

ARTICLES

THE IMPACT OF RECENT BANKING REGULATIONS ON THE MARKET FOR CORPORATE CONTROL

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I. Introduction	861
II. Capital Adequacy Requirements, Regulatory Policy, and the Market for Corporate Control	865
A. Background	866
B. The 1989 Risk-Based Capital Regulations	870
1. Economic Consequences of the Regulations	872
2. Alternatives to Risk-Based Capital Requirements ..	874
C. Regulation of Highly-Leveraged Transactions.....	876
D. Impact on the Market for Corporate Control.....	878
III. Junk Bonds, Takeovers, and FIRREA	879
A. Partial Deregulation, Money Brokers, Deposit Insurance, and Junk Bonds	879
B. The Self-Fulfilling Prophecy of FIRREA	881
IV. Conclusion: The Adverse Impact of Recent Regulatory Changes on the Market for Corporate Control	883

I. INTRODUCTION

The efficacy of the market for corporate control¹ as a powerful mecha-

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1. For the seminal statement of the market for corporate control thesis, which holds that the threat of a change in control provides incumbent managers with the incentive to maximize share value, see Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965). For a summary of the role of the market for corporate control in the modern contractual theory of the corporation, see Butler, *The Contractual Theory of the Corporation*, 11:4 GEO. MASON L. REV. 99

nism for disciplining disloyal and inept corporate managers has been demonstrated by numerous empirical studies² and validated by the extreme efforts to which some corporate leaders have gone to influence public policies affecting the market for corporate control. Efforts to restrict the takeover market have been manifest in numerous public policies and policy proposals. Legal commentators have correctly identified the passage of state takeover statutes,³ increased and expanded enforcement of insider trading regulations,⁴ proposed changes in the federal income tax treatment of certain corporate interest payments,⁵ plant closing legislation,⁶ and antitrust enforcement⁷ as poorly disguised attempts to impede the market for corporate control. Such restrictions undoubtedly harm the efficiency of the United States economy.

One aspect of regulating the market for corporate control that has yet to be addressed is the impact of banking regulations⁸ on takeover activity. Banks and savings and loan associations are important to takeover activity for two reasons. First, commercial banks often provide financing to acquiring firms at the crucial early stages of the takeover process. Banks might make short-term "bridge" loans and commitments to the acquiring firm while the deal is being consummated and before long-term

(1989). For legal commentary based on the market for corporate control, see Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978); Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982) (buyouts increase societal welfare by minimizing the monitoring costs associated with the separation of ownership and control of publicly held corporations); Repetti, *Management Buyouts, Efficient Markets, Fair Value, and Soft Information*, 67 N.C.L. REV. 121, 124-25 (1988); Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1174 (1981).

2. For a review of the evidence, see Jarrell, Brickley, & Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49 (1988).

3. See Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365; Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987).

4. See, e.g., Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9 (1984); Macey, *From Judicial Solutions to Political Solutions: The New, New Direction of the Rules Against Insider Trading*, 39 ALA. L. REV. 355 (1988).

5. See, e.g., Ribstein & Adler, *Debt, Leveraged Buyouts, and Corporate Governance*, Cato Institute Policy Analysis, No. 120 (May 2, 1989).

6. See generally PLANT CLOSINGS: PUBLIC OR PRIVATE CHOICES? (R. McKenzie ed. 1984).

7. See, e.g., Barnes, *Nonefficiency Goals in the Antitrust Law of Mergers*, 30 WM. & MARY L. REV. 787 (1989). See also *California v. American Stores*, 110 S. Ct. 1853 (1990) (states have authority to seek divestiture in Clayton Act antimerger cases).

8. This Article uses the phrase "banking regulation" in the generic sense to mean regulation of all banking institutions including commercial banks, bank holding companies, savings and loans, and thrifts.

financing can be arranged.⁹ Often these short-term loans are paid off when the acquiring firm sells so-called "junk bonds."¹⁰ Occasionally banks also make long-term loans to acquiring firms. Second, during the 1980s, savings and loan associations became an important buyer of junk bonds—that is, an important source of funds for takeovers. The development of junk bonds presented savings and loans (S&Ls) with another

9. One of the more controversial areas of bank involvement in corporate acquisition financing involves financing the leveraged buyout (LBO). In its simplest terms an LBO is "a transaction in which a company's capital stock or its assets are purchased with borrowed money causing the company's new capital structure to be primarily debt." S. REED & LANE & EDSON, P.C., *THE ART OF M&A: A MERGER/ACQUISITION/BUYOUT GUIDE 2-3* (1989) [hereinafter *THE ART OF M&A*]. In other words, a leveraged buyout is a form of corporate restructuring in which a small group of investors (usually the corporation's management) generates cash by selling large amounts of debt in order to buy all or most of the corporation's stock. See R. BREALEY & S. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 816 (3d ed. 1988). LBO debt is often financed, at least in part, through so-called junk bonds. See *infra* note 10.

To understand bank involvement in an LBO acquisition, it is necessary to look closely at the mechanics of LBO acquisitions. Often the acquiring corporation will form a holding company and acquire a large block of the target company's shares on the open market. The acquiring firm will then make a tender offer directly to the target firm's shareholders to buy a certain percentage of the target firm's stock. See Lehn, Blackwell & Marr, *The Economics of Leveraged Takeovers*, 65 *WASH. U.L.Q.* 163, 167-69 (1987). Once the tender offer is completed, the target firm merges with the holding company; the new corporation's assets are managed by the parent acquiring corporation. *Id.*

The tender offer is financed by the holding company's borrowing. Typically, there are three layers of financing: the senior debt layer, the subordinated debt layer (also referred to as mezzanine financing), and the equity layer. See, e.g., Greve, *Management Buy-outs and LBOs*, *THE MERGERS AND ACQUISITIONS HANDBOOK* 349-52 (M. Rock ed. 1987). The senior lenders hold both secured and unsecured debt. This group consists largely of commercial banks, and usually constitutes about half of the total value of the LBO transaction. A. MICHEL & I. SHAKED, *THE COMPLETE GUIDE TO A SUCCESSFUL LEVERAGED BUYOUT* 183 (1988). Subordinated debt is generally held by large institutional investors such as pension funds and insurance companies. These securities normally have characteristics of both debt and equity. *Id.* at 186-88. They are riskier than the senior debt securities—if junk bonds are used in the transaction, they will be used at this level. *THE ART OF M&A*, *supra*, at 157-58.

Equity investment generally makes up the smallest of the three financing layers. As the residual class of investors, this is the riskiest of the three layers and therefore offers the highest rate of return. In most LBOs, the participating management group is required by the institutional investors to acquire an equity investment, thereby giving the managers a greater incentive to be successful. Greve, *supra*, at 351.

