subject to the act. Thus an institution that owns one or more nonbank banks can avoid the requirement that it be engaged solely in activities "closely related to banking."⁷⁰ A company of any sort could own and operate a consumer choice bank so long as the bank either avoided offering demand deposit accounts or stayed out of the business of making commercial loans.

66. 12 U.S.C. § 1841(c)(1) (1988).

67. 12 U.S.C. § 1813(h) (1988).

68. Competitive Equality Banking Act of 1987, § 101(c), codified at 12 U.S.C. § 1843(f)-(h).

69. The Conference Committee recognized this explicitly: "the bill would not cover as a bank an uninsured institution that did not, for example, offer demand deposit or transaction accounts, or one that offered such accounts but did not engage in the business of making commercial loans." Competitive Equality Banking Act of 1987, H.R. Rep. No. 100-261. 100th Cong., 1st Sess. 120 (1987).

70. 12 U.S.C. § 1843(c)(8) (1988).

III.

PROS AND CONS OF CONSUMER CHOICE BANKS

Having set forth a brief description of what a consumer choice bank would look like, and discussed the legal regulation applicable to such banks, we now turn to an analysis of the costs and benefits of such an institution. As should already be evident, we believe that the benefits of such an institution are likely to exceed the costs. Our reasons follow.

Advantages of Consumer Choice Banks. — The main advantages of consumer choice banks are these: (1) they permit banking institutions to compete on more equal terms with nonbank financial institutions by offering uninsured deposit accounts to consumers; (2) they offer consumers and small businesses the option to place funds in an uninsured account, which they might reasonably want to do in order to earn higher interest, even at the cost of increased risk; (3) they facilitate the flow of new capital into the banking system; and (4) they further the goals of the dual banking system and are, we believe, consistent with the purposes that animated Congress in the various banking statutes applicable to insured depository institutions today.

1. LEVELING THE PLAYING FIELD BETWEEN BANKS AND NONBANKS

One argument in favor of consumer choice banks is that they avoid the skyrocketing costs of federal deposit insurance, costs that have become a significant drag on bank profits and that are likely to rise even further in future years. Indeed, the costs of deposit insurance have risen to the point that some banks might actually be able to gain a competitive advantage over other banks by operating *without* deposit insurance.

A decade ago, the idea that a bank would voluntarily eschew federal deposit insurance would have seemed preposterous. Deposit insurance was extraordinarily cheap and provided bank customers with an inexpensive assurance that their funds would be safe. Today, however, it is not at all clear that the absence of federal deposit insurance would be a fatal impediment to the ability of a bank to operate. The reason is that deposit insurance is no longer an obvious subsidy to banking institutions.

The effective cost of deposit insurance has increased more than five-fold since 1984. As shown in Table 1, prior to 1990 the deposit insurance assessment for commercial banks stood at 8.3 basis points — 8.3¢ per \$100 of insured deposits. In 1990, however, premiums rose to 12 basis points, and the following year

they went to 19.5 and then 23 basis points. Most recently, the FDIC has decided to raise premiums to an average of 25.4 basis points after adjustment for risk. There is reason to believe that the premiums will rise even higher in coming years.⁷¹

Table 1: Insurance Assessments at Banks and Thrifts
Per \$100.00 of Deposits

Year	BIF/FDIC	SAIF/FSLIC
1935-1950	8.3¢	12.5¢
1950-1984	8.3¢	8.3¢
1985-1989	8.3¢	20.8¢
1990	12.0¢	20.8¢
1991	19.5¢-23.0¢	23.0¢
1992	23.0¢	23.0¢
1993 (proposed)	25.4¢ (average)	25.4¢ (average)

Source: CCH Fed. Banking L. Rep. 47,334 (figures for 1990 and 1991); 88,542 (1992 figures); P. Bartholomew, Reforming Federal Deposit Insurance 30 (CBO 1990); Rhem, FDIC Fixes Premium at Average 25.4¢, Am. Banker, Sept. 16, 1992, at 1.

