Are Banks Special?

Catherine England

The U.S. banking industry faces large and increasing problems. Between 1985 and 1990, bank failures averaged almost 170 per year. At least four of the nation's money center banks are on the brink of insolvency. Credit quality problems are a growing concern as banks' net loan charge-offs reached a postwar high in 1989. The Congressional Budget Office predicted in February that the Bank Insurance Fund will exhaust its reserves sometime in the next year. A wrong move—whether by action or inaction—could create another taxpayer-funded black hole in the banking industry.

A looming banking crisis following hard on the heels of the savings and loan debacle of the 1980s has led to intense scrutiny of the bank regulatory system. At no time since the Great Depression have such basic questions been asked about the role of banks within the economy, and properly so. If we are to enter the 21st century without committing taxpayers to a possible trillion dollar bailout of the banks' deposit insurance fund, Congress and administration officials must address the most fundamental questions about the banking industry: Why do we insure and regulate banks? Are banks special? If so, how are they special? In answering these questions, we must separate market failures from government failures. Only then can we design long-term policy prescriptions that will ensure a stable and efficient financial sector.

This article reviews the debates over the special nature of banking. It concludes that banks are indeed special, but they are special primarily because of government policies. Banks and their customers have become increasingly dependent on continuing subsidies and protections provided by the government. Failing to address the sources of government failure will lead at best to an out-of-step banking industry increasingly bypassed by its customers. At worst, declining profitability and mounting failures will lead to nationalization of the banking system and the substitution of regulators' credit allocation decision for those of private bankers.

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Government Policies and the Banking Business

Since the earliest banks evolved from merchants' and goldsmiths' operations, government involvement with the banking business has been more the rule than the exception. This involvement is not particularly surprising in light of banks' historic influence over the allocation of credit. Banks are where the money is (or at least where it was). This traditional function of banking has served as a magnet to governments across time and cultures. Banks provided a source of funds with which to conduct government projects (including, but not limited to, wars), and banks' credit allocation decisions could be influenced by government officials to assist "friends"—industries or individuals—in their private economic endeavors.

As a quid pro quo for providing financial aid to government-sanctioned borrowers or when government intervention in the banking business caused problems—for example, when the king failed to repay his war debts—banks asked for favors and protection for themselves. Government-imposed barriers to entry into banking have been one historically popular device for protecting the interests of bankers and for keeping money in banks where the government wanted it.

In more recent times arguments have developed to justify government intervention as being in the "public interest." Bank regulations are defended today as being necessary to promote the safety and soundness of banks, or they are said to be based on ethical precepts, such as preventing discrimination against the poor. But as George Benston pointed out in a 1989 conference paper, government regulation and control of banks predated concerns for financial stability by hundreds of years.

The result of centuries of government attention is that banks are special because continued government involvement has made them special. From geographic restrictions that limit the ability of banks to open and close offices to powers restrictions that define the products and services a bank may offer, banks in the United States today are often artificial institutions, influenced more by laws and regulations than by market forces.

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To understand how government policies have shaped many of today's banks into institutions that require special care and feeding, it is useful to consider the attributes of banking that characterize the "specialness" of banks. First, banks offer deposits payable at par on demand and thus form an integral part of the payment system. Second, banks provide idiosyncratic loans to small, local businesses. Finally, in performing the first two functions, banks combine liquid liabilities with illiquid assets, and thus they create the potential for "inherent instability" in the face of lost depositor confidence. In reviewing the relative contributions of the marketplace and of government policies in creating each of these three characteristics, it is useful to start with the third and work backward.

Liquid Liabilities and Illiquid Assets. In a footnote in his recently published book, *The Savings and Loan Debacle*, former Federal Home Loan Bank Board member Lawrence J. White lamented, "If banks could simply suspend their promise of payment until they could convert their assets into cash at a reasonable pace, this suspension would ease the bank's problems; but it would mean a unilateral abrogation of the bank's 'contract' with its depositors and would deprive them of the promised liquidity of their assets." This concern, the fact that commercial banks have been defined in the United States as institutions that fund relatively illiquid assets with liquid liabilities, has provided the most important continuing justification for the federal safety net and extensive bank regulation.

