

Policies and Prescriptions for Safe and Sound Banking: Shocks, Lessons, and Prospects

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Both the external environment and the internal business practices of banking in the United States changed enormously over the past two decades. (For simplicity, I refer here to any federally insured depositories and their holding companies as banks.) By the middle of the 1980s, the U.S. macroeconomy had suffered through its most turbulent years since the 1930s. Then, seemingly suddenly, real economic activity became much less volatile beginning about the middle of the 1980s. Because some of the public policies that might have been appropriate under different circumstances had become outmoded and provided inappropriate incentives for risk taking, numerous and substantial legislative and regulatory changes were enacted. Financial deregulation was both deep and broad and greatly affected both regulated institutions and regulators. Technological advances in computing and communications that were pertinent to banking lowered the relative prices of such services considerably. Advances in financial techniques and in the ranges of financial products and services offered by, and offered to, banks importantly affected the risks that banks faced and measured as well as the kinds and amounts of risks that banks ultimately decided to retain or to shed.

These changes had important shorter-run and longer-run effects on banks' earnings and conditions. As of the middle of the 1980s, concern about the then current and likely future conditions of banks was widespread. One result of that concern was the publication in 1986 of the book *Perspectives on Safe and Sound Banking: Past, Present, and Future*, by George Benston et al. (the Report), which provided comprehensive descriptions, diagnoses, and prescriptions about banking for banks and for public policymakers. My commentary notes many of the Report's most salient prescriptions, changes in regulations (and legislation) that followed the Report, and the extent to which regulatory changes to date conform to the Report's recommendations. As such, the Report provides a touchstone for analyzing regulatory and other developments in banking over the past two decades.

Among the banking conditions that were affected by the vicissitudes of the macroeconomy were banks' capital ratios. By the middle of the 1980s, banks' capital

ratios had been in a longer-term, substantial downward trend. Since that time, however, the large and steady increase in the aggregate capital ratio in banking has been notable. Below, I discuss a variety of reasons why bank capital ratios may have risen so much over the past twenty years.

I also call attention to how banks and their regulators may effectively sidestep some of the intended capital-related constraints of the prompt corrective action (PCA) provisions embodied in the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. In addition, I discuss how the options to sidestep PCA during periods of generalized banking difficulties encourage banks to seek “safety in similarity.” Finally, I review some of the unresolved issues posed by and for the restructuring of financial regulators.

Turbulence in Banks’ External Environment

Over the past two decades, the banking landscape changed considerably. Changes in the macroeconomics, both at home and abroad, in public policies, in computing and communication-related technologies, and in techniques of financial analysis have changed banks’ overall conditions and business practices. Along with interest rate deregulation, we have seen broad and deep deregulation of geographic and activity barriers in banking. The 1994 Riegle-Neal Interstate Banking and Branching Efficiency Act (IBBEA) largely, though not completely, deregulated both interstate banking and branching. The 1999 Gramm-Leach-Bliley Financial Services Modernization Act largely ended the half-century-old Glass-Steagall prohibitions against a single firm owning commercial banking, investment banking, and insurance subsidiaries.

Technological advances were stunning. Progress, and resulting declines in real prices, in computing, telecommunications, data collection and storage, and the Internet were rapid and far-reaching. These advances rendered feasible, at often dramatically lower costs, the complex financial products that are now used by banks and their customers and the complex financial risk management techniques used by banks and their regulators.

Lower communication and transport costs also generally increased internationalization of financial markets for banks and their customers. Greater internationalization also increased tourism and migration, real and financial international transactions between and within companies, foreign direct investment, and real trade deficits. Banks, domestic and foreign, became more internationally oriented when they followed their customers and on their own accounts, with U.S. banks operating abroad and foreign banks increasing their operations in the United States.

