Moral Hazard Deposit Insurance and Banking Regulation

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I

INTRODUCTION

A century and a quarter ago, Walter Bagehot, the Victorian social critic said: "'The distinctive function of the banker begins as soon as he uses the money of others'; as long as he uses his own money he is only a capitalist."¹

In the words of Justice Brandeis, honest bankers "who are using . . . the money of others, realize that they hold the money in trust for its owners and must be fair to the beneficiaries."²

Banking thus is a fiduciary activity.³ For that vast majority of bankers who are scrupulously honest, that fiduciary precept is self-evident, self-executing, and unvaryingly observed. As the recent savings and loan experience demonstrates, however, a significant minority do not voluntarily adhere to fiduciary principles. Yet costly fiduciary failures are not unique to the savings and loan story. Sig-

¹ The author was appointed Chief Counsel of the Office of Thrift Supervision of the U.S. Treasury Department in May of 1990. The views expressed in this speech are those of the author.
² Quoted in ALPHEUS THOMAS MASON, BRANDEIS: A FREE MAN'S LIFE 409 (1946).
³ See Lane v. Chowning, 610 F.2d 1385, 1388-89 (8th Cir. 1979) ("[I]t is well settled that the fiduciary duty of a bank officer or director is owed to the depositors and shareholders of the bank, and not to the Chairman of the Board or Chief Executive Officer."); First Nat'l Bank of La Marque v. Smith, 436 F. Supp. 824, 831 (S.D. Tex. 1977) (fiduciary obligation of corporate officers is "even stronger in the case of a bank, both because of the fiduciary nature of banking and because of the duty to depositors."); Federal Sav. & Loan Ins. Corp. v. Huff, 704 P.2d 372, 378 (Kan. 1985) (state corporations statute "estabhshes [that] the legislative intent is to place higher standards of duty on savings and loan institution officers than on officers of ordinary for profit corporations."); Gibraltar Realty Corporation v. Mount Vernon Trust Co., 12 N.E.2d 438, 439 (N.Y. 1938) ("[A] bank deposit is more than an ordinary debt, and the depositor's relation is more than an ordinary debt, and the depositor's relation to the bank is not identical with that of an ordinary creditor."). See also Briggs v. Spaulding, 141 U.S. 132, 147 (1891) ("Bank directors are often styled trustees, but not in any technical sense . . . But, undoubtedly, under circumstances, they may be treated as occupying the position of trustees to cestui que trust.").
significant fraud has accompanied virtually every financial disaster since the South Sea Bubble of 1720.  

But there is something different about the savings and loan story. That difference lies in the extent of dishonesty in failed institutions and in the way the losses have fallen directly on the U.S. taxpayer. Over 800 persons have been convicted of thrift-related crime; 156 of those convicted are former directors or officers of institutions; hundreds of others have been banned from the banking and thrift business by administrative orders; dozens of lawsuits, seeking to retrieve tens of billions, have been brought; and the clean up is not yet complete. The extent of fiduciary wrongdoing and the cost to the public is without precedent in economic history.

In opposing the deposit insurance proposal in 1933, Franklin Roosevelt predicted that insurance would “put a premium on unsound banking in the future.”

Have the savings and loan losses proved Roosevelt right? In part, they have. This leads to the second distinguishing feature of the savings and loan debacle. By socializing the risks of “unsound banking,” deposit insurance facilitated the unsafe and fraudulent activity that caused the extensive losses that we as taxpayers must now make up. It did so by impairing market mechanisms that might otherwise have inhibited fiduciary breaches.

Depository fiduciaries are sheltered from the rigors of the market because risky activities are unlikely to cause depositors to depart undercapitalized banks. That serves the objective of deposit insurance: to retain the confidence in the banking system throughout economic cycles. But, because deposit insurance may separate risk from reward, that insurance can catalyze legal and financial hazard.

I draw two conclusions: First, that deposit insurance can produce substantial distortions in the incentives governing banks and thrifts. Second, that deposit insurance itself need not lead to large losses.