The relative illiquidity of banks' assets is usually explained by the asymmetric nature of information about the value of the typical bank's loan portfolio. Because the bank's loan officers have specialized knowledge about its customers that may not be easily verifiable, it is assumed that the bank cannot at any given point in time *prove* the value of many of its assets. Therefore, if a bank manager is forced to sell quickly a significant portion of the bank's assets to raise cash to pay depositors, the bank may not recognize the full value of its portfolio, and it could be forced into insolvency through the resulting "fire sale losses." Federal deposit insurance and the discount windows of the Federal Reserve Banks are deemed necessary to defend solvent banks against the threat of failure brought about by illiquidity.

This analysis overlooks several key considerations. First, as Mark Flannery pointed out in *Governing Banking's Future*, if information is really the problem, government regulators need only make public their examination reports and then let individuals decide where to keep their money. Far from promoting the dissemination of information about the relative health of competing depository institutions, however, the government has aided in obfuscation. Federally mandated accounting requirements effectively cut off experimentation with accounting methods that might have provided depositors with more accurate pictures of banks' financial health. When the Financial Accounting Standards Board recommended in 1988 that banks report the market values of certain securities in the footnotes of their financial statements, some of the strongest opposition came from the Federal Reserve and the Federal Deposit Insurance Corporation. Furthermore, federal regulators generally discourage advertising or promotional campaigns in which better capitalized banks attempt to attract funds on the basis of their financial strength. For all their public concern about a lack of information, government officials are reluctant to open their books to the public for fear that depositors and other private bank creditors would then exercise undue influence over a bank's closure. As the recent Treasury Department report, *Modernizing the Financial System*, noted, "The timing of the closure decision is a key tool of implementing [the government's policy for protecting financial intermediaries against systemic risk], and thus *giving this policy instrument to the private market may be highly inadvisable*" (emphasis added).

Setting aside regulators' actions that limit available information, it is also important to recognize that high information costs do not represent a market failure in and of themselves. In fact, without information costs, there would be no reason for financial intermediaries to exist. If individuals had perfect information about the credit needs and credit worthiness of businesses and other borrowers, no one would need banks or other intermediaries. Savers could buy assets and hold them until they needed cash, at which point someone would pay full value for them.

Information is obviously not costless; it is a resource like any other. In the absence of government intervention, uninsured banks and their creditors, including their deposit customers, would have strong incentives to find ways of reducing the overall costs of communicating reliable information and overcoming the problems created by asymmetric information. For example:

- In the days before federal deposit insurance bankers generally reported the value of their assets at the *lower* of book or market value. This provided depositors and noteholders with the assurance that, if anything, the bank was stronger than it appeared in its financial statements. This practice was superseded by regulatory requirements relying on book value accounting.
- During the nineteenth century considerable information was generally available about the assets held in banks' portfolios, particularly by today's standards. Newspaper reports often warned of banks overcommitted in particular railroad bonds or other investments, for example. Careful analyses of the surviving financial records of banks that suffered runs indicate that 19th century bank runs were not random events. As a rule, they focused on institutions about which there were legitimate causes for concern.
- Through the early twentieth century many bank stockholders assumed "double liability." That is, in the event of failure, stockholders contributed additional sums up to the par value of their stock to pay claims of the bank's creditors. This provided banks with additional capital reserves on which bank creditors could rely in the event of problems. Double liability also brought the incentives of bank owners into closer alignment with the interests of bank creditors, created more risk-averse attitudes among stockholders, and thus assured depositors and noteholders that owners would closely monitor the activities of bank managers.
- Before federal deposit insurance, banks established back-up sources of liquidity, through private clearinghouses, for example. Gary Gorton and Donald Mullineaux have described how the clearinghouses, established primarily for check collection and clearing purposes, took on the task of monitoring the financial health of member banks. In the event of a run on a particular institution, the clearinghouse determined whether the bank was insolvent or simply illiquid. If illiquid, the other clearinghouse members provided funds to stabilize the bank. If insolvent, the bank was closed. Remaining clearinghouse members often took steps to protect depositors and noteholders of the insolvent bank by accepting the failed bank's notes or extending credit to individuals and businesses with claims against the insolvent bank.
- Despite the greater dependence of borrowers on banks in the past, banks' dependence on loans has actually increased since the introduction of federal deposit insurance. From 1934-1939 loans represented 29.43 percent of banks' total assets; in the 1960s, loans accounted for 51.49 percent of assets; and by the period 1985-89, loans made up 59.94 percent of banks' assets. In the absence of federal deposit insurance, institutions with a substantial share of liquid liabilities would undoubtedly hold a more liquid portfolio of assets than many banks hold today. Recent advances in the securitization of loans—including mortgages, automobile loans, and credit card receivables, for example—would also help reduce the risk of illiquidity that uninsured banks would face today.