This increase from 8.3 to 25.4 basis points over a four year period is dramatic enough, but it only captures part of the full story, for it omits the rebates which banks traditionally received from the FDIC on their premium assessments. Because very few banks failed, the FDIC traditionally returned about half of its assessment income to insured banks each year.⁷² The effective assessment costs for banks were thus more like 4 basis points than the nominal 8.3 basis points. Beginning in 1981, however, the flow of rebates began to dry up; the effective assessment rose to 7 basis points in 1981-83,⁷³ and beginning in 1984 the FDIC stopped paying out any rebates at all.⁷⁴ There is no realistic pros-

71. The FDIC's decision not to raise assessments for 1992 was based more on the shaky condition of the banking industry than on any judgment that increased assessments will not be necessary to replenish the insurance funds. See Rehm, Seidman Sees No Need to Hike FDIC Premium, Am. Banker, September 11, 1991, at 1.

72. See M. Schroeder, Bank Officer's Handbook of Commercial Banking Law 11.01[3] (6th ed. 1989).

73. See Silverberg, Raising Premiums Will Cause Wave of Change in industry, Am. Banker, September 20, 1990, at 4.

74. See Rehm, FDIC's Shortfall Hit \$10 billion in 88, Am. Banker, April 26, 1989, at 1.

pect that rebates will start again any time soon.

Moreover, the real cost of assessments is also a function of the amount of effective insurance coverage offered by the FDIC. As shown in Table 2:

Table 2: Federal Deposit Insurance Coverage 1933-1980

Year	Coverage
1933	\$ 5,000
1950	\$ 10,000
1966	\$ 15,000
1969	\$ 20,000
1974	\$ 40,000
1980	\$100,000

Source: P. Bartholomew, *Reforming Federal Deposit Insurance 36-37* (CBO 1990); U.S. Department of the Treasury, *Modernizing the Financial System: Recommendations for Safer, More Competitive Banks*, Figure 6 (1991).

Congress has repeatedly increased the nominal coverage limits, from \$5,000 in 1933 to \$100,000 in 1980. These increases represent an approximate doubling of explicit coverage in real terms.⁷⁵ And these figures actually understate the increase in real coverage, since starting with the onset of a wave of bank failures in the early 1980s and lasting until very recently, the FDIC's strong preference was to facilitate purchase and assumption transactions in which *all* depositors, even those with deposits in excess of the \$100,000 coverage limit, were made whole.⁷⁶ More recently, however, this de facto infinite coverage has been scaled back. Congress instructed the FDIC in 1991 to utilize the least cost resolution procedure and (by 1994 at the latest) not to bail out uninsured depositors if doing so results in any increased costs to the Bank Insurance Fund.⁷⁷ Thus, it appears that de facto coverage levels will be reduced at the same time as the effective costs of premiums is skyrocketing.

The utility to the banking industry of uninsured depository

75. See P. Bartholomew, *Reforming Federal Deposit Insurance 36* (CBO 1990).

76. See Macey & Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 Colum. L. Rev. 1153, 1182 (1988).

77. FDICIA § 141, to be codified at 12 U.S.C. § 1823(c)(4)(E)(1)(i). Under limited conditions, the FDIC may pay off uninsured depositors to avoid systemic risks.

facilities is apparent, not only from the costs of deposit insurance assessments that such a facility would avoid, but, equally importantly, because such a facility would allow banks to compete on a more level playing field with uninsured financial institutions which are increasingly offering transaction services. The most significant such competitor is the money market mutual fund. As we discuss in other work,⁷⁸ investors in money market mutual funds now enjoy transaction privileges similar to those of bank depositors: the holder of such a fund can write checks to third parties which are accepted in the course of business as readily as are bank checks. It is true that most money market mutual funds impose limits on the number of checks than can be written in a given period, or on the minimum size of checks, but these limitations can be substantially overcome by the use of credit cards for the acquisition of cash from automatic teller machines and for the consummation of day-to-day transactions. It is quite practicable today for a wealthy individual to opt out of the banking system by combining the use of a money market mutual fund and credit cards (which might be issued by an institution other than a bank); indeed, many have done so already.

