Lecture 22 will cover the following parts of chapter 11 of the textbook.
How Asymmetric Information Explains Banking Regulation

1. **Government Safety Net and Deposit Insurance**
   A. Prevents bank runs due to asymmetric information: depositors can’t tell good from bad banks
   
   B. Creates moral hazard incentives for banks to take on too much risk

   C. Creates adverse selection problem of crooks and risk-takers wanting to control banks

   D. Too-Big-to-Fail increases moral hazard incentives for big banks
How Asymmetric Information Explains Banking Regulation

2. Restrictions on Asset Holdings
   A. Reduces moral hazard of too much risk taking

3. Bank Capital Requirements
   A. Reduces moral hazard: banks have more to lose when have higher capital
   B. Higher capital means more collateral for FDIC
How Asymmetric Information Explains Banking Regulation

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

5. Disclosure Requirements
   A. Better information reduces asymmetric information problem
Why a Banking Crisis in 1980s?

**Early Stages**

1. Decreasing profitability: banks take risk to keep profits up

2. Deregulation in 1980 and 1982, more opportunities for risk taking

3. Innovation of brokered deposits enabled circumvention of $100,000 insurance limit

4. $\pi \uparrow$, $i \uparrow$, net worth of S&Ls $\downarrow$
   - A. Insolvencies $\uparrow$
   - B. Incentives for risk taking $\uparrow$

*Result: Failures $\uparrow$ and risky loans $\uparrow$*
Why a Banking Crisis in 1980s?

Later Stages: Regulatory Forbearance

1. Regulators allow insolvent S&Ls to operate because
   A. Insufficient funds
   B. Sweep problems under rug
   C. FHLBB cozy with S&Ls

2. Huge increase in moral hazard for zombie S&Ls: now have incentive to “bet the bank”

3. Zombies hurt healthy S&Ls
   A. Raise cost of funds
   B. Lower loan rates

4. Outcome: Huge losses
Political Economy of S&L Crisis

Explanation: Principal-Agent Problem

1. Politicians influenced by S&L lobbyists rather than public
   A. Deny funds to close S&Ls
   B. Legislation to relax restrictions on S&Ls

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

Limits on Scope of Deposit Insurance
1. Eliminate deposit insurance entirely
2. Lower limits on deposit insurance
3. Eliminate too-big-to-fail
4. Coinsurance

Risk-based Insurance Premiums
1. Hard to implement

Other Proposed Changes
1. Regulatory consolidation
2. Market-value accounting