What Lessons Should Japan Learn from the U.S. Deposit-Insurance Mess?*

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Received January 29, 1993; revised March 1, 1993

Kane, Edward J.—What Lessons Should Japan Learn from the U.S. Deposit-Insurance Mess?

In any representative democracy, public officials are subject to incentive conflict. Japan can benefit from understanding and eliminating the particular conflicts in bureaucratic incentives that make U.S. regulators reluctant to acknowledge and resolve deposit-institution insolvencies in a timely fashion. Weaknesses in accountability for the delayed consequences of regulatory decisions tempt regulators to help inefficient and insolvent banks to resist exit at the expense of other parties. To improve incentives, the consequences of regulatory choices must be made transparent enough for outsiders to monitor them. This can be done by assigning responsibility for privately insurable risks to private coinsurers and defining more fully government responsibilities for monitoring and minimizing financial institutions' exposure to catastrophic risk. J. Japan. Int. Econ., December 1993, 7(4), pp. 329–355. Department of Finance, Boston College, Chestnut Hill, Massachusetts 02167. © 1993 Academic Press, Inc.

Journal of Economic Literature Classification Numbers G18, G21.

Although the Federal Savings and Loan Insurance Corporation (FSLIC) is dead, its corporate corpse remains unburied. The cadaver has been surgically disassembled into a series of bureaucratically recoded insurance and salvage subsystems. The most important of these subsystems have been transplanted as corporate subsidiaries into the body of the Federal

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Deposit Insurance Corporation (FDIC). If a grave site should ever be prepared for the parts not recycled, the headstone ought to read:

While insured depositors never lost a penny, U.S. taxpayers are still losing their shirts.

The FSLIC's continuing losses provide strong testimony to the difficulty, in the face of pressure from securities-firm and foreign-bank entry into deposit and loan markets, of preventing a governmental system of deposit insurance from degenerating into an expensive mechanism for retarding the exit of crippled deposit-institution competitors. Improvements in financial technology and increasing price volatility for financial instruments transformed government deposit insurance in the United States, after 30 years of initial success, into a system for nurturing inefficient and unsound firms and perversely rewarding socially imprudent investments. Starting in the mid-1960s, the U.S. deposit-insurance system began to alleviate natural market pressure on failing thrift institutions to voluntarily recapitalize themselves or exit through merger or liquidation. Not forcing insolvent institutions to choose one of these three painful options rewarded unsound banking practices and effected an unintended and badly structured nationalization (or deprivatization) of a large segment of the nation's financial assets and institutions.

After a long period of expansion, the Japanese banking industry is facing parallel pressure for individual-bank exits. So far, Japanese authorities have been reluctant to encourage the prompt recapitalization of weak banks or to estimate for the public the opportunity costs of the capital forbearances this policy implies. Nevertheless, in contrast with the managers of FSLIC, Japanese officials are striving mightily to restrain the growth of troubled banks. While this difference in policies should limit the size of the losses to which taxpayers and healthy institutions are exposed, it leaves poorly performing assets and franchises in the hands of managers whose incentives are distorted by capital weakness. It also leaves the administrative-guidance and forbearance decisions that government officials make insulated from the healthy discipline of financial and managerial markets.

To clarify the dangers that such a regulatory strategy poses, this paper reviews the facts of the FSLIC mess and shows that a theory of incentive conflict in government regulation is consistent with these facts. It argues that, because Japanese financial regulators are in competition from regulators in other countries for the right to oversee how the world uses Japanese savings, it is important to align the incentives of politicians and regulators more closely with those of Japanese taxpayers.

The public-policy issue is not whether the Japanese government should follow a recapitalization strategy, a liquidation strategy, or a merger strat-
TABLE 1 
NUMBER AND ASSETS OF S&Ls

<table>
<thead>
<tr>
<th>Year</th>
<th>Number</th>
<th>1960–1990 total assets (in $ billion)</th>
<th>Average total assets (in $ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>6320</td>
<td>71.5</td>
<td>11.3</td>
</tr>
<tr>
<td>1965</td>
<td>6185</td>
<td>129.6</td>
<td>21.0</td>
</tr>
<tr>
<td>1970</td>
<td>5669</td>
<td>176.2</td>
<td>31.1</td>
</tr>
<tr>
<td>1975&lt;sup&gt;a&lt;/sup&gt;</td>
<td>4931</td>
<td>338.2</td>
<td>68.6</td>
</tr>
<tr>
<td>1980</td>
<td>4613</td>
<td>629.8</td>
<td>136.5</td>
</tr>
<tr>
<td>1985&lt;sup&gt;b&lt;/sup&gt;</td>
<td>3246</td>
<td>1070</td>
<td>329.5</td>
</tr>
<tr>
<td>1990</td>
<td>2337</td>
<td>994</td>
<td>425.3</td>
</tr>
</tbody>
</table>


<sup>a</sup> Prior to 1975, data are for June 30. From 1975 on, figures are for the year end.

<sup>b</sup> 1985 and 1990 figures relate only to FSLIC-insured S&Ls and measure assets by applying so-called "regulatory accounting principles." Although there were 720 uninsured or state-insured S&Ls in 1980, crises occurring in Ohio and Maryland during the first half of 1985 drove almost all of the surviving segments of the industry into the FSLIC’s domain.

egy. This is for private financial institutions and financial markets to decide. The public-policy issue is to make sure that private decision makers receive sufficient information and opportunity to make this choice in a timely fashion.

I. A Background Summary of the FSLIC Debacle

The number of U.S. savings and load associations (S&Ls) has been shrinking since the 1920s. But as Table 1 clarifies, until the late 1980s, the industry continued to grow both in aggregate assets and in the average size of firms.

To understand the origins of the FSLIC mess, it is necessary to review S&L activities and to appreciate how they have been changing. Until the 1970s, the S&L business was a simple one. S&Ls funded themselves with short-term savings deposits (mostly of the passbook variety) and put the funds gathered into long-term home mortgages that were written at fixed contract rates of interest.

The profits S&L firms expected to earn came from leverage (i.e., a high ratio of assets to net worth) and from mismatching the maturities of their
assets and liabilities. Even today, the liabilities of S&Ls turn over on average much faster than their assets do. This portfolio strategy is called short-funding. Short-funded institutions expose their income and capital to interest volatility risk.

As long as yield curves are positively sloped, putting new deposits into new mortgages generates substantial accounting income. However, to calculate an S&L’s economic income on outstanding positions, one must include interest-induced changes in the value of deposits and loans. When interest rates increase, the net effect of these revaluations is to reduce economic income below its accounting value and, for sufficiently large interest-rate increases, to drive it negative. When interest rates fall, the positive effect on mortgage prices is truncated by customer efforts to refinance their loans at fresh interest rates. The importance of this truncation increases as the difference widens between a household’s contract interest rate and the rate it could obtain on a new mortgage. Because of refinancing activity, over a full interest-rate cycle, S&Ls gain less from interest-rate declines than they lose from interest-rate increases.

