

What Reforms Are Needed to Improve the Safety and Soundness of the Banking System?

HARVEY ROSENBLUM

The author is executive vice president and director of research at the Federal Reserve Bank of Dallas. This commentary was presented at the conference “Safe and Sound Banking: Past, Present, and Future,” held August 17–18, 2006, and cosponsored by the Federal Reserve Banks of San Francisco and Atlanta and the founding editors of the Journal of Financial Services Research.

It is an honor for me to be included among the discussants at this conference to commemorate and evaluate the contributions and impact of Benston et al. in their 1986 work, *Perspectives on Safe and Sound Banking* (1986). My assignment is to focus particularly on the excellent and insightful paper by Flannery (2007) and, to a lesser extent, the fine papers written by Furlong and Kwan (2007) and by DeYoung (2007). The three papers dovetail beautifully and are difficult to separate.

Let me begin with my conclusions. First, the citizens of the United States and many other countries enjoy the benefits of a safer and sounder banking system in 2006 in comparison with that which existed in the early 1980s. Second, much of the improvement in the health and resilience of today’s banking system can be traced to the ideas contained in *Safe and Sound Banking* and to the passionate and persistent advocacy of these ideas by its authors. Much like the proverbial bulldog on a meat truck, they would not let go until many of their recommendations were enacted into law or supervisory practice. I have stated publicly in other venues that several of the authors of *Safe and Sound Banking* deserve the Nobel Prize in Economics—first, for the originality of their contributions to the fields of economics and finance that changed the conventional wisdom of the profession and, second, for the profound influence they have exerted on the improvement of economic policy.

While much has been accomplished to improve bank safety and soundness in the United States and elsewhere, further changes in legislation, regulation, and supervisory practices are necessary to capitalize upon and to further the improvements of the past twenty years. In analyzing the changes over the last two decades and in recommending additional reforms for the future, two themes will pervade my comments. First, don’t let the quest for perfection be the enemy of the good. (After all, even in the Bible, Genesis 1, God declares at the end of each day that his creations are good.) Second, many of the changes I recommend to further the agenda of a safer and sounder banking system for the world of 2006 and beyond could not have been anticipated by the authors of *Safe and Sound Banking* when they were writing the book in 1986, given the state of the world that existed in the early 1980s.

To further improve bank safety and soundness in the years ahead, I recommend that (1) banks be examined and rated specifically on their organizational complexity and (2) that systemically important banks that are too big to resolve quickly be recapitalized according to a model that is known in advance by their competitors and by the general public.

A Fundamentally Different Banking Industry?

Throughout the post–World War II period, the profits of the U.S. banking industry have tended to correlate fairly well with the growth and health of the overall economy. Recessions were generally accompanied and followed by a downturn in banking industry earnings. The U.S. economy experienced a short and mild recession in 2001 (some of which has since been revised away). If past relationships could be depended upon to predict the future, bank industry earnings would have declined in 2001, 2002, and perhaps even in 2003 as the macroeconomic recovery did not gain traction until late 2003. (Of course, if the past were a good predictor of the future, marriages would rarely end in divorce, and the Yankees would almost always win the World Series.)

It is interesting to note that during the 2001 recession and the period since, the banking industry has kept setting new profit records (Federal Deposit Insurance Corporation [FDIC] 2006). Are we living in the midst of a paradigm shift? This question is difficult, and not enough time has elapsed to answer it. Let me add that the strong earnings performance has held up in an environment where the yield curve has had a steep, positive slope (2003–04) and, more recently, when the slope of the yield curve has flattened and even turned slightly negative (2006). Allow me to stick my neck out by saying that the resiliency of the banking industry I know today is in many ways fundamentally different from the one I knew when I started my career with the Federal Reserve System in 1970. And I think many of the changes for the better are due, in large part, to the implementation of many of the policy recommendations found in *Safe and Sound Banking*.

What Has Changed? What Has Stayed the Same?

