
FRBSF WEEKLY LETTER

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The Federal Safety Net for Commercial Banks: Part I

From the late 1970s through 1982, the plight of the thrift institutions attracted considerable attention. A number of legislative measures were adopted in attempts to shore up savings and loans and mutual savings banks. At that time, there seemed to be little concern over the ability of banks, especially large banks, to remain sound. This has changed. The spotlight now features problems facing commercial banks.

Captured in the spotlight, along with the banks, has been the network of financial support provided by the Federal Reserve, as lender of last resort, and the Federal Deposit Insurance Corporation, as insurer of deposits. This *Weekly Letter* and the next examine the potential problems involved in administering this "federal safety net" for commercial banks. They take a look, first, at the lender-of-last-resort function of the Federal Reserve, and then at federal deposit insurance.

Background

Whereas the thrifts historically have been buffeted by their exposure to interest-rate risk (because they funded long-term fixed-rate mortgages with short-term liabilities), the banking industry has been hit by losses related to credit risk—the risk of borrowers defaulting on loans. Much publicity has been given to the losses from energy-related lending, which proved to be the undoing of Penn Square Bank and affected a number of other large banks, including Continental Illinois. The earnings of many banks are still suffering from the effects of the last recession on the performance of their commercial loans. And, some banks have been hurt by problems connected with their real estate lending.

The magnitude of these problems is reflected in the statistics. The number of bank failures jumped in 1982 and 1983, totaling 48 last year. Through June of this year, there were over 40 bank failures, the highest half-year rate since the 1930s. The FDIC's list of problem banks counted more than 690 institutions as of June 1984, over double the figure just 18 months earlier. As worrisome as these figures might be, what could be the most serious threat to commercial banks, the large

volume of debt owed by less developed countries (LDCs), still lies ahead. A major confrontation between LDC borrowers and the banks appears to have been averted for the moment, but the future of the bank loans to some of the LDCs, particularly Argentina, remains in question.

Federal safety net

Against this backdrop of measurably increased risk, the banks have accumulated added capital in 1983 and 1984. The capital-to-asset ratio for insured commercial banks is estimated to be modestly higher now than in the previous five or so years, but it is still well below the levels of the 1960s. Commercial banks, however, do not depend solely on their own capital to meet financial problems or to prevent a crisis in public confidence. Explicit and implicit guarantees that come with the federal safety net provided by the Federal Reserve in its capacity as lender of last resort and the Federal Deposit Insurance Corporation (FDIC) considerably bolster the position of banks. This federal safety net has been credited with ensuring the stability that the banking industry has experienced since the 1930s. The recent rescue of Continental Illinois attests to the continued capacity of the system to avert a financial crisis.

Despite the success of this system, the federal safety net has come under increased scrutiny in part because there is a concern that this system of federal aid to banks can have unintended and undesirable side effects. With regard to the Federal Reserve, the concern is that the Federal Reserve's role as a lender of last resort will conflict with its role as a monetary authority and the goal of achieving price stability. In the case of deposit insurance, the worry is that the federal guarantee on deposits creates incentives for additional risk-taking by banks. This problem may be exacerbated by deregulation in banking, which may make it more difficult to keep these incentives for risk-taking in check through supervision and regulation.

Lender of last resort...

The weakened condition of some banks has raised concerns in some quarters about the Federal

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Reserve's reactions. As it protects the financial system by acting as a lender of last resort, the Fed, some fear, may make monetary policy too expansionary by providing an excessive amount of liquidity to the banks and therefore indirectly to the public. While this concern is real, it is probably overstated because the conflict can be avoided from a purely technical point of view.

When the Federal Reserve was established in 1913, it had one prime function—to be the lender of last resort. It was not involved in monetary policy as currently defined because the gold standard established the monetary rule and left policymakers relatively little discretion. The Federal Reserve functioned primarily to provide “an elastic currency” in order to deter the adverse effects of banking panics on the economy.

The lender-of-last-resort function is a classic central bank role. Commercial banks fund at least some of their loans with deposits that are available on demand or that have very short maturities; these qualities make the deposits highly liquid. If the public perceives that a bank is having trouble with its loans (assets), it will have every incentive to remove its liquid uninsured deposits. The lender-of-last-resort function provides liquidity in the face of such bank runs. It does so by taking illiquid but *sound* loans as collateral from commercial banks in return for providing reserves which the banks can use to meet the deposit withdrawals.

...and monetary policy

It is technically possible for the central bank to meet this increased liquidity need without following an easier monetary policy. Take the case of a single bank such as Continental Illinois. The Federal Reserve at the peak of its lending, apparently supplied a large volume of reserves to that institution through the discount window, taking in sound but illiquid loans as collateral. This made it possible for depositors to withdraw their funds from that institution and re-deposit the funds into institutions they thought were safer. The reserves thereby initially stayed in the banking system.

Continental Illinois also received extensive aid in the form of the rescue package involving the FDIC

and a number of commercial banks. However, only the Federal Reserve's actions have the potential of increasing reserves in the entire banking system. To prevent the increase in reserves *via* the discount window loans to Continental Illinois from increasing the reserves of the banking system as a whole, the Federal Reserve could and did withdraw reserves from other banks *via* open market operations. This was done with about a one-week lag and enabled the Federal Reserve to allow one bank to get the liquidity it needed without increasing the liquidity of the entire banking system. This is the most likely type of problem a liquidity crisis might present to monetary policy, and it is the easiest to deal with.

