Chapter 11
ECONOMIC ANALYSIS OF BANKING REGULATION

How Asymmetric Information Explains Banking Regulation

1. Government Safety Net and Deposit Insurance
   A. Prevents bank runs due to asymmetric information: depositors can’t tell good from bad banks
   B. Creates moral hazard incentives for banks to take on too much risk
   C. Creates adverse selection problem of crooks and risk-takers wanting to control banks
   D. Too-Big-to-Fail increases moral hazard incentives for big banks

2. Restrictions on Asset Holdings
   A. Restricts moral hazard due to too much risk taking

3. Bank Capital Requirements
   A. Reduces moral hazard: banks have more to lose when have higher capital
   B. Higher capital means more collateral for the Federal Deposit Insurance Corporation

4. Bank Supervision: Chartering and Examination
   A. Reduces adverse selection problem of risk takers or crooks owning banks
   B. Reduces moral hazard by preventing risky activities
   C. New trend: Assessment of risk management

5. Disclosure Requirements
   A. Better information reduces asymmetric information problem

6. Consumer Protection
   A. Standardized interest rates (APR)
   B. Prevent discrimination: e.g., CRA

7. Restrictions on Competition to Reduce Risk-Taking
   A. Branching restrictions
   B. Separation of banking and securities industries in the past: Glass-Steagall Act

Why a Banking Crisis in 1980s?

Early Stages
1. Decreasing profitability: banks take risk to keep profits up
2. Deregulation in 1980 and 1982, more opportunities for risk taking
3. Innovation of brokered deposits enabled circumvention of $100,000 insurance limit
4. \[
   \frac{\text{Insolvencies}}{\text{i}} \uparrow \frac{\text{net worth of S&Ls}}{\text{i}} \uparrow
   \]
   A. Insolvencies \uparrow
   B. Incentives for risk taking \uparrow

Result: Failures \uparrow and risky loans \uparrow

Later Stages: Regulatory Forbearance
1. Regulators allow insolvent S&Ls to operate because
   A. Insufficient funds
   B. Sweep problems under rug
   C. Regulators cozy with S&Ls
2. Huge increase in moral hazard for zombie S&Ls: now have incentive to “bet the bank”
3. Zombies hurt healthy S&Ls
   A. Raise cost of funds
   B. Lower loan rates
4. Outcome: Huge losses

**Political Economy of S&L Crisis**

**Explanation: Principal-Agent Problem**

1. Politicians influenced by S&L lobbyists rather than public
   - A. Deny funds to close S&Ls
   - B. Legislation to relax restrictions on S&Ls
   - C. Competitive Bank Equality Act (CEBA) of 1987 had inadequate amount for bailout

2. Regulators influenced by politicians and desire to avoid blame
   - A. Loosened capital requirements
   - B. Regulatory forbearance
   - C. Example: Keating and Lincoln Savings and Loan