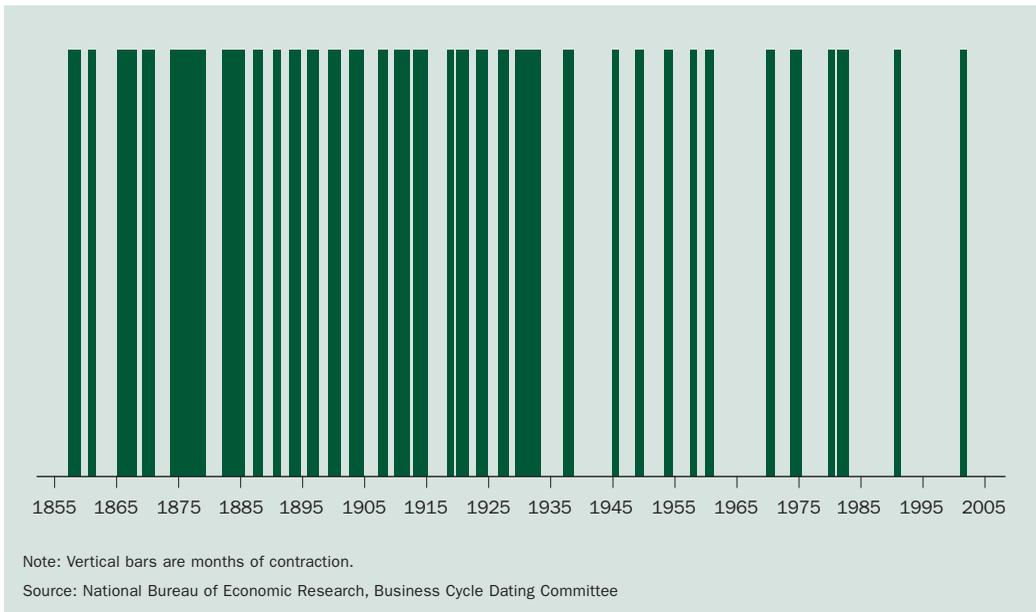
Several changes have occurred in the twenty years since the publication of *Safe and Sound Banking*. Because the impacts of these changes are mutually reinforcing, I list them in no particular order. The important changes include

- increased market discipline;
- increased bank capital, related to risks;
- prompt corrective action (PCA) coupled with transparency;
- a growing recognition that the concept of too big to fail (TBTF) is unacceptable;
- a macroeconomic environment of low and stable inflation combined with fairly steady economic growth, with the economy being in recession during only 15 of 240 months, or roughly 6 percent of the time—what Fed Chairman Ben Bernanke has labeled “the great moderation” (see Figures 1–4), keeping in mind that banking safety and soundness has benefited from, as well as contributed to, the reduction in economic volatility over the last twenty years; and
- broadened powers for banks to diversify across new product lines and geography.

Some things have not changed. Among the important recommendations that the U.S. Congress chose not to address are

- three bank supervisory agencies at the federal level,

Figure 1
Fewer Economic Downturns



- the dominance of book-value accounting,
- mission creep at the Federal Reserve, and
- mandatory issuance of subordinated debt.

In the remainder of my comments, I will examine some further changes that are needed and, just as important, one aspect of banking supervision and regulation that ought to be left alone.

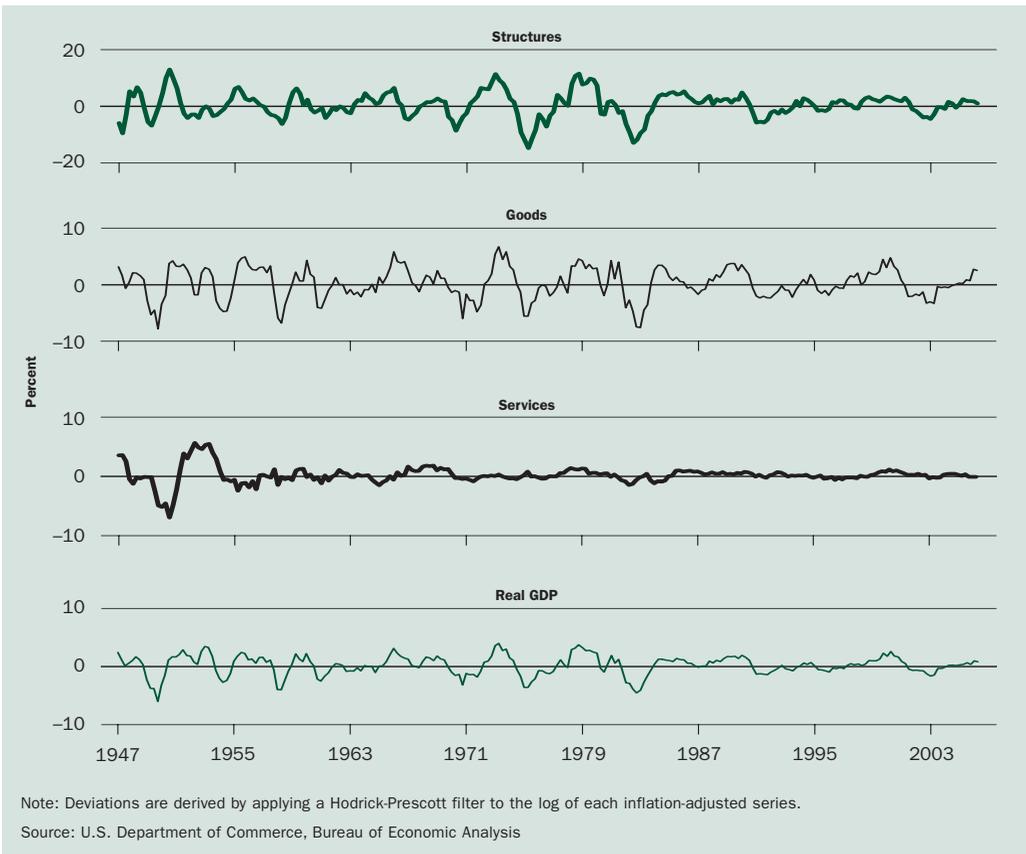
The Need for Further Changes and Improvements