The “Great Moderation” is a significant, though not completely explicable, macroeconomic development for banks. The Great Moderation refers generally to the large and rather sudden decline, beginning in the mid-1980s, in the volatility of real gross domestic product or its growth rate. The data in Table 1 reveal some of the most striking differences in the U.S. macroeconomic environment. The table presents means, standard deviations, maximums, and minimums for monthly federal funds interest, civilian unemployment, and consumer price inflation rates for the 1970–2005 period and its two halves, 1970–86 and 1987–2005. Strikingly, the means, standard deviations, maximums, and minimums are all lower in the latter period. The declines are often substantial. The mean annual inflation rate fell by more than half, from 6.7 to 3.1 percent. Its standard deviation fell by two-thirds, from 3.3 to 1.1 percent.

Figures 1 and 2 display the time series of monthly data for the nominal federal funds interest rate and for the unemployment rate for the 1970–2005 period and their means for the two halves of that period. The mean interest rate fell by 3.8 percent,

Table 1
Annual Interest, Unemployment, and Inflation Rates, 1970–2005

	Interest rate	Unemployment rate	Inflation rate
1970–2005			
Mean	6.7	6.2	4.8
Standard deviation	3.5	1.4	3.0
Maximum	19.1	10.8	14.6
Minimum	1.0	3.8	1.1
1970–1986			
Mean	8.7	6.9	6.7
Standard deviation	3.5	1.5	3.3
Maximum	19.1	10.8	14.6
Minimum	3.3	3.9	1.2
1987–2005			
Mean	4.9	5.6	3.1
Standard deviation	2.2	0.9	1.1
Maximum	9.9	7.8	6.4
Minimum	1.0	3.8	1.1

from 8.7 to 4.9 percent; the mean unemployment rate fell by 1.3 percent, from 6.9 to 5.6 percent. By these and other measures, the macroeconomic environment for banks was more benign over the most recent decades. It remains an open question, however, as to how much of the Great Moderation and the lower mean rates are due to smaller average-sized real and financial shocks, to better microeconomic and macroeconomic policies, or to changes in technologies and techniques.

Prescriptions and Policies from the Middle of the 1980s Onward

By the mid-1980s, we were (unknowingly) at the beginning of the Great Moderation and (knowingly) in the midst of an ongoing wave of general deregulation that had begun a decade earlier. The 1986 Report described and diagnosed the sources of some of the ills that afflicted banking and prescribed policies to correct them. Many of the Report's recommendations for policy adjustments to make—and, perhaps as importantly, to avoid—have been adopted since 1986. However, many of the recommendations in the Report were also not followed. Furlong and Kwan (2007, this issue) describe in detail which of the Report's recommendations were adopted and to what extent.

Table 2 attempts to summarize succinctly the Report's recommended and the actual policy changes since 1986. The top row in the table lists policy changes recommended by the Report (a "to do" list). The bottom row lists policy changes that the Report advised against (a "don't do" list). The left column lists the policy changes that took place (a "did" list); the right column then lists the policy changes that did not take place (a "didn't" list). Thus, the northwest cell includes the policy changes recommended by the Report (for example, weakening barriers between banking and finance) that were actually carried out. The northeast cell includes recommendations (for example, removing the task of consumer protection from banking regulators) that have, so far, not been implemented. The southwest cell includes policies that the Report advised against (such as separating thrift insurance and supervision) but were imple-

