

Though some oppressive Depression-era regulation has been removed, there is still need for reform of the U.S. banking industry.

Banking Approaches the Modern Era

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THE PAST TWO DECADES HAVE SEEN A radical transformation of regulations controlling the size, location, and activities of U.S. banks. Included in those changes are state-level reforms of branching barriers, relaxation of deposit interest rate ceilings, the passage of a nationwide bank-branching law in 1994, and the expansion of bank powers throughout the 1980s and 1990s. The reforms culminated in the passage of the Gramm-Leach-Bliley Act of 1999, which established financial holding companies — an alternative to more limited bank holding companies — as a platform for building the global, universal U.S. banks of the next generation.

Prior to the sea change of the past two decades, banks mostly focused narrowly on deposit taking and lending in separate local markets. Now, U.S. banks operate on an unprecedented large scale throughout the country and the world, and are able to marry traditional lending and deposit-taking activities with investment banking, private equity investing, asset management, insurance, and many other financial services. What caused the drastic changes? What barriers to efficient financial intermediation still remain? And what have we learned from the recent experience about the next wave of innovation and deregulation in the financial services industry?

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A BRIEF HISTORY

In order to answer those questions, we must first recognize how unusual the prior structure of U.S. commercial banking was in comparison with other countries' banking systems. Commercial banking began in the United States, as in most other countries, as an instrument of state intervention and economic planning. Banks were chartered in the late eighteenth and early nineteenth centuries to accomplish government-sanctioned purposes. The scarcity of such charters created monopoly rent for banks, which acted as an implicit tax-and-transfer scheme that supported the activities in which the favored banks engaged.

By the middle of the nineteenth century, in most states, that mercantilist approach was replaced by one of "free" bank chartering. But banks were still subject to special taxes or required to hold government paper as part of their extensive regulatory mandate.

State regulation One key feature of the U.S. system was that state laws largely determined bank regulation. States were free to establish barriers to entry in banking that limited new entrants from competing with existing banks. Not only was interstate banking forbidden, but, in most states until the 1980s, competition within states was also circumscribed by regulations that limited branching or consolidation. Despite the Constitution's clear mandate to ensure unfettered interstate commerce, the Supreme Court did not interpret interstate banking barriers as barriers to commerce. That opened the way for local special interest groups (including both bankers and some bank



borrowers) to lobby for branching restrictions. The limits on branching produced a system of thousands of banks, which reached nearly 30,000 by 1921.

Consequences The geographic fragmentation and narrowly circumscribed powers of American banks made the U.S. system inferior in several respects. It limited diversification of loan risks and diversification of income from mixing different banking services. Small, undiversified banks tended to be riskier, leading to greater instability during economic downturns. Small, rural banks were most vulnerable, and they responded by lobbying for deposit insurance — at both the state and national levels — as a means to protect themselves at the expense of taxpayers and large banks (which bore a disproportional share of the costs of mutual deposit insurance). The perverse incentives of state-level deposit insurance systems enacted before World War I produced banking collapses in several states in the 1920s, which added further to the costs from unit banking.

Unit banking also created a mismatch between the small scale of banks and the growing scale of industrial enterprises, which increasingly came to operate regional or nationwide networks of production and distribution during the second industrial revolution of the late nineteenth and early twentieth centuries. The mismatch made it increasingly difficult for banks to finance industrial activity, either as lenders or as under-

writers of securities, and thus made the cost of industrial finance unnecessarily high.

Finally, unit banking made agricultural finance more costly by limiting the development of regional or national markets for bankers' acceptances to finance the movement of crops (an instrument that was prevalent in other countries). Bankers' acceptances worked best in the context of nationwide branch banking, where banks could finance crop movements through the clearing of balances across regions within the same bank.

The Depression In the wake of the agricultural banking busts of the 1920s, those flaws became increasingly apparent to critics of the American bank regulatory system. The recognition of the bank fragility produced by entry barriers underlay a widespread and successful movement to permit branching and consolidation within and across states, and to repeal deposit insurance. As banks grew in size, they also found it beneficial to increase industrial lending and develop additional services for industrial borrowers, including the underwriting of securities offerings. But the Great Depression cut that initial wave of bank deregulation short.

