

FINANCIAL REGULATION AND THE FRAGILITY OF THE BANKING SYSTEM

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Since the mid-1970s, public policy in the United States has sought to deregulate economic activity on a wider front. However, over the last several years, the regulation of banks has become much broader and far more restrictive.

The extremely forceful regulation by Federal bank supervisors pressured banks to reduce the extension of credit to private borrowers. The resulting decrease in the availability of funds and higher interest rates were felt particularly by small businesses. The more stringent examination standards — especially those imposed by the Comptroller of the Currency — were applied with the goal of increasing the “safety and soundness” of individual institutions. However, the unintended result was a serious weakening of the banking system as a whole.

In late 1991, the U.S. Congress adopted — and the President signed — legislation that will have a severely adverse effect on the stability and efficiency of the nation’s banking system in the years ahead. Spurred by the desire to protect commercial banks from the kind of loss-driven crisis that engulfed savings and loan associations (S&Ls) and taxpayers from the related costs, Congress mandated numerous regulatory changes that will limit the range of financial activities in which banks can engage, raise the level and costs of capital requirements, and thrust supervisors much more deeply into the day-to-day management of financial institutions.

The main objectives of the new measures were (1) to enhance the “safety and soundness” of insured institutions, (2) to minimize potential drains on the Federal insurance funds, and (3) to increase the ability of both borrowers and lenders to match risks and returns in the marketplace. Yet, as the numerous and complex provisions in the bill are implemented over the next several years, the expected benefits are likely to fall considerably short of the actual costs.

This range of adverse consequences is illustrated by the expected impact of the bill’s mandates in several areas: (1) capital requirements, (2) brokered deposits, (3) resolution of bank failures, and (4) Federal Reserve lending to distressed institutions.

EXPANDED ROLE OF NATIONAL BANK EXAMINERS

Effective in the Winter of 1990, the U.S. Comptroller of the Currency instructed National Bank examiners to employ much more rigorous standards in the evaluation of risk in commercial banks’ loan portfolios. The principal target was commercial real estate, but commercial and industrial loans were also examined more closely.

Essentially, the examiners made inappropriate use of appraisal techniques, discounted cash flow analyses, and other methods whose overall effect was to mark-to-market assets which banks ordinarily carry at book value. These more rigorous valuation standards basically assumed the borrower was going-out-of-business soon and would be forced to liquidate the collateral securing the loan in the currently depressed market.

In some cases, 25 percent to 50 percent of banks’ commercial real estate loans were downgraded by 2 to 3 risk levels. As a result, many banks had to increase their loan loss

CHART 1
Changes in Banks' Real Estate Lending Practices
1980-91

Category	Traditional Practices, 1980	Liberal Practices, 1989	Restrictive Practices, 1991
Land Loans	No	Yes	No (Yes, Special Case)
Construction Loans	Yes	Yes	No (Except to Complete Project)
Take-Out-Requirements	Yes	No	No
Long-Term Loans	No	Yes	Yes (Maturities Shortened)
Loan-to-Value Relations (percent)			
Equity Required	30-35	0-10	35-40
Loan Limit	70	100	65
Loan-to-Value Ratio	65-70	0-100	60-65
Interest Rates			
Class I Borrowers	Prime Rate	Prime Rate Less 2-3 pts.	Prime Rate Plus 1-2 pts.
Class II Borrowers	Prime Rate Plus 1-2 pts.	Prime Rate	Prime Rate Plus 3-4 pts.
Class III Borrowers	Prime Rate Plus 2-3 pts.	Prime Rate Plus 1-2 pts.	Prime Rate Plus 4-5 pts.

Source: Prepared by Brimmer & Company, Inc.

reserves while many others were forced to charge off significant proportions of their real estate portfolios. As a consequence, numerous previously creditworthy customers (especially real estate developers) could not qualify for new loans, and others were required to repay existing loans.

The more restrictive examination standards aborted a clear trend toward more liberal bank real estate lending policies. The changing profile is illustrated in Chart 1. In 1980, the average bank did not finance unimproved land, construction loans were short-term, and developers had to have a commitment from a long-term lender to assume the bank loan. Equity had to equal 30 percent to 35 percent of the market value of the project, so loan-to-value ratios were held in the 65 percent to 70 percent range. Only the most highly-rated borrowers were eligible for the prime interest rate, while less creditworthy borrowers paid 1 to 3 percentage points above prime.