In his introduction, Mark Flannery states that his goal is “to identify underresearched and/or underappreciated issues that affect bank safety and soundness or financial system stability.” Professor Flannery adds that he enjoys the “great luxury to write a paper that poses questions but is not required to provide complete answers” (Flannery 2007, 83). In my remarks, I plan to practice that same philosophy.

Market discipline—the role of credit-rating agencies. For as far back as I can remember, and probably for a lot longer, businesses and government entities that wished to borrow from the general public have found it necessary to have their credit-worthiness evaluated and rated by one or more credit-rating agencies. The two best-known agencies are Moody’s and Standard & Poor’s. These agencies are private-sector, for-profit companies. The general methodologies they use to assign credit ratings are public information and are typically covered in textbooks on finance and economics in chapters on the structure of interest rates (for example, see Kaufman 1995, Exhibit 7-1, 133; or Mishkin and Eakins 2005, chap. 5, table 1, 105).

I think of credit-rating agencies as the market’s somewhat imperfect attempt to provide a privatized form of supervision and regulation to parts of the financial system. Credit-rating agencies reduce information asymmetries, adverse selection, and moral-hazard problems, thereby enhancing the flow of credit in the economy. In this respect,

Figure 2
Deviations from Trend Real Growth

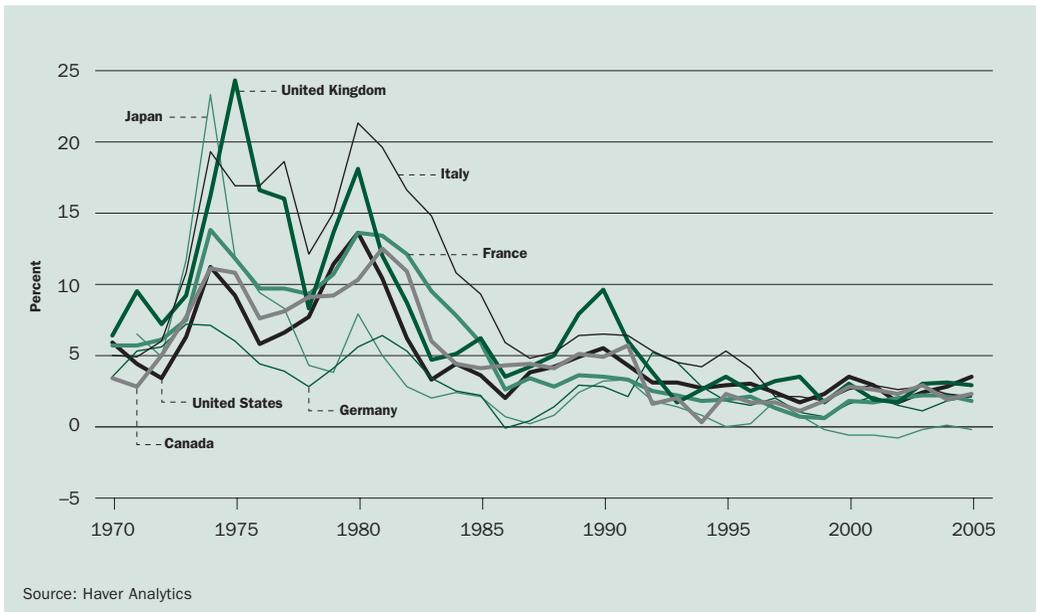


advocates of increased market discipline should champion the role played by existing credit-rating agencies and should support the creation of new ones to add more competition to that industry. Entry into this industry is restricted by the Securities and Exchange Commission (SEC), which certifies such companies as nationally recognized statistical rating organizations (NRSROs).

Flannery seems to lament the growing role of these private-sector firms in evaluating the creditworthiness of borrowers, particularly under Basel II. Flannery states, “Delegating credit evaluation to a private firm amounts to supervisory outsourcing, apparently based on the idea that the rating agencies provide better default risk assessments than examiners could” (p. 88). Let me offer a casual observation. I have my doubts about whether bank examiners would do a better job of evaluating debt default risk unless they had access to inside, nonpublic information. After all, examiners are trained to use the same credit analysis models and methodologies. If the only criterion were the quality of credit-rating judgments, I would assert that bank examiners and the credit-rating agencies would do equally good, but imperfect, jobs. Too many nonquantifiable uncertainties (in the Knightian sense) exist for credit-risk analysis to be perfect.

If we broaden the criteria to include the cost and speed of credit evaluation, the credit-rating agencies have a clear advantage over bank examiners since they provide and sell their ratings to thousands of interested clients. These economies of scale and

Figure 3
Global Decline in Inflation