The Depression accentuated the weakness of many small banks that were already distressed. Bank distress during the Depression is a complex subject. Recent empirical research by Joseph Mason and me shows that, prior to 1933 (the trough of

the Great Depression), the 1930s bank failures — like those of the 1920s — were regional phenomena that mirrored deteriorating local economic fundamentals. In early 1933, sudden, economy-wide deposit withdrawals — produced in part by anticipation of President Franklin Roosevelt’s decision to abandon the gold standard — led to a nationwide “bank holiday.” But before 1933, bank failures varied across regions in severity and timing, and were predictable results of changes in local economic activity. Local runs on banks (much less nationwide runs on banks) were not important contributors to bank distress prior to early 1933.

From the standpoint of economic reasoning, the Great Depression reinforced the logic of bank deregulation by showing the vulnerability of a geographically fragmented and undiversified banking system. Moreover, as Eugene White has shown, the Depression years also revealed an advantage from universal banking: Banks that engaged in securities underwriting during the 1920s benefited from greater income diversification and were less likely to fail during the Depression.

Backlash But the effect of the Depression on the political economy of bank regulation was to reverse the process of deregulation and the removal of entry barriers. Populist senators and congressmen defended small banks and portrayed them as victims of rapacious large banks, which they accused of dishonest practices and blamed for causing the Depression. The mixing of commercial and investment banking was particularly vilified as creating conflicts of interest within banks that combined underwriting and lending.

Recent historical studies by Randall Kroszner and Raghuram Rajan, and by George Benston, have refuted congressional allegations that universal banking promoted conflicts of interest. But those studies were produced too late to prevent the regulatory backlash caused by congressional accusations of impropriety. The historic 1933 Banking Act was a classic logrolling compromise through which populist supporters of small, rural banks, like Rep. Henry Steagall, won federal deposit insurance in exchange for limiting the investment banking activities of commercial banks (a favorite hobby horse of the sincere but misguided Sen. Carter Glass).

From the standpoint of the industry and the public, federal deposit insurance and limits on commercial banks was a “lose-lose” compromise. From the standpoint of Congress, it was the usual “win-win.”

WHY DEREGULATION AFTER 1980?

From the perspective of this thumbnail historical sketch of U.S. banking history, one might argue that the most remarkable aspect of the post-1980 bank deregulation is that it was so delayed. Why did it take so long to correct the regulatory mistakes that were exacerbated by the Great Depression? What finally led the government to permit banks to diversify regionally and branch out in products as well as locations?

Interestingly, the process of reform in the 1980s was somewhat similar to the earlier experience of the 1920s. In both eras, bank distress was an important spur to change, as it created local demands for new inflows of bank credit to replace failed

or shrinking banks. That led to the relaxation of branching restrictions, first at the state level, then regionally and nationally. And fortunately, there was no Great Depression shock to interrupt the new process of rationalization and reform.

Competition An additional important influence on post-1980 deregulation was the growing competition that American banks faced, both domestically from securities markets and non-bank intermediaries (e.g., finance companies) and internationally from other countries’ banks as opportunities for international competition expanded. The constraining influence of American regulation became recognized both as a cause of foreign bank entry into U.S. markets and a barrier to the expansion of U.S. banks abroad. Technological changes in communications and information technology that facilitated the development of securities markets and international capital flows played a role here, because they permitted new entrants to compete more easily with U.S. banks and thus drove reluctant politicians to act. (See “The Motivations Behind Banking Reform,” Summer 2001.)

Regulation Q Another influence on competitive pressures facing banks was the high inflation environment of the late 1960s and 1970s. High inflation reduced the attractiveness of bank deposits, whose interest rates were subject to “Regulation Q” ceilings. Regulation Q — another provision of the 1933 Act — was intended in part to limit competition within banking, and thereby strengthen banks. Its other purpose was to discourage commercial bank financing of stock market transactions through the call loan market. In the 1930s, Sen. Glass opposed the “pyramiding” of reserves — interbank transfers of deposits to New York banks during times of low loan demand in the periphery — because he believed that the practice made banks too vulnerable to stock market cycles. Regulation Q was intended to cure the alleged malady.

