

## Cato Institute Policy Analysis No. 149: Judging the 1991 Reform Effort: Do U.S. Banks Have a Future?

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### Executive Summary

When President Bush signed into law the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) on August 9, 1989, he promised that the bailout legislation for savings and loans would "safeguard and stabilize America's financial system and put in place permanent reforms so these problems will never happen again." Less than 18 months later, disturbing predictions of a possible crisis among U.S. banks have raised doubts about the administration's ability to deliver on its promise of "never again."

Although there is considerable disagreement about the state of the banking industry's health, there is enough unsettling news to cause many taxpayers to take notice. Bank failures increased dramatically during the 1980s. Between 1945 and 1980, bank failures averaged fewer than five per year. In only four of those years (1975, 1976, 1979, and 1980) did 10 or more banks fail. Between 1981 and 1989, however, the average annual number of bank failures jumped to 114.<sup>(1)</sup> The changes in the bank failure rate between 1955 and 1990 are illustrated in Figure 1. Credit quality represents a serious problem for a significant number of banks. Those industry trends become even more disturbing when they are coupled with newsmaking events such as the failure of the Bank of New England, Chase Manhattan's recent decision to cut 5,000 jobs while setting aside \$850 million to cover bad loans, or the recent prediction by the Congressional Budget Office that the Bank Insurance Fund will become insolvent sometime in 1992. Year-end financial statements from the nation's banks will be examined with uncommon interest in the coming months, and the Federal Deposit Insurance Corporation's reserve position will be watched closely in an effort to ascertain the insurance fund's financial health.

Figure 1  
Number of Bank Failures, 1955-90

Sources: Congressional Budget Office, *Reforming Federal Deposit Insurance* (Washington: CBO, September 1990), pp. 142-43. The number of bank failures in 1990 was supplied by the Federal Deposit Insurance Corporation. (Graph Omitted)

The bad news coming from the banking industry will also draw attention to the Treasury Department's recently released report on deposit insurance reform. Mandated by FIRREA, the report offers a blueprint for broad reform of the regulatory structure of the financial services sector, and alternative proposals from both Congress and the industries affected have already begun to appear. All such suggestions for reform must be carefully evaluated, however. If policymakers are to prevent the deteriorating condition of the banking industry from developing into a sequel to the S&L crisis, reform must address the fundamental problems facing the nation's banks. Taxpayers must not be satisfied with halfway, patch-up measures.

This paper describes four broad criteria against which alternative reform proposals should be judged. But first, the fundamental sources of the banking industry's malaise are identified.

### **Following in the S&Ls' Footsteps**

There is widespread agreement that policymakers ought to heed the lessons of the S&L, or thrift, debacle of the 1980s. There is less consensus about what those lessons were. A careful examination of the thrift crisis reveals that a government failure, not a market failure, lay at the root of the industry's problems. Like the S&L industry before it, the banking industry is threatened primarily by its regulatory structure.

Contrary to popular understanding, the thrift industry was insolvent on a market-value basis throughout the 1970s. The industry as a whole was in the red by \$110 billion by 1980, before any of the deregulatory reform initiatives were passed.<sup>(2)</sup> Before 1980 savings and loans were required to invest the majority of their asset portfolios in 30-year, fixed-rate mortgages secured by real estate within a 50-mile radius of their home offices. Those loans were funded primarily by passbook savings accounts, generally payable on demand. Funding long-term, fixed-rate assets with short-term liabilities is a recipe for disaster if interest rates rise rapidly, as they did in the 1970s. It was the interest-rate risk--dictated by government regulation--that bankrupted the thrift industry initially. The government-mandated lack of geographic diversification helps explain the regional pattern of problems. Failures mounted most dramatically in regions with the most economic problems, such as Texas.

The steps toward deregulation taken in 1980 and 1982 were attempts to address the most immediate problem faced by the S&Ls--their overdependence on geographically concentrated fixed-rate mortgages--but policymakers failed to address the full range of problems. Congress and the White House left federal deposit insurance in place, and they allowed hundreds of insolvent institutions to remain open, their operations funded by a virtually unlimited claim against federal taxpayers. As Meigs and Goodman observed:

Deregulation affected healthy and unhealthy institutions in different ways. It gave insolvent institutions more opportunities to throw Hail-Mary passes. However, these institutions were only being kept alive in the first place by federal deposit insurance. For healthy institutions, deregulation was a long-term necessity. Without it, many could not have survived the competition in the financial marketplace.<sup>(3)</sup>

As was the case with the S&Ls, the fundamental problems faced by banks can be traced in large part to the regulatory structure under which they labor. The problems have three sources: (1) geographic restrictions, (2) product restrictions, and (3) federal deposit insurance.

### **Geographic Restrictions**

First, and most important historically, are the branching restrictions faced by U.S. banks. In a survey of two centuries of international banking history, Anna J. Schwartz observed that "of the seventeen countries listed, . . . the United States experienced the greatest number of years of panic."<sup>(4)</sup> The overdependence of many U.S. banks on the economic health of a single industry or region goes a long way toward explaining their relative instability.

Even our experience during the Great Depression was fundamentally different from that of other countries. As Schwartz noted, "The three banking panics . . . in 1930-33 in the United States were unique occurrences in the world."<sup>(5)</sup> Although Canada also experienced falling prices and output during the 1930s, no Canadian banks failed. Their nationally branched banks closed numerous offices, but depositors were protected as accounts were transferred to other branches. Significantly, only 10 of the more than 9,000 banks that failed in the United States during the 1930s had more than two branches outside their home cities.<sup>(6)</sup>

Regional banking crises continue to make news. The problems faced by Texas banks, dependent as they were on the health of the oil industry, occupied regulators throughout the 1980s. The failure of the Bank of New England on January 6, 1991, is raising questions about a crisis among New England banks as that region's economy falters.<sup>(7)</sup> Whatever benefits supporters might attribute to geographic restrictions, a large part of the blame for the instability among U.S. banks must also be laid at their door.