During the 1970s and 1980s, S&Ls diversified out of their traditional specializations. They broadened the product line on both sides of their balance sheets. While S&L efforts to expand the use of term deposits and adjustable-rate mortgages helped to lessen the industry’s average exposure to interest-volatility risk, it did not by any means eliminate the exposure.

Taking the market value of unrealized losses on S&L mortgages into account, the secular rise observed in interest rates and interest-rate volatility between 1960 and 1982 devastated the economic value of S&L income and net worth. Although S&L and government accountants chose not to book these losses as they were accruing, across an institution’s portfolio their impact could be estimated with a reasonable degree of accuracy by appraisal techniques.

To value nonmarketable assets, appraisers rely on prices and interest rates that are observable in trades made in comparable assets and on methods for projecting and discounting the values of the future cash flows stipulated by the contracts. For 1971–1984, appraisal-based measures of the effect on S&L capital of the unbooked losses induced by interest-rate movements are shown in Table II. The table splices together estimates prepared for different subperiods by Kane (1989a) and Brumbaugh (1988). To adjust for an acknowledged upward bias in Kane’s method, the magnitude of his original estimates is scaled down by one-third.

These figures clarify that, from 1971 on, the S&L industry could not cover its deposit liabilities from its own resources. What kept insolvent S&Ls from being closed by depositor runs was the willingness of FSLIC to keep in force federal guarantees that served to protect depositors against loss. In effect, FSLIC supplied enough free equity capital to fill in the
TABLE II

<table>
<thead>
<tr>
<th>Year</th>
<th>Kane's adjusted estimates</th>
<th>Brumbaugh's estimates</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971</td>
<td>−3.77</td>
<td>—</td>
</tr>
<tr>
<td>1972</td>
<td>−5.43</td>
<td>—</td>
</tr>
<tr>
<td>1973</td>
<td>−4.64</td>
<td>—</td>
</tr>
<tr>
<td>1974</td>
<td>−7.55</td>
<td>—</td>
</tr>
<tr>
<td>1975</td>
<td>−7.77</td>
<td>—</td>
</tr>
<tr>
<td>1976</td>
<td>−7.25</td>
<td>—</td>
</tr>
<tr>
<td>1977</td>
<td>−6.62</td>
<td>—</td>
</tr>
<tr>
<td>1978</td>
<td>−6.87</td>
<td>—</td>
</tr>
<tr>
<td>1979</td>
<td>−9.32</td>
<td>—</td>
</tr>
<tr>
<td>1980</td>
<td>−12.78</td>
<td>−12.47</td>
</tr>
<tr>
<td>1981</td>
<td>−15.41</td>
<td>−17.32</td>
</tr>
<tr>
<td>1982</td>
<td>−10.63</td>
<td>−12.03</td>
</tr>
<tr>
<td>1983</td>
<td>−6.03</td>
<td>−5.64</td>
</tr>
<tr>
<td>1984</td>
<td>—</td>
<td>−2.74</td>
</tr>
</tbody>
</table>

Sources: Kane (1989a, p. 75) and Brumbaugh (1988, p. 50).

hole in operating firms' balance sheets. In economic terms, this meant that the red ink in S&L income and balance sheets spilled over onto FSLIC and, through FSLIC, onto U.S. taxpayers.

Part of the policy scandal is that the accounting methods used by S&Ls and FSLIC were adapted to increase the delay in recognizing the deterioration in FSLIC's position. As Table III shows, until 1986, official estimates

TABLE III
OFFICIAL ESTIMATES OF FSLIC RESERVES, 1960–1986

<table>
<thead>
<tr>
<th>Year end</th>
<th>Total reserves ($ million)</th>
<th>Percentage of value of accounts insured</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>381</td>
<td>0.62%</td>
</tr>
<tr>
<td>1965</td>
<td>1537</td>
<td>1.35</td>
</tr>
<tr>
<td>1970</td>
<td>2903</td>
<td>2.05</td>
</tr>
<tr>
<td>1975</td>
<td>4120</td>
<td>1.48</td>
</tr>
<tr>
<td>1980</td>
<td>6462</td>
<td>1.28</td>
</tr>
<tr>
<td>1985</td>
<td>4600</td>
<td>0.54</td>
</tr>
<tr>
<td>1986</td>
<td>−6300</td>
<td>−0.71</td>
</tr>
</tbody>
</table>

Source: Kane (1989a, p. 9).
of FSLIC's reserve position remained reassuringly positive (Kane, 1989a, p. 9). Table IV is offered to communicate the magnitude of the losses that authorities routinely covered up. Using market-value estimates of the enterprise-contributed net worth of every FSLIC-insured institution existing or closed in fiscal years 1985–1989, the table measures the size of the aggregate loss exposure that bureaucrats at FSLIC managed so long to keep off their books.

To keep accrued losses from registering on FSLIC’s books, regulators had to help insolvent S&Ls to resist forms of exit that would have fully privatized their equity. Without federal guarantees, private creditors would have forced insolvent S&Ls to recapitalize themselves (perhaps by transferring ownership in whole or large part to the creditors) or else be involuntarily merged or liquidated out of existence. In taking over private creditors’ exposure to loss, economic theory dictates that a government guarantor should mimic market-driven behavior. In not insisting on an explicit claim for itself to future profits, FSLIC encouraged insolvent S&Ls to take poorly structured, longshot gambles. For troubled S&Ls, the beauty of these gambles was that, while FSLIC took the downside, it permitted S&L owners and managers to lay claim to much of the upside potential.

Table II shows two windows of opportunity for controlling FSLIC losses. First, if, instead of nullifying market pressures for recapitalization during the late 1960s, FSLIC had forced insolvent S&Ls to recapitalize, merge, or liquidate themselves, the S&L industry would never have remained shortfunded and undercapitalized enough to load such large losses onto FSLIC in later years. Second, even if this opportunity had been missed, subsequent losses could have been reduced if recapitalization had been demanded when and as disinflation lowered interest rates in
### Table V

<table>
<thead>
<tr>
<th>Year</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>70.9</td>
</tr>
<tr>
<td>1981</td>
<td>70.0</td>
</tr>
<tr>
<td>1982</td>
<td>64.9</td>
</tr>
<tr>
<td>1983</td>
<td>60.7</td>
</tr>
<tr>
<td>1984</td>
<td>56.0</td>
</tr>
<tr>
<td>1985</td>
<td>52.8</td>
</tr>
<tr>
<td>1986</td>
<td>52.0</td>
</tr>
<tr>
<td>1987</td>
<td>53.4</td>
</tr>
<tr>
<td>1988</td>
<td>54.0</td>
</tr>
<tr>
<td>1989</td>
<td>56.9</td>
</tr>
</tbody>
</table>

*Source: Barth et al. (1990, p. 23).*

1982–1983. This second opportunity was seized by the Federal Deposit Insurance Corporation in handling the roughly 500 shortfunded mutual savings banks that it insured.