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- Different contracts, through which depositors voluntarily reduced the liquidity of some of their deposits, would be likely to develop. As a general rule, the interests of creditors and debtors diverge over the "liquidity" of any loan contract. Call options and prepayment rules and penalties constitute an important negotiating point for many consumer and business loans. There is a similar tension between banks' primary creditors (their depositors) and the banks' owners and managers, but the presence of the Fed's discount window coupled with federal deposit insurance applied to interest-bearing checking accounts has made liquidity relatively inexpensive to provide. Not surprisingly, the funds held in demand deposits surged in the 1980s. If depositors were forced to bear the full cost of liquidity, however, they would be likely to reduce the funds held in accounts payable on demand and to accept more restrictions on their own actions.

As the Treasury Department report pointed out, "It is the 'first come, first served' nature of the [deposit contract] that gives depositors the incentive to run. Those depositors at the beginning of the withdrawal line lose nothing, while those at the end lose everything." One solution to this problem is employed by money market mutual funds. Mutual fund shares are constantly marked to market, so that a shareholder's position in line does not affect his ability to recover his pro rata portion of the fund if, for whatever reason, it is liquidated on short notice. Another solution was devised by Scottish banks in the early nineteenth century. Several banks printed "option clauses" on their notes. At the option of the bank's board of directors, the bank could suspend specie payments for up to six months while it liquidated assets in a more orderly manner. To induce noteholders to accept such a provision, the banks promised to pay an interest penalty to noteholders if the option was invoked. Meanwhile, the bank's notes continued to circulate in payment for goods and services. Provisions by banks and S&Ls allowing them to delay payments on savings accounts for up to 60 days are in a similar vein. Such contractual terms serve to protect those depositors at the end of the line. Bank customers would want to be compensated for accepting such limitations, and clearly some accounts would need to remain liquid. But in the absence of federal guarantees, bankers and their customers would have an incentive to develop contractual agreements that protected both banks' liquidity and depositors' interests.

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- Finally, with the federal deposit insurance subsidy removed and regulatory restrictions out of the way, financial institutions might evolve in a way that effectively separated illiquid assets from liquid liabilities. In the days of goldsmiths and merchant bankers, there were apparent economies of scope between the creation of private money and the provision of credit. As government involvement in the banking industry grew and as the activities of banks were circumscribed by government-imposed entry and exit requirements, the combination of money creation and commercial lending became the norm. In the absence of government subsidies and protection, however, strong incentives would exist for banks either to address the potential for instability created by the mismatch between their liabilities and assets or to evolve into some other, more stable form.

In fact, there are unmistakable trends in the direction of separating banks' lending and payment system activities, as James Burnham points out in his article in this issue. As information costs have fallen, intermediation services have changed, and banks have often been left behind. Rather than relying primarily on banks for their credit needs, a growing number of the nation's corporations now raise money directly from financial markets. Although consumers do not currently enjoy direct access to financial markets when seeking credit, nonbank firms increasingly provide consumer credit by selling shares in pools of consumer loans in the financial markets. As Gary Gorton and George Pennacchi concluded in a May 1990 conference paper, "The basis for banking reform ought to be a recognition that the root problem justifying traditional bank regulation is disappearing." As a consequence of these changes, advocates of the "banks are special" position have renewed their search for banks' uniqueness in the separate functions of traditional banks.

