A PROPOSAL FOR REMOVING GOVERNMENT AGENCIES FROM SUPERVISING OR INSURING BANKS AND S&LS

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I. THE GOVERNMENT—PRIMARILY THE FED—AS BANK SUPERVISOR

In March 2023, three large U.S. banks failed, and one was closed and liquidated.[2] The most prominent failure was Silicon Valley Bank, a California chartered bank for which the Federal Reserve was the federal safety and soundness supervisor. Two of the banks were among the 30 largest U.S. banking organizations and had been considered "well-capitalized" up until the time of their failure.[3] The failures triggered runs on other banks around the United States, which the government was able to forestall by promising to protect all deposits beyond the $250,000 deposits already protected by the FDIC.[4] As bad as this was, it was only the latest in a continuum of bank failures and financial crises that have characterized the U.S. financial system for the last 100 years.

Indeed, this was nothing new, but simply a shadow of earlier years. In a 2013 speech to the Chicago Fed, Bill Isaac, a former chair of the Federal Deposit Insurance Corporation from 1978 to 1992, noted:

> The period from 1978 to 1992 was exceptionally tumultuous for the U.S. economy and financial system. . . . Our largest banks were loaded with loans to lesser developed

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[1] The general proposal in this paper for a privatized system of bank and S&L supervision was first advanced in a book entitled *Back from the Brink: A Practical Plan for Privatizing Deposit Insurance and Strengthening Our Banks and Thrifts,* published by the American Enterprise Institute in 1990. PETER J. WALLISON, BACK FROM THE BRINK (1990). That proposal, in the wake of the S&L crisis of 1985-1989, was written by Peter J. Wallison, with detailed footnotes by Bert Ely. This paper leaves out a great deal of the original work's details but adds a discussion after recent bank crises about the failures of the Fed as a bank supervisor and conflicts of interest between the Fed's monetary policy role and its role as a bank supervisor.

[2] *See FDIC: 2023 Bank Failures in Brief*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/resources/resolutions/bank-failures/in-brief/bfb2023.html (last visited Mar. 25, 2024).

[3] U.S. GOV'T ACCOUNTABILITY OFF., GAO 23-106974, *Bank Supervision: More Timely Escalation of Supervisory Action Needed* 10-11 (2024), https://www.gao.gov/assets/d24106974.pdf; Gov't Accountability Off., *GAO Highlights: Bank Regulation* (Apr. 2023), https://www.gao.gov/assets/gao-23-106736-highlights.pdf (last visited Mar. 25, 2024); Silicon Valley Bank, Message to Stakeholders Regarding Recent Strategic Actions Taken by SVB at 2 (Mar. 8, 2023), https://s201.q4cdn.com/589201576/files/doc_downloads/2023/03/r/Q1-2023-Investor-Letter.FINAL-030823.pdf.

[4] Press Release, Fed. Rsrv., Joint Statement by Treasury, Federal Reserve, and FDIC (Mar. 12, 2023), https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312b.htm.

> countries. The Federal Reserve, FDIC, and Treasury developed a contingency plan to nationalize the major U.S. banks if the LDC countries renounced their debts. Some 3,000 insured banks and thrifts failed during this period. Our seventh largest bank, Continental Illinois, in downtown Chicago, failed and was in effect nationalized by the FDIC and many regional banks went under, including nine of the ten largest banks in Texas.[5]

More recently, the FDIC reported that there were 516 bank failures between 2009 and 2023.[6] Since the 1970s, over 90 banks with assets of $1 billion or more have failed.[7]

The safety and soundness of U.S. banks are the responsibility of three government agencies, the Federal Reserve (Fed), the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC). The Fed is by far the largest of these—with the broadest responsibility—regulating and supervising over 4,900 bank holding companies, 839 state member banks, 470 savings and loan holding companies, 154 foreign banks operating in the U.S., 41 Edge Act and agreement corporations, 52 state member banks foreign branches, 40 financial holding companies, 442 domestic financial holding companies, and 8 designated financial market utilities.[8] The OCC regulates and supervises a little over 1000 national banks,[9] and the FDIC is the safety and soundness regulator for over 5000 national and state chartered banks and savings associations.[10]

There have been three major financial crises involving regulated and supervised banks and S&Ls just since the 1980s—one centered in 1989 involving bank and S&L failures with aggregate losses of $390 billion, one in 2008 with aggregate bank losses of $515 billion, and the one in 2023 with losses of $319 billion.