The most important effect of Regulation Q was to limit banks’ ability to compete with non-bank sources of finance in the 1960s and 1970s. High inflation eroded the return that savers could earn on low-interest deposits, and thus encouraged alternative intermediaries (e.g., credit unions and finance companies) and alternative instruments to deposits, the most important of which was commercial paper. The commercial paper market grew rapidly in the 1960s and 1970s, and became an important alternative to bank loans for high-quality corporate issuers. Just as importantly, commercial paper was the primary means of financing the growth of finance companies, which became important competitors in both commercial and consumer lending.

Institutional investors High and uncertain inflation also pointed to the advantages of equity investments over debt in household portfolios, and that encouraged the growth of equity as an alternative to debt in corporate finance. The move to equities received assistance from the establishment of new equity-holding intermediaries — pension funds and mutual funds — that, as wholesale purchasers of stock offerings, substantially reduced the physical and informational

costs of placing equity. The new “institutional investors” also funded pioneering efforts in the development of venture capital intermediaries, which transformed the financing options of growing young firms in new industries. The growth of institutional investors was encouraged by tax incentives for employee pensions and the decreasing attractiveness of fixed-income instruments.

The need for change All of those changes in intermediation technology became important in the 1960s and 1970s, and served to undermine the dominant position of depository institutions as repositories of savings and sources of funding. Because the banks’ new competitors were outside the purview of U.S. bank regulation, the regulators were faced with the choice of either overseeing the shrinkage of the U.S. banking industry or fostering its efficient transformation through deregulation. The Federal Reserve played an important role in advancing deregulation by relaxing barriers on bank activities (to the extent allowed by law) and advocating the need for more sweeping changes to preserve the competitive position of American banks.

Deposit insurance In addition to the relaxation of interest rate ceilings, the elimination of entry barriers, and the expansion of bank activities, the 1980s and 1990s saw important changes to federal deposit insurance. The reforms included the establishment of minimum capital standards and the creation of a set of rules, collectively known as “prompt corrective action,” that, in principle, should result in the closure of undercapitalized or insolvent banks before they produce large losses for the insurance fund.

The reforms attempt to prevent deposit insurance from

subsidizing (and thus encouraging) greater risk-taking by banks. Here, the spurs to change were the costly and politically embarrassing activities of risk-taking thrifts and banks during the 1980s. The FIRREA Act of 1989 and the FDICIA Act of 1991 — although unsatisfactory in important respects — represented a relatively rapid response (by congressional standards) to the thrift and banking crises of the 1980s. As with the Banking Act of 1933, Congress acted because the political costs of failing to address perceived regulatory flaws became significantly large.

BANKING AFTER THE REGULATORY CHANGES

The regulatory changes of the 1980s and 1990s are reflected in a fundamental transformation within the banking industry. The industry now consists of a complex structure of holding company subsidiaries that perform a variety of financial transactions.

Size The size distribution of banks has taken on a “barbell” shape, with giant nationwide banks and small local banks, but few in between. The consolidation wave of the 1980s and 1990s saw middling-size banks absorbed by nationwide or “super-regional” powerhouses. There is a clear link between size and scope driving scale economies in universal banking. Only larger banks that operate vast networks, which can spread overhead costs over many clients and assets, can expand into the full range of products and services needed to enhance the value of bank-client relationships. Some products (e.g., asset securitization, trust management, and derivatives origination) enjoy very large economies of scale.

