Federal Reserve Bank of Cleveland Annual Report

1990

SINCE ALL INDUSTRIES EXIST IN A CONSTANTLY CHANGING ENVIRONMENT, "PROTECTION" CREATES VULNERABILITY AND INCREASES THE COSTS OF BANK FAILURES.

CHARLES W. PARRY

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The President's Foreword

Comprehensive banking reform is urgently needed. The rising costs of the federal safety net for financial institutions, the real resource losses that these costs represent, and the weakened competitive position of banks underscore the importance of legislative and regulatory action.

Reform must deal with many complex and interrelated issues. One is the size, scope, and operation of the federal safety net itself. Another set of issues involves the powers of banks, the products they are able to produce and sell, and the location of their facilities. Finally, the proper role and structure of the regulations governing the business of banking must be reexamined.

Regulatory policies and the safety net have been shaped by a belief that banking is "special," and that the economy is especially vulnerable to failures, banking panics, and other malfunctions in banking markets. The result has been a gradual but misguided replacement of market forces and functions by government regulations and subsidies.

As argued in this year's annual report essay, treating banks as separate, unique firms is unnecessary. Finance companies, insurance companies, and brokerage houses provide many of the same services as banks. Policies that separate banking from other businesses leave our banking system hobbled and unable to compete with financial firms, while increasing the taxpayers' exposure to large costs — both in efficiency and in outright losses from deposit insurance and payments system guarantees.

Furthermore, many of our notions about bank failures and systemic risk are based on a distortion of history. A closer look at the forces that led to the Great Depression and other, earlier panics seems to indicate that poor monetary policy decisions and a lack of timely, reliable information caused the crises, not an inherent weakness of banks.

Recent problems in banking seem to be rooted in the increasing assumption of financial risk by government and in the gradual but pervasive transfer of that risk away from private-sector decision makers. While the problem of government assumption of risk is not unique to banking, it is particularly serious in banking.

The solution seems clear: banks' special protection — the safety net — must be reduced. Financial reform should rely on the incentives and corrective processes of the marketplace. Regulations must be gradually eliminated so that banks are subject to the same market forces as are unregulated, unprotected financial firms. The result will be a more efficient, competitive, and stable financial system that will not

need to rely on taxpayer subsidies to compete, or even survive, in the financial marketplace.

The Fourth District is guided in performing its central bank functions and providing services to financial institutions by our 23 directors, to whom we extend our deepest appreciation. Our directors represent a variety of banking, business, agricultural, consumer, and labor interests from throughout the District. Their valuable and dedicated service and guidance, as well as that of the members of our Small Bank and Small Business Advisory Councils, are very much appreciated.

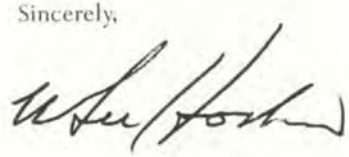
We are especially grateful for the leadership of Charles W. Parry, retired chairman and chief executive officer of Aluminum Company of America, who retired from our board of directors after having served as chairman and Federal Reserve agent since 1987. John R. Miller, former president and chief operating officer of Standard Oil Company of Ohio, who has served on our Board since 1986 and has served as deputy chairman since 1987, has been appointed chairman of our board.

Special thanks are extended to those directors who have completed their terms of service on our boards: William H. May (chairman and president of First National Bank of Nelsonville) and Robert D. Storey (partner, McDonald, Hopkins, Burke & Haber Co., L.P.A.), who served on our Cleveland board; Jerry L. Kirby (chairman, president, and chief executive officer of Citizens Federal Savings & Loan Association), who served on our Cincinnati Branch board; and Stephen C. Hansen (president and chief executive officer of Dollar Bank, FSB) and Milton A. Washington (president and chief executive officer of Allegheny Housing Rehabilitation Corporation), who served on our Pittsburgh Branch board.

The insight and dedication of our member of the Federal Advisory Council, Thomas H. O'Brien (chairman, president, and chief executive officer of PNC Financial Corp), will also be missed. Thomas O'Brien has represented the Fourth District on the Advisory Council since 1988 and served as president of the Council in 1990. Our directors have chosen John B. McCoy (chairman, president, and chief executive officer of Banc One Corporation) to represent the Fourth District during 1991.

Finally, I wish to extend my personal gratitude to the officers and staff of the Bank, whose energy, creativity, and commitment made 1990 a successful year.

Sincerely,



W. Lee Hoskins
President
April 11, 1991

The Banking Industry: Withering Under the Umbrella of Protection

The existing structure of the U.S. banking system has been formed as much by regulation as by market forces. The broad regulatory structure implemented following the financial chaos of the Great Depression was shaped by the belief that the banking business is "unique" or "special," distinct from other financial industries. Yet today, finance companies, insurance companies, brokerage firms and,

more broadly, capital markets provide many of the same services as banks.

The conflict between regulation and market forces has reduced the efficiency, stability, and competitiveness of the U.S. financial system. There is a widespread belief that the restoration of competitiveness will require an expansion of powers for banks and a reduction of regulation. There is also concern about systemic financial instability and possible costs to the taxpayer, as in the recent thrift industry crisis.

