

Regulating Banks: Comment on Kareken

In his detailed evaluation of bank regulations, John H. Kareken (in this issue) rightly focuses on the two main problems, the competitive issue, including interstate branching, and the issue of safety. As background he provides a survey of how federal banking regulation has evolved. My discussion will focus on the issue of safety, with just a few comments on the competitive issue and one comment on the evolution of the banking system. Since my task is to discuss only those points on which I disagree with Kareken, my comments may unfortunately sound more critical than they are intended to be.

I. Regulatory History

In his historical discussion Kareken raises a provocative question. Prior to 1934, why did the private sector not develop, as an alternative to conventional banks, other banks that invest only in short-term government securities and hence are perfectly safe? The answer is probably that a policy of investing only in perfectly safe assets does not suffice to protect depositors fully. Even now, with our elaborate system of bank examination, many bank failures are due to fraud. Suppose that a bank invests only in Treasury bills but that a bank officer absconds with a substantial proportion of the bank's assets. Depositors then incur losses despite the safety of the bank's portfolio. It may seem that, if banks are large enough, this would not prevent the existence of banks that are almost perfectly safe. According to this argument, while a small bank may lose a significant part of its assets because of fraud and theft, only a small proportion of a large bank's assets can disappear in this way. But as the Vesco case suggests, this argument is questionable. Moreover, a large bank starts out by being a small bank, and if the public distrusts a small bank that claims it provides perfect safety, this small bank will never grow into a large bank.

In addition, as far as potential small depositors are concerned, the situation prior to 1934 was quite different than it is now. Starting in 1911 there was a perfectly safe bank for time deposits—the U.S. government's Postal Savings System. To be sure, it did not provide potential small depositors with the convenience of checking accounts, but then neither did banks because commercial banks wanted the accounts of only the well-to-do. And with many of the well-to-do wanting to borrow from banks, it is hardly surprising that they did not hanker after a bank that would invest only in perfectly safe assets.

II. Industry Structure

Turning to the competitive issue, Kareken is much too hard on Congress. I am puzzled by his complaint about the inconsistency of preserving unit banks while at the same time claiming to be concerned about bank safety. Although at one point Kareken recognizes that "safety and soundness need not be all that is wanted in a banking industry" (p. 000), at other points he seems to work on the assumption that, if unit banking reduces the safety of the banking industry, then it should, ipso facto, be eliminated. Like Kareken I am no friend of the local monopolies that unit banking protects, but if the public wants to limit the size of banks for some reason, such as the fear of the political power that a large bank might wield, then the McFadden Act might be a good way to achieve this. Perhaps it would be better to use some other method, such as imposing an absolute size limit on banks, but, in principle, it can be entirely logical to adopt two policies that are inconsistent in the sense that one policy makes it harder to achieve the goals of the other policy.

Kareken also complains about Congress passing the decision on mergers and the boundaries of the banking industry on to the regulatory agencies. In general, there is much to be said against the argument that the "politicians" should turn policy-making over to the "experts," but in this case Congress's passing of the buck seems justified. Even though I believe that in almost every case the only good industrial policy is to foster competition, my mind, unlike Kareken's, is not boggled by the Eighty-ninth Congress telling a regulatory agency that it should also look at aspects of a proposed merger other than its competitive effect. Suppose, for example, that there are large economies of scale in banking. One might then want to surrender some of the advantages of competition to gain greater technical efficiency. To be sure, the empirical evidence suggests that such economies of scale do not exist. But I can sympathize with Congress not wanting to decide this; the regulatory agencies are better equipped to determine whether a recent paper on scale economies in the *Journal of Monetary Economics* has used the correct econometric techniques.

Similarly, Congress is not in a good position to draw the line between banking and other industries. Congress functions best when it brings the common sense, intuition, and moral awareness of the public to bear on an issue. But common sense, intuition, and moral awareness do not provide a ready guide to whether banks should be allowed to underwrite revenue bonds. More specifically, the volume of campaign contributions offered by both sides of this dispute must be immense. One should be able to rely on congresspeople voting for the public interest rather than for the interest of their campaign contributors in those cases in which the public interest is clear and important. But in this case it is obviously not clear and may not even be important. Hence I prefer to see this decision made by a regulatory agency rather than by Congress.