Interestingly, small banks have not disappeared. In fact, many new small banks have been chartered during the consolidation waves of the 1980s

and 1990s. The reason the small banks persist is that not all bank customers need the full range of banking products and services provided by large-scale universal banks. Small banks have flatter organizational structures, implying less decision-making distance between senior management and customers. In some instances, the shorter distance permits small banks to process information about customer creditworthiness more quickly, especially when judgments about the character and experience of the borrower are central to the loan decision. If small banks focus on particular niches defined by types of customers they wish to attract, they can do so with greater agility than larger universal banks, which must be all things to all people. Tech-

FROM THE PAGES OF REGULATION

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nological changes that permit Internet access and “outsourcing” allow small banks to profitably perform a wide range of functions for customers in which they serve as the customer contact but not the ultimate executor of all aspects of the transaction. The availability of derivatives as hedging instruments and the availability of software to assist small institutions in determining their market risk exposures have also removed some of the competitive disadvantage in managing market risk that used to adhere to small size.

Who benefits? It is not clear whether, on balance, regulation currently favors small or large banks. Some fixed costs associated with regulatory compliance favor large banks. On the other hand, large banks make more attractive targets for extortionist demands by “community groups,” particularly when those banks seek regulatory approval for large mergers. And the cost structure of check clearing by the Fed (which does not charge marginal cost for its services) probably favors small banks. Deposit insurance no longer favors large banks now that the “too-big-to-fail” doctrine of the 1980s has been effectively repealed as part of the 1991 FDICIA legislation. A bailout of a large bank’s uninsured depositors must now be paid for by a special assessment on surviving banks, and thus the costs will be borne to a large extent by surviving large banks. (See “The New Safety Net,” Summer 2001.) The hope of FDICIA’s drafters is that this will lead surviving large banks to lobby against such bailouts, thus eliminating any favoritism toward “too-big-to-fail” banks.

REGULATION AFTER GRAMM-LEACH-BLILEY

Gramm-Leach-Bliley accomplished three related objectives:

- It repealed remaining limits on bank entry into investment banking and insurance.
- It established a new financial holding company structure to house those activities.
- It defined the regulatory roles of the Fed, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, the Commodity Futures Trading Commission, and other financial regulators in the regulation of financial holding companies.

Although some observers greeted the Gramm-Leach-Bliley Act as an historic triumph of deregulation, it is better viewed as a modest accomplishment. To the extent that the legislation expanded bank powers, it was an extension and codification of changes that had occurred more gradually over many years before the law’s passage. And it is likely that Gramm-Leach-Bliley will not be the last bank deregulation bill. There remain several key issues not resolved by the act, and there is every reason to believe that the continuing pressures of technological change and competition will push the banking system further than the drafters of Gramm-Leach-Bliley envisioned.

Six major flaws in bank regulatory structure remain:

- The lack of clarity about what financial activities are

allowed under the new law, which creates regulatory risk and invites politicization of the regulatory process.

- The misguided goal under the new law of segregating “commerce” from “finance.”
- The inappropriate reliance on the central bank as the overarching financial regulator.
- The persistence of the view that chartered financial institutions enjoy special rents by virtue of their charter, and that it is appropriate for government to impose explicit or implicit taxes on them to recover some of those rents.
- The absence of credible market discipline alongside supervisory discipline to prevent abuse of the government safety net.
- The failure to rein in quasi-public institutions that compete with private financial institutions in housing finance (i.e., the GSE problem).

In order for the U.S. banking industry to advance, lawmakers and regulators must address each of those points.

Financial activities The new law allows financial activities to be done within financial holding companies, but it does not clearly define what a “financial activity” is. Whether banks should be allowed to do real estate brokering, which is clearly a financial activity by any reasonable definition, has been the most hotly contested case thus far, as local real estate brokers battle to prevent banks from entering their turf. If the Fed finds that real estate brokering is not a financial activity, then banks will be prevented from engaging in that activity.

Such regulatory roulette results in banks facing unnecessary risk as they plot their strategic direction in customer and product development. What is more, it politicizes the regulatory process. That, no doubt, helps to explain why so few non-bank financial institutions have sought to become financial holding companies under the rules established by Gramm-Leach-Bliley.

Commerce vs. finance The fuzzy definition of permissible activities is the result of the government’s desire to prevent an unfettered mixing of “finance” and “commerce.” There is no convincing economic argument for that separation.

