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# REGULATION AND RESPONSIBILITY: A NOTE ON BANKING

*Frank H. Easterbrook*†

Arrange our principal financial intermediaries from most to least “troubled.” You get: (1) savings and loan associations; (2) commercial and mutual banks; (3) insurance companies; (4) pension funds; (5) investment banks; (6) mutual funds. There is a pattern: the more regulated the intermediary, the closer it seems to the brink. This is no coincidence. It is all but inevitable and will remain so no matter how skillful and well intentioned the regulators.<sup>1</sup>

Regulation means reducing the firm’s opportunities. Some things become illegal; others require permission and are hedged about with “safeguards”; still others are taxed. Banks do not make any distinctive product and have no captive customers. All financial intermediaries assemble capital from persons willing to postpone consumption (in exchange for a greater payment in the future) and invest in projects with payoffs that should enable them to fulfill their bargains with the suppliers of capital. Anything banks can do, other intermediaries can do. Pension funds and insurance companies finance the same sorts of buildings in which banks invest; investment banks buy and sell commercial paper that is a substitute for loans from banks; mortgage brokers make loans to householders; money market funds issue drafts that work the same as checks. In recent decades innovations in capital markets have made it easier to assemble capital through mutual funds, to market commercial paper, and so on; insurers and pension funds have increased in size as vehicles for deferred consumption.

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<sup>1</sup> I am a consumer rather than a producer of scholarship on this subject and have borrowed from the thoughts of persons who have given it serious attention. See EDWARD J. KANE, *THE S&L INSURANCE MESS: HOW DID IT HAPPEN?* (1989); LAWRENCE J. WHITE, *THE S&L DEBACLE: PUBLIC POLICY LESSONS FOR BANK AND THRIFT REGULATION* (1991); Daniel R. Fischel, Andrew M. Rosenfield & Robert S. Stillman, *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301 (1987); Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153 (1988); Jonathan R. Macey & Geoffrey P. Miller, *America’s Banking-System: The Origins and Future of the Current Crisis*, 69 WASH. U. L.Q. 769 (1991); Kenneth E. Scott, *Never Again: The S&L Bailout Bill*, 45 BUS. LAW. 1883 (1990). I use their ideas shamelessly without further citation.

Banks will prosper only to the extent they retain a comparative advantage over these rivals in assembling capital and finding attractive investment projects. Yet regulation closes some opportunities to an institution, increases the cost of seizing other opportunities, and so diminishes or eliminates that institution's comparative advantage. Capital is mobile and moves to another intermediary.

Regulators can respond in three ways: they may cut down on regulatory costs; they may "protect" the regulated institution by playing Handicapper General and imposing regulatory disadvantages on other institutions in order to create a "level playing field"; or they may dole out subsidies that recreate profits in the regulated institution at some cost to taxpayers and economic efficiency. Banking regulation has done a little of each. Banks have been allowed to offer competitive interest rates and to operate some affiliated businesses. Legislatures have constrained the behavior of banks' rivals. And deposit insurance serves as a mighty subsidy, now hundreds of billions of dollars.

Reductions in regulation promote efficient capital markets but carry with them high risk of failure (competition is a ruthless pruner). Extension of regulation to other institutions does the reverse—and by cutting down on the comparative advantage of some other institution causes money to flee once again and creates a demand for still more regulation at capital's new destination. In the limit capital flees the nation. Nothing Congress can do will create restrictions abroad, and capital does not respect borders. Nations that have tried to imprison capital by making their currencies non-convertible have failed, and by interfering with the accumulation and investment of funds these nations have eliminated any prospect of economic growth. Because the United States offers a shrinking portion of the world's investment opportunities, the power of the federal government to regulate financial intermediation declines daily—although its power to *transfer* wealth among institutions remains. As for subsidies: these can restore paper profits for a while, but they disguise the underlying inefficiency of the sector and attract money that erodes the profits and in the end saddles the subsidizer with ever-larger losses. We are experiencing this phenomenon in the savings and loan industry and should keep in mind Santayana's aphorism that "Those who cannot remember the past are condemned to fulfil it."<sup>2</sup>