scope should not be dismissed. So my question to Mark Flannery, to this audience, and to those who do financial research is, if not the credit-rating agencies who offer transparency—something that bank examiners do not—then what else is to be relied upon for credible analysis of credit risk at an affordable cost? Would freer entry into the credit-rating industry improve the quality and reduce the costs to consumers of credit ratings? Is seeking perfection the enemy of the good? If financial markets desire and need a better form of market-imposed discipline, why hasn't the entrepreneurial spirit fostered an innovation that provides better discipline than credit-rating agencies?

Increased bank capital. In discussing capital adequacy regulation, Professor Flannery asserts that supervisors “require bankers to hold more equity capital than they would otherwise choose to hold” (2007, 94). This statement is likely true but requires some qualifications. I would prefer to question how much equity capital banks would hold if there were no safety net in the form of federal deposit insurance, no central bank as a lender of last resort, and no public-sector supervision of the banking industry. Under these circumstances, how much capital would the market—that is, depositors and other creditors—demand of banks? Would it be more capital or less capital than required under present-day Basel I standards and future Basel II standards? My judgment tells me that, in the absence of the safety nets, the market would demand that banks hold more capital than required under Basel I or Basel II. If this assumption is true, then FDIC insurance provides a regulatory subsidy to the banking system, particularly because over 90 percent of banks have been paying no explicit premiums for deposit insurance in recent years.¹ Future research needs to address this issue.

1. The regulatory subsidy goes beyond federal deposit insurance, but I focus on that aspect because it dominates insured depositors' perception of bank safety. “Free” deposit insurance is about to become a thing of the past; see Adler (2006).

Figure 4
Declining Inflation Risk Premium



Some other relevant questions can be asked: Do banks increase their risk exposure when they perceive that supervisors require them to hold more capital than they otherwise would choose if left to their own devices? If so, are supervisory-imposed capital standards counterproductive in that they undermine bank safety and soundness? Do risk-based capital and risk-based deposit insurance premia complement one another—a kind of belt-and-suspenders system—or does this combination amount to legislative and supervisory overkill? After all, some optimal level of capital exists for each bank and the banking system, and the pursuit of safety and soundness can create a strong disincentive to the necessary risk appetite of the banking system and act as a brake on potential economic growth.

In this context, an additional question is worth raising—namely, just how much safety and soundness do we, as a society, really want? If near 100 percent safety and soundness is the goal, it can be accomplished via narrow banks or through a 100 percent reserves banking system (Litan 1987; Wallace 1996; Phillips 1995). If the goals are broader and more complex—as is the case for the Federal Reserve System, whose mandates include full employment and price stability in addition to bank safety and soundness—then capital regulations must adjust accordingly.