II

I begin with a fundamental premise: Deposit insurance is a fact of life. All industrialized countries have it, although protection is not as great elsewhere as in the United States. Federal deposit insurance has been useful and successful. It is widely credited with avoiding the panics and resulting contractive economic collapses that infected the economy periodically until 1933. The insurance

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5 U.S. TREAS. DEPT’T, MODERNIZING THE FINANCIAL SYSTEM (Feb. 1991), ch. XXI.
program could be modified in ways that would limit future taxpayer exposure to losses without impairing its fundamental purpose of maintaining confidence.

Deposit insurance therefore is and should remain a fixture. Our insurance system serves its primary function of maintaining public confidence in a stable banking system and does that very well. The national economy has not only survived but also prospered during a decade that has seen a large number of bank and thrift failures. That the banking system and the economy as a whole have remained stable in the presence of these many bank failures appears to be an unusual event in free market economic history. Deposit insurance is likely due much of the credit.

III

But we have also faced in the last decade less salutary results from deposit insurance.

The direct cause of hazard lies in the potential of an insured depository institution to operate in a risky, unsound fashion without real economic risk to its owners. The managers and directors also bear no risk, at least until the institution is ultimately taken over by the regulators, who often sue those fiduciaries.

Our experience in the savings and loan crisis illustrates what happens when risk and responsibility are separated from reward. The system can be endangered.

Deposit insurance, however, cannot be viewed as the sole source of the losses we have suffered. It may have been one of several "but for" causes, but it has not in itself been a sufficient cause of those losses. Another factor is that state and federal legislators and regulators permitted thrifts to undertake risky activities with little economic capital. Without federal deposit insurance, thrift operators would have been less able to take advantage of these relaxed investment rules—because depositors would have withdrawn their money from undercapitalized, uninsured institutions engaging in high risk activities.

An aside on banks and equity capital:

The average equity capital-to-asset ratio for all nonfinancial firms in 1986 was 36%. By contrast, the average bank capital-to-asset ratio is generally around 6%. Several of the largest thrifts that eventually failed operated with less than 2% capital. That de-

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7 Id.
pository institutions can still attract depositors with such a low capital-asset ratio is due to deposit insurance.8

The combination of thin capital and generous deposit insurance privatized the gains and socializes the losses—in other words it created a "heads we win, tails you lose" opportunity for shareholders.

One result of this incentive structure was that the supposed "deregulation" of the thrift industry in the early 1980s actually led to "decapitalization" of segments of the industry. The shareholders and managers in thinly capitalized institutions then had every incentive to take on greater and greater risk, in the hopes of hitting it big. The mixture of deposit insurance, weak capital rules, high risk activities, and limited law enforcement powers became a recipe for failure.

Was it right or justified for some thrift operators to run their institution in a high risk, unsound fashion? Of course not, and we should bring ethics and personal responsibility back into the discussion for a moment. Those owners and operators of risky thrifts were subject to fiduciary duties long articulated in case law, statute, and regulation.

All too often some thrift operators ignored their duty to safeguard the depositors' money. Our experience raises questions, however, about the efficacy of fiduciary duties in the face of pressure from contradictory incentives.

This is a substantial reason why, beginning in 1989, we have seen statutory and regulatory initiatives that directly address the need for more risk sensitive regulation and more effective civil law enforcement in banking.

One of the first acts of the Bush administration was to submit legislation in early 1989, endorsed by the Congress in FIRREA, that addressed the problems in thrift regulation due, in part, to the distortions caused by deposit insurance.

The centerpiece of the FIRREA legislation in 1989 was an increase in capital standards that give bank and thrift owners a greater stake in the soundness of an institution.

An essential companion to the increased capital requirements is more rigorous accounting standards. The 1989 legislation abol-

8 Id. Bank capital-asset ratios were around 15% in the early 1930's, before the institution of deposit insurance in 1933. This 15% number in fact understates the effective capital level at that time, because national bank shareholders, unlike shareholders in other industries, were subject to an additional capital assessment up to the par value of their shares. This double liability was phased out during the 1930's after the introduction of deposit insurance. Id. at 3, 6.
ished the rules that favored accounting illusion over economic
substance.