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Our savings and loan business shows the process at work, and in its terminal phase. Banks (including S&Ls) have had a compara-

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<sup>2</sup> GEORGE SANTAYANA, 1 LIFE OF REASON ch. 12 (1906).

tive advantage in assembling capital at retail and investing in assets such as real estate and small businesses that financial markets do not value very well (because each parcel and firm is different). Hiring capital from scattered small investors and lending to closely held corporations and purchasers of real estate creates a maturity mismatch: the S&L or bank borrows in the short-term market and lends in the long-term market. By contrast, insurance companies and pension funds borrow and lend long, while mutual funds borrow and lend short.

A maturity mismatch creates distinct problems of illiquidity and valuation. Withdrawals can force a bank or S&L to sell illiquid assets at distress prices, and the prospect of such sales means that those who get out first emerge whole while the losses fall on those who linger. Thus the potential for "runs" and associated failures. Central banks can mitigate the problem by lending against the assets, avoiding the need for their immediate sale. And banks themselves can and do deal with liquidity problems by selling their loans in secondary markets, such as the mortgage pools assembled by Fanny Mae and Freddy Mac. Pooled investments are not an unmitigated boon, however: pools erode the banks' comparative advantage by enabling persons to invest in real estate loans and the like, bypassing banks entirely. The S&L becomes a placement and collection agent while the investors who purchase interests in the pools supply the capital.

Steps to deal with the liquidity problem aggravate the valuation problem. Long-term loans at fixed rates are highly sensitive to changes in the social interest rate. Inflation or any other reason for higher interest does two things at once: it increases the price the bank must pay in the short-term market to hire money, and it diminishes the capital value of its portfolio of loans. Liquidity through mortgage pools and the like makes this capital loss evident immediately; the price of interests in the pool drops as interest rates rise, and the reverse. Selling these interests and generating instant cash simply realizes the loss faster.

None of this would be troubling but for one thing: banks' and S&Ls' liabilities are in nominal dollars. When the value of assets in a mutual funds falls, investors absorb the loss and the fund itself is unaffected; so too with defined-contribution pension plans. Insurance companies hedge against investment losses by retaining discretion over returns credited to the policy, and even defined-benefit pension plans cope by promising benefit levels that they fully expect to adjust upward if the investments have their expected return; a shortfall means less or no increase in benefits. Banks and S&Ls

promise fixed dollars; any shortfall means failure and a transfer of liabilities to the insurance fund.

Public insurance, created in part to discourage runs, also reduces the risk of placing money with a bank or S&L. It leaves depositors no reason to monitor the riskiness of their investments. If all investments in banks are equally risky, why not go to the one offering the highest interest—and coincidentally the highest risk to the fund? When risky banks can attract money as easily as sound ones, too much capital flows to the hands of inferior managers. Failure is the wedge to separate good from bad; capitalist economies rely on failure to improve efficiency. When we use public funds to create a no-risk, no-failure sector of the economy, we purchase extra (but disguised) risk and failure. Deposit insurance subsidizes failure, obtaining the cash by taxing success in and out of the financial services industry. Subsidy creates more of the thing subsidized and less of the thing taxed; we produce more failure and less success.

With insurance comes strings, to hold down the cost of the subsidy. Regulators require banks to have a specified net worth (a cushion under the public commitment), restrict investment in assets deemed especially risky, and so on. Unfortunately such controls may backfire. A command to infuse new capital into a S&L may induce the investors to abandon it instead. An obligation to hold a narrow portfolio of safe investments paradoxically may increase risk. A loan secured by a mortgage on a parcel of real estate is safe individually; the security interest assures that. But a portfolio of residential loans, although safe against default, is highly sensitive to changes in interest rates. They are safe individually and risky in the aggregate. Perhaps the worst thing that can happen to an S&L is for the rates to rise and all of its customers to pay off their loans; the capital loss is large.