## **Product Restrictions**

A second set of problems has arisen from the attempt to legally define a "bank." Industries are not static, unchanging phenomena. They evolve and adapt in response to technological change, product and service innovations, and organizational developments. The transportation sector, for example, has evolved from the use of wooden sailing ships and horse-drawn carts that took months to deliver a package to the use of airplanes that furnish overnight delivery. That development required not only the technological advance embodied in aircraft but also the vision to provide a new service (overnight delivery) by means of a previously untried organizational form (a hub-and-spoke network).

Imagine what would have happened if, just a decade ago, the federal government had tried to provide a legally binding definition of any of a dozen rapidly changing industries. Neither facsimile machines nor videocassette recorders were nearly as prevalent in 1981 as they are today, but those innovations have dramatically changed business communication and home entertainment. What products and services would consumers not enjoy today if the government attempted to define every industry? How would individual firms fare if they were legally unable to adapt to changing market conditions?

It was just such a misguided, static approach that legislators applied in 1933 when they sought to define commercial banking entities as being separate from other financial institutions and from commercial enterprises. That effort to freeze banks in time continues, and it has deprived the United States of much of the experimentation and innovation that lead to new contractual or organizational forms and better service. In addition, as other financial services firms have offered new products, the ability of banks to respond has been stymied. In every aspect of their business, banks have lost market share over the past 20 years.

As just one example of how changing market conditions have affected banks, consider the increasing importance of securitized credit. In 1976 there was \$13 billion in non-financial commercial paper outstanding. By December 1989 the total had grown to \$129 billion. Commercial paper is a close substitute for short-term bank loans among corporate customers, and its relative importance as a short-term funding source doubled between 1976 and 1987 as the nation's largest corporations increasingly looked outside the banking industry for ways to meet their credit needs.<sup>(8)</sup> Similarly, since its creation in 1982, the noninvestment-grade (or junk) bond market has had a dramatic impact on the financial industry. Despite their well-publicized use in takeovers, junk bonds in their more mundane role continue to replace commercial bank loans as a source of short-term credit for midsize companies.

Consumers also have benefited from developments in the broader financial services market. The growth of securitized mortgages has attracted nontraditional lenders so that a growing share of home mortgages is originated through nondepository mortgage companies. In 1970 savings institutions (S&Ls and savings banks) held almost 44 percent of all mortgages, and depository institutions (savings institutions and banks) held 59 percent. By 1988 the share of mortgages held by savings institutions had dropped to 29 percent, and the share held by depository institutions had declined to 49 percent.<sup>(9)</sup> Automobile and credit card loans are increasingly securitized, and players such as General Electric Credit Corporation are providing a growing share of consumer credit.

In short, bankers' inability to adapt and innovate has not protected them from competition. Instead, it has left them with a shrinking pool of customers and thereby has reduced their importance in the evolving financial services industry.

## **Federal Deposit Insurance**

The third part of the regulatory system that needs attention is federal deposit insurance. Just as opponents predicted it would in 1933, an expanding federal deposit insurance system has steadily removed the need for bank owners and managers to compete for business on the basis of their institutions' financial strength. Faced with largely indifferent depositors, bankers have been freed to emphasize other goals. The pursuit of higher profits, unconstrained by creditors' concerns for safety, can often lead to wasteful investments and unnecessary losses.<sup>(10)</sup>

Meanwhile, owners of diligently managed, well-capitalized banks have been paying, and will continue to pay, for the excesses of their more aggressive competitors through the deposit insurance fund. In effect the government has created

an externality by allowing owners, managers, and creditors of poorly run institutions to force others to pay the cost of their mismanagement. As Meigs and Goodman noted:

Federal deposit insurance subsidizes the attempt by troubled thrifts to lure funds from the healthy sector of the financial markets. To make matters worse, this subsidy is paid for by premiums imposed on healthy institutions and, if necessary, by additional revenues collected from U.S. taxpayers.(11)

Those cross-subsidies are likely to increase if the regulatory structure--including the deposit insurance system--is not reformed.

The final irony, of course, is that it is not the excessive profitability of the banking industry that has taxpayers and policymakers worried; it is the lack of profits that is creating problems. As was the case in the S&L industry during the 1980s, federally insured deposits could soon become the means through which last-gasp gambles and Hail-Mary passes are funded as failing banks desperately attempt to survive in a market that is passing them by.

The banking industry's problems are most often attributed to causes other than the regulatory system--slumping real estate markets, recession, irresponsible Third World governments, oil shocks, and war in the Middle East, to name a few. But vulnerability to external shocks is merely proof that the regulatory system is not working. Instead of creating an adaptable financial system able to weather economic storms, government policies have produced a network of banks unable to survive unless conditions are perfect. It is time for a change.

### **Judging Reform Proposals**

It is increasingly apparent that something must be done about the banking industry. Determining what that something should be is less straightforward. Below are four criteria---summarized in the form of questions--that should be applied to every reform alternative that Congress considers. Taxpayers should demand that whatever reform is adopted provide affirmative answers to all four questions.

#### **Does the Proposed Reform Address Both Federal Deposit Insurance and Structural Issues?**

Federal deposit insurance and the structure imposed by the bank regulatory system are inextricably linked, a point the Treasury Department emphasizes in its report. Attempting to address just one aspect of the problem risks exposing taxpayers to substantial losses.

