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# STAFF MEMORANDA

## BANKING RISK IN HISTORICAL PERSPECTIVE

George G. Kaufman

# Banking Risk in Historical Perspective

George G. Kaufman\*

Banking is a risky business, always has been and presumably always will be. But is it inherently riskier than other types of businesses and do bank failures have more serious consequences for the local or national economy than the failure of other types of businesses? What can history tell us? This paper reviews banking history before the 1930s and draws lessons for public policy today.

The types of specific risks in banking (used in the generic sense to include all depository institutions) have not changed much through the years. They include:

1. Fraud (by far the most common, important, and costly),
2. Credit risk,
3. Interest rate risk,
4. Liquidity risk (“fire-sale” losses),
5. Foreign exchange risk,
6. Operations risk, and
7. Regulatory risk (interference with optimal product and/or pricing strategies).<sup>1</sup>

All but regulatory risk were important before the great expansion in bank regulation in 1933-35. Risks can drive the market value of an institution’s assets below that of its liabilities—many of which are payable at par on demand—so that it would be unable to repay all of its deposits in full and on time. In this way, banks differ from money market and other mutual funds, all of whose liabilities are capital and not repayable at par value. All of the risks are thus borne by the shareholders.

## Bank Failures Before the FDIC

To survive in a risky world, banking firms must cope with risk and manage it. How well did the banks do before the establishment of the FDIC in 1934 or even before the Federal Reserve in 1914? The answer is pretty well—indeed, amazingly well relative to most current inherited wisdom.

\*George G. Kaufman (Loyola University of Chicago and Federal Reserve Bank of Chicago). A speech given at the Conference on Bank Structure and Competition, Federal Reserve Bank Chicago, May 15, 1986.

From 1875 through 1919, the rate of commercial bank failures averaged slightly below that of nonfinancial firms, although the annual variance was greater. Even though there were about 10,000 commercial banks in 1895, 20,000 in 1905, and 30,000 (or twice as many as today) in 1920, in only one year were there more than 200 bank failures (491 in 1893) and in only nine years were there more than 100 failures (1893, 1895, 1896, 1897, 1904, 1908, 1913, 1914, and 1915).<sup>2</sup> Losses to depositors, all of whom were uninsured, were also small, averaging only about 0.20 percent of the banking industry's total deposits annually. (This estimate by the FDIC understates the losses somewhat because it does not use present value in valuing payments not received until after the due date of the deposits or deduct the secondary costs of not having full access to one's deposits. Nevertheless, it does provide a ballpark estimate.)

The Indianapolis Monetary Commission of 1898, one of a number of commissions of bankers, legislators, and the public to analyze banking conditions before the establishment of the Federal Reserve concluded that, "So far as experience goes, . . . it seems that the losses which . . . have been incurred under the national banking system. . . and which might be expected. . . have been insignificant."<sup>3</sup> An article in the February 1931 *American Bankers Association Journal* placed losses at failed national banks up to that time at ten cents on the dollar compared to ninety cents on the dollar at failed nonfinancial firms.<sup>4</sup> Even in crisis years, including 1929-1933, losses to depositors rarely exceeded one percent of total deposits at all banks annually. Supporting evidence on the relatively small cost of bank failures to the local community comes from an article in the October 1932 *Bankers Monthly*, which argued that from 1930 through mid-1932—near the highest level of bank failures—no trouble was reported in nearly seventy percent of all cities and towns in the United States. Moreover, only one city with a population of more than 26,000 that had a bank in 1927 did not have one in mid-1932 (Hammond, Indiana) and only seventeen cities with a population in excess of 10,000 saw its only banks disappear. For all cities and towns with populations over 1,000, only 420, or less than four percent, lost their only banks in this period.<sup>5</sup>

## Market Discipline Exerted

Why were bank failures relatively few in this period and depository losses relatively small? I believe that this reflected the combined effects of substantially greater market discipline and quicker bank failure resolution. Market discipline was greater because more parties—shareholders and all depositors—had more at stake. Each party acted to reduce its own risk of loss. Shareholders for national banks and some state banks faced not only the loss of the current value of their investments but also an additional amount up to the par value of the investments at time of issue. That is,

they were subject to double liability. This represented a form of ex-post settling up of losses. Thus, they exerted pressure on bank managers to incur low portfolio risk exposure. Depositors (and in an earlier period, holders of bank notes) exerted influence on bank management both to incur low portfolio risk and to maintain high capital ratios. Depositors correctly viewed capital as the best buffer they had against having to incur losses. The greater the amount of capital, the greater the losses the institution could withstand before it became insolvent and subjected depositors to loss. As a result, primary capital to asset ratios were extraordinarily high by today's standards. This ratio averaged 35 percent at all commercial banks in 1870, 30 percent in 1890, 20 percent in 1910, and 12 percent in 1920, not including provisions for double liability. Assessments were made on shareholders of failed banks, although they were not always collected in full.

