DISCUSSION

GRAY:

This discussion has been very interesting, but it seems to beg the larger question of how we got into the crisis. I agree that the deposit insurance increase of the so-called midnight raid of March 1980 was not the sole causative factor, and there are some other questions which remain unanswered. Is there something in the tax code affecting banks, real estate, and these bankruptcies? After all, the First American Bank collapse here in Washington, D.C., involving BCCI, was certainly hovering in the background. What someone surely should have known sooner is that the bank was in terrible shape because of real estate. Is there something in the tax code or in other parts of our law that geared so much lending toward real estate? We do not seem to have quite the same number of problems, oddly enough, in our old rust-belt industrial sector.

EASTERBROOK:

I don't see any clean link between capital gains taxation and others. Taxing rules for banks are so different from the rules for other institutions that it is very hard to translate from capital gains taxation at the shareholder level to the behavior of banks.

GRAY:

I was asking the question in the larger sense: if an entrepreneur has a choice between debt and equity, what leads him to borrow rather than go to the market for equity capital? I am not talking about how banks are taxed, but about how the person receiving the debt or the equity is taxed.

EASTERBROOK:

Tax considerations play an enormously important role, if you're an entrepreneur deciding whether and what kinds of claims to write. Banks have somewhat different incentives. Let me reiterate a point that I made in my talk. In the United States, which imposes severe limitations on the kinds of instruments banks can accept in exchange for money, banks have an incentive, entirely apart from the tax system, to persuade firms to issue debt, because banks can't accept equity. If you go to a bank in Germany or Japan, the bank, in exchange for putting up a large sum of money, can accept claims that are in part debt paper and in part equity paper. Banks have an incentive to write whatever set of claims is most conducive to the survival of the business, for the banks want to get paid. They want to get money out. A bank in the United States, by contrast, always
attempts to persuade the firm to write debt. The banker will be thrown in jail if he accepts equity in exchange for money. And that, I think, is one of the problems with U.S. bank regulation. I don’t want to comment on any pending proposals for changes in legislation, but the shortage of diversification, and the way in which banks in the United States are much narrower than banks in other industrialized nations, is an important ingredient in understanding why the failure rate is higher here than elsewhere.

WEINSTEIN:

May I comment on the tax issue? There are several tax code provisions that we might point to and ask if they really have been beneficial to banking. I think Boyden Gray is right in suggesting that some of them played a role in what has happened in the thrift business. Real estate, of course, is the major investment for thrifts and over the '80s it became an increasingly important investment vehicle for commercial banks in various parts of the country. In the early '80s and to a lesser extent before then, the tax code was structured in a way that substantially favored investments in real estate. And there was, among other things, a considerable opportunity to transmute ordinary income into capital gains through investment in real estate. That plainly had a large influence on the tremendous amount of lending and other investment activity in real estate, both commercial and residential, during the 1980s. Then in 1986, Congress abruptly changed the rules, while many projects were in midstream, after many investments had been made, and many loans had been granted, in reliance on the prior rules. The first changes were not innocent of involvement in the extensive financing that thrifts and banks gave to real estate during the early to mid-80s, and the last change was hardly innocent of involvement in the collapse of many thrifts that were heavily involved in commercial real estate projects at the time.

The differing tax treatment of dividends and interest is also of significance. Corporations in certain circumstances will favor debt because the interest on servicing of that debt is deductible and dividends on equity are not. So of course this tax rule does deter some forms of equity investment. In banking it is important to the public and depositors, with or without insurance, to have a good equity base.

There is another tax rule that affects thrifts and it is known best to those whom I would call the “techies” in the business. It’s called the QTL rule, the qualified thrift lender rule. And just to make things particularly complicated, there is one version of it in the
banking laws\(^1\) and another version of it in the tax laws\(^2\) and they may not always reach the same result. But the end result in the tax code is that thrifts over the years build up deductions if they have a certain percentage of their portfolio in residential real estate and similar investments that are defined in the law. They build up these deductions as reserves against which losses are thereafter offset. One result is excessive regulatory and tax code constraints on depository institutions in moving back and forth between different charters or different lines of business. There are a lot of very technical but important differences in what you can do, that depend on whether you are a thrift or commercial bank or a savings bank. And it can depend on whether you've got a federal charter or one of the fifty-two or -three state and territorial charters that are available. But once you are a thrift and you build up this QTL reserve, there is a tremendous tax cost in its recapture if you seek to change your charter and way of doing business and then fail to qualify under the Tax Code QTL provision. So we have some of these more obscure and hidden costs that impair movements in the business that might be rationally responsive to changes in the business climate.

**EASTERBROOK:**

I trust you don't get any extra supervisory goodwill as a result of building these things up.