The S&L debacle provides a case study of the hazards associated with focusing solely on structural issues--the products and services provided by depository institutions, for example--without at the same time addressing flaws in the deposit insurance system. Although U.S. banks must have the ability to respond to competitive forces and customer needs by offering a wider range of products and services if they are to survive into the 21st century, there is no reason that taxpayers and healthy banks should be asked to underwrite whatever schemes may be devised by overly aggressive bank owners and managers. Forcing bankers to fund new projects by attracting private, uninsured (or largely uninsured) creditors will ensure that banks expand their activities in a prudent manner.(12)

It is equally important to recognize that federal deposit insurance was a response to the failures of the unit banking system of the 1930s.(13) Meaningful reform of the federal deposit insurance system that does not also address interstate branching restrictions risks creating a banking system that the market has already rejected once.

Restrictions on the range of services that banks can offer also arose largely in the 1930s. In part the restrictions were a reaction to the perceived excessive competition among individual banks, and between the banking industry and other types of financial institutions. Policymakers of the day sought to prevent future failures by guaranteeing profits through protecting individual markets. Thus, the acceptable activities of commercial banks, S&Ls, insurance companies, and investment banks were clearly defined, and cross-competition was eliminated to the degree possible.

Restrictions on banking activities were also a response to the moral hazard problem created by federal deposit insurance.(14) Though the term "moral hazard" was not used in the 1930s, analysts of the day clearly understood that a federal guarantee of all bank deposits would remove the need to compete on the basis of institutional strength and

financial stability. By making deposits in all banks equally safe, federal deposit insurance increases bankers' incentives for risk taking. By strictly circumscribing the range of services that banks could provide, policymakers hoped to limit the risk embodied in bank portfolios. Advances in financial theory have demonstrated, however, that the old warning against putting all your eggs in one basket is as valid for banks as it is for farmers. In addition, simply forcing bankers to focus their attention on loans in no way limits the risks they take. The choices about whom to lend to, how much collateral to demand, the length of the loan contract, and the interest rate charged can all affect the expected return and the risk that banks accept.(15)

In short, branching restrictions led to federal deposit insurance, which led to product restrictions. Attempting to address one part of that Gordian knot without attending to the others will only pull it tighter around the necks of U.S. bankers and taxpayers. Deposit insurance reform and the multiple aspects of structural reform must be part of the same package if we are to cut through the tangle.

### **Does the Proposed Reform Facilitate the Restructuring of the Banking Industry?**

By virtually any measure, the U.S. depository market is overcrowded. In today's world of computers and rapid telecommunications, there are simply too many separately owned and operated banks and near-banks (that is, S&Ls and credit unions). There are not enough deposit customers, good-quality lending opportunities, capital, or management talent to keep them all operating profitably and efficiently, especially in the face of increased competition by nonbank financial companies. As a result, the number of banks is already declining (as evidenced in part by the high failure rates). If current trends continue, of the roughly 12,500 banks that exist today, only some 8,100 will remain by the end of the year 2000.(16) As the financial sector continues to evolve, the long-term survival of healthy institutions will require that federal and state policies facilitate the process of consolidation.

Current interstate banking laws do not go far enough. Bank holding companies active in interstate markets are still required to operate one or more separate bank affiliates (depending on the state's branching laws) when they cross state lines. Interstate branching would reduce the costs and increase the benefits of an interstate banking system, for both the banks involved and their customers.(17)

Further mergers among financial institutions also will help provide long-term protection for depositors. With more than 28,000 banks, S&Ls, and credit unions in the United States, there is little reason to be concerned about potential antitrust problems any time in the foreseeable future.(18)

Banks and other depositories also must be allowed to simply leave the financial services industry. If large numbers of failures occur over the next few years, they should not be viewed negatively. The exit of failed banks will have a positive effect on the remaining institutions.(19) Consumers also will benefit as a restructured industry will offer greater financial strength, possibly without reducing the number of offices open to serve the public. That assumes that some form of interstate branching is introduced. It is less expensive and less risky to enter a new market by opening or acquiring a new branch than it is to open or acquire a whole new bank.

Finally, and most important, the adoption of interstate branching need not lead to a banking system dominated by a half-dozen nationally branched institutions. Removing current restrictions on branching certainly would encourage some large banks to open offices nationwide. But evidence from both California and New York, where statewide branching has seen some of the largest banks in the country effectively countered by smaller institutions with a strong local orientation, is consistent with the expectation that surviving banks would exhibit a wide range of sizes and business plans.(20) Although some economies of scale and cost savings obviously exist in large, branched banks, such advantages often can be effectively countered by more personalized retail service, greater knowledge of the local economic environment and business community, and back-office resources shared by several smaller banks.(21) In the United States there will always be room for several thousand strong, well-managed community banks, especially if entry barriers for new banks are kept relatively low.(22)

### **Does the Proposed Reform Create the Incentives Necessary to Produce a Banking System Better Able to Withstand External Shocks?**

The first ingredient necessary for a stronger banking system is improved profit opportunities. If banks are to take the

kinds of risks that promote economic growth (by lending to small, untried business ventures and newly formed households, for example), they cannot be treated like utilities with an allowable rate of return. Banks must be in a position to earn profits that contribute to their overall economic strength if they are to provide support during economic downturns rather than become a drag that contributes to the inevitability of a recession.

Removing restrictions on the products and services that banks can provide for their customers, allowing interstate branching, and facilitating the economically necessary contraction of the industry will help improve the economic health of the remaining banks and thrift institutions. But rebuilding a banking system able to withstand economic shocks requires more than structural reform. It also requires reform of the federal deposit insurance system.

To address the problems created by federal guarantees, all banks, both large and small, must have a significant number of private creditors with money at risk who, through the courts or some other mechanism, are able to force the closure of their bank. Those private creditors could be uninsured (or partially uninsured) depositors who are able to force closure by removing their funds. They could be subordinated debtholders with the right to force a bank into bankruptcy court. Or they could be private insurers who have the power to take over the operation of an unprofitable bank. Policymakers must not be allowed to create exceptions for institutions because of their size or location. Market-sponsored discipline is the only way to depoliticize the decision to close a bank.