This does not mean that the agency's economists will necessarily make the right decision. It is not an issue on which economics has much to say. The economist's trained intuition tells him or her two conflicting things. One is that, since the market generally does the right thing, banks should be allowed to enter other lines of commerce and other businesses should be allowed to enter banking. But it also tells him that allowing banks to enter various lines of commerce probably does not matter. As long as there is free entry, excess profits in any line of business will attract sufficient entrants even if banks are not allowed to enter.

Neither of these two conflicting suppositions is entirely compelling. There may well be cases, particularly in small towns, in which free entry does not exist. For example, there may not be enough room for more than one firm in the industry, or the existing firms may have enough influence with the city council to make entry by "outsiders" difficult. But a local bank could enter this business and be an effective competitor. Economists know little about this type of problem. At the same time, the argument stating that the more competition the better assumes that a potential competitor uses only his own resources and does not rely on potential access to the insurance fund of the Federal Deposit Insurance Corporation (FDIC). If subsidiaries of banks are low-cost producers in a certain industry only because they pass the risks of this business on to their banks, and hence to the FDIC, then the competition they provide need not be desirable. Whether bank subsidiaries are able to pass risk on to their bank, and ultimately on to the FDIC, is a question one should ask a lawyer rather than an economist. Fortunately, the regulatory agencies do have lawyers.

III. Deposit Insurance

Kareken is too critical of the deposit insurance system. This system is obviously not designed in a way that an economist would wish. There

is no market mechanism, such as higher insurance premiums, that limits risk taking to the correct amount. Instead, the FDIC is trying to make do with a combination of enforcement procedures against recalcitrant banks and with a threat to let uninsured depositors fend for themselves. As Kareken rightly points out, the enforcement procedures are slow and cumbersome, while the threat of letting large depositors take their lumps is not plausible with regard to very large banks; and if the FDIC protects large deposits only in big multinational banks, then this is grossly unfair to smaller banks and their depositors. Moreover, as Kareken points out, large depositors can protect themselves by splitting their deposits among banks. Even if the courts eventually agree to let the FDIC stop money brokers from providing this service, money brokers will still be able to furnish depositors with lists of banks that pay high rates. Moreover, for many business borrowers the threat of losing part of their accounts is weakened by the fact that they can exercise the right of offset with respect to their outstanding loans.

What is surprising, therefore, is that the deposit insurance system has worked as well as it has, that the FDIC has not been left holding the bag more often. It seems plausible that credit for this is due, in part, to two enforcement provisions that are informal and unplanned. One is that business borrowers have an incentive to avoid dealing with a risky bank. If their bank fails, they will then have the trouble and uncertainty of establishing a connection with a new bank or of passing the scrutiny of the bank into which their previous bank was merged. A second limitation on risk taking is that bank officers have an incentive to protect their jobs and also to avoid having the name of a failed bank appear on their *curricula vitae*.

The first of these informal enforcement provisions is desirable since a bank should have to take into account the costs that its failure would impose on its loan customers. But the second is more questionable. Suppose that the FDIC would set premiums that price risk absolutely correctly. The additional inhibition of risk taking that results from bank officers protecting their careers would then cause banks to take too little risk.¹

So perhaps the present insurance system is not working so badly after all. It is surely better than the system that prevailed prior to 1934; just imagine the impact of the Continental Illinois situation in a pre-1934 setting. And despite its small size relative to deposits, the FDIC's fund has not been threatened by failures. The insurance system is far from perfect, but one can plausibly argue that it works better than our monetary and fiscal policies and perhaps better than the "average" government policy.

1. In principle, salaries of senior officers should rise enough to compensate them for the greater risk, but there are likely to be many cases in which this does not happen.