Among the advantages that a money market mutual fund offers over banks is the fact that, because the fund obligations are not insured by the FDIC, the costs of federal deposit insurance premiums are not passed on to customers in the forms of higher fees or lower interest. This cost saving, in turn, gives the money market mutual fund a significant cost advantage over the commercial bank — an advantage that is likely to grow more significant over time as the deposit insurance assessments increase. Banks are likely to lose increasing market share to these nonbank depository institutions simply as a result of the costs of deposit insurance, not to mention the other disadvantages under which banks labor which we discuss below. The predictable consequence is that over the coming years banks will suffer increasing competition for their core deposit businesses, competition that banks will be unable to match unless they, too, are able to offer a form of uninsured deposit account to bank customers.⁷⁹

All this strongly suggests that the benefits of deposit insurance are no longer so great as to make it impossible for a bank to

78. See Macey & Miller, *Nondeposit Deposits and the Future of Bank Regulation*, __ *Michigan L. Rev.* __ (1992).

79. Banks are permitted to act as investment advisors to money market mutual funds, but cannot distribute interests in the fund without running afoul of the Glass-Steagall Act. See *Inv. Co. Inst. v. Camp*, 401 U.S. 617 (1971).

conduct its business without federal deposit insurance. A bank could, we believe, operate effectively without deposit insurance provided that the bank customer had reasonable assurance as to the probability of repayment of the obligations. This does not mean that customers would demand an iron-clad guarantee that their deposits be repaid in full; customers would accept some tradeoff of risk in exchange for increased return on their investments.

2. PROVIDING CONSUMERS AND SMALL BUSINESSES WITH ACCESS TO UNINSURED DEPOSIT ACCOUNTS

The cost savings made possible by relinquishing deposit insurance would not be wholly or even principally captured by the consumer choice bank itself. Rather, to a considerable extent, the pressure of competition would force consumer choice banks to pass these advantages on to their customers in the form of higher interest rates or lower fees on deposit accounts. Consumers would have the option of investing their funds in an insured, low-interest account at an ordinary bank or thrift institution, in an uninsured, higher-interest account at a consumer choice bank, or in a combination of insured and uninsured accounts.⁸⁰ Other things equal, it would appear desirable to allow consumers to make their own decisions about whether they prefer to invest in higher-yielding uninsured accounts or lower-yielding insured accounts.

It is particularly appropriate for consumers to obtain the benefit of higher-yielding, uninsured deposits in light of the fact that wealthy individuals and larger businesses have enjoyed this option for years. As we document in another study,⁸¹ corporate treasurers wanting to obtain maximum yield for their institutions' funds coupled with a high degree of liquidity need not deposit these funds in insured accounts at banks. They have many other options for short-term, high-yield investments which, while not perfectly secure, are nevertheless very safe. They may, for example, make deposits in the Eurodollar call market,⁸² maintaining

80. Consumers can, of course, already go into uninsured money market funds or other uninsured investments (such as the stock market), but they might prefer to have some of their funds in a transaction account at a bank where the funds could earn interest based on the bank's profit on its loan portfolio.

81. Macey & Miller, *Nondeposit Deposits and the Future of Bank Regulation*, — Michigan L. Rev. — (1992) (forthcoming).

82. The Eurodollar market is the market for deposits denominated in dollars in banks or branches outside the United States. M. Stigum, *The Money Market* 46 (3d ed. 1990).

transactional flexibility because the call market is essentially a demand deposit account.⁸³ Because Eurodollar deposits are not insured, deposits in this market are not subject to the costs of federal deposit insurance. Yet the Eurodollar market is a wholesale market only available to larger corporations, and not to individuals (other than the very wealthy) or smaller businesses.⁸⁴