This is an unenviable—maybe even scandalous—record.[11] Not only has the FDIC been required to compensate the depositors in all these banks who had insured deposits, but it reduced the profitability of all surviving banks that had to pay higher rates for deposit insurance afterward. The losses to uninsured depositors, and to other individuals, businesses, and the economy generally have not apparently been calculated or reported, but were substantial. Once again, for its regulatory failures, the Fed apologized to Congress

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[5] William Isaacs, Speech to the Chicago Fed (2013) (on file with author).

[6] *FDIC: Bank Failures in Brief – Summary*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/resources/resolutions/bank-failures/in-brief/index.html (last visited Mar. 25, 2024).

[7] Shane Barber, *What's Going on with Bank Failures*, MOD. WEALTH MGMT. (Mar. 16, 2023), https://www.modwm.com/whats-going-on-with-bank-failures/.

[8] *The Federal Reserve System Purposes and Functions: Function*, FED. RSRV., https://www.federalreserve.gov/aboutthefed/files/pf_5.pdf (last visited Mar. 25, 2024).

[9] *About OCC*, OFF. OF THE COMPTROLLER OF THE CURRENCY, https://www.occ.treas.gov/about/index-about.html (last visited Mar. 25, 2024).

[10] *What We Do*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/about/what-we-do/ (last visited Mar. 25, 2024).

[11] There have been efforts in Congress to remove the Fed's safety and soundness authority over the banking system. According to a March 16, 2023, note by Aaron Klein of the Brookings Institution, Sen. Dodd's first draft of what became the Dodd-Frank Act removed the regulation and supervision of banks like SVB from the Fed.

and said it is reviewing its activities and systems with a view to improving them. But it is always thus, with another financial crisis certain to come in the years ahead.

It is the thesis of this paper that government regulation and supervision of U.S. banks—by the Fed, the OCC, and the FDIC—is both ineffective and an increasing danger to the U.S. economy. It is a failure of all the agencies involved, but particularly the Fed, which has the largest and most important portfolio of banks and bank holding companies to regulate and supervise. Among other things, it has become clear that the Fed has a conflict of interest between its monetary policy activities and its bank supervision. For this reason alone, the United States needs an entirely new system for both bank supervision and deposit insurance.

Accordingly, to create a more stable, safe, and sound U.S. banking system, the regulation and supervision of the U.S. banking industry should be transferred to a new and independent private regulatory structure—based on and utilizing the financial resources and knowledge of the banking industry itself—that can focus on the safety and soundness of the financial institutions it is supervising. Such a system, as described in Section II below, will not require any government involvement or resources and, through risk-based deposit insurance, will be able to produce a more stable banking industry than the U.S. has experienced since the founding of the Federal Reserve in 1913.

After the most recent collapse, the Government Accountability Office (GAO) found that risky business strategies, along with weak risk management, contributed to the failures of Silicon Valley Bank and Signature Bank. In both banks, rapid growth was an indicator of risk, but the Fed did nothing effective to prevent their eventual collapse. In 2019-2021, the total assets of Silicon Valley Bank and Signature Bank grew by 198 percent and 134 percent respectively—far exceeding growth for a group of 19 peer banks (33 percent growth in median total assets).[12] To support their rapid growth, the two banks relied on uninsured deposits, which can be an unstable source of funding because uninsured depositors are more likely to withdraw their funds during times of stress.[13] Moreover, it is now possible for depositors to withdraw funds electronically, without having to appear at the bank's teller windows. This makes bank "runs" even more uncontrollable.

In the 5 years prior to 2023, regulators identified concerns with Silicon Valley Bank and Signature Bank, but both were slow to mitigate the problems the regulators identified, and regulators did not escalate supervisory actions in time to prevent failures.[14]

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12 U.S. GOV'T ACCOUNTABILITY OFF., GAO 23-106736, PRELIMINARY REVIEW OF. AGENCY ACTIONS RELATED TO MARCH 2023 BANK FAILURES 11 (2023), https://www.gao.gov/assets/gao-23-106736.pdf [hereinafter U.S. GAO 23-106736].

13 *Id.* at 12–13.

14 *Id.* at 17–23.