A recent book by Lawrence White on banking in Scotland in the first half of the 1800s is of interest with respect to the importance of capital to banks and bank customers.<sup>6</sup> Bank shareholders were subject to unlimited personal liability. For example, when the Fife Bank failed in 1829, each holder of a 50 pound sterling share was assessed 5,500 pounds. In effect, the shareholders were general partners. This served to protect depositors and greatly diminished the incentive for bank runs. Bank failures and panics were infrequent and, when they did occur, losses to depositors were insignificant. In contrast, shareholders of English banks at the same time had limited liability and bank runs, failures, and panics were not uncommon. One contemporary observer was quoted as saying "a run upon a bank, as happens in England sometimes, or a panic, are terms the meaning of which is hardly understood in Scotland."<sup>7</sup>

There is also evidence that depositors and noteholders in the United States cared about the financial condition of their banks and carefully scrutinized bank balance sheets. Arthur Rolnick and his colleagues at the Federal Reserve Bank of Minneapolis have shown that this clearly happened before the Civil War.<sup>8</sup> Thomas Huertas and his colleagues at Citicorp have demonstrated the importance of bank capital to depositors by noting that Citibank prospered in periods of general financial distress by maintaining higher than average capital ratios and providing depositors with a relatively safe haven.<sup>9</sup> Lastly, an analysis of balance sheets suggest that banks took less interest rate risk exposure before the establishment of the FDIC. Although many short-term loans were more or less automatically rolled over at maturity, they were repriced at the new market interest rate, making them equivalent to floating rate loans.<sup>10</sup>

## Quicker Failure Resolution

Before the 1930s, banks were also declared legally insolvent and "closed" much more quickly than since. This appears to have occurred because financial markets were not as efficient then as they are today, so that liquidity was more costly. Many economically solvent banks experiencing deposit runs could not sell sufficient assets quickly at near their equilibrium market value nor borrow sufficient funds quickly at near equilibrium market rates to accommodate the deposit outflow, particularly in the absence of a FDIC guarantee. Bank liquidity was a binding constraint on continued operations. As a result, banks frequently closed themselves voluntarily during a liquidity crisis when they ran out of notes or could not make full payments to the clearing house at day-end. While operations were suspended, bank examiners would make a determination whether capital was sufficient or insufficient to reopen the bank. If capital was insufficient at national banks, they were given three months to raise sufficient capital by assessing shareholders. These practices limited the ability of banks to continue to operate with zero or negative capital and continue to accrue losses on depositors. Today, in contrast, aided by technological advances in financial markets and federal deposit insurance guarantees, banks can raise considerable amounts of funds quickly and liquidity is not a binding constraint on continued operations.

## Consequences of Bank Runs

Runs on banks occur when large numbers of depositors, particularly holders of demand deposits, lose faith in a bank's ability to meet its obligations in full and on time and simultaneously act to withdraw their funds. To accommodate the outflow, the bank must: 1) borrow the shortfall, 2) sell liquid assets, or 3) do both. Before the 1930s, it was common for a large bank facing a run to receive voluntary assistance from other banks in its community. Such assistance was only forthcoming if the troubled bank was believed by the other banks to be solvent. Often the lead in such a mutual support program was played by the local clearing house. Healthy banks had strong incentives to aid only solvent institutions. If they were wrong, their own depositors would respond by withdrawing funds. This fear of runs exerted a powerful market discipline on bank management. (An analogous recent example was the arrangement by a number of major money center banks under the leadership of the Morgan Guaranty Bank to recycle funds to the Continental Illinois Bank before the final rescue package was put in place by the FDIC.)

