Commentary on "Eroding Market Imperfections: Implications for Financial Intermediaries, the Payments System, and Regulatory Reform"

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Discussion thrives on controversy and controversy thrives on difference. Because Robert Eisenbeis and I have similar views on many current issues in financial reform, clarifying our differences is inherently a fussy task. To make the contrast as sharp as possible, I am going to recast his ideas into two sets of stylized syllogisms and supporting argumentation. The goal of this exercise is to identify logical weaknesses that verbal reasoning might otherwise tend to obscure.

Syllogisms

Readers whose symbolic logic is rusty may find it useful for me to review what a syllogism is. A syllogism is a carefully constructed triad of related sentences. The first two sentences are premises: assertions whose truth or falsity a researcher must establish separately. These assertions are called a syllogism's major and minor premises, respectively. A syllogism's final sentence is called the ***conclusion*** because it is implied by the premises. If the premises of a well-constructed syllogism are true, the conclusion must be true also. Symbolically, the canonical form for a syllogism may be written as follows:

$$A = B \text{ (major premise)},$$
$$B = C \text{ (minor premise)},$$
$$\therefore A = C \text{ (conclusion)}.$$

A syllogism can be unsatisfactory for either of two reasons. First, a logical defect (or fallacy) may exist in the statement of the premises. Second, the evidence presented may be insufficient to establish empirically the truth of the premises assumed.

Professor Eisenbeis offers two broad conclusions: (1) that over time deposit institutions are becoming economically less viable, and (2) that this trend threatens "the stability of financial markets and the payment system" in ways that require regulatory reform. The existence of two conclusions presupposes two syllogisms. For convenience, we may call these the viability and stability syllogisms. By stating his implicit syllogisms explicitly, I hope to identify the controversial elements in his supporting arguments and to underscore the particular points on which Eisenbeis and I have different perspectives.

The viability syllogism

In the viability syllogism, the major premise is that market imperfections completely explain the existence of deposit institutions. The minor premise is that all relevant market imperfections are being reduced as well as transformed by technological change and evolving market conditions.

Eisenbeis justifies his major premise by an appeal to authority. However, while it is clear that various imperfections are *sufficient* for deposit institutions to exist, the logical necessity of the particular set of imperfections on which he focuses his paper ought to have been established more firmly. Skipping this logical step creates unacknowledged problems in proving part of the minor premise. To demonstrate his minor premise fully, Eisenbeis would need to list all relevant imperfections, to consider the extent to which movements in one type of imperfection tend to induce movements in another, and to evaluate the direction, extent, and interdependence of recent empirical movements in each type of imperfection.

Eisenbeis explicitly names three types of imperfections in financial markets as relevant (transactions costs, asset indivisibilities, and asymmetric and costly information), and his discussion goes on to develop an even more-important fourth imperfection (regulatory interference). He views government and private regulators as implicitly

levying ***positive*** taxes on deposit institutions, and views regulatees as energetically attempting to avoid associated net tax burdens.

Eisenbeis implicitly parameterizes the idea of decreases in the first two types of imperfections and discusses movements in them in great detail. As a result, his claims that transactions costs and asset indivisibilities are lessening prove very persuasive. Unfortunately, his discussion of the other two types of imperfection is less disciplined. Because Eisenbeis does not stop to define either information costs or regulatory interference operationally, he is not led to produce direct empirical evidence on the extent to which the distortions they induce are increasing or decreasing. Instead, evidence of an increasing fusion of financial markets and activities (as exemplified by globalization of important financial markets, expanding product lines at U.S. financial-services firms, disintermediation, and stripped securitization) is taken as indirect evidence that relevant market imperfections must have decreased at least on balance. This leaves open the possibility that (as I believe) information costs and regulatory distortions may actually have been increasing in recent years and have done so partly in response to changes in transactions costs and asset indivisibilities.