TABLE 1
Credit Risk Ratings and Required Reserves, 1991
(Percent)

Loan Characteristics	Required Reserve
Very Low Risk	
1. Secured by cash, securities	1.0
2. Large national borrower	1.0
3. Large regional/local borrower	1.0
Low Risk	
4. Middle market borrower	5.0
5. Other assets especially mentioned	5.0
Moderate Risk	
6. Watch list	10.0
7. Substandard	20.0
High Risk	
8. Doubtful	50.0
9. Loss	100.0

Source: Prepared by Brimmer & Company, Inc.

By 1989, these long-standing practices had been greatly liberalized. Land loans were common place, and construction loans were long-term and not conditioned on a take-out commitment. Many developers put up as little as 10 percent equity, and some bank loans financed 100 percent of the property's market value. The best borrowers paid interest rates 2 to 3 percentage points below prime. Credit ratings of others had been upgraded, and they could get accommodation at prime or paid only 1 to 2 percentage points more.

Under pressure from bank supervisors, virtually all banks adopted more conservative real estate lending policies. In fact, they retreated almost to the guidelines they followed in the early 1980s. By some measures, they back-tracked even further — especially with respect to increased equity investment and higher interest rates.

As a result of the severe regulatory pressure, commercial and industrial loans at many banks were also downgraded to higher risk categories which require higher loan loss reserve ratios. Table 1 shows the configuration of business loans, risk assessment, and loan loss reserves required in an average bank. Requirements range from 1.0 percent on credits carrying very little risk, to 5.0 percent for those posing low risk, to 10-20 percent for those with moderate risk. Loans whose repayment is doubtful carry reserves of 50 percent. A 100 percent reserve applies in those cases where a loss is virtually certain.

Beginning in 1990, commercial banks also tightened the standards applicable to commercial and industrial firms. The most significant change was a decrease in credit ratings. In general, the average borrower was demoted 1 to 2 notches on the risk scale. As a result, many credit lines were cut back, and numerous outstanding loans had to be paid off. Furthermore, average loan maturities were shortened, and many firms (which had previously borrowed on an unsecured basis) had to post collateral.

TABLE 2
Interest Rates on Commercial and Industrial Loans^a by Size
1988-91

Category	May 1988	Nov 1988	May 1989	Nov 1989	May 1990	Nov 1990	May 1991	Nov 1991
Small Loans (S) ^b	11.41	12.19	13.53	12.67	12.34	12.54	11.91	9.19
Spread (S-P)	2.91	2.19	2.03	2.17	2.34	2.54	2.69	1.60
Prime Rate	8.50	10.00	11.50	10.50	10.00	10.00	8.50	7.58
Large Loans (L) ^c	7.71	9.42	11.10	9.81	9.43	9.08	6.74	5.73
Spread (L-P)	-0.79	-0.58	-0.40	-0.69	-0.57	-0.92	-1.76	-1.85

^a Fixed rate loans with maturities under one year.

^b Small Loan average size: \$1 - \$99,000.

^c Large Loan average size: Over \$1,000,000 except May and November, 1991: Over \$10,000,000.

Source: Prepared by Brimmer & Company, Inc. Data from Federal Reserve Board, *Terms of Lending at Commercial Banks, Survey of Loans Made*. Quarterly Data Published Irregularly.

The severe tightening of bank lending practices had a substantially adverse effect on the availability and cost of credit to small businesses. As shown in Table 2, the difference between the prime rate and interest rates on small loans (virtually all of which go to small firms) rose significantly from mid-1989 to mid-1991. Over this period, the differential widened from 2.03 percentage points to 2.69 percentage points. In contrast, the interest rates on large loans (extended to large borrowers) lagged even further behind the prime rate. Here the spread widened from -0.40 percentage point to -1.76 percentage points.

With the onset of the 1990-91 recession — and the subsequent easing of monetary policy by the Federal Reserve — interest rates decreased. The spread between the prime rate and interest rates on small bank loans also narrowed somewhat. Yet, the differential between rates on small and large loans became wider.

CAPITAL REQUIREMENTS AND MANDATORY INTERVENTION

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDIC/IA) was adopted by Congress on 27 November 1991 and signed by the President on 19 December 1991. Among other provisions, it instructed Federal bank supervisors to develop detailed regulations under which they must intervene in the management of insured financial institutions under a variety of circumstances. The basic objective of this part of the bill was to force regulators to act quickly to minimize the impact of a distressed institution's ultimate failure on the Bank Insurance Fund (BIF).

