Readings

Probing Banking's Black Hole

The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation
by Lawrence J. White
(Oxford University Press, 1991), pp. 308

Reviewed by Robert E. Litan

In every crisis there are seeds of opportunity for someone. The S&L crisis has proven to be no exception. The thrift burial and asset disposal activities of the Resolution Trust Corporation, for example, will occupy the attention and fill the pocketbooks of armies of consultants, lawyers, accountants, and appraisers. Other teams of lawyers and expert witnesses will devote the next five or ten years of their lives to suing or defending those believed to be responsible for the disaster. Meanwhile, many journalists are just now cashing in on their book-length exposés of what supposedly went wrong.

Larry White, one of the nation's leading applied microeconomists, probably will not make a lot of money on his academic entry into the S&L book derby. Nor did he make a lot of money during the crisis, as a member of the now-defunct Federal Home Loan Bank Board that used to regulate S&Ls and administer their deposit insurance fund, the Federal Savings and Loan Insurance Corporation (FSLIC). To the contrary, Larry and his colleagues—including the infamous M. Danny Wall, the chairman of the board during the latter portion of the Reagan administration and the beginning of President Bush's tenure—got nothing but headaches while they were there and a deep hangover since they have left.

Nevertheless, the nation's policymakers would learn a lot by reading White's book, indeed probably a lot more than from the many journalistic accounts of the various anecdotes that have made headlines. It is tempting to write off the S&L debacle as an unhappy coincidence of crooks and gamblers whose faces now adorn the major magazines and newspapers. But all of us public policy junkies know that the roots of the crisis go much deeper.

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White's book pushes all the right policy buttons. It explains how the structure of the thrift industry was flawed from the beginning: locking thrifts into long-term, fixed-rate mortgages with short-term funds was a recipe for disaster when short rates spiked, as they did in the early 1980s.

White argues that both of the policy reactions to the high interest rates of that period were fundamentally correct. Removal of the Regulation Q ceiling on thrift (and bank) deposit interest rates was necessary to prevent a massive hemorrhage of deposits. And, in principle, it was appropriate to permit thrifts to diversify beyond mortgages, just as the congressional authorization of adjustable-rate mortgages in 1980 was long overdue.

One policy mistake that permitted the thrift crisis to get out of hand was the utter failure of supervision in the early to mid-1980s. (White argues that supervisory flaws were corrected by the late 1980s, but this was too late to prevent much of the damage.)

The other mistake, of course, was the failure to close *economically* insolvent thrifts in a timely fashion. The thrift insurance fund could not do this, of course, because it did not have the money. Nor did either Congress or the president ask for it.

White argues that one of the reasons why more was not done sooner lay in flawed historical accounting conventions, which concealed the dimensions of the "black hole" in the industry. He is surely right that cost-based accounting has concealed, and continues to hide, substantial losses in the depository industry. Nevertheless, I doubt that the course of the crisis would have been much different had thrifts been required to report their condition on the basis of market values, one of the major reform recommendations White endorses (and of which he has been one of the strongest and most articulate proponents).

Table 1: Open Tangible Insolvent Thrifts and Minimum Costs of Resolution, 1980–1989

Year	(1) Number	(2) Assets (billions)	(3) FSLIC Resolution Cost for Recognized Failures ($/Assets)	(2) × (3) = (4) Estimated Cost of Resolution (billions)	(5) Percent of Thrifts Losing Money
1983	515	234	.059	13.9	35.2
1984	695	336	.146	49.1	27.9
1985	705	335	.175	58.6	21.2
1986	672	324	.246	79.7	27.0
1987	672	336	.348	116.7	35.2
1988	508	283	.309	87.7	30.3
1989	517	283	.580	164.3	37.0

Sources: For columns (1), (2), (3), James R. Barth and Philip F. Bartholomew, "The Thrift Industry Crisis: Revealed Weaknesses in the Federal Deposit Insurance System," paper presented at Stanford University's conference on Reform of Deposit Insurance and the Regulation of Depository Institutions in the 1990s, Washington, D.C., May 18-19, 1990. For column (5), Federal Home Loan Bank Board and Office of Thrift Supervision data.

