# Rethinking and Living with the Limits of Bank Regulation

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## Introduction

The attention of U.S. taxpayers temporarily was drawn to the problems of federal deposit insurance in mid-January 1989 by the Treasury Department's short-lived proposal to make the costs of federal deposit insurance explicit. The attention-grabbing device was a proposed 25 basis points (0.25 percent) fee for deposit insurance. The rationale for the fee was that depositors increasingly choose to rely on deposit insurance instead of their own assessments of the probability of an institution's failure when deciding where to place their funds and how much to place in a single institution.

The savings and loan (S&L) crisis has taught us that managers of insured institutions also have relied too much on deposit insurance and too little on risk control and on pricing for risk when those managers conduct the lending and investment policies of their institutions. Suppliers of capital to insured institutions (all too few of whom were managers whose own funds were at risk) came to view regulatory controls and supervisory evaluations as adequate substitutes for the direct policy guidance and supervision that owners whose own funds were at risk might be expected to provide in the absence of such official insurance, regulation, and supervision. Finally, the taxpayer, having no obvious reason to disbelieve indus-

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try and governmental assurances that all was well, ignored the necessary maintenance of the financial services system until it was too late.

Official estimates in August 1989 placed the cost of the S&L bailout at $92–159 billion over 10 years—more than twice the value of the net worth remaining in the healthy part of the industry. But the true cost is now acknowledged to be considerably higher, and rising. If the S&L industry were an automobile, a rational driver (taxpayer), hearing that the repair cost was more than twice the value of his car, might conclude that it would be more efficient to junk the car and apply the same monies toward the purchase of a new car.

In 1957, banking historian Bray Hammond published a book with the apt title *Banks and Politics in America, from the Revolution to the Civil War.* Once we understand that we are dealing with banks and politics, not cars, we can begin to understand that the repair decisions will not be rational or efficient and that the cost will be only a small obstacle to any solution that we can dream up. We might even charge the repair cost on our credit card by putting it "off budget." In any event, the U.S. taxpayer, having deferred necessary maintenance and repairs, now is being asked to pay an exorbitant price when these services are finally performed.

Besides the subsidies mentioned above, the existing regulatory system imposes taxes on the financial services industry, and, like all taxes, these reduce market-oriented incentives for performance and increase overall inefficiency. Such taxes may be explicit (such as franchise taxes and taxes on property owned but leased to others) or implicit (such as non-interest-bearing reserve requirements). The subsidy elements of the financial services industry, in turn, attract nonbank interlopers to the federal safety net. In the end, banks and S&Ls are little more than a set of regulatory taxes and subsidies—nothing inherently special, after all, to differentiate them from other kinds of firms.

There are problems in the financial services industry that need repair, but as Keynes (1931, pp. 139–40) once put it, just because we have magneto trouble does not mean that "we shall soon be back in a rumbling waggon and that motoring is over." The principal purpose of this essay is to describe how we might go about repairing the magneto and, vowing to see that necessary maintenance will be undertaken, how we can resume our journey in comparative comfort and with a degree of safety that is priced explicitly to reflect the risks that we are consciously willing to bear.

## The Regulatory Environment

From the mid-1960s through the early 1980s, the financial services industry became less segmented and more integrated and competitive. The financial-structure arrangements of the 1930s became increasingly challenged, both at home and abroad, especially after 1960. The continued separation of different types of financial institutions into different markets after 1960 could be viewed as owing more to the government's interference in financial markets, in the form of restrictions on the activities of different types of financial institutions, than to natural market developments.

In particular, under the financial structure arrangements of the 1930s, banks, bank holding companies, and thrift institutions were relegated to offering the public a narrow range of financial services in markets protected from the entry of nondepository institutions. In return for the exclusion of banks from their turf, financial services companies that engaged in insurance or securities underwriting were prohibited from accepting retail deposits and were denied direct access to the Federal Reserve's payments mechanism.

Advances in communications and computer technology have, however, increased the volume, geographic scope, and efficiency of financial markets. Those advances also have fostered the development of new, comparatively unregulated services such as money market mutual funds, which are substitutes for traditional banking services. Technological innovations, coupled with the inflationary pressures of the 1970s and early 1980s, have eroded—and in some instances completely broken down—the regulatory barriers among banks, thrifts, and other providers of financial services.

Today, nonbanks compete with banks in markets once exclusively the domain of banks. For example, banks compete with the financing subsidiaries of General Motors and Ford in the market for car loans, with General Electric and Prudential in the commercial loan market, and with Merrill Lynch and Sears in deposit-gathering markets. With the increasing globalization of financial markets, U.S. banks face competition from foreign banks in both the international and domestic markets. Increased competition from both foreign banks and nonbank providers of financial services has reduced domestic banks' and thrifts' shares of the financial services market.

Clearly, as financial markets have become more integrated and competitive, the distinction between depository institutions and other financial institutions is now more closely related to the set of regulatory taxes and subsidies faced by and available to banks and thrifts than to the special nature of their products. In other words, it is the restrictions on organizational form, the locations of the institutions, and what businesses they can engage in, coupled with access to the federal deposit insurance guarantees, the Federal Reserve's discount window, and the Federal Reserve's payments mechanism, that make depository institutions special.