An example of the dysfunction that currently prevails—and has for many years—is clear in the GAO's report to the relevant House of Representatives committee about how the Fed addressed some deficiencies in SVB's risk-management program. According to this report, "on June 30, 2022, FRBSF downgraded SVB's [ratings]. . . . [E]xaminers found that the bank's management and board performance needed improvement and were less than satisfactory."[15] Among many other things, the San Francisco Federal Reserve Bank (FRBSF), the regulator and supervisor of SVB, believed that the bank's risk management system "did not address foundational, enterprise-level risk-management matters."[16] Accordingly, the Fed's supervisory staff "stated its intent to initiate an informal, nonpublic enforcement action, in the form of a memorandum of understanding with SVB Financial Group and SVB."[17]

FRBSF staff told GAO that the San Francisco Fed staff started working on the memorandum of understanding (MOU) in late August 2022, with collaboration from the Federal Reserve staff, the Federal Reserve's legal staff and the Federal Reserve's Board staff, and that—even after all that staff involvement—the memorandum ultimately needed "senior-level review."[18] Then, after all this consultation the, "memorandum of understanding was subsequently kept open to allow for the completion of additional examination work" by FRBSF.[19] "However," the account ends drily, "the Federal Reserve did not finalize [the memorandum] before SVB failed in March 2023."[20] That's eight months of delay, allowing another needless bank crisis and the loss of several billion dollars for the government, bank shareholders and depositors, and the U.S. economy.

This is undoubtedly not the only case where the Fed's supervisory staff failed to prevent a bank collapse. As noted above, there have been three major financial collapses involving insured and supervised banks—many of them Fed supervised banks—since 1980. It is no surprise that a government bureaucracy could not get its act together effectively, but the question is whether the same government bureaucracy that has always acted slowly on every other matter can be expected to perform differently when billions of dollars and the stability of the U.S. economy is at stake. The many financial crises in the U.S. make clear that the answer is no.

The FDIC was the primary safety and soundness regulator of Signature Bank, and its actions were no better than the Fed's. The GAO reported that "FDIC had not completed its 2022 examination documents for Signature Bank at the time of its failure. . . . According to preliminary findings we

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15 *Id.* at 21.

16 *Id.*

17 U.S. GAO 23-106736, *supra* note 12, at 22.

18 *Id.*

19 *Id.*

20 *Id.*

reviewed from FDIC's 2022 liquidity target examination, FDIC planned to reiterate its 2019 matter requiring board attention on liquidity contingency planning."[21] It also had drafted a new "matter requiring board attention" on liquidity contingency planning.[22] "FDIC stated that because Signature Bank did not mitigate its liquidity and management-related issues in a timely manner, FDIC issued an interim CAMELS rating downgrade on March 11, 2023, the day before Signature Bank was closed[.]"[23]

Clearly, both the Fed and the FDIC were dilatory in their responses to both SVB and Signature Bank. That in itself, after all the problems in the US banking system over the last 100 years, must be remedied. The fundamental question is whether government agencies have the ability to respond promptly even when problems are identified. In most cases where government operates, bureaucratic foot-dragging can be tolerated, but it's clear that this is not permissible in bank regulation.

But it is not only the Fed's and FDIC's bureaucratic sluggishness that is a problem. There are also elements of the Fed's role as monetary authority that interfere with effective bank regulation.

During the relevant period, the Fed's FOMC first raised interest rates, lowered them to historic lows, then raised them again.[24] These steps were taken to deal with the Fed's responsibilities for price stability and economic growth. It may be that these dual responsibilities—assigned by Congress—are inconsistent with one another. It may not be possible for the Fed to do both. Economic growth and jobs may require the Fed to lower interest rates, while price stability seems to require the Fed to raise interest rates to combat inflation. Performing both of these roles effectively may be impossible, and Congress should consider whether it would make sense to focus the Fed only on its initial responsibility—to assure price stability and the value of the dollar.

Nevertheless, we are where we are, and in considering the Fed's responsibility for bank safety and soundness we have to recognize how that responsibility is affected by the Fed's role in the economy. In this respect, there seems to be a clear conflict of interest. While the Fed wants to improve economic growth and employment, the Fed's bank supervisory system should be preventing banks from taking substantial credit risks. On the other hand, when the Fed wants to fight inflation and raises interest rates, that weakens the banks, as it clearly weakened SVB by reducing the value of their loan and securities assets.

