

Federal Bank Regulatory Policy: Comment on Kareken*

In his paper, John H. Kareken (in this issue) reviews the development of federal bank regulation in the United States and evaluates the effectiveness of the current regulatory structure. He concludes pessimistically that "present-day federal bank regulatory policy cannot (should not) be counted on to keep the banking industry sufficiently safe and sound. . . . Yet . . . there is no obvious alternative to the policy of the present" (p. 47). To Kareken, the most appealing alternative is to split banks into two separate businesses, one offering payments services (transaction deposits) and restricted to 100% reserves in cash or Treasury securities (i.e., a money market fund) and the other offering non-transaction deposits and permitted wider investment opportunities. This idea, of course, goes back at least to the Peel Act of the mid-1800s.

My reading of the effectiveness of bank regulation and how it can be improved is quite different. In no way do I share Kareken's "despair." To a large extent, our different outlooks reflect differences in our answers to the questions of how important are bank runs and individual bank failures and how stable is the banking system? Although he expresses some doubts, Kareken does not question and implicitly accepts the generally held view that bank failures are more important than the failures of other firms, both because they offer liabilities that serve as money and because they may spread from bank to bank through the banking system. In addition, he assumes that the banking system as a whole is unstable. In contrast, both theory and empirical evidence lead me to conclude that, except in instances of man-made policy errors, (1) individual bank runs and failures are generally not much more impor-

* I am indebted for many of the ideas in this comment to Herbert Baer, George Benston, Robert Eisenbeis, Paul Horvitz, and Edward Kane, with whom I have discussed the strengths and weaknesses of the banking system frequently in recent months.

tant for levels of economic activity than are failures of other firms of comparable size and importance in the community, (2) individual bank failures are not inherently contagious and generally do not start a domino chain of failing banks, and (3) the banking system as a whole is stable, particularly since the introduction of federal deposit insurance in 1934.

Let us examine these statements one at a time. Banks fail in economic terms when the market (present) value of their assets declines below the market value of their deposits (and other borrowings). At that time all depositors and other creditors cannot expect to be paid in full and on time, and the bank needs to be declared insolvent in order to treat all depositors and other creditors equally. If not, those depositors that withdraw their funds from the bank first will be paid in full and those who wait, either because of ignorance or later maturity dates, will experience losses. Delay in declaring a bank insolvent does not effect the size of past losses—they have already occurred. It affects only the identities of those who take the hit. But particularly under federal deposit insurance, delay can increase the magnitude of future losses as the bank is encouraged to gamble to seek large, failure saving gains, that is, to throw "Hail Mary" passes. Banks with no capital left have little to lose and much to gain in following such a strategy.

Because depositors know that a large proportion of a bank's deposits have put options exercisable at par without notice at any time and that banks operate on fractional reserves and may have to take losses on hurried "fire sales" of earning assets at below their fair equilibrium market values given normal search time, they are motivated to withdraw their uninsured funds from a bank that is perceived to experience financial difficulties as soon as the difference between the value of the banking affiliation and the costs of fund transfer, which are low, fall below the expected deposit loss. If the bank is economically solvent at the time a bank run starts, the only harm to the bank will be fire-sale losses on asset sales or from paying higher rates on hurried borrowings. If these losses exceed the bank's net worth, the bank would experience "fire-sale insolvency." Because all the bank requires to remain solvent is time, assistance from other banks aware of the bank's true status and/or the Federal Reserve as lender of last resort is appropriate and may reasonably be expected to be forthcoming. If the bank is economically insolvent when the run starts, additional losses attributable to the run per se would also be only fire-sale losses and probably small relative to the losses before the run, although larger than the fire-sale losses experienced by solvent banks as the assets may on average be expected to be less marketable. In this case, assistance from other banks is unlikely to be forthcoming and from the Federal Reserve inappropriate. Such a bank particularly needs to be declared insolvent in order to treat remaining depositors fairly and evict owners/managers before they can incur greater losses.

What are the consequences of a bank run on other banks? That depends on what depositors do with the funds they withdraw. They have three alternatives: to redeposit at other banks, to purchase other securities, or to hold currency outside the banking system. If depositors consider any perceived financial difficulties to be limited to one or a few banks, they are likely to redeposit their funds directly at other, perceived safer, banks. After all, currency is an inferior form of money for almost everything but the purchase of small-ticket items. If redeposited, the deposits are only transferred within the banking system: they are not destroyed. There is no decline in aggregate money and credit, and the instability at the affected banks is not transmitted to the system as a whole.