This latter-day system of regulatory taxes and subsidies has not kept pace with the changes in financial markets. Regulatory changes in reaction to developments in the marketplace have been made in a piecemeal fashion, usually with the purpose of either validating market innovations or reregulating areas where market forces have made existing regulations obsolete. Just as the market has become adept at reducing or eliminating regulatory taxes, it has become equally adept at increasing the size of the subsidy inherent in programs like fixed-rate federal deposit insurance or access to subsidized discount-window credit, sometimes on less than completely sound collateral.

Federal deposit insurance was adopted in 1933 and began operations in 1934 to prevent a recurrence of systemwide bank runs by small depositors. By guaranteeing the transaction and savings balances of *small* depositors (originally limited to $2,500), deposit insurance removed the incentives for those individuals to participate in runs and, thereby, increased the near-term stability of the financial system, particularly for its smaller unit-bank components. Unfortunately, the way federal deposit insurance is priced and the way it has been administered since World War II have created governmental subsidization of the risks undertaken by insured banks and thrifts. These subsidies, in turn, led to perverse incentives for risk taking by insured institutions and ultimately destabilized the financial system. Misguided policies of regulatory forbearance in the late 1970s and in the 1980s further served to increase both the size and the ultimate taxpayer cost of subsidies.

The recent trend toward more-integrated financial markets and less-specialized institutions is not necessarily a bad one. On the contrary, increased competition among providers of financial services increases their efficiency and reduces the public's cost of financial intermediation. In theory, consumers benefit from better financial services at a lower cost. If we ignore the cost of subsidy elements, society as a whole benefits from competition of financial services because fewer resources are used up in providing those services.

The current regulatory structure needs to be updated to account for the market-driven changes that have occurred. Explicit recognition of perverse incentives is required along with a revamping of the existing system of regulatory taxes and subsidies. Increased emphasis should be placed on market discipline and regulatory oversight in the form of stronger and more effective supervision for insured banks and thrifts; less emphasis should be placed on pure "thou shalt" or "thou shalt not" regulation. Of course, to make a reformed system work effectively and in an unsubsidized manner, we need a complete overhaul of federal deposit insurance.

The structural weakness in our financial system is well documented. At the beginning of 1989, one-third of this nation's thrift institutions were either insolvent or on the brink of failing (Barth and Bradley 1989). Another third of the industry needed to raise new capital soon to remain viable. Although the picture is brighter for the banking industry, banks have failed in record numbers during this decade; only in 1988 did the annual number of official S&L failures begin to surpass the annual number of official bank failures in the 1980s. Banks that failed or needed federal assistance to remain open in the 1980s included large banking organizations like Continental Illinois of Chicago, First Republicbank of Dallas, First City Bancorp of Houston, and, most recently, MCorp of Dallas. Furthermore, there are indications of continued weakness in the banking industry. The FDIC's problem-bank list still contains roughly 10 percent of all banks, and the cost of resolving bank failures has averaged as much as 33 cents per dollar of failed bank assets (Bovenzi and Murton 1988). Despite the progress made during the past few years in reducing the exposure of the U.S. banking industry to loans to less-developed countries, these credits continue to be a difficult point of exposure for several of our largest banking institutions (Todd 1988a, 1989).

Much of the blame for the current problems in the banking and thrift industries can be placed on our outdated regulatory structure. For example, regulations that encouraged thrifts to finance portfolios of long-term, fixed-rate mortgages with short-term savings deposits made the thrift industry extremely vulnerable to the secularly rising interest rates in the late 1970s and early 1980s. This defect laid the foundation for the current thrift crisis, as thrifts weakened by interest-rate disintermediation in the 1970s gambled for recovery, and all too often lost, in the deregulated environment of the 1980s. On the whole, experience would suggest that such a regulatory structure provided progressively less-effective supervision and regulation and required increased levels of protection or subsidy for the thrift industry.[1]

Similar examples can be found in banking. For instance, our outdated regulatory system played a role in the banking crisis in the energy and farm belts. Branching laws, which tend to cause restriction of the geographic diversification of banks' loan portfolios, can

[1]For an agency-theoretic discussion of these points, see Kane (1989a).

make banks extremely susceptible to regional economic downturns. This lack of diversification was especially true in regions like the Southwest, where one or two industries dominated the economy.

These unintended effects of outdated regulations were compounded by the presence of fixed-rate deposit insurance and the politicization of the regulatory process. The willingness of the FDIC and FSLIC to routinely guarantee the deposits of statutorily uninsured depositors and other uninsured claimants when banks and thrifts fail has removed depositors as a source of market discipline on banks and thrifts (Caliguire and Thomson 1987). Political interests have placed numerous roadblocks in the way of those regulators who were courageous enough to try to deal with the problem forcefully in recent years. Rather than deal with problems when they arose, those interests directed political energy at cosmetic efforts to cover up and push each crisis into the future. Policymakers must have hoped that, by buying time to deal with various crises, the ultimate taxpayer cost of, or political accountability for, resolving them would be smaller or more diffused (Kane 1989a).