As an example, beginning in 2008, when the economy was in the midst of the 2008 financial crisis, many large companies were in trouble—or had

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21 *Id.* at 25.

22 U.S. GAO 23-106736, *supra* note 12, at 25.

23 *Id.*

24 *Open Market Operations*, FED. RSRV., https://www.federalreserve.gov/monetarypolicy/openmarket.htm (last visited Mar. 25, 2024).

already failed—and the U.S. unemployment rate had reached 10 percent.[25] This was obviously the time for a Fed interest rate cut, and it did this by increasing the money supply and reducing bank reserve requirements between 2008 and 2014.[26] These actions would put downward pressure on interest rates to support economic activity and job creation.

Then, beginning in 2015, when market interest rates had reached an historic low of 0.25-0.50 basis points, the Fed began to raise rates again, probably to forestall what it saw as inflationary pressures.[27] Twenty-five basis point increases began again in late 2016 and continued through the end of 2018, when the rate had reached 2.25-2.50 percent.[28] Then, unsatisfied with the growth in the economy and no longer worried about inflation, the Fed began to cut rates every few months until by October 2019 the rates were 1.50-1.75 percent.[29]

When the Fed cut interest rates, its purpose was to encourage banks to take more risks—making more low interest loans to stimulate economic growth. When interest rates are low, banks are competing for good loans, but when interest rates reach something less than one percent, banks are competing for any loans available in the market. Then, when interest rates rise again, the loans that banks have put on their books—even Treasury securities—lose value because their rates are well below the new market rates.

Thus, in 2020, when the Fed was concerned about the rate of economic growth, it cut rates 50 basis points in early March and another 100 points in mid-March.[30] Rates again remained historically low for a year until the Fed began a series of increases in March 2022 (25 bps), May 2022 (50 bps), and 75 bps in June, July, September, and November, and 50 bps in December.[31] As is well known, SVB had a substantial amount of mortgage-backed securities and high quality Treasury bonds on its balance sheet, but as interest rates rose these began to lose value.

So, by 2023, the Fed had increased rates rapidly in 2022, after cutting rates in the year before that. Now, it began a series of increases of 25 bps in February. March, May and July of 2023.[32]

The purpose of a rate cut is often to encourage banks to lend more and take more risk. This is especially true when the Fed is trying to keep the economy from falling into recession, or worse. Low interest rates encourage individuals and businesses to borrow. In these cases, which may have the character of emergencies, the Fed may (and has) cut interest rates to zero or near zero. Under these circumstances, banks almost always take substantial

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25 Peter S. Goodman, *U.S. Unemployment Rate Hits 10.2%, Highest in 26 Years*, N.Y. TIMES (Nov. 6, 2009), https://www.nytimes.com/2009/11/07/business/economy/07jobs.html

26 FED. RSRV., *supra* note 24.

27 *Id.*

28 *Id.*

29 *Id.*

30 *Id.*

31 *Id.*

32 FED. RSRV., *supra* note 24.

risks in trying to find assets that pay any kind of interest, and these assets can be, and often are, riskier than the loans the same banks might make when the economy is functioning well.

What were bank supervisors expected to do when rates are rapidly rising and falling because of Fed policies? In these cases, regulators and supervisors would have to be particularly careful about the quality of the assets banks are acquiring. However, it would not be surprising to find that in cases of low or zero interest rates, Fed regulators are not conditioned to worry about the assets banks are acquiring. To wade in with restrictions about loan quality during this period would be inconsistent with the FOMC's policy of stimulating economic growth. But on the other hand—from the perspective of safety and soundness—regulators and supervisors have a special responsibility to make sure that banks don't weaken themselves for the future, when interest rates return to normal levels, or higher, depending on the Fed policy.

These increases and decreases in interest rates reflect Fed policy, adopted by the Fed's Open Market Committee, often after considerable debate and controversy. The Vice Chair for Regulation and Supervision is a member of this powerful committee and has a vote in the group's decisions. He or she, accordingly, probably feels an obligation to see that regulatory or supervisory policies are consistent with the outlook for the economy assumed by the FOMC when it changes its view from raising to cutting interest rates. Thus, when interest rates are low the Fed's safety and soundness regulators are not likely to penalize banks for making risky loans, and when interest rates rise Fed safety and soundness regulators are in a weak position to penalize banks for having the risky loans on their balance sheets that the FOMC wanted them to take on.