A run on a particular bank seldom spilled over to banks not subject to the same underlying problems. In most runs, the funds from the bank under

siege were redeposited in other banks that were perceived by depositors to be safer. Finding such banks did not appear to be difficult for most depositors in a large, heterogeneous country with basically unit banking. Even if there was a "flight-to-quality" and the funds were initially used to purchase safer securities, e.g., U.S. Treasury securities, it was likely that the seller of the securities would redeposit the funds in a bank. Otherwise, why would he or she sell the securities in the first place? In addition, most business firms and larger households could not conduct their operations efficiently using currency. Thus, these runs primarily represented a game of musical banks with an unchanged amount of deposits in the system as a whole. There was little, if any, damage either to the economy of the market areas served by the banks or to the national economy. Most runs were of this type.

This is not to argue that flight-to-quality runs do not have any adverse effects. They do. The flight from private, including bank, securities to government securities could increase interest yields on the former securities relative to yields on the latter. This is likely to discourage private investment relative to public investment. Moreover, the runs, particularly if they involve large banks, will increase uncertainty and fears of crisis, further dampening private investment and income. But these effects are of a far less serious order of magnitude than the harm generally associated with runs leading to cumulative nationwide bank failures.

However, if depositors lost faith in all banks, then they would not redeposit the withdrawn funds but would hold them in the form of currency outside the banks. That is, there would be a run on the banking system rather than on individual banks. In the absence of a replenishing of reserves by the central bank, reserves available to the banking system would decline, and the economy would then experience the classic multiple contraction of bank deposits and credit that is described in all money and banking textbooks. This, in turn, would result both in a decline in aggregate income and in an increase in bank insolvencies from increased hurried fire-sale losses as almost everyone becomes a hurried seller of assets. It also would trigger the much feared self-perpetuating rounds of bank failures that carry away with them innocent as well as guilty institutions. In the process, there is mutual reinforcing interaction between economic forces and bank failures.

But runs on the system have been infrequent. If, as argued above, a currency drain is a prerequisite for nationwide contagion, then the potential for a run on the system is evidenced by an increase in currency held by the public outside of banks relative to total bank deposits or stock of money concurrent with a decline in the stock of money. On an annual basis, these conditions existed in only four periods from the Civil War to the

present—1878, 1893, 1908, and 1929-33—and in only 1893 and 1929-33 did cumulative bank failures appear likely.

This statistical conclusion is reinforced by a search of the banking literature, which contains few references to cumulative bank failures before 1932.<sup>11</sup> (In contrast, British literature, e.g., Ricardo, Thornton and Bagehot, contains numerous references to national contagion. This may be attributed to England being a smaller, more homogeneous country with fewer and relatively larger banks. In such an environment, depositors are more likely to view more seriously the probability of systematic risk affecting all banking and less likely to locate perceived safer banks.) A 1929 American Bankers Association study reported that although 30 percent of individual bank closings were followed within ten days by the failure of close-by banks, after adjusting for one day only suspensions and members of chain banks, the percentage declined by almost one-half. The study concluded that the importance of runs had been greatly exaggerated and that loss of public confidence of itself cannot be advanced as a leading cause of the majority of bank failures. Furthermore, a solvent bank which has been forced by a run to close its doors should liquidate sufficient of its assets to pay its liabilities substantially in full.<sup>12</sup>

## Changes in Risk Exposure Since the 1930s

A number of forces have increased the potential risk exposure of individual institutions.

1. Advances in telecommunication and computer technology have permitted faster and cheaper transfer of funds across greater distances and have enlarged the potential market areas of individual institutions. Institutions can now expand deposits multifold almost overnight by tapping the national and world markets. This both increases the cost and reduces the ability of bank managers, shareholders, depositors, and regulatory agencies to closely monitor operations and makes it easier for institutions that are so inclined to place big bets quickly and to engage in fraud.

2. The introduction of federal deposit insurance with flat premiums and de facto almost 100 percent coverage has had both good and bad news. The good news is that, because the insurance has effectively eliminated the possibility of small depositors withdrawing currency from the banking system, it has immunized the system as a whole from individual bank failures. The bad news is that it has helped to increase the risk exposure of individual institutions, and thereby their failure rate, in a number of ways:

- a. Insurance has reduced the number of players and dollar amounts at risk and therefore the strength of market discipline. Insurance, per se, of any

type—fire, accident, theft, etc.—makes the insured party unintentionally a little less careful by reducing the pain of potential losses. If we have theft insurance, we are less likely to return to our home or automobile to double check whether we had actually locked it. The same is true with deposit insurance. Bank managers are aware of less shareholder and depositor monitoring through “looking-over-the-shoulders” and become, again unintentionally, a little less cautious in their portfolio risk exposure.