Let me posit that the real goal—which is rarely stated—is a financial intermediation system that can support a dynamic and growing economy subject to a safety and soundness constraint that can be different for each of the various types of intermediaries. Some of these financial intermediaries, which we call “banks,” are funded with a special class of liabilities, which we label “deposits.” These deposits are used to fund idiosyncratic loans that are a critically important source of credit that helps to fund a dynamically diverse and growing economy. This goal requires some risk-taking—more risk than under a goal of 100 percent safety and soundness.

Prompt corrective action and its interaction with the goals of monetary policy. If banks have a role—even a mission—to play in supporting noninflationary

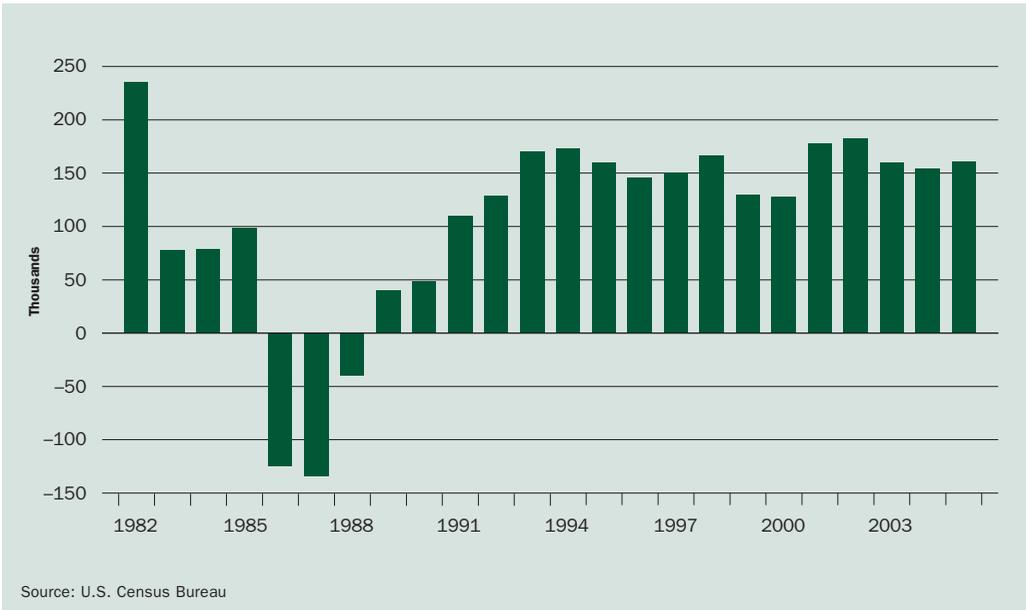
economic growth, then the issue of bank capital has to be viewed in a somewhat different way. Banks need to maintain a capital cushion in excess of the regulatory minimum in order to fund the lending necessary to support a growing economy. Under PCA, banks with less than the regulatory minimum cannot fund additional loans, though in the short run they can fund loans by selling Treasury securities that are not subject to a risk-based capital requirement. Such a bank is capital constrained and cannot expand its loan book. Indeed, a bank with capital below the regulatory minimum must shrink its loan book. If the aggregate of all banks in a nation, that is, the banking system, has a level of capital below the regulatory minimum, bank lending will ultimately shrink, and in all likelihood the quantity of money and credit in the economy will also be forced to decline, thereby triggering a contraction of macroeconomic activity.

When a large percentage of banks in a particular region do not meet their capital requirements, a decrease in bank lending at the regional level inevitably follows. This credit crunch is brought on by a shortage of bank capital. This situation happened in Texas in the second half of the 1980s and in New England in the early 1990s (Rosenblum 1990a, 1990b, 1991, 1999, 2002; Syron 1991; Peek and Rosengren 1995, 1996; Bernanke and Lown 1991; Rosenblum and Clair 1993). In this environment—that is, when capital requirements provide a binding constraint upon the size and growth of the banking system—monetary policy can become impotent in the sense that increasing the reserves of the banking system will not induce an expansion of bank credit and the money supply (Bliss and Kaufman 2002). This situation is somewhat parallel to a Keynesian liquidity trap. Clearly, the Federal Reserve has a large stake in the safety and soundness and capitalization of the banking system because the Fed’s legal mandate to achieve full employment implicitly requires a safe and sound, well-capitalized banking system.