Needless to say, this is the essence of a conflict of interest, and is an untenable position for a bank safety and soundness regulator. The ideal case would be that the safety and soundness regulator should follow a consistent policy over the years—limiting the number of low interest loans or otherwise risky loans when the Fed is trying to encourage these loans, because these loans will turn out to be problematic when interest rates rise again. Or, correspondingly, when interest rates are rising or high as a result of the Fed's effort to combat inflation, the safety and soundness regulator should have previously followed policies that would limit the effect of higher interest rates on bank assets of loans and securities. The result should be a consistent policy over time.

It can be argued that the U.S. has had so many financial crises because the Fed, in its role as safety and soundness bank supervisor, had simply accommodated the interest rate policies of the Chairman and the Federal Open Market Committee instead of a policy that would accommodate the inevitable future changes in interest rates.

In other countries, there is no direct link between the monetary authority's interest rate policies and the regulatory policies of the bank supervisor. In Canada, for example, the monetary policies of the country are managed by

the Bank of Canada,[33] which has all the general authorities of the Fed to raise and lower interest rates, but the oversight of banking organizations in Canada is done by the Office of the Superintendent of Financial Institutions (OFSI), which is an agency of the Department of Finance, managed by the Minister of Finance.[34] Deposits in Canadian banks are insured by yet another independent agency.[35] It may not be coincidental that Canada has not had a single bank failure in the past 30 years.[36]

II. A NEW PRIVATE SECTOR SYSTEM FOR THE REGULATION AND SUPERVISION OF U.S. BANKS AND S&LS

The book *Back from the Brink*, from which this paper is partially adapted, focused on the then most recent financial disaster, the collapse of the Savings and Loan (S&L) industry, and the fact that the disaster was brought about by the deposit insurance system—a system designed to assure S&L depositors that they could safely deposit their savings in S&Ls. The paper noted:

> In every other area of the economy, where the distorting effect of federal deposit insurance is not present, the market denies funds to undercapitalized entities or to those whose prospects for using new money profitably are perceived to be dim. . . . [However], the introduction of discipline in the form of deposit risk, while it may discipline managers, also introduces an instability that may do more damage to the economy than the deficiency it is meant to cure. For that reason, the crude interventions of depositor discipline have historically been rejected in favor of comprehensive deposit insurance, with discipline supplied by government regulation and supervision. The S&L debacle, if it shows nothing else, demonstrates that government regulation and supervision are not wholly adequate to this task.[37]

These words were written more than 30 years ago, and ring even truer today. Again and again over these 30 plus years, we have seen that government regulation cannot substitute effectively for market discipline. Indeed, in some of the financial crises we have experienced—such as the financial crisis of 2008—government housing policies were the proximate cause of the financial crisis by leading the private sector. There, without any interference by bank regulators, banks were led into a swamp of low-quality mortgages.

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33 *About us*, BANK OF CANADA, https://www.bankofcanada.ca/about/ (last visited Mar. 25, 2024).

34 *The OFSI story*, OFF. OF THE SUPERINTENDENT OF FIN. INST., (Mar. 25, 2024), https://www.osfi-bsif.gc.ca/en/about-osfi/osfi-story.

35 *About CDIC*, CANADA DEP. INS. CORP., https://www.cdic.ca/about-us/ (last visited Mar. 25, 2024).

36 Courtney Reilley-Larke & Aaron Broverman, *The Silicon Valley Bank Failure: Why Banks Don't Fail In Canada Like in the U.S.*, FORBES (Feb. 12, 2024), https://www.forbes.com/advisor/ca/banking/silicon-valley-bank-failure.

37 WALLISON, *supra* note 1, at 2.

Then, in the wake of the resulting crisis, government policymakers handed yet more power to the Federal Reserve.

Of course, the government's solution was to tighten some of the rules and promise to do better. Everything wrong, of course, was fixed. But here we are in 2024, a year after a crisis produced by the Federal Reserve and (again) the FDIC. So again, I am suggesting that we look at the possibility of a private deposit insurance system run by the banking industry itself.