As White himself demonstrates (at p. 114 of his book), throughout the 1980s the bank board had available to it data on the numbers of thrifts that were open but insolvent measured even by historical accounting rules. As shown in Table 1, it was easy for the board to calculate the estimated costs of closing these institutions. All the board members had to do was multiply the most recent average cost of resolving prior thrift failures by the aggregate assets held by insolvent thrifts. This would at least have given them a ballpark figure for the size of the problem. This method of calculation shows that the costs were far above the FSLIC's limited resources (approximately $6 billion) and were escalating beginning in 1983.

The question to ask is why the board did not go to the White House and to Congress with estimates such as these and ask for money far sooner than it did? As a key player in this drama, White should be able to tell us why not. But he does not, probably because he views his book as a work of serious scholarship and not as a "kiss-and-tell" diary of his travails in the government.

Of course, most readers will know why neither branch of government wanted to tackle the thrift disaster sooner. The Reagan White House did not want to hear about the need for more money before the 1988 presidential election. Meanwhile, key congressional Democrats, it turns out, were persuaded by their "friends" and "supporters" from the S&L industry to proceed slowly.

Another issue that I would have liked White to discuss at greater length concerns the reasons for the timing of the 1988 "thrift deals"—or the assisted sales of dead thrifts to such entrepreneurs as Lew Ranieri (the godfather of the mortgage-backed securities market), Robert Bass (of the wealthy Bass Group), William Simon (former Treasury secretary turned savvy investor), and Ronald Perelman (chairman of Revlon), among others.

On the mechanics of these deals, White is superb. He patiently explains that if the bank board had not entered into these transactions, many large insolvent thrifts would have remained open without new management and would have continued to gamble their way to additional losses. This is so because the FSLIC clearly lacked the resources simply to liquidate the institutions—paying off their depositors and taking back their assets.

White also lays out the reasons for the unusual guarantees extended to these purchasers: protection against losses on sales of problem assets and against erosion of the spreads between the thrifts' cost of funds and their diminished asset yields. The board would have simply handed the purchasers a fat promissory note in lieu of these guarantees if there had been any reliable way to measure the magnitude of the negative net worth that regulators had to erase to attract anyone to take the dead thrifts off their hands. But there was none. No one knew how insolvent the institutions were, and the only way that the board could interest buyers was to defer the determination of the price tag by extending the guarantees.

The question that White does *not* answer, however, is why the board waited so long to do these deals—in particular, why there was the rush to negotiate and complete so many transactions between the end of the November 1988 election and December 31, 1988. The most frequently heard answer—that certain tax breaks favorable to acquirers of failed thrifts were scheduled to expire at year-end 1988—is simply unsatisfactory. The board knew about the expiration of those provisions in 1987. Why was it not more aggressive in arranging deals then?

Instead, the American public witnessed a veritable avalanche of deals completed during round-the-clock negotiations in December 1988. In this pressure-cooker environment "due diligence" by both sides presumably went out the window. The deals simply "had to be done" to beat the December 31 deadline.

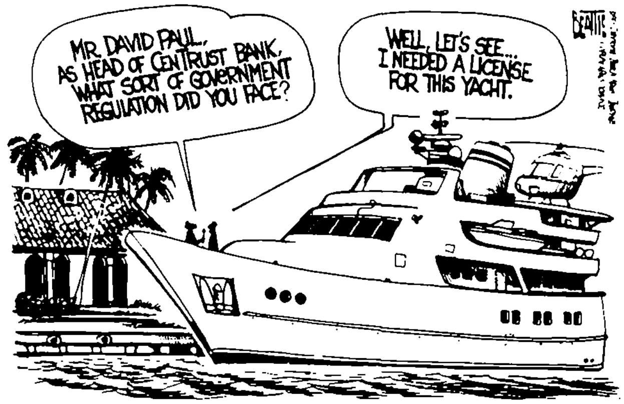
Again, the sophisticated—or cynical—reader suspects the reason for the board's waiting until after the election to arrange these transactions. Had it done so with a similar degree of intensity in 1987 or 1988, it could have given time for Democratic presidential candidates and their congressional colleagues to develop a coherent political attack on then-Vice President Bush.

Perhaps all of this is wrong. If it is, then Larry White, as the sole Democrat on the board during this period, would be able to tell us so, or at the very least, to reveal what really explained the timing of the 1988 thrift deals. But he does not do so in this book.

White concludes with a superb explanation of the major options available for preventing future thrift disasters. Unlike many market-oriented economists, he does not call for scaling back or eliminating deposit insurance. To the contrary, he argues that deposit insurance should be extended to cover *100 percent of all deposits.* De facto, of course, this is current policy, at least for large banks. But Larry wants it for all banks—the independent bankers should be happy—to remove the threat of systemic runs.