The regulatory scheme to achieve this goal consists of an array of capital requirements and mandatory actions which primary bank supervisors must take according to a specified timetable. The approach is outlined in Chart 2. Within one year after the bill's enactment, regulators must establish five categories of institutions based on capital adequacy, and each bank must be assigned to one of them. They are (1) well capitalized,

CHART 2
Bank Capital Standards and Required Regulatory Response

Capital Classification ^a (Leverage Capital Ratio)	Relation to Capital Standard	Regulatory Restrictions
(1) Well capitalized (over 6 percent).	Significantly above standard.	None. May continue to accept brokered deposits and underwrite insurance in states where they were engaged in activity prior to 21 November 1991.
(2) Adequately capitalized (5-5.9 percent)	Meets relevant standards.	None. May request FDIC approval to accept brokered deposits.
(3) Undercapitalized (3-4.9 percent).	Fails at least one standard.	Close regulatory surveillance. Must submit a capital restoration plan within 45 days of designation. Limits imposed on asset growth, acquisitions, and ability to borrow from Federal Reserve Bank.
(4) Significantly undercapitalized (2-2.9 percent).	Significantly below standard.	Prohibition of payment of bonuses or granting of pay raises without regulatory approval. May be ordered to elect new Board of Directors or hire new officers. Regulators can set limits on deposit rates; mandate sale of new stock; impose restrictions on transactions with affiliates; order sale of the latter; or order sale of the institution.
(5) Critically undercapitalized (Under 2 percent).	Below 2 percent of assets.	Payments on subordinated debt must cease within 60 days after designation. Bank must be placed in conservatorship, receivership or liquidated within 90 days unless regulators agree on an alternative plan.

^a Capital classifications were not defined in the bill. However, it is assumed that a variation of the existing risk-based capital requirements will be adopted initially. Under the latter, Tier 1 capital (consisting mainly of common and perpetual preferred stock and undistributed profits) is expressed as a percentage of average total assets less goodwill to yield the leverage capital ratio for banks. Percentage estimated in classes (1) through (4) by Brimmer & Company, Inc.

Source: Prepared by Brimmer & Company, Inc. Summary of selected provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991.

(2) adequately capitalized, (3) undercapitalized, (4) significantly undercapitalized, and (5) critically undercapitalized (where capital is below 2 percent of assets). Except for category (5), the bill did not define the capital standards to be used in classifying the institutions. Bank supervisors must develop detailed regulations within one year.

However, from the legislative record, it appears that Congress assumed bank regulators would adopt some version of the risk-based capital requirements currently in force. Under the latter, Tier 1 capital (consisting mainly of common and perpetual preferred stock plus undistributed profits) is expressed as a percentage of average total assets less goodwill to yield the leverage capital ratio. Tier 2 capital (made up mainly of subordinated long-term debt) is measured the same way. If the Tier 1 ratio were applied, the result would be a classification of institutions roughly as follows:

Classification	Capital Ratio
1. Well capitalized	Over 6.0
2. Adequately capitalized	5 - 5.9
3. Undercapitalized	3 - 4.9
4. Significantly undercapitalized	2 - 2.9
5. Critically undercapitalized	Under 2.0

The bank regulators also already have in place a rating system (usually referred to as CAMEL) for evaluating an institution's overall condition. The main elements of the scheme are shown in Table 3.

Five standards are considered and rated on a scale (1) through (5). In calculating an overall rating, the scores a bank receives for each standard are summed to produce a weighted average number (with differing weights applying to each standard). The illustrations in Table 3 suggest that Bank I (with an overall Rating of 1.40) was highly regarded by bank supervisors. Bank II (Rated 3.15) was in generally satisfactory condition. Bank III (Rated 4.40) was classified as unsatisfactory.

A bank's overall rating is kept confidential. However, in the industry, it is understood that only a few banking institutions (including J.P. Morgan) have a CAMEL Rating of 1.00. Perhaps a few dozen have a 2.00 Rating, and most of them are small-to-middle size institutions.

These CAMEL Ratings will most likely be used as a scale in classifying banks according to the new capital-driven scheme.

Once the new capital regime is in effect, banking institutions that are well capitalized would not be subject to explicit restrictions. They could also continue to accept brokered deposits — if they were engaged in that activity prior to 21 November 1991. Adequately capitalized banks would also be free of restrictions — except they would have to obtain FDIC approval before accepting brokered deposits.