This will raise a number of questions in the minds of people who—despite all—still trust the government to make things right. But if 100 years of successive failure are not enough to warrant a substantial change in a government program, the U.S. deserves the wasteful financial crises it will endure in the future.

The important thing to recognize is that using the banking system to protect the safety and soundness of banks was how things worked before the Federal Reserve was established. At that time, there were bank clearinghouses in most of the major U.S. cities. In fact, these are the cities where many of the Federal Reserve Banks are now located. The clearinghouses were where debts and credits among the local banks were settled. As the system strengthened over time, clearinghouses took on other stabilizing activities. If a bank in the system failed, the clearinghouse would issue its own notes, known as clearinghouse certificates. These were backed by the capital of all the banks in the clearinghouse, and thus were trusted by the public. The clearinghouse notes circulated like cash, and when there was no further question about the health of the other banks in the system, the clearinghouse notes were withdrawn.

The clearinghouse system was highly efficient, in part because the conditions of most banks were monitored by the clearinghouses to which they belonged, and by other banks. Banks that were not well managed, or taking too many risks in the view of their contemporaries, could be excluded from the clearinghouse. Exclusion was obviously a very bad sign to the public at large.

Nevertheless, the system was not yet mature. In 1907, there was a panic with runs on a number of banks at the time of a stock market collapse.[38] The reasons for the panic have never been entirely clear, but it was stopped when J.P. Morgan began to shore up banks with his personal funds.[39] The lessons drawn were that the US Treasury was not able to keep banks afloat when large numbers of depositors wanted to withdraw their funds. This eventually gave rise to the Federal Reserve and its regulation and supervision of state-chartered banks and bank holding companies.

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38 Jon R. Moen & Ellis W. Tallman, *The Panic of 1907*, FED. RSRV. HIST. (Dec. 4, 2015), https://www.federalreservehistory.org/essays/panic-of-1907.

39 Richard A. Naclerio, *The Panic of 1907: How J.P. Morgan Took Over Wall Street*, GOTHAM CTR. (Apr. 20, 2021), https://www.gothamcenter.org/blog/the-panic-of-1907-how-jp-morgan-took-over-wall-street.

Here, then, we have two elements that, if properly employed, could be the basis of a private safety and soundness supervision system: (i) the capital of all the banks in a given system—not a fund requiring replenishment like the FDIC—is what stands behind the creditworthiness of each bank (that number, incidentally, was $2.260 trillion in the first quarter of 2023), and (ii) the responsibility for ensuring that each bank in the system is well-managed and operating safely rests with the other banks—that is, banks with a knowledge of the market and the pressures under which all banks are operating are the ones that will bear the risk of whether other banks are operating safely.

A. *The Monitoring System.*

It would not be feasible, of course, for each bank to monitor all other banks. That might have been true in the clearinghouse period, but not today. However, in the banking world today it should not be difficult to create a whole industry of private firms made up of or employing qualified bank monitoring specialists, together with syndicates of banks willing—for a fee—to insure the depositors of banks and S&Ls against loss of all of their deposits.

In this system, a monitoring group ("MG"), a private company somewhat like an accounting firm that employs qualified bank monitors and supervisors, would contract with the banks it will monitor. Indeed, accounting firms could find this activity to be a natural extension of their business. An MG could monitor dozens of banks. The Fed doesn't charge for its regulatory and supervisory activity, but as we have seen it doesn't do a particularly effective job either. The MG would be compensated by fees negotiated with the banks that it monitors.

Given that this structure involves thousands of banks and S&Ls, and perhaps hundreds of MGs, it should be possible to establish monitoring rates annually through a bidding process. In effect, this will form the basis of a risk-based bank monitoring fee, a system that the current government system has never been able to establish. Over time, as a bank's condition remains healthy through both easy and troubled periods, the bids for monitoring it will decline. In this way, well-managed banks and those with high or excess capital will be able to benefit financially from their quality management and reduced risk profile. On the other hand, of course, a bank that is deemed to take excessive risks will receive higher bids from prospective monitors, who will be reflecting the greater monitoring risks.

After an initial investigation, the MGs interested in monitoring a particular bank will bid for that bank's examination fee during the succeeding year, specifying the schedule for its examination and the information it will require. In most cases, the bank will accept the lowest bid or the one with the fewest restrictions or demands. Although the bank will be interested in reducing the cost of its monitoring, choosing the least expensive MG may not

be the most effective strategy in the long run, because the bank will also have to pay the cost of its private deposit insurance, described below.