Kareken questions the standard arguments for extensive deposit insurance on two grounds. First, he dismisses the consumer protection argument, which he calls a social justice argument, as relevant only for the "relatively poor and financially unsophisticated" and hence as justifying only a deposit insurance system with a very low ceiling. But there is more to it than that. Surely there are scale economies in examining banks, and it is more efficient for the FDIC to do it than for each depositor who is not poor to have to do it on his or her own. To be sure, magazines that rate banks along the lines of *Consumer Reports* could develop, but would this be more efficient than having the FDIC do it? If there is only one rating magazine, then we have the inefficiencies of monopoly, and if there are several such magazines, then there are the inefficiencies of overlapping investigations. Moreover, what happens if a bank becomes substantially more risky after the magazine has reported on it? Continual updates would have to be issued—and read by depositors. Perhaps one could adopt Allan Meltzer's (1967) suggestion that, instead of automatically insuring each account, depositors can choose whether to buy insurance. I suspect that this would make little difference, that nearly all depositors would buy it. Moreover, it could lead to messy lawsuits, with some depositors claiming that officials of a failed bank provided misleading information.

Kareken is also uneasy about the macroeconomic, that is, the "third party," argument for deposit insurance. Admittedly, this argument is frequently not well stated, but it is fundamentally sound. If massive bank failures reduce the volume of the medium of exchange, this is much more serious than an equivalent dollar reduction in other forms of wealth because we use the dollar not only as a medium of exchange but also as the standard of value. Since prices are more or less inflexible in terms of the standard of value, they are also inflexible in terms of the medium of exchange. Hence a massive reduction in the medium of exchange results in clogged markets, the type of problem modeled by Robert Clower (1967).

It might be useful to sketch how one might formulate all this in terms of a formal model. Consider an economy in which output is produced and distributed among agents with the aid of two factors (labor-capital and deposits) that have to be used in fixed proportion (i.e., assume stable velocity and price rigidity). Assume further that the first factor accounts for 98% and the second factor for 2% of total output. (Two percent is a rough approximation of banking's share in national income.) Since the two factors have to be used in fixed proportion, the destruction of, say, 10% of the second factor by some disaster (e.g., bank failures) reduced gross national product not by 0.2% but by 10%. In deciding the risks to take, the owners of the second factors take into account only the loss to them and not the loss to the owners of the first factor, some of which would become redundant if the supply of the

second factor falls. This creates a case for government intervention unless these externalities can be internalized by, for example, long-term contracts. In banking this cannot be done because there is no way in which those whose output is unsalable in the case of massive bank failures can make contracts with holders of deposits that induce the latter to select safer banks.

This seems to suggest that only transactions accounts need to be insured, but this is too narrow a view. To prevent clogged markets one must avoid a massive reduction not only in those funds that can legally be transferred but also in those funds that the public intends to use for expenditures in the near future, even if they have to be transferred into the medium of exchange first. This includes many types of time deposits, though others, such as Keough accounts, are obviously not included. It follows that one might want to insure, along with transactions accounts, some types of time deposits but not others. Such a differentiation certainly follows from the logic of the macro argument for deposit insurance, but it is just for these long-term time deposits that the consumer-ignorance argument is strongest. One can hardly expect the depositor to know how sound a bank will be, say, 5 years from now.

Our policy of insuring one form of wealth and not others can therefore be defended by saying that the integrity of this form of wealth is more important. But one can go beyond this. Critics of the macro argument for deposit insurance are right in insisting that a change in the value of other types of wealth also affects expenditures. Hence there is a macro argument for preventing sharp declines (and increases!) in the value of other assets as well as deposits. But there are strong micro arguments against insuring other forms of wealth that outweigh the macro argument. Government insurance and the controls associated with it inhibit risk taking. This is a less serious drawback in banking than in other industries because in banking the high leverage probably tends to generate too much risk taking in the absence of government controls.² Thus the *reductio ad absurdum* argument that the macro case for insuring deposits implies that all assets should be insured can readily be rejected.

There is, however, another frequently mentioned problem with the macro argument that Kareken does not discuss. This is that protecting against a massive decline in deposits does not require deposit insurance. Instead, the Federal Reserve could be required to respond to a financial panic in the classic way, by making sufficient reserves available to banks. But this argument is less plausible now that insolvencies

2. In principle, the need to compensate depositors for the higher risk should prevent excessive risk taking. But if depositors do not have sufficient knowledge of a bank's riskiness, then some banks have to pay an excessive risk premium, while others pay too low a risk premium. The latter have an incentive to take excessive risk.

as well as liquidity crises have become important threats to the banking system. The Federal Reserve should not have to lend to insolvent banks. It is appropriate to require banks to pay an insurance premium to protect their depositors against bank insolvency.