Corporate treasurers can also obtain the benefits of a deposit account without having to pay the passed-on costs of deposit insurance premiums by making bank deposits in the form of repurchase agreements ("repos"). In a repurchase agreement with a bank, the supplier of funds "purchases" a security from a bank under an agreement to resell at a later date for a higher price. Although structured as a purchase and sale of a security, in economic substance the repurchase agreement is a loan secured by the securities that are ostensibly being bought and sold. A corporate treasurer can make an arrangement with a bank to place funds in automatically renewable overnight repurchase agreements, subject to the understanding that upon instructions from the corporate treasurer the bank will transmit (by wire or otherwise) some or all of the repurchase amount to a specified third party. Alternatively, rather than structuring the transaction as a renewable overnight repurchase agreement, the bank and the customer can agree on an open repo arrangement of indefinite term but callable on demand.⁸⁵ At least some banks—probably most business-oriented banks—have made repos as convenient an arrangement as possible with their customers by adopting minimum balance policies "under which any excess deposit balances the customer holds with them are automatically invested in repo."⁸⁶ The effect of these repurchase arrangements is substantially similar to a standard deposit account; but since the repo is technically a sale of securities and not a deposit, the bank pays no deposit insurance on the arrangement and can pass these cost savings along to the corporate customer. As yet, repo arrangements such as this appear to be available only to larger corporate accounts. Thus ordinary depositors do not obtain the benefits of this form of nondeposit transaction arrangement.⁸⁷

83. See M. Stigum, *The Money Market* at 47 (3d ed. 1990).

84. *Id.* at 46-47.

85. *Id.* at 436.

86. *Id.* at 437.

87. We argue elsewhere that banks may begin to offer retail customers some of these benefits by means of "retail repos". See Macey & Miller, *Nondeposit Deposits and the Future of Bank Regulation*, — *Michigan L. Rev.* —

Other things equal, there appears to be little reason as a matter of policy why ordinary individual depositors should not be allowed to make the considered choice to place their funds in uninsured transaction accounts at a bank. At the moment, it is difficult for ordinary bank customers to effectuate that choice, although relatively easy for larger customers. The consumer choice bank would rectify that disparity and allow smaller consumers a wider range of choice regarding their transaction accounts than they enjoy under the present banking system.

3. FACILITATING THE FLOW OF CAPITAL INTO THE BANKING SYSTEM

We have already seen that a consumer choice bank can be structured as a nonbank bank and that an institution owning or controlling such a bank would not thereby be classified as a bank holding company for purposes of the activities restrictions of the Bank Holding Company Act.⁸⁸ It appears quite possible that such a nonbank bank could operate as a viable business entity today, despite the assumption by the drafters of the 1987 legislation that they were closing the nonbank bank "loophole."⁸⁹

As noted above, depository institutions might not suffer excessive costs—and might actually benefit—from electing to operate without federal deposit insurance.⁹⁰ It also seems feasible to satisfy the additional requirement—that the institution either avoid offering demand deposits or stay out of the business of making commercial loans — without prohibitive limitations on operations. A nonbank bank might raise capital by offering only instruments such as certificates of deposit and time deposits. More likely, it could stay out of the business of making commercial loans, devoting its assets instead to home mortgages, personal loans, and investments in money market instruments such as commercial paper. This institution could even make a limited amount of traditional commercial loans so long as it did not engage in the "business" of making such loans.

(1992). As yet, however, the use of repos as transaction accounts appears to be nearly exclusively reserved for large customers.

88. See notes 61-70 and accompanying text *supra*.

89. The Senate Report predicted confidently that upon enactment of the proposed legislation "[t]he nonbank bank loophole is closed." Competitive Equality Banking Act of 1987, Report of the Senate Committee on Banking, Housing and Urban Affairs, S. Rep. No. 100-19, 100th Cong., 1st Sess. 3 (1987). The Conference Committee agreed. Competitive Equality Banking Act of 1987, H.R. Rep. No. 100-261, 100th Cong., 1st Sess. 119 (1987).

90. See notes 71-79 and accompanying text *supra*.

In light of recent experience, it hardly seems an enormous sacrifice for a banking institution to eschew the commercial loan market. As we demonstrate in prior work,⁹¹ technological and market changes have left commercial banks with increasingly risky loan portfolios as stable borrowers turned to direct, nonintermediated markets (most importantly, the commercial paper market) to meet their financing needs. Given that commercial loans are evidently less attractive investments than they were in years past, the costs of exiting the business would not appear nearly as substantial as they might once have been. The nonbank bank, in short, may remain a viable form of depository institution for the provision of banking services in the 1990s.