Over the long term, politically influenced closure decisions tend to undermine the stability of the banking industry for three reasons. First, a politicized closure process invites pressures to prop up or bail out losers.<sup>(23)</sup> Second, a politicized closure decision creates an uncontrollable externality as healthy banks are forced to absorb many of the costs of protectionist policies. Third, a politicized closure process discourages the kind of management practices that lead to stability within the banking community. Each of those reasons is discussed below.

By its nature the political decisionmaking process is particularly responsive to and protective of those firms and individuals who suffer losses in the market. Bailouts are so easy to provide and so appreciated by those who receive aid, and the costs can be spread over the broader community. Such reasoning is especially apparent when the fate of one or more highly visible banks is at stake. Political decisionmakers, both in Congress and at the regulatory agencies, typically focus on the short-term costs of failures to individual investors or depositors and to local communities.<sup>(24)</sup> Unfortunately, the short-term costs of failure cannot be avoided through a bailout; they can only be spread through the wider community. More important, such efforts almost inevitably lead to substantially greater long-term costs.

The expectation of bailouts helps reduce the pain of failure and encourages banks to take on additional risks--especially if "everyone else" is making similar investments.<sup>(25)</sup> Under current conditions, banks' boards of directors are more likely to ask their managers why they have not devoted additional resources to the latest popular investment--whether Third World loans, energy loans, or real estate--than to urge the managers to be cautious. Because bankers backed by an extensive federal safety net often plunge into seemingly attractive investments in pursuit of higher short-term profits, the banking industry is more vulnerable to changes in market conditions than it would be if more caution were used initially. Swings in industry health are thereby exacerbated rather than muted.

It is also important to recognize the effects of bailouts on the institutions that are not bailed out. During the 1980s the top 25 percent of the Texas S&Ls maintained an average capital ratio of 8 percent. As late as 1988, 148 of the state's 278 thrifts were solvent. There was nothing inevitable about the dramatic losses experienced by many Texas S&Ls. Unfortunately, the federal government's policies toward the thrift industry neither recognized nor rewarded the skill of those owners and managers who successfully steered their institutions through the turbulent 1980s. To the contrary, those people generally were penalized.

Rising deposit insurance premiums were imposed on profitable institutions as the Federal Home Loan Bank Board and Congress initially sought to raise the money necessary to pay for the crisis from the surviving S&Ls. The politically motivated decision to leave hundreds of insolvent thrifts open throughout the 1980s also forced more stable S&Ls (as well as banks) to compete with institutions whose owners and managers had nothing left to lose. As zombie thrifts sought new deposits to fund their go-for-broke investments, they drove up interest rates for all federally insured institutions.<sup>(26)</sup> Genie Short and Jeffery Gunther have estimated, for example, that the top quarter of the Texas thrift industry paid a premium of 0.33 percent just because they were located in Texas.<sup>(27)</sup> Finally, when direct assistance is

provided to keep an institution operating, new capital is often injected by the federal regulators while problem assets are removed. That may be good news for the S&L or bank involved (or whoever acquires it), but healthier competitors that do not qualify for federal aid must continue funding their nonperforming loans, and they are thereby placed at a disadvantage. The government has established a mechanism through which the losers can externalize the costs of their misguided investments and activities. Healthier competitors pick up a major part of the bill.

In short, politically protecting losers reduces the long-term survival prospects for remaining banks and S&Ls by skewing the competitive process. For the economy as a whole, bailouts send a dangerous message: why not take the additional risk?

The third way in which an extensive federal safety net undermines long-term stability can best be illustrated by considering what would happen in its absence. Imagine how the behavior of bank owners and managers would change if federal deposit insurance did not exist. Their entire approach to their business would be altered as the responsibility for attracting and retaining depositors would revert to them. No magic, government-sanctioned sign on the door would bring in funds. Somehow bank owners and managers would have to communicate a sense of continued financial strength and stability to their customers. Although it is impossible to predict exactly how they would accomplish that--after all, increased competition (and hence innovation) in providing "safety" would be one of the benefits of eliminating federal guarantees--evidence from other markets and from banking history does provide some clues.

Consider bank capital, for example. In the absence of federal deposit insurance, successful banks probably would maintain capital ratios higher than those with which most banks operate today. During the 1980s consumer finance companies, which fund loans to individuals by issuing uninsured commercial paper and corporate bonds, maintained average capital ratios of between 12.3 and 15.3 percent. By contrast, the largest 50 banks' average capital ratios ranged between 4.6 and 5.4 percent during the past decade.<sup>(28)</sup> Banks themselves had larger capital cushions in the days before federal deposit insurance was introduced. George Kaufman has reported that, at the turn of the century, "capital ratios at banks were close to 25 percent and effectively even higher, as shareholders at national banks and some state banks were subject to double liability up to the initial par value of their shares."<sup>(29)</sup> Capital cushions provide depositors with the reassurance that normal operating losses will be absorbed by stockholders, not imposed on creditors. The more capital, the more protection provided to depositors.

Debates over adequate capital often evolve into discussions of the accounting procedures applied to banks. Current accounting methods often do not provide an accurate measure of a bank's health, in large part because assets are carried at acquisition (or book) value instead of reflecting changes in market conditions. In the absence of federal deposit insurance, owners and managers of healthy, well-managed banks would have an incentive to lead the way toward more accurate accounting procedures. Because managers of strong banks would want their depositors to maintain confidence in their financial statements, especially when other banks failed, they would be more forthcoming in their accounting statements from the beginning. Thus, stronger institutions would adopt more open, market-oriented accounting in an effort to prove their superiority. Banks or S&Ls that did not follow suit would be viewed suspiciously by their customers, who would demand to know what they were hiding.

In a world without federal deposit insurance, there would also be changes in the way bankers approached new loans and investments.<sup>(30)</sup> Instead of focusing solely on the short-term profit potential, investment committees at successful institutions would pause to consider the impact on their banks' financial condition, and hence their ability to retain depositors if the investment were to sour. Such analysis would take place before investments were made.