10. R. BREALEY & S. MYERS, *supra* note 9, at 816. The term junk bond describes any debt security classified below investment grade by the bond rating services. *Id.* at 307. "Junk bonds are medium- to long-term obligations (10-15 years) of the target that (1) are subordinated to its senior debt, (2) are normally unsecured, and (3) bear high interest rates (13-17%)." *THE ART OF M&A*, *supra* note 9, at 157. The label 'junk bond' is as deceptive as it is pejorative. The label implies there are two general classes of bonds: investment grade and 'junk.' However, there is a wide range of quality within each category. Comment, *Junk Bonds: Do They Have a Value?*, 35 *EMORY L.J.* 921 (1986) (authored by Michael D. Floyd).

investment opportunity that was far superior in basic financial terms to many of the other investment options allowed under thrift regulations.¹¹

These two areas of banking regulation that affect takeovers have undergone substantial changes in recent years. First, changes in bank capital adequacy guidelines and related regulations have altered the treatment of loans to finance changes in corporate control in a manner that increases the bank financing cost of takeovers. Second, statutory changes have eliminated the ability of thrifts to purchase junk bonds, thereby eliminating an important source of funds for corporate control transactions. In both instances, the new regulations do not come close to attaining their stated goals of increased safety and soundness in the banking system. In fact, both sets of regulations have the potential to increase the riskiness of bank asset portfolios.¹² Thus, the regulatory changes not only adversely affect bank safety and soundness, they also decrease overall corporate efficiency.

Part II of this Article briefly discusses the historical development of the regulation of bank capital, focusing on the 1989 risk-based capital adequacy regulations as well as the 1989 highly leveraged transaction guidelines and their impact on the banking industry's involvement in takeover transactions. This section also shows how the perverse incentives created by the present system of federal deposit insurance impact on the takeover market. Part III discusses the role of thrifts in corporate takeovers and the effect of the Financial Institutions Reform, Recovery and Enforcement Act of 1989,¹³ including its prohibition on thrifts' purchasing junk bonds. The concluding section speculates as to why these seemingly unwise regulations were adopted.

11. See *infra* text accompanying notes 88-91.

12. Because increasing the riskiness of banks and S&Ls is at odds with the stated purpose of the regulatory changes, one might infer that the regulations were intended to protect politically-influential, entrenched corporate managers by restricting bank and thrift financing of corporate control transactions, thereby impeding the market for corporate control. One of the fundamental tenets of public choice economics is that the true purpose of legislation should be inferred from its consequences, not from the legislative history. See, e.g., Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 335 (infer legislative intent from the probable consequences of the action). For applications of public choice economics to banking regulations, see Butler & Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677 (1988); Macey, *Special Interest Groups, Legislation, and the Judicial Function: The Dilemma of Glass-Steagall*, 33 EMORY L. J. 1 (1984); Shughart, *A Public Choice Perspective of the Banking Act of 1933*, in THE FINANCIAL SERVICES REVOLUTION: POLICY DIRECTIONS FOR THE FUTURE 87 (C. England & T. Huertas eds. 1988).

13. Pub. L. No. 101-73, 103 Stat. 183 (1989).

II. CAPITAL ADEQUACY REQUIREMENTS, REGULATORY POLICY, AND THE MARKET FOR CORPORATE CONTROL

The federal government has long been interested in the safety and soundness of the banking industry. As part of their effort to provide macroeconomic stability and to protect the deposit insurance system, bank regulators have generated an abundance of regulations designed, among other things, to reduce banks' risk exposure.¹⁴ The most often relied upon types of regulations involve bank capital requirements. Banking regulators have traditionally looked at bank capital as a buffer to absorb unexpected losses and as a means of maintaining public confidence in the banking system. Capital regulations invariably center on the concept of "capital adequacy." Capital adequacy refers to the minimum level of capital that regulators feel is necessary for the safe and sound operation of a bank.¹⁵

Capital adequacy became a major concern of bank regulators in the 1980s for several reasons. First, bank capital ratios declined throughout the 1970s and 1980s.¹⁶ Second, there was a general perception that there was an increase in riskiness of bank assets during this period, especially in view of potential losses on loans to less-developed countries. Finally, the collapse of the S&L industry focused regulators' attention on methods of controlling bank risk taking: chief among these methods was regulation of capital. These factors led regulators to impose new risk-based capital guidelines in 1989.¹⁷

This section begins with a review of the historical origins of bank capital regulations, followed by a summary and critique of capital adequacy regulations as a means of increasing bank safety and soundness. This section then explores alternative means for regulating bank risk. The highly-leveraged transaction guidelines issued by the banking regulators in May 1989 and their ineffectiveness in providing safety and soundness to the banking system are also discussed. Finally, this section analyzes both the capital adequacy regulations and the highly-leveraged transac-

14. See generally 12 C.F.R. § 3 (1990).

15. See, e.g., Norton, *Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities?*, 49 OHIO ST. L.J. 1299, 1302 (1989).

16. Keeley, *Bank Capital Regulation in the 1980s: Effective or Ineffective?*, ECON. REV. FED. RESERVE BANK OF SAN FRAN. 3, 3 (Winter 1988).

17. See, e.g., *Risk-Based Capital Requirements for Banks and Bank Holding Companies: Hearing Before the Subcomm. on General Oversight and Investigations of the House Comm. on Banking, Finance and Urban Affairs*, 100th Cong., 1st Sess. 3 (1987) [hereinafter Capital Hearings].

tion guidelines as impediments to the efficient operation of the market for corporate control.

A. Background

From the earliest days of the republic, both the state and federal governments have contributed to the regulation of banks.¹⁸ Through 1837, both the state and federal governments limited their involvement in bank regulation to the chartering process.¹⁹ The period of 1837-1933 saw an increase in the amount of federal banking regulation, particularly with the creation of the Federal Reserve system in 1913.²⁰ Not until the Great Depression, however, did both the amount and intrusiveness of federal banking regulations increase dramatically.²¹

By the early 1930s, the financial services industry in the United States "had been totally discredited."²² The Congress responded with the passage of the Banking Act of 1933,²³ popularly known as the Glass-Steagall Act. The Glass-Steagall Act introduced sweeping reforms, including the segregation of the banking and securities industries²⁴ as well as the creation of the Federal Deposit Insurance Corporation (FDIC).²⁵

The system of federal deposit insurance created in 1933 assesses a premium on all insured banks at the same base rate.²⁶ The problem with the flat rate is its inability to account for the risk variations of different banks

18. For a thorough discussion of the history of banking regulation, see A. CARRON, *REFORMING THE BANK REGULATORY STRUCTURE* (1984); Huertas, *The Regulation of Financial Institutions: A Historical Perspective on Current Issues*, in *FINANCIAL SERVICES: THE CHANGING INSTITUTIONS AND GOVERNMENT POLICY* (G. Benston ed. 1983); Victor, *Regulation-Defined Financial Markets: Fragmentation and Integration in Financial Services*, in *WALL STREET AND REGULATION 7* (S. Hayes ed. 1987).

19. Huertas, *supra* note 18, at 8-10.

20. *Id.* at 10-18; Victor, *supra* note 18, at 8-15.