However, by the time that interest rates turned down in mid-1982, FSLIC-insured S&Ls and FDIC-insured mutual savings banks had begun to reduce their specialization in home mortgage assets (Table V). They began in particular to load themselves up with riskier *real estate* development loans and investments. Even for the 1982 and 1983 loans, losses would have been less intense—and a substantial amount of new losses would have been avoided—if insolvent S&Ls had been forced in 1982–1983 to recapitalize or else. Had this regulatory strategy been followed, the amount of aggregate overbuilding would have been lessened. Insolvent S&Ls would not have been pouring funds into the overheated U.S. real estate market in an industry-approved and regulator-authorized effort to help them to “grow out of their weakness.”

Opportunities for borrowers to overleverage themselves could not have burgeoned unless lenders failed to charge sufficiently for their own expanding loss exposure. This exposure was underpriced because neither insured lenders that were insolvent nor their regulators had strong incentives to evaluate and price the risks being taken (Hendershott and Kane, 1992).

It is important to understand that the regulatory strategy that ruined the U.S. S&L industry was of the industry’s own making and resembles the strategy recently employed in Japan. During two decades of industry-
supported regulatory and legislative adjustments, less-regulated competitors such as money-market mutual funds and brokerage firms offering cash management accounts took considerable market share from U.S. S&Ls. While the S&Ls relied on government officials to wall off outside access to their industry and customer base behind self-designed regulatory barriers, substitute institutions and substitute instruments developed that used emerging electronic technologies to "teleport" through and around the industry's supposed regulatory defenses.

II. INTRODUCTION TO THE INCENTIVE-CONFLICT THEORY OF MISREGULATION

A "surety" is a person or company that, at the request of another party, accepts responsibility for the performance of some act in favor of a third party if the obliged party fails to perform as promised. The central problem for government-sponsored deposit insurance sureties does not lie in making their guarantees credible to deposit-institution customers. This is an easy task as long as the full faith and credit of a nation's Treasury can be explicitly or implicitly used to shore up the resources of the government bureau that acts as surety. The trick lies in minimizing the taxpayer loss exposures that result from taxpayer's unlimited liability for any and all losses the surety might accumulate. Japanese taxpayers and public servants need to understand that the roots of FSLIC's spectacular losses run much deeper than bad economic luck, insider crime, structural weaknesses in risk-management controls, and innocent regulatory "mistakes." Using language favored by philosophers, bad luck and crime are "conditions" rather than causes, while regulatory "weaknesses" and mistakes are manifestations of deeper causes.

Bankers want deposit insurance as a competitive advantage. Politicians want deposit insurance as a way to avoid being embarrassed by bank failures. Because they are more directly answerable to politicians and bankers than to taxpayers, in practice government regulators are pulled more toward avoiding failures and subsidizing deposit-institution operations than they are toward minimizing taxpayer loss exposures.

The seeds of the mess lie in defective incentives for measuring and controlling the taxpayer loss exposures that politicians and top regulatory officials create (Kane, 1989a; Barth, 1991). These incentive defects engender conflicts with bureaucratic and personal goals that, in tough times and in tough cases, tempt government officials around the world not to enforce the underwriting standards, coverage limitations, and takeover rights that constitute taxpayer's best theoretical defenses against cumulative deposit-insurance losses (Kane, 1989a). Although highly ethical individual regula-
tors may routinely reject these temptations, the main lesson of the S&L insurance mess is that it is fatuous for society to depend on a regulatory framework whose successful operation demands acts of selfless heroism from its top managers. Despite the public spiritedness felt by top government officials, temptations posed by incentive defects for regulators become particularly hard to resist whenever a large hidden shortage of explicit reserves develops at the surety itself.

What was and is missing from deposit-insurance arrangements in the United States is timely accountability for the opportunity losses that supervisory and regulatory forbearances impose on taxpayers. Incumbent politicians and bureaucrats have short time horizons and specific career and reputational interests that frequently diverge from those of taxpayers. Once the loss exposure of a government deposit-insurance corporation outstrips its explicit resources, divergences in interests make it rational in a representative democracy for authorities to abuse their discretion by covering up evidence of emerging insolvencies at the institutions they supervise and by postponing painful loss-control activity to their successor’s “watch on the bridge.”

In public-policy discussions, eschewing disciplinary actions that informed taxpayer “principals” would want their regulatory “agents” to perform on their behalf is described euphemistically as regulatory “forbearance.” What makes forbearance strategies attractive is the ease with which government officials and trade-association spokespersons can repeatedly deny the existence of industry insolvency problems and the difficulty of credibly pinning the consequences of inappropriate forbearance decisions on the particular officials who conceived and executed them. The lack of reliable measures of the surety’s true condition and the absence of audit trails for forbearance decisions and their specific consequences encourage officials to delay tough actions and to gamble on making a “clean getaway” either to another term in office or to a high-paying job in the private sector. By blaming officials disproportionately for whatever problems happen to surface while they are in office and by not nailing officials for the forecastable future damage they create when they adopt short-sighted supervisory strategies, the U.S. press and voting public reinforce authorities’ propensity to gamble inefficiently with taxpayer money.

Japan should see that, in financial markets around the world, decisions to deregulate entry have been forced upon resistant politicians and regulators by technological and political forces. But markets have had a harder time forcing elected politicians and top regulatory officials to deregulate exit. Officials have a short-run reputational interest in retarding the exit of economically insolvent and inefficient firms when these happen to fall within their traditional client base. The principal-agent conflict (Jensen
and Meckling, 1976) this spells for taxpayer interests becomes more acute as accountability declines.

Applying the theory of principal-agent conflict to government regulation serves to explain many ex post policy "failures"—particularly in the pricing and administration of deposit insurance—as the consequences of ex ante equilibrium behavior rather than as innocent mistakes. The immediacy of a perpetrator's regret provides an acid test by which to distinguish an innocent mistake from a self-interested "calculated gamble." A calculated gamble is regretted only if and when it fails. Favoring the interests of a nation's decapitalized institutions can serve politicians' and regulators' interests at the expense of society in general. It may be expected to keep a politician's and regulator's watch on the bridge less turbulent, to preserve officials' reputations and reelection or postgovernment employment opportunities, and to result in a flow of implicit or explicit side payments.

Economic analysis supports the view that incentive incompatibilities inherent in representative democracy make government regulators dangerous. They have control of their reporting frameworks and a propensity to cover up and procrastinate. They can and do routinely distort information flows about the quality of their performance in the short run, while repeatedly putting off painful adjustments that would serve taxpayers better. In Japan, as in the United States, government has been marked by scandal, short-lived administrations, delays in making important policy decisions, and lack of transparency in decision-making processes.