Figure 1
Interest Rates: 1970–86 versus 1987–2005

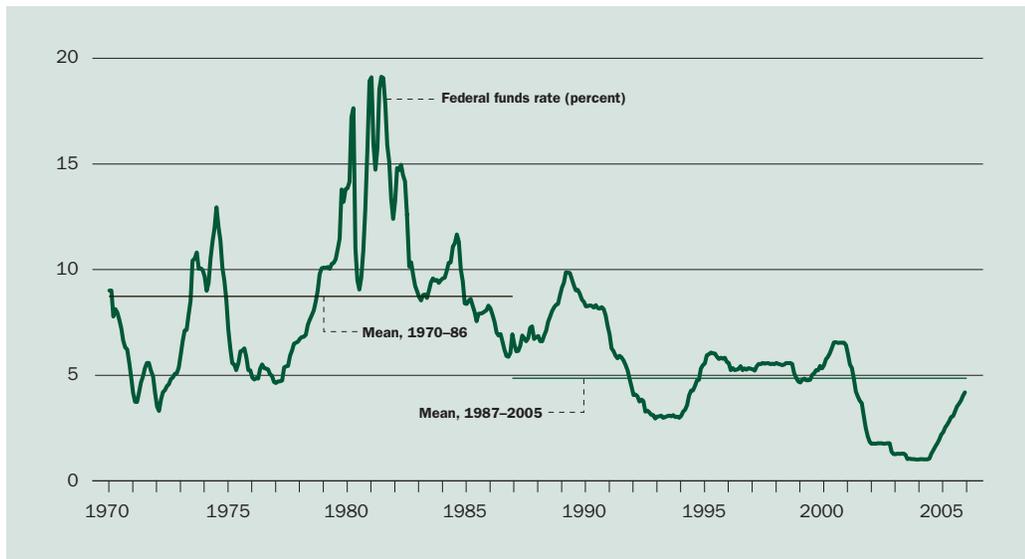
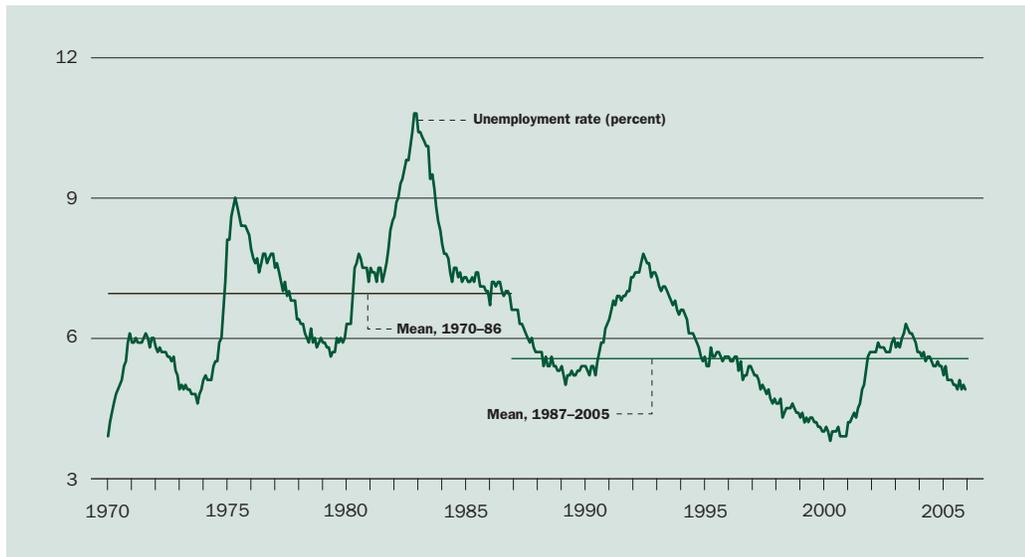


Figure 2
Unemployment Rates: 1970–86 versus 1987–2005



mented; the southeast cell includes the policies that the Report advised against (such as creating a single super-regulator) that have not been implemented.

