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# FRBSF WEEKLY LETTER

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## The False Hope of the Narrow Bank

Current proposals to reform the banking system are intended to limit the cost of the safety net, while enhancing the stability and competitiveness of U.S. banks. One proposal that has received a significant following is to limit the safety net to "narrow" banks. These banks could offer insured deposits, but would be restricted sharply in their asset powers. Risky assets would be held by other banks not enjoying deposit guarantees. The result is supposed to be a banking system that is both safe and stable.

This *Letter* highlights some of the flaws in the concept of deposits backed only by safe assets. In particular, I argue that the issuance of deposits backed by risky assets has important economic justification. Making banks "narrow" thus risks handicapping the flow of funds to commerce. Just as importantly, however, the narrow banking notion does not solve the problem of banking system stability.

### The narrow bank

Although differing in their details, all the narrow banking proposals involve partitioning the banking system into "safe" banks for deposits, and "risky" banks whose liabilities would enjoy no insurance. The safety of deposits in the narrow banks would be guaranteed by a system of essentially full deposit coverage. In turn, the integrity of the insurance fund would be preserved by permitting insured banks only to hold "safe" assets.

Some proponents of narrow banking define "safe" assets to include only government and agency securities. Others, such as Bryan (1991) would extend the range of assets permitted in the insured "core" banks to others that "have proven over time to be relatively safe," including home mortgages and accounts receiving financing. Implicit in all of the proposals, however, is the notion that the use of demand debt to finance risky assets can be restricted without great harm.

### Banking and information asymmetry

To see why this reasoning might be flawed, it is first necessary to characterize the informational environment in which banks exist, and which

justifies their existence as intermediaries. (It is easiest to introduce the necessary arguments by assuming initially that deposit insurance does not exist.)

Financial intermediaries (including banks) exist in a world in which the information needed to assess financial risks is not perfect, or evenly distributed. In particular, the businesses that want to borrow to finance new projects tend to have better information about the true prospects of the projects than do the (outside) lenders. Similarly, bank management has better information about the quality of its investments than do outside depositors. Without special contracts, the uninformed parties would be reluctant to provide credit for fear of being exploited by the better informed parties. Depositors would not lend their funds to banks, and banks would not lend their funds to firms.

Contractual solutions have evolved to address this dilemma. Bank loan agreements incorporate features to permit banks to monitor the activities of the borrower, and to take actions, if necessary, to protect the bank's interests. Analogously, depositors need to be offered special contractual protection to be induced to place their funds in a bank. Depositors are uninformed relative to bank management, and most also do not have the resources to be good monitors; in addition, the bank can be expected to worry less about its reputation with individual depositors than with larger investors. Thus, depositors need to be offered a particularly potent and economical means of avoiding exploitation by the bank.

Demand debt is just such an instrument. By requiring banks to make good on deposits at fixed nominal value on demand, and with low transaction costs, holders of demand deposits can easily withdraw their investment in a poorly managed bank. In this way, they exert discipline on bank behavior.

### Why combine deposits and risky loans?

Demand debt thus is a concession by bank management to the needs of depositors for control. At

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first glance, however, it seems to be a very costly concession. In the absence of deposit insurance, demand debt exposes banks to runs, and banks must invest partly in liquid assets to meet the uncertain withdrawals of depositors. Since a bank's greatest returns are from assets that exploit its monitoring expertise (assets that are, by definition, illiquid), having to accommodate the possibility of runs thus is costly to the bank.

But would other forms of liabilities be cheaper? For example, banks alternatively could raise funds by issuing equity shares (similar to a money market mutual fund). These claims do not impose liquidity restrictions on the bank's asset portfolio. However, the work of Myers and Majluf (1984) suggests that equity would be even more costly than debt in a setting of asymmetric information about the value of the bank's assets. This is because uninformed equity holders will be reluctant to agree to the new issuance of equity; since they are uninformed about the quality of the assets to be acquired, they cannot be certain that the new equity issuance is in their interest (rather than being a dilution of their claims). This can cause new issuance of equity shares to depress share values, making equity shares a costly way of financing new assets.