**WEINSTEIN:**

True.

**GRAY:**

Are there any questions from the audience?

**QUESTION:**

This is a general question directed to all the panelists. You have not touched on consumer bankruptcy, which, to some extent, may be the link missing between the two sides of the table. It may also cast some doubt on Professor Warren's assertion that the Bankruptcy Code does not operate to socialize risks. We have now reached a point where there are approximately one million consumer bankruptcies a year, and the number is rising. The debt discharged in consumer bankruptcy is almost entirely credit card debt, and credit card debt today is held mainly by eight or ten major American banks, for which it is the most profitable part of their business. Interest rates on credit card debt have been unregulated since the *Marquette* decision in 1978.\(^3\) The result has been that banks issu-

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ing credit cards have been able to convert their losses by raising interest rates. The prime rate fell from 19% in 1981 to 8% in 1986; during that period, bank card rates remained stable. During the two-year period beginning in April of 1989, the prime rate fell by one-third and bank card rates actually rose, which suggests that the assumption that there is effective competition with respect to bank card rates is misplaced. I wonder, if this process continues, whether several of our banks will be in a position where substantial socialization of risk will be needed to protect the integrity of the banking system. Is what we have here a cocktail composed of Congressional Democrats resistant to tightening consumer bankruptcy exemptions and the Administration or its agencies resistant to the reimposition of a floating usury rate on credit card transactions?

WARREN:

No. Your data are right. Citibank lost $150,000,000 last year on all of its operations other than credit card operations, and made $600,000,000 on its credit card operations.\(^4\) It is nice to know that the last time you used your Visa card you subsidized those bad LBO loans and bad debts to Argentina.

But I do not draw the inference that we are talking about some kind of socialization of risk. I think we are watching the same thing happen on the consumer side that we watched happen on the business side. Banks have rising losses in consumer bankruptcy, but what have they done every single year? They have put out as many more cards as they could. Why? Because it is profitable to take those credit card losses. That is what the statistics show them: go ahead, because although one out of a hundred debtors cannot pay, 99 are paying off at 21% interest. And when the spread between the wholesale and retail cost of money is from 6% to 21%, business is profitable—even the highest risk business.

What troubles me is the suggestion that the answer is to tighten the consumer bankruptcy laws that give those debtors relief. Clamping down on consumer debtors will yield very little. The problem in consumer bankruptcy is that the people who file cannot pay their debts. You can rip out their fingernails, you can sweat them, you can tell them they cannot have any kind of discharge in bankruptcy, but the reality is that they cannot pay. For the banks to describe these losses as bankruptcy losses is a little joke. The credit card companies have plain, old fashioned, bad debt losses. When you give a ninth credit card to somebody who makes $16,000 a year, two things are likely to happen. First, you run a real risk that when

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\(^4\) Michael Quint, Banks Raise Scrutiny of Credit Cards, N.Y. TIMES, Sec. 1, at 33 (May 27, 1991).
the holder makes charges on it, he is not going to pay you back at the other end. Second, enough people will pay back at 21% interest for you to make a profit on it. That is exactly what is going on now.

The connection you make between bank failures and dependence on high-interest credit cards is a fair one. But surely you are not suggesting that the way to save the banks is on the backs of unsophisticated, high-risk consumer borrowers. In effect, the banks are currently trying to make up their losses from real estate lending, leveraged buyouts, foreign loans and the like, by expanding their super-profitable credit card business. And if the credit card business is not so profitable as the debtors become riskier, should we squeeze the debtors harder? I do not think so. The answer is not to cut consumer protection. It is to demand better lending activity generally.

JONES:

What I would point out in response to that is yes, you can feel sorry for the debtor who is unable to pay his or her credit card debt, but if there were no bankruptcy discharge at all, we would all think much more closely before borrowing the money.

WARREN:

I am not sure that that is empirically true. Most of the people who do not pay their credit card debts do not go into bankruptcy. They just do not pay them. They move. They change names. They juggle and shuffle. There are a lot of responses to debt. Knocking over a convenience store is a response to debt. It is not the case that if you cannot get a discharge in bankruptcy you will somehow become a rich or a responsible person. The credit card companies know this. They do actuarial lending—high profit actuarial lending.

QUESTION:

I would like to address this question to Judge Easterbrook. You talked about greater diversification of loan maturities. I would like to address a different type of diversification—that is, geographical diversification. Many states will not allow banks to operate outside of their boundaries; if the laws would encourage nationwide banks, so that you could have a bank extending from Washington, D.C. to Texas while the Texas real estate economy is in the doldrums and D.C. is booming, wouldn’t the banks have a better chance of riding it out?