b. By having depositors look to the FDIC for their protection, deposit insurance has reduced the demand for bank capital. As noted earlier, banks maintained much higher capital to asset ratios before FDIC.

c. Flat rate deposit insurance premiums increase the expected profitability to institutions of placing riskier bets as the expected return from such strategies increases but the interest cost of deposits does not rise proportionately, particularly for smaller banks and thrift institutions which are de jure fully insured.<sup>13</sup>

d. The ability to attract de jure or de facto insured funds in relatively large amounts quickly makes liquidity more readily available to troubled institutions and reduces the likelihood of a quick resolution of failures by regulatory agencies. Institutions with zero or even negative economic net worth are more likely to continue in operation, to continue to generate losses, and, with little to lose and everything to gain, likely to go for broke by throwing long “Hail Mary” passes. As the odds of these passes being completed are very small, the institutions’ losses are likely to expand.

3. The reduced emphasis by regulatory agencies on market value accounting, particularly for thrift institutions, has reduced the value of information to the institution itself, shareholders, depositors, and the regulatory agencies. This has made both internal and external monitoring more difficult and has often hidden the degree of risk exposure actually assumed by the bank. Management information systems effectively become management misinformation systems. Moreover, these procedures do not recognize losses on time or in full and permit institutions with negative market value but not negative book value net worth to continue in operation. The decrease in emphasis on market value accounting has occurred primarily during crises when regulators and legislators did not wish to acknowledge the large number of problem and failed institutions. In 1938, the three major commercial bank regulatory agencies agreed to value loans and securities “in the light of inherent soundness rather than on the basis of day to day market fluctuations” in the early 1980s, the Federal Home Loan Bank Board introduced regulatory accounting principles (RAP) to supercede the generally accepted accounting principles (GAAP) to increase thrift institution recorded capital; and, in the mid-1980s, the bank regulators

preferred to delay recognition of the depressed value of agricultural loans at agricultural banks.<sup>14</sup>

4. Increased regulation introduced after the Great Depression has restricted the ability of depository institutions to adopt optimal pricing and product diversification strategies. Examples of regulations and legislative acts with, at least, some such unintentional side-effects include Regulation Q, Community Reinvestment Act, Bank Holding Company Act, McFadden Act and Glass-Steagall Act (1933).

## Public Policy Lessons for Today

1. Individual bank runs and failures are not necessarily contagious to innocent banks and are even less likely today with credible federal deposit insurance that eliminates the incentive for small depositors to withdraw currency from the banking system. Because larger depositors are unable to conduct their operations with currency, a run on the banking system as a whole is now effectively impossible. As a result, public policy can permit individual bank runs and failures, even for large banks, without fear of widespread contagion.<sup>15</sup> Indeed, the fear of individual bank runs represents an important and effective form of market discipline and such runs should not be discouraged unless they threaten to ignite runs on innocent banks.

2. Runs on individual banks are not likely to result in the failure of economically solvent, but temporarily illiquid, banks. For larger solvent banks experiencing runs, support is likely to be provided by other large banks. Also, the Federal Reserve recognizes its role of lender of last resort for all institutions and the banking system as a whole better than it did before the Great Depression.

3. Recognition of individual bank failures by declaring economically insolvent banks legally insolvent does not appear to be costlier to the community or nation than the failure of nonfinancial firms of comparable size and importance. Similar to failed grocery stores and other nonbank firms, failed banks generally do not disappear as physical entities. Rather, they tend to be recapitalized, sold, or merged. This is true for most of early U.S. history and also, according to the FDIC, for more recent history. At least 40 of the first 50 small agricultural banks that failed in 1985 were reopened under new management. When a regulatory agency "closes" a bank, it closes bank managers/owners, not bank tellers or activities. The major purpose of a declaration of bankruptcy for nonbank firms is to keep insolvent firms operating and to protect them from their creditors until a more permanent solution can be worked out. In nonregulated industries, where demand continues to exist, entry quickly occurs to replace a failed firm. Today, even more than before, bank products and services are rela-

tively homogeneous and can be provided by a variety of financial institutions. Moreover, entry into these lines of activity is relatively easy and low cost. Surveys show that most customers now use more than one financial institution, so that a management change in or even loss of one familiar institution should not be excessively costly. As discussed earlier, however, particularly larger bank failures can impose social costs by creating uncertainty and fear and raising interest rates on private securities.