Regulations induce S&Ls (especially) to invest in narrow portfolios of similar assets. Portfolios of similar investments have high covariance and are exceedingly risky. To avoid the interest-rate risk an intermediary must invest in assets with low (even negative) covariance. Yet such investments also enable the institution to avoid regulatory scrutiny; the regulator cannot tell whether the investment strategy has been designed to transfer excess risk to the insurance fund. Freedom in selection of assets gives bank regulators fits. Therefore they discourage (and Congress sometimes forbids) the kind of diversification that modern portfolio theory defines as essential to prudence!<sup>3</sup>

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<sup>3</sup> See BEVIS LONGSTRETH, *MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE* (1986) (collecting sources).

Other "safeguards" such as net worth standards are pointless when the firm has no net equity. As new capital inures to the benefit of the Treasury, the investors swallow their losses and move on; sunk costs cannot be retrieved. Manipulation—phony capital—is of course more attractive. Regulators may even create it to make themselves look good. Banking regulators approved a set of accounting conventions that can be charitably described as odd (the uncharitable description is also unprintable), to which they added a new kind of "goodwill": the capital shortfall of an acquired bank is treated as an asset on the acquiring bank's books, to be amortized over 15 or more years. Only a regulator can turn a liability into an asset by the stroke of a pen. Flim-flam of this sort, when practiced in the private market, lands entrepreneurs in jail. It is not hard to imagine what the SEC would say if an issuer of securities listed such an "asset" on its books.

Back to the maturity mismatch. If interest rates rise, the capital value of the portfolio falls, and the reverse. In the late 1970s interest rates rose dramatically. By 1981 the net worth of the S&L industry was a negative \$100 billion.<sup>4</sup> S&Ls could try to ride out the troubles and wait for rates to fall. Rates did fall during the 1980s, and a substantial majority of institutions weathered the storm. But it was not easy to sit tight during what Edward Kane has called the Zombie Bank phenomenon: the walking dead S&Ls feed on the living.

Investors in an S&L with negative net worth have been wiped out. They could walk away—but they need not. Still in control of the institution, they can jack up the risk. They have the equivalent of warrants on the upper tail of the distribution; the taxpayer covers all loss. If a high-variance strategy pays off, the investors reap the gains; if it doesn't, they have lost nothing. So they make high risk loans, getting the business by charging the borrower less than a sound rate of interest. Shaving the rate of interest in this way depresses the returns available to soundly managed S&Ls. Where do the Zombies get the money to invest? They offer higher returns to depositors. Freed by deposit insurance of the risk of nonpayment, the depositors are happy to oblige. Brokered deposits assemble some of the money, but cash flows to higher bids with or without brokerage. Again this siphons money away from sound institutions, which find themselves squeezed at both ends. Zombie banking harms more than the investors in sound banks. It injures society at large by diverting too much money to marginal projects. And by drawing money into these projects, it puts pressure on the next

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<sup>4</sup> An average of the estimates in KANE, *supra* note 1, at 75, and R. DAN BRUMBAUGH, JR., *THRIFTS UNDER SIEGE* 50 (1988).

layer of financial intermediaries. Its profits decline, and the ailment spreads.

In most sectors of the economy, firms with negative net worth are washed through bankruptcy and their assets released for more productive endeavors. Not so in banking. The bankruptcy laws do not apply; regulators seek to postpone the day of reckoning in order to reduce claims on the insurance fund or to serve their patrons. Discretion invites political influence. Forbearance in the hope of revival characterizes the regulatory sector, which plays the same double-or-nothing strategy as the Zombies themselves.

Some of the Zombies will get lucky, but, as the strategy has a negative present value at each institution, the effect across hundreds of S&Ls is substantial, and the Treasury pays. The bill came due in 1989. Congress does not part with \$100 billion and up without exacting a toll in the form of additional regulation. For example, it required S&Ls to invest a greater portion of their assets in real estate and to get rid of subordinated debentures ("junk bonds"). That change made regulatory oversight easier and made each loan safer—but the S&Ls' portfolios are less safe, because there will be greater covariance. Rearranging portfolios damaged adjacent sectors. Pressure to sell off debentures depressed their price and made them less liquid, to the detriment of other institutions (banks, insurance companies, university endowments) holding them, and to the detriment of entrepreneurs in need of capital.<sup>5</sup> Pressure on the next tier of financial intermediaries may cause the cycle to repeat.