I am sympathetic with White's case for 100 percent insurance, although in the current environment it is a political nonstarter. I also agree with White that the principal place to look for added discipline against excessive risk-taking by depository managers is to shareholders (through capital requirements) and holders of subordinated (uninsured) debt. In essence, White endorses what is fast becoming conventional wisdom on how to fix the deposit insurance system: mandatory "early intervention" by regulators.

But early intervention will not be truly automatic, White argues, unless and until the system for measuring capital in depositories is radically changed—from historical-cost accounting to market-value accounting. This is a position shared by Richard Breeden, chairman of the SEC, who wants



to impose it on publicly traded bank holding companies.

Although my own written work has also endorsed a movement *toward* market-value accounting, I recognize the practical difficulties of precisely evaluating the prices of many of the nonmarketable loans that banks and thrifts hold. Of course, White is right that it is better for the regulators to have imprecise measurements of the numbers that count than to have precise measures of numbers that do not. But (unfortunately for them) accountants live in a highly litigious world where precision counts for a lot. The Solomonic compromise is what the Financial Accounting Standards Board is on the verge of doing: requiring banks to *disclose* their market valuations of assets and liabilities along with their regular financial statements reflecting historical costs (or generally accepted accounting principles), rather than *replace* the GAAP numbers with those marked-to-market.

But still this does not solve the problem of when regulators should be compelled to intervene. A subordinated debt requirement, at least for large banks (above $1 billion in assets), could help. If large banks were required to maintain some portion of their capital as subordinated debt with maturity of at least one year, then they could not support asset growth solely through additional retained earnings (or equity), but rather would be required to regularly issue subordinated debt to the open market. Regulators could then use the interest rates set by the market on those debt issues as guides for action.

If, for example, the spread between the market rate on a bank's subordinated debt and that of Treasury securities of the same maturity widened to, say, 400 basis points, then the regulators could be required to suspend a bank's dividends. And if the spread widened to 600 basis points, then the bank could be placed in conservatorship.

An alternative or supplement to a subordinated debt requirement is to require the Federal Deposit Insurance Corporation (FDIC) to sell reinsurance on a small part of its risk (say 5 percent or less) on the largest banks. Under the assumption that a private market in reinsurance would develop over time, the cancellation of reinsurance and subsequent inability of a large bank to obtain similar coverage elsewhere could be an automatic trigger for conservatorship. Such a plan has been proposed by Sen. Alan Dixon.

Skeptics wonder, of course, whether a sufficient number of private suppliers of reinsurance would come forward. I am optimistic, on the basis of conversations during the past several months with a number of insurers, securities companies, and even healthy banks that would like to get into this business.

The downside of a reinsurance plan is that regulators would be required to police the solvency of the insurers. No such supervision and regulation are needed to implement a subordinated debt requirement. In addition, the subordinated debt requirement could be implemented immediately without waiting for a competitive reinsurance market to develop.

In the end, I favor trying subordinated debt immediately and at the same time authorizing the FDIC to begin marketing reinsurance. Eventually, both forms of private discipline could help take the politics out of the decision to close or reorganize an insolvent depository.

I suspect that after serving in one of the most politically charged jobs in Washington in recent years, Larry would heartily endorse this recommendation. In the meantime, for all those who want a highly readable and intelligent guide to the policy framework that made all the anecdotes possible, read his book.

Toward Efficiency in Antitrust

Antitrust Policy and Interest Group Politics
by William F. Shughart II
(Quorum Books, 1990), 208 pp.

Reviewed by Paul H. Rubin

This book does an excellent job of applying the tools of the economic analysis of interest groups and of public choice to antitrust. It therefore exhibits both the strengths and weaknesses of public-choice analysis. Public choice is best at explaining the origin of laws that benefit well-defined, relatively narrow interests, such as railroad regulation. It is also very good at showing how interest groups use existing laws and regulations to further their own goals. Public choice is weakest at explaining the origin of laws with more general economic impact, such as environmental or antitrust legislation. While the book presents relatively little original research, it does summarize the existing research on the subject, and, of course, William Shughart has actively contributed to this literature.

