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Financial Regulation: Comment on Kareken

The rapidly evolving character of the financial system is raising again the question, What, if anything, is its regulation supposed to accomplish? I also start from John H. Kareken's (in this issue) premise that we want to guarantee the availability of transactions balances in order to prevent the economic externalities of monetary contraction and as a public service to protect the average unsophisticated user of money from losses. Let me trace in these comments where this premise takes me. I come out pretty much the same as Kareken does on the issues. I do see the possibility of serious trouble brewing.

Most of the operational problems with the monetary system lie, as is widely agreed, with fractional reserves. Because of the practice by banks of paying on demand or short notice, their lack of liquidity becomes a much more important and common occurrence than it is for other businesses. Depositors never know whether illiquidity means insolvency, and in any event they want to avoid the inconvenience of immobilized funds. Hence, if the liquidity of a depository institution is suspect, customers will withdraw their funds post haste since many safe alternatives exist. These institutions are therefore particularly vulnerable to runs, which can turn moderate illiquidity into the extreme case of being unable to pay. Unfortunately, runs easily spread to other institutions that may initially be liquid by ordinary standards but will be put in danger. The result is financial stringency and economic contraction.

It is, therefore, not only the losses of isolated failures that concern the authorities but also the spread of a fear-motivated run for safety into government securities and currency or other safe havens. Past a threshold, runs are part of an unstable dynamics, the contractionary consequences of which were perfectly clear to early commentators on panics. The banking system had to suspend conversion of deposits into currency. Banks called loans, and the entire economy became illiquid.

(*Journal of Business*, 1986, vol. 59, no. 1)

0021-9398/86/5901-0005$01.50

The payments system had to limp along on expedients. The high correlation of banking crises with severe depressions in U.S. history shows why banking reform was imperative to the pre–World War I financial and business community. The absence of old-fashioned banking panics in the post–World War II period is a great achievement; it has probably contributed more to the general welfare than most of the widely touted "welfare programs."

How did the reformers do it? Clearly the crucial elements were the Federal Reserve System and the Federal Deposit Insurance Corporation (FDIC). Although these institutions have been justified on a variety of grounds and have taken on a range of objectives, I see periodic banking panics as the focus of the reform momentum that assured legislative enactment. In *A Monetary History of the United States*, Friedman and Schwartz (1963) write favorably of the FDIC but have few kind words for the Federal Reserve System. To monetarists the Federal Reserve has been a disappointment, and if the FDIC had come before 1913, it could have prevented panics and precluded the need to establish the Federal Reserve. Whether history has intentionally played a trick on monetarists may be questioned, but in a perverse twist to their views, the Federal Reserve as an institution is stronger than ever today, and the FDIC is in deep trouble.

The FDIC actually worked well for a long time. Its regulatory procedures were never onerous, deposit rate ceilings never mattered much while market interest rates were low, and deposit insurance removed the incentive for a majority of depositors to start a run. Many banks failed, to be sure (as indeed they should have if insolvent), and for a long time the FDIC presided over a lazy industry, shielded from outside and inside competition and devoid of innovation. Nevertheless, contagious runs were ended. Not only did banking panics not occur since the catastrophic 1933 episode, but also hardly anyone even thought it possible that they would. The government had made deposits nearly as safe as its own currency.

But the FDIC is subject to moral hazard. The flaw was too minor at first to matter, but freewheeling competition has finally begun to exploit it. If depositors are protected against default, they need not be concerned with the risk of bank assets. Banks can take greater risks to increase the chance of higher earnings, while the FDIC covers the downside risk of major losses. The pressure on banks from greater competition to increase the return on their assets by taking more risks was contained to some extent by deposit rate ceilings. In equilibrium theory such ceilings would have no effect on the profit-maximizing degree of risk taking, but they could work to discourage more aggressive managements from entering the industry. The upward trend in interest rates since World War II gradually forced the elimination of the ceilings. There was no sadder example of the cynical but futile efforts of the government to avert the circumvention of its regulation of deposit rates than the increase in 1970 of the minimum denomination of Treasury bills from $1,000 to $10,000. Soon thereafter the money market mutual funds expanded to service the small investors who had been ruthlessly deprived of the unregulated market interest rates offered on Treasury bills. It was clear then that the ceilings were doomed, and those on large deposits were soon eliminated. Most of the ceilings stayed on until the early 1980s, however, because the protected thrift institutions feared for their survival without them, and afterward many thrifts expired.