Such a change would not mean there would be no risk taking in the economy. Loans to new businesses would still be available. After all, that is where banks have their greatest comparative advantage. But risks would be less concentrated as banks sought to build diversified asset portfolios. Concern about the impact of potential losses on depositor confidence also would lead uninsured banks to approach complicated new financial products more slowly than they do under a regime with an extensive safety net. Until risks associated with new products were well understood and could be explained to concerned depositors, banks would be unlikely to embrace them with enthusiasm.

Banks unprotected by an extensive federal safety net would also invest a greater share of their portfolios in more liquid

assets.(31) The need for liquidity can arise simply through an unexpected demand for cash that has nothing to do with the institution itself, or it can arise through depositors' uncertainty about the continued financial health of an institution. Either way, a solvent, financially stable bank is protected by holding a more liquid portfolio. Increased liquidity makes it possible to meet unexpected cash demands without raising questions about a bank's solvency. Liquidity increases depositor confidence; individuals who know that their bank can easily liquidate a substantial portion of its assets are less likely to participate in a run on the bank in the first place.

The suggestion that banks ought to take responsibility for meeting customers' demands for cash, however motivated, is often viewed with suspicion. Indeed, the federal government is often deemed responsible. But banks enter into contractual obligations to redeem customers' deposits--some on demand, others after a specified time period. As Huston McCulloch has pointed out: "A sound financial institution can meet its obligations with or without the confidence of its depositors. An institution that relies on confidence alone without substance . . . is by definition a confidence racket, a 'con game.'"(32)

The demand for increased liquidity will also contribute to the spread of market-value accounting in the banking industry. As a larger share of the assets created by banks through their lending activities is securitized and placed on a secondary market, more information will be available to all concerned about the current value of each bank's portfolio. Such developments will not necessarily favor only larger banks. Lowell Bryan has described how smaller banks might use their specialized knowledge of local or regional markets to create a market niche in which they could originate and service loans sold on the secondary market.(33) Such a process also reinforces the improved diversification of bank portfolios, even those of small banks.

Another means by which uninsured banks might address the need for liquidity is mutual protection agreements with other banks. The existing federal funds market, through which banks with excess reserves make overnight loans to institutions in need of additional funds, would seem to provide a natural mechanism through which banks in need of liquidity could turn to their fellow bankers. But history provides even more examples. In the days before the Federal Reserve was created, clearinghouse associations in many cities helped stabilize the banking market. Solvent but illiquid banks were able to obtain loans from their clearinghouses. During panics, clearinghouses coordinated banking activity to ease the demand for specie.(34) If there was a question about a bank's solvency, the clearinghouse settled the question, and in the event of a failure, the clearinghouse oversaw the closure of the insolvent member institution--often protecting the insolvent bank's depositors and noteholders.(35)

The role played historically by clearinghouses also raises the possibility of private deposit insurance provided through a system of cross-guarantees.(36) Given U.S. experience with federal deposit insurance, it may be that many depositors would feel more comfortable if their funds were protected by some sort of private financial insurance, provided through either a cross-guarantee system or independent insurers. Placing private deposit insurers in the role of third-party monitors with the power to examine and, when necessary, close banks could well be a form of security offered by bankers to reassure their depositors.

Finally, a system in which depositors' funds are at risk does not wipe out uninsured accounts in the event of a bank failure. In reviewing bank runs before 1920, George Kaufman found that the average loss rate to depositors in failed banks was 0.20 percent.(37) In other words, before 1920 the average depositor with funds in a failed bank recovered more than 99 cents of every dollar he had deposited in the institution. More recently, the American Bankers Association has reported that the FDIC's recovery record in recent years has been about 93 percent of assets for banks with over \$1 billion in assets and about 70 percent for banks with less than \$1 billion.(38) On average that would indicate that uninsured bank creditors today could expect to recover about 88 percent of their unprotected deposits. When anticipating conditions in the absence of federal deposit insurance, however, it is important to note that losses have increased in recent years because the federal government has been increasingly patient with troubled institutions, in some cases allowing them to remain open long after they have become insolvent. There is a positive relationship between the losses suffered by a failed bank or S&L and the time allowed to pass between the point of economic insolvency and the institution's closure.

Note that all the management practices discussed here-- increased capital, greater liquidity, more accurate accounting techniques--place a premium on anticipating and avoiding problems. In a world without expansive government

guarantees, the efforts of bank owners and managers to reassure depositors and overcome information problems would lead to increased strength and stability in the industry.

There is no doubt that, without federal deposit insurance, depositors would be more likely to demand their funds on short notice than they are in the presence of a federal guarantee.(39) But the willingness of depositors to withdraw funds from weak or insolvent banks or S&Ls is the market's means of protecting itself against \$500 billion black holes like the one created in the thrift industry in the 1980s.

### **Does the Proposed Reform Promise to Improve Service to Bank Customers?**

In the final analysis, the only reason for the banking industry to exist is to serve its customers. This entire paper has been about how reform might increase the ability of banks to respond to their customers' needs for both financial services and stability. Nothing could be more indicative of how the bank regulatory system has failed individual and business consumers than the declining role played by banks in almost every type of financial service they offer. As a result of bankers' growing frustration with new nonbank sources of competition, considerable attention has been devoted to the probable benefits of deregulation for bank customers. Glowing pictures are painted of a brave new world of financial services.

Interstate branching would afford individuals increased access to their bank accounts.(40) Evidence from Canada indicates that a system of widely branched banks is also able to clear checks more quickly, thereby giving individuals and businesses faster access to deposited funds. Less restrictive branching laws would help reduce stress on the payment system as companies with widespread offices could reduce the number of banks with which they deal and hence the number of funds transfers required.(41) Removing restrictions that limit the services banks (and other financial institutions) can offer is expected to provide bank customers with the convenience of one-stop financial shopping. An individual buying a new home, for example, could apply for his mortgage and homeowner's insurance at the same time. Small, rapidly growing businesses could also benefit from being able to turn to their banks for aid in floating their first stock or bond issues.