The larger the number and/or size of banks perceived to be in difficulty, the less likely are depositors to view as many other banks as safe and to redeposit directly. Many are likely to purchase perceived safer securities, such as those of the U.S. Treasury—a flight to quality. The outcome now depends on what the sellers of the safer securities do with the proceeds. Because these transactions are likely to be relatively large, it is likely that the funds will be deposited at a “safe” bank, possibly, particularly in the United States, quite a distance away. If so, aggregate deposits again are not changed. But interest rate spreads are likely to be changed as depositors bid down the yields (bid up the price) on safe securities and bid up the yields (bid down the price) on riskier securities, including negotiable order of withdrawal (NOW) bank deposits. This is likely to dampen private investment and create uncertainty. Both effects may be expected to affect economic activity adversely. Although adverse, these are likely to be second-order effects. If, however, the sellers of the safe securities hold the proceeds as currency, then the implications are different and more serious.

If the withdrawn funds are not redeposited at other banks either directly or indirectly but held as currency, they represent a reserve drain from the banking system as a whole, that is, a run on the banking system as a whole rather than on individual banks or groups of banks. Unless offset by an injection of an equal dollar amount of reserves by the Federal Reserve, the banking system will undergo the much feared multiple contraction in deposits and credit, and aggregate supply of money will be reduced. The difficulties of one bank will spread to other banks and the instability transmitted throughout the system. Banks are also likely to experience greater fire-sale losses as the number of sellers increases, and more are likely to be driven into fire-sale insolvency. In this scenario, private bank support is more difficult and appropriate Federal Reserve action more important. A net currency drain from the system is thus a prerequisite for individual bank problems to contaminate a large number of other banks and the system as a whole as well as to decrease the aggregate money supply.

But net currency drains are now unlikely and, as will be shown later, have not been frequent in U.S. history. As long as depositors have confidence in the ability of the federal deposit insurance funds to pay fully and promptly and the minimum coverage per account is not too low, small depositors have no incentive to withdraw deposits from any bank and hold currency. Large depositors cannot conduct their operations with currency. Thus even in the absence of appropriate Federal Reserve policy to maintain reserves, contagious and severe bank problems are highly unlikely in today's federal deposit insurance environment. There is no reason, therefore, in delaying declaring a bank insolvent. Even if the declaration intensifies the run on the bank, it is unlikely to destabilize many other banks or the banking system.

Aside from contagiousness, how important is a bank failure to the community? As noted, banks fail when they experience losses on assets greater than their net worth. Aside from fraud, losses are likely to reflect the depressed economic conditions of the bank's loan customers, of the local community, or of the nation. Such losses represent feedback from the economy to the banks and must be distinguished from any further effects that bank failures have on the economy. Only the latter are of concern to us here. When a bank fails and is declared insolvent, employees, customers, and creditors as well as shareholders are harmed. With the exception of customized loans, however, bank services are rather homogeneous, and most employees and customers should not be inconvenienced greatly in transferring to other banks or providers of the particular service. Indeed, banking services are more homogeneous than are the products of many other types of firms, and the cost of transfer may therefore be less. Furthermore, in most circumstances, a failed bank is likely to be sold or merged so that the facility will remain, although possibly as a branch office. Under these circumstances, customers with long-standing loan connections are likely to be disadvantaged the most, but even here it may not be very much, as not all loan officers of the failed bank will be removed. Thus, although bank failures are not costless, they are also not calamities.

Why then have we been so fearful of bank runs and failures and directed public policy at minimizing them if not preventing them altogether? My recent research suggests that many of the public's concerns are based on a brief and not very representative period in U.S. history—the Great Depression from 1929 to 1933.¹ During that period, the number of banks declined by 40%, from some 25,000 to near 14,000 while the economy declined to record depths. The financial system was a shambles, banks in many states were closed for all business for days at a time during bank "holidays," and, finally, all banks were tem-

1. Much of the research discussed here was done for a project on bank safety and soundness sponsored by the American Bankers Association (Benston et al. in press).

porarily closed by President Roosevelt in March 1933. Depositors lost faith in almost all banks, and the currency to total bank deposit ratio jumped from 9% in 1929 to 19% in 1933 and to 23% if the increase in government guaranteed postal savings is included as currency. Aggregate deposits and money declined by one-third, and banks appeared to fail in domino style. Many of the survivors of this financial holocaust were so traumatized by the event and recorded it with such emotion and flair that they affected public policy not only at the time but for decades to come. Most of the regulations stressing safety and anticompetitiveness—such as Regulation Q, separation of investment and commercial banking, more restricted entry, and introduction of the Federal Deposit Insurance Corporation (FDIC)—were enacted at the time.