Financial deregulation (an unambiguous relaxation of the rules of financial-services competition for all players) should be distinguished from desupervision of the activities of insolvent and inefficient financial-services firms. Financial deregulation did not cause the U.S. deposit-insurance mess and will not itself cause a parallel Japanese mess. Inadequate constraint on the pursuit of self-interest by government officials is the root cause of U.S. problems and is what threatens Japan with relaxation of supervision today. It is dangerous to let officials use undisclosed pressure on selected institutions to persuade them to put managerial or financial resources into crippled competitors (as regulators did with the Iyo and Toyo Shinkin banks).

It would be better if public-service incentives did not make it so attractive for authorities to help troubled deposit institutions to resist exit pressure. Ideally, markets for the services of current and former government officials ought to reward regulators in any country that choose to protect taxpayer interests faithfully at the expense of incurring the displeasure of politically powerful regulatory clients and their political allies. But to play this role, markets for the services of high officials must routinely receive much better information about what regulators do and when they do it.
III. An Explicit Model of Incentive Conflict in Government Deposit Insurance

Economic theory portrays the market value (MV) of any enterprise as the discounted present value of the future cash flows it generates. In deposit insurance, annual cash flow \( F \) represents the net value of two sources of revenue and two sources of cost. Revenues come from explicit premiums \( P \) and the average interest rate \( r \) earned on insurance reserves \( R \). Costs consist of monitoring costs \( C_M \) and expenses incurred in resolving bank insolvencies \( C_E \).

Let us suppose, for convenience, that costs and revenues are the same every year and that the cost of capital of the deposit insurer is the same as the interest rate earned on reserves. Under these assumptions,

\[
F = P + rR - C_M - C_E, \tag{1}
\]
\[
MV = \frac{F}{r}. \tag{2}
\]

Both in a stationary state and in the real world, the value of all right-hand variables would be conditional on:

1. the insurer's loss-control policies;
2. political, personal, and bureaucratic constraints that affect managers' policy choices; and
3. the risk exposure of insured banks.

To express this conditionality, we hypothesize that \( C_E \) falls as the insurer's monitoring effort increases and increases with three other variables: \( V \), the volatility of the financial environment in which insured banks operate; \( LE \), the loss exposure insured banks create for the insurance fund; and \( H \), the capacity of bank managers to hide the consequences of their risk-taking from government monitors. Assuming that monitoring efforts are adequately proxied by monitoring costs,

\[
C_E = C_E(V, LE, H, C_M) \tag{3}
\]

If we also assume that managers take \( R \), \( r \), and \( V \) as given, officials could influence \( MV \) only by varying premiums \( P \) and monitoring activity to control \( H \) and \( LE \). Value-maximizing officials would see that \( \partial MV/\partial P \) and \( \partial MV/\partial C_M \) both equaled zero.

\(^1\) The model presented in this section is adapted from Kane (1989b).
As a more realistic model, let us assume that officials are fully informed about $C_M$ and $P$, but they can develop value blame-shifting deniability options ($D$) from accepting an imperfect perception of $LE$ and of the average future value of $C_E$ this perception implies. Let us represent these "partially informed" estimates by $LE^*$ and $C_E^*$ and assume that each is a proper fraction $(1 - h)$ of its true value. We assume that $(1 - h)$ is itself an increasing function of monitoring effort. This means,

$$D = D(C_E - C_E^*) = D(hC_E|C_M).$$

(4)

These assumptions create a model in which incentive conflict leads officials to support opportunities for banks to conceal loss exposure from government monitors. This is done to develop personal benefits for top officials. The idea of incentive conflict implies that officials' objective function $U$ includes both $MV$ and an index of personal benefits which we have temporarily identified as $D$:

$$U = U(MV, D).$$

(5)

Compared to the value-maximizing case, increases in $MV$ are less desirable to the extent that they induce declines in $D$. Officials are led to curtail insurer monitoring efforts and to delay the resolution of bank solvencies to prevent adverse information from surfacing in official records during their watch.

An even richer model can be created by assuming that authorities receive not one, but two forms of personal benefits. The first consists of implicit and explicit bribes ($B$) that flow from what the Japanese characterize as "money politics." The second roots officials' ability to enhance their human capital not in "deniability" per se, but in a general ability to enhance public perceptions of the quality of their job performance ($J$). Reputation-enhancement activities include the opportunity to overstate credibly to the outside public the strength of the insurance fund by refusing to certify more than a fraction ($f$) of the loss exposure acknowledged in officials' own "inside" estimates $LE^*$ and $C_E^*$. In this model, the objective function (5) is replaced by

$$U = U(MV, B, J),$$

(6)

and an official's job performance may be identified as the change in the public's perception of the fund's market value ($MV_f$) between the official's appointment date $t_0$ and the current date $t$: 
\[ J = J[MV^x(t) - MV^x(t_0)]. \]

To underscore incentives for officials to cover up and mismonitor, it is convenient to assume that \( r, R, \) and \( P \) are exogenous variables that insurance officials cannot control. In this case, \( f \) and \( C_k \) become the only policy instruments available to influence \( MV \) and \( J \) or to respond to \( B \).

The FSLIC mess suggests that the marginal utility of implicit bribes and cover-up activity increases as the loss exposure of the fund grows. At the same time, it clarifies the ability of a bank’s managers or a fund’s officials to hide insolvency declines as the depth of their insolvencies grow.

As long as \( C_E \) remains small, governmental public-relations efforts can credibly paint negligible adjustments in premiums or monitoring effort cleverly enough to reverse adverse movements in \( MV^x \). However, when \( C_E \) is very large or the inherited “certification fraction” \( f_0 \) is terribly small, or when \( C_E \) and the industry’s concealment capacity \( h \) deteriorate suddenly, it is hard for a regulator to tighten monitoring and insolvency resolution sufficiently without being perceived to be causing the industry problems he or she is seeking to cure. Career penalties for acknowledging unrealized losses create the possibility of an incentive-crossover point at which even a bribe-proof official’s sense of honor is overwhelmed by the reputational and career benefits of covering up the magnitude of the agency’s insolvency problems.

Self-interested regulatory forbearance is myopic for society. It worsens \( C_E \) in the long run because covering up fund and client insolvencies means permitting insolvent clients to operate. Among other authors, Barth et al. (1990) show that insured insolvent institutions face strong incentives to undertake positively skewed, negative-present-value endgame gambles.