If structured as a nonbank bank, the consumer choice bank would offer the potential for allowing new capital into the banking system from the nonbank sector. As long as the consumer choice bank limited itself to funding sources not withdrawable on demand, or stayed out of the business of making commercial loans, the strictures of the Bank Holding Company Act would not apply to an institution owning or controlling such an institution. Thus, consumer choice nonbank banks could be owned or controlled by firms engaged in all sorts of industrial or financial activities. This limited breakdown of the barrier between banking and commerce would facilitate the influx of new capital into the banking industry at a time when the existing capital has been reduced by operational losses. Consumers and the banking system as a whole stand to benefit.

4. PRESERVING THE DUAL BANKING SYSTEM

Another potential advantage of the consumer choice bank is its potential role in serving the beneficial goals of the dual banking system. As analyzed by Professor Kenneth Scott in a seminal article,⁹² The dual banking system can be understood and justified as a means of facilitating competition among regulatory agencies for charters, thus causing the regulatory system as a whole to move in the direction of economic efficiency. In Professor Scott's model, the dual banking system allows depository institutions to select their own regulators — for example, by converting between federal and state charters depending on the

91. See Macey & Miller, *America's Banking System: The Origins and Future of the Current Crisis*, 69 *Wash. U.L.Q.* 769 (1991).

92. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 *Stan. L. Rev.* 1 (1977). For a discussion and partial critique, see Miller, *The Future of the Dual Banking System*, 53 *Brook. L. Rev.* 1 (1987).

circumstances — and thus avoid becoming trapped by a regulator and subjected to unnecessary, burdensome and inefficient regulations.

The Scott thesis has been challenged by subsequent work by Butler and Macey demonstrating that the competition between state and federal regulators is steadily diminishing as Congress increasingly preempts state regulations.⁹³ Congress provided substantial validation of the Butler-Macey critique in FDICIA, which, as already noted, imposes sweeping preemptive federal constraints on the operations of state-chartered savings associations and nearly as sweeping regulations on those of insured state-chartered banks.⁹⁴

Consumer choice banks would represent at least a partial return to the more flexible regulatory environment praised by Professor Scott. We have seen that consumer choice banks would operate free of most — although not all — of the preemptive federal legislation otherwise applicable to state-chartered institutions. If consumer choice banks turn out to be preferable means of conducting a depository institution business as compared with banks operating with deposit insurance under existing federal regulation, the depository institutions in question could shift some or all of their operations over to the uninsured depository facility, thus avoiding federal regulations which might be unnecessarily restrictive on the institution's activities or policies.

Consumer choice banks, moreover, would appear to serve an essential value of federalism which underlies the dual banking system: the value of facilitating experimentation with new forms of doing business at the state level in order to develop a more efficient economic system nationwide. The notion of the states as "laboratories" for economic experimentation, common since Justice Brandeis' dissenting opinion in *New State Ice Co. v. Leibman*,⁹⁵ would appear to be well-served by consumer choice banks, which allow the states the regulatory and operational flexibility to structure the activities of banks chartered within their borders in accordance with a state's own view of proper public policy.

The ability of consumer choice banks to engage in investments or activities not permitted to insured depository institutions should not be seen as any kind of regulatory accident.

93. Butler & Macey, *The Myth of Competition in the Dual Banking System*, 73 *Cornell L. Rev.* 677 (1988).

94. See *supra* notes 18-21 and accompanying text.

95. 285 U.S. 262 (1932).

Congress has deliberately determined to restrict preemptive federal legislation, for the most part, to insured depository institutions, as to which the federal interest in preserving the federal deposit insurance funds is direct and immediate. Congress has not abandoned the principle of allowing states to determine the nature and scope of the regulations applicable to state-chartered banks. Even the most recent legislation, passed in the midst of the greatest crisis in the banking industry since the 1930s, does not significantly limit the activities and powers of uninsured state-chartered banks: Congress elected to impose the strictures of FDICIA section 303 only on insured institutions, and left open the option for uninsured institutions to continue to engage in activities or make investments as authorized under state law.

Accordingly, uninsured depository facilities do not run counter to the fundamental tenor of congressional enactments in this area. On the contrary, they are consistent with Congress' repeated insistence that state authorities should have principal responsibility to define the nature and extent of the powers of state-chartered banking institutions.