21. The large volume of banking legislation in the decade following the Great Depression included the following: The Federal Home Loan Bank Act of 1932, 12 U.S.C. §§ 1421-49 (1988); The Banking Act of 1933, 12 U.S.C. § 227 and ch. 2, 3, 6 (1988); The Federal Credit Union Act of 1934, 12 U.S.C. §§ 1751-90, 1795 (1988); The Banking Act of 1935, 12 U.S.C. § 228 and ch. 1-6, 13 (1988).

22. Victor, *supra* note 18, at 15.

23. 12 U.S.C. § 227 and ch. 2, 3, 6 (1988).

24. 12 U.S.C. § 378 (1988). Today, Glass-Steagall is most often understood to mean that narrow part of the original act which separated commercial banking from investment banking.

25. 12 U.S.C. § 1811 (1988). Even in 1933, some healthy banks opposed the adoption of deposit insurance for fear that it would cause a moral hazard problem.

26. 12 U.S.C. § 1817 (1989). Since 1989, savings and loan associations have also been insured by the FDIC under this provision.

and savings and loans.²⁷ This scheme encourages risk taking because banks know they will pay the same premium no matter how risky their loans are; therefore, banks are more likely to make high risk loans because of their correspondingly higher rate of return.²⁸ In addition, there is no incentive for depositors to monitor bank risk taking because the government has guaranteed their deposits.²⁹ This creates the so-called "moral hazard"—an incentive for banks to engage in riskier activity because of their ability to shift the costs of risk taking to the insurance fund. This problem becomes particularly acute in times of trouble: the closer the bank is to insolvency, the more willing it is to embark on extremely risky ventures in a desperate attempt to save the bank. When no market incentives exist for controlling risk taking, regulation is crucial to the protection of the federal deposit insurance system.³⁰

27. Indeed, the banking regulators recognized this problem in 1983 stating, "The fact that the present assessment structure does not consider individual risk is an undeniable flaw—but one that has not caused much concern until recently." FEDERAL DEPOSIT INSURANCE CORPORATION, FEDERAL HOME LOAN BANK BOARD, & NATIONAL CREDIT UNION ADVISORY BOARD, REPORT TO CONGRESS ON FEDERAL DEPOSIT INSURANCE (June 1983). To date no action has been taken to change the premium structure of federal deposit insurance.

28. See generally, R. BREALEY & S. MYERS, *supra* note 9, at 392 (as return on an asset increases, so does risk).

29. See, e.g., H. BUTLER, BEYOND THE BAILOUT: LONG-TERM SOLUTIONS TO THE CRISIS IN FEDERAL DEPOSIT INSURANCE 5 (Heritage Foundation Backgrounder No. 696, 1989); Scott, *Deposit Insurance and Bank Regulation: The Policy Choices*, 44 BUS. LAW. 907 (1989). Although the insurance system is in theory limited, in practice there is de facto coverage of all depositors and creditors. GENERAL ACCOUNTING OFFICE PUB. NO. 89-47, TROUBLED FINANCIAL INSTITUTIONS: SOLUTIONS TO THE THRIFT PROBLEM 121 (Feb. 1989).

30. However, in the absence of federal deposit insurance, it is not at all clear from economic theory that minimum capital standards are necessary for the safety and soundness of banks. See, e.g., Macey & Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153 (1988); Pringle, *The Capital Decision in Commercial Banks*, 29 J. FIN. 779 (1974); Blair & Heggstad, *Bank Portfolio Regulation and the Probability of Bank Failure*, 10 J. MONEY, CREDIT, & BANKING 88 (1978). But see Taggart & Greenbaum, *Bank Capital and Public Regulation*, 10 J. MONEY, CREDIT & BANKING 158 (1978). In addition to arguing that capital requirements are needed to prevent bank failures, proponents of the risk-based capital standards argue that such measures instill confidence in the banking system. See, e.g., Santomero & Watson, *Determining an Optimal Capital Standard for the Banking Industry*, 32 J. FIN. 1267, 1270 (1977); Mingo, *Regulatory Influence on Bank Capital Investment*, 30 J. FIN. 1112 (1975). However, there are means more effective than regulating capital to build confidence in the banking system. These means include federal (or private) deposit insurance, bank examinations, and the Federal Reserve Board as the lender of last resort. Pringle, *supra*, at 779. In fact, the necessity of bank capital adequacy requirements is found in the ill-conceived federal deposit insurance system that eliminates many market incentives to limit risk taking. With the advent of deposit insurance, virtually all of a bank's deposits are guaranteed, so there is little or no direct cost to depositors when a bank fails. It is true that bank failures drain the resources of the federal deposit insurance agencies, and therefore place an additional tax burden on society. However, rather than change bank capital standards, those agencies

Banks' capital adequacy did not become a regulatory concern, however, until the post-World War II era. In the mid-1950s, the Federal Reserve Board devised a strategy that assigned arbitrary risk weights to the assets making up a bank's capital.³¹ The risk-asset approach to bank examination did not become the prevailing view among banking regulators until the 1970s with the rise of bank holding companies,³² which fall within the regulatory purview of the Federal Reserve Board.³³

The Comptroller of the Currency took a somewhat different view of capital adequacy. The Comptroller determined a bank's capital adequacy on a case-by-case basis in light of the bank's overall health.³⁴ By the end of the 1970s, the Comptroller's rating system became accepted as an interagency standard, promulgated in 1978 as the Uniform Interagency Bank Rating System (CAMEL System).³⁵

In addition to the Federal Reserve Board and the Comptroller of the Currency, the FDIC also monitors capital adequacy. Before a bank may receive a certificate to do business as an insured bank, the FDIC must consider several factors, including the adequacy of the bank's capital structure.³⁶

Although banks' capital adequacy has been a regulatory concern since World War II, formal bank capital adequacy guidelines were issued for the first time in 1981.³⁷ The 1981 regulatory guidelines divided banking

could more effectively achieve their regulatory goals by improving their monitoring of banks, possibly by charging the more risk-prone banks a higher deposit insurance premium. *See, e.g.,* Taggart & Greenbaum, *supra*, at 168 (when insurance fee does not reflect risk, banks are encouraged to shift costs to the deposit fund).

31. Norton, *supra* note 15, at 1317.

32. *Id.*

33. 12 U.S.C. §§ 1841-50 (1988).

34. The Comptroller's office considered the following factors when evaluating capital adequacy: the quality of management; liquidity of assets; the history of earnings and of the retention thereof; the quality and character of ownership; the burden of meeting occupancy expenses; potential volatility of the banks' deposit structure; the quality of operating procedures; and the bank's capacity to meet present and future financial needs of its trade area, considering the competition it faces.

Norton, *supra* note 15, at 1318 (quoting Charles Van Horn, former Regional Administrator of National Banks for the Second Region).

35. The CAMEL system looks at 5 aspects of bank operations: Capital adequacy, Asset quality, Management, Earnings, and Liquidity. The bank's soundness is then given a rating based on these factors. *Id.* at 1320, n.86.

36. 12 U.S.C. § 1816 (1988).