In reality, we cannot predict with certainty what new products and services would develop in the absence of restrictions on the services that banks provide and the locations at which they provide them. An important part of the competitive process is discovery and innovation. Giving wider rein to that process will certainly benefit bank customers, and chances are good that the greatest benefits will accrue to small businesses and individuals with comparatively few financial resources. Wealthy individuals and the nation's largest corporations are already the beneficiaries of healthy competition for their business; there are few services to which they do not have access. In addition, the nation's wealthiest families and Fortune 500 entities represent a relatively small share of the total market for financial services. The financial needs of middle- and lower-class individuals and families and of the dynamic small-business sector provide a potentially more fruitful ground for the bulk of the nation's banks. Throughout history, in fact, the masses have benefited more from innovation and technological change than have the wealthy. As Nathan Rosenberg and L. E. Birdzell have observed: "The most lucrative new products were those with a market among the many, rather than among the few. . . . It is much easier to think of innovations which benefited only the less well-off than it is to think of innovations which have benefited only the rich."(42) There is reason to believe that unleashing competition among banks and other financial services firms would continue that tradition.

### **What Is Missing?**

Before concluding, it is worthwhile to comment briefly on five specific topics that are not included in the above discussion.

First, there is no discussion of the need for improved government supervision. No matter how well intentioned or well trained, government examiners who attempt to shoulder the entire burden of controlling risk taking by banks are faced with an impossible task. Reforms that increase our dependence on government supervision to the detriment of market oversight are doomed to eventual failure. Decentralized oversight, like that provided by private creditors with their money at risk, is required to adequately monitor and control the activities of decentralized private institutions. Those who doubt the power of private overseers should explain why mortgage companies, consumer finance companies, and money market mutual funds--all of which lack the extensive federal guarantees and regulation afforded the S&Ls with

which they compete--have avoided the abuses of the thrift industry over the past decade.

It should be noted that attempts to apply the FIRREA formula by developing some definition of a "safe" banking portfolio likewise will lead to problems.(43) A centrally devised investment formula cannot address the market realities faced by every institution for any length of time. In fact, it may not reflect the market realities faced by any institution. Managerial skills and market conditions are different for every bank. Congress cannot micromanage banks from Washington.

Second, no criteria are given that specifically focus on the need to minimize the contingent liability of taxpayers. Limiting the need for taxpayers to make forced contributions to the banking industry is important from many perspectives, and the concerns of taxpayers have been mentioned often. It is worth repeating that the ability to shift losses to taxpayers encourages excessive risk taking by both bankers and insured depositors. Allowing the market to force banks to internalize the costs of their actions by requiring banks to fund their activities with accounts that are uninsured will also provide the best protection for taxpayers.

Third, there is no explicit discussion of the "too-big- to-fail" problem. To fully satisfy the third criterion, the discretion of the federal bank regulators must be sharply curtailed, and new policies must be applied consistently to all financial institutions. For discipline to be exercised by private creditors, be they uninsured depositors or private insurers, those with money at risk must be denied government-sponsored escape routes, regardless of the size of the institution. Thus, discount-window lending and current payment system policies that frequently allow large depositors to escape before an institution is closed must be reexamined. That does not rule out the possibility of a "big bank failure plan" designed to provide additional liquidity to the economy--through open market operations, for example.

Fourth, there is no discussion of the transition problems presented by reform. The timing of reform is important, although not as important as getting the reform right. Policies of the past five decades have created a trap. Because it is widely accepted that all deposits in banks of any size are effectively protected, depositors (especially those placing large sums) have focused on interest rates, often disregarding considerations of bank stability. Any sudden change in policy would cause a massive movement of funds. Consequently, an argument can be made for providing a transition period--for making changes in policy effective at some future date, say January 1, 1995. That would allow both bankers and their depositors to make the changes required in an orderly fashion. The law should make it absolutely clear, however, that as of the announced date, bailouts of uninsured creditors will end.

Fifth, although the criteria discussed here call for an increase in the role played by private creditors, there is no explicit discussion of how far we must go in reducing our dependence on federal deposit insurance. Entirely eliminating federal deposit insurance--say, by the turn of the century--would lead to the greatest benefits for the economy as well as the banking industry. A desire to retain some minimal protection is understandable, however. Adjusting the original \$2,500 guarantees for inflation would lead to deposit insurance today of roughly \$27,500 per account, for example. The key to reducing our dependence on federal deposit insurance is eliminating the discretion of the FDIC to expand guarantees.

## **Conclusion**

Those who oppose changes in the federal deposit insurance system or the structural regulation of banks often raise fears about the inherent instability of banking and the externalities associated with bank failures in the absence of federal intervention. A closer look at historical

evidence indicates that such fears are significantly overblown. The inherent instability of U.S. banking (our periodic regional crises, for example) can be traced to government policies such as those limiting the ability of banks to expand geographically. Depositor runs resulting from a loss of confidence in banks were almost always triggered by legitimate questions about banks' ability to continue meeting their obligations. Depositor confidence was not something over which uninsured banks had no control. Decisions about capital, liquidity, accounting standards, and investments were much more important factors in the success or failure of a bank than was the plight of other banks.

Compare those conditions with the ones faced by banks today. Through an ever-expanding system of federal deposit insurance, the federal government has created externalities over which bank owners and managers have no control. Federal deposit insurance premiums continue to rise as remaining institutions are forced to pay for an increasing

number of failures. The decision to leave an insolvent bank open (an increasingly frequent occurrence) forces better managed institutions to compete with owners and managers who have nothing left to lose. If forbearance policies continue, the politically protected bad apples will begin to undermine the reputations of the more responsible members of the banking community. It was just such a sequence of events that all but destroyed the S&L industry while many thrift owners and managers watched helplessly.