Assigning any particular implemented policy change (or inaction) to one of the four cells can be problematic, and some differences in assignments are surely reasonable. Furlong and Kwan’s detailed descriptions of policy changes highlight the difficulties of classifying whether some actual policy changes follow the recommendations in the Report in full, in part, in spirit, in name only, or not at all. In some cases, policy changes might partially follow a recommendation and might reasonably be placed somewhere

Table 2
Recommended and Implemented Policy Changes from Benston et al. (1986)

		Policy changes implemented during 1986–2006	
		Did	Didn't
Benston et al. (1986)	Do	<ul style="list-style-type: none"> • Adopt statistical early warning systems • Increase bank disclosures • Increase supervisory disclosures • Allow insurers to close banks • Risk-base capital premiums • Enact prompt corrective action • Haircut uninsured creditors • Count subordinated debt as capital • Use subordinated debt yields in supervision • Remove banking/finance barriers 	<ul style="list-style-type: none"> • Add deposit insurance to OCC role • Remove consumer protection from banking regulators • Consider enterprisewide risk • Risk-base deposit insurance premiums • Market value assets and liabilities • Remove supervision from the Fed • Restrict Fed as lender of last resort • Supplement FDIC with private deposit insurance
	Don't	<ul style="list-style-type: none"> • Separate thrift insurance and supervision • Increase nominal-dollar insurance ceilings 	<ul style="list-style-type: none"> • Cap interest rates • Limit banking activities more • Create single super-regulator

in between. Thus, I augment the basic two-by-two matrix with a “somewhere in between” cell that includes policy changes that have been carried out in name but that in effect probably are closer to not having been carried out. For instance, I list risk-based insurance premiums as a policy that was carried out in name but clearly was not carried out to the extent recommended by the Report. As Furlong and Kwan discuss more extensively, FDIC insurance premiums are barely risk based—the overwhelming majority of banks have not paid any premiums for years despite the presence of a risk-based premium schedule and the likely changes in their risk profiles over the past decade (see also Wilcox 2001).

Despite its inevitably approximate assignments, Table 2 helps distinguish the forest from the trees. The table prompts two questions, one directly related to the table and a second question that is implied. First, how much did policymakers follow the Report’s recommendations? Second, have banking and regulatory developments since 1986 reflected the issues the Report focused on? The diagonal cells in Table 2 provide information about the first question. The longer the lists in the northwest and southeast cells and the shorter the lists in the northeast and southwest cells, the more one might regard policymakers as having adhered to the recommendations of the Report. The longer the lists in the off-diagonal cells, the more discouraging for those who agree with the Report’s recommendations.

It is challenging to assign weights to the relative importance of each individual recommendation and policy in Table 2. Nevertheless, it seems unassailable that a number of very important items are listed in each diagonal cell. Thus, an appraisal of the influence of the Report would have to conclude, perhaps unsatisfactorily, that while much of the Report has been implemented, much has not. On balance, however, it is striking how many of the significant, recommended reforms have been implemented.

Banks’ being permitted to count subordinated debt toward capital requirements is one of the key issues and sets of recommendations in the Report. The Report clearly

calls for counting subordinated debt toward regulatory capital requirements. The Report does not, however, call for mandatory issuance of subordinated debt, instead calling for further study of the topic. A Federal Reserve staff study (Study Group 1999) weighs the pros and cons of mandatory issuance and finds the technical challenges of regular issuance at fixed intervals burdensome for all banks, particularly for smaller banks. Whereas banks have resisted mandated subordinated debt, banks seem to like subordinated debt or bondlike trust preferred securities (TPS), not as a complement to, but rather as a substitute for, equity capital in tier 1. Wilcox (2002, 2003) explores the rationales of counting subordinated debt and TPS toward capital requirements and the use of collateralized debt obligations that might make subordinated debt and similar instruments financially feasible for ever-smaller depository institutions. Given that payoffs from subordinated debt to the FDIC look more like those of debt than equity, perhaps banks and taxpayers could reasonably agree to substituting subordinated debt for equity in capital requirements, especially if subordinated debt creditors really are fully at risk. However, regulators still seem to much prefer equity to uninsured debt, perhaps in the belief that such creditors will not be fully at risk.

