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## Scholarship in Banking Law: An Introduction to the Symposium

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For decades, when law schools and law reviews looked at the world of banking, they seemed to see only the private law dimension of commercial transactions among bank customers and with their banks. Law schools offered courses on bills and notes, creditors' rights, or later the Uniform Commercial Code, but nothing on the public law side of bank regulation. A large industry of central importance to the functioning of the economy had been subject to an elaborate system of examination and supervision and detailed regulation for over a century; yet that system of legal control did not arouse much interest or attention from law school academics.

That situation began to change in the 1970s, as courses or seminars on bank regulation started to appear in the legal curriculum. In due course, scholarly articles examining aspects of bank regulation became more noticeable in the law journals. And now, whole issues are devoted to a field that seemed arcane and scarcely visible a mere twenty years ago. The editors of the *Ohio State Law Journal* are to be commended for lending emphasis to this trend.

Of the eight articles comprising this issue, three represent the private law tradition—though not necessarily in traditional ways—and five are devoted to questions involving the public regulation of banks. I will try to provide a brief description of and some personal commentary on each.

Professor Gerald McLaughlin of Brooklyn Law School, in *Letters of Credit and Illegal Contracts: The Limits of the Independence Principle*, discusses the extent to which courts should depart from the principle that an irrevocable letter of credit must be paid by the issuing bank, regardless of any claims or disputes involving the parties to the underlying sales transaction. Exceptions have already been recognized in some circumstances when there is fraud in the underlying transaction; Professor McLaughlin argues for extension to situations involving other forms of illegality.

But more generally, in determining whether an exception to the independence principle is warranted, he advocates the use of a balancing approach that explicitly considers the impact of the exception on the seller, the issuing bank, and the future utility of the letter of credit mechanism. The balancing analysis is illustrated with a number of specific examples, on the basis of which Professor McLaughlin proceeds to recommend the proper legal treatment of that type of situation. I find myself more persuaded of the merits of his general approach than of his specific conclusions, for

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it is hard to know whether all the relevant examples have been considered and placed on the balance scales. The discussion, however, is provocative and enlightening.

In the wake of commercial failures, banks in the last few years on a number of occasions sued to collect on their loans, only to be met with counterclaims on various theories seeking, and sometimes obtaining, damages for the borrower greater than the amount of the loan itself. Professor Werner Ebke, of the University of Konstanz, and James Griffin, of the Texas Bar, consider cases (primarily in Texas) basing lender liability on breaches of the duty of good faith and fair dealing in commercial lending transactions. In *Good Faith and Fair Dealing in Commercial Lending Transactions: From Covenant to Duty and Beyond*, they distinguish between viewing that duty as arising out of contract as an express or implied term or as arising out of tort law from "special circumstances" in the relationship between borrower and lender. Under the latter theory, the possibility of punitive damages is opened up, so obviously it is the position preferred by plaintiffs' attorneys.

Ebke and Griffin find the trend in these cases to be disturbing. The content of the duty is defined by few objective standards, leaving the doctrine too vague to serve well the ends of fairness or deterrence. The distinction between contract and tort theories is being eroded, so that extraordinary damages may be imposed in almost any case. Ebke and Griffin suggest that "defensive lending" practices may emerge. One might add that, to the extent the doctrine cannot be well defined or expressly contracted around, the risks and therefore the rates of loans will inevitably be increased for all commercial borrowers.

A bridge between private law and public law is provided by Professor Edward Rubin, of the University of California at Berkeley School of Law, in *Uniformity, Regulation, and Federalization of State Law: Some Lessons from the Payment System*. He traces the evolution of the law governing check collection from the common law and state enactments of the Negotiable Instruments Law and the Uniform Commercial Code to a growing federal role derived from the Federal Reserve Act of 1913 and the Expedited Funds Availability Act of 1987. The latter statute partially pre-empts the UCC in certain respects by its own terms or implications, but goes much further and gives the Board of Governors of the Federal Reserve System blanket authority to regulate "any aspect of the payment system,"<sup>1</sup> potentially displacing (at a minimum) all of Articles 3 and 4 of the UCC.