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What do we learn? How do we avoid a repetition? Let us hope that the central lesson is that regulation and subsidy defer but ultimately enlarge the costs of failure. Assembling and deploying capital efficiently is essential to prosperity. Let us rejoice in, rather than squelch, the comparative advantages of the different intermediaries. There are at least four ways to enjoy rather than suppress the economic advantages of banks.

1. End the subsidy of deposit insurance and the associated regulation designed to protect the public fisc. Let bankruptcy separate good from bad. In the United States before deposit insurance was introduced during the New Deal, depositors lost an average of 0.21% of their investments during bank failures.<sup>6</sup> Investors accept such losses routinely in stock and bond markets; the Dow Jones In-

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<sup>5</sup> See Frank H. Easterbrook, *High-Yield Debt as an Incentive Device*, 11 INT'L REV. L. & ECON. 183 (1991).

<sup>6</sup> George G. Kaufman, *Implications of Large Bank Problems and Insolvencies for the Banking System and Economic Policy* 5 (Staff Memorandum No. 85-3, Federal Reserve Bank of Chicago, 1985).

dustrial Average fluctuates more than that every day. Depositors can reduce even this small exposure by diversifying across banks—just as they are already diversified across investments by owning real estate, insurance, and pension plans. Remaining risk may be spread by private insurance.

This conference is about individual rights and responsibilities. Making investors responsible for their choices is attractive on moral as well as economic grounds. We allow persons to select occupations, places to live, spouses, and so on, reaping the rewards and bearing the risks of failure and regret even though these are both harder to diversify and much larger than their exposure in banking transactions. Individual rather than socialized choice and reward (or penalty) has produced great gains. Let pensions and the Social Security system serve as the safety net. The economic boon from more efficient financial intermediation will swamp the small losses in particular failures.

2. If deposit insurance, as a way to protect improvident (= undiversified) persons from themselves, remains an imperative in the United States, then set prices for the insurance correctly. Zombies forced to pay the real costs of their activities will return to their graves quickly.

There are good and bad ways to price insurance. Regulatory risk assessment—classifying the general riskiness of different investments and charging more for insurance as risk rises—is a formula for disaster. Putting loans in categories is discretionary, imprecise, and ultimately misguided. It is impossible to overstate the importance of both diversification (rather than concentrating in loans that are “safe” only when viewed one at a time) and the elimination of official discretion (to cut politics out of banking).

Markets can supply risk assessments free of charge to the government. Congress could require banks and S&Ls to issue debentures subordinated to all other claims. The interest rate implicit in the price realized for the instruments would give the market's estimate of the riskiness of the bank.<sup>7</sup> Or Congress could cut public insurance to 90% of deposits and require banks to insure the other 10% in the private market; the price charged to each bank for private insurance could be used as the price for public deposit insurance.

Markets are of course imperfect—people who influence market prices are fallible and short of information—but are superior to regulatory alternatives. Markets pool the information of many inter-

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<sup>7</sup> See Kenneth E. Scott, *Deposit Insurance—The Appropriate Roles for State and Federal Governments*, 53 BROOK. L. REV. 27, 35 (1987).

ested persons, whose financial exposure induces them to do the best they can when making bids. Regulation relies on the guess of a few people whose wallets are not at risk.<sup>8</sup> The difference in accuracy is substantial. Interest rates on uninsured deposits in the United States vary by more than 200 basis points, in just the direction that risk implies. Equity prices of troubled financial intermediaries fall six to eighteen months *before* regulators put the banks on the problem list (a step that itself long precedes serious action). When "problem lists" are leaked to the press, prices of the banks' securities do not move; they already impound the value of the information. Markets look pretty good compared with, say, the predictions of banking regulators during the 1970s and 1980s.<sup>9</sup>