To what extent do regulatory developments since 1986 correspond to the issues identified in the Report? Indeed, many of the Report's recommendations have been implemented. Somewhat surprisingly, however, given its focus on safety and soundness, the Report treated bank capital (and its requirements) very sparsely. Unlike in the Report, the (in)adequacy of bank capital was much discussed during the entire decade of the 1980s. Maisel (1981) and other studies had already paid and brought considerable attention to the issues and evidence about bank capital adequacy. The thrift crisis was under way and very visible. As the market value of thrifts' capital and eventually even the book value of their capital vaporized, regulatory capital was created from vapor. In addition, U.S. and European banks had long complained about the low ratios of capital required by Japanese regulators for their banks. And discussions that led to Basel I's capital regulations had begun.

Despite recognizing "the current perceived capital weakness in the industry" (Benston et al. 1986, appendix, 305), the Report argues that "a full discussion of the problem of bank capital is beyond the scope of this project" (176). While the Report's appendix briefly discusses and advocates risk-based capital requirements, the Report largely eschews any position on whether nominal or effective capital requirements should be increased, recommending only that banks should be closed when their market values of net worth sink to 1 to 2 percent of assets.

Why Have Capital Ratios Risen So Much?

Furlong and Kwan (2007) emphasize higher capital level ratios as a major, if not predominant, change associated with banking regulation over the past two decades. There are several plausible reasons why capital ratios may have risen so much. An obvious candidate is the set of public policies that raised minimum nominal and effective required bank capital ratios. One might term this effect "Basel and Washington" in reference to the cities where the international accord and capital-related regulations were agreed upon.

Changing evaluations of the private and public policies adopted toward banking may have also raised capital markets' assessments of banks' optimal capital ratios. One might term this effect "New York" in reference to capital markets. Whether enhanced credibility of strong supervisory action (either through outright closures or through restrictions on activities for undercapitalized institutions) that raised optimal capital ratios should be attributed to Washington or New York is partly a semantic

distinction. Which city most affected banks' strikingly higher capital ratios in recent years has yet to be determined.

The threat of effective least-cost resolutions or early closure may have raised pressure from creditors and equity holders on banks to hold more capital. Alternatively, Flannery and Rangan (2004) argue that banks on their own may have chosen to hold more capital as an optimal response to their conscious decisions to hold riskier assets. The empirical support for this latter hypothesis is far from universal, as the perceived riskiness of bank assets probably rose considerably from the late 1960s through the mid-1980s while capital ratios simultaneously fell.

Other reasons for the striking increase in bank capital ratios might range from improved fiscal, monetary, and regulatory policies to better product, activity, and regional diversification by banks; from better management to better luck. Declines in capital ratios prior to the Great Moderation were sometimes attributed to an unusual spate of adverse shocks from the early 1970s through the early 1980s. In the absence of adverse shocks, even practices roughly similar to those of earlier periods might restore capital ratios in the shorter term. An extended recent period of better luck—in the sense that the average shock recently has been as beneficial as the shocks before the middle of the 1980s were adverse—might have brought some temporary, but long-lasting, overshooting of optimal capital ratios, which would be expected to be corrected over time.

PCA, Accounting, and “Safety in Similarity”

The 1986 Report argued that mispricing of risks by deposit insurers was, in large part, responsible for the bank and thrift crises of the 1980s. The Report thus implicitly argues that pricing such risks correctly—for instance, via risk-based insurance premiums and risk-based capital requirements—would greatly reduce the likelihood of similar crises in the future. As noted above, many of the Report's recommendations were implemented, and many others were not. Aside from the policies and issues the Report identified and foresaw, several other regulatory developments provide reasons for outright optimism, and some provide reasons for more guarded optimism.

Among the reasons for outright optimism are the “virtuous volleys” of policy changes between regulators and banks. We term sequences of public and private policy changes “virtuous” when successive changes reverberate upon each other and in the process produce banking that is safer and sounder. For instance, binding capital requirements can stimulate better risk management. Faced with demands from regulators for higher capital ratio cushions above formal minimum requirements, banks may develop and upgrade their risk management systems (for instance, collecting and analyzing more and better data) and resulting value-at-risk (VaR) estimates to rebut the necessity of higher capital cushions.