Issuing long-term debt is another means of avoiding the liquidity cost of demand debt. But it, too, imposes additional costs in an environment of asymmetric information. Specifically, exercising control via long-term debt involves longer delays and greater transactions costs for depositors than would be incurred with demand debt, making it a less effective means of exerting influence.

Thus, the issuance of demand debt by intermediaries holding risky assets is not serendipitous. It occurs precisely *because* bank assets are of uncertain value, and bankers are better informed than depositors. Therefore, as long as there is a significant group of informationally handicapped investors and risky projects to undertake, intermediaries investing in these assets will tend to issue demand deposits. And the existence of demand deposits will tend to make the banking system prone to runs.

## **Banks as money market mutual funds?**

Would a system of "safe" banks with the exclusive authority to issue insured deposits resolve this dilemma? To see the effects clearly, imagine

the most extreme form of the narrow bank, one that only holds riskless government securities. Since riskless securities make information asymmetry problems moot, narrow banks could issue demand equity, instead of demand debt. And they would tend to do so, since it does not pose any liquidity burdens, and thus is cheaper than demand debt to offer. In essence, such narrow banks would be like today's mutual funds.

A banking system based on demand equity would be very safe. Since equity holders have pro rata, rather than fixed, claims on the bank, they would gain nothing by running. Deposit insurance would be redundant in such a narrow bank, except perhaps to protect against fraud.

But would "risky" deposit-taking banks cease to exist? On the contrary: As long as banks with risky assets must deal with uninformed investors, they will have to issue demand debt. And, unlike the "safe" narrow bank, the risky bank provides monitoring services that add value to the financial transaction—value that bankers can share with depositors in order to attract their needed funds. Thus, as Jacklin (1987) has shown formally, the marketplace will prefer the demand debt of risky banks, even if it is uninsured, to equity claims on "safe" assets, because of the superior, risk-adjusted returns.

## **A dilemma**

As a consequence, the narrow banks will have a hard time surviving, despite their "safe" asset structure, and most deposits will be held in risky banks. The risk of runs would still exist because the demand debt of risky banks would still be the dominant bank liability. Regulators could try, of course, to "force" the dominance of narrow banks by forbidding risky banks from issuing demand deposits. But to do so would exact a clear penalty on the economy, if banks are the intermediary the market prefers. Thus, narrow banking does not solve the problem of instability in the banking system except at great expense to the intermediation of credit.

And it is not even clear that the "safety" of the narrow banking system comes with particularly low social costs. Most of the securities that make up the supply of "safe" assets are themselves backed by public guarantees, either explicitly in the case of agency issues, such as mortgage-backed securities, or implicitly in the case of

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federal and local government debt, which is guaranteed by virtue of its claims on the future taxpaying capability of Americans. Thus, to promote narrow banking based on these "safe" securities, rather than deposit insurance, to some degree involves simply substituting one kind of taxpayer guarantee for another.

### Dealing with instability

If narrow banking is not the answer to the problem of bank runs and banking instability, what is? There are two answers to this question, depending upon whether one believes the public sector or the private sector is more prone to making mistakes.

One alternative is to eliminate the safety net altogether, on the grounds that it is unlikely to be managed well by the public sector. Proponents of this approach argue that the concomitant increased discipline that depositors impose on banks would contain risk-taking. This increased discipline necessarily would come at the expense of an increased risk of runs. Proponents of this view, however, argue that the costs of these runs are low compared to the costs of a mismanaged safety net.

The second alternative is simply to manage the safety net better, by requiring bank capital levels that are high enough so that the marginal value of public safety net guarantees is low. This requires raising capital requirements, marking bank portfolios to market, and immediately reorganizing banks that fail to meet the high capital requirements. In this way, the incentive to exploit the safety net is diminished. In a previous *Letter*, we discussed the successful application of this

approach by a European banking system that has broad asset powers (Pozdena 1990).

### Conclusion

In any case, narrow banking seems *not* to be a solution. The artificial partitioning of bank asset powers is inconsistent with the underlying economics of the business of banking. Imposing narrow banking would not eliminate the issuance of risky demand debt and the concomitant dilemma of bank runs, but would handicap financial intermediation. This is why, from the earliest known banks in Italy in 1200 A.D. to the present, risky banks that issued demand debt dominated those issuing claims on "safe" stores of value.

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