EASTERBROOK:

My comments about diversification were not principally directed to diversification across durations. They were directed to diversification across the entire spectrum of investments. You want the institution to have investments whose returns are subject to dif-
ferent risks at different times. Part of the problem in the banking system has been caused by the lack of geographic or industry diversification. If some banks are specialized in oil and something happens there, those banks go belly-up. Specialization in markets is beneficial. A bank making loans for oil exploration and drilling needs people who are real specialists, who know how to evaluate those risks. Concentration promotes such specialization and expertise. If you have somebody making the loan decisions who does not know much about the oil industry, you can get some really loony decisions. Unfortunately specialization of this kind, although it makes each loan individually more sensible, leaves the bank with a boom-or-bust portfolio. Given the business cycle, a bust eventually arrives. That is why I stressed the benefits of increasing the diversification over time, over industry, over geography, over type of investment, and so on.

QUESTION:
I was wondering if any of the panelists would like to comment on the increasing rise of lender liability suits, how that has affected the decline of nonbankruptcy work-outs, and whether some lenders seek the shelter of the Bankruptcy Code to avoid these suits.

JONES:
It is not at all clear to me that lender liability suits have encouraged the precipitous filing of bankruptcy petitions, because in most cases it is the choice of the debtor whether to go into Chapter 11. Also, I believe the lender can be as equally vulnerable to a charge of lender liability for what he does in Chapter 11 as for what he might have done outside, once the stay is lifted, for instance. What I can assure you is that the threat of lender liability lawsuits has had a tremendous and hugely unfavorable impact on the banking industry. Every lender is looking at this debtor and thinking, what have I not got in my documents, or worse yet, what have I got in my documents that you are going to say is a violation of good faith and use to sue me for punitive damages. It has made a very difficult relationship.

WARREN:
One consequence, I think, of an increased fear of lender liability suits is to change the leverage somewhat between debtor and creditor. The consequences show up both outside Chapter 11, in negotiations, and inside Chapter 11, because the lawsuits that the debtor has against anyone else are property of the estate. Some Chapter 11 attorneys are beginning to perceive that a lender liability suit may be the very best way to refinance a Chapter 11 and reorganize a business. So it has certainly changed this balance.
EASTERBROOK:

I have a five-word comment. Not in the Seventh Circuit.

QUESTION:

I have a question for Judge Jones, whose comments were a breath of fresh air compared to what I often hear at commercial law league meetings. You mentioned in particular that a lot of Chapter 11s are filed by single asset real estate concerns. Do you think that there should be more aggressive use of the doctrine of bad faith filing, under which the court can simply dismiss the bankruptcy case, and the secured creditor can go ahead rather than going through the whole procedure of obtaining relief from the stay?

JONES:

As you probably know, I wrote a case on bad faith filings,\(^5\) and I heard that when it came out it caused a boomlet of excitement among lending attorneys in the Fifth Circuit. Then one of my former law firm partners appeared before a bankruptcy judge in Austin and moved to dismiss a single asset case, saying that it was in bad faith. The judge's comment was, "I do not believe in that. Next point." What is so annoying about bankruptcy is that there is a set of procedural rules that ought to be but are not normally followed. A creditor ought to be able to move to lift the stay and to get a hearing and a result within thirty days. That almost never happens. A debtor has 120 days to file a plan of reorganization; the last time I read some of the commentary in Congress in 1978, it was clear that they really thought this would happen—that debtors would get about 120 days. And if they could not come up with something, the case would not go on. If those time limits were simply rigorously imposed, you would not have to worry about things like good faith. I do believe there is an underlying concept of good faith in filing a Chapter 11, in accordance with which the idea of reorganization is simply antithetical to a single creditor-single debtor context. Every bankruptcy judge you talk to will tell you, "Oh yes, we throw out those cases as fast as we can." I do not see it happening. It is not true.

QUESTION:

I would like to direct this question to Mr. Weinstein. In the course of the last six months, I have been catching a glimpse in the paper about various banking reform packages. I wonder if you could clarify this for me, particularly the talk about banks going into insurance, insurance companies going into banking, taking down the wall between capital investments that was put up in the '30s,

\(^5\) Little Creek Dev. Co. v. Commonwealth Mortgage Corp., 779 F.2d 1068 (5th Cir. 1986).
banks involved in that and the development of national interstate banking.