Eisenbeis' discussion of movements in information is too brief. Without offering direct supporting evidence, he merely asserts that improvements in the flow of information "make it easier for lenders to assess the risks of dealing with offshore borrowers." Although I would agree that accounting and stock market information moves more freely and speedily than ever, I think that increased volatility in interest rates and foreign-exchange rates has made it economically far harder to interpret both traditional cost-based accounting records and (in view of the implied volatility of unmeasured conjectural government guarantees) even stock-market information. The increasing value of finding ways to extract inside information on firm value is underscored by trends in takeover activity, associated insider-trading scandals, and the size of monitoring and distribution fees collected by specialized financial-analyst firms. As shown by efforts to deny and then to understate the Federal Savings and Loan Deposit Corporation's developing economic insolvency, some of the most stubborn inadequacies in public information flows trace to financial regulators' and politicians' self-interested endeavors to conceal adverse information about the poor quality of their joint regulatory performance. At least as long as market-value accounting for deposit

institutions can be forestalled, information about poor regulatory performance can be suppressed and even transformed cleverly into a plea for additional regulatory powers and an incremental budget with which to implement these powers.

In his analysis of regulatory competition, Eisenbeis overlooks the possibility that regulatory competition can transform small positive regulatory burdens into large net subsidies. This is because he barely confronts what I take to be two essential issues. First, he only sporadically links observed regulatory adjustments endogenously to movements in the other types of imperfections. Second, he neglects the political economy of regulation, leaving out the profound incentive conflicts that lead politicians and regulators to offer client financial-services firms addictive regulatory subsidies that are not in the economic interest of ordinary taxpayers (Kane, 1987). To analyze the future viability of deposit institutions, it is necessary to recognize that politicians and regulators earn rents both from hiding adverse information and from delivering subsidies selectively to regulatory clients. Because regulation can act as a subsidy as well as a tax, the economic viability of even such deeply insolvent firms as zombie savings and loan associations cannot be properly evaluated without including the endogenous responses of taxpayers, politicians, and competitive regulators.

Incorporating these political-economy factors leads me to view the uneven growth Eisenbeis cites in offshore lending as reflecting heightened international competition among inappropriately constrained government regulators in many countries. Far from being supported by improved information flows, the bulk of the credit risk in expanded offshore activities has been shifted conjecturally to underfunded regulatory agencies and to the taxpayers in various countries that ultimately back them up.

In competing for clients, government regulators have two complementary advantages over private suppliers of regulatory services. The reputational capital that government status confers cuts government regulators a great deal of slack. It permits their agencies both to bear the financial strains of predatorily subsidizing critical elements in their regulatory-service package for years on end and to manage self-interestedly the short-run flow of information concerning the effectiveness and cost-efficiency of their regulatory performance. In particular, they enjoy an option not to measure and not to report

important implicit costs that are generated by their operations. In effect, governmental status gives an agency conjectural backing from the government at large that puts "added weight" behind its *financial* and its verbal claims.

This added weight makes it easier for agency managers to run the operating deficits necessary to support a strategy of "addictive subsidization" and to hide these subsidies from taxpayers for long periods of time. In effect, agencies use promotional subsidies and predatory news management to create and sustain an inefficiently large demand for their products. In the private economy, addictive subsidization is employed by dope dealers who regularly give away samples of their products to first-time users.

We can cite two strong examples of this marketing strategy in action. First, in financial services, successive Federal Reserve subsidization of its check-clearing and electronic transaction services has served to restrict the growth of competing private entities. Similarly, federal deposit-insurance subsidies have increased deposit-institution risk-taking and kept or driven state and private suppliers largely out of the game.

It is important to realize that regulatory subsidization is only half of the strategy. The second half is that inefficiences created by these subsidies (remote disbursement, high intraday volume of electronic clearing and overdrafts, and the spread of zombie deposit institutions) are transformed by "predatory news management" into justifications for expanding the subsidizer's jurisdiction. In effect, crises are created in lagged fashion by inefficient policies instituted by one set of regulators and legislators. Then, their successors "mine" resulting crises for new powers by scare tactics in ways that distract the public and would-be critics from the true causes of policy failure. Reformers should seek to eliminate distortionary regulatory subsidies and not to overlay additionally distortionary countermeasures.