There is another justification for deposit insurance not mentioned by Kareken, namely, that, given the great velocity of many transactions accounts in large banks, a failure of a large bank would create a dreadful mess. Many transactions would have to be retraced. If A receives a wire transfer from B and immediately uses the funds to pay C, who at once pays D, and so forth, the failure of A's bank would cause great problems for others in the chain.

IV. Some Reform Proposals

One reform supported by Kareken is to reinstitute Regulation Q. He is, of course, right in saying that the elimination of Regulation Q allows banks to obtain deposits quickly and hence to "go for broke" if failure seems likely. But is this enough to justify reimposing the regulation? Surely not. Regulation Q has done immense damage in generating periodic deposit outflows and in fostering inefficient nonprice competition. It discriminates against the poor, and it leads to financial innovations, such as money market funds, that degrade the meaning of the monetary aggregates. Compared to these disadvantages, the fact that Regulation Q makes life easier for the FDIC seems quite minor.³ Moreover, it is by no means clear that the revival of Regulation Q would really help the FDIC. The experience during the 1969 credit crunch demonstrated that, unless banks can issue large certificates of deposit (CDs) that are exempt from the Regulation Q ceiling, a credit crunch could generate a financial crisis during which large banks might fail. This is why the ceiling on large CDs was removed in 1970, and it is precisely large CDs that can be used to go for broke.

Kareken also suggests that we consider going to 100% reserves. This is certainly worth considering since it would make control over M1 much easier as well as reduce bank failures. But a 100% reserve system has its own problems. An obvious one is the cost of restructuring the banking system to separate transactions accounts banks from banks for genuine savings. This would be extremely costly not just for the regulatory agencies and banks but also for the general public, which would have to relearn how to conduct its banking. (The public, just having gone through the travails of the AT & T breakup, is not likely to take kindly to such radical bank reform.) Second, it would raise the cost of

3. In addition, Regulation Q has a macro effect since it raises the interest elasticity of the LM curve. Whether this is desirable depends on whether unpredictable shifts occur primarily in the IS or the LM curves.

holding money since transactions account banks would have to finance themselves entirely by service charges. As a result, the quantity of money held would be even more suboptimal than it is now. Third, there would be a strong incentive to invent new types of accounts that function as transactions accounts but avoid the 100% reserve requirement; and as these new accounts are brought within the scope of the reserve requirement, still other types of accounts would be invented. What Edward Kane (1981) has called the "regulatory dialectic" would flourish. But all the same, 100% reserves is an interesting idea.

The specific reforms suggested by Kareken are not the only potential protections against excessive risk taking. Another approach is to prohibit any senior officer of a bank that fails with losses to the FDIC from ever working for another insured institution. This would not only make senior bank officers more cautious but also give them an incentive to inform the FDIC before the bank deteriorates to the extent that its capital is wiped out. Since perhaps the major current problem for the FDIC is that it does not learn soon enough about the losses that a bank has, such a "reign of terror" against bank officers deserves consideration. It is, of course, far from ideal. It would be inequitable in many situations. It might discourage risk taking too much in some cases while having little impact in other cases in which the senior officers are close to retirement, and it may create problems in case of a merger. But then every solution has its problem.

V. Capital Requirements

A consensus seems to be forming that the best solution to the FDIC's problem is a much higher required capital ratio. Kareken rejects this approach, arguing that "requiring more 'capital' does no real good. . . . If a bank in trouble does not change its loan policy then unless it was entirely the victim of a bad draw, it must in time be in trouble again" (p. 000). This argument fails to distinguish between the dollar value of a bank's capital and its capital/deposit ratio. It therefore ignores the cushioning function of capital. Suppose that a bank's loans go into default and that the bank recovers only 90% of their book value. If the bank has a capital ratio of more than 10%, then only the stockholders lose, not the depositors or the FDIC. By contrast, if the bank had only a 5% capital ratio, the FDIC and perhaps large depositors would suffer.