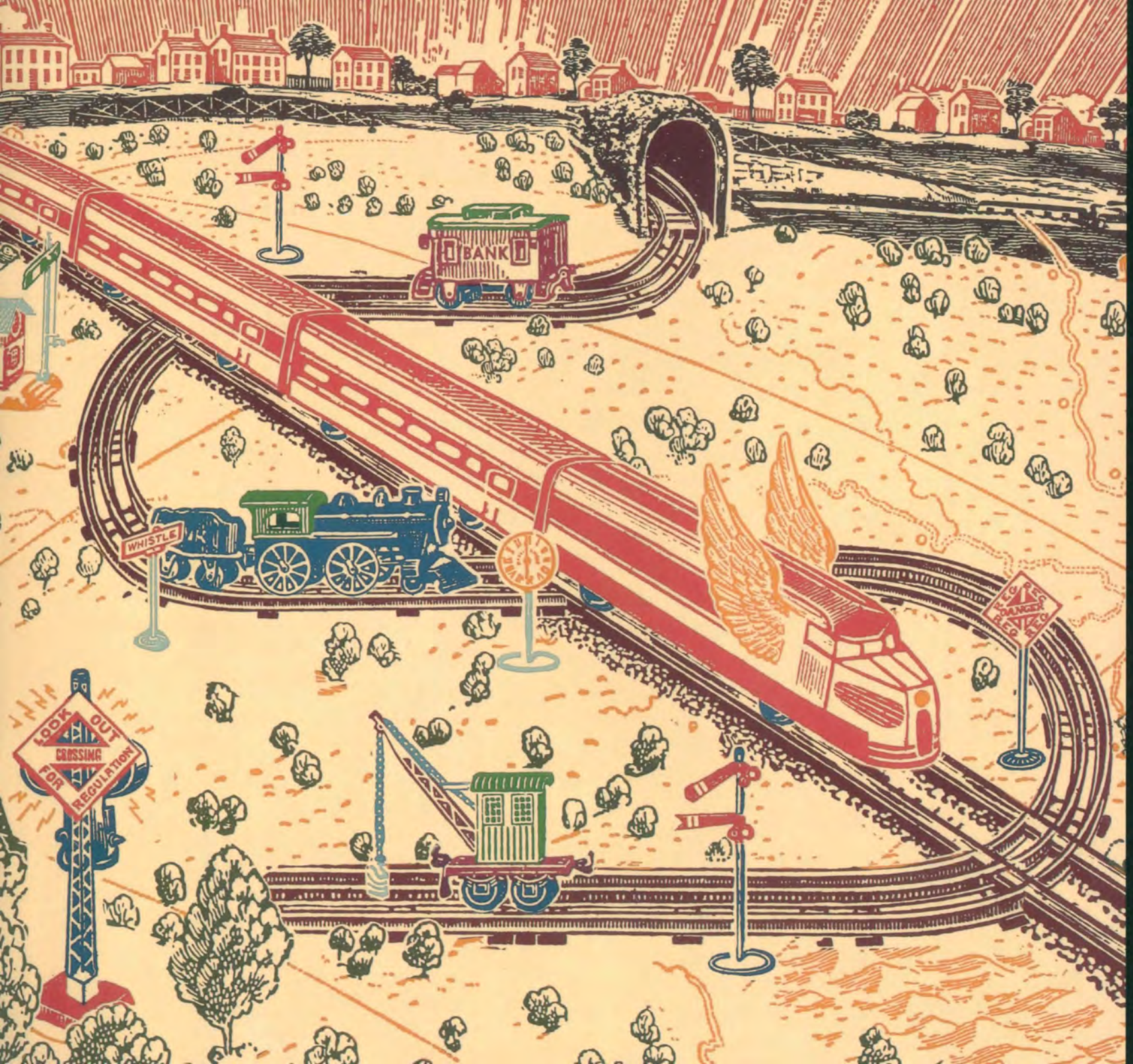
The importance of these issues is widely recognized. Proposals to reform banking have already been advanced, and more are sure to follow. Comprehensive reform must address a number of difficult issues. Among them will be bank powers, the ownership of banks by nonbanking firms, the proper role and organizational structure of banking regulation, and the appropriate size and scope of the federal safety net for banks — deposit insurance, access to the Federal Reserve discount window, and payments system guarantees.

Recent financial problems in the banking and thrift industries, which are often cited as a rationale for continued regulation or more regulation, can just as easily be regarded as the results of a process of regulation since the 1930s. Banking regulation has become self-justifying: regulations themselves impose costs and create problems that additional regulations endeavor to correct.

Banks have lost market share to unregulated providers of financial services. The combination of regulation and the federal safety net has encouraged banks to take more risks. The costs of bearing those risks have been transferred to the taxpayer. The result has been losses to taxpayers and real resource losses for the economy as savings are diverted to less productive uses.

As financial markets continue to evade restrictions, regulatory policies and practices will continue to become less effective, and the subsidized federal safety net for banks will become even more costly. In short, the time for financial reform to replace government intrusion with competitive market forces is at hand.

In this essay, we examine the delivery of banking services and observe that other types of firms are delivering those same services. There is nothing inherent in banking services to justify separating that business from other financial services. Banks' uniqueness must stem from other factors, such as the risk of disrupting other parts of the economy. We conclude that these systemic risks can be handled more effectively with market mechanisms. If banks are not treated as special financial services firms and are allowed to compete with the unregulated providers of financial services,



THE CONFLICT BETWEEN REGULATION AND MARKET FORCES HAS REDUCED THE EFFICIENCY, STABILITY, AND COMPETITIVENESS OF THE U.S. FINANCIAL SYSTEM.

the health of the banking industry will be maintained.

What Do Banks Do?