The combination of an outdated regulatory system, fixed-rate deposit insurance, and politically motivated regulatory forbearance programs has cost the American taxpayer dearly. In terms of economic costs, the financial system is less efficient than it could be. Many bankers and thrift executives are exhausting scarce financial resources in circumventing outdated regulations.

Fixed-rate deposit insurance and regulatory forbearance policies decrease the efficiency of the economy in two ways. First, they protect inefficient firms at the expense of efficient firms and the public. Second, by subsidizing risk, they result in an overinvestment in risky assets for the economy as a whole. For example, by some congressional estimates, Texas will receive a net capital inflow of $31 billion over 30 years from the current S&L rescue plan, essentially the accounting entry that squares the balance sheet for the thrift industry's overinvestment in Texas real estate during the 1980s. For the average citizen, such inefficiencies mean paying higher prices for an inferior product (such as deposits backed by unoccupied Texas real estate).

The fiscal cost of maintaining the status quo has increased dramatically in recent years. Pauley (1989) estimated that resolving the thrift crisis will cost more than $124 billion on a present-value basis.[2]

[2]Pauley's $124 billion estimate includes $50 billion for prior case resolutions and $74 billion for restructuring insolvent thrifts. The $124 billion estimate does not include financing costs for $81 billion ($150 billion) if the spending is financed over 10 (30) years at current market interest rates.

The Shadow Financial Regulatory Committee issued a statement on December 5, 1988, which estimated that losses not yet recognized on the books of the FDIC, but reasonably probable of occurring, would have exceeded the estimated cumulative premium income and reserves by almost $14 billion at year-end 1988, leaving only a small net positive balance (about $400 million) in the FDIC fund. Another recent analysis estimated that the FDIC's fund should reflect about $10 billion of unrecognized losses, leaving a positive balance of about $4 billion in the fund (Brumbaugh and Litan 1989). Current proposals to resolve the debt crisis of developing countries also could cost the U.S. Treasury another $12 billion through tax losses caused by loan charge-offs, increased quotas for the International Monetary Fund, or governmental assistance for recapitalizing troubled large banks that, in light of the precedent set by the thrift industry's rescue in 1989, is almost certain to be requested in case of a worsened crisis.

Who will pay the $200 billion or more that officials now estimate it will take to clean up the U.S. financial system? Regrettably, the U.S. taxpayer is being asked to foot almost all of the bill, both directly through higher taxes and indirectly through higher borrowing costs, higher transaction account fees, and lower returns on savings. This outcome is the greatest single illustration of the failure of the regulatory structure existing in the financial services industry: Regulation was supposed to prevent such calamitous taxpayer costs from being incurred.

## The Inadequacy of Current Reform Measures

Because the current crisis and regulations are inexorably intertwined, two tasks lie before us to avoid aggravating or repeating the current decline of the financial services industry. The first task is the massive cleanup of the financial system; the second is the implementation of comprehensive regulatory and supervisory reforms. Insolvent institutions must be closed or recapitalized before fundamental regulatory reforms can be adopted. However, without meaningful reforms to the deposit insurance mechanism and the regulatory structure, there are strong incentives that would cause the current situation to be repeated, possibly within the next few years (Kane 1989b).

If we have learned anything from the current thrift-industry debacle, it is that deregulation and deposit insurance reform can be applied only to an industry that already is healthy. The increase in deposit insurance coverage from $40,000 to $100,000 in 1980 and the new powers granted to thrifts by the Garn–St. Germain Act of 1982 and by state legislatures contributed enormously to the losses now facing the U.S. taxpayer. Insolvent thrifts recognized the perverse incentives, then rationally used these new powers (especially liberalized loan-to-value ratios for real estate and direct investments in real estate) to try to gamble their way out of insolvency. Some won their bets and returned to profitability; most, however, did not, and the losses accrued to the FSLIC and, hence, to the U.S. taxpayer. Although many thrifts were quite capable of carrying out increasingly risky deposit-taking and investment strategies using their traditional pre-1980 powers, the experience of the 1980s points out the dangers of expanding risk-taking opportunities for institutions that have little or no private capital.

The events surrounding the March 1985 collapse of the Ohio Deposit Guarantee Fund (ODGF) are a stark warning of the importance of transition when implementing reforms. When institutions are insolvent, changes in deposit insurance coverage, either through reductions in insurance limits or through the failure of the insurance fund (as was the case with the ODGF), cause runs on those (insolvent) institutions. Furthermore, the less time that market participants have to process the information associated with changes in regulations and federal deposit insurance, the greater the probability that runs will occur on solvent institutions, although such runs are infrequent and usually can be stopped once solvency is demonstrated. Besides, the existence of bank runs is not necessarily the problem: The real public policy and legal problem is allowing insolvent banks to remain open and to continue to receive new deposits (Kaufman 1988). Therefore, in addition to dealing with insolvent banks and thrifts now, part of the first task for reform is to provide for a short transitional period in which to adjust to market-oriented reforms.