Better risk management can, in turn, stimulate better regulation. Regulators may permit more experimentation among “better” banks. In a common and perhaps sensible approach of testing the waters one toe at a time, bank regulators gradually allowed Section 20 subsidiaries of bank holding companies to engage in more and more investment banking. Regulators also eventually amended capital regulations to better reflect market risks in banks' trading books. Along the way, banking regulators developed more and better tools to analyze banks' risks, which presumably led to more appropriate demands for capital cushions.

Despite examples of virtuous volleys of public and private policies and the mounting capital ratios since the early 1990s, regulator-bank volleys need not all be virtuous. Just as binding capital requirements may lead to more sophisticated risk

management systems, they also may stimulate capital arbitrage. Indeed, a major impetus to Basel II was the sense that banks had effectively been able to skirt some of the important strictures of Basel I via capital arbitrage.

Another reason for optimism about upcoming bank safety and soundness is the sizable actual bank capital cushion that has accumulated over the last two decades. To date, regulatory reforms have apparently performed adequately, but the exceedingly benign macroeconomic environment apparently has put little stress on banks and thus on regulatory reforms.

The most recent decade has pleasantly surprised regulators and banks alike with a series of largely positive shocks that have nursed a healthy capital cushion for the banking system in general and for most individual banks. Though we have been through a lot of shocks and shifts since the Report was released, on average we may simply have had better luck. Indeed, a leading explanation for the Great Moderation of the macroeconomy is that the mean and variance of adverse shocks dwindled after the middle of the 1980s. And indeed many, and probably most, of the sizable shocks and shifts the economy has experienced in the last decade and a half also helped, rather than hurt, the financial sector. The same might be said for regulatory, technological, and technique shocks. In that sense, luck on average in recent years has been good.

What will happen when major adverse shocks strike again, as they are likely to eventually, is not altogether clear. The regulatory regime implemented over the past two decades might work as well as it is presumed to work. The current substantial capital buffers might well shield banks and the macroeconomy from serious implications. The fortunate absence of severe shocks and stresses, however, leaves the current arrangements largely untested.

This perspective then raises the question of whether relatively untested regulatory changes, such as PCA, will stand up when adverse shocks lean on it. Advocates of PCA express confidence that, in its actual application, PCA will indeed be both prompt and corrective, in contrast to regulators' capital forbearance, which allowed banking problems to fester and grow. Such prompt corrective action can reduce the expected losses to banking, the FDIC, and taxpayers. Such confidence has so far been little borne of experience. In that regard, it is reminiscent of the confidence placed until the 1970s by many macroeconomists in the long-term stability of the trade-off between unemployment and inflation rates. According to our revised thinking, borne of the painful experiences of the 1970s, that trade-off may be real and important in the short term but much different, and perhaps nonexistent, over the long run.

How strictly will PCA be applied in the face of serious banking problems? When the going gets really tough, will banks' losses get reported? When the banking industry is troubled, would a troubled bank report unbiased amounts of charge-offs and loan-loss provisions for contemporaneously or prospectively troubled loans on their financial statements? Will regulators, when confronted by many simultaneously troubled institutions, strictly apply prior provisioning standards for all of those banks? Will legislators allow such strict enforcement, or will they demand, explicitly or implicitly, that regulators be understanding of economic repercussions on the constituencies of elected representatives?

PCA does not eliminate all of the incentives and abilities for regulators and banks to collaborate to reduce reported problems. Indeed, by emphasizing regulatory strictures as a function of reported capital ratios, PCA may strengthen such incentives, opening the possibility for a new strain of "regulatory arbitrage." And, in such a case, some may well regard reporting discretion as an escape clause from the rigors of rules that may work to the benefit of the economy generally.