Deposit rate ceilings might be viable when the trend of interest rates is flat, so that depository institutions that lend long do not suffer disintermediation from high interest rates, except temporarily during cyclical peaks or stringencies. But in the inflationary environment since the mid-1960s, deposit rate ceilings are simply not feasible. Moreover, they were an obnoxious form of price fixing, which had to go sooner or later.

With the end of deposit rate ceilings, competition for deposits has flourished. Facing a new market competition, many depository institutions have seen a need or an opportunity to benefit from a higher return on assets, and risks have been increased. Who bears this risk? Obviously, top management and stockholders bear much of it, but with deposit insurance the FDIC bears an uncomfortable amount of it, at the public's expense. Since a bank and its depositors do not bear all the downside risk, the expected return can be raised through riskier investments. The FDIC hesitates to reduce its own risk by lowering the minimum coverage of deposit insurance. If large depositors are not covered, they will run at the first sign of trouble, which will impair a bank's liquidity and lead to its collapse, just what the FDIC wants to avoid. It is true that withdrawals from troubled banks would usually send the funds into other banks and not into currency and thus would not produce the monetary contraction of earlier panics. And, in any event, Federal Reserve open market operations can provide the quantity of reserves needed to keep the total money supply at a targeted level. Still, the failure of large banks can be disruptive and can complicate the conduct of monetary policy. Moreover, the FDIC worries that its fund could be inadequate to cover a series of large failures. Reducing the coverage of only savings and time deposits would be unsettling and unappealing. If all depositors are protected, therefore, as has been true of FDIC-managed mergers of many troubled banks and as was done for Continental Illinois (without merger), a greater part of the risk passes on to the FDIC. Since takeover banks are not eleemosynary institutions, the FDIC ends up with the bad assets.

The moral hazard created by this arrangement indicates that the cost to the FDIC can only increase, and several solutions have been proposed. The oldest proposal is to vary the insurance fee by the degree of risk. This is the obvious solution in theory. But it is hard to see that this can work effectively in practice. Would the fees in fact be large enough to make a difference? How is the FDIC to measure the degree of risk of different bank portfolios consistently? Even if past variance of market value were deemed adequate to measure future risk, which I doubt, most bank loans have no secondary market and no market indication of value. Are bank examiners to eyeball the risks? Even aside from the impracticality of this approach, imagine the political repercussions of the examiners deciding that loans to a particular industry were especially risky, say, the oil-drilling industry that tore Continental Illinois asunder. I dare say the FDIC would hear from not a few oil state senators and congressmen, and that would be the end of that decision.

Along with an evaluation of the riskiness of bank portfolios, it is proposed that the FDIC announce the results of examinations to depositors. The FDIC wants the depositors to exert pressure on bank management to maintain sound loans. But this does not solve the problem. As soon as the FDIC were to raise doubts about a bank's portfolio, the depositors would depart en masse. The extra basis points depositors receive in interest would not compensate for the FDIC's prediction of possible failure ahead. The departure of the depositors would put the bank in the FDIC's lap. The FDIC will therefore think twice about such public announcements, particularly when the stockholders are likely to sue the FDIC for "spreading deleterious misinformation"!

If it is not practical to charge banks different fees according to the expected cost of the FDIC's insurance on the basis of the riskiness of assets, banks must be forced to maintain a minimum level of riskiness. Can the regulation of bank behavior be improved? Present regulatory procedures, as Kareken points out, are inadequate. Examiners can record delinquent loans, but since they cannot easily judge the riskiness of loans still making payments, they cannot control the riskiness of bank portfolios. An easily enforced proposal is to increase bank capital or subordinated debt that accomplishes the same purpose as capital. This undoubtedly would help, but the amounts that are likely to be acceptable to the banking community are not likely to make a major difference. The catch-22 is that the problem banks would have to get into a much sounder condition before they could raise sizable additions to capital. And if they succeeded, would they not then increase their portfolio risks commensurately? Something more radical seems called for.