Following through on the idea that the banking industry's capital—and not a government program—should be what backs the deposit insurance system, groups of banks will form syndicates to bid for an individual bank's deposit liability. In other words, the deposit insurance risk of any bank will be "acquired" by a syndicate of banks in much the way risks are sold to (or bought by) insurance consortia on the floor of Lloyd's of London.

For assuming the deposit insurance risk of a bank, the bank syndicate will receive a payment from the insured bank. The payment will vary according to the risk of default. One of the key elements of risk will the quality, diligence and experience of the MG that is the bank's monitor. In general, banks that are well managed, and pay low fees to the MG for monitoring will pay a low premium to the deposit insurance syndicate. Banks with a weak or inexperienced monitor will be required to pay a higher insurance fee to the syndicate. It should be possible for the premium on an insurance contract to be raised on an interim basis where the insured bank has missed certain risk parameters during a year.

All U.S. banks will also agree to "stop-loss" provisions so that the banks that are members of insurance syndicates that suffer significant losses would not be seriously weakened by a catastrophic loss. This means that the banks that initially assumed the risk would be protected by an agreement of all banks that no bank in a loss protection syndicate would lose more than a specified percentage of its capital in the event of a catastrophic collapse of one or several insured banks. If the losses from a catastrophic event reach that level, all banks will be required to assist the syndicate or syndicates that have suffered the losses. These cases would likely be very rare, but a stop-loss provision would assure that a major collapse would not have unusual systemic effects.

In this system, a bank like SVB would have faced additional monitoring fees from its MG as its condition declined or its risks increased. Its problems, as detailed in the GAO report described above, would be promptly reported by its MG to the insurance syndicate, and would probably have resulted in an increase in its insurance fee.

If a bank could not reach agreement on a monitoring fee with an MG, or could not find another MG and insurer syndicate within a limited period of time, it would have to close. No bank or S&L would be permitted to operate without an MG and a contract with an insurance syndicate.

CONCLUSION

Again, Bill Isaac's summary is applicable. "It's clear from the three major banking crises in the past 40 years [(1974-1976, 1980-1992, and 2008-2009)] that we have not achieved [the necessary] balancing act. None of these crises occurred because of lack of regulatory authority but rather the failure

of regulators to use their authority effectively to rein in excessive speculation by financial institutions. . . . Ineffective regulation is worse than no regulation because it gives citizens a false sense of confidence that government is protecting them."[40]

The relevant question about the current U.S. system of supervising and regulating banks and S&Ls is whether there is a better way. As it's done now—through various agencies of the federal government—has left the people and businesses of the United States, the richest and most advanced country on Earth, with regular financial crises, personal financial losses, and needless disruptions in their lives and activities. These have continued over the 110 years since the Federal Reserve was established. Perhaps it's because of the nature of banking—perhaps there just is no better way—but that seems highly unlikely.

Let's consider something as essential as the food delivery system for the 350 million people in the United States. The government has no significant role in this, except to assure safety through laws and periodic inspections, but Americans almost never find themselves without available nourishment, anywhere in the country, any day of the week, and any time of the year. The delivery of oil and gas for home heating continues without any government role, and the same is true of gasoline for automobiles and electricity for lighting streetlights and homes and powering manufacturing. Even Elon Musk's Space-X has been putting more satellites into Earth orbit than NASA.

All these essential services work day-to-day without any government role, and without any significant failure or disruption that affects more than the particular customers of a failing institution. Why can't this work for banking?

The answer is that it can. The difference between all these services and banking is that banking is heavily regulated and controlled by the government, while the rest run on private incentives. It may be that banks require supervision, but if so, incentives can be built into supervision so that banks can be compelled to act safely and soundly the same way that other private sector suppliers of goods and services do. It only takes a bit of imagination and the will to try.

In this paper, I have suggested how such a system might be run. It's what is called high level in the sense that no one has gone down into the details to make sure it functions properly, but once a monitoring group is responsible for the safety and soundness of a bank, there is no reason to suppose that it will not respond to the same incentives that keep the food, electricity, gas and other systems working without government management.

This would be a radical change, to be sure, but no one can deny that the current system isn't working.

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[40] *See* Isaacs, *supra* note 5 (on file with author).