Too risky? One commonly proffered argument revolves around the need to limit the range of activities that can be financed by the insured liabilities of commercial banks, in order to prevent abuse of the government safety net. But regulators can solve that problem (and already have solved that problem for many years) by requiring the bank or financial holding company to house such activities (e.g., private equity and underwriting) in separate subsidiaries. Sections 23a and 23b of the Federal Reserve Act prevent risk transference from subsidiaries to banks within the holding company by limiting inter-subsidiary lending. Congress has already agreed that the safeguards are adequate protection against risk transference to banks from non-bank financial affiliates, so there

is no reason to believe that non-financial activities would pose a special problem for the safety net. Indeed, there is reason to believe the opposite. Financial activities tend to admit more opportunity for mischief in risk-taking than non-financial activities. And derivative transactions — which can be a source of large, sudden, increased risk by a bank looking to undertake risk at public expense — are often housed within chartered banks themselves.

Too powerful? Another argument for separating commerce from banking revolves around concerns about the concentration of power that may result from combining banking and credit. But in a large, highly competitive economy like that of the United States, it is implausible to argue that permitting Microsoft or AT&T to be affiliated with a chartered commercial bank would somehow make the software or telecommunications markets less competitive.

Trouble for the Fed The misguided separation of finance and commerce (and the regulatory risks and political infighting that it invites) is especially troubling given that the designated arbiter of the definition of “financial activity” is the central bank. Placing the Fed in the middle of such political disputes threatens its primary monetary policy function by politicizing the central bank. Similarly, giving the Fed “umbrella” authority to regulate financial holding companies exposes the central bank to undesirable political pressure. The mixing of monetary and regulatory power also creates a potential conflict of goals within the central bank. The Fed may be tempted to forbear from enforcing bank regulations because of countercyclical goals that favor an expansion of credit. Recent experience from around the world suggests that this is highly undesirable and counterproductive behavior, but central bankers that have such power often abuse it.

Most developed countries have recognized the dangers of housing regulatory authority within their central banks. In Japan, Canada, Australia, the United Kingdom, Germany, France, Italy, and many other countries, the primary entities that regulate and supervise financial intermediaries are independent of the monetary authorities. Only in the United States does the central bank continue to play so important a role in financial regulation and supervision. In part, that fact reflects the deference with which pronouncements by Alan Greenspan were greeted on Capitol Hill during the debate over banking reform. The Fed chairman’s successful power grab for his institution is one of the unfortunate by-products of his remarkably successful career as a central banker.

No rents to redistribute Another shortcoming of Gramm-Leach-Bliley was its failure, despite the efforts of Sen. Phil Gramm (R-Texas), to adequately address problems that were created by the Community Reinvestment Act of 1977. (See “Renovating the CRA,” Summer 2001.) The act begins with the premise that banks owe a special debt to their communities by virtue of the privileges conferred on banks in their charters. The CRA effectively requires banks to subsidize community programs at their own expense.

The mercantilist logic that underlies the special taxation of chartered banks is outdated; in today’s competitive environment, bank charters no longer confer rents on their recipients. Special taxes on banks erode their ability to compete and discourage non-bank financial firms from taking advantage of Gramm-Leach-Bliley provisions.

The safety net Gramm-Leach-Bliley also missed the opportunity to extract the concession of credible deposit insurance reform from the banking industry as a quid pro quo for deregulation. Because of its complexity and technical nature, prudential capital regulation is little understood or discussed in the press. But this is one of the most important areas, inside and outside the United States, in which government policy has failed and continues to fail.

The current approach to capital regulation — requiring a minimum amount of accounting equity relative to some measure of bank asset risk as the means of establishing bank stability and proper incentives — does not work. Neither capital nor risk is measured reliably. Experience with bank failures in the United States over the past several years has shown that the existing system of prompt corrective action does not prevent many bank failures from resulting in large losses to the deposit insurance fund.