Luengnaruemitchai and Wilcox (2004) and Stever and Wilcox (2007) argue that discretion in the reporting of bad news might allow banks, in conjunction with their regulators, to sidestep, or at least postpone, PCA triggers. Accounting rules do somewhat limit such accounting discretion, but they may not completely preclude it in full for such “discretionary” items as loan-loss provisions and charge-offs. Past and ongoing examples of such collaboration between banks and regulators in the United States and abroad during troubled times are too many to ignore. Much of the litany of underreporting of bad news is well known and even acknowledged: U.S. thrifts and banks in the 1980s, U.S. banks again in the early 1990s, U.S. banks during the LDC crisis of the 1980s, and Japanese banks in the 1990s and 2000s.

In their empirical results, Luengnaruemitchai and Wilcox (2004) and Stever and Wilcox (2007) find evidence that individual banks have engaged in reporting discretion in response not only to their own conditions but also to their peers’, a hypothesis termed “safety in similarity.” Stever and Wilcox (2007) estimate loan-loss provision (LLP) and charge-off (CO) functions on panel data for the thirty largest banks during the 1985–2005 period. The finding that LLPs and COs rise and fall with a bank’s own cash flow fits others’ research results that such discretionary items tend to be used by banks for the purposes of “earnings management.” In addition, the authors find that banks report fewer losses, *ceteris paribus*, when other banks are troubled. The size and significance of this effect waned after the early 1990s, likely either because it was gone or could not be detected during that high capital period. Stever and Wilcox hypothesize that when the banking industry is troubled, banks have a larger incentive to cluster. The value of the accounting discretion option is likely to be most valuable to a bank when it is troubled at the same time that other banks are troubled. Being similar to other banks can reduce the odds of being troubled when the rest of industry is not troubled. Indeed, Stever and Wilcox find that, when the banking industry was troubled, there was less dispersion across banks of their equity and asset betas, their assets’ risks (volatilities), and their asset portfolio shares. Their results also show that individual banks moved their asset betas closer to the industry mean faster when the banking industry was troubled. Thus, these results suggest that reporting discretion has been actively used, although it may be currently practiced less. Whether that discretion will be exercised in the future remains to be seen.

Restructuring Financial Regulators

Benston et al. (1986) recommended root-and-branch restructuring of financial regulators. The Report called for both (1) regulators to be responsible for the deposit insurance of the institutions they regulated and (2) dual banking to be retained. As such, the Office of the Comptroller of the Currency would operate its own insurance fund for national banks, the Federal Deposit Insurance Corporation would be the sole federal banking regulator responsible for state-chartered banks, the Office of Thrift Supervision would operate its own insurance fund (as the Federal Home Loan Bank Board did), and the Federal Reserve System would largely be relegated to conducting monetary policy. The Report’s recommendations have not been implemented.

These recommendations do raise the issue of whether, in a world where both integration and competition of both financial institutions and financial regulators are increasing, the Fed should be a banking regulator. Several researchers have presented evidence that supports a narrower focus for central banks. Using cross-country data, Goodhart and Schoenmaker (1995) and Di Noia and Di Giorgio (1999) find a positive correlation between the rate of inflation and the central bank having responsibility

for both monetary policy and supervision. Using data for the formal actions that federal bank supervisors take against banks, Ioannidou (2002) presents evidence that the Fed's monetary policy responsibilities affect its supervisory behavior compared to the bank supervisory behavior of the other federal banking regulators. In particular, she finds that when the Fed increases the federal funds rate, relative to the other federal banking supervisors, the Fed's supervisory posture eases somewhat. Barth et al. (2002) report evidence that countries whose central banks regulate banks tend to have banks that have higher measured credit risks. As the holding companies the Fed regulates are permitted to engage in activities that span more of the entire financial sector, pressures seem likely to impel the Fed to increasingly expand, rather than contract, the scope of its regulatory purview toward adding to its duties being a de facto regulator for insurance and securities firms.