Close regulatory surveillance would be triggered if a bank is classified as undercapitalized. The statute mandates that the primary regulator require the affected institution to submit a capital restoration plan within 45 days of being so designated. The supervisor must impose limits on the bank's asset growth and acquisition of other banks. Moreover, its ability to borrow from the Federal Reserve would be restricted.

As the position on the classification scale decreases, the pressure on regulators to intervene rises sharply. At the fourth stage (significantly undercapitalized), the institution is prohibited from paying bonuses or granting pay increases to officers without

TABLE 3
Federal Bank Examination Rating Standards

Rating	Examination Standard					
	Capital	Assets	Management	Earnings	Liquidity	Total
Weight:	35	25	10	15	15	100
Bank I						
1. Excellent	1		1		1	
2. Outstanding		2		2		
3. Satisfactory						
4. Substandard						
5. Unsatisfactory						
Sub Total	35	50	10	30	15	140
Total/Weighted Average						1.40
Bank II						
1. Excellent						
2. Outstanding						
3. Satisfactory	3	3	3		3	
4. Substandard				4		
5. Unsatisfactory						
Sub Total	105	75	30	60	45	315
Total/Weighted Average						3.15
Bank III						
1. Excellent						
2. Outstanding						
3. Satisfactory						
4. Substandard	4			5	4	
5. Unsatisfactory		5	4			
Sub Total	140	125	40	75	60	440
Total/Weighted Average						4.40

Source: Prepared by Brimmer & Company, Inc.

regulatory approval. It may also be ordered to elect new members of the Board of Directors or to employ new officers. Regulators can also set limits on deposit rates, mandate sale of common or preferred stock, impose restrictions on transactions with affiliates, order the sale of the latter, or force the sale of the entire institution. For all practical purposes, institutions in Class 5 (critically undercapitalized) come under the complete control of bank regulators. Once designated, the bank or holding company must cease payments on subordinated debt within 60 days. It must be placed in

TABLE 4
Assets, Capital, and Capital Ratios of
25 Largest Bank Holding Companies, 30 June 1991
(Ranked by Ratio Size)

Bank Holding Company	Risk-Adjusted Assets ^a	Tier 1 Capital ^a	Capital Ratio
1. Republic, NY	15.3	2.2	14.13
2. Fleet Norstar, RI	23.7	2.2	9.36
3. Bank One, OH	33.1	3.0	9.05
4. Sun Trust, GA	25.4	2.3	8.88
5. Norwest, MN	25.1	2.0	8.00
6. PNC, PA	34.8	2.7	7.74
7. First Union, NC	29.0	2.0	6.81
8. BankAmerica, CA	105.4	7.1	6.77
9. J.P. Morgan, NY	75.1	5.0	6.71
10. NCB, NC	50.6	3.4	6.69
11. C&S Sovran, GA	41.7	2.8	6.67
12. First Fidelity, NJ	20.3	1.3	6.63
13. Manufacturer Hannover, NY	58.2	3.5	6.09
14. First Interstate, CA	41.1	2.5	5.98
15. Barnett, FL	25.1	1.5	5.86
16. Bankers Trust, NY	47.4	2.8	5.84
17. First Chicago, IL	51.2	2.8	5.53
18. Wells Fargo, CA	50.5	2.7	5.41
19. Bank of New York, NY	46.6	2.4	5.12
20. Mellon, PA	26.8	1.4	5.12
21. Chemical, NY	67.8	3.4	5.05
22. Security Pacific, CA	78.4	3.9	4.92
23. Chase, NY	97.0	4.8	4.91
24. Bank of Boston, MA	28.6	1.4	4.80
25. Citicorp, NY	218.1	8.9	4.08

^aBillions of Dollars. Source: Prepared by Brimmer & Company. Data from American Banker [1991].

conservatorship, receivership, or liquidated within 90 days — unless regulators agree on an alternative plan.

The effect of the new regulatory regime on individual banks cannot be determined until regulations are promulgated (which must occur before the end of 1992). However, a rough idea is suggested by the data in Table 4. The figures show risk-adjusted assets, capital, and capital ratios for the 25 largest bank holding companies as of 30 June 1991. Thirteen of them would have fallen in Class (1), eight in Class (2), and four in Class (3). None of them would have been in Classes (4) or (5).