The importance of transition can be illustrated by thinking of the financial system as a heroin addict and deposit insurance subsidies as heroin. To safely cure our patient of his addiction, we first need to stabilize his condition. In the case of depository institutions, we must stabilize the banking system by closing or recapitalizing insolvent banks and thrifts. Then we need to proceed with a treatment program that allows the patient's body to adjust to functioning without heroin. During this transition period, markets must adjust to functioning without the deposit insurance subsidy. The alternative solution, making the patient withdraw "cold turkey," runs the risk of killing the patient or, in our case, causing the collapse of a large part of our financial system. On the other hand, the "cold turkey" solution is preferable to keeping the patient functioning only by using ever-increasing doses of heroin.

Some regulators and their political mentors seem to have opted for legalizing the heroin—making deposit insurance available permanently in unlimited amounts—because they say that they do not believe the financial system could stand any withdrawal pains. That choice is wrong, and that approach raises profoundly troubling moral issues, such as whether private bankers should have the right to conduct their fully insured affairs in such a way as to create what amounts to full-faith-and-credit claims on the Treasury, without political accountability.

In August 1989, Congress enacted legislation that largely followed proposals by the Bush administration to deal with the fiscal aspect of the S&L crisis. It is expected that, through higher taxes, the U.S. taxpayer will directly pick up all costs of closing, reorganizing, or recapitalizing the original set of roughly 500 thrifts that are either insolvent or in danger of failing (about $300 billion over 30 years), except for about $40 to $60 billion (the amount estimated to become available from deposit insurance premiums over the years). This latter part of the cost, ostensibly paid by the industry, also will be borne indirectly by consumers through the effects of higher deposit insurance assessments on the pricing of services offered by banks and thrifts.

The first problem with the recently passed Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 is that it fails to commit enough money to resolve the problem fully. Recent statements by FDIC Chairman L. William Seidman indicate that the bailout funding in FIRREA is at least $20 billion less (and perhaps as much as $50 billion to $100 billion less) than what is needed to resolve the funding aspect of the crisis. As with the $10.8 billion of Financing Corporation (FICO) bonds authorized under the Competitive Equality Banking Act of 1987 (about $7 billion have been issued), failure to commit enough resources to solve the S&L problem today only guarantees a much bigger cost for cleaning up the problem in the future. Committing fewer resources than necessary to fully resolve the FSLIC insolvency is analogous to a doctor's removing only part of a cancerous tumor from a patient. It is a sure-fire recipe for a near-term repeat of the crisis. Furthermore, the pressures of the moment in putting together the rescue plan may have caused the needless jettison of alternatives like closing and liquidating all 1,000 or so insolvent and unprofitable thrifts without committing taxpayers' money.

FIRREA does contain reforms to the thrift supervisory and regulatory process, although those reforms are less sweeping now than the ones initially proposed in the Bush administration's plan (upon which FIRREA was based). The most significant reform was supposed to be the equalization of capital standards between banks and thrifts. Unfortunately, FIRREA waters down this provision significantly, and thrifts will be allowed to use goodwill (in decreasing amounts) to meet capital requirements until 1995. It remains to be seen whether the gradual phaseout of goodwill as capital by 1995 will survive the lobbying efforts of thrift-industry special interest groups like the U.S. Savings League. Other reforms contained in FIRREA include the separation of the thrift deposit insurance fund from administrative oversight by the Office of Thrift Supervision (formerly the Federal Home Loan Bank Board) and an increase in deposit insurance premiums for banks and thrifts.

The main problem with FIRREA is that it commits huge amounts of money to resolving the S&L crisis without conditioning the availability of that money on fundamental supervisory and regulatory reforms—in particular, reform of the underlying mechanism of federal deposit insurance (Kane 1989b).[3]

Too many banks will continue to be considered too big to let fail; important legal and economic distinctions between insured and uninsured deposits will continue to be ignored; and states with concentrations of troubled S&Ls, such as Texas and California, will not be asked to provide matching funds for the rescue, even though Ohio, Maryland, and Colorado all eventually provided state monies to resolve problems of privately insured S&Ls and industrial banks in their states in recent years.

The federal taxpayer, who will bear the ultimate cost of resolving the FSLIC crisis, has the right to expect that policymakers would institute measures to prevent recurrence of the S&L crisis. Supervisory and regulatory reforms are the appropriate legislative reactions in return for the taxpayer's increase in present-value tax liability. Such reforms would increase the efficiency of the financial system, enabling banks and S&Ls to fail without costing taxpayers a cent for the deposit insurance subsidy, which, in turn, would give the public better financial services at a lower cost.

It might appear at first glance that once a bailout of the S&Ls (as distinguished from putting insolvent and unprofitable thrifts into receivership) was decided upon, it did not matter much who was taxed to pay for it, who received it, whether the bailout funds were raised by taxation or borrowing, whether the borrowing was on budget or off budget, or whether taxpayers or S&L "users" (depositors

[3]For a discussion on the need for reforms to forestall future crises, see Kane (1985, chaps. 5 and 6; 1989a, chap. 6) and Benston et al. (1986).

and borrowers) should bear the costs. Nevertheless, these issues are significant because of their precedent-setting value and because of what the public's responses to these issues tell us.