For Federal Home Loan Bank Board (FHLBB) chairmen during the FSLIC’s last 20 years, \( C_E(t) \) usually exceeded \( C_E(t_0) \). Moreover, Congress refused FSLIC the right to restructure premiums beyond imposing a blanket supplementary premium and denied it the resources required to undertake sufficient monitoring and recapitalization activities to protect the fund. Hence, the only way each new set of top FHLBB officials could obtain a positive performance rating would have been by concealing jointly with industry managers a larger and larger fraction of anticipated losses than their predecessors did.

Government enterprises are not subject to discipline of hostile outside takeover. Their capacity to misrepresent their income and net worth is limited instead by watchdog institutions such as the press and academia and by government auditors. Faced with hidden problems, a self-interested regulator wants to avoid bad press far more than he or she wants to avoid myopic policies. It is difficult for a succession of agency heads to hide
adverse information indefinitely. Although government auditors are subject to short-run political pressures, too, they are a long-run source of accounting discipline. However loose it may be in the short run, over long periods accounting discipline is a force for truth. An insurer's deception cannot go on forever. Unless rescued by exogenous favorable changes in the financial environment, some agency head eventually must find it in his or her career interest to accept the political costs of trying to raise insurance premiums, intensify monitoring efforts, and step up the pace of insolvency resolution. However, this agency head may find that the legislature or higher administrative officials to which he or she reports are not ready to accept the political heat generated by the increased tax burden or government deficit this strategy implies. In the mid-1980s, Congressional leaders fought former FHLLB Chairman Ed Gray when he decided midway in his term that it would be wise to move in these directions.

Introducing uncertain political opposition to agency efforts to increase $C_M$, $P$, and $f$ or to lower $h$ forces responsible officials to choose between two risky courses of action: reform or coverup. Let us assume that each official is risk-neutral and estimates the mean present value of postgovernment wages under the most attractive reform scenario to be $W_{PR}$. We further assume that he or she expects postgovernment compensation to be $W_{PC}$ if the coverup works, but a much lesser amount, $W_{PM}$, if the coverup fails and a fund meltdown occurs. (All of these values are, of course, conditioned on the current values of $h$, $f$, and LE.) To complete the model, we assume that regulators perceive the probability that the projected coverup will fail before they leave their post as $P_M$ and that $W_{PC} > W_{PR} > W_{PM}$.

A strictly self-interested but bribe-proof official would choose a reform strategy if and only if

$$W_{FR} \geq P_M W_{PM} + (1 - P_M) W_{PC}. \quad (8)$$

Through 1987, thrift-industry lobbying generated disinformation that painted LE as if it were only a few billion dollars. This strategy raised the possibility that a realistic official acknowledgement of the size of FSLIC's insolvency could precipitate a crisis. Industry spokespersons stood ready to blame any straight-talking official for mishandling his or her post and causing the large losses that he or she would be revealing. In terms of the parameters of Eq. (8), industry lobbying supported a coverup by keeping estimates of $W_{FR}$ close to $W_{PM}$ and officials' estimates of $P_M$ low.

But the longer a coverup goes on, the harder it becomes to keep the deception going. First, not acknowledging losses in a firm's accounts as
they develop does not make them disappear. It simply defers accounting recognition. Losses that have been deferred into the present from the past create a drag on the industry’s and the insurance fund’s ability to report positive current earnings. Second, permitting economically insolvent institutions to stay in operation tends, on average, to escalate to the size of the insurance fund’s losses over time. For decapitalized firms, the downside risk of speculative projects belongs predominantly to the guarantor. Moreover, the eagerness with which troubled institutions bid for deposits and risky projects undermines the margins and market values even of the fund's healthy clients.

IV. OPPORTUNITIES FOR ACCOUNTING COVERUP

In plain terms, the root problem in U.S. deposit insurance may be described as a scandal in bank and government accounting that helps authorities to conceal from public view disreputable actions and to hide unfavorable information that would support a different and stricter cause of action. In tough times, the valuation and itemization principles that deposit-institution accountants and regulators use contain options that encourage large opportunity losses to be hidden from public view. They also let discretionary nonrecurring profits be recorded in ways that can overstate profits and net worths for years on end. The rosy bias in these readings and in projections that are based upon them have much in common with the rigged scales dishonest butchers use to overcharge their clients. With a high-tech show of irrelevant precision, they systematically and repeatedly mismeasure the obligations deposit insurance is putting on the taxpayers' bill.

Accountability for regulatory performance must begin with accurate information. Incentive reform must first reduce the opportunity for coverup. Throughout the U.S. mess, authorities have shown a propensity for blocking the flow of information they deem to be unfavorable to their individual and collective reputations. Legislation is needed to assure the timeliness and accuracy of information supplied by managers of insured institutions, managers of deposit insurance funds, and incumbent politicians. For the United States, I have proposed imposing self-reporting obligations and comprehensive market-value accounting principles on all financial regulators and insured institutions. This reporting system would force managers to attest that they have measured their performance and loss exposure as accurately as they can. The proposal would impose civil and criminal penalties on private and government officials who can be shown after the fact to have willfully provided less than their best estimate of their enterprise’s market value. The benefits of these accounting reforms
are twofold. First, the resulting information flows would help to clarify the capitalized cost to taxpayers of politicians choosing to pressure regulators to allow insolvent deposit institutions to stay in operation; second, more transparent information flows would assist the press and academic researchers to help voters assign blame for future messes by limiting incumbent politicians’ opportunities to claim ignorance of the long-term consequences of ruinous policies.

Of course, developing a better information system is only a first step. Something must also be done to limit officials’ discretion to forbear inappropriately. To reduce the scope for time-wasting activity requires either privatizing loss-control decisions or enacting a series of action-forcing rules that would redefine and penalize derelictions of duty at all levels.

By feigning ignorance about the extent of hidden losses and of their long-term economic consequences, FSLIC officials miserved U.S. taxpayers. Notwithstanding the opportunities to do better proffered by the FDIC Improvement Act of 1991, top U.S. regulators continue to move the Bank Insurance Fund (BIF) along the same insolvency-supporting ruts in the road that led FSLIC to ruin. Much as FSLIC regulators did during the 1970s and most of the 1980s, forbearance by gambling banking regulators in the early 1990s is dividing the U.S. banking industry into crippled and healthy segments. This policy is forcing healthy institutions and taxpayers to supply implicit equity funds to seriously crippled competitors.

Policies that retard the exit of insolvent firms implicitly infuse badly structured government capital into the balance sheets of living-dead institutions that we may aptly call “zombies.” The economic life a zombie firm enjoys is an unnatural, life-in-death existence that is possible only because implicit or explicit government deposit insurance keeps creditors from taking control and resolving its insolvency. Limited liability gives zombie institutions the ability to reap potential gains from new investments while saddling the government surety with responsibility for losses. Unless managerial scruples or career risks intervene, a zombie’s tenuous hold on life puts it in a no-lose situation: Heads it wins, tails taxpayers and healthy competitors underwrite its loss. This transforms zombie institutions into risk-loving monsters that may aptly be said to “prey” on financial markets and on the profit margins of otherwise viable competitors.