Banks perform three primary functions: they intermediate between savers and borrowers, they process information regarding creditworthiness, and they play a prominent role in the nation's payments system.

As intermediaries, banks connect borrowers with lenders, providing the public with liquid deposits while the funds are placed largely with borrowers in the form of mostly illiquid loans. Such deposits are an important medium of exchange, and such loans are an important source of credit in the economy.

In the course of providing loans, banks acquire information about firms — much of it confidential. This information can lead to superior credit analysis and also gives banks an advantage in monitoring, writing, and enforcing complicated covenants. As a result, when firms announce that they have received a bank loan, it is taken as good news and their stock prices rise — in contrast to firms' announcements of new equity or bond issues.

Banks also acquire information about the public's savings and transactions needs, and market various products and services to meet these needs. These information-gathering activities, in turn, provide part of the basis of banks' comparative advantage as intermediaries.

As participants in our nation's large and complex payments system, banks form a highly efficient network through which huge volumes of financial transactions clear and are settled. These transactions take place among retailers and their suppliers, for example, or among securities firms active in the stock market. The system economizes on resources by eliminating many cash transactions and by minimizing settlement and transportation costs.

The prominent role banks play in providing intermediation, information, and transactions services indicates that banks do have an important role in the economy. But it is no longer the case that these services are provided only by banks. A closer look shows that many firms from traditionally distinct industries — insurance companies, finance companies, and capital markets — compete with banks in all of their traditional functions.

Bank Services Are Not Unique

Consumers of financial services care primarily about the type of services provided and about the price and quality of those services. Customers can, and increasingly do, purchase these services from a financial industry that does not functionally separate banks from nonbanks.[1] Banks and nonbanks alike provide many standard financial services: loans, cash management, savings arrangements, checkable deposits, and so on.

Sources of Funds

Banks are still the dominant provider of transactions services. In 1990, checkable deposits in banks (including demand deposits, money market deposit accounts [MMDAs], and other checkable deposits) were 31 percent of M2, the Federal Reserve System's broad measure of money in circulation. Savings and small time deposits were 48 percent of M2. But transactions deposits are no longer the exclusive domain of commercial banks. Money market mutual funds (MMMFs) now account for 10.4 percent of M2; cash makes up another 7.3 percent.

Banks today compete with the government and other market participants for "purchased money" obtained from the wholesale credit markets. Though banks are holding their own in a rapidly growing market, they face substantial competition.

For example, between 1980 and 1989, certificates of deposit (CDs) outstanding — banks' primary vehicle for raising funds in the wholesale credit markets — more than doubled, from $256 billion to $541 billion. At the same time, U.S. Treasury bills increased from $200 billion to $407 billion, and commercial paper outstanding increased from $124 billion to $529 billion.

Extending Credit

Banks and nonbanks compete vigorously in extending credit. Although the role of banks has declined, banks still finance a significant portion of our country's physical investment. Bank loans (excluding mortgages) accounted for 15 percent of credit given to nonfinancial businesses in 1989. Today, banks hold 27 percent of outstanding claims against nonfinancial firms, although this share was 33 percent in 1980.[2]

Nonbanks also make consumer and commercial loans, and a lot of them. For example, GE Financial Services has a commercial loan portfolio second in size only to Citibank's. Among all lending institutions with financial receivables above $3 billion in 1987, nonbanks held 46 percent of all financial receivables and 44 percent of the consumer loans. Banks held the remaining 54 percent and 56 percent of loans in those categories. These numbers should not be that surprising: the largest consumer lenders (in order of importance) were General Motors Acceptance Corporation, Citicorp, Ford Motor Credit, and American Express.

In the commercial lending arena, large nonbank lenders extend 48 percent of all commercial loans. For example, Ford Motor Credit makes real estate loans and buys credit card receivables via thrift and finance company subsidiaries. And insurance companies alone account for more than half of the commercial loans made by the nonbank lenders of this group.[3]

Both banks and nonbanks are diverse. Some, such as

Citicorp, Sears, and Prudential, aim to be financial supermarkets. Others, such as Bankers Trust, Household International, and J.C. Penney, have a more sharply focused range of services. Still other, smaller firms — both banks and nonbanks — have taken an even more specialized, boutique approach to providing financial services. Perhaps this diversity best demonstrates the nonuniqueness of banks. The services of banks now come from many different firms, both conglomerates and specialists.

Capital Markets

An area of rapid growth that highlights the competition between banks and capital markets is asset securitization — the process of creating a new, tradable asset that is ultimately backed by the original loan.

More than one-third of all home mortgages made in the United States are securitized, bundled into groups, and sold. The volume of mortgage-backed securities exceeds all commercial and industrial loans made by banks. In recent years, commercial mortgages, auto loans, and credit card receivables have been securitized, though the total is still less than 5 percent of these loans outstanding. These new instruments provide a way for banks to make loans more marketable, to diversify portfolios, and to remove some loans from their balance sheet, increasing returns to equity.[4]

However, firms other than banks securitize loans, which is one important way capital markets may substitute for the intermediation function banks have historically performed. This process erodes one more boundary separating banks from nonbanks, since fewer and fewer assets can be regarded as being illiquid.

Capital markets increasingly provide funds directly to corporations, as marketable securities continue to replace bank loans as a source of corporate funding.[5] A major factor in the shift to capital markets has been the advent of shelf registration, SEC Rule 415. Initially adopted in early 1982, the rule allows corporations to file just one registration statement covering securities that may be, but need not be, issued anytime in the next two years. Corporations can also list a number of investment banks, leaving the choice of underwriter until later. This provides flexibility and the ability to act quickly, taking away two advantages of bank loans.