Provision of Credit to Small Businesses. In identifying what it believes constitutes the special nature of banks, the Treasury Department report noted: "Information costs and monitoring problems for potential lenders (savers) often preclude the direct funding of innovative types of long-term investment *via* money and capital markets. . . . Such a market failure arises most noticeably when the prospective borrowers are small firms, entrepreneurs, or firms with no established reputation in the proposed line of business." The Treasury Department then concluded: "According to the 'bank specialness' view, any threat of bank runs causes banks to forego the funding of some illiquid investment projects that are economically viable. Where the threat of runs exists, banks tend to hold more liquidity (and make fewer loans available for illiquid projects) than would otherwise be necessary."

Advocates of this view often claim that institution-specific information gathered by banks in serving a local community makes it difficult to liquidate failed banks at a "fair" market value, and the concern is frequently expressed that local credit customers might find it difficult to establish new banking relationships if their existing bank fails. As the Treasury Department report observed, "[s]ignificant reduction in the deposit insurance subsidy could tighten the terms on which credit is made available at insured depositories by a sufficient amount to cause macroeconomic concern."

Without question, the best loan officers rely on subjective information about individual businessmen and the local economy that may be impossible to quantify or to convey easily. And many banks selling loan participations and raising funds receive a premium because of the expertise and reputations of their loan officers. The nonquantifiable positive value that attaches to a portfolio compiled by a good loan officer should not be simply assumed to exist at every bank, however. In fact, the market does apply additional information when valuing the loan portfolio of a failed institution. The fact of failure provides evidence that the credit decisions of that organization ought to be viewed with some skepticism. It is not surprising that the market often assesses the loan portfolio of a failed bank at below book value. Once the failed bank has exited the market, however, existing banks and new entrants will have every incentive to seek out and offer to serve those small business customers that represent solid credit risks.

More important to the long-run health of the economy, there are substantial costs associated with artificially supporting uneconomic credit decisions by undercapitalized banks. Poor lending decisions perpetuated by the federal safety net also make it more difficult for legitimate businesses to start up or survive by artificially reducing the availability of credit and increasing competition in other markets. Subsidized lending may also contribute to boom-and-bust cycles, for example in real estate. We shall never know what businesses were not undertaken and what long-term job opportunities were not created during the 1980s because insolvent S&Ls supported by federal deposit insurance were funneling money into empty office buildings and shopping malls in the middle of nowhere.

Finally, as the Treasury Department report recognized, "[f]inancial institutions not covered by deposit insurance provide an increasingly large amount of intermediated credit—more now than banks." Short-term business credit companies, venture capital firms, and finance companies represent growing nonbank sources of funds to small businesses. Furthermore, existing nonbank sources of credit may be constrained by other regulations, including the rigid information disclosure requirements of the Securities and Exchange Commission. By increasing the fixed cost of raising funds in the capital markets, such regulations limit the options available to small businesses and force them to be more dependent on banks than they would otherwise be. Reducing the burden imposed by such requirements would make it easier for small businesses to raise money directly from investors or for securities firms to create small business loan divisions and to sell shares in the portfolios generated.

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Demand Deposits Payable at Par. Some banking analysts argue that an efficient payment system requires a risk-free asset that always trades at par. These analysts generally go on to conclude that such an asset would not exist in the absence of government regulation and safety net guarantees. Both assumptions, first that an "efficient" payment system requires a risk-free asset payable at par and second that such an asset will only arise through a government-regulated banking system, deserve closer attention.

As the title suggests, George Selgin's book, *The Theory of Free Banking*, is primarily a theoretical work, but in his opening chapter, Selgin does provide a brief description of private banking systems that developed without (or with very limited) government oversight or subsidies. In Scotland (from 1792 to 1845), in Sweden (from 1831 to 1902), in Spain (before 1873), and in Foochow, capital of the Fukien province of China, (ending in 1911), Selgin found unregulated banking systems exhibiting very stable conditions. Bank notes traded at par over long periods of time, and failures were rare.

In fact, in Sweden the private banks competed more successfully with the Swedish Parliament's Riksbank than the government had anticipated. Despite taxes imposed on the private banks and despite the fact that Riksbank notes were the only legal tender, the Riksbank's circulation continued to decline in the face of competition from the private banks. Faced with declining seigniorage revenues, the government abolished the right of private banks to issue notes. Such historical analysis provides at least some reason to suspect that privately provided assets payable at par would develop in the absence of government subsidies.