Two radical reforms discussed by Kareken are of interest even if at present without wide support. One is to require banks to insure deposits with private companies and to close down the FDIC. Private insurance has the advantage of letting the market determine the riskiness of bank portrfolios and the charge for insurance. To be sure, the government would have to stand behind the insurance companies because, if widespread defaults threatened the insurance companies, the purpose of the insurance would be lost. (Such a reprieve for a continuing role for the FDIC might enhance the political chances of this proposal.) Aside from the question of how to handle government reinsurance, the privatization of deposit insurance might work satisfactorily. Unfortunately, it would have to be tried for a time to foster confidence, and the uneasiness of the public during the transition until the privatization proved adequate would make the changeover difficult and would be an obstacle to its ever being tried. A method of bridging the transition, however, might be to start by allowing private insurance while FDIC insurance was still made available but gradually to reduce the latter's coverage to force a phase in of privatization. Moral hazard for the FDIC as a reinsurance agency might still exist, but it would be substantially reduced.

The second radical reform discussed by Kareken is the old but appealing proposal to separate the depository and lending functions of commercial banks. The proposal is to subject deposits to 100% reserves, say, a combination of Treasury bills and federal funds. Deposits of transactions balances only would be insured, but the insurance would be unnecessary except for embezzlement. This is an effective way to remove the FDIC's coverage from savings and time deposits without increasing the danger of runs to the money supply. Kareken is concerned that with sweep accounts banks could provide a large quantity of transactions accounts but record only a small amount at the end of each business day that required reserve backing. But I presume that only the recorded transactions balances having the required backing would be insured. Sweep accounts would lack insurance and full backing and would have to be segregated. That would discourage some holding of sweep accounts—but by no means all since without the required backing such accounts could pay a higher rate of interest. Indeed, by contrast, accounts backed by Treasury bills would probably pay little interest since the income from the bills would barely cover the cost of servicing active transactions accounts.

One hundred percent reserves are a complete solution to the problem of moral hazard in deposit insurance. But it would radically change the nature of commercial banking and appears too radical to be adopted. Except for the traditional type of loans to carry marketable inventories, bank loans with a lien on less liquid collateral could no longer be financed by short-term deposits. When trouble developed, such deposits would be withdrawn, forcing a contraction of loans and possibly insolvency. On a broad scale the process would be contractionary. Given the illiquidity of such loans, they would need to be financed by long-term funds or equity. There would have to be a complete separation of deposit taking and illiquid commercial lending into unrelated institutions. Loans would be made by funds rather than by banks, which might turn most of them for small businesses into equity investments, much as is done by venture-capital firms. The supply of such loans would be less responsive to cyclical swings in demand, which could be good for economic stability but would be unattractive to borrowers and their political representatives.

The difficulties with deposit insurance lead me finally to possible developments accompanying the evolving innovations in the payments system. We are on the threshold of all kinds of new transactions services, many outside the confines of traditional depository institutions. I see two implications for regulation. First, within depository institutions, many accounts labeled as time and savings accounts, or converted to overnight repurchase agreements and not recorded at the end of the day, will be providing transactions services. This makes it more difficult to judge the adequacy of bank liquidity to cover potential short-term withdrawals. Second, and more important, transactions balances outside bank and thrift institutions will not be insured, and the FDIC will be providing insurance for only a part of total transactions balances. If these uninsured new balances are subject to runs, there would soon be a call to insure them and to regulate the institutions providing them. Such regulation would be more difficult than it is now for commercial banks and thrifts, however, and might prudently not be attempted. In that event, the growth of such new transactions balances might be the beginning of the end of this regulation. If private insurance proved unfeasible, the need to avoid runs might lead the issuing institutions to adopt marking to market for all such balances. Thus also would the need for insurance to prevent runs be removed. Such a welcome development would bring with it, however, a great variety of transactions balances that made monetary targeting more difficult and less reliable. Although nonmonetarists could then applaud the demise of monetary targeting, all monetary control of the economy, however conducted, would be impaired.

Until we can live without deposit insurance, I really do not see attractive alternatives to some kind of regulation. Despite the problem of moral hazard, patchwork of the system can probably extend its life for a while. Patchwork means such steps as outlawing brokered deposits that take advantage of higher rates paid on insured certificates of deposit by troubled banks, increasing bad debt reserves on questionable loans as a disincentive to making too many of them, raising subordinated debt along with new capital to cover losses, and continuing to bail out troubled banks, hoping the number does not escalate. The situation will have to get much worse before we will see radical changes.

References

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