37. *See* Joint News Release of the Comptroller of the Currency and the Federal Reserve Board, 1 Fed. Banking L. Rep. (CCH) ¶ 5554A (Dec. 17, 1981). This discussion ignores the nominal statutory minimum capital requirements for issuance of a national bank charter. *See* 12 U.S.C. § 51 (1988).

institutions into three classes: community, regional, and multinational. Community banks were required to maintain a minimum capital-to-asset ratio of six percent, regional banks were required to maintain a five percent ratio, and multinational banks were to be considered on a case-by-case basis.³⁸ Prior to 1983, however, no statutory requirement of a minimum capital level for banks existed. Therefore, the regulators' primary remedy against nonconforming banks was to issue a cease and desist order on the grounds that noncompliance was an unsafe or unsound banking practice.³⁹ *First National Bank of Bellaire v. Comptroller of the Currency*⁴⁰ constitutes the first challenge to the Comptroller's authority to issue cease and desist orders in cases of inadequate bank capital. The *Bellaire* court vacated a cease and desist order of the Comptroller requiring the bank to raise its capital-to-assets ratio to not less than seven percent.⁴¹

In 1983, Congress passed the International Lending Supervision Act (ILSA),⁴² requiring the federal banking agencies to set minimum capital requirements. At the request of the Comptroller, Congress included section 3907(a)(2) to overrule *Bellaire* by giving each federal banking agency "the authority to establish such minimum level of capital for a banking institution as . . . [that] agency, in its discretion, deems to be necessary" ⁴³

After *Bellaire* and the passage of the ILSA, the Comptroller devised minimum capital ratios for national banks.⁴⁴ The regulation divides bank capital into primary and secondary capital.⁴⁵ National banks must "maintain total capital equal to at least 6 percent of . . . assets and primary capital equal to at least 5 percent of . . . assets."⁴⁶ However, the Comptroller has the discretion to require higher minimum capital

38. Comptroller of the Currency, Administrator of National Banks, Examining Circular 206, 1 Fed. Banking L. Rep. (CCH) ¶ 5554A (Dec. 18, 1981).

39. 12 U.S.C. § 1818(b)(1) (1988). However, "most banks did cave in under agency pressure" applied through the cease and desist order. Horvitz, *More is Better as Far as Capital Requirements Go*, Am. Banker, Apr. 24, 1986 at 4, col. 1. Other remedies available to regulators include the right to condition or deny applications based on financial factors as well as the power to restrict dividend payouts, resort to more frequent examination (at the bank's expense), and other coercive tactics.

40. 697 F.2d 674 (5th Cir. 1983).

41. *Id.* at 684-87.

42. 12 U.S.C. §§ 3901-12 (1988).

43. 12 U.S.C. § 3907(a)(2) (1988).

44. See 12 C.F.R. § 3 (1990).

45. *Id.* at § 3.2 (c)-(e).

46. *Id.* at § 3.6.

ratios.⁴⁷

B. *The 1989 Risk-Based Capital Regulations*

The concern with risk intensified in the 1980s,⁴⁸ largely because of "deteriorating asset quality, increases in off-balance sheet activity and declining capital ratios."⁴⁹ This concern, combined with the beginnings of the S&L debacle, prompted the Comptroller, along with the FDIC and the Federal Reserve Board, to propose risk-based capital standards for banks in 1987.⁵⁰ The three agencies published final regulations early in 1989.⁵¹

The new risk-based capital adequacy guidelines are designed to force banks to restructure their asset portfolios to include more low risk assets such as cash or government securities. The new capital guidelines, which are to be phased in over a three year period, raise the minimum capital-to-assets ratio to eight percent.⁵² The major innovations of the new regulations include a system for weighting the riskiness of bank assets and new definitions of capital.

The new regulations require banks to maintain capital equal to a percentage of the face value of the bank's assets. The percentage varies with the riskiness of each asset. In assigning risk weights, balance sheet assets are divided into four categories: zero percent (*e.g.*, cash and cash equivalents); twenty percent (*e.g.*, short term claims guaranteed by U.S. depository institutions); fifty percent (*e.g.*, loans secured by first liens on one to four family residences); and one hundred percent (*e.g.*, commercial loans).⁵³ The dollar value of the assets in each category is multiplied by the risk weight assigned to that category. Off-balance sheet items, such as standby letters of credit and performance bonds, are multiplied

47. *Id.* at § 3.10.

48. *See, e.g.*, Capital Hearings, *supra* note 17.

49. Keeley, *supra* note 16, at 3.

50. Joint News Release of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Board of Governors of the Federal Reserve System, 1985-87 Transfer Binder Fed. Banking L. Rep. (CCH) ¶ 86,776 at 92,172 (Jan. 8, 1987).

51. *See* 54 Fed. Reg. 4168 (1989) (to be codified at 12 C.F.R. §§ 3, 3.100) [hereinafter Comptroller's Guidelines] (Comptroller's risk-based capital guidelines); 54 Fed. Reg. 4186 (1989) (to be codified at 12 C.F.R. §§ 208, 225) [hereinafter Board Guidelines] (Federal Reserve Board's risk-based capital guidelines); 54 Fed. Reg. 11,500 (1989) (to be codified at 12 C.F.R. § 325) [hereinafter FDIC Policy] (FDIC's policy on risk-based capital). The regulations are virtually identical; this paper will use those issued by the Comptroller of the Currency as a reference.

52. Comptroller's Guidelines, *supra* note 51, at 4182.

53. *Id.* at 4180-81.

by an appropriate conversion factor (zero, twenty, fifty, or one hundred percent) to arrive at an on-balance sheet credit equivalent, which is then assigned one of the four risk weights.⁵⁴ The risk-weighted assets total is the sum of the results for each category.⁵⁵

In addition to providing risk weights for assets, the new regulations redefine capital. Capital is divided into "Core" or "Tier 1" capital and "Supplementary" or "Tier 2" capital. Tier 1 capital consists primarily of common and perpetual noncumulative preferred stock. Tier 2 capital consists of perpetual preferred stock, mandatory convertible debt, loan loss reserves, certain forms of term-subordinated debt, and limited-life preferred stock.⁵⁶ In calculating total capital, goodwill is subtracted from Tier 1 capital, subject to a grandfathering provision.⁵⁷ At least fifty percent of total capital must be Tier 1 capital, and up to ten percent of Tier 1 capital can be comprised of Tier 2 capital elements.⁵⁸

The risk-based capital ratio is equal to total capital divided by the sum of the risk-weighted assets.⁵⁹ By December 31, 1992, this ratio must be eight percent; also by that date at least fifty percent of total capital must be made up of Tier 1 elements. However, there are rules for the transition period. By December 31, 1990, all banks are expected to maintain a minimum ratio of total capital to risk-weighted assets of seven and one-quarter percent⁶⁰ (up from the present six percent requirement⁶¹).