A more sophisticated financial sector has developed a wide range of flexible, less conventional methods for acquiring funds. Securities, such as options, zeros, and swaps, are able to incorporate much of the flexibility required to deal with contingencies, which have been the hallmark of bank loan agreements. Both borrowers and lenders have increasingly accepted these instruments.

THE PAYMENTS SYSTEM

In recent years, the payments business has become an arena of growing competition between banks and nonbanks, although banks still dominate the major payments methods. Checks account for 25 percent of the volume of payments and 20 percent of the value. Wire transfers account for 0.04 percent of the volume of payments and 78 percent of the value.[6]

Still, a good fraction of what people use as their medium of exchange is provided by firms such as Sears, Penney's, and American Express. These firms have a large portion of the nation's credit card business, and American Express now has cash machines in airports. The access cards they provide to their customers have an even more promising future: the cards can carry account information from which the customer's account can be automatically debited and credited, while the account balance earns interest.

As more firms have become interested in offering various kinds of payments services, the lines between banks and nonbanks have blurred. Nonfinancial firms often buy these services from banks, and the banks themselves often buy these services from third parties: sometimes a data processing subsidiary in the holding company, sometimes an outside vendor.

With few exceptions, only banks and other depository financial institutions, such as thrifts, are allowed to have direct access to the major settlement systems. The major settlement systems include CHIPS (Clearing House Interbank Payments System) and FedWire (the Federal Reserve System's electronic communications network).

The clearing activity of providing information about who owes whom need not flow through a bank and, as mentioned above, many banks contract out for this service

when they do provide it. The settling activity of netting out transactions and actually delivering payments has favored banks because it has been so easy for banks to shift their reserve accounts with the Federal Reserve — certainly easier than sending cash across country.

But in the future, more well-defined groups of transactors may establish accounts at correspondent banks to settle their payments, as some credit card companies already do. As technology progresses, and electronic networks get cheaper, the role of banks in the payments system may further deteriorate.

The competition banks face in each of their roles refutes the idea that regulation is needed because banks or the services they produce are unique. Vigorous competition provides the best safeguard against financial concentration. Even small investors choose MMMFs, credit cards, and mortgage brokers — indicating a capacity to use

The FEDERAL SAFETY NET HAS ENCOURAGED BANKS TO TAKE MORE RISKS...THE COSTS OF BEARING THOSE RISKS HAVE BEEN TRANSFERRED TO THE TAXPAYER.

information when incentives exist to provide it.

Instead, the case for banks being unique must rest on other considerations. Perhaps consumers need protection from the informational advantages gained by banks. Perhaps the prominent role banks still play in intermediation and payments poses problems of systemic risk or concentration of financial power.

If banks are unique or special, it is because of the risk of disruption to other aspects of economic life that might result from malfunction or disorder in the banking system. The desire to reduce or avoid such systemic risks was an important factor motivating the special treatment of banks and, supposedly, justifying the safety net of federal deposit insurance, access to the discount window, and payments system guarantees.

Systemic Risk Is Exaggerated

The rationale for the safety net and for regulations treating banks as though they were unique is to safeguard the economy in general, and financial markets in particular, against financial panic and collapse. By protecting individual depositors and banks from the effects of bank failure, the argument goes, the economy is insulated from systemic risk. Systemic risk conjures up the image of widespread failures of banks, where one bank failure causes other banks to fail, and so forth.

Unfortunately, the common view of bank failures, which is rooted in the financial collapse of the 1930s, is misleading. It overemphasizes the likelihood and effects of financial fragility and has been used to justify restrictions, regulations, and a safety net to protect the banking industry and the public. This misinterpretation is responsible for making the banking industry less competitive and for shifting too much risk to the public.

Historically, bank failures often came in waves, accompanied by runs and panics that seemingly precipitated economic collapses. Consequently, there are two concerns about bank failures today: that banks' line of business makes them prone to failures and panics; and that bank failures have a crippling impact on the wider economy, far worse than failures of similarly sized industrial firms.

RUNS AND PANICS

Why might banks be more prone to failure than other types of enterprise are? It has been argued that the fractional reserve structure of the banking system makes the intermediary process vulnerable to runs and panics. Under a fractional reserve system, a bank may not have enough ready cash to meet a concerted cash withdrawal. If a bank were forced to liquidate assets quickly, it might obtain far less than the assets' intrinsic value (the fire sale problem). Those depressed asset prices could reduce the

current market value of other banks' assets and increase banks' vulnerability to runs.

An alternative view, which we assert is more accurate, is that in a fractional reserve banking system, panics are caused by a lack of information about the condition of individual banks. During a recession or a credit crunch, people might suspect that some banks are doing poorly, but they don't know the true extent of the problem or exactly which banks are in trouble. Even if the entire system is sound and solvent, people don't want their deposits stuck in the one bank that actually has a fatal problem. Unfortunately, in the current situation, the pervasive presence of the federal safety net diminishes the incentives for banks to provide such information and for consumers to use such information.

Could multiple bank failures affect the entire economy? Multiple bank failures could cause the money supply to shrink rapidly, with the classic case of this being the Great Depression. As banks failed, depositors lost confidence in banks and withdrew their money. Banks protected themselves by holding more cash, which exacerbated the problem. Consequently, a given monetary base supported far less money than had been circulating, and the money supply dropped by a third. This deepened an ordinary recession into the landmark economic collapse of the twentieth century.