The capital ratio is therefore much more important than Kareken suggests. Banks provide assets that are safe enough to serve as a medium of exchange even in the absence of insurance because as financial intermediaries they diversify their risks and because the depositor is protected by two capital ratios, that of the primary borrowers and that of the bank. Since some of their debts are a medium of exchange, banks can borrow very cheaply, and this gives them an incentive to lever as much as they can. If depositors knew the bank's lever-

age, this would not work because, as shown by the Modigliani-Miller theorem, they would require a higher rate of return as the bank increases its leverage. But in many cases they do not know the bank's leverage, so banks have an incentive to lever too much. The government's response has been to impose capital requirements that are fairly low and to back up this capital cushion by providing a secondary capital cushion of socialized capital. This socialized capital, which is sufficient to pay off all bank liabilities, consists of two items. The first is the FDIC's insurance fund, and the second is the *de facto* commitment of the Treasury to come to the rescue of the FDIC should its funds be insufficient. The latter does not mean, as is often claimed, that the taxpayer is required to bail out banks. If the FDIC should need an infusion of taxpayer funds, this would probably come in the form of a loan that the banks would subsequently have to pay off via higher FDIC premiums.

What are the proper roles of private and socialized capital? The great advantage of private capital is that it provides a more appropriate incentive for the optimal level of risk taking than does socialized capital, a type of capital that makes risk taking seem to be a free good. Moreover, it is hardly fair to make sound banks pay higher insurance premiums because other banks have taken too much risk or have too little capital.

Since deposits should be protected, and private capital can never do so fully, there is some role for socialized capital, but it is a very limited role. It should protect only against shocks that are so rare and unpredictable, for example, another Great Depression or a major war, that banks do not have an appropriate incentive to protect against them. In addition, even if the private capital ratio is large enough, given our large number of banks, there are likely to be a few scattered failures all the time because there will always be a few banks near the extreme tail of the probability distribution of bad luck.

This suggests that if bank failures increase, as they have in recent years, the private capital ratio should be raised. Since the function of capital is to protect the FDIC and uninsured depositors, such capital need not consist of equity capital but, as Kareken suggests, could be junior debt. Such debt, if traded on a sufficiently broad market, has an additional advantage; it allows the FDIC to see what the private market thinks about the safety of a bank and hence provides the FDIC with an early warning system.

But adding capital is painful, particularly for small banks that cannot tap the national capital market. Fortunately, there is a compromise solution. At present, the insurance system discriminates against small banks because, *de facto*, all deposits of the large multinational banks are insured. It might therefore be appropriate for the FDIC to issue two types of insurance contracts. One would explicitly insure all deposits but would require banks to have a much higher capital ratio. The other

contract would not require a higher capital ratio but would not insure large deposits. Small banks that have few large deposits but find it difficult to raise capital would then choose the latter contract, while large banks would be driven by competition to choose the fully insured contract. This would, of course, require that the FDIC make it clear that under the second contract it will not bail out large depositors and will make them bear a share of the cost when a failure is handled by deposit assumption.

An increase in bank capital would, of course, not be a panacea. An alternative recently proposed by Ian Giddy (in press), namely, the continual marking of bank assets to market and the imposition of a liquidity constraint, would be preferable if it should turn out to be administratively and politically feasible. As Giddy points out, the capital ratio is not a good measure of a bank's riskiness. Moreover, insofar as banks have a preferred level of risk, they would try to offset the lesser risk inherent in a higher capital ratio by holding more risky assets. But fortunately, the greater the capital ratio, the less the risk that banks will want to assume. Moreover, bank examiners have some control over the purchase of risky assets. Admittedly, there is a possibility that the regulators would use the higher capital ratio as an excuse for not being hard-nosed enough in bank examinations. One can readily construct a model in which the FDIC maximizes a utility function with only two arguments—avoiding disputes with banks and reducing the probability of bank failures. In such a model the number of bank failures depends on the relative costs to the FDIC of bank failures and bank criticism. Making banks safer by a higher capital ratio then has no effect on the actual number of failures (unless it reduces bank criticism of the FDIC). But I do not believe that such a model captures reality because the FDIC's utility function also has another argument—obeying the law; and if banks carry obviously unsound loans on their books at acquisition value, the FDIC will sooner or later force a write-down. If the banks have sufficient capital, they will be able to survive this. Kareken appears to be more critical of the regulators and believes that bank examiners are outmatched. Perhaps he is right. This is an issue on which detailed empirical evidence is needed but does not seem to be available.

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