What would happen in the unlikely case of a run on many banks simultaneously? Put differently, what would happen if the public wishes to reduce its holdings of deposits at all banks because it perceives the banks to be risky, and instead, prefers to increase its holdings of alternative (nonbank) safe assets? In the case of transaction deposits, the public would desire to reduce its holdings of checking accounts and (most likely) increase its holdings of currency, the alternative medium of exchange. Among investment deposits, the public might wish to reduce its holdings of time and savings deposits and (most likely) increase its holdings of the safest alternative asset—Treasury securities. The Federal Reserve's role is to supply the currency demanded by the public—both through open market operations and through the discount window—to satisfy the public's demand for safe and liquid assets without necessarily easing monetary policy.

In the most probable case, where the public converts its demand or other checkable deposits into currency, the previously set targets for M1 could remain operational because the public's desire to hold M1 would not change. The public merely desires to decrease its holdings of the transactions deposit component of M1 and increase its holdings of the currency component of M1. As a first approximation, this changes the composition of M1 but not necessarily its level.

Obviously, the extent to which M1 or any other monetary aggregate can be expected to remain

within its target range and to continue to be a useful guide to policy in the face of a run on banks depends on the nature and the predictability of the portfolio shifts made by the public. However, the history of bank runs suggests that such portfolio shifts have been relatively predictable; in the past, the public has increased its demand for the safest alternative assets—currency and Treasury securities.

While it is technically possible to avoid expansionary monetary policy in the face of a major need to act as a lender of last resort, it is also possible for human error to creep into the operation of monetary policy. The potential for such error clearly rises with the volume of deposits being withdrawn from depository institutions and the uncertainty over the nature of the public's portfolio shifts. In the 1931-33 banking crises, which involved a large volume of deposit withdrawals, the Federal Reserve appears to have erred on the side of following too tight a monetary policy; it did not supply enough liquidity to meet the demands of the public. The result was that the Fed contributed to the severity of the recession. Since that time, the Federal Reserve has avoided the same mistake.

Conclusion

The problems evident in the banking industry have spotlighted the benefits of the Federal Reserve acting as lender of last resort as part of the federal

safety net for banks. At the same time, concerns have been raised that, as the Federal Reserve meets the liquidity needs of banks, monetary policy will be compromised. The Continental Illinois episode has demonstrated clearly that the Federal Reserve can address the liquidity problems of an individual bank without altering monetary policy. In the case of a more general demand for liquidity by banks, say, due to the public desiring to hold relatively more nonbank assets, there still is no inherent conflict between the Federal Reserve's roles as monetary authority and lender of last resort.

A concern of some financial market commentators seems to be that the Federal Reserve may attempt to prevent bank runs rather than react to them by relieving the pressure on the banking system through a premature increase in bank reserves and liquidity. While that might help reduce the chances of a bank run developing, at least for a while, the precaution would risk an increase in the money supply above targeted levels and imply an easier monetary policy. The use of the deposit insurance guarantee, even for "uninsured" depositors as in the case of the Continental Illinois Bank, avoids the risk of the Federal Reserve following an excessively easy monetary policy to prevent disruptive bank runs. However, the deposit insurance guarantee creates its own set of problems, which will be considered next week.

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Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding	Change from	Change from 12/28/83	
	7/11/84	7/04/84	Dollar	Percent Annualized
Loans, Leases and Investments ^{1 2}	181,790	-1,304	5,765	6.0
Loans and Leases ^{1 6}	162,680	1,118	7,325	8.7
Commercial and Industrial	49,290	- 217	3,327	13.4
Real estate	60,423	34	1,524	4.8
Loans to Individuals	28,628	- 38	1,977	13.7
Leases	5,031	1	32	- 1.1
U.S. Treasury and Agency Securities ²	11,984	- 168	- 523	- 7.7
Other Securities ²	7,127	- 17	- 1,036	- 23.5
Total Deposits	189,792	-4,325	- 1,205	- 1.1
Demand Deposits	45,849	-4,237	- 3,388	- 12.7
Demand Deposits Adjusted ³	30,998	2,132	- 333	- 1.9
Other Transaction Balances ⁴	12,440	- 345	- 335	- 4.8
Total Non-Transaction Balances ⁶	131,502	256	2,517	3.6
Money Market Deposit Accounts—Total	38,426	- 199	- 1,171	- 5.4
Time Deposits in Amounts of \$100,000 or more	39,814	399	1,649	8.0
Other Liabilities for Borrowed Money ⁵	18,931	-1,447	- 4,076	- 32.9
Weekly Averages of Daily Figures	Period ended 7/02/84	Period ended 6/18/84		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (-)	140	45		
Borrowings	96	131		
Net free reserves (+)/Net borrowed(-)	44	- 86		

¹ Includes loss reserves, unearned income, excludes interbank loans

² Excludes trading account securities

³ Excludes U.S. government and depository institution deposits and cash items

⁴ ATS, NOW, Super NOW and savings accounts with telephone transfers

⁵ Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

⁶ Includes items not shown separately