Apart from shrinking the money supply, bank failures can close off borrowers from funds, or otherwise disrupt credit relationships by making funds more difficult and costly to obtain. Bank failures intensified the Depression in the U.S. relative to that experienced in countries such as Canada, which had no bank failures.

Bank failures could have a broad economic impact on the payments system, too. People fear that if a few banks, or even one pivotal bank, cannot settle (that is, pay against the claims presented to it), other banks counting on those funds would become unable to settle, and failures could spread. With the usual process for completing transactions compromised, routine commercial transactions — selling stock, paying workers, and buying groceries — could become much more difficult, if not impossible.

THE FAILURE FALLACY

Earlier in our nation's history, banks adopted practices consistent with survival in a less-regulated environment and, in general, their adaptations were successful. In the years before the Depression, banks suppressed panics by "currency suspension." Banks stopped converting notes and deposits into gold (or greenbacks). Under suspension, banks did not close; they cleared checks, and they made and serviced loans. Often, the banks allowed

withdrawals for small amounts or for meeting payrolls. In some extreme cases, the clearinghouse association would issue certificates that served as money.

Branch banking also acted as a defense against bank failures. Branching allowed banks to diversify geographically, so that cash demands, local fraud, or adverse changes in local business were not fatal. Branches could pool and shift cash and expertise to meet local emergencies. The remarkably smaller number of failures and panics both in Canada and in those U.S. states that allowed branching testify to its efficacy.[7]

The upheaval of the Depression has led to distorted interpretations about previous banking panics in the nineteenth century. But contrary to popular notions, nonbank firms failed more frequently than banks did during the National Banking Era (1864-1914). In the most severe banking panic (1873), only 1.3 percent of the banks failed, and depositors of those failed banks lost, on average, 2.1 cents for every dollar of deposits. Conventional wisdom also exaggerates losses in the earlier Free Banking Era, when banks issued their own currency. In fact, using bank notes was as safe as using gold.[8]

Misconception also surrounds the most fearsome banking panic, the Great Depression. Bank failures contributed to the crash in money, but the Federal Reserve could have offset this by maintaining the money supply. Consequently, the Great Depression represents a failure of macroeconomic and monetary policy, not of banking practices or policy.

Furthermore, the Great Depression was unique in another respect. The Federal Reserve was not an effective lender of last resort in the 1930s, thereby contributing both to the sharp decline in money and credit and to banking failures. Before the Federal Reserve was created in 1913, private clearinghouses and private insurance funds acted as lenders of last resort. Since the Depression, deposit insurance and an expanded Federal Reserve have further supplanted clearinghouses and other market mechanisms to protect against risk and financial failure.

IMPERFECT INFORMATION

A false diagnosis of panics as random outbreaks that suddenly strike an illiquid fractional reserve system has led to inappropriate banking policies. This interpretation, which stresses the unpredictable and mysterious conditions promoting banking panics, serves to justify too many regulatory prescriptions that are really placebos.

The imperfect-information theory, which leads to very different policy conclusions, provides a superior explanation of panics. Bank panics, in fact, follow a predictable pattern, and occur when the failures of

nonbank firms reach a threshold level.

Furthermore, before the Great Depression, banks generally were not strapped for cash during panics. Banks could quickly obtain funds by liquidating their large holdings of marketable securities. Moreover, the arrival of funds (gold) sufficient to meet the public's demand was often not sufficient to stem panics. It was only when the public received enough information to sort out the safe from the failing banks that the panic subsided.

Panics did not drag down good banks with the bad. Before the Depression, in part because banks held much more capital then they now do, very few otherwise solvent banks failed because of bank runs.[9] Rather, the panics sorted out the solvent and insolvent banks.

Too Big to Fail

Solutions to contemporary banking problems are, unfortunately, based all too often on faulty conventional wisdom about banking failures. The Continental Illinois rescue is widely regarded as the onset of the "too big to fail" doctrine, a practice that encourages large banks to depend on regulators all the more. The bailout of Continental in 1984, in which uninsured deposits (more than 90 percent of deposits) were explicitly guaranteed by the federal government, was rationalized as a means of protecting smaller banks holding deposits with Continental. Officials contended that smaller banks might fail if Continental could not honor its obligations to them. In retrospect, regulators were also concerned that the funding sources of other large banks would become unstable if Continental were permitted to fail.[10]

Evidence from the markets argues against any large contagion effect of a Continental failure upon other banks. Neither Continental's announcement of a large increase ($400 million) in problem loans nor the loss of purchased funds had a significant impact on other bank stock prices.

In similar fashion, the news of Continental's difficulties did not produce a large shift of funds out of the U.S. banking system. There was a flight to quality, however, with investors transferring funds to safer banks and more secure deposits.[11]

One can, of course, explain away the market's disavowal of contagion risk—signaled by the small reactions in the stock market and money flows—as confidence in the too big to fail doctrine. This only reinforces the point. Continental's exposure to high risk stemmed from an erosion of incentives to protect against loss. A clear precommitment to allow the risk of failure to fall on banks would cause banks to take on less risk.[12]

Payments System Guarantees

Concerns about systemic risk have also influenced the regulation and operation of

the payments mechanism. With a few exceptions, only banks have clearing and settlement privileges on the nation's payments system. By restricting access and by regulating the settling of payments, the Federal Reserve has attempted to provide stability to this important system.