WEINSTEIN: There is pending an administration proposal that is wending its way through committees in both the House and Senate side that would make a variety of changes in the banking business as opposed to the thrift business. As I indicated before, some regulatory changes would be more strenuous in requiring closure or other action for banks whose capital or soundness fell below specified levels. Subject to a variety of detailed conditions and questions of timing, the present barriers on interstate branching would be eliminated. Thrifts can now branch interstate subject to our agency's approval. Banks, as indicated before, are subject to a crazy quilt pattern of regulation that the states largely control, and this legislation would, among other things, eliminate that. The legislation would also permit banks to be held by what would be called financial services holding companies. These companies could diversify broadly within the financial services industry but not with insured funds, so that the insured banking subsidiaries would be fenced off behind so-called firewalls. But the enterprise as a whole could, for example, invest in equities that are now forbidden, engage in investment banking which, to some extent, also is forbidden, or undertake other activities that are now forbidden. The legislation would permit a bank to be part of a broadly diversified financial services enterprise and also allow banks to be owned by industrial companies as thrifts can be now. We have about thirty or forty thrifts that are owned by companies like Ford and ITT, to give you two prominent examples. Banks now cannot be affiliated with industrial companies. This legislation proposes to permit that. There are varying degrees of controversy attached to each segment of the proposal. I think the most controversy lies in the so-called banking and commerce issue—that is the ownership of banks by industrial companies—and on the extension of powers into securities, insurance, and other diversified businesses.

EASTERBROOK: I said I wasn't going to comment on pending legislation and I'm not. Still, we should understand when we talk about socialization of risk that we are talking about government, about law. New legal standards can make it in private persons' interests to internalize risks. Without saying anything about the particular bills that have been proposed by particular persons, one logical response to legislation of the kind that Mr. Weinstein is describing—diversification plus a firewall—is that such rules make it advantageous for the bank itself to segregate the insured deposit business and hold liquid as-
sets underlying the insured business so as to have a larger uninsured deposit business, and other borrowing and lending that is less heavily regulated. That simultaneously increases the diversification of the banks' total portfolios and diminishes the risk that risk will be socialized because there is a greater likelihood that hard assets will support the insured side of the banking business. This sort of law, by authorizing modified broad banks, gives people incentives to create narrow banks too.

**QUESTION:**

This is a question for the banking side of the panel. Perhaps either of you would comment on the kinds of takings cases that are being brought now pursuant to changes in the accounting rules of the kind Mr. Weinstein spoke about. As I understand the scenario, in the mid-80s the regulators invited solvent banks to take on the portfolios of insolvent banks, and the accounting rules permitted goodwill as well as marked-to-cost rather than marked-to-market accounting. Those rules have subsequently been changed, and the theory is that making this change in the middle of the game amounts to a taking.

**WEINSTEIN:**

I should fear to tread but I will not. Certainly we contend in our papers and the two dozen or so pending cases that the takings argument is frivolous. While the canons of ethics are supposed to preclude me from giving testimony as to my personal beliefs, I will tell you about a series of cases in which I was involved as a private lawyer. We made substantially similar takings arguments and, not much to my surprise, I and others making those arguments uniformly lost. In the early '80s, Congress enacted a statute called the Multi-Employer Pension Amendments Act of 1980. It imposed on pre-existing pension plans, covering a variety of unions, so-called multi-employer pension plans, very substantial liabilities that were far greater—and I mean tens of millions of dollars in some cases—than those that had been contracted for in the collective bargaining process. All of us who were representing employers that were hit with those bills in the early days of litigation over the statute made takings arguments. We lost each and every time, at least when the issue reached an appellate court.

**QUESTION:**

Just a quick question for the right side of the panel. Is the social stigma against bankruptcy now largely gone?

**JONES:**

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6 Pub. L. No. 96-364.
I think it is. A prominent Houston bankruptcy attorney said that bankruptcy is the financing law of the '80s, and I think he meant exactly what he said. I think most businessmen, since many businesses have a large self-interested management component, know they can stay on in Chapter 11, even though they could not pay their debts and are unlikely to survive in a liquidation. Thus, there are big incentives to file in Chapter 11.

W AR R E N :

Let me give an alternative view, just on the business side of the house. Managers who think they are going to go into bankruptcy and survive are stupid. Of the managers of publicly traded companies who went into bankruptcy in the last decade, 52% were replaced within the first year and 66% by the end of the second year. In a follow-up study, researchers found that not one of those managers was rehired by a publicly traded company. In fact, most of them are still unemployed. Of the 198 managers who were studied in this group, two committed suicide. I think the perception that a manager lightly says, "How about a little bankruptcy" is just wrong. Managers consider bankruptcy when the alternative is death today. That is why we see so many dead cases going into bankruptcy. The notion that there is no penalty imposed on the individuals who make the decision to go into bankruptcy is just not true.

G R A Y :

I am going to exercise the prerogatives of the chair and thank the panel and the audience. It has been very interesting for me.

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8 Id.