In formulating a risk-based capital ratio, banking regulators have attempted to increase the safety and soundness of the banking system. The new regulations are designed to make riskier banks incur the costs associated with meeting the capital adequacy guidelines. To that end, the risk-based guidelines should deter excessive bank risk taking by increasing the capital requirement for riskier assets, making those assets less attractive to banks. The new regulations, however, create efficiency as well as safety and soundness problems of their own. These problems will be addressed below.

54. FDIC Policy, *supra* note 51, at 11,512.

55. *Id.* at 11,511.

56. Comptroller's Guidelines, *supra* note 51, at 4179.

57. "Goodwill that national banks have been allowed to count as capital as a result of the transition rules contained in 12 C.F.R. 3.3 is grandfathered until December 31, 1992, but will be deducted from Tier 1 capital after that date." Comptroller's Guidelines, *supra* note 51, at 4182.

58. *Id.*

59. FDIC Policy, *supra* note 51, at 11,516.

60. Comptroller's Guidelines, *supra* note 51, at 4182.

61. 12 C.F.R. § 3.6 (1990).

1. *Economic Consequences of the Regulations*

The concept of promoting safety and soundness in the banking industry by formulating risk-based capital guidelines presumes that such guidelines will tend to limit banks' risk taking. The new regulations do provide some incentive for banks to hold less risky assets; whether these incentives will produce more than a marginal effect is not clear. However, the new regulations will potentially harm the economy in at least four respects.

First, the regulations may lead to an increase in overcapitalized banks.⁶² This hurts society by diverting capital from more productive uses. In addition, by artificially constraining bank asset portfolios, the new regulations may have the effect of increasing the risk exposure of banks. These costs are better understood by analyzing the incentives created by the new regulations. The new capital-to-asset ratio is derived by dividing total capital by the risk weighted assets.⁶³ This gives banks an incentive to hold less risky assets, which have lower assigned risk weights, such as cash or government securities; the higher the number of low risk securities, the smaller the total of risk-weighted assets. To meet

62. Viewed properly, the question of bank capital adequacy includes at least two offsetting costs: the cost of bank failure from insufficient capitalization, and the cost of forced overcapitalization imposed on the bank and on society in general (in terms of foregone opportunities that would otherwise be available to banks without capital requirements). Santomero & Watson, *supra* note 30, at 1267-68 (1977). Further analysis of the two costs of bank capital adequacy reveals that the cost of bank failure from insufficient capitalization is arguably much less than the cost of forced overcapitalization imposed on the bank. Of course the existence of federal deposit insurance skews any discussion of what is or is not adequate capitalization. It is arguable that in a system where the taxpayers bear the cost of bank failures, the existence of overcapitalized banks is a fair trade off for fewer bank failures. However, this premise presumes that bank failure is linked to bank capitalization. Capital requirements have little, if any, relation to the goal of achieving safety and soundness in the banking industry. First, it is not clear that insufficient capitalization actually costs society in terms of increased bank failures. At least one commentator believes "[e]mpirical studies have found no significant relationship between capital positions and bank failure." Pringle, *supra* note 30, at 779. Banks do not fail because they are undercapitalized, but rather because "the [bank] has not responded to market forces with a satisfactory mix of price and product performance relative to its competitors in the industry or else the product the [bank] is offering is not in sufficient demand by consumers to justify its production in the first place." Macey & Miller, *supra* note 30, at 1155.

Even if banks do sometimes fail because of insufficient capitalization, some would argue that occasional bank failures are good for the economy as indicators that markets are working to penalize inefficient operations. Tussing, *The Case for Bank Failure*, 10 J.L. & ECON. 129 (1967).

63. FDIC Policy, *supra* note 51, at 11,516. See generally Malloy, *U.S. International Banking and the New Capital Adequacy Requirements: New, Old, and Unexpected*, 7 ANN. REV. OF BANKING L. 75, 88-105 (1988) (demonstrates how to calculate the capital-to-assets ratio under the new regulations).

the higher capital-to-asset ratios of the new regulations, banks will face several choices: raise capital through the sale of equity or debt, retain additional earnings, or reduce their asset base (thereby reducing the proportional amount of capital they must raise or retain relative to assets).⁶⁴ An obvious result of the new capital requirements is that banks' asset portfolio growth will be constrained,⁶⁵ and the composition of those asset portfolios may be affected. Banks are encouraged to limit the amount of high risk, and therefore high return, assets in their portfolios because high risk assets are weighted more heavily, requiring banks to retain a larger amount of capital.

Second, the selection of risk weights reflects an explicit decision to channel financial resources into one sector of the economy and away from other sectors. For example, the housing industry may be favored by treating home mortgages as low risk investments. This type of government "credit rationing"—similar to the type of central planning found in socialist states—is antithetical to free market principles allowing resources to flow to their highest value use as determined by market signals.

Third, the costs of credit rationing may have immediate adverse consequences on the performance of corporate managers by interfering with the market for corporate control. The asset portfolios of many banks include loans made to corporations to finance leveraged buyouts. These loans fall into the one hundred percent risk weight category.⁶⁶ To the extent the new guidelines discourage banks from holding assets in the one hundred percent risk weight category, they will discourage banks from financing leveraged takeovers. If increasing the efficiency and competitiveness of the American economy is the goal of economic policies, then the new capital regulations, which discourage such transactions, are not desirable from a policy perspective.

Fourth, not only are the new capital requirements potentially harmful to the efficient allocation of resources, they are potentially harmful to individual banks and to the federal deposit insurance fund by actually increasing the probability of bank failure. While limiting the amount of high risk assets a bank may hold would seem a desirable regulatory pol-

64. See, e.g., Norton, *supra* note 15, at 1314; Keeley, *Banks' Cost of Capital*, FED. RES. BD. WKLY. LETTER (Mar. 17, 1989). Note, however, that a reduction in a bank's asset base reduces the absolute amount of capital it must raise, but not the amount of capital relative to assets.

65. Norton, *supra* note 15, at 1314. See generally Mingo, *supra* note 30, at 1112.

66. Comptroller's Guidelines, *supra* note 51, at 4181.

icy, such a policy may increase the probability of bank failure. Blair and Heggstad have shown that this type of portfolio regulation forces banks to inefficient frontiers,⁶⁷ thereby decreasing the safety and soundness of the banking system. Indeed, basic portfolio theory indicates that regulators should not concern themselves with the types of assets a bank selects, but rather should look at the overall return and variance of the bank's portfolio.⁶⁸

Thus, the economic analysis of bank capital regulations suggests that the regulations cannot achieve their desired goals and may lead to results contrary to the overall purposes of banking regulations.

2. *Alternatives to the Risk-Based Capital Regulations*

The analysis of the preceding subsection suggests that the new risk-based capital regulations are inefficient and potentially harmful to the banking system and to the economy in general. Regulators could better achieve safety and soundness in the banking system by focusing their regulations in different directions. In the most basic terms, the economic criticisms of capital regulations suggest that the best way to achieve safety and soundness in the banking system is to monitor and penalize excessive risk taking either by reforming the current capital guidelines, or by restructuring the deposit insurance system to rely more on market mechanisms, such as the bond market, to better monitor bank risk taking. Two possible avenues for reform of the present system should be pursued.