Nevertheless, the cost to the economy of legally closing an economically insolvent institution appears to be far less than the cost of maintaining such institutions in operation and unintentionally signaling to the managers and owners of other banks that insolvent institutions will be permitted to continue to operate and that they need not curtail their risk exposure. The cost of such nonaction by regulators is clearly evident in the experiences of the thrift institutions in recent years. Dan Brumbaugh and his colleagues at the Federal Home Loan Bank Board have reported that in 1984, when negative interest rate spreads were still a major problem at thrifts and the market value of net worth of the industry as a whole was below zero, savings and loan associations expanded their deposits by 20 percent.<sup>16</sup> In contrast, deposits at commercial banks, which on average were in far better financial condition, expanded only half as fast. Construction lending, which is viewed as riskier than traditional residential mortgage lending, accounted for six percent of the assets at all SLAs, but for fully 25 percent of the assets at those SLAs that had doubled in deposit size between 1983 and 1984. Likewise, risky acquisition and development loans totaled only 2 percent of industry assets, but 13 percent of the assets of the rapidly growing institutions. They also showed that reductions in the market value net worth of individual thrift institutions were good predictors of future further reductions and that the greater was the spread of GAAP or RAP capital above the market value of capital, the more likely was the institution to engage in risky types of activities. The costs to FSLIC, and thereby also the taxpayer, of making good on the difference between the market value of SLA bad assets and the value of insured deposits, which is basically all deposits in the industry, is currently estimated in excess of \$20 billion.

Commercial banks are no less likely to respond in the same way to these incentives as these SLA managers/owners. A recent *Wall Street Journal* headline read "Hello, We're an Insolvent Bank; How Big a Loan Would You Like?"<sup>17</sup> The FDIC recently reported that, at year end 1985, 29 percent of the banks required to file monthly reports on brokered deposits—those with fully insured brokered deposits in excess of either the bank's capital or 5 percent of its total deposits—had received the lowest supervisory ratings of 4 or 5, which is indicative of a problem bank. These 29 percent held 31 percent of total reported brokered funds. In contrast, only 8 percent of all commercial banks holding only 7 percent of all bank

deposits were rated 4 or 5.<sup>18</sup> Although not risky per se, insured brokered deposits permit a bank to grow rapidly from outside its usual market area and to place big bets quickly if it were so inclined.

Capital forbearance is currently being introduced for troubled agricultural and energy banks. Although the program is considerably more restrictive than its counterpart for thrift institutions, the plan is not necessary and potentially dangerous as it could lead to greater risk taking by the banks on their smaller capital base and to eventual greater government regulation. It would be a better idea to have the banks raise additional capital, if the owners wished to keep them, or to sell out to new owners. This process worked reasonably well before the 1930s, and there is no reason that it should not work equally well now. This may take some time, but probably more in the neighborhood of seven weeks than seven years as permitted in the program. Long-term capital forbearance is really bad bank management/owner forbearance; not bank depositor/loan customer forbearance.

Fast footwork or cash accounting is also no cure for bank solvency problems and, at best, may postpone the adverse effects of the problems until the next regulator or administrator. Cash accounting schemes, whether spelled GAAP or RAP could just as well be spelled PONZI, after Charles Ponzi, who may be said to have effectively simulated the operation of a high-risk federally insured thrift institution before FSLIC.<sup>19</sup> Only he who owns the printing presses, such as the U.S. government, can run on a cash accounting basis indefinitely.

Some proponents of capital forbearance plans have supported their argument with an analogy to a water fire extinguisher. One keeps such an extinguisher fully filled for emergencies, wishes that one does not have to use it, and finds it useful until all the water is used up. Right analogy, but wrong conclusion! If one had the desired amount of water in the extinguisher to begin with and a fire caused one to use some but not all of the water, it is likely that one would replenish the spent amount in preparation for the next fire. Maybe not the same hour or even the same day, but certainly before seven years.

Regulatory agencies need to close institutions promptly when the market value of net worth falls to zero. If the free market system is permitted to work, good banks will drive out bad banks, not the reverse of bad banks driving out good banks. The latter, or Gresham's Law applied to banking, may already be at work in the thrift industry, where some bad (failing or failed) institutions are paying more than 200 basis points above average for insured deposits. Through competitive pressures, these high rates are forcing up the rates paid by good (healthy) institutions, endangering their solvency.