The stability syllogism

With this as background, it is relatively easy to discuss the stability syllogism. Eisenbeis' major premise is that competitive pressures and declines in market imperfections have greatly increased the risk of economic insolvency facing individual deposit institutions. His

minor premise is that parallel innovations in the ways that payments are typically made have created uncontrolled credit risk ***for the system*** that have outmoded the present regulatory structure (particularly deposit insurance) as a way of managing the safety and soundness of the financial system. His conclusion is twofold: (1) payment system risk should be attacked by the Federal Reserve's undertaking real-time monitoring aimed at eliminating daylight overdrafts, and (2) explicit government deposit insurance should be phased out.

I regard this syllogism as logically defective. It leaves out the role of Fed subsidies in creating payments systems risk and what I regard to be the key element in the ***de facto*** federal financial safety net. This key element is authorities' dual option to extend their guarantees of a troubled firm's liabilities beyond their ***de jure*** limits and to permit economically insolvent institutions to continue in operation. Ending explicit deposit insurance will not eliminate conjectural guarantees and the distortionary subsidies these options engender. Political, bureaucratic, and career self-interest makes it virtually inevitable that authorities prefer to forbear from enforcing solvency requirements and deposit insurance coverage limits when they perceive that the ***de jure*** failure of a firm or set of firms would threaten the stability of the financial system as a whole. During the last 22 years, examples of this behavior have abounded in the savings and loan industry. The Federal Deposit Insurance Corporation's treatment of energy, agricultural, and world-class (or too-big-to-fail) banks exemplifies the same proclivities.

Politicians and regulators value the opportunity to bail out insolvent deposit institutions on an ex post basis and the 1987 financial-reform act shows no readiness to give up this right. As long as authorities'retain an unlimited option to forbear, deposit insurance will exist ***de facto,*** at least on an implicit and conjectural basis. Eliminating explicit deposit insurance, as Eisenbeis recommends, is a narrowly legalistic solution as opposed to a fully realistic one. It would not solve the problem of pricing and administering federal guarantees of deposit-institution liabilities. It would simply eliminate a familiar mechanism for collecting user fees from deposit-institution recipients of conjectural federal guarantees.

Strategic forbearance is institutionally advantageous for deposit-institution regulators and disadvantageous for the federal taxpayer. Underpricing and inefficiently administering the Federal Reserve's

clearing and settlement system, the discount window, and deposit-insurance guarantees can be seen as a series of regulatory "treatments" and supplementary regulations designed to keep these systems from breaking down as forms of "countertreatment." Like the sequential administration of a poison and its antidote, the treatments and countertreatments are far from costless. Moreover, because each has unintended side effects, their simultaneous application is by no means distributionally or allocationally neutral. Taken together, they expand the demand for regulatory services and unnecessarily enlarge the role that federal agencies get to play in our country's financial life. In the final analysis, then, massive deposit-institution insolvency threatens ***not*** the stability of the nation's financial system but the net worth of its taxpayers.

Prospects for meaningful reform of financial regulation

Financial change is creating a desperate need for U.S. financial regulators to develop better information, monitoring, and policing systems. However, before taxpayers can rationally rely on politicians and regulators to operate these systems appropriately, they must reform the incentive system under which these agents operate.

The chief problem blocking meaningful reform of the U.S. financial regulatory system is that existing patterns of federal subsidies create business for regulators and rents for elected politicians. The agency problems exist because badly informed taxpayers have allowed competing government regulators an opportunity to adopt inappropriately constrained jurisdiction-maximizing strategies of competing with each other for potential clients.

Whether they recognize it or not, financial reformers seek implicitly to impose uncompensated costs on politicians and regulators. Without appropriate compensation or the introduction of behavior-modifying punishments, it is unreasonable to expect politicians and regulators either to surrender their existing job benefits or to stand up to the political and bureaucratic pressures that would be unleashed by the sectors that currently enjoy subsidies if progress were made toward rationalizing the system.

The root problem is to constrain government regulators to play fair with taxpayers. A minimum first step is to force a full account-

ing to taxpayers of the economic costs of each agency's operations and commitments. Without external coercion, government managers have little reason to reveal the market value of the operating losses inherent in jurisdiction-expanding patterns of long-lived subsidization.

References

Edward J. Kane, "How Market Forces Influence the Structure of Financial Regulation," (unpublished) Ohio State University; Columbus, 1987.