For example, in 1987 the average (arithmetic mean) insured deposit account under both FSLIC and FDIC was only about $8,000. In 1988 the average FSLIC-insured account remained at $8,000, while the average FDIC-insured account at closed institutions rose to nearly $12,000. Yet, industry and governmental officials maintain that the financial fabric of Western civilization will rip apart if we fail to pay off deposits as large as $100,000 per account—or even more in those banks deemed by current regulatory standards to be too big to let fail.

The *median* insured amount is even smaller than $8,000 or $12,000, the arithmetic mean being skewed upward somewhat by the small number of $100,000 accounts. Also, the cost of a $124 billion bailout for FSLIC would be slightly in excess of $1,100 per tax return (times about 110 million tax returns). Thus, it requires a remarkable feat of logic, with unusually flexible standards for measuring efficiency or Pareto optimality, for economic policymakers to assert that it is logical, lawful, fair, precedented, efficient, or optimal either to tax the average (mean) taxpayer more than $1,000 at present value or to borrow more than $1,000 at present value for that taxpayer's account, in order to make what amounts to a transfer payment to all holders of insured deposit accounts in excess of $8,000 and to uninsured claimants.

As for precedents, there are none of even remotely comparable magnitude in U.S. history. Recent federal bailouts (Lockheed, New York City, Chrysler, and Continental Illinois) involved amounts ranging from $3 to $80 per tax return, and only the Continental rescue (another deposit insurance–related bailout) involved more than $20 per tax return. In other words, the current S&L bailout is so extraordinarily in a class by itself—a truly world-class white elephant—that there is no rational way to explain it. Yet, it appears that the bailout (as opposed to the harsher alternatives) is considered to make eminent good sense in congressional and lobbying circles in Washington, D.C. On the other hand, the S&L bailout might just be a graphic illustration of the ultimate costs of a politics-as-usual approach to bank supervision and regulation.

## Alternative Blueprints for Reform

It is possible to approach deposit insurance and regulatory reform proposals like the choices on a Chinese restaurant's menu (one from option A, one from option B, etc.). Political compromises regarding banking structure often resemble choices made from such a menu. Nevertheless, policy choices that are put together in this fashion usually lack intellectual rigor and usually are not very robust in real-world, marketplace competition. It would be preferable to consider the general patterns of the competing options so that future reforms could be built consistently, according to the blueprints for reform that were chosen earlier. The current congressional (and some of the regulatory agencies') plans for reform have certain commendable aspects but are more a hodgepodge of competing and irreconcilable issues than an embodiment of consistent principles.

Three options that are presented below (two polar approaches and one compromise approach) may be considered as yardsticks against which to measure any proposal for beginning to limit the taxpayer's risks while nudging the currently regulated part of the financial services industry in the direction of becoming able to compete, without subsidy, with nonbank financial companies and foreign banks. The benefits of a free-market approach to banking powers, along with the principal yardsticks by which each of the three alternatives should be measured, are efficiency gains and protection of the public purse. The selection of which financial services the providers would offer should be determined increasingly by the markets and decreasingly by the regulators. The three alternatives presented here are (1) reregulation; (2) a free-market approach to banking; and (3) increased supervision, greater market discipline, and limited insurance.

*Reregulation*

One alternative that seemed increasingly likely for several months but currently seems to be receding somewhat is more regulation of the financial services industry. In a strict sense, reregulation precludes any new powers for regulated financial institutions. Others would argue that new powers are necessary and that stricter regulations can offset the risks to the federal safety net. In a limited and heavily regulated manner, federal regulators already either have approved or have requested public comment on new activities for banks, bank holding companies, and thrifts. The most controversial proposed powers involve expanded deposit-taking, lending, and investment powers. Often, it is proposed that those powers be combined with entirely new or comparatively uncommon activities like insurance and reinsurance brokerage and underwriting, operation of travel agencies and resort hotels, distribution and underwriting of corporate debt and equity securities, direct investments in real estate, and management and leasing of real property.

In principle, reregulation could be used to protect the federal safety net from risks arising from the new activities. This could be done by increased and risk-sensitive capital adequacy requirements, detailed regulatory safeguards, increased frequency and intensity of supervisory inspections, more mandatory filing of regulatory reports, and requirements for strict enforcement of corporate separateness, often called "firewalls" in the regulatory debates (Keehn 1989). The problem with the "strict supervision/regulation" approach is that it greatly diminishes the overall efficiency of the financial services industry. Increased regulatory taxes could shrink the deposits taken by banks, compared with deposits or comparable accounts taken by competing nonbank financial companies, as a percentage of market share. Greater regulatory taxes would increase the regulated industry's demand to expand regulatory subsidies (the deposit insurance component of the safety net) correspondingly. Indeed, some proponents of more regulation would expand deposit insurance coverage and assume that increased taxpayer costs of this subsidy could be reduced by an increasingly aggressive system of bank regulation. Given the existing tendencies to politicize bank regulation, it is difficult to foresee how a sufficiently objective bank regulatory system could be created to control the risks to the public purse, especially given the perverse incentives currently embedded in the federal safety net.