The first part of the book discusses basic issues. Chapter 1 deals with the history of antitrust law. Shughart discusses various hypotheses about the impetus behind the original passage of the antitrust laws, including explanations related to efficiency, to the conflict between small business and large business, and to the key role of the antitrust bar. He finds all of these explanations lacking. We do not have a good public-choice explanation for the antitrust laws. This chapter also demonstrates inefficiencies in three important decisions—*Addyston Pipe, Standard Oil,* and *Brown Shoe.*

Chapter 2 provides a good introduction to special-interest theories of regulation. Shughart relies on the Stigler-Peltzman model, which shows that although transfers will often go to concentrated groups, no beneficiary will get all that it wants from the government. Lacking in this chapter is any discussion of recent research by Kalt and Zuppan, Kau and Rubin, or others showing that "ideological" factors can apparently influence the form and content of regulation, particularly broad-based regulations such as antitrust. I shall return to this issue below. Shughart argues that politicians might like to use the antitrust powers of the Federal

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Trade Commission and the Antitrust Division of the Department of Justice to stop the acquisition of firms in their districts, but he provides no evidence that this occurs. Indeed, FTC and Antitrust Division enforcement appears to be relatively insulated on a case-by-case basis from such influences. State antitrust regulation is a more likely source for such protection of domestic firms, but there is no discussion of this possibility.

The second part of the book analyzes the behavior of particular interests within the current framework of antitrust. This is the strongest section of the book. In Chapter 3 Shughart considers business enterprises. Many businesses—competitors who fear increased efficiency as well as unwilling targets—attempt to use the antitrust laws to stop mergers, and the government may help them. Other anticompetitive uses of antitrust involve the Robinson-Patman Act and allegations of violations in vertical cases, such as disputes between franchisees and franchisors. Chapter 4 discusses the "antitrust bureaucracy"—the FTC and the Antitrust Division. Shughart shows that cases brought have no relation to what economists would define as "social welfare." He explains this anomaly in terms of the private interests of FTC and Antitrust Division attorneys: litigation experience is valuable to government attorneys who wish to move to private law firms. Shughart argues that cases are selected, not because of their effects on efficiency, but because they can be tried in a reasonable time.

Chapter 5 discusses the role of Congress. The FTC is highly responsive to Congress. Complaints are more likely to be dropped if the firms involved are headquartered in the districts of congressmen on committees with responsibility for the FTC's budget and oversight. When more liberal congressmen (as measured by ADA ratings) are on oversight committees, the FTC has been more activist. (This result contradicts the pure "economic-interest" theory that underlies much of the book and is best explained in terms of ideological theories.)

Shughart considers the interests of the judiciary in Chapter 6. The analysis begins with the Landes-Posner theory that judges enforce legislative bargains. Shughart discusses Mark Cohen's findings that sentences are harsher when there is a better chance for the judge hearing a case to be promoted. The chapter also examines the inherent conflict of interest when the commissioners at the FTC serve as both prosecutors and judicial decisionmakers.

Chapter 7 analyzes the motives of the private antitrust bar, which wants more litigation. The amount of private litigation greatly increased in the 1960s. Most cases settle, which is not surprising since economic models of litigation indicate that litigation cost is a deadweight loss. Shughart also indicates that antitrust can be used for extortion, since some defendants will settle even outrageous cases rather than spend resources on litigation.

The last two chapters provide a policy overview. Chapter 8, "Use of Antitrust to Subvert Competition," provides further examples of the anticompetitive use of antitrust, such as competitor and target suits to block mergers and efforts by parties to induce the government to investigate (and perhaps sue) rivals. Chapter 9, "Reform in the Realm of Interest Group Politics," claims that the actual consequences of antitrust are the intended consequences. Thus, reform is unlikely since the laws are, according to this argument, doing what those in power want them to do. Nonetheless, Shughart does advocate certain reforms—eliminating the FTC, repealing the Clayton Act, restricting the Antitrust Division to policing only horizontal price-fixing and "overwhelmingly large" mergers. Even when economists believe that reform is impossible, we are unwilling to act on our beliefs.

In his foreword James Miller indicates that this is an exceptional book, but that Shughart may be overly pessimistic in his conclusions. I agree with both points. There has been some improvement in antitrust. In recent years judges have begun to view many private antitrust claims with greater skepticism. For example, a case involving a target of a takeover that alleges an antitrust injury can only be brought in a few circuits. In most others targets are denied standing. In almost all cases competitors now lack standing to prevent a merger. There is much less hostility toward various vertical restrictions in contracts. A standard (absurd) plaintiff's case—an antitrust suit by a franchisee against a franchisor with the franchise brand name product identified as a "tying" product—has become virtually impossible since about 1984.