There is a popular statement that depositors need to have faith in their banks. Nothing can be further from the truth! In religion, faith is important; but not in banking. There, good assets are important. I would not trust a banker who asks me to have faith in him. Banks do not have funding problems; they have asset quality problems. Before the Federal Reserve, clearing houses frequently provided additional financial information about their banks (generally as a group, not individually) at times of crises and runs. They realized that faith is easier to obtain if the facts warranted it.

Lastly, it would help to transfer the authority to declare institutions legally insolvent from the chartering agency, which has little to gain by doing so and much to lose through a blot on its record and adverse publicity, to the insurance agency, which takes the loss and realizes that the size of the loss will likely be larger the longer it waits to resolve the failure. (That this proposal is not a cure-all is evidenced by the fact that the power to close federally insured SLAs rests with FSLIC.)

4. Capital plays a major role in bank safety. The greater is bank capital, the more losses can any individual institution sustain before net worth falls to zero and losses accrue to depositors. The evidence suggests that bank capital ratios are lower now than they would be in the absence of either the Federal Reserve or the FDIC. Just as uninsured depositors insisted on high ratios of capital before the FDIC as safety margins, the FDIC should now insist on the same for its own safety.

It is worthwhile to clarify two common misunderstandings about capital: one, that there is a shortage of capital and two, that it is expensive. The capital shortage argument applies to physical capital or tangible goods, the enlargement of which generally requires a cutback in the output of consumption goods and takes time, not to financial capital. Financial capital is only a piece of paper that says "equity" on it rather than "debt" or "deposit." Moreover, any funds raised by the sale of new capital is not lost from the financial system, but is recycled into it just as funds raised through deposits. Money and other mutual funds, which are fully funded by capital, have not reported experiencing any shortage.

The "capital is expensive" argument is only partially true. It does not consider the overall cost of all funds to the bank. In a world of no taxes in which all deposits were uninsured, an increase in capital by an institution with its higher cost would, *ceteris paribus*, displace an equal amount of deposits or debt and, by reducing the institution's risk, reduce its interest cost proportionately. This is quite clear for nonfinancial firms that reduce their debt-to-equity ratios. Finance theory tells us that in such a world a change in a firm's capital structure by itself cannot cause a lasting change

in its value, one way or the other. But we do not live in such a world. Federal deposit insurance exists and appears to be underpriced for most banks, and taxes exist. Thus, displacement of deposits by capital can increase the total cost of funds to an institution both because it loses any insurance subsidy embedded in the cost of deposits, particularly for smaller, more fully insured institutions, and because it loses the ability to deduct interest from taxable income. Dividends are not tax deductible. However, the former cost may be alleviated by introducing risk sensitive insurance premiums and the latter cost by permitting subordinated debt on which interest is tax deductible.

5. Some regulations intended to promote one objective, say, greater safety and soundness, may be partially or totally counterproductive and unintentionally interfere with achieving the objective. As noted earlier, this appears to have been the case for Regulation Q and to a lesser extent for the Bank Holding Company Act, Community Reinvestment Act and Glass-Steagall (1933). All implications, long-run as well as short-run, should be analyzed before attempting to cure a perceived illness with a regulation. As Henry Sidgwick observed in his principles of economics textbook 100 years ago:

It does not follow that whenever *laissez faire* falls short, government intervention is expedient; since the inevitable drawbacks of the latter may, in any particular case, be worse.<sup>20</sup>

## Conclusion

George Santayana said that "those who cannot remember the past are condemned to repeat it." Although frequently quoted, this is really a rather uninteresting statement, particularly to audiences that sit through historical presentations. To me, the more interesting question is "what do those who remember the past do?" My observation is that all too frequently they end up doing the same as those who do not remember, but are likely to agonize over it first. That is, Kaufman's generalization of Santayana's statement is that "those who cannot remember the past are condemned to repeat it and those who can remember are not only condemned to repeat it but to agonize over their decision first."