Potential Costs of Consumer Choice Banks. — Against these benefits, the consumer choice bank creates a number of potential costs. These include the following: (1) the danger that consumers will confuse uninsured with insured deposits, and place funds in uninsured accounts in the mistaken belief that they are insured; (2) the danger that uninsured depository facilities will effectively "free ride" on the atmosphere of trust and confidence in the banking system that is created by the pervasive presence of federal deposit insurance; and (3) the danger that uninsured depository facilities will be subject to runs that might spill over to other depository institutions, eventually causing systemic problems.

1. THE PROBLEM OF CONSUMER CONFUSION

The principal argument against the utility of consumer choice banks would appear to be the concern for consumer confusion. The argument is that the pervasive existence of deposit insurance among the nation's depository institutions may lull consumers into believing that their deposits at depository institutions are insured even when they are not. Consumers who in good faith deposit money in an uninsured bank in the reasonable expectation the money will be safe even if the bank fails are in for a rude shock when they discover that the facts are otherwise. The result could be a significant, unanticipated loss for the depositors, a loss which they would willingly have avoided — for example, by

depositing their funds in a lower-yielding, insured deposit elsewhere — had they known about the risk they were taking on at the uninsured institution.

The object lesson for these arguments was the experience of depositors in privately insured savings and loans and credit unions in Ohio,⁹⁶ Maryland,⁹⁷ and Rhode Island,⁹⁸ many of whom apparently deposited funds under the belief that the deposits were insured by a government body. As it turned out, the deposits were not insured by any government body, at least not *ex ante*, and depositors in the failed institutions were threatened with loss. The unfortunate experience in these states has been thought to teach two lessons: first, that federal deposit insurance is necessary to prevent panics; and, second, that consumers are easily misled into believing that their deposits are insured when in fact they are not.

It does not follow, however, that deposit insurance is necessary to prevent panics or that consumers are necessarily confused about whether their accounts are insured or not. The unfortunate situations in Rhode Island, Ohio and Maryland appeared to stem in substantial part from the fact that the agencies insuring deposits in those states had names that invited consumers into the erroneous belief that their deposits were insured by a state agency.⁹⁹ As long as full disclosure is made to consumers that accounts at consumer choice banks are not insured, the chance of consumer confusion would be minimized. Consumers can be trusted to make competent and informed decisions about what to do with their money if given sufficient disclosure about the risks involved in their decisions. Existing law already requires that consumers be carefully warned about the risks of depositing their funds in a consumer choice bank.¹⁰⁰ If further safeguards are re-

96. See Garsson, *The Ohio Thrift Crisis*, *Am. Banker*, March 22, 1985, at 1.

97. See Report of the Special Counsel on the Maryland Savings and Loan Crisis, *Am. Banker*, June 6, 1986, at 4.

98. See 77 Federal Reserve Bulletin 425 (1991) (statement of Richard Syron, President, Federal Reserve Bank of Boston, to the Subcommittee on General Oversight and Investigations of the House Committee on Banking, Finance and Urban Affairs); Atkinson, *Credit Unions: Collapse of Private Insurer Keeps Eyes on Rhode Island*, *Am. Banker*, January 29, 1991.

99. The Rhode Island insurance firm was the "Rhode Island Share and Deposit Indemnity Corporation," see 77 Federal Reserve Bulletin 425 (1991) (statement of Richard Syron, President, Federal Reserve Bank of Boston). The Maryland insurer was known as the "Maryland Savings Share Insurance Fund," see *Let's Cancel Private Bank Insurance*, *N.Y. Times*, May 15, 1985.

100. See *supra* notes 18-20 and accompanying text.

quired, it would be perfectly possible for states to impose them as a matter of state law.

2. FREE RIDER PROBLEMS

A related objection to consumer choice banks is that such institutions would implicitly free ride on a public good created by the federal deposit insurance programs, namely the confidence with which the public views the nation's banking system generally as a result of the fact that the vast majority of depository institutions are federally insured. According to this argument, consumer choice banks would be able to attract deposits in such an atmosphere of public trust and confidence at a much lower cost of funds than they would have to pay if most banks were uninsured. Thus consumer choice banks would be implicitly subsidized by insured banks that must pay federal deposit insurance assessments.