Excessive reliance on regulations tends to discourage new activities that the regulatory authorities supposedly intend banks to undertake. Moreover, reregulation would drive enterpreneurial bankers into evasive behavior designed to circumvent the regulations. In this manner, S. Waite Rawls, vice chairman of Continental Illinois, noted: The proper response to regulatory firewalls is to "hire real good lawyers" to figure out ways around them.[4]

Principal-agent problems associated with increased regulation create incentives for regulators whose banks fail (or would fail but for the federal safety net) to declare that some banks are too big to let fail but should not be required to shrink, even though such banks could not be supervised or regulated properly in their current size or structure. Belatedly recognizing the fundamental unfairness and inefficiency of such treatment of large banks, regulators increasingly have decided to subsidize small banks too, instead of attempting to reduce the big banks' subsidies. This exercise, if prolonged, will prove to be quite costly for taxpayers.

[4]Quoted in Horowitz (1989, p. 6).

One fundamental objection to the reregulation of the financial services industry is that it might not be consistent with protection of the federal safety net. The ongoing emergence of new technology, new competitors in the industry, increased costs of supervision, and the resulting inefficiency of a highly regulated industry seem to be strong and well-established forces, whose influence will be difficult to offset. Market forces will continue to circumvent new and existing regulations in attempts to maximize the joint value of bank equity and the subsidy inherent in the safety net (Kane 1977).

The overriding reasons for rejecting ongoing reliance on increased regulation as an alternative to reducing or eliminating both the federal safety net and the increased reliance on market forces are the efficiency losses that would emanate from the destruction of competition and from the consequent damage to taxpayers' property rights. Holders of private capital (bank shares or claims on banks) should not be able to put their funds at risk in ways that automatically trigger taxpayer-funded rescues when those ventures go wrong. The range of acceptable, efficiency-promoting expectations regarding federal subsidy of the risky activities of large banks should be from "never" to "almost never"; instead, the range of actual expectations is from "always" to "almost always." Bankers have perverse incentives to increase the risks in their asset portfolios and to circumvent regulations in doing so when they know in advance that regulators can be counted on for taxpayer-funded rescues when risky investments turn sour.

*Free-Market Approach*

A second option is the total abolition of both regulatory taxes and public subsidies of banking. On its face, this option—favored by students of free banking and open markets—is the most efficient alternative. Let anyone who wants to open a bank do so, but without federal deposit insurance, a central bank discount window, or a government-sponsored payments mechanism that offers intraday (daylight overdraft) credit. If private entities, including insurance companies, clearinghouses, and the like, want to replace the withdrawn federal guarantees, then let them do so, but only at the explicit cost of their users.

Opponents of this approach argue that deposit insurance and a central bank discount window are necessary to ensure the stability of the financial system (Diamond and Dybvig 1983). Regulation, in turn, they argue, is necessary to limit the cost to the taxpayer of providing the financial safety net. Opponents believe that efficiency gains afforded by a free-market environment come at the cost of financial stability and that decreased financial stability may result in a reduction in social welfare. To support their position, opponents of free-market banking often point to the banking crises during the 1930s.

The interpretation of events in the 1930s by defenders of the federal safety net is not consistent with historical evidence. The fragmented structure of the U.S. banking system (prohibition of interstate branch banking) then, as today, arose more from the way banks were regulated than from market-driven evolution. This fragmented structure and the Federal Reserve's failure to supply enough aggregate liquidity to financial markets at critical junctures through open-market operations during the 1929–33 era were two primary causes of the banking system's collapse in the 1930s (Friedman and Schwartz 1963). There was no cheap, efficient, safety-net alternative to collapse in the face of the banking system's structural and liquidity problems.

The stability of the financial system may be enhanced by improving the quantity, quality, and timeliness of information available to market participants, or, in other words, by reducing the information costs for participants in financial markets. Lower information costs lessen the possibility that *irrational* bank runs (runs on solvent institutions) would occur. Clearinghouses and other interbank funding markets should be able to allow solvent, though liquidity-constrained, institutions to demonstrate their solvency and end any irrational runs. Reduced information costs also would reduce the probability of rational bank runs (runs on insolvent institutions) because the market could recognize problems in individual institutions sooner and force corrections through a combination of gradual deposit outflows and higher funding costs for such institutions (Kaufman 1988).

In a free-market banking system, clearinghouses may replace central bank discount-window functions altogether—the clearinghouse acts as the ultimate provider of temporary liquidity assistance to individual institutions. Also, the clearinghouse has market-driven incentives to enforce market-value accounting and early closure rules on its members because all clearinghouse members would have to cover the losses arising from claims on insolvent members whose liabilities were honored in the clearings at par (Gorton and Mullineaux 1987). As long as the central bank or monetary authority supplied sufficient legal-tender or credible, lawful-money liquidity to the market in the aggregate, the market should be able to resolve individual institutions' liquidity problems (Todd 1988b). Moreover, the central bank's discount-window function no longer would be necessary to redress regional liquidity imbalances affecting individual, solvent institutions: In a nationwide, free-market banking system, there would be no regional liquidity imbalances that did not, in fact, reflect deeper, underlying causes—like solvency problems.