Why do public policy makers, such as congress and financial regulators, pursue policies that both history and theory suggest are suboptimal and often counterproductive? After all, they are not stupid; not unaware of history; and not tools of the industry, consumers, or labor. I believe it is because of the asymmetrical incentive structure that confronts most politicians and bureaucrats. If everything goes well, there are no major

rewards—there is no profit-sharing in government. But if a major breakdown occurs during their term, all hell breaks loose and the costs to the public policy makers are high. Thus, there is a natural tendency, if possible, to push potentially painful solutions to the future and hopefully to the next administration. In banking, this strategy is generally possible. Public policy makers can hide their heads in the sand to avoid giving official recognition to the unfavorable events, use their arms both to build up the mound and to do an appropriate amount of waving to provide a perception of action, and hope that things will somehow work out for the best before the problem becomes too large not to recognize. As evidence, one needs only to read the recent *mea culpa* statements of former regulators Dick Pratt, Brent Beesley, Peter Stearns, Bill Isaac, and so on.<sup>21</sup> A bank analyst quoted in the *Wall Street Journal* hit the nail on the head when he said we are all Neville Chamberlains buying peace in our time.<sup>22</sup>

Why then do we meet here today and why do I spend time on this talk? Is there hope for change? I strongly believe that there is. Through education, one can slowly change the perception of the cost/benefit payoff of alternative strategies.<sup>23</sup> Deregulation has occurred in other industries, even in industries in which safety is a major concern, such as airlines. And whose safety can be of greater concern than that of human beings? Despite much doubt before deregulation, the accident rate in both airlines and trucking have tended to decline after deregulation.<sup>24</sup> I also hope to increase belief in the effectiveness of market discipline in banking if it is permitted to operate without constraints. But in order to have market discipline, it is first necessary to have political discipline. Regulators need to spend less time agonizing and more time implementing some of the proposals laid out in the preceding section. Theory and evidence which indicate that these proposals, which may appear to some to be dangerous and unpopular, will not be so in the long run and that they will set the stage for a more effective regulatory system.

To assist public policy makers in being willing to accept greater political discipline, let me close by plugging the newly organized Shadow Financial Regulatory Committee. The purpose of this committee is to provide independent and expert analyses of both short- and long-run implications of forces affecting the financial services industry, including regulatory and legislative policy initiatives. The only common philosophical ground of the members is a preference for free market solutions whenever possible and consistent with bank safety and soundness. The current members include a mix of nonacademics with financial institutions and regulatory backgrounds—Larry Connell, former head of the National Credit Union Administration; Jerry Hawke, former general counsel for the Board; Roger Mehle, former Assistant Secretary of the Treasury; and Richard Aspinwall of Chase Manhattan—and academics specializing in financial institutions and markets—George Benston (Rochester), Franklin Edwards (Columbia),

Robert Eisenbeis (North Carolina), Paul Horvitz (Houston), Edward Kane (Ohio State), Allan Meltzer (Carnegie-Mellon), Kenneth Scott (Stanford and former general counsel for the Federal Home Loan Bank Board), and myself.

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<sup>1</sup> These risks are analyzed more completely in George J. Vojta, *Bank Capital Adequacy* (New York: First National City Bank, 1973), and George J. Benston and George G. Kaufman, "Risks and Failures in Banking: Overview, History, and Evaluation," in George G. Kaufman and Roger C. Kormendi, eds., *Deregulation Financial Services: Public Policy in Flux* (Cambridge, MA.: Ballinger Press, 1986).

<sup>2</sup> A more detailed review of banking history in this period appears in Chapter 2 of George J. Benston, Robert A. Eisenbeis, Paul M. Horvitz, Edward J. Kane, and George G. Kaufman, *Perspectives on Safe and Sound Banking: Past, Present, and Future* (Cambridge, MA.: MIT Press, 1986).

<sup>3</sup> *Report of the Monetary Commission of the Indianapolis Convention* (Chicago: University of Chicago Press, 1898), p. 259.

<sup>4</sup> Joseph Stagg Lawrence, "What is the Average Recovery of Depositors?," *American Bankers Association Journal*, February 1931, pp. 655-56, 722-23.

<sup>5</sup> "No Banking Adjustment in 68% of All Cities and Towns," *The Bankers Monthly*, October 1932, pp. 585-588.

<sup>6</sup> Lawrence H. White, *Free Banking in Britain* (Cambridge, U.K.: Cambridge University Press, 1984).

<sup>7</sup> White, p. 143.

<sup>8</sup> Arthur J. Rolnick and Warren E. Weber, "Banking Instability and Regulation in the U.S. Free Banking Era," *Quarterly Review* (Federal Reserve Bank of Minneapolis), Summer 1985 and "The Causes of Free Bank Failures," *Journal of Monetary Economics*, October 1984.