There is a sore need for a reformed approach that incorporates market signals into the supervisory process and depends on market incentives to act upon perceived weaknesses in banks. Market discipline would incorporate market estimates of bank default risk into prudential regulation. That would increase the information used by examiners and, even more importantly, make it harder for supervisors to deny obvious problems. Thus, it would prevent distorted accounting and bureaucratic “forbearance” from undermining prudential regulation.

Many advocates of reform have argued that the only credible approach to preventing abuse of the government safety net is to incorporate market discipline into the supervisory process. Numerous proposals to accomplish that have been presented and debated — most notably, various plans to require large banks to issue a minimum amount of uninsured debt as part of their capital requirements. The proposals received substantial backing from academics and regulators, and even received some support from the Bankers’ Roundtable before the passage of Gramm-Leach-Bliley. After the act passed, however, large banks successfully opposed a subordinated debt requirement, arguing that it was unnecessary and potentially costly.

GSEs Perhaps the final frontier of bank deregulation is the reform of the government-sponsored enterprises (GSEs) that control housing finance in the United States (Fannie Mae, Freddie Mac, and the twelve Federal Home Loan Banks). The GSEs were formed with high public goals in mind, but it appears that they have outlived their usefulness (if, in fact, they ever were useful) and they create significant distortions and risk.

Mae and Mac Fannie and Freddie are out of control, both economically and politically. The two for-profit institutions

enjoy special benefits, including implicit taxpayer support for their liabilities. Critics from across the political spectrum have chastised the two GSEs for a number of reasons, including:

- They do not contribute significantly to Americans' ability to own homes.
- The government guarantee of their debts wastes taxpayers' money (\$10 billion a year) and poses a risk of catastrophic loss to taxpayers.
- Their role as privately owned firms with public benefits enables them to compete inappropriately with U.S. Treasury securities, thus raising government borrowing costs.
- They attempt to monopolize mortgage origination and use that monopoly status to expand into retail operations, which could have adverse consequences for competition in the industry.
- They exert a poisonous influence on Congress as powerful lobbying organizations that spend oodles of cash to silence opponents.

Fannie Mae and Freddie Mac should be reined in through a two-step process: immediate prudential regulation of their financial structure and risk management, followed by full privatization.

FHLBS The powers of the Federal Home Loan Banks (FHLBS), which provide subsidized funding to member institutions (including thrifts, banks, and insurance companies), were expanded under Gramm-Leach-Bliley. Now the FHLBS provide subsidized financing of small business loans by member institutions, in addition to subsidizing mortgage lending. Small banks, in particular, lobbied hard for those subsidies. The political power of the FHLBS has waxed over the past decade as they have come to be one of the primary channels through which banks can gain access to federal government largesse.

Possibilities What are the prospects for rectifying the GSEs' key shortcomings? There is little immediate prospect that Congress will address any of the problems. But in the long run, there is hope.

With respect to mixing commerce and finance, clever bankers will find ways to work around regulatory limits, and eventually Congress probably will be led to conclude that it is both practically impossible and highly counterproductive to enforce such a separation. A similar process led to the elimination of the barriers between banking and finance, codified in 1999, and is likely to be repeated over the next decades.

With respect to the five other problems, congressional action will depend on the extent to which the shortcomings weaken U.S. banks to the point that Congress is pressed to act. Here, the likely outcome is much less certain, and will depend on exigencies that are hard to forecast. The likelihood of reforming bank capital standards or privatizing the GSEs will rise substantially if an embarrassing financial collapse occurs at significant cost to taxpayers and surviving banks, just as the

prospects of removing the Fed from the regulatory process would be heightened by a supervisory scandal.

CONCLUSION

Bank regulation does not adapt continuously to achieve the most efficient outcome; it reacts to extreme circumstances. Those reactions reflect unpredictable political bargains that often introduce as many inefficient distortions as they purport to correct.

Bank deregulation in the 1980s and 1990s went a long way toward eliminating the many inefficiencies of the state-regulated banking system of the late 1800s. But important regulatory impediments still exist, such as the distinction between finance and commerce, the moral hazard created by deposit insurance, and the special status of the GSEs. **R**

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