A significant number of smaller banks would have fallen into Class (5). In a survey conducted in late 1991 (based on statistics as of 30 June 1991), the American Banker identified 41 banks (with total assets of \$7.5 billion) whose Tier 1 capital equaled less than 2.0 percent of risk-adjusted assets [American Banker, 1991]. It identified an additional 32 banks (with total assets of \$13.7 billion) where the capital ratio was in the 2.0 to 3.0 range. (The survey also identified 82 savings and loan associations — with \$37.2 billion in assets — whose capital ratios were below 2.0 percent. Another 78 — with \$56.3 billion in assets — had capital ratios in the 2.0 to 3.0 range.)

So, for these 213 financial institutions (53 banks and 160 S&Ls), the imposition of the new capital standards would have had an extremely negative impact. It is quite likely that many of them would have been forced into liquidation without serious consideration being given to their long-run prospects for survival. Under the FDIC/IA newly mandated instructions to bank regulators, the latter would not have had the flexibility to work with the institutions to help them survive.

MARKET FOR BROKERED DEPOSITS

The FDIC/IA of 1991 essentially terminated the market for brokered deposits. This activity consists primarily of retail securities brokers accepting funds from their customers, accumulating amounts into accounts just under \$100,000, and redepositing them in insured institutions. The funds are usually channeled into certificates of deposit (CDs) at above-average interest rates.

This segment of the money market expanded substantially during the 1980s. It was employed heavily by S&Ls to attract funds — which were used to finance commercial real estate and other speculative ventures. Because of this linkage, Congressional critics argued that brokered deposits were a major cause of the S&L crisis, and they essentially sought to abolish the practice. Consequently, the banking bill mandated the FDIC (within 150 days) to promulgate regulations prohibiting all institutions (except those that are well capitalized) from accepting brokered deposits.

In fact, even before the legislation was adopted, bank regulators were already discouraging institutions from accepting such deposits. This was especially true in the case of S&Ls. Reflecting these regulatory pressures — and the liquidation of many S&Ls — the amount of brokered deposits on their books shrank from \$70.0 billion on 30 June 1989, to \$25.0 billion on 30 June 1991. This was a decline of 64.3 percent. Over the same period, brokered deposits at banks rose from \$32.0 billion to \$45.0 billion — a gain of 40.6 percent [American Banker, 1992].

While reliance on brokered deposits has not been widespread, they have been of substantial importance to a number of institutions — some of them fairly large. The 10 largest users of such deposits are shown in Table 5. The highest ratios were found at the three smallest institutions (where such funds represented 62.0 to 88.8 percent of total deposits). At three large banks (with total deposits of \$10.33 billion to \$16.14 billion), the proportion ranged from 18.7 to 24.5 percent. At the largest institution (with total deposits of \$57.50 billion), brokered deposits equaled 5.7 percent of the total.

The market for brokered deposits represented one of the most efficient segments of the banking system. It facilitated the mobilization of funds in surplus areas and channeled them to areas which faced a shortage. Simultaneously, it enabled savers to earn returns well above those prevailing in the local market — while benefiting from the safety provided by insurance. Therefore, by virtually prohibiting the use of brokered

TABLE 5
Ten Largest Users of Brokered Deposits
Ranked by Percentage of Total Deposits, 30 June 1991
(Amounts in Billions of Dollars)

Institution	Equity Ratio	Total Deposits	Brokered Deposits	
			Amount	Percent of Total
1. Sears Savings Bank	4.12	3.20	2.84	88.80
2. Greenwood Trust	12.96	4.46	3.05	65.70
3. Columbus S&L	-24.82	4.68	2.90	62.00
4. MBNA America Bank	7.34	4.78	2.33	48.70
5. Chase Manhattan Bank (USA)	8.14	5.49	1.96	35.70
6. Fleet National Bank	5.64	6.59	1.97	29.90
7. Continental Bank	6.53	16.14	3.96	24.50
8. Maryland National Bank	3.76	10.33	2.44	23.60
9. Pittsburgh National Bank	5.51	11.66	2.18	18.70
10. Chase Manhattan Bank	4.81	57.50	3.28	5.7

Source: Prepared by Brimmer & Company, Inc. Data from American Banker [1992].

deposits in the future, Congress drastically constricted one of the most efficient sectors of the banking system.