<sup>9</sup> Harold van B. Cleveland and Thomas F. Huertas, *Citibank, 1812-1970* (Cambridge, MA.: Harvard University Press, 1985).

<sup>10</sup> Randall C. Merris and John Wood, "A Deregulated Rerun: Banking in the Eighties," *Economic Perspectives* (Federal Reserve Bank of Chicago), September/October 1985.

<sup>11</sup> Benston, et al., Chapter 2.

<sup>12</sup> Gilbert Thorndyke, "Fiction and Fact on Bank Runs," *American Bankers Association Journal*, June 1929, p. 1269.

<sup>13</sup> Benston et al., Chapters 3 and 9, and Edward J. Kane, *The Gathering Crisis in Deposit Insurance* (Cambridge, MA.: MIT Press, 1985).

<sup>14</sup> "Revision in Bank Examination Procedure and in the Investment Securities Regulation of the Comptroller of the Currency," *Federal Reserve Bulletin*, July 1938, pp. 563-66; James R. Barth, R. Dan Brumbaugh, Daniel Sauerhaft and George H. K. Wang, "Insolvency and Risk-Taking in the Thrift Industry," *Con-*

*temporary Policy Issues*, Fall 1985; and Federal Deposit Insurance Corporation, *Capital Forbearance*, BL-12-86, March 27, 1986.

<sup>15</sup> Benston et al., Chapter 4; and George G. Kaufman, "Implications of Large Bank Problems and Insolvencies for the Banking System and Economic Policy," *Staff Memoranda 85-3* (Federal Reserve Bank of Chicago, 1985).

<sup>16</sup> James R. Barth, Donald J. Bisenius, R. Dan Brumbaugh, Jr., and Daniel Sauerhaft, "The Evolving Role of Regulation in the Thrift Industry," (Working Paper, Federal Home Loan Bank Board, March 1986) and R. Dan Brumbaugh, Jr., "Empirical Evaluation of the Determinants of Losses for the Federal Savings and Loan Insurance Corporation," 1982-1984 (Working Paper, Federal Home Loan Bank Board, February 1986).

<sup>17</sup> *Wall Street Journal*, March 13, 1986, p. 33.

<sup>18</sup> Panos Konstas, "Brokered Deposits," *Banking and Economic Review* (Federal Deposit Insurance Corporation), May 1986, pp. 4-5.

<sup>19</sup> In 1919, Ponzi promised to double investors' funds within 90 days. By applying the old borrow-from-Peter-to-pay-Paul strategy efficiently and operating in both Boston and New York, he quickly attracted large enough amounts of funds to earn very healthy "management fees" and even be able to reduce the time promised investors to 45 days. When his operating strategy was publicized in the *Boston Globe* in 1920, a run developed by faint-of-heart investors, who requested their funds back immediately. Being unable to do so in full, the operation collapsed. In its approximately one year of business some \$20 million was received. Although the first investors did double their investment, the later investors suffered losses of about \$5 million. In honor of Ponzi, I have composed the following limerick:

There once was a man named Ponzi  
Who swore he could double your monzi  
Flo sent him her dough  
He gave it to Joe  
And now Flo's funds are gonzi.

<sup>20</sup> Henry Sidgwick, *Principles of Political Economy* (London: Macmillan Publishing Co., 1887), p. 414.

<sup>21</sup> Mike Carroll, "Ex-FSLIC Chief Peter Stearns Recalls Sojourn of Disillusion," *American Banker*, December 12, 1985, pp. 1, 18, 29, and *Deposit Insurance Reform and Related Supervisory Issues*, Hearings Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 99th Cong., 1st Sess., July and September, 1985.

<sup>22</sup> Jeff Bailey, "Deferred Loan Losses at Thrifts and Banks Snowball Across U.S.," *Wall Street Journal*, January 8, 1986, p. 1.

<sup>23</sup> Milton Friedman, "Economists and Economic Policy," *Economic Inquiry*, January 1986, pp. 1-10; Milton Friedman, "Monetary Policy: Theory and Practice," *Journal of Money, Credit and Banking*, February 1982, pp. 98-118; and George G. Kaufman, "Monetarism at the Fed," *Journal of Contemporary Studies*, Winter 1983, pp. 27-36.

<sup>24</sup> Council of Economic Advisors, *Economic Report of the President and Annual Report* (Washington, D.C.: GPO, 1986), pp. 159-163.