When S&L regulators decided to cover up the extent of FSLIC losses in the 1970s and 1980s and to defer hundreds of needed insolvency resolutions, they could cite four plausible excuses that, by passing the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 and the FDIC Improvement Act of 1991, the U.S. Congress has made inoperative.

These four time-honored excuses were:
(1) Regulators' authority to move against economically insolvent zombie institutions that could show positive accounting net worth depended on examiner writedowns that were difficult to defend both in the courts and in the political arena;

(2) regulators did not have enough borrowing authority to cover the asset writedowns their insurance fund would have to absorb (the Resolution Trust Corporation, which is charged with reprivatizing assets in failed U.S. thrifts, still faces this problem today);

(3) regulators could not be sure either that the U.S. Congress would repair deficiencies in insurance-fund reserves with taxpayer funds or that individual legislators would not strongly pressure them to go easy on zombie institutions for political reasons;

(4) given the uncertain nature of taxpayer backup, regulators had some reason to fear the admittedly remote possibility that rationally based runs on troubled banks and thrifts by uninsured depositors might degenerate into a costly national crisis.

With these reliable excuses for delay stripped away, in 1991–1993 faint-hearted banking regulators in the United States offered less convincing excuses for delaying insolvency resolutions. They claimed that it was a good gamble to wait for truly eager private buyers to come along to take over each of hundreds of troubled deposit-institution franchises and their weakest assets. To defend this claim, they exaggerated the financial and macroeconomic dangers of insisting on prompt recapitalizations. They downplayed the interest costs of waiting and the perverse effects on bank investment incentives this strategy introduces. Finally, they had to dismiss or mischaracterize empirical evidence on how much this strategy cost taxpayers in the S&L insurance mess.

The fundamental question for Japan is to understand and avoid the defects in bureaucratic incentives that rendered U.S. thrifts regulators so deeply reluctant to resolve deposit-institution economic insolvencies when and as they developed. In 1992, the same bureaucratic, career, and reputational benefits persuaded U.S. banking regulators to pretend as thrift regulators did in 1983 that plainly non recurring and easily reversed accounting profits that can be booked as a result of a nonrepeatable, election - year decline in interest rates have permanently restored hundreds of terminally weak banks and thrifts to health.

Leaving a weak deposit - institution's insolvency unrepaired is unfair to taxpayers because taxpayers hold the bag for the downside of every interest - rate gamble and any other speculative bet a zombie institution manages to put on the table. The rapid expansion of positions in government securities by U.S. banks and the billions of dollars in nonrecurring profits reported in bank securities trading in 1992 would have scared an unconflicted

V. Temporary World Dominance of Japanese Banks and Resulting Deregulation Pressures

To put the lessons that the U.S. deposit-insurance mess has for Japan in fuller perspective, let me first describe my understanding of Japanese banks' past success and how this success has generated "deregulatory pressure" in Japan.

My analysis (Kane, 1991a) traces Japanese banks' international competitive muscle to four interconnected sources:

(1) Japan is a nation with a high rate of saving. By itself, this condition would tend to push Japan's domestic interest rates below other countries to create a flow of capital exports out of Japan. In principle, either Japanese or foreign institutions could intermediate this flow, according to which firms would be able to intermediate savings most efficiently.

(2) Rather than let the world's most efficient intermediators win this business, during the 1980s Japanese regulators used deposit-rate ceilings to assist Japanese banks not to compete as aggressively against each other for domestic deposits as foreign-bank entry would require. This activity kept deposit interest rates in Japan from rising to world levels and illustrates how a nation's "regulatory regime" can be manipulated in the short run to help its domestic banks. The goal was to lock up the supply of Japanese deposits to control opportunities to service the worldwide demand for Japanese savings from deficit units.

The minimum account size for exempting funds from deposit-rate ceilings has been lowered in recent years, but movements have been slow and grudging. In Japan, money-market funds based in the securities industry did not step in as they did in the United States to take business away from domestic deposit institutions and make deposit-rate ceilings counterproductive for deposit institutions (Rosenbluth, 1990). This difference reflects the greater level of competition between securities and banking regulatory bureaus in the United States than that in Japan.

(3) At the same time that Japanese authorities were energetically enforcing deposit-rate ceilings on low-denomination instruments, rules inherited from the past and the strength of national loyalties felt by Japanese savers made it hard for foreign banks and domestic securities firms to enter Japanese deposit markets straightforwardly.

(4) Although Japanese banks have low accounting capital, until their
real-estate and stock markets went into a tailspin, they had relatively high levels of market-value capital. Higher market-value capital gave Japanese banks two competitive benefits. First, by enhancing the durability of these banks, it lowered the domestic cost of debt capital to Japanese banks. Second, outside of Japan, additional market-value capital gave foreign depositors special comfort. While the banks of all major countries enjoy some form of conjectural back-up guarantee from their home-country governments, for large deposits and commitments Japanese banks were able to offer corporate and other customers the additional protection of substantial amounts of stockholder-contributed capital. However, in 1991–1992 Japanese banking regulators signaled their willingness to move down the path of hidden assistance and accounting "relief" to delay loss recognition for capital-short banks.

Japanese banks’ gains in market share made parallel inroads into the share of the global market for financial regulatory services that foreign regulators had long enjoyed. By the late 1980s, this cumulative loss of market share eventually triggered a foreign regulatory response (Lamfalussy, 1989). So far, the focus of U.S. and British pressure on Japanese authorities to revise their domestic regulatory patterns has been obliquely directed. Foreign government pressure has focused on increasing capital requirements for Japanese banks and opening securities markets rather than deposit markets in Japan. For U.S. banks, the securities-market emphasis may represent a far-sighted strategic ploy or it may merely reflect an agency cost from letting U.S. State and Treasury secretaries be recruited repeatedly from a securities-industry background.

Examples of foreign pressure on Japanese regulators include the following three actions:

(1) In late 1989, the UK moved to halt branching by Japan’s regional banks in Britain until Japan more fully liberalized British firms’ ability to participate in the Tokyo Stock Exchange (Evans, 1989).

(2) France was reputed to have held up an application by a Japanese bank to establish a branch office in Paris until Credit Lyonnais was granted a seat on the same Tokyo Stock Exchange (Evans, 1989).

(3) Similarly, the U.S. Congress passed 1988 legislation calling on the Fed not to recognize as “primary dealers” in U.S. government securities financial institutions from countries that deny similar competitive opportunities to U.S. firms.