Like the consumer confusion argument, the free rider argument is essentially premised on the notion that the public cannot reliably distinguish between insured and uninsured institutions. If the public can reliably distinguish between these types of institutions, the consumer choice bank would not have much ability to free ride on insured depository institutions, simply because the public's confidence in insured depository institutions would not spill over to uninsured institutions. By the same token, if the public can reliably distinguish between insured and uninsured institutions, the failure of an uninsured institution should not significantly reduce public confidence in the integrity of their deposits in insured institutions.

Moreover, while depositors in consumer choice banks would obviously be subject to greater failure risk than holders of deposits insured by the FDIC (who face no risk), it is not clear that consumer choice banks would actually present a serious failure risk in most cases. Recall that such banks would be regulated by the states, which might elect to impose special regulations in light of the absence of deposit insurance. Moreover, the managers of consumer choice banks, because they are subject to real depositor monitoring, can be expected to work hard to ensure the bank's solvency and to provide assurances to depositors that their funds are not in jeopardy. One would expect that, other things equal, consumer choice would on average be more conservatively managed than insured banks because depositors would demand assurances of careful management before entrusting their funds to an uninsured account.

Even if some degree of free riding on the public's trust in depository institutions is possible for consumer choice banks, that cost must be weighed against the substantial public benefits that these banks appear to offer, in the form of more efficient operations, potentially beneficial economies of scope through the mixing of banking and nonbanking financial activities, and more motivated managers subject to the lash of depositor discipline. On balance, the costs of free riding do not appear significant enough to raise serious concerns about the utility of consumer choice banks.

3. RUNS AND PANICS

A final major argument against consumer choice banks is that, even if depositors in such banks are fully informed of the risks of their investments, and even if the problem of free-riding on public confidence in the banking system is not serious, there is still the danger that runs on consumer choice banks would spread to insured depository institutions, or to many other uninsured institutions, to the potential detriment of the economy as a whole.

While this problem cannot be discounted, it appears that the limited experiment in consumer choice banks we recommend in this paper would not pose a serious risk of systemic breakdown. If, as we have suggested, consumers could distinguish insured from uninsured banks, it is exceedingly unlikely that the failure of a consumer choice bank, or even of a substantial number of such banks, would spread to the insured segment of the industry. It is true that the failures of private insurance systems in Maryland, Ohio and Rhode Island caused minor panics at institutions covered by the private insurance systems. In those cases, however, the panics were understandable since the information available to depositors — that the private insurance fund was insolvent — applied to all the banks covered by the insurers in question. The risks of consumer choice banks would not be so heavily cross-correlated. Moreover, the panics in those states did not spill out to any significant degree into the insured bank sector. The public was evidently able to distinguish between institutions that were governmentally insured and ones that were not. There is, accordingly, little reason to believe that the establishment of consumer choice banks would create any significant risk of a widespread bank panic.

CONCLUSION

This article has explored a regulatory option that appears to

be relatively untested in today's changing banking marketplace: the uninsured deposit facility or consumer choice bank. We have demonstrated that the legal regulations applicable to consumer choice banks would be significantly different than those applicable to similarly situated insured banks. Consumer choice banks can potentially engage in a considerably broader range of activities than can their insured cousins. This is not to say that consumer choice banks would be unregulated: to the contrary, they would be subject to some, albeit minimal, federal regulation and to whatever substantive regulations might be imposed by their chartering states.

On the whole, consumer choice banks would appear to offer significant benefits for banking institutions, for consumers and for the economic system. The banking industry today is experiencing competition from money market mutual funds and other nonbank institutions that are not required to pay the increasingly expensive deposit insurance assessments. Even under the forthcoming regime of risk-adjusted deposit insurance premiums, it is not clear that the banking industry will be able to withstand this competition without serious stress. The consumer choice bank offers a more level regulatory playing field in which the competition between banks and mutual funds can play itself out to the benefit of consumers of financial services generally.