Shughart himself indicates some improvements. He discusses the decline in FTC enforcement of the Robinson-Patman Act as a result of criticisms by economists. He also indicates that, perhaps as a result of Robert Bork and Richard Posner's critiques, both FTC and Antitrust Division policies did improve in the 1980s. Although the number of private antitrust suits did increase beginning in the 1960s, it has fallen from its peak. Shughart shows that the number of private cases filed reached a maximum of 1,611 in 1977. By 1984, the last year covered by his data, the number had fallen to 1,100. This decrease has continued, and in 1987 only 758 suits were filed.

How can we explain this improvement? There is strong evidence of the effect of ideas on regulatory reform. Ideas can matter—particularly in situations such as antitrust where there is no strong economic-interest story to explain the passage of regulatory laws. If ideas do indeed matter, then books such as Shughart's may serve a more important function than he is willing to admit. By pointing out the myriad inefficiencies in current enforcement of antitrust law, analyses such as this may help to improve matters. Moreover, of course, James Miller, William Shughart, and many other public-choice economists (including the author) were hired by the FTC and the Antitrust Division to help make decisions regarding the efficiency of particular cases and enforcement efforts and were (sometimes) heeded. This indicates that there is some political interest in efficiency. And the lessons of this book may help to achieve this goal.

At the very least, those who read this book will come away with a better understanding of how antitrust laws function and what motivates certain cases. Newspaper stories regarding cases that may seem absurd to the uninitiated are often just as absurd as they seem.

Loosening the Grip of the ICC

The Economic Effects of Surface Freight Deregulation
by Clifford Winston, Thomas M. Corsi, Curtis M. Grimm, and Carol A. Evans
(Brookings Institution, 1990), 66 pp.

Reviewed by Cornish F. Hitchcock

It has been eleven years since Congress decided to loosen the grip of the Interstate Commerce Commission on the trucking and railroad industries, and thus the time is right for a scholarly assessment of how well the Motor Carrier Act and the Staggers Rail Act are working. That is what the authors of this monograph set out to provide, and they succeed admirably.

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The trucking and railroad deregulation laws followed by two years the Airline Deregulation Act of 1978, which served as a model for these and other initiatives deregulating the U.S. transportation industry. Since then the effects of airline deregulation have received considerable attention from scholars, the news media, and elected officials. Everyone has a view about how well things have worked since Congress gave the airlines freedom to decide where to fly and what fares to charge while remaining subject to safety regulations, antitrust and consumer protection laws, and a small community subsidy program.

Somewhat curiously, despite a wealth of studies showing that airline deregulation has generated a significant net gain for consumers, some critics maintain that the whole idea was a mistake or at least that substantial modifications are needed. This discontent is reflected by a myriad of reform proposals that have been introduced in Congress in recent years, and the controversy is unlikely to fade any time soon.

This focus on the airline industry is in a way unfortunate, because it has diverted public attention from developments in the trucking and railroad industries since they were deregulated. And that story deserves to be told. As the study by Winston and his colleagues makes clear, significant public benefits have flowed from economic deregulation, particularly in the trucking field. This connection to airlines is important because the trucking industry was deregulated by using the same model as the airlines, and if the gains in trucking are as positive as this study indicates, that may suggest that the Airline Deregulation Act was not such a bad idea either.

What is curious about the truck and rail deregulation laws is that they were enacted to solve diametrically opposite problems. The trucking industry was earning excessive profits, and the railroads were earning insufficient profits.

In the trucking arena Congress was concerned about excessive truck rates, which were brought about through overt price-fixing under a 1948 law giving truckers antitrust immunity for such activity. Adding to the problem were restrictive regulatory practices, including limits on the commodities one could haul and the routes one could serve. In practice this meant (to borrow an example used in the 1980 debate) that a trucker could deliver tomatoes to a Campbell soup plant but could not haul away tomato soup. The Motor Carrier Act of 1980 sought to end this waste by eliminating most of the carriers' antitrust immunity and by giving truckers the flexibility to haul more commodities in more markets—measures that would increase competition.

The Staggers Rail Act responded to a very different stimulus, the seeming collapse of the domestic railroad industry in the previous decade. Even after unprofitable passenger service was spun off into Amtrak in 1970, the industry endured a series of bankruptcies among northeast and midwest lines, and in 1980 nearly every railroad was earning a rate of return below those earned in other industries.