First, if capital regulation is to be the method for controlling bank risk, regulators should focus on the optimal level of capital rather than an "adequate" level of capital for a bank. Pringle suggests that optimality could be achieved both in terms of risk bearing and in terms of maturity structure of liabilities.⁶⁹ Indeed, Santomero and Watson would maximize societal welfare by equating the marginal returns from bank capital requirements to the marginal cost of capitalization.⁷⁰ However, this may be easier said than done; from the standpoint of banking regulators, especially the FDIC, the more capital, the better. The political economy of banking regulation in the aftermath of the S&L debacle suggests that

67. Blair & Heggstad, *supra* note 30, at 88-90.

68. *Id.* at 92. See generally R. BREALEY & S. MYERS, *supra* note 9, at 149-65 (basic discussion of risk, return, and portfolio theory).

69. Pringle, *supra* note 30, at 780.

70. Santomero & Watson, *supra* note 30, at 1277.

banking regulators are now more inclined to err on the side of driving permissible risk taking below the optimal level.

In terms of controlling risk, bank regulators would probably do better by not trying to regulate the individual elements of the asset portfolio. Instead, the riskiness of the portfolio could be controlled by regulating the total return and variance of the portfolio. The current regulations only look at the credit risk of individual bank assets. However, a well-diversified portfolio can eliminate much of the unique risk associated with any one asset.⁷¹ This type of portfolio regulation would be more efficient because it would control risk without forcing banks to sacrifice profits from the riskier loans.⁷²

A second alternative is to rely solely on market forces to control risk, eliminating any type of capital regulation, at least for the larger banks.⁷³ Reforms that rely more heavily on market forces to control risk taking could better provide for the bank regulators' well-founded obsession with bank risk. Chief among these reforms would be a restructuring of the deposit insurance system. Numerous approaches to deposit insurance reform have been proposed, including the privatization of deposit insurance.⁷⁴ All of the proposals are designed to deal with the moral hazard inherent in the current federal deposit system. In the place of capital requirements, regulators could allow the market to monitor bank performance by requiring banks to float large amounts of a certain type of subordinated bond.⁷⁵ The bond market would then act as a monitor of the performance of the bank. Banks with poorly performing bonds could be subject to more frequent examinations and a higher deposit insurance premium. This would certainly be more efficient, and would likely be an easier method of monitoring at least the large banks. Proposals like this one are in essence a recognition of the fact that regulators cannot effectively monitor risk when all market incentives to control risk are elimi-

71. See R. BREALEY & S. MYERS, *supra* note 9, at 149.

72. See Blair & Heggstad, *supra* note 30, at 92.

73. Of course, much of the risk taking by large, publicly traded corporations could be controlled by market forces emerging from the threat of the market for corporate control, except for the fact that there are numerous impediments to a smoothly functioning market for bank control. See Macey & Miller, *supra* note 30; Brickley & James, *The Takeover Market, Corporate Board Composition, and Ownership Structure: The Case of Banking*, 30 J.L. & ECON. 161 (1987).

74. See, e.g., Scott, *Deposit Insurance—The Appropriate Roles for State and Federal Governments*, 53 BROOKLYN L. REV. 27, 33-38 (1987) (discussion of several options to correct the moral hazard inherent in the current federal deposit system rate structure).

75. *Id.* at 37-39.

nated. Relying on, rather than eliminating, market incentives to control risk taking would make the regulators' job far easier.

C. Regulation of Highly-Leveraged Transactions

The same concern with bank risk that led to the adoption of the 1989 risk-based capital adequacy guidelines was targeted toward bank involvement in corporate transactions, specifically leveraged buyout (LBO) financing. In general, the late 1980s witnessed considerable congressional pressure to limit takeover activity and substantial resistance on the part of regulators to clamp down on such activities.

Typical of the legislative response is the skeptical attitude toward LBO financing taken by Congressman Henry Gonzalez, chairman of the House Banking Committee. At a hearing on LBO financing before his committee, Chairman Gonzalez expressed concern about the "leveraged buyout mania of the 1980s" and its effect on the economy. He further questioned "the wisdom of allowing federally insured deposits to finance this type of lending."⁷⁶ At a congressional hearing on LBOs, Kenneth Pinkes, a vice-president of Moody's Investor Service, echoed the Chairman's concerns, noting that "there is a false sense of confidence about the ability to analyze away risk" in LBO transactions.⁷⁷ Many view LBOs as evils in and of themselves and therefore applaud new regulations that discourage banks from financing such ventures.⁷⁸ However, one should not draw any conclusions from the rhetoric of politicians and embittered corporate managers.

Although there is substantial disagreement in the academic world, many legal commentators view LBOs as little more than an opportunity for management to benefit at the expense of stockholders.⁷⁹ Banking regulators, while recognizing the potential benefits of LBOs, take a somewhat wary approach. Alan Greenspan, chairman of the Federal Reserve

76. *Leveraged Buyouts and Corporate Takeovers: Hearings Before the House Comm. on Banking, Finance, and Urban Affairs*, 101st Cong., 1st Sess., 1-2 (1989) [hereinafter *LBO Hearings*].

77. *Id.* at 21.

78. "[L]everaged buy outs are eating at the foundation of America's stock market economy." *LBO Hearings*, *supra* note 76, at 7 (statement of Walter Fauntroy, District of Columbia Delegate). "LBOs could operate to adversely affect the long term capital markets on which many corporations rely . . ." *Id.* at 57 (statement of John W. Dowdle, former Senior Vice-President of Financial Services, RJR Nabisco). "[E]veryone would lose [in the takeover of Polaroid] except the raiders . . . and investment bankers . . ." *Id.* at 92 (statement of Richard Duffy, Employees' Grass Roots Coalition Against Hostile Takeovers).

79. See, e.g., Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 *YALE L.J.* 1354, 1366 (1978).

Board, has acknowledged that LBOs and other forms of takeovers improve efficiency and enhance competition among corporations. Greenspan, however, remains concerned about LBOs in industries vulnerable to business downturns.⁸⁰

In response to congressional pressure on takeovers, regulators turned their attention towards commercial loans used to finance corporate control transactions. In May of 1989, banking regulators announced that special scrutiny should be given to bank involvement in takeover financing.⁸¹ This regulatory concern was ultimately codified in the highly-leveraged transactions (HLT) guidelines promulgated in October 1989.⁸² Banking regulators defined HLT financing broadly enough to cover virtually all bank financing of corporate control transactions.

This latest regulatory attempt, however, was misguided and will probably result in unintended consequences or the achievement of unstated goals. The regulations are subject to the same criticisms levied at the risk-based capital guidelines. For example, once again portfolio theory tells us that the HLT regulations probably will not add to the safety and soundness of the banking system; rather they will likely force banks to operate inefficiently and may actually encourage bank failure. More efficient alternatives exist to achieve the desired results. In addition to possibly diminishing the safety and soundness of the banking system, the regulations will likely produce a second, less apparent outcome: a weakened market for corporate control due to the increase in cost of bank participation in efficiency-creating corporate takeover transactions, such as leveraged buyouts.