Federal Reserve oversight of the payments system creates real, but less obvious, distortions. Through either CHIPS or FedWire, banks can undertake and settle large transactions for parties about which they have inadequate credit information. Why do banks undertake such risk? In the case of CHIPS, the costs associated with a failing party are reduced by the probability of the Federal Reserve's support of that party — via a discount window advance — in order to maintain the integrity of the entire system.

On FedWire, the Federal Reserve guarantees payments under the policy of payments finality, so credit risk is passed directly on to the Federal Reserve System. This leads to daylight overdrafts, often exceeding $50 billion each day, where banks wire funds out before the funds are wired in.

The assumption of responsibility by the government for some of the risks inherent in the payments process reduces the payments system's incentive to develop its own defenses against these risks. Other markets successfully rely on private clearinghouses. In fact, the stock and option exchanges have improved their risk management systems to lessen the impact of defaults, as volume has increased and defaults have become potentially more damaging.

Payments system participants could take similar steps to protect against risk. One proposal is to price or limit the daylight overdrafts now allowed on FedWire. Without guaranteed support, banks in the system would diversify among their respondents to reduce their exposure to any one failure. Private lines of credit could also provide needed liquidity during emergencies.[13]

In the absence of the safety net, managers of banks would maintain larger cushions in the form of cash, liquidity, and capital, raising the threshold of payments gridlock and electronic bank runs, and reducing interbank exposures. Moreover, private risk-control measures would be developed and adopted as

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bank managers sought orderly ways to reduce the risk of failure. Incentives to demand and use information about the financial condition and practices of banks would be greatly strengthened.

Regulatory Incentives

Why have regulators been so reluctant to let banks, even medium-sized banks, fail outright? One reason may be the desire, on the part of regulators as well as consumers of financial services,

to avoid all risks of widespread failure that could result from a failed bank, even when that risk is very small.

Another reason is that regulators can conserve the cash in the deposit insurance fund by finding ways to avoid paying off the depositors of unhealthy banks, that is, by not actually allowing a bank to fail. Finally, regulators may want to avoid failures because a bank failure can be seen as an incrimination of the regulatory process itself. If regulations are effective, the thought goes, why are banks failing?

The reluctance to allow banks to fail can be very costly. Regulators resolve most bank failures using the "purchase and assumption" method. In this method, another (presumably healthy) bank purchases the sub-par bank as a going concern, obtaining its deposits and assets. The FDIC often adds money to compensate the acquiring bank. This transaction ends up protecting all of the depositors, insured and uninsured alike, and often other debtors of the sick bank as well.

Regulatory treatment of insolvent banks differs from other commercial bankruptcy procedures. This creates dangerous incentives for regulators. For example, because it can act both as a claimant and as bank management in the failure-resolution process, the FDIC is subject to a conflict of interest.[14] The FDIC does not act solely as an insurer, concerned with the long-term viability of its insurance fund. The FDIC has broad powers to control the operations of weak banks, including seizure of the bank and operation of it directly as a receiver. All too often, good money is thrown after bad.

In short, systemic risk, properly viewed, is not a catastrophic problem, either in the payments mechanism or in financial markets more generally, unless the misguided efforts to protect against systemic risk diminish effective private-sector initiatives against risk. In our view, that is close to being the case in the United States, where the safety net has been substituted for private capital and liquidity. The effect is perverse because it undermines financial incentives to control risk in financial markets.[15]

Constantly improving electronic technologies and more developed bond, futures, and derivative securities markets allow banks to add risk faster and more readily, if they desire to. This risk-taking is increasingly dangerous as insolvent firms play the game for larger and larger stakes. Even insolvent thrifts pursuing a go-for-broke strategy were able to obtain funds from depositors across the United States through well-developed national capital markets.

Regulators themselves may be tempted to adopt risky strategies if too many banks get into trouble. When the deposit fund cannot

TODAY, FINANCE COMPANIES, INSURANCE COMPANIES, BROKERAGE FIRMS AND, MORE BROADLY, CAPITAL MARKETS PROVIDE MANY OF THE SAME SERVICES AS BANKS.

cover expected losses, its guardians can only institute forbearance policies to give wayward banks another chance. Regulators hope these bets will pay off.

The likely outcome of this approach is that taxpayers must ante up again. The transfer of taxpayers' funds seems especially absurd in the case of the reckless savings and loans, in which the depositors' money was used to build, among other things, see-through office buildings, empty malls, and unbooked desert resorts.

Estimates published by the Treasury Department place the present value of resolving the failures of roughly 600 thrift institutions targeted for assistance at somewhere between $150 billion and $200 billion. Private estimates go higher. If another 400 of the currently troubled thrifts fail, the estimates increase by another $100 billion. More important, recent evidence on the adequacy of the FDIC bank fund clearly indicates significant additional taxpayer exposure.

Eliminating the Distinction

Nobel Laureate James Tobin, in a classic treatment of banking nearly 30 years ago, summarized his views on many of the issues discussed in this essay as follows:

> *The distinction between commercial banks and other financial intermediaries has been too sharply drawn. The differences are of degree, not of kind...Any other financial industry subject to the same kind of regulations would behave in much the same way.*[16]

As Tobin observed, much of the apparent uniqueness of banking results from government regulations. We believe that deposit insurance, payments system guarantees, and special bankruptcy rules are examples of situations in which regulation has artificially "stabilized" an industry. Since all industries exist in a constantly changing environment, this "protection" actually creates vulnerability and increases the costs of bank failures. Considering that the goal of regulation should be to correct market failures that retard economic growth and well-being, financial regulation should foster the activities and services that serve to promote that growth.