It might disturb U.S. and European citizens that, without an open debate, domestic authorities traded banking privileges in their countries for securities privileges (especially in equity markets) in Japan. Since corporate Japanese borrowers can more easily go abroad than most deposit
customers can, securities markets would have been harder for Japanese officials to insulate effectively in any case. On these grounds, the bilateral regulatory deals may seem to strike a prototypically short-sighted and sectorally skewed bargains for the U.S. financial industry. However, given the global expansion of securitization (Sinkey, 1992), the long-run effects of these deals promise to be much more favorable for foreign deposit institutions than an analysis of the short-run effects would suggest.

Economic winners in the short run are Japanese banks and Western securities firms. Short-run benefits were also won by current Western politicians and regulators, who are perceived in Japan and at home as having done something useful and (like Ronald Reagan) may merit lucrative postgovernment speaking engagements in Japan.

The losers in the short run are U.S. and European banks who must plan to enter and expand in Japan by means of a securities arm. However, entering and expanding through impersonal securities-type products may prove strategically optimal for foreign banks over the longer run. Hence, the agreement may inadvertently have directed a well-designed end run around Japanese entry barriers for foreign banks. In the long run, successors to current regulators both in Japan and abroad may be surprised by the harvests they reap.

M. Mayer (1992) emphasizes that information-rich societies allocate credit via securities markets while information-poor societies must rely on financial intermediaries. In the global and information-rich society foreseeable for the 21st century, extensive systems of bank branch offices threaten to become obsolete. This obsolescence threatens to burden the balance sheets of institutions (such as Japanese banks) unlucky enough to have invested substantial resources in them. As market participants come to appreciate this, Japanese savings may flow increasingly from Japanese banks to foreign and domestic securities firms.

In the United States, we have seen painfully slow adaptation by deposit institutions. Needed shrinkage of institutions has been retarded, and an even slower progression has emerged for branch closings. Branch closings have occurred mainly as part of megamergers that build substantial market share in specific geographic regions. For members of the current generation of bankers, it may be that an enterprise’s market share has to rise above a sizeable threshold to make branch shrinkage seem safe.

VI. A Theory of Regulatory Competition

The essence of globalization is that the world is becoming “one market” for financial services. The essence of what we call the genericization of financial-services firms (FSFs) is that distinctions among the product lines
of traditionally narrow species of institution are becoming economically immaterial.

Although the press often portrays the globalization and genericization of FSFs as if these trends can be traced to ideologically driven deregulation (a deliberate and unalloyed relaxation of preexisting regulatory restraints on FSF competition), in most countries it is more accurate to treat financial deregulation as a dialectical, market-driven response to the forces of globalization and genericization (Kane, 1984, 1991b,c). Authorities have typically ratified shrinkage in their traditional clienteles only when and as deregulation was forced upon them by armies of better-adapted financial competitors that they could not control.

Beginning with Scott (1977), a major focus of recent economic research has been to analyze the effects that technology and financial deregulation have had on the structure of banking institutions and markets in the United States, Europe, and Asia. In the concept of a market's structure, economists include four dimensions of supply-side activity:

1. the number of competing firms;
2. the distribution of market shares across these firms;
3. the range of products that incumbent competitors offer; and
4. the profit margins these incumbent competitors earn.

High and low profit margins tell us whether and how the other three elements of market structure are apt to change over time. When profit margins are high, traditional and nontraditional competitors should seek aggressively to expand their market shares. When margins are low, new entry should slow and some traditional competitors should exit.

Contemporary theories of industrial organization seek to explain every market's structure as evolving through time to permit efficient firms to discipline or displace relatively inefficient competitors. The force of these theories is particularly easy to grasp when we focus on hypothetical markets that meet a set of ideal conditions that have come to be called "perfect contestability" (Baumol et al. 1986).

A market is perfectly contestable when entry and exit costs are each zero and incumbent firms exit quickly whenever they find themselves faced with negative profits. In perfectly contestable markets, low-cost firms readily displace high-cost firms and incumbent competitors are prevented from setting monopoly prices by the threat of hit-and-run entry by other equally efficient firms.

An important complication arises when assessing the contestability of any financial-services market. The contestability of each and every financial-services market depends on the contestability of supporting markets for regulatory services. The U.S. deposit-insurance mess clarifies how inherently less than perfectly contestable financial regulatory markets are.
This is due partly to the transition costs of shifting to a new regulatory supplier and partly to the ability of incumbent regulatory entities to resist exit pressures for long periods of time.

Economically, financial regulation is a good like any other good. But financial regulation is a class of service that is valued not for itself, but for the benefits it confers on those who use the products of the regulated financial industry. Regulatory services seek to enhance the confidence and convenience that customers find in the products of the regulated firms.

Substitutability in FSF products is reflected in parallel substitutability in regulation. Regulatory benefits can be produced in many ways. This substitutability converts every regulatory relationship into a voluntary contract. It is useful to define the long run as a period long enough that transition costs don’t affect an FSF’s choice of regulator. In the long run, FSFs choose their regulatory environment to maximize the net regulatory benefits (NRB) that they receive from suppliers of regulatory services. When regulatory burdens exceed benefits, NRB may be interpreted as a net regulatory burden and be defined as the difference between the costs and the benefits that exposure to regulation generates for them.

It is instructive to look at financial regulators in different countries and within a country at different levels of government (e.g., state vs federal entities) as competing firms. These firms are typically government-owned, although some—like clearinghouses or stock and futures exchanges—are private self-regulating organizations.

Each financial regulator may be conceived microeconomically as a firm that competes for clients in what is an increasingly global and contestable industry. Each regulator has multiple goals, only some of which are strictly economic. Each regulator’s pursuit of its goals is limited by important statutory, political, and market restraints. Politics makes sure that some of these restraints are hidden, particularly economically counterproductive ones.

In treating the market for financial regulatory services as imperfectly contestable, one merely acknowledges that regulators face substantial entry and exit costs and that regulatees face substantial search and switching costs when trying to move to a more congenial regulatory environment.

The supply side of this market consists of governmental entities and private self-regulatory organizations. Because government suppliers of regulatory services play a large role in the market for regulatory services, the demand for regulation ties financial markets explicitly to political and bureaucratic markets. For government players, the bottom line of competition is measured by budgetary resources which rise and fall with jurisdiction or market share.

The message of the U.S. deposit-insurance mess is that imperfections in regulatory markets create “agency costs” for taxpayers and market
power for government officials. After officials formally deregulate entry into traditionally segmented deposit markets, strong incentives exist for them to delay adapting their prudential supervision to monitor the taxpayer loss exposure that develops in incumbent client firms. For insured deposit institutions, this delay amounts to a government-financed barrier to the healthy exit of insolvent firms. In turn, the difficulty of affecting exits prospectively limits the profitability that potential new entrants into these markets can project for themselves.

Three advantages in cost and managerial autonomy enjoyed by government regulators increase their ability to impose agency costs on taxpayers:

1. the uncased financial strength a government surety receives from its presumptive access to implicit taxpayer backup;
2. uncased policing powers that are conferred automatically by governmental status; and
3. the lack of takeover discipline on the managers of a government surety, whose positions are controlled only by reelection and reappointment processes that give government managers more slack than private executives typically enjoy.