With one brief and minor exception during the 1950s, the U.S. economy has not experienced nationwide deflation since the Great Depression. However, I can speak personally and anecdotally, but not statistically, about the regional deflation that hit Texas and a few surrounding energy-producing states in the second half of the 1980s. Since the Bureau of Labor Statistics and the Bureau of Economic Analysis do not produce state-level or regional price-level statistics, there are no consumer price index or personal consumption expenditure data that I can use to make my point. But housing, land, and other asset prices did fall, in some cases by more than half. No broad wage data are available either, but circumstantial evidence suggests that the value of human capital declined. Texas, which year in and year out typically experiences a large net in-migration from the rest of the United States and from foreign countries, actually experienced a net out-migration for a few years during the late 1980s. For example, net in-migration to Texas averaged 120,000 persons annually from 1982 to 1985 but changed to net annual out-migration of 100,000 from 1986 to 1988 (see Figure 5).

As bank capital declined with the increasing loan losses, bank credit and deposits declined as well. Texas job growth, which typically averages a full percentage point above the rate of U.S. job growth, was negative. Texans moved elsewhere to find employment. And this state of affairs occurred during an era when regulatory forbearance, rather than prompt corrective action, was supposedly the *modus operandi* of the bank supervisory agencies. This situation predated PCA, which did not become law until it was included as part of the Federal Deposit Insurance Corporation Act of 1991. Although I am only making a conjecture, I will assert that PCA would have accelerated and deepened the rate of money and credit contraction in response to the loan losses and capital write-offs in Texas that followed the sharp drop in oil prices from \$28 to roughly \$10 per barrel between November 1985 and January 1986.

Figure 5
Net Migration to Texas



PCA is designed to deal with instances where bank capital declines in a slow and orderly way and where capital can be raised while the bank is still clearly solvent and not on the edge of insolvency. PCA is also designed to induce a change in the behaviors of bankers and bank supervisors in situations where undercapitalized banks are isolated events. But what about the situation where seriously undercapitalized banks are the rule rather than the exception and the undercapitalized banks are geographically concentrated? Who will recapitalize these banks when their current and future prospects appear dismal?

PCA may not work well when dozens or hundreds of banks undergo a severe loss of capital after experiencing a common economic shock, or even a shock whose origin is not economic (say, a series of weather-induced shocks such as hurricanes, drought, or earthquakes). But this limitation does not mean that PCA is not a useful mechanism for quick and early correction of undercapitalized situations. The papers by Flannery (2007) and Furlong and Kwan (2007) seem reluctant to give credit to PCA for increasing bank safety and soundness. To my way of thinking, this reluctance exists because these authors expect PCA to work primarily by changing supervisory behavior. To be sure, a change in supervisors' behavior is a necessary condition for PCA to have its intended impact. But altered supervisory behavior is not a sufficient condition. For PCA to work as intended, bankers must have a complete understanding of PCA in advance and must adjust their behaviors accordingly. Knowing the consequences of failing to meet supervisory minimum capitalization, bankers will take extra precautions to keep their banks in the "well-capitalized" group and to avoid falling below the category of "adequately capitalized." They will also take extreme measures to avoid the risks that could push their banks into the categories of being "undercapitalized, significantly undercapitalized, or critically undercapitalized." The reason is simple. Bankers understand the consequences of being undercapitalized. These consequences include (1) requesting that current stockholders purchase more

capital, thereby having their ownership stake diluted; (2) accepting limits on asset growth; (3) facing restrictions on dividend payouts; and (4) if all of the above is not sufficient to get their attention, then facing restrictions on their compensation (Kaufman 1995, 298–99). If you want to get a banker's full, undivided attention, threaten him or her with reduced salary and no bonuses!

The bankers I come in contact with seem to be fully aware of these provisions of PCA, and they have changed their behaviors accordingly. This new attitude and the resulting behavior with respect to capital has been in place for well over a decade, long enough for these good behaviors to have become good habits. From the perspective of bank safety, these are good habits. PCA is working, at least under the types of economic stresses and strains of the last decade. Long live PCA.

The end of “too big to fail”—size versus complexity. Professor Flannery notes that “during the 1990s, U.S. supervisors appeared to become more comfortable with the notion that even relatively large bank failures could be resolved without systemic implications” (2007, 87). Further, he notes, and I would agree, that “this is a good development, but it has not been tested under stress.”