What has produced this extensive federalization of an area previously left predominantly to state law and private ordering? It is not merely the need for uniform rules governing interstate transactions—that was met by the NIL and UCC, adopted in every state. Professor Rubin points to a need for uniform oversight and implementing regulation, to keep up with an area in which procedures constantly change under the impact of improved technology, and to the political ability of the consumer movement to achieve some of its objectives in one fell swoop through a

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1. Rubin, *Uniformity, Regulation, and Federalization of State Law: Some Lessons from the Payments System*, 49 OHIO ST. L.J. 1251, 1258 (1988) (quoting Expedited Funds Availability Act, 12 U.S.C.A. § 4008(c)(1)(A) (West Supp. 1988)).

national legislature. What the consequences of this step will be, for the welfare of either banks or consumers, Professor Rubin does not undertake to judge.

A contrasting view of the sources of bank regulation is given by Professor Jonathan Macey, of Cornell Law School. In *The Political Science of Regulating Bank Risk*, he adopts a "public choice" perspective and interprets bank regulation as another example of the use of legislative power to transfer wealth from less well-organized consumers to better organized producers. Thus he sees the deposit insurance system as designed to subsidize banks by lowering their acquisition cost of funds and the Glass-Steagall Act as designed to benefit commercial banks and investment banks by restricting competition in both industries. In each instance he attacks the "public interest" view of legislation, arguing that deposit insurance encourages excessive risk-taking and Glass-Steagall blocks diversification; the result is not a contribution to a safe and sound banking system, but the very opposite.

Professor Macey attributes this outcome to a number of factors, in addition to the advantages in terms of stakes and organizational efficiency of small groups over large ones. Banking issues are usually too complex and ideologically boring for either congressional representatives or their constituents to get involved. Bank regulators fall into the category of narrow-spectrum administrative agencies devoted to a single industry and more susceptible to capture by it.

If one accepts Professor Macey's description, what is his prescription? Essentially, gloomy resignation—the problem of giving regulators and politicians incentives that will cause them to act more in the public interest is "intractable," and hence "meaningful change is unlikely to occur."<sup>2</sup> In this regard, his article exemplifies what has always been the least satisfying aspect of public choice theory. On the positive side, it is most helpful in understanding the basis for legislative or administrative decisions. But on the normative side, it tends to lead to a kind of fatalism: whatever is, is (politically) efficient.

Two of the authors in this issue address the answer to the problem of perverse risk incentives, created by the uniform deposit insurance premium assessment mandated under existing law, that is currently being emphasized by the banking authorities in the United States and elsewhere—namely, higher risk-based minimum capital requirements for banks. Professor Joseph Norton, of the Southern Methodist University School of Law, explores the concept of capital adequacy standards and reviews the history of their use in bank regulation in *Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities?* To begin with, the term "capital" is given different meanings in different contexts; its definition for bank capital regulation still occasions disputation. In principle, I would contend, it is the market value of all realizable assets minus the market value of all liabilities that are on a parity or senior to those liabilities that the banking authorities are concerned to protect (presumably, deposit liabilities); the calculation should not be based on accounting numbers or confined to on-balance-sheet items.

Professor Norton provides a useful account of the history of bank capital

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2. Macey, *The Political Science of Regulating Bank Risk*, 49 OHIO ST. L.J. 1277, 1278 (1989).

regulation in the United States and the issuance in July 1988 of the report on *International Convergence of Capital Measurement and Capital Standards*<sup>3</sup> by the so-called Basle Supervisors Committee, comprising all the major banking nations. When it comes to an evaluation, however, he seems a skeptic. Many of the pertinent issues—the reality of a threat of bank runs, the degree of supervisory effectiveness, the use as a prop to a system of subsidized deposit insurance, and the cost to the banking industry—are raised, but their treatment seems to me less than satisfactory. That is not too surprising; such matters are complex and difficult and would at a minimum demand several additional articles by themselves.

The new bank capital rules are also addressed by Professor William Lovett, of Tulane Law School, in *Moral Hazard, Bank Supervision and Risk-Based Capital Requirements*. The reach of the title is somewhat greater than that of the article, for he concentrates more on the Basle Committee formula and its implications for bank entry into fields such as insurance or securities underwriting. On the moral hazard issue, he accepts (rather uncritically, in my view) the proposition that the central government must bail out all (large?) banks and their depositors. That policy creates the moral hazard—that is, it changes the costs and profit incentives facing bank management, leading them to act in a manner that increases the risks and costs to the insuring government. There are those, myself included, who see the problem of eliminating a subsidy to bank risk-taking as central to badly needed reform of our deposit insurance system; Professor Lovett simply notes that higher capital requirements, shareholder losses, and bank supervision should be able to take care of the matter. Would that it were that straightforward!