In addition, the regulation of U.S. banks and the Fed's operating decisions with regard to Fedwire have played important roles in shaping the U.S. payment system. For example, the geographic restrictions applied to U.S. banking raised the costs of developing a private, nationwide clearing system. Although the Federal Reserve System was modeled on successful private clearinghouses that served specified cities and regions, the problems created by thousands of small banks and the absence of any widely branched institutions that could aid in the development of a nationwide system of efficient check collection made a government-dominated payment system virtually unavoidable. By contrast, Canada's payment system is run by the Canadian Bankers' Association, although the Bank of Canada does play a role. The presence of several Canadian banks with branches throughout the country means, first, more checks are handled within a single bank rather than routed through the payment system and, second, even interbank payments often do not have to travel so far to reach a branch of the paying bank as in the United States. Float is simply not the problem in Canada that it is in this country.

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The U.S. payment system has also been influenced by the Federal Reserve's commitment to subsidize and protect Fedwire. The Fed assumes all credit risk on Fedwire and allows banks to create daylight overdrafts without penalty. Every payment accepted onto Fedwire is guaranteed as final by the Federal Reserve against the failure of the sending bank. Thus, the Fed simply does not ask banks using the Fedwire system to exercise any oversight with regard to their counterparties when they receive or send payments. In addition, the Fed generally allows banks to continue to send payments over Fedwire even when their reserves have been depleted by earlier payments. Banks are expected to make up these deficits by the end of the day through payments received, interbank loans from the federal funds market, or discount window loans. Unless the bank requires a discount window loan to cover its payments, Fedwire imposes no charges or penalties for assuming the credit risk represented by such overdrafts.

Clearly, no privately operated automated clearinghouse can compete effectively against the Fed's blanket guarantee of payments and its willingness to allow substantial overdrafts without penalty. The Clearing House Interbank Payment System (CHIPS), for example, does not compete directly with Fedwire but offers a complementary service by processing international payments. Even so, the Fed has brought considerable pressure on CHIPS participants to adopt operational changes sanctioned by the Federal Reserve in the name of systemic stability.

Many students of the U.S. payment system would also question whether it can be termed "efficient." We continue to move enormous amounts of paper through the check collection system. Just as banks have little reason to protest against the subsidies provided through Fedwire, individuals and businesses have been similarly sheltered from the full costs of check-clearing. As a result, there is little support for innovative, more efficient systems such as point-of-sale terminals or debit cards. Dramatic improvements in the U.S. payment system are unlikely as long as banks and their customers receive subsidies from the current system.

These considerations raise questions about the assertion that an efficient payment system requires extensive government involvement (though the existing allocation of costs and benefits probably requires a government role). Before leaving this topic

"Billy, I want to interest you in our new Kandy Kredit Kard."

entirely, however, it is worth considering possible tradeoffs involved in maintaining a "payment system based on an asset guaranteed payable at par."

The provision of federal deposit insurance has not been costless. Federal guarantees kept money flowing to weak and poorly managed S&Ls throughout the 1980s, for example. Although these guarantees protected the ability of insolvent thrifts' depositors to be assured of receiving the par value of their deposits, the resulting protection also contributed to the ultimate costs of the fiasco. Taxpayers will eventually be required to absorb most of the more than $500 billion spent over the next 30 years to pay for thrifts' investment mistakes. If similar trends of risk-taking and forbearance are indeed present among banks and their regulators, as many observers fear, future costs to taxpayers could be even higher. Guaranteeing the par value of certain deposits under all circumstances could become inordinately expensive. Minor fluctuations in the value of a fully checkable money market mutual fund backed by Treasury securities, for example, might be considered a small price to pay to avoid another financial disaster.

In fact, we have experience with nonpar systems. Today's payment system is clearly supplemented at the consumer level by the use of credit cards. But as Gerard Milano noted in *Governing Banking's Future*, the Fed decided in the late 1960s to stay out of the emerging bank credit card business. As a result, the VISA and MasterCard systems have developed practices that routinely allocate part of the cost of the credit risk to merchants accepting credit card "payments" while at the same time investing in leading-edge technology that helps minimize risk by tying individual stores into a nationwide on-line approval system. Milano observed: "There might also be a priced credit risk system for check collection today if the Federal Reserve had not eliminated the practice of discounting in check collection some years ago.... The Federal Reserve's accounts of its war on nonpar check collection usually ignore the fact that the discounts effectively applied a market price to collection float and credit risk."