LEAST-COST RESOLUTION OF BANK FAILURES AND UNINSURED DEPOSITS

The bill mandated that the FDIC, in disposing of insolvent insured banks, use methods that result in the least cost to the Bank Insurance Fund. In general, the FDIC is prohibited from taking any steps that would result in protecting uninsured depositors. In the past, the FDIC usually sold all of a failed bank's deposits to a stronger bank which then carried on with the entire deposit business. The effect was to provide the equivalent of insurance for depositors with balances above the \$100,000 insurance limit. Under the new measure, the FDIC is essentially told not to sell uninsured deposits. Instead, it is to save on cash outflow by throwing them into the pool of general liabilities to be satisfied (at least in part) from the ultimate sale of the failed bank's other assets.

The result of implementing this new policy stands out clearly in the statistics. During the first 2½ months of 1992, the FDIC closed 21 failed banks. In nine of these (42.9 percent), uninsured depositors lost money. This was a dramatically higher proportion than was registered during the preceding three years: 1989, 32 of 206 (15.5 percent); 1990, 20 of 168 (11.9 percent), and 1991, 21 of 124 (16.9 percent).

These losers were mainly middle-sized and unsophisticated depositors. The truly large depositors — who can monitor banks' conditions and redeploy their funds in a timely fashion — cut their balances below the insurance ceiling well before the banks

failed. For example, 769 depositors held \$21.0 million in uninsured accounts in the nine failed banks in which losses were incurred in the January-mid-March period of 1992. The FDIC estimates that, by not covering these deposits, it saved \$5.0 million. Many of those who suffered losses were religious and charitable institutions and public agencies.

FEDERAL RESERVE LENDING AND SYSTEMIC RISK IN THE BANKING SYSTEM

The bank reform bill severely limits the ability of the Federal Reserve to cope with problems in financial markets which may arise from the sudden drainage of funds from commercial banks. The constraints are imposed by the provision which prohibits the Federal Reserve from lending to an undercapitalized institution for more than 60 days during any 120-day period — unless the bank's primary regulator provides a "certificate of viability".

If that condition is not met — and the Federal Reserve extends loans anyway — the System would be liable for part of any losses incurred by the Bank Insurance Fund if the institution fails.

This injunction cuts across the principal means the Federal Reserve has used to help banks through severe liquidity problems. The Federal Reserve Board states:

Extended credit is available to depository institutions, when similar assistance is not reasonably available from other sources, when exceptional circumstances or practices involve only a particular institution, or when an institution is experiencing difficulties adjusting to changing market conditions over a longer period of time. [Federal Reserve Bulletin, 1992, A8]

On a number of occasions in the past, the Federal Reserve has used its authority to make extended loans to prevent liquidity problems at one bank from spreading to other institutions or to the money and capital markets generally [Brimmer, 1989]:

- New York money market banks (1970). To replace commercial paper which could not be rolled over at the time of the Penn Central bankruptcy.
- Franklin National Bank failure (1974). To buy out defaulted foreign exchange contracts; to replace run off of CDs at other banks; to replace run off of Eurodollar deposits in London.
- Collapse of Silver Futures Prices (1980). To allow banks to lend to brokerage firms and to commodity speculators to cover losses caused by the sharp fall in silver prices.
- Continental Illinois (1984). To replace liquidity lost because of the sudden drain of Eurodollar deposits, interbank deposits, corporate balances, and federal funds.
- Southeast Bank (1991). To replace the run off of corporate, interbank, and other money market deposits while sale of the bank holding company was under active consideration.

All of these episodes involved situations in which the Federal Reserve had to act speedily as a lender of last resort. If it had not been willing — or been unable — to perform this function, one or more banks would have failed suddenly and most likely would have pulled down a number of otherwise sound institutions. Because of the restrictions imposed in the FDIC/IA of 1991, the Federal Reserve will be hampered in the future. As a result, the financial system as a whole will be exposed — unnecessarily — to greater risk of disruption.

CONCLUDING OBSERVATIONS

In summary — and contrary to expectations — as the more restrictive standards mandated by bank supervisors migrated through the banking system in 1990-91, credit availability was reduced, and a marked divergence occurred in interest rates. Small firms had to bear a disproportional share of the cutback in lending and the higher cost of credit. In contrast, the relative advantage enjoyed by the largest borrowers became even wider.

In the legislative arena, the banking bill which became law in December 1991, will most likely undermine the stability and efficiency of the banking system in coming years. In the mistaken belief that it was helping to enhance the “safety and soundness” of individual banks — and simultaneously protecting Federal insurance funds — Congress actually established an inflexible regulatory regime which will cut back on the scope of the financial activities in which banks can engage, increase the level and costs of capital requirements, make the money market less efficient, and involve regulators much more extensively in the internal affairs of banking institutions.

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