80. Ricks, *U.S. Regulators Tell Congress They Generally Favor Leveraged Buy-Outs*, Wall St. J., Feb. 28, 1989, at A10, col. 4.

81. FDIC Guidelines for Highly Leveraged Transactions of May 10, 1989, 4 Fed. Banking L. Rep. (CCH) ¶ 49,271 (May 19, 1989).

82. In October 1989, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Comptroller of the Currency jointly adopted the following definition of highly leveraged transactions:

[A] bank or bank holding company is considered to be involved in a highly leveraged transaction (HLT) when credit is extended or investment is made in a business where the financing transaction involves the buyout, acquisition, or recapitalization of an existing business. In addition to this purpose test, one of the following criteria must be met for the transaction to be considered an HLT:

—The transaction at least doubles the subject company's liabilities and results in a leverage ratio higher than 50%.

—The transaction results in a leverage ratio higher than 75%.

—The transaction is designated an HLT by a syndication agent.

Banking Circular 242, Oct. 30, 1989, Fed. Bank. L. Rep. (CCH) ¶ 49,272 (Mar. 16, 1990).

D. Impact on the Market for Corporate Control

Both the new capital adequacy regulations and the HLT guidelines will decrease the efficiency of the market for corporate control. The capital adequacy guidelines provide banks with an incentive to avoid takeover loans because there is a higher capital requirement against such loans, as opposed to home mortgages, for example. The HLT regulations give banks an incentive to limit their participation in loans to highly leveraged corporations in order to avoid increased scrutiny by banking regulators. Limited participation by banks in takeover loans means it will be harder for investors to finance leveraged buyouts, thereby decreasing the number of takeover transactions and reducing the efficiency of the market for corporate control.

From a policy perspective, it may appear that limiting bank involvement in such risky transactions is a good thing. However, as indicated earlier, risk must be assessed in terms of a bank's entire portfolio. A bank should be able to diversify away much of the risk in any one transaction. In addition, several factors serve to reduce the riskiness of LBO transactions. First, LBOs tend to occur in mature companies with large cash flows. This facilitates the new owners' ability to repay the debt. In addition, a relatively small group usually holds the debt, thereby increasing their ability to monitor the new firm.⁸³ Finally, the new owners are usually directly involved with managing the new firm, thereby aligning the incentives of ownership and management in the new firm.⁸⁴

On the other hand, as the firm's leverage increases, bankruptcy costs increase. Bankruptcy costs include "the costs of bankruptcy per se and the indirect costs associated with the effect that impending bankruptcy may have on the incentives of stockholders to redistribute wealth from debtholders in ways that reduce firm value."⁸⁵ Bankruptcy costs become increasingly acute in recessionary times. These costs are partly offset by the relatively fast repayment schedule of most LBO loans, usually five to ten years, and by the realization that downturns in the business cycle will have an adverse effect on all businesses.

There are arguments both for and against LBO financing. In the final

83. R. BREALEY & S. MYERS, *supra* note 9, at 816.

84. See Greve, *supra* note 9, at 351.

85. Lehn, Blackwell, & Marr, *supra* note 9, at 176. See generally Modigliani & Miller, *The Cost of Capital, Corporate Finance, and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958) (general explanation of debt and equity financing and the costs associated with each). See also *supra* note 30 and accompanying text for an explanation of the related concept of moral hazard.

analysis, the issue turns on who is in a better position to analyze the costs and benefits of such transactions. It would be hard to argue that regulators know more than the banking community about which loans banks should or should not be making. Ideally, the market should decide which banks are acting efficiently and which are not.⁸⁶ Banks that make sound loans will be rewarded by continued survival; banks which make unsound loans will ultimately fail.

Unfortunately, the role of federal deposit insurance has mitigated the effect of market discipline.⁸⁷ The combined effects of a flat rate premium and de facto coverage of all depositors effectively insulates banks from traditional market forces. By removing the monitoring function of the marketplace, banking regulators can justify further regulation as the only constraint on bank risk taking. Nevertheless, it appears that bank regulators overstepped the extent of regulation justified on this ground when they reduced the portfolio options available to banks. If the incentives for risk taking are held constant, then new regulations do no more than make it more difficult for banks to achieve their optimal level of risk.

III. JUNK BONDS, TAKEOVERS, AND FIRREA

Undoubtedly, junk bonds played an important role in the financing of takeovers in the 1980s. Identifying the source of the demand for these new financing instruments is an important issue when considering the takeover. Where did all of the money come from? In part, the answer to this question lies in the dramatic changes in the structure of federal deposit insurance programs in the early 1980s.

A. Partial Deregulation, Money Brokers, Deposit Insurance, and Junk Bonds

The collapse of the savings and loan industry is often blamed on the partial deregulation of thrifts in the early 1980s. However, the financial condition of the thrift industry had deteriorated significantly in the late 1970s. The development of innovative financial products outside the banking and thrift industries, such as money-market accounts, combined with regulated limits on interest rates offered on accounts at banks and S&Ls left thrifts often unable to offer interest rates high enough to attract and retain savers. The ability to offer higher rates, however, would not

86. See *supra* note 73 and accompanying text.

87. See *supra* notes 26-29 and accompanying text.

have provided much relief because, at that time, thrifts were essentially limited to investing in home mortgages. With the downturn in the home mortgage market of the 1970s, thrift profits plunged as depositor interest rates rose above the return on long-term mortgage portfolios. It has been estimated that, even before substantial deregulation in the 1980s, the S&L industry's liability exceeded the market value of its assets by \$150 billion.

The S&L industry was in serious trouble, and Congress tried to help with a series of deregulatory steps. The Depository Institutions Deregulation and Monetary Control Act of 1980⁸⁸ increased the amount of federal deposit insurance coverage from \$40,000 to \$100,000 per person per institution and provided for the gradual deregulation of interest rates that could be paid on deposits by insured institutions—banks and S&Ls. The Garn-St. Germain Depository Institutions Act of 1982⁸⁹ attempted to help the industry by providing S&Ls with new outlets for investing their deposits. In addition to granting them the power to invest in junk bonds, the Act permitted S&Ls to make equity or direct investments in high-risk, speculative commercial real estate ventures. These changes had a profound effect.

The regulatory changes led to the emergence of “money brokers”—a type of middleman who channels deposits to institutions paying the highest interest rates. Federally insured institutions—banks or S&Ls—attracted enormous amounts of deposits, virtually overnight, by offering interest at rates slightly above the market. In addition, depositors had no incentive to concern themselves with the safety or soundness of the depository institutions because the federal government guaranteed the deposits. Some institutions, especially S&Ls, experienced phenomenal rates of growth in both deposits and assets.