Another advantage of the consumer choice bank is that it offers to consumers and small businesses the option, now available principally to wealthy individuals and to larger businesses, of committing funds to an uninsured transaction account. Other things equal, there appears to be little merit in denying ordinary consumers access to the higher interest rates that uninsured bank accounts would offer as compared with insured accounts.

Consumer choice banks would, if structured as nonbank banks, permit the inflow of new capital into the banking industry from firms that are not permitted to acquire an insured institution because their activities are not deemed closely related to banking under the Bank Holding Company Act. Other things equal, the inflow of new capital would appear to offer significant potential benefits for the condition of this distressed industry.

The consumer choice bank would facilitate a relatively controlled experiment with deregulation of the banking industry. Because consumer choice banks are not generally subject to the pervasive preemptive federal regulatory scheme which applies to all insured depository institutions to one degree or another, such banks could, at the option of their chartering states, be allowed to

engage in a broader range of activities and investments than is permissible for their insured cousins. The experience of uninsured depository facilities could then be assessed in determining whether it would be wise to allow insured institutions to engage in similar activities.

Moreover, the consumer choice bank would facilitate the realization of ideals of federalism which have long animated the bank regulatory structure. A principal justification of the dual banking system is that it permits genuine differences in regulatory treatment to exist between different types of depository institutions. The regulatory options available under the dual banking system have been increasingly suppressed of late as the federal government has exercised its preemptive muscle to cast a blanket of uniformity over the industry. The consumer choice bank represents a partial return to the ideals of federalism and freedom of movement among regulatory regimes that have traditionally characterized our dual banking system.

While the consumer choice bank offers a variety of benefits, it is not without potential costs. We recognize that consumers would be ill-served if they were induced to believe that their deposits in a consumer choice bank were in fact insured. Moreover, if there is even a colorable claim of confusion, depositors who have suffered loss in a consumer choice bank will lobby the political system to reimburse their losses. However, existing law already requires substantial disclosure that the deposits are not insured and that the depositor stands to suffer loss if the bank fails. States would be free to impose such additional disclosure or consumer protection requirements as they see fit. Thus there would appear to be adequate safeguards in place already, or within the reach of state regulators, to overcome the danger of consumer confusion.

Another potential danger of consumer choice banks is the possibility that they will free ride on the public good of public confidence in the banking system that is created by the deposit insurance system. If such free riding in fact took place to a significant extent, consumer choice banks might be seen as imposing a cost on society in that the amount of federal deposit insurance and the level of public confidence in the banking system would be lower under a system of consumer choice banks than it would be if uninsured depository facilities could be made to pay for the benefit they receive from federal deposit insurance. However, we believe that the free riding problem would not be significant if the danger of public confusion is successfully overcome. If the public

understands that a bank that fails is an uninsured bank, the level of confidence in the insured segment of the banking system will not be seriously eroded by publicity given to failures of uninsured banks.

A third possible danger is the disruptive effect of runs and panics. Although state bank regulators could mitigate the run danger to an extent by capital adequacy regulation, there is no question but that a consumer choice bank, even one subject to capital adequacy regulation at the state level, is subject to runs in a way that an insured bank is not. This fact alone, however, is not a conclusive demonstration of the social disutility of the consumer choice bank. The social costs of a bank run may not be overly severe if the run does not spread to a generalized panic. Moreover, bank runs have benefits as well as costs. The threat of a bank run keeps bank managers alert to the welfare of depositors and the safety and soundness of their banks. And the speed with which a depository institution is closed in a bank run may represent a net social benefit if the institution is losing money and should be closed quickly.

The panic problem is somewhat more problematic. No one would want to see a repeat of the bank panic of 1933. As long as uninsured depository facilities remain a relatively limited part of the financial services sector, however, the danger that the failure of any one institution or even the linked failure of several such institutions would turn into generalized panic does not seem realistic, especially if the public is sufficiently informed that a run on an uninsured depository facility does not threaten insured institutions.

In short, we recommend that the banking industry and state bank regulators consider the possible utility of the uninsured depository facility, or consumer choice bank, as a new form — albeit one with a long pedigree — for the provision of financial products and services in the rapidly changing banking marketplace of the 1990s.