3. The maturity mismatch creates the perceived need for insurance and regulation. A third possibility, then, is to eliminate the maturity mismatch—to make banks more like money market funds.<sup>10</sup> Congress could limit deposit insurance (and perhaps the right to use the word "bank") to institutions whose deposits are fully secured by liquid instruments, such as Treasury securities, commercial paper, or shares in mortgage pools. Both the risk and the need for oversight of such "narrow banks" are minimal. Incautious investors would be secure without the need for (substantial) public subvention; other persons could assemble and deploy capital without the regulatory strings now in place.

4. Most of the rest of the developed world uses a completely different solution: the "broad bank," a diversified institution combining commercial with investment banking, free to put capital into equity as well as debt.<sup>11</sup> Rates of bank failure in Europe and Japan are low; diversification protects depositors. Banks that can invest in financial instruments of all kinds need not prefer debt over equity.

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<sup>8</sup> See Frank H. Easterbrook, *Monopoly, Manipulation, and the Regulation of futures Markets*, 59 J. Bus. S103, S114-16, S122-26 (1986).

<sup>9</sup> Macey & Miller, *Bank Failures*, *supra* note 1, at 1197-98, collect a lot of this evidence.

<sup>10</sup> See *Blueprint for Restructuring America's Financial Institutions: Report of a Task Force* (Brookings Institute, 1989) (reflecting the contributions of George J. Benston, R. Dan Brumbaugh, Jr., Jack M. Guttentag, Richard J. Herring, George G. Kaufman, Robert E. Litan, and Kenneth E. Scott).

<sup>11</sup> See, e.g., Takeo Hoshi, Anil Kashyap & David Sharfstein, *The Role of Banks in Reducing the Costs of Financial Distress in Japan*, 27 J. FIN. ECON. 67 (1990); David G. Litt, Jonathan R. Macey, Geoffrey P. Miller & Edward L. Rubin, *Politics, Bureaucracies, and Financial Markets: Bank Entry into Commercial Paper Underwriting in the United States and Japan*, 139 U. PA. L. REV. 369 (1990); Stephen D. Prowse, *Institutional Investment Patterns and Corporate Financial Behavior in the United States and Japan*, 27 J. FIN. ECON. 43 (1990); J. Mark Ramseyer, *Legal Rules in Repeated Deals: Banking in the Shadow of Defection in Japan*, 20 J. LEG. STUD. 91 (1991); Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469 (1991); Mark J. Roe, *Political and Legal Restraints on Ownership and Control of Public Companies*, 27 J. FIN. ECON. 7 (1990).

Today a bank in the United States must try to persuade its clients that more debt is a Good Thing; banks in Japan or Germany may buy equity when that is the prudent course for the client and the bank itself. This is how the banking industry developed in the United States too—suggesting the economic value of such institutions. Until the forcible dismantling of the industry by the Glass-Steagall Act and related legislation in the 1930s, we prospered with the assistance of broad banks. Much of the regulatory legislation from that era has been repealed; perhaps it is time for us to rejoin the rest of the developed world in banking too.

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A brief recap. In a world of free-flowing capital, the best-intentioned efforts, carried out by the most conscientious regulators, are likely to shift and increase costs of failure simultaneously. Thoroughgoing regulation by incorruptible public servants may be the most fearsome of all, for it stifles competition most completely. Regulatory handicaps on one institution cause capital to flee; the handicapped institution may be propped up for a while, but a delayed fall is a bigger fall.

More reliance on competition and diversification, and less on regulation, will turn off the spigot attached to the Treasury and will improve the efficiency of financial intermediation. Coinsurance, risk rating, narrow banks, broad banks—all rely on the market. Risk is borne by those who create it (and who have something to gain) rather than spread to the public at large. Markets reflect individual rather than collective responsibility and produce a pleasant overlap between moral and economic understandings.