Another key regulatory issue addressed by FIRREA is what hap-
pens if an institution fails to meet its capital requirements. FIRREA
broadened the agency's power to take over an institution that fails
its capital requirements, and OTS is shutting such institutions down
unless there is credible evidence that they can attract new capital.

But regulations are only as effective as the agency that adminis-
ters them. During the 1980s we saw evidence that a Gresham's Law
operated in the interaction of state and federal regulation of
thrifts—state regulators competed to relax regulatory standards and
thereby attract thrift charters. FIRREA stopped that as well. Now,
if the federal insurance fund is on the hook, a federal regulator sets
the minimum requirements for operation of a savings association.

Regulation was also burdened by certain attitudes and con-
straints that hindered aggressive agency enforcement. The prevail-
ing view was that high profile, aggressive enforcement should not be
pursued in the depository business. The traditional regulator pre-
ferred an informal, confidential process, often resting more on per-
suasion than process.

FIRREA has changed all that. That Act expanded the ability of
the agencies to levy civil money penalties for wrongdoing in insured
institutions and enhanced our general enforcement powers. Last
year's crime bill establishes a presumption that bank and thrift en-
forcement actions should be public, rather than private. This was an
important development, for if actions are public not only does the
industry realize the regulator will respond forcefully to abusive con-
duct, but the notices of charges, consent agreements, final orders,
and other documents form a body of literature that provides gui-
dance to those charged with the safe and sound operation of insured
depository institutions.

The Administration and Congress have already put in place a
series of measures designed to moderate the adverse potential of
deposit insurance. Some, like the increased capital requirements,
address the question of economic incentives and provide a cushion
to protect the insurance fund. Others, like effective enforcement
and restrictions on the investments that can be made with insured
funds, are both corrective and prophylactic.

CONCLUSION

Given the current scandals in the financial world, I would like to
close by briefly considering the question of fraud, and its connection
to financial crashes and panics. History shows that where one finds
a speculative boom, frauds and swindles may not be far away.\footnote{Kindleberger, supra note 4, at 90.} The euphoria present on the way up leads to over-investment and excess leveraging. The participants expect values to continue to go up in order to keep the cycle going. Then the rise begins to slow, and the market that seemed destined to go on forever may suddenly halt. As the bubble bursts, raised expectations and overleveraged commitments become harder and harder to meet. Before federal deposit insurance, the usual result was panic, bank runs, accelerated deflation, and economic contraction.

Federal deposit insurance seems to have eliminated the destructive panics and bank runs. Despite the large numbers of bank and thrift failures over the last several years, and the scandal of fraud and wrongdoing involved in all too many, we have seen no panics or mass withdrawals by depositors. Instead, there is confidence in the federal guarantee and depositors continue to seek the best return regardless of the risk of failure.

Deposit insurance in the 1980s catalyzed a different sort of fraud, one where undercapitalized depositories survived as the walking dead, exposing themselves to ever higher levels of risk in the hope of a big win. Some schemes conducted by the operators of thrifts and banks were fraudulent from the outset. But others become fraudulent due to the moral hazard created by deposit insurance, and the euphoric illusions of a speculative boom. And meanwhile deposit insurance eliminated discipline by those who would otherwise be exacting monitors: depositors.

So what can we learn?

The savings and loan crisis provides an instructive example of the consequences of separating risk from reward in the financial marketplace.

The choice, in the presence of deposit insurance, is not between "regulation" and "market." The better option is regulation within the market, including regulation that seeks to re-enforce market based incentives and limits. Regulation must include rules that maintain the connection between the private opportunity of gain and private risk of loss that deposit insurance would otherwise eliminate. The degree of regulation should be inversely proportional to the health of an institution. The regulatory framework must be backed up by effective civil law enforcement. The legislative and regulatory activity in Washington since 1989 has been in service of these objectives.