Although the increased investment powers of S&Ls and the increased insured amount provided the opportunity for abuse, the structural defects of the federal deposit insurance system⁹⁰ must bear the blame for the continued collapse of the S&L industry after the deregulatory actions in the early 1980s. A basic problem shared by the Federal Savings and Loan Insurance Corporation (FSLIC) and FDIC⁹¹ is that, unlike most

88. Pub. L. No. 96-221, 94 Stat. 132 (1980).

89. Pub. L. No. 97-320, 96 Stat. 1469 (1982).

90. See *supra* notes 26-29 and accompanying text.

91. Under FIRREA, the functions of the FSLIC were taken over by the FDIC. 12 U.S.C. § 1823 (1988).

forms of private insurance, the premiums paid by S&Ls and banks do not reflect the risks actually covered by the insurer. The deposit insurance system, with flat rate premiums based on total deposits of each institution, encourages and subsidizes high-risk investing by managers of insured institutions.⁹²

Granting the additional powers to solvent S&Ls probably prevented the failure of many marginal institutions. But giving these same powers to insolvent thrifts exacerbated the moral hazard problem; they had nothing to lose by making excessively risky investments in a desperate attempt to get back into the black. Moreover, the structure of deposit insurance compounded the problem because depositors had no reason to avoid the riskier institutions—federal deposit insurance treats all firms the same. In fact, depositors, through deposit brokers, were attracted to riskier institutions because they tended to offer higher rates.⁹³

B. The Self-Fulfilling Prophecy of FIRREA

One important fact stands out through the turmoil of the S&L industry in the 1980s—the first failure of an S&L attributed to junk bond investments did not occur until February 1990. In spite of this fact, congressional leaders singled out junk bonds as one of the major culprits in the collapse of the S&L industry.⁹⁴ The resulting statutory and regulatory changes in the savings and loan industry have had a tremendous impact on the market for corporate control. The corporate takeover mania of the 1980s has come to a screeching halt.

The most dramatic change came in the summer of 1989 with the passage of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA).⁹⁵ FIRREA provides radical reforms for the S&L industry in an effort to curtail the current crisis. Among other things, the Act provided \$159 million to bail out the S&L industry, abolished the FSLIC, and forced S&Ls to maintain the vast majority of their assets in

92. The problems of federal deposit insurance have long been recognized and discussed in the scholarly literature. See, e.g., E. KANE, *THE GATHERING CRISIS IN FEDERAL DEPOSIT INSURANCE* (1985).

93. See, e.g., G. SHORT & J. GUNTHER, *THE TEXAS THRIFT SITUATION: IMPLICATIONS FOR THE TEXAS FINANCIAL INDUSTRY* (Fed. Res. Bank of Dallas Sept. 1988).

94. See, e.g., Thomas, *Fraud Is Called a Small Factor in S&L Cost: Consultant's Study Cites Real Estate Values, High Rates*, *Wall St. J.*, July 20, 1990, at A2, col. 2 (Mr. Ely says, "To listen to some people on Capitol Hill, you would think that junk bonds caused the end of Western civilization. That's just not true.")

95. Pub. L. No. 101-73, 103 Stat. 183 (1989).

housing and housing-related investments. Title 2 of the Act prohibits S&Ls from directly or indirectly acquiring or retaining junk bonds; divestment is required by July 1, 1994.

The provisions limiting S&L asset portfolios are unwise for several reasons. First, they are ineffective ways to control risk. As shown previously, if regulators wish to limit an institution's riskiness, they must consider the risk and return of the entire portfolio of assets, rather than make blanket limitations on the types of assets available to S&Ls. By the Federal Home Loan Bank Board's own admission, as late as 1988 there was "no indication that investing in high yield bonds . . . [had] caused the failure of a thrift institution."⁹⁶ It was only after the passage of FIRREA that the junk bond market plummeted. Indeed, the empirical evidence suggests that by limiting S&Ls' investment opportunities, FIRREA may have actually increased their riskiness.⁹⁷ The provision requiring thrifts to divest themselves of junk bonds will also make it more difficult for investors to finance takeover transactions, thereby making the market for corporate control less efficient.

Although FIRREA was passed in response to the collapse of the S&L industry, some of its provisions appear to have actually added to the S&Ls troubles. For example, some evidence suggests that the provision requiring divestment of junk bonds was responsible for the drop in the junk bond market. In the last quarter of 1989, when the new law became effective, junk bonds suffered their worst losses up to that point.⁹⁸ This had a severe impact on the S&L industry because many thrifts, particularly the larger ones, held a significant number of junk bonds. Hence the self-fulfilling prophecy of FIRREA: by requiring S&Ls to divest their junk bond holdings, the Act caused the junk bond market to falter. This in turn caused the asset portfolios of those S&Ls holding junk bonds to decline, giving regulators the chance to point the finger at the junk bond market as a major culprit in the S&L crisis. FIRREA has the dubious distinction of both hindering the market for corporate control and adding to the costs of the S&L bailout.

96. GENERAL ACCOUNTING OFFICE PUB. NO. 89-48, *HIGH YIELD BONDS: ISSUES CONCERNING THRIFT INVESTMENT IN HIGH YIELD BONDS* (1989).

97. R. BROWN, J. MCKENZIE & R. COLE, *GOING BEYOND TRADITIONAL MORTGAGES: THE PORTFOLIO PERFORMANCE OF THRIFTS* 22 (Fed. Res. Bank of Dallas, FIS No. 1-90, 1990).

98. *Wall St. J.*, Jan. 15, 1990, at C2, col 1.

IV. CONCLUSION

The new risk-based capital regulations, the HLT guidelines, and FIRREA attempt to provide safety and soundness in the banking industry by encouraging banks and thrifts to avoid holding risky assets. However, the methods chosen by regulators result in reduced efficiency in the banking system, possibly increasing the risk of bank failure. By discouraging banks from making high-yield, high-risk loans, banking regulators have not only reduced the efficiency of the banking system, they have also reduced the efficiency of the market for corporate control by discouraging corporate control transactions, such as leveraged buyouts.

The efficiency of the banking system is further reduced by its built in insulation from market discipline. The system of federal deposit insurance, at the core of the modern banking system, has removed from bank managers much of the incentive to monitor the performance of the bank. Whether intentionally or not, the federal deposit insurance system has created a need for some type of regulatory monitoring of bank risk taking since banks no longer have adequate market incentives to monitor themselves. Unfortunately, the federal government has tried to fill this void through such ill-advised regulatory efforts as the risk-based capital guidelines, the HLT guidelines, and FIRREA.

The effect of these regulations on the number of LBOs and other corporate control transactions is not known. Regardless of the actual effect, however, it makes little economic sense for banking regulators to attempt to reduce this type of efficiency-generating transaction. Rather, regulators must consider other, more efficient methods of risk regulation. This may mean different methods of capital regulation, or it may require abandoning capital regulation altogether. Finally, any system of risk regulation will have to address the problems and perverse incentives created by the present system of federal deposit insurance.