In summary, although alternatives to the banks' provision of payment services are the least developed among nonbank competitors, there is reason to believe that private, efficient, stable payment services would develop even in the absence of the federal safety net.

The Narcotic of Government Programs

The preceding discussion has argued that legally binding definitions, safety net subsidies, and restricted government services have largely shaped the banking system we have today. An unencumbered financial system would undoubtedly have developed differently as owners, managers, and customers sought answers to problems created by

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costly information, differing attitudes toward risk, and conflicting preferences for liquidity. But the difficulties created by government subsidies and restrictions go deeper than simply affecting depositors' expectations about the acceptable cost of maintaining a checking account. The banking system and its customers have become dependent on existing government protections.

The past decade has seen both theoretical and empirical work on the impact of the moral hazard created by mispriced federal deposit insurance. As long as depositors believe the government's promise to protect or replace their funds in the event of a failure, they will have reduced incentives to expend the time or resources to compare the relative stability of different depository institutions. As expanding government guarantees have replaced market discipline, many of the sources of information demanded by and available to bank customers about the practices of individual banks have dried up. As the federal government has taken on an increasing share of the responsibility for providing "safety," bank managers and owners have been freed to pursue other objectives, including higher profits. In the process many banks have compiled asset portfolios that incorporate more risk than would be acceptable in the absence of federal guarantees.

But the moral hazard problem is not limited to federal deposit insurance. For depositors, the very presence of government examiners, with or without deposit insurance, tends to undermine market supervision. To the extent that individuals trust the government to promote safe and sound banking practices, depositors become less concerned with monitoring their banks themselves. If the government has issued its "seal of approval" by allowing a chartered bank to continue operating, then why be concerned about the unsavory character and questionable business judgment of the president?

Perhaps even more important, an expanding government presence has encouraged bank owners and managers to depend on the government to defend them against the negative consequences resulting from unsound decisions. When the government closely defines and regulates the "acceptable" activities of banks, boards of directors are often content with ensuring that their banks comply with regulatory requirements when pursuing new lines of business. If the government has identified "appropriate" investments for banks, what more need boards of directors add? When the government promises to fulfill the role of lender of last resort, it replaces private sources of liquidity and discipline—like the clearinghouse associations. When the government offers to insure deposits, it undermines the need to provide private capital to reassure depositors. When the government assumes from the market the responsibility for closing insolvent institutions, it encourages bankers to engage in "bandwagon" lending practices. Why not follow the latest lending fad, especially if the nation's largest banks are going along? If enough banks get in trouble, the regulators will declare a "Third World debt crisis" or a "farm credit crisis." The usual regulations will be waived so that regulators can avoid closing a significant number of banks.

Officials within Congress, the executive branch, and the Federal Reserve Board might be more politically accountable for the macroeconomic impact of fiscal and monetary policies if banks' owners and depositors were not partially sheltered from the effects of destabilizing actions.

As other governments have throughout much of history, U.S. policymakers (both state and federal) have also taken advantage of the existence of an extensive safety net to pursue policies that would be inconsistent with the maintenance of a healthy unprotected banking system. Officials within Congress, the executive branch, and the Federal Reserve Board might be more politically accountable for the macroeconomic impact of fiscal and monetary policies, for example, if banks' owners and depositors were not partially sheltered from the effects of destabilizing actions. Geographic restrictions that have long protected thousands of small, locally owned banks and S&Ls from more intense competition would not have survived without federal deposit insurance. It is unlikely that in 1980 there would have been 3,000 specialized mortgage lenders funding 30-year fixed rate mortgages with short-term savings accounts without federal deposit insurance. The State and Treasury Departments' pleas to banks to continue lending to many Third World countries during the 1980s would have fallen on deaf ears in the absence of promised government protection. Community Reinvestment Act requirements would be much more costly to enforce in the absence of a federal safety net. Obviously, the government continues to use the banking industry (broadly defined) to allocate credit to favored sectors, and in return it promises to help underwrite any resulting losses.