For example, concentrating regulatory attention on specific services provided by banks deflects energy from larger issues. The lessons of capitalism suggest that we should respect diversity in how firms structure themselves to deliver services, promote competition among current and potential service providers, and encourage consumer choice through the provision of better information.

We think that the market system can do a better job than is commonly supposed. The growth of nonbanks and a more reasoned interpretation of the history of bank failures support this idea

and, taken to the extreme, make a strong case for total deregulation of the banking industry. While some kind of financial safety net might be useful, there should be no presumption that it take the form of the current costly, and completely public, system.

Financial reform is moving onto the legislative agenda. This reform should be shaped to rely on market forces and outcomes. If it was ever correct to treat banking as a unique vehicle — a separate line of commerce — it is not correct now.

The steadily increasing costs of ignoring or blocking evolution within the financial services industry make it imperative for all of us — consumers, producers, even regulators — to face the challenges ahead. Continuing to rely on regulatory direction will further weaken the competitiveness of the U.S. banking system, misallocate scarce resources, and undermine the long-term growth and stability of our economy.

Footnotes

1 Banking has been treated as though it is a separate "line of commerce" from other financial services. From an economic perspective, a line of commerce is a distinct product market, a set of goods and services for which there are only weak substitutes. Generally, banks are defined as firms that provide checkable transactions deposits — available at par on demand — and make commercial, industrial, and consumer loans. The term "banks," as used throughout this essay, encompasses all depository financial institutions, including savings and loans and credit unions.

2 A more dramatic decline in market share occurred in lending to large corporations, those best able to use the capital market. From 1975 to 1986, banks' share of the short-term debt of large corporations fell by almost half, from 50 percent to 27 percent. This sharp decline in market share seems to indicate that banks have not been able to compete in this very active, rapidly expanding market for commercial lending to large, high-quality borrowers.

3 The data on large institutions are from Linda Aguilar, "Still Toe-to-Toe: Banks and Nonbanks at the End of the '80s," Federal Reserve Bank of Chicago, *Economic Perspectives* (January-February 1990), pp. 12-23.

4 For a more extensive discussion, see Lowell L. Bryan, *Breaking Up the Bank* (Dow Jones-Irwin, 1988), chap. 6.

5 On the other hand, banks do play an important role in supporting corporate borrowing from nonbank sources. Of the 1,400 issuers of commercial paper in 1988, only 56 of them did not back that paper with a 100 percent line of credit from a bank (credit commitment). Of those 56, only 15 had less than 50 percent backing, and none less than 10 percent. See Charles W. Calomiris, "The Motivations for Loan Commitments Backing Commercial Paper," *Journal of Banking and Finance* (May 1989), pp. 271-78.

In addition, mergers and acquisitions (M&As) are often financed initially by bridge loans from banks while other funding is being arranged. Banks also provide much expertise and earn fee income in M&A and LBO (leveraged buyout) activities.

6 Additional details on the payments system can be found in Mark J. Flannery, "Payments System Risk and Public Policy," in William S. Haraf and Rose Marie Kushmeider, eds., *Restructuring Banking and Financial Services in America* (American Enterprise Institute, 1988), pp. 261-87.

7 Discussion on branching and its effects on bank failures and the economy can be found in Ben S. Bernanke, "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression," *American Economic Review* (June 1983), pp. 257-76; Joseph G. Haubrich, "Nonmonetary Effects of Financial Crises: Lessons from the Great Depression in Canada," *Journal of Monetary Economics*, vol. 25 (1990), pp. 223-52; and Charles W. Calomiris, "Is Deposit Insurance Necessary? A Historical Perspective," *Journal of Economic History* (June 1990), pp. 283-96.

8 The myths of the Free Banking Era are debunked in more detail in Arthur Rolnick and Warren E. Weber, "New Evidence on the Free Banking Era," *American Economic Review* (December 1983), pp. 1080-91; and Gary B. Gorton and Donald J. Mullineaux, "The Joint Production of Confidence: Endogenous Regulation and Nineteenth Century Commercial Bank Clearinghouses," *Journal of Money, Credit and Banking* (November 1987), pp. 457-68.

9 A critical comparison of banking panics can be found in Gary B. Gorton and Charles W. Calomiris, "The Origins of Banking Panics: Models, Facts, and Policy Implications," in R. Glenn Hubbard, ed., *Financial Markets and Financial Crises* (University of Chicago Press for the National Bureau of Economic Research, forthcoming).

10 For an insider's account, see Irving H. Sprague, *Bailout* (Basic Books, 1986).

11 More details on market reactions are in Anthony Saunders, "The Interbank Market, Contagion Effects and International Financial Crises," in Richard Portes and Alexander K. Swoboda, eds., *Threats to International Financial Stability* (Cambridge University Press, 1987), chap. 6.

12 See Walker F. Todd and James B. Thomson, "An Insider's View of the Political Economy of the Too Big to Fail Doctrine," Federal Reserve Bank of Cleveland, *Working Paper* 9017 (December 1990).

13 These and other related points are forcefully argued in Marvin Goodfriend and Robert G. King, "Financial Deregulation, Monetary Policy and Central Banking," Federal Reserve Bank of Richmond, *Economic Review* (May/June 1988), pp. 3-22.