The issue here is not just one of “bigness.” It is more an issue of the complexity of the banking organization, particularly if its branches, subsidiaries, and offices are spread across several countries, each with its own supervisory scheme, most of which are different and far from harmonized. Basically, the issue boils down to which supervisor is in charge and who is responsible for what. To put it simply, there has been some, but not enough international cooperation in harmonizing bankruptcy practices across countries (see Herring 2002; Bliss 2003; Rosenblum 2003; and Mayes 2006). Moreover, because twenty-first century financial holding companies deal in a myriad of securities and derivative products that are regulated by a whole other set of functional regulators, it is not just banking rules that need to be harmonized. Some of these financial conglomerates are so complex that they have become what I have previously labeled “too complex to supervise” (Rosenblum 2003).

A tax on organizational complexity. Some financial companies have designed their corporate structures with a number of diverse goals in mind, including minimizing tax burdens and taking advantage of perceived laxity of regulation in some jurisdictions, all in an effort to maximize shareholder returns. In the process, their organization charts have begun to resemble a bowl of spaghetti with lines of communication, reporting, direction, and control becoming confusing, not only to outsiders looking in but to insiders as well. I have labeled such organizations “too complex to manage” (Rosenblum 2003). And I have recommended that the CAMELS ratings add another letter, an *O*, to represent either organizational complexity or opacity.² These issues related to complexity are the ones that allow a problem to go undetected and fester before it can be recognized and dealt with by both management and supervisors.

I will illustrate my point through a hypothetical example. Suppose a bank earns a passable 2 on its examination rating for each of the six categories in its CAMELS rating, thereby earning a composite rating of 2 on the 1–5 scale. But suppose that the supervisory authority deems the banking institution's organizational structure to be so unnecessarily complex and opaque that it gives the bank a 5 for organizational complexity—the new seventh letter in the CAMELSO rating system. The 5 would likely change the bank's composite examination rating from a 2 to a 3 and would surely get the attention of the bank's management and its board of directors. Such an indirect

2. The CAMELS system rates banks on capital adequacy, asset quality, management quality, earnings, liquidity, and sensitivity to market risk.

but explicit tax on organizational complexity might induce a bank's management to simplify its structure.³

TBTF—lessons from LTCM. While I am on the subject of too big to fail, I need to note my concern and surprise that the last instance of a failure that raised TBTF issues was Long Term Capital Management (LTCM), yet LTCM went unmentioned in the papers prepared for this conference. LTCM was a hedge fund, not a bank, but it was big, and its possible disorderly unwinding could have posed problems for the financial markets and the banking industry under the circumstances that prevailed in August–September 1998. Let me raise the question of whether LTCM provides a road map for how to handle a so-called too-big-to-fail systemic bank. LTCM was recapitalized, probably reluctantly, by its competitors and suppliers, with ownership divided into fourteen roughly equal pieces. In essence, LTCM failed; its owners, investors, and principals lost virtually all their equity and control; and the new owners got whatever benefits they could from their ownership stake. To use a Darwinian metaphor, a severely weakened animal was thrown to the wolves and the buzzards. No public money was promised, spent, or put at risk to alleviate what otherwise could have been a very disorderly situation.

The LTCM precedent raises an interesting question. What if there were a rule, known in advance, that if one of the three or four systemically important banks were on the brink of failure, then each of the, say, ten or fifteen or twenty other largest banks would have to recapitalize the failed bank according to some preestablished formula? Each bank would provide financial capital and other resources, including some management talent, to protect its investment. One benefit to these banks would be protecting them from creditor concerns that the deposit insurance fund could otherwise have been seriously depleted. A quick and orderly resolution would also calm depositors and other creditors rather than make them wonder which bank is next in line to fail. The rule, enforced by the bank supervisory authorities, would impose the necessary outside coordination and discipline on the process to make it work. I offer the LTCM precedent as food for thought.