In short, claims by opponents of free-market banking that active, discount-window operations are necessary to prevent liquidity crises in the banking system and that, consequently, a regulatory apparatus is necessary to prevent abuse of subsidized discount-window credit are unfounded either in logic or in historical fact (Todd 1988b). Although neither claim reflects necessity, a great deal of policymakers' *convenience* might be wrapped up in such claims. One suspects that, as was the case with banking regulation reforms of the 1930s, proponents of a more centralized and more heavily regulated financial structure tend to exaggerate (perhaps unknowingly and in completely good faith) both the potential and actual consequences of bank runs or bank closings to justify the regulatory system and subsidies that they advocate, rather than recognize the overall efficiency and public welfare gains of a free-market banking structure.

Individuals should be able to maintain unimpeded access to transaction accounts, even after bank failure, in a free-market banking structure because a greater variety of other institutions either would assume the transaction accounts in clearinghouse-arranged dispositions of insolvent members or would offer new account services (although not necessarily at the same prices) to depositors of the failed institutions. Thus, from the general public's perspective, overall efficiency and public benefits of a free-market banking structure should be maintained at least at the present level and, in fact, should be much greater.

A free-market financial structure would be more stable, in the aggregate, than its critics claim. Market forces would create stabilizing pressures for much earlier resolutions of problem bank cases than is now the case, even though individual problem banks might perceive the system as less stable from their particular perspectives, because their survival as individual institutions would be much less assured than at present.

The government's role in a free-market environment would be to improve the flow of information to the public, such as by conducting examinations and then publishing the findings (Thomson 1989, 1990). Public filings with the Securities and Exchange Commission and analyses by the rating agencies already perform analogous functions for publicly listed nonbank companies. It should be possible, with correct incentives, for bank supervisors to mimic the information retrieval, analysis, and disclosure functions of the SEC with respect to publicly listed companies.

A free-market banking system would satisfy the dual objectives of maximum efficiency and minimum taxpayer exposure to loss. Such a system would require a supervisory willingness to allow banks, even the biggest ones, which are "special" only in terms of the regulation and subsidies that they receive, to fail. Also, such a system would increase market discipline, especially depositors' discipline. No bank could be too big to let fail.

It is doubtful that a free-market approach to banking would be feasible if it had to be administered by the current "too big to let fail" regulators or if even the tiniest vestiges of the federal safety net were left in place. Therefore, although this approach is the best one in terms of economic theory and historical logic, it does not appear to be politically viable now because of its potential for displacing too many well-placed defenders of the status quo. Nevertheless, this approach should serve as our long-run objective when designing a system that would be politically feasible in the near future.

*Increased Supervision, Greater Market Discipline, and Limited Insurance*

An alternative that might move us significantly along the road toward market-responsive banking would combine increased supervision and greater market discipline with a decreased role for pure regulation (Hoskins 1989b). A necessary element of this alternative is reduction of the role and amount of federal deposit insurance. After a forward warning date, all new deposits would be segregated from old deposits and insured only at the limit selected pursuant to administrative deliberations. Old deposits would be grandfathered at the $100,000 deposit balance level, and deposits in excess of $100,000 could be handled with receivership insurance or a modified payout plan. Receivers could estimate probable recoveries on the estates of failed banks and make that percentage of recovery available to depositors immediately. There would be no ceiling amount for such receivership insurance, but there essentially would be coinsurance on all deposits for the unrecovered amounts. The FDIC tried briefly to implement such a plan, called "the modified payout" plan, for uninsured depositors in the early 1980s but abandoned it when Continental Illinois failed in 1984.

A reduction in deposit insurance coverage could be effected by regulation—no new statute would be necessary—because the existing statutes authorize deposit insurance up to the maximum prescribed level ($100,000); they do not require that the deposit insurance ceiling be set at that level. For example, new, lower limits could include a general deposit insurance ceiling of $10,000 (e.g., 90 percent insurance for amounts between $10,000 and $20,000, 80 percent between $20,000 and $30,000, etc., and not more than 50 percent insurance for deposits in excess of $100,000 *per person* in *all* insured banks, not just per insured account).[5] Strictly enforced, lower limits would allow the "too big to let fail" doctrine to have the decent burial it deserves; would provide supervisors with incentives to adopt early closure policies to prevent or limit the effect of bank runs; would encourage increased reliance on strong and effective supervision (inspection, reporting, and public disclosure) instead of regulatory policies that will always be avoided by skilled lawyers and those who employ them; and would return a large measure of market discipline to banking.[6] In any case, federal deposit insurance in excess of $10,000 per account could be viewed properly as a taxpayer subsidy of the insured bank to induce the depositor to hold claims on the bank instead of Treasury bills.[7] Large banks could be brought into the framework of increased supervision and market discipline by requiring them, or their parent holding companies, to issue debt obligations in wholesale amounts that were subordinated to the claims of the central bank, depositors, and deposit insurers.