14 For a detailed comparison, see Michael Dotsey and Anatoli Kuprianov, "Reforming Deposit Insurance: Lessons from the Savings and Loan Crisis," Federal Reserve Bank of Richmond, *Economic Review* (March/April 1990), pp. 3-28.

15 An excellent, though technical, estimate of this effect is in George C. Pennacchi, "A Reexamination of the Over- (Or Under-) Pricing of Deposit Insurance," *Journal of Money, Credit and Banking* (August 1987), pp. 340-60.

16 James Tobin, "Commercial Banks as Creators of Money," in Deane Carson, ed., *Banking and Monetary Studies* (Richard D. Irwin, 1963), pp. 408-19.

This essay presents this Bank's views about the urgent need for comprehensive banking reform that allows market competition to replace costly government regulations and subsidies. The views expressed in this essay are not necessarily shared by the other Federal Reserve Banks or by the Board of Governors of the Federal Reserve System.

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Comparative Financial Statement

For years ended December 31

STATEMENT OF CONDITION

	1990	1989
ASSETS		
Gold certificate account	$ 688,000,000	$ 661,000,000
Special drawing rights certificate account	645,000,000	508,000,000
Coin	39,289,608	35,198,010
Loans and securities:		
Loans to depository institutions	-0-	260,490,000
Federal agency obligations bought outright	379,907,713	375,348,521
U.S. government securities		
Bills	6,740,802,414	6,016,323,386
Notes	5,475,949,688	5,256,981,596
Bonds	1,866,912,501	1,772,647,794
Total U.S. government securities	14,083,664,603	13,045,952,776
Total loans and securities	14,463,572,316	13,681,791,297
Cash items in process of collection	256,888,868	311,132,941
Bank premises	36,121,850	33,636,690
Other assets	2,126,715,647	1,996,567,172
Interdistrict settlement account	1,076,627,132	1,213,581,514
Total Assets	$19,332,215,421	$18,440,907,624
LIABILITIES		
Federal Reserve notes	$17,005,076,555	$15,565,816,189
Deposits:		
Depository institutions	1,816,463,408	2,107,236,707
Foreign	8,250,000	8,100,000
Other deposits	2,061,427	62,171,052
Total deposits	1,826,774,835	2,177,507,759
Deferred availability cash items	82,867,142	287,754,553
Other liabilities	166,785,489	162,828,823
Total Liabilities	$19,081,504,021	$18,193,907,324
CAPITAL ACCOUNTS		
Capital paid in	$ 125,355,700	$ 123,500,150
Surplus	125,355,700	123,500,150
Total Capital Accounts	$ 250,711,400	$ 247,000,300
Total Liabilities and Capital Accounts	$19,332,215,421	$18,440,907,624

INCOME AND EXPENSES

	1990	1989
CURRENT INCOME		
Interest on loans	$ 773,106	$ 2,429,631
Interest on government securities	1,176,904,432	1,149,099,468
Earnings on foreign currency	143,052,007	56,068,247
Income from services	43,460,030	42,968,475
All other income	623,087	592,146
Total current income	$ 1,364,812,662	$ 1,251,157,967
Current operating expenses	69,518,138	66,379,062
Cost of earnings credits	10,432,184	11,691,875
Current Net Income	$ 1,284,862,340	$ 1,173,087,030
PROFIT AND LOSS		
Additions to current net income		
Profit on foreign exchange transactions	$ 3,772,191	$ 702,956
Profit on sales of government securities	117,666,511	68,403,659
All other additions	11,432	3,270
Total additions	$ 121,450,134	$ 69,109,885
Deductions from current net income		
Loss on foreign exchange transactions	$ -0-	$ -0-
All other deductions	1,712	1,190
Total deductions	$ 1,712	$ 1,190
Net additions or deductions	$ 121,448,422	$ 69,108,695
ASSESSMENTS BY BOARD OF GOVERNORS		
Cost of Unreimbursable Treasury Services	$ 11,878,601	$ 3,338,604
Board of Governors expenditures	5,676,400	4,877,500
Federal Reserve currency costs	12,427,914	10,402,141
Total assessments by Board of Governors	29,982,915	18,618,245
Net Income Available For Distribution	$ 1,376,327,847	$ 1,223,577,480
DISTRIBUTION OF NET INCOME		
Dividends paid	$ 7,488,534	$ 7,054,527
Payments to U.S. Treasury (interest on Federal Reserve notes)	1,366,983,763	1,207,926,053
Transferred to surplus	1,855,550	8,596,900
Total distributed	$ 1,376,327,847	$ 1,223,577,480

The Federal Reserve System is responsible for formulating and implementing U.S. monetary policy. It also supervises banks and bank holding companies, and provides financial services to depository institutions and the federal government.

The Federal Reserve Bank of Cleveland is one of 12 regional Reserve Banks in the United States that, together with the Board of Governors in Washington, D.C., comprise the Federal Reserve System.

The Federal Reserve Bank of Cleveland, its two branches in Cincinnati and Pittsburgh, and its Regional Check Processing Center in Columbus serve the Fourth Federal Reserve District. The Fourth District includes Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky.

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THIS ANNUAL REPORT WAS PREPARED BY THE RESEARCH DEPARTMENT AND THE PUBLIC AFFAIRS AND BANK RELATIONS DEPARTMENT, FEDERAL RESERVE BANK OF CLEVELAND.

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