But a review of history shows that this period was the exception rather than the rule. Although there were some 10,000 commercial banks in operation by 1892 and 20,000 by 1906, there was only 1 year between 1865 and 1919 in which more than 200 banks failed (491 in 1893) and only 9 years in which more than 100 banks failed. The annual rate of bank failure averaged 0.8%, below the failure rate of 1.0% for other firms. The annual losses suffered by depositors at failed banks was estimated by the FDIC to have averaged only 0.2% of total deposits. (This estimate is somewhat on the low side as the FDIC did not discount delayed payments by an interest rate. Nevertheless, it does provide a ballpark figure.) Currency drains, as measured by an increase in the currency to total bank deposit ratio concurrent with a decline in aggregate deposits, occurred in only three years—1873, 1893, and 1908. To the extent that currency drains are a prerequisite for contagious bank failures, contagion was likely to have occurred at most in only these three years and probably only in 1893. Studies at the time attributed failures primarily to fraud, mismanagement, and depressed local economies. Hardly any mention was made of contagiousness or ripple effects. And this was before federal deposit insurance and, until the last 6 years, also before the Federal Reserve System. Private banks themselves took on the task of offsetting systematic effects of bank runs and failures and stabilizing the system. At times of serious runs to convert deposits into currency (or, earlier, notes into specie), the banks with the implicit approval of the regulators called time-out, temporarily suspended convertibility, but continued almost all other bank operations, including fund transfers by check and loan origination. The suspension provided banks with the necessary time to search out the highest bidders for their more specialized loans and to minimize fire-sale losses. At the same time, bank clearing houses circulated their own transferable certificates, which the banks and, at times, the public used as a currency substitute. In his later study, Cagan (1965) has noted that financial panics, in which most bank failures occur, tended

to lag national economic downturns in almost all periods. In sum, the evidence is strong that in this period, at least, the major direction of causation was from depressed economic conditions to bank failures rather than the other way around.

In the 1920s the number of bank failures jumped sharply to an average of about 600 per year and the failure rate to more than twice that of other firms. Yet the national economy experienced no economic downturns. Most of the banks that failed were small and in agricultural areas. They spread little fear. Indeed, the currency ratio declined steadily from 15% to 9%.

The introduction of federal deposit insurance in 1934, which may be attributed to the failure of the Federal Reserve to inject sufficient reserves to offset the currency drain of 1930–33 and to prevent the money stock from declining, has stabilized the banking system even more. Nevertheless, to allay any possible public concern about the sufficiency of the insurance fund, such as has recently happened for some state funds (Ohio and Maryland), deposit insurance should be transformed into a full faith and credit guarantee of the federal government. But recent advances in technology that permit the almost immediate and costless transfer of funds both within and across institutions, the high and volatile interest rates, and federal deposit insurance premiums that are independent of an institution's risk exposure have provided both the means and the incentives for individual banks to incur additional risk. Although losses from such risk are unlikely to destabilize the banking system or the national economy, they are likely to result in substantial losses to the deposit insurance agency (and thus the taxpayers) if the insolvent institutions are not caught soon enough. Thus there remains legitimate public concern about the financial health of individual banks.

The best and most workable solution to excessive risk taking by individual banks is to increase the forces of market discipline to the levels in other industries. This can be achieved in a number of ways. Bank owners can be placed at greater risk by increasing capital requirements. As studies have shown, the major reason that bank capital is low has been the artificially low failure rate under regulation and de facto 100% insurance of almost all depositors. Before the FDIC, bank capital ratios were more than twice as high and exceeded 30% in the second half of the nineteenth century. In addition, national bank shareholders faced double liability, and, when banks failed, assessments were made and collected. To banks, capital is a source of funds that is distinguished from deposits primarily in two ways—dividends on equity are not a deductible expense for tax purposes and capital funds are not insured. (Thus, it is difficult to understand Kareken's argument that "more capital means nothing unless it must be used to purchase relatively safe assets" [p. 45].) The tax disadvantage can be reduced

by permitting part of the requirement to be satisfied by short-term subordinated (*de facto* as well as *de jure* uninsured) debt. By being forced to enter the market periodically, banks will be more sensitive to the interest rate required on such debt. The rate will also serve as a signal to depositors.