A growing role for the Federal Reserve. The authors of *Safety and Soundness* suggested a reduced role for the Federal Reserve. Congress has chosen to ignore this recommendation; indeed, the Fed's role has been expanded. The provision of normal and emergency liquidity remains the sole responsibility of the Fed. In addition to retaining its role as the primary supervisor for bank holding companies, the Fed was made the umbrella supervisor for financial holding companies under the Gramm-Leach-Bliley Act. This move gives the Fed a supervisory reach over a lion's share of the nation's banking assets. The Fed, in essence, retains its role as "the super-agency that nobody planned" (Guttentag 1975, 137). The Fed's mission creep extends beyond the supervisory arena to include the payment system. Why has this expansion happened? Why did Congress adopt so many of the recommendations from *Safety and Soundness* but ignore all the recommendations about restructuring the powers of the federal bank supervisory agencies? Was it politics or economics? Was it the reputation of Fed Chairman Alan Greenspan? My answer is that the decision was based at least 90 percent on economic considerations.

In an economic or financial emergency, the country needs, indeed requires, a non-political organization with the financial wherewithal, the expertise, the experience, the broad mission, and the leadership to step into the situation and quickly get the situation under control. During such crises there is no time for jurisdictional disputes about who has the responsibility or who was appointed by Republicans versus Democrats. When the financial or banking system is under great stress, government agencies with single

missions and narrow mandates are often incapable of setting priorities or making trade-offs among competing and conflicting public goals. The FDIC and the Office of the Comptroller of the Currency (OCC) focus nearly exclusively on bank safety and soundness. Only the Federal Reserve is charged with the job of internalizing the trade-offs between the items on its long list of interdependent goals, including economic growth, full employment, price stability, financial system resilience, bank safety and soundness, and payment system stability. When something goes wrong, the American public, and thereby their elected representatives in Congress, want one person or institution to be accountable for trying to alleviate the situation. Nobody wants to hear a high-level public official utter, “It wasn’t my job or mandate to worry about that aspect of the problem” (Rosenblum 1994).

Economics is about maximizing an objective subject to a set of constraints. The FDIC and OCC have the job of maximizing bank safety and soundness. The Fed’s job is to maximize the economic health of 300 million U.S. citizens subject to a bank safety and soundness constraint. Under normal economic and financial conditions, the three agencies perform essentially the same supervisory duties. But under conditions of economic and financial stress, the Fed may need to diverge from its usual and customary role in bank supervision and regulation. The Fed was designed to do this, and it has evolved over time in keeping with the evolution and innovations in the economy and financial markets. Congress recognizes that daily life is not simple; it involves a range of constant trade-offs. Accordingly, Congress has created and expanded the role of the Federal Reserve and delegated to it many of Congress’s own responsibilities under the U.S. Constitution.

In recent years, many governments have removed bank supervisory functions from their central banks and transferred these duties to a financial services authority (FSA) that in many cases is also responsible for supervision and regulation of financial markets, insurance, and securities companies. Because no major banking and financial crises have occurred in the short span of years that FSAs have been in existence, we cannot yet judge whether separating banking supervision from the monetary-policy and lender-of-last-resort authority will work well in practice. In spite of the fact that distinctions between different types of financial intermediaries have become blurred in recent years, it is not clear to me that consolidating all financial supervision and regulation in a single government agency provides any significant benefits over the divided system that currently exists in the United States. Ironically, a solution to the cross-border regulation problems I discussed earlier is being proposed jointly by the Federal Reserve Bank of New York, the SEC, and the U.K.’s FSA (Geithner, McCarthy, and Nazareth 2006). For the time being, the U. S. Congress appears wise not to tackle the issue of bank supervisory consolidation in the United States.

Conclusions

Many, but not all, of the recommendations in *Safe and Sound Banking* have been implemented over the past twenty years. The result is a safer and sounder banking system than would otherwise have been the case. While we enjoy the benefits of this safer, sounder, and more resilient banking system today, it does not necessarily follow that we have a safer financial system. Risk taking has moved from banks to other financial institutions where regulatory subsidies do not exist and where market discipline can be more effective. This situation is as it should be and as the authors of *Safe and Sound Banking* intended.

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3. One lesson from the bankruptcy of Enron, which was not a bank, is that unnecessary organizational complexity can be a problem for both top management and a range of other stakeholders.

Two additional reforms seem necessary to further improve the safety and resilience of the banking system in 2006 and beyond. First, organizational complexity needs to be discouraged, perhaps through a specific examination rating for that characteristic. Second, a set of resolution procedures needs to be put in place and known in advance for how the bank supervisory authorities will deal with the recapitalization and reorganization of systemically important banks that are too big to resolve quickly by traditional methods. One such resolution model is provided by the 1998 private-sector recapitalization of Long-Term Capital Management.

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