As Edward Kane, a long-time student of the deposit insurance system, observed:

The threat of having to live through negative early effects makes postponing needed changes attractive to officials whose decision-making horizons are short, and who may be more than ordinarily sensitive to the embarrassment of having to admit making false starts and reversing them.<sup>(44)</sup>

Failing to address the problems that currently beset the banking industry will effectively assign banks to the scrap heap of history. Federal policies pursued during the S&L crisis--such as attempts to ignore developing weaknesses or to deal with them in a halfhearted manner--will condemn the U.S. economy to decades of third-rate performance. Taxpayers could easily face trillions of dollars of losses as just one legacy of policies that continue to prop up an inefficient financial structure.

As Kane indicated, the needed reforms will not be achieved without cost. Our financial services industry-- especially many depository institutions--has become addicted to the protection provided by virtually complete federal deposit insurance and a politicized closure mechanism. And just as a drug addict faces a painful withdrawal period when breaking the narcotic's hold, so painful adjustments will take place within the banking industry if substantial structural and deposit insurance reform is implemented. But U.S. financial firms, and the U.S. economy, would be stronger and more competitive for the effort.

In the long run, government agents cannot successfully protect one segment of the financial services industry from competition any more than Congress could have protected candlemakers or buggy whip manufacturers. Granting banks (as well as other financial institutions) the freedom to respond to changing conditions, as well as the incentives to do so, does not mean an end to institutions that look like or call themselves banks. It does mean that banks in business in the year 2000 will be there because they provide their customers with high-quality service and financial strength.

## Notes

(1) It is important to keep in mind that "bank failure" is a measure of industry health passed through a government filter. It is not so much a measure of insolvency as a measure of the number of banks that government regulators choose to recognize as insolvent. Between 1980 and 1988, for example, S&L failures averaged only 54 per year despite the fact that analysts both inside and outside the government recognized that several hundred institutions were insolvent.

(2) See, for example, Edward J. Kane, *The S&L Insurance Mess: How Did It Happen?* (Washington: Urban Institute, 1989), pp. 75-76. Another source of pre-1980 data is A. James Meigs and John C. Goodman, *Federal Deposit Insurance: The Case for Radical Reform* (Dallas: National Center for Policy Analysis, December 1990), p. 6. For an example of an early analysis of the problem, see Joe Stilwell, "The Savings and Loan Industry: Averting Collapse," *Cato Institute Policy Analysis* no. 7, February 15, 1982.

(3) Meigs and Goodman, p. 16. For a more in-depth discussion of the causes of the S&L crisis, see Catherine England, "A Market Approach to the Savings and Loan Crisis," in *An American Vision: Policies for the '90s*, ed. Edward H. Crane and David Boaz (Washington: Cato Institute, 1989), pp. 105- 28.

(4) Anna J. Schwartz, "Financial Stability and the Federal Safety Net," in *Restructuring Banking and Financial Services in America*, ed. William S. Haraf and Rose Marie Kushmeider (Washington: American Enterprise Institute, 1988), p. 39.

(5) *Ibid.*, p. 40.

(6) Meigs and Goodman, p. 15.

(7) It was the Bank of New England's concentration in regional real estate loans that led to its downfall.

(8) William S. Haraf and Rose Marie Kushmeider, "Redefining Financial Markets," in *Restructuring Banking and Financial Services in America*, pp. 2-3.

(9) Council of Economic Advisers, *Economic Report of the President* (Washington: Government Printing Office, 1989), p. 395.

(10) The greatest losses generated by the S&L debacle may never be fully recognized. Imagine what enterprises might have been funded and what new jobs might have been created with the money that instead was squandered by insolvent S&Ls looking for high short-term profits.

(11) Meigs and Goodman, p. 11.

(12) Some banks will still fail because of ill-considered new ventures. But the massive, industrywide losses experienced by thrifts would be avoided. The reasons are discussed more fully in conjunction with the third criterion.

(13) When Franklin Roosevelt took office as president in March 1931, he and his comptroller of the currency supported interstate branching as an alternative to introducing federal deposit insurance. For a description of how the unit banking structure was responsible in large part for the widespread bank failures in the 1920s and 1930s, see Bert Ely, "The Big Bust: The 1930-33 Banking Collapse--Its Causes, Its Lessons," in *The Financial Services Revolution: Policy Directions for the Future*, ed. Catherine England and Thomas F. Huertas (Boston: Kluwer Academic Publishers, 1988), pp. 41-67. Helen M. Burns, *The American Banking Community and New Deal Banking Reforms, 1933-1935* (Westport, Conn.: Greenwood Press, 1974) also provides an account of the political debates over the introduction of federal deposit insurance.

(14) "Moral hazard" is used to describe the behavior of an insured party who makes less effort to avoid the insured-against event once insurance is obtained. For example, motorists insured against theft may be less diligent than uninsured individuals about locking their car doors.

(15) During the 1930s it was also argued that investment banking activities caused commercial banks to fail. There was never any evidence to support that assertion. In fact a careful examination of the evidence indicates that failures were concentrated among smaller banks with no investment banking activities. See, for example, William F. Shughart II, "A Public Choice Perspective of the 1933 Banking Act," in *The Financial Services Revolution*, pp. 87-105, or Robert E. Litan, *What Should Banks Do?* (Washington: Brookings Institution, 1987).

(16) See Robert T. Clair, Paula K. Tucker, and Thomas F. Siems, "Interstate Branching: Time for the Next Step Forward," unpublished paper, Federal Reserve Bank of Dallas, 1990, p. 9.

(17) In a recent paper on the benefits of interstate branching, three economists from the Federal Reserve Bank of Dallas predicted that as interstate branch networks are developed, "higher prices for acquired banks could be expected." *Ibid.*, p. 7.