Congress recognized that ICC regulatory policies had a lot to do with the industry's unprofitability, and the commission's implementation of earlier "reform" laws was too cautious and inadequate to deal with the railroads' systemic problems. Rather than take additional half-steps, Congress decided to cut the industry loose to a large degree. The Staggers Act gave railroads the freedom to set their own rates for many commodities and to enter contracts with individual shippers while preserving limited rate regulation for those perceived to be "captive shippers," such as the coal industry.

Railroads were also given more freedom to exit unprofitable routes, which allowed the larger carriers to streamline their route networks, while setting off a boom among regional "short-line" railroads that acquired the abandoned track. With their lower costs, these railroads were able to maintain service to local shippers.

Thus, despite opposite problems in these two industries, Congress responded with the same basic policy prescription: more competition.

Winston and his colleagues set out to quantify how well this prescription worked so that they could assess the economic effects of trucking and railroad deregulation and determine the winners and the losers. Their analysis shows that deregulation in both modes was a considerable success, although they are careful to point out that there were some losers.

The authors estimate that these two laws have yielded $20 billion in annual benefits for shippers and consumers, as measured in 1988 dollars. Railroads and some truckers (those hauling commodities that are shipped by the truckload, such as fuel oil) also came out ahead, with annual benefits of $2.9 billion and $.88 billion, respectively, again in 1988 dollars.

The biggest losers were less-than-truckload truckers, who fill their trucks with a number of different commodities that move to their final destination through various break-bulk terminals similar to airline hubs. Annual losses for these carriers were pegged at $5.3 billion in 1988 dollars, while the loss to railroad and less-than-truckload labor was pegged at $3 billion annually, again in 1988 dollars.

The net welfare gain from truck and rail deregulation thus stands at roughly $15.5 billion a year in 1988 dollars. The authors attribute these savings directly to Congress's decision to end the distortions caused by ICC regulation. Indeed, as the authors also point out, this estimate of savings is probably conservative, and some commentators have credited trucking deregulation in particular with the rise of just-in-time inventory management techniques.

In short, this study verifies what many proponents of these laws argued at the time they were debated, namely, that economic deregulation would promote competition, efficiency, and sizeable consumer savings. The question logically arises: can we expect further gains from these statutes? And what additional changes should Congress make?

On this point, Winston and his colleagues sound a cautionary note, principally with respect to the railroads. Indeed, their study recalls that sound advice embodied in the Hippocratic oath: First, do no harm.

Thus, the authors argue that the principal policy goal in the rail area should be to promote greater efficiency, mainly by imposing no new barriers on a railroad's ability to abandon routes. They also call upon the ICC to preserve competition by maintaining antitrust scrutiny over potentially anticompetitive proposals and practices.

They note that shippers could have gained an additional $5.6 billion (in 1977 dollars) if rail rates had been forced, through increased competition, to marginal rates. They warn, however, that any effort to achieve these gains now would take place at the expense of railroad profits, which continue to be low despite recent gains.

On the trucking side, the authors sensibly call for greater attention to truck safety, which can be accomplished without reimposing economic regulation. They also call for ending the remaining vestiges of antitrust immunity and for better management of the nation's roads and infrastructure.

My one quarrel is with the secondary importance the authors seem to assign to one vital reform, abolishing rate and route regulation of the trucking industry at the intrastate level. The Motor Carrier Act stands as an anomaly among the transportation deregulation laws of the late 1970s and early 1980s, as it is the only one that did not mandate some form of federal preemption. This is no small matter. Many states still regulate intrastate rates and routes under the same type of heavy-handed system that Congress essentially discarded eleven years ago at the interstate level. It makes no sense to perpetuate such a regime, and "states' rights" cannot be an acceptable excuse, since Congress has already trumped the states to some degree in the rest of the transportation industry.

This study notes that the current system of state regulation imposes sizeable costs on shippers and consumers and that reform would yield substantial rate reductions, possibly by at least 30 percent. Indeed, a recent study prepared by Bruce Allen for the U.S. Department of Transporation estimated $3 billion in annual savings from this one reform alone.

But this is more a matter of emphasis than substance. The central value of this book is the diligence and rigor that it brings to the task of analyzing and quantifying the economic consequences of regulatory change in surface freight transportation. The authors have made a valuable contribution to the debate over the future of regulatory policy, and I hope this book receives the wide audience that it deserves.