Within and across countries, financial regulators compete: in the quality of the services they perform, in the resource efficiency of service production and delivery, and in where the burden of financing regulatory costs are laid. Implicit or explicit taxpayer backup means that government regulators face an incomplete benefit-cost test of the efficiency of their operations. A potential exists for decoupling regulatory benefits from the cost burden of producing these benefits by laying burdens for failing-firms gambles on general taxpayers.

Changes in the market structure of a country’s financial regulation industry occur principally in two ways:

1. active efforts by regulators to defend their traditional turf; and
2. passive change in regulatory market shares as client FSFs adapt their lines of business to pursue unfolding profit and market-share opportunities.

The second class of development almost never traces to aggressive initiatives conceived and undertaken by government regulators. Most government officials want to keep or improve market share, but in the short run are reluctant to seek out new tasks. The switch from inaction to action occurs as short-run bureaucratic costs accumulate into an undeniable longer-run threat that demands a response.

Passive changes typically beget active responses after a lag. Eventually, government bureaucracies do react to losses and gains of market share in defensive ways. Two prototypical examples of defensive bureaucratic reactions occurred in the United States during the 1970s and early 1980s.
First was the response to the success that money-market mutual funds (MMMFs) regulated by the Securities and Exchange Commission (SEC) had in winning market share from deposit institutions. After a lag, this redistribution of regulatory market shares triggered counterattacking legislative proposals from deposit-institution regulators. These regulators were unable to persuade Congress to sweep returns on MMMFs into the system of ceilings limiting the explicit interest rates deposit institutions could pay to small savers. As a result, beginning in 1980, depository firms and their regulators acquiesced in a plan to phase out the deposit-rate controls. In the second case, the SEC and the securities industry were incumbents that had lost market share rather than insurgents that had gained it. What they reacted against was innovation by commodities exchanges and the loss of market share to these exchanges' government regulator, the Commodity Futures Trading Commission (CFTC). Innovative stock-index derivative products trading on commodities exchanges diverted securities business to an emerging financial futures industry. SEC agitation for Congressional restoration of market share led the CFTC to lessen the tension by ceding dominion over some classes of innovative commodities-exchange contracts to securities exchanges and the SEC.

Permanent costs of regulatory migration must be distinguished from merely transitional costs. Transitional costs are not part of the net benefits or burdens of regulation that are equalized by regulatory competition in the long run. It must also be noted that gross burdens and benefits from regulation can and do differ in equilibrium. Persistent differences reflect differences in tastes for confidence and convenience in different regulators' population of clients and their customers. The desirability of servicing a nation's demand for confidence and convenience explains why less regulation is not always better regulation.

Due to information asymmetries (i.e., coverups) the costs of regulation can sometimes be dealt to third parties, especially to taxpayers and occasionally to FSF customers. The more costs can be shifted to third parties and the greater are clients' hidden losses, the greater is the possibility that a "competition in laxity" can develop. To control competition in laxity, third parties must be given the ability to monitor the costs regulators deal to them. This requires forcing the production of information on the true costs of regulation and a curtailing of the discretion regulators enjoy to hide developing problems and to defer resolution of economic insolvencies at clients that experience massive "hidden" losses.

VII. SUMMARY AND CONCLUSIONS

The U.S. S&L insurance debacle provides a road map to the "dark side" of global competition among government regulators. It raises an ugly monument to the role that agency costs can play in a representative
democracy. It shows how expensive it can be for a nation's taxpayers to permit the narrow self-interest of government officials to support inefficient financial market structures by delaying the exit of insolvent zombie institutions.

It shows how trade associations can become controlled by the interests of zombie firms, so that lobbying pressure against policies of prompt recapitalization reinforces the conflicts of interest that politicians and regulators have with taxpayers. The debacle underscores the danger taxpayers face when authorities choose not to expose a true and fair evaluation of the economic condition of government sureties and of the private firms such enterprises insure. It shows that hiding the losses that failing firms impose on taxpayers is massively costly to taxpayers in the long run. To make these costs more visible, the net worth of insured institutions should be measured by appraisal methods and market-value criteria and should be monitored frequently by technologically up-to-date information systems.

In any representative democracy, the emergence and proliferation of insured zombie institutions must be guarded against. This can only be done by aligning the incentives of government servants more closely with those of taxpayers. This means making politicians and regulators accountable in a timely fashion for actions that underprice risk and blockade entries and exits that could increase the long-run efficiency of a nation's financial structure. For this to happen, the occurrence and consequences of anti-taxpayer regulatory choices must be made transparent enough to be monitored effectively by the press and public.

One way to control the reluctance of bureaucratic regulators to force insolvent firms to choose between recapitalization and exit is to increase the transparency of supervisory decisions by enlisting private coinurers into the loss-control process (Kane, 1993). A second approach is to define regulators' supervisory duties in greater detail.

In the United States, the FDIC Improvement Act of 1991 emphasizes the second path. The Act installs a trip-wire system of mandatory discipline that is tied tightly to measures of the extent to which an institution has accounting capital of its own at stake. In this system, tougher and tougher penalties are imposed on a troubled deposit institution as its capital shrinks into progressively more dangerous zones. The final step in the disciplinary chain gives a troubled institution 90 days to recapitalize itself or to forfeit its charter and have its insolvency resolved by government regulators.

To eliminate the toleration of zombie institutions and to ensure that zombies don't multiply into a powerful political bloc, the trip-wire system must strive to measure net worth and risk frequently, and do so in economic rather than accounting terms. Zombies spread zombiness to their competitors. They do this by bidding up funding costs and bidding down rates of return on assets until industry profit margins become unsustaina-
ble. These low margins effectively drive private capital out of the insured industry and replace it with badly structured government capital.

The tale of the S&L insurance mess is a story of how, as thrift regulators looked away, a series of small problems accumulated into an unmanageable disaster. So far, U.S. bankers and banking regulators have refused to believe that the lessons of this mess apply to them. The result has been to leave roughly 1000 crippled U.S. banks on the threshold of zombiness.

The problems the financial-services industry faces in Japan echo those faced by U.S. thrift institutions in the 1980s and by U.S. banks today. One advantage that Japan has is that its currently weak segment of banks has fewer imbedded losses than its U.S. counterpart. Observers can only hope that Japanese banks and banking regulators move themselves quickly through the problem-denial stage. The market value of Japanese bank capital has shrunk rapidly since 1988 with the decline in Japanese stock prices and real estate and with the growth of nonperforming loans. However, if the economic insolvency of individual banks is tolerated for extensive periods of time, odds are that Japanese taxpayers and the strongest members of the Japanese banking industry will pay a heavy price.

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