Another idea worth considering for making large banks more sensitive to market discipline would be to require common voting equity-holders to purchase predetermined amounts of such subordinated

[5]A version of this approach was proposed by the Federal Reserve Bank of Minneapolis in its 1988 *Annual Report*. Under this plan, complete federal deposit insurance would be limited to $10,000 per insured account (still slightly in excess of the average or arithmetic mean insured account), but with federal insurance available for 90 percent of amounts in excess of $10,000 but less than $100,000. This plan bears some resemblance to the original (1933) concept of "interim" federal deposit insurance, which provided for graduated amounts of coinsurance: 100 percent for accounts up to $10,000, 75 percent for accounts between $10,001 and $50,000, and 50 percent for accounts in excess of $50,000. See the Federal Deposit Insurance Act in *Federal Reserve Bulletin* 19 (1933), pp. 385, 388 (Section 12B of the Federal Reserve Act).

[6]Thomson (1987) shows that lower deposit insurance limits, coupled with strict adherence to those limits, would allow the federal deposit insurers to observe, and then to charge, depository institutions the actuarially fair value of their deposit insurance.

[7]Treasury bills (maturing in as few as three months) may be purchased directly over the counter at Federal Reserve Banks in denominations as small as $10,000. Treasury bills are highly liquid investments (the active secondary market makes them almost perfect substitutes for banks' savings accounts and time deposits) and may be used as collateral for borrowings from banks and securities firms in order to raise cash in advance of maturity. Responding to a questioner after a May 1989 speech, W. Lee Hoskins (1989a), president of Federal Reserve Bank of Cleveland, observed:

> I'm not arguing for the total elimination of [deposit] insurance, although I wouldn't mind living in such an environment. But, if we think we need some insurance, then I think we ought to limit the coverage. You, sir, having some mistrust of banks, may decide that Treasury bills are your best investment. It is not as if the American investor does not have a default-free alternative to banks.

debt, or to post surety bonds in those amounts obtained from nonbank companies. Subordinated debt or surety bonds would act as an additional, equity-like buffer between losses in the asset portfolio and the exposure of the uninsured depositors, the central bank, and deposit insurers (Kane 1987; Benston et al. 1986, chap. 7). Any move toward improved market discipline would require better communication of information to the public regarding the actual condition of banks (e.g., by requiring or, perhaps, merely authorizing banks to release examination reports and supervisory ratings to the public) and also would require greater use of market-value accounting for banks. Currently, only banks' portfolios of trading account securities are marked to market value regularly; in addition, investment account securities and loans could be marked to market at least once per calendar quarter. This approach would enable banks and bank holding companies to engage in a broader range of activities than they now do and certainly would pose no insurmountable obstacle to increased ties between banks and other types of financial intermediaries. Supervision, reporting, and disclosure would provide some measure of protection to the investing public, while market-value accounting, subordinated debt, and limited deposit insurance would reduce taxpayers' costs if one of the deregulated entities failed. Moreover, if some ongoing separation between banking and nonfinancial firms were desired, that separation would remain possible.

The critical intellectual element in analyzing this third alternative is preservation of the principle that insured deposits should not be used to fund assets whose value is not marked to market regularly and should not be held by banks unwilling to disclose their true condition to the public. If the public chooses to place its funds in banks relying on regulation and nondisclosure to retain market position, then the public gradually should be made to understand that its investments in regulated, nondisclosing banks should not be backed by claims on taxpayer funding. Abroad, depositors in Islamic banking systems already are familiar with the principle that depositors share the profits (higher rates of return on deposits) as well as the losses of their banks (Iqbal and Mirakhor 1987), and U.S. depositors were familiar with this principle before 1933.

Our objective currently should be to allow private individuals to make investment decisions and to reap the rewards while insulating the taxpayer from those individuals' losses. Time and advance warning will be necessary to enable us to make this transition successfully. However, the difficulty in changing the status quo to our desired banking structure should not deter us from pursuing this goal. Segregation of old from new deposits after a future date, phasing down the insured deposit ceilings, implementing coinsurance, changing to an early closure rule, and adopting market-value accounting standards are all feasible with enough advance warning. Advance warning also would give us time to prepare to close or reorganize all institutions found to be insolvent or capital deficient.

## Conclusion

Our current system of regulatory taxes and subsidies is unworkable and has proved to be very costly. The present situation must be resolved—and quickly. Beyond that, fundamental reforms are necessary, and the provision of taxpayer assistance must be linked to these reforms. The criteria for judging the reforms should be increases in the efficiency of the financial system and protection of the public's purse. Market-oriented reforms that reduce the deposit insurance subsidy and that rely primarily on supervision and market discipline, as opposed to regulation, to guide the actions of bank and thrift managements are superior to other types of reform in meeting these criteria.

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