The formula of the Basle Committee is explicated in some detail, but without analysis; nonetheless, the extent to which political considerations have entered into a supposed economic assessment of risk can be detected throughout. The final target capital figure (eight percent of risk-adjusted assets), in particular, apparently floated down from Mt. Sinai (or Mont Blanc), for no theoretical or empirical foundation was given.

As for bank entry into new fields, Professor Lovett asks how risk-based capital requirements will or should be applied to insurance or securities underwriting, carried on by the bank itself or through a subsidiary or an affiliate. Basically, he does not seem sympathetic to such a development, citing concerns about concentration, conflicts of interest, and supervisory competence. The prospect for or benefit of added competition in those fields is not considered, nor is the potential contribution of low activity covariances to the reduction of bank (and government insurer) risk.

Competition is at the core of the article by Professor Peter Carstensen, of the University of Wisconsin Law School, on *Public Policy Toward Interstate Bank Mergers: The Case for Concern*. His article comprises an impressive and well-nigh exhaustive compendium of objections to a policy of permitting “interstate combina-

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3. Committee on Banking Regulations & Supervisory Practices, *International Convergence of Capital Measurement and Capital Standards* (July 1988) (copy on file with the Ohio State Law Journal).

tions of leading banks.”<sup>4</sup> Fundamental to his argument is the premise that such combinations do not achieve economies of scale or scope; indeed, he contends, small banks are more efficient than large ones. Large (a term left mostly undefined) interstate combinations are driven, therefore, not by efficiency gains, but by the quest for monopoly rents. Thus there should be a negative presumption against large interstate combinations, meaning they would mostly be denied approval.

Despite the weight of argument, I am left unconvinced. These are, in the jargon of the antitrust economist, geographical market extension acquisitions; as such, they do not normally create any significant change in the concentration of the market of either the acquiring or the acquired bank and hence do not afford opportunity for the extraction of increased monopoly rents. Then why are they being sought? Professor Carstensen finds the evidence of efficiency gains or losses from larger size to be weak and inconclusive, and he concludes that on balance both the benefits and costs to society of interstate combinations of large banks are slight. (It might seem awkward to move from that concession to a policy and procedure of general prohibition, but he manages—a tribute to the observation that analysis often comes out where it began.)

But I would go further—“banking” is not a single homogeneous product, but a wide variety of financial services. As to some of those services, efficient scale is obtained at relatively small size (for example, home mortgage lending), while others are most cheaply produced by very large organizations (for example, international trade financing); Citicorp and a neighborhood bank do not have the same product mix. It is very hard to disentangle the resulting cost and profit data, and most studies of economies of scale in banking do not. There is more to the drive for efficiency than Professor Carstensen seems willing to credit.

Legislative impediments to attaining efficiency in the banking system are the focus of John McCoy, Chairman and Chief Executive Officer of Banc One Corporation, in *The Future of U.S. Banking: A Modest Legislative Agenda to Encourage Competitiveness*. Modesty, like beauty, no doubt lies in the eye of the beholder; he wants removal of the barriers to interstate banking and bank entry into securities activities, insurance, and real estate.

To date, responses to changing technology and correspondingly broadened markets in banking have come more on the state level. Congress has left the McFadden Act and Douglas Amendment unaltered since enactment, while the states have moved toward regional and even nationwide banking. Mr. McCoy urges Congress to take more of a leading role in eliminating an outmoded tangle of restrictions on geographical and product expansion, leaving the definition of the “banking business” to be determined by productive efficiencies, rather than by legislative fiat. At this point, unfortunately, Mr. McCoy and Professor Macey would do well to enter into dialogue with each other; the Congress is not engaged in a search for efficiency, nor does the banking industry call the tune by itself. Fortunately, such dialogues will be facilitated and enriched by this issue of the *Ohio State Law Journal*.

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4. Carstensen, *Public Policy Toward Interstate Bank Mergers: The Case for Concern*, 49 OHIO ST. L.J. 1397, 1398 (1989).