The 1986 Report also called for sustaining a vibrant dual banking system. Some of the interactions between interstate banking and branching and the practical operation of an effective dual banking system were unlikely to be foreseen then, and some have not yet been fully envisioned. For example, the 1994 Riegle-Neal IBBEA permitted national banks with interstate branches to consolidate their operations largely under a single set of rules. In contrast, state banks were disadvantaged in that they still were burdened with different set of rules for branches in different states. At least partly to reduce the resulting disincentives for banks to be state chartered, the 1997 amendments to Riegle-Neal permit out-of-state branches of state banks to import their home state rules to the extent that out-of-state branches of national banks operate under national, rather than state, rules.

Wilcox (2005) refers to this system of "home-run" regulation, in which an individual bank can, in practice, choose from among more than fifty U.S. (state plus national) charters and operate anywhere in the United States under the rules of its chosen charter simply by locating its legal headquarters in the state that offers its preferred charter. If dual banking does have the advantages that banks and policymakers have so long claimed for it, then perhaps dual banking was "too good to be two." And, now, rather than regulatory duopoly, such home-run regulation allows not just two, but many, charters to reign within a given state. To date, the practical implications of regulatory reciprocity have not been very large, but, so far, the amendments are relatively new and seem largely unrecognized.

Conclusion

The last four decades brought large and sometimes wrenching shocks and shifts to the macroeconomic environment in which banks operate. The same period also brought sweeping, mostly beneficial changes in public policies, which aimed largely at deregulating the prices, activities, and locations of banking activities. Banks also benefited from the enormous technological and analytical advances that improved banks' abilities to measure and manage their risks.

By the middle of the 1980s, the difficulties and maladies afflicting banking were large and well known. Among the most prominent and far-reaching diagnoses and prescriptions was the 1986 book, *Perspectives on Safe and Sound Banking: Past, Present, and Future*. We used the book as a touchstone for evaluating banking policy prescriptions and outcomes. An impressively large share of the book's recommendations has been implemented in full or in part. And, of course, as one might anticipate about such a comprehensive list of prescriptions, not all of the recommended policies were implemented, and some policies that run counter to those of the book have been implemented.

Despite the impressive scope of its prescriptions, the Report was largely silent about capital. This silence is especially notable because of the amount of attention that capital had received by the middle of the 1980s and the preoccupation with capital that regulators have shown since then. Since the book appeared, bank capital has risen markedly and presumably, but not certainly, reduced solvency risks to banks and to the FDIC itself. Why capital levels have risen so much is even less certain. Likely reasons include reductions in the mean and variance of shocks adverse to banking and pressures from Basel, Washington, and New York.

Regulations now trigger increasing restrictions on banking as a function of falling capital ratios. These regulations might increase incentives for banks and their regulators to exercise options to report bad news and concomitantly encourage banks to seek safety in similarity in the face of adversity. Fortunately, the relatively benign environment has not severely tested how PCA will work in practice. While PCA's stimulus to higher capital ratios may help shield banking from macroeconomic difficulties, PCA has yet to be severely tested, and consequently caution about its effects under stress is warranted.

The past two decades brought substantial shifts in macroeconomic performance; in the permissible prices, activities, and locations of banks; and in banks' business practices. The period also brought proposals for substantial restructuring of the financial regulators. So far, formal adjustments to the structure of financial regulators have not been substantial. But far-reaching changes might yet emerge from the current set of regulations. One, as yet virtually unnoticed, change is that out-of-state branches are now permitted to operate under their home state charters. This change could lead from the current dual banking system to a "home-run" system that allows branches in a given state to operate under any one of more than fifty charters.

In addition, the Federal Reserve System's assuming the role of umbrella supervisor for financial holding companies offers the prospect of the Fed, perhaps both in appearance and in practice, being an important regulator not just of banks and their holding companies but also of the insurance companies and securities firms in those holding companies. The Fed could thus become the de facto regulator for most, if not almost all, of the financial sector. Whether the Fed should, wants to, or will embrace that role remains to be seen.

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