Uninsured depositors should also be placed at risk *de facto* as well as *de jure* and suffer losses, if necessary, so that they behave more like creditors of other firms and monitor the bank's risk more carefully. At the same time, senior management at insolvent banks needs to be penalized and evicted, and directors need to assume greater liability for major policies and control procedures at their banks. No bank should be too large to fail (so shareholders may not be totally wiped out and most of management continued), although some may be too large to liquidate, recapitalize, or merge quickly. But, as I have argued and as the FDIC has, in part, proposed recently, this is not an insurmountable problem (see Kaufman 1985). The FDIC can take temporary control of an insolvent large bank, introduce management changes, and mark down the value of uninsured deposits by the estimated prorated negative net worth. The bank is not "closed"; there is no interruption in business; and customer relations would be basically undisturbed. The FDIC would be required to sell, merge, or liquidate the bank within a specified period of time. Except in cases of fraud (and of unexpected interest rate increases for thrift institutions), uninsured depositor losses are unlikely to be very large as the value of the bank's total assets is unlikely to drop abruptly by large amounts, no less to anywhere close to zero—that is, contrary to statements by some regulators at the time of the Continental Illinois rescue, nonfraudulent banks are rarely totaled! A loss of a few cents on the dollar is most likely if the bank is declared insolvent soon enough. The largest losses to both uninsured depositors and the insurance agencies have come from fraud, which is difficult to detect and monitor so that the bank is not caught in time, and not from ordinary loans and investments gone wrong, which are easier to monitor. This suggests that, contrary to Kareken's recommendation, bank examiners need to reduce their emphasis on loan quality. But they need to increase their concern for detecting fraud.

Finally, federal deposit insurance premiums need to be scaled, at least in part, to an institution's risk exposure. This is necessary more to reestablish market incentives than to collect actuarially fair premiums, which, as discussed above, are more a function of monitoring than of known risk exposure. (Indeed, as the insurance agency experiences no losses whatsoever if it catches the bank before new worth becomes negative, deposit insurance is really not traditional insurance but a guarantee.)

As Kareken notes, imposition of risk premiums is difficult. But it is

not that difficult if introduced partially. An increasing proportion of bank assets are marketable or have marketable surrogates as a result of the "securitization" of loans, for example, mortgage loans, consumer loans, and business loans. There are even markets for bonds of Latin American countries. Tools have been developed to permit reasonably accurate measurements of interest rate risk. Many off-balance sheet items will remain a problem for some time. Other problems exist, such as the appropriate progressivity to put into the premiums to solicit the desired risk behavior. Although difficult, a partial start to risk-related premiums (and possibly also capital) appears considerably better than increased regulation. Moreover, it is the failure to introduce risk-related insurance premiums rather than the lifting of Regulation Q that makes brokered deposits a threat by permitting risk-seeking banks to increase their size and potential losses quickly. Restoring Q ceilings to stop this practice would damage the banking industry substantially more than would risk-related insurance premiums.

I will deal briefly with a few other points of disagreement. Kareken questions Congress's concern over merger and concentration as reflected in legislation such as the Bank Merger acts and Bank Holding Company acts. But at the time these were enacted, entry into banking was greatly restricted. In such an environment, competitive concerns are legitimate. It is interesting to note that these concerns have almost disappeared as entry barriers have fallen both *de jure* and *de facto* through the provision of banking type services by nonbanks.

Kareken also expresses concern that new powers may make banks riskier and particularly notes the riskiness of underwriting insurance, corporate bonds, and equities. But as is well known, it is not only the variances of these activities that affect the bank's risk but also the covariances, and it is likely that many new activities will reduce the bank's overall risk exposure. It is, however, possible that the variances of some new powers may be sufficiently large relative to the variances of presently permitted powers to offset the covariance effects and that either the reduced overall risk or the potentially higher payoff may entice banks onto higher risk preference schedules.

I share Kareken's doubts about being able to insulate risk in bank subsidiaries, but the same incentives hold for holding company subsidiaries if risk-sensitive insurance premiums are not adopted. Banks' experiences in coming to the rescue not only of the real estate investment trust (REIT) subsidiaries of their own holding companies but also of the REITs that were not legally affiliated but had common names is strong evidence.

Finally, I am doubtful about the effectiveness of Kareken's proposal to split banks into transaction deposit and other deposit businesses as a substitute for deposit insurance. With the advances in telecommunications already discussed, it would be difficult, if not impossible, to pre-

vent banks from having customers turn higher yielding "other" deposits effectively into transaction deposits, much as they did earlier with time deposits. If so, we would need to insure these deposits again. In addition, potential economics of scope would be lost. Correctly priced and administered federal deposit insurance is a more efficient solution.

In sum, I find Kareken unduly pessimistic. The banking system is much sounder than he believes. With appropriate federal deposit insurance bank regulation need not be as concerned with safety and soundness as he believes. The faults in our regulatory system may be repaired more efficiently and with fewer undesirable side effects than either major reregulation or the splitting of banks into 100% reserve transaction deposits and uninsured fractional reserve nontransaction deposit operations. It is time to unshackle our thinking about banking from the constraints imposed on us by the financial holocaust of the Great Depression. Banking is a business much like any other business and, if provided with the appropriate reward-punishment incentive structure and appropriate public policy by the Federal Reserve, requires little different regulation than other businesses.

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