(18) Indeed, current policies supporting geographic and product restrictions were designed to limit competition, not promote it. Their repeal should lead to improved services for bank customers.

(19) Given current profit prospects, large numbers of existing banks will be unable to raise the additional capital necessary to meet the higher capital requirements now being phased in. Thus, if regulators are serious about enforcing the standards, some institutions will leave the industry.

(20) Clair, Tucker, and Siems (p. 9) note as a matter of interest that if the entire country comes to reflect California's bank-per-capita ratio, the number of U.S. banks will stabilize at around 3,900.

(21) See Catherine England and John Palffy, "An Optimistic Scenario for Small Banks," *Business Forum*, Summer 1983, pp. 25-27.

(22) Many countries with only a handful of banks--Canada and Germany, for example--have limited entry into their financial markets by imposing very restrictive conditions on obtaining new bank charters.

(23) That can occur through secured or unsecured loans from the government to the institution in question, or it can occur through changes in the way regulations are applied to a specific set of assets or institutions.

(24) The focus on short-term costs remains true even among S&Ls. On September 10, 1990, William Seidman, chairman of the FDIC and the Resolution Trust Corporation (charged with the cleanup of the thrift industry), testified before the Senate Banking Committee. He observed that a declining real estate market was threatening additional thrifts, and he suggested that it might be cheaper to let some of those institutions lacking adequate capital continue to operate, under government supervision of course, until the real estate market improved. Seidman went on to observe that "we need a new word for forbearance," since that practice has been so badly discredited. See Jerry Knight, "U.S. May Not Close Weak S&Ls: FDIC Chairman Says Allowing Thrifts to Stay Open Could Trim Costs," *Washington Post*, September 11, 1990, pp. C1, C2.

(25) There is obviously safety in numbers for depository institutions. One bank suffering from bad agricultural loans or overexposure in foreign markets will probably be closed. But when several banks have difficulties with such investments, we face what is labeled a farm credit crisis, a Third World debt crisis, or--as is now the case--a crisis in the real estate market. Such purported crises allow regulators to feel justified in bending their regulatory rules to accommodate the institutions involved. The Federal Home Loan Bank Board's early responses to the S&L crisis--lower capital requirements and the introduction of regulatory accounting procedures--reflected just such a justification.

(26) They probably drove up interest rates for the federal government as well. During the 1980s federally insured deposits offered an attractive alternative to Treasury securities.

(27) See Genie D. Short and Jeffery W. Gunther, *The Texas Thrift Situation: Implications for the Texas Financial Industry* (Dallas: Federal Reserve Bank of Dallas, September 1988), p. 7.

(28) U.S. Department of the Treasury, *Modernizing the Financial System: Recommendations for Safer, More Competitive Banks* (Washington: Department of the Treasury, February 1991), Table 1, following p. II-5.

(29) See George G. Kaufman, "The Truth about Bank Runs," in *The Financial Services Revolution*, p. 17.

(30) The traditional stereotype of hard-hearted conservative bankers quick to foreclose on those who failed to make scheduled loan payments was probably a well-earned testament to the constant efforts of bankers to protect their depositors' money. Are we really better off with the more modern stereotype of flashy, high-flying bankers and S&L managers?

(31) The usual definition of liquidity requires that the asset in question can be turned into cash without a substantial loss in value.

(32) J. Huston McCulloch, "The Ohio S&L Crisis in Retrospect: Implications for the Current Federal Deposit Insurance Crisis," in *Proceedings of a Conference on Bank Structure and Competition* (Chicago: Federal Reserve Bank of Chicago, 1987), p. 232.

(33) Lowell L. Bryan, *Breaking Up the Bank: Rethinking an Industry under Siege* (Homewood, Ill.: Dow Jones-Irwin, 1988).

(34) See Richard H. Timberlake, "The Central Banking Role of Clearinghouse Associations," *Journal of Money, Credit and Banking*, February 1984, pp. 1-15.

(35) Surviving banks no doubt viewed that apparent benevolence as good business strategy. Agreeing to accept the

deposits or notes of a failed bank at face value helped demonstrate the financial strength of remaining institutions and calm any market fears that might develop. It was also a way to attract new customers.

(36) See Bert Ely, testimony to the Committee on Banking, Housing and Urban Affairs of the United States Senate on deposit insurance reform, May 17, 1990.

(37) Kaufman, p. 16.

(38) American Bankers Association, "Federal Deposit Insurance: A Program for Reform," comment submitted to the Treasury Department, March 1990, p. 16.

(39) Recent reexaminations of banking history have provided evidence that the days before federal deposit insurance were not as chaotic as many people believe. Bank runs did occur, but for the most part they were the means used to close insolvent banks. When solvent institutions experienced unexpectedly high withdrawals, they were generally able to raise the necessary cash and survive the run, thereby proving their financial strength. See, for example, Kaufman or Arthur J. Rolnick and Warren E. Weber, "Inherent Instability in Banking: The Free Banking Experience," *Cato Journal* 5, no. 3 (Winter 1986): 877-90.

(40) Interstate automatic teller machine (ATM) networks already give individuals greater access to cash than many enjoyed just a decade ago. Conditions could be improved further, however.

(41) One example is the 7-Eleven store chain. Each 7-Eleven store has a local bank in which it deposits receipts. Every day, the parent company, Southland Corporation, withdraws the funds from the local banks and consolidates the money in the corporate account. Many of those thousands of daily transactions would be unnecessary if a branched network allowed more individual stores to deposit their receipts directly in the parent company's account.

(42) Nathan Rosenberg and L. E. Birdzell, Jr., *How the West Grew Rich* (New York: Basic Books, 1986), p. 27.

(43) Part of FIRREA attempted to respond to the poor investments of many institutions by forcing S&Ls back into specialized mortgage lending.

(44) Kane, p. 21.