Banks' balance sheets reflect the government's influence. Growing credit quality problems, declining profitability, and rising bank failures are only the most visible signs of an increasingly fragile industry created by regulatory constraints and requirements and excessive dependence on the federal safety net. The resulting downward spiral has two broad implications.

First, if unaddressed, government-sponsored subsidies and protections will become a destructive tax over the next decade. Much can be learned from the recent savings and loan debacle. The initial phase of the tax can already be seen in rising deposit insurance premiums, and continuing failures will further drain the Bank Insurance Fund. Federal policymakers are reluctant to commit taxpayer funds to a banking industry bailout. Even as Congress debates various plans to provide additional capital of up to $25 billion to the FDIC, it is with the understanding that banks will repay the loan over the next several years. But without significant deregulation and deposit insurance reform, sustained improvement in the health of the banking industry is unlikely. Continuing problems will lead to substantial pressure to compound the tax on healthier banks through a stepped-up forbearance program that will leave increasing numbers of undercapitalized and insolvent banks open and competing with their stronger counterparts. Profits will fall further, and when a bailout or widespread nationalization of the banking industry becomes inevitable, there will be congressional efforts to punish those private-sector actors named as responsible for the government's failure.

The second implication of this analysis is that making the changes necessary to save the banking industry from worsening problems will be extremely difficult and costly. Arguments that the banking industry should be deregulated and forced to operate without an extensive safety net seem to fly in the face of recognized problems with credit quality, illiquid assets of questionable value, and an inability to attract new capital. Suggestions that depositors be stripped of their government protection seem ludicrous in light of claims by S&L and credit union depositors in Maryland, Ohio, and Rhode Island that they "did not know they were not federally insured" or in the face of losses by groups like the United Negro College Fund when all deposits are not fully protected.

But depositors and bankers are dependent on the federal safety net precisely because there is a federal safety net. Why should depositors spend the time or effort to gather information about the health of individual banks if they are, as a rule, protected wherever they put their money? Why should banks absorb the cost of maintaining higher capital levels if they face no consequent penalty in gathering or retaining deposits?

Substantial transition costs will accompany any effort to reduce federal regulation and protection. Depositors would have to learn again to watch for danger signals when choosing a bank—like above-market interest rates offered on deposit. Bankers would have to develop new operating procedures as they learned again to compete for deposits by providing information and financial stability to depositors as well as attractive products and services. Although the need for depositors and bankers to learn new ways of doing business argues for setting an "effective date" some time in the future (say, January 1, 1995), it is absolutely essential that the banking industry be started on the road to reduced dependence on federal protections and subsidies. There is no other way to assure the future health of the industry.

Although the need for depositors and bankers to learn new ways of doing business argues for setting an "effective date" some time in the future, it is absolutely essential that the banking industry be started on the road to reduced dependence on federal protections and subsidies.

Conclusion

This article has attempted to step back from the current political debates to ask whether the economic functions of the banking industry are in any sense unique. Although the provision of payment and credit services is essential to the functioning of a productive economy, the provision of such services does not require continued subsidies or oversight.

Banks in general, and U.S. banks in particular, have been made "special" by the web of intervention that surrounds them. State and federal policymakers decide where banks can and cannot open offices and what services banks can and cannot offer. Government decisionmakers often seek to influence credit allocation decisions. Removing these choices from the hands of bankers has reduced the ability of U.S. banks to compete effectively, either at home or abroad.

More important, attempts to protect banks through federal deposit insurance, discount window loans, and government-directed closure systems have largely removed U.S. banks from the realm of market discipline. The *Wall Street Journal* recently ran an op-ed in which Martin Feldstein speculated about the value that ought to be attached by regulators to the "going concern benefits" of a bank that is insolvent by accounting standards. Is it not the role of private investors in a capitalist economy to determine whether a business has any "going concern" value? And if we do not allow private investors to make that decision where banks are concerned, how can we expect banks to serve such a function when other borrowers are involved?

It is time to free banks from the visible hand of government and to allow them to evolve in response to market forces. Individual consumers, business customers, and the economy would all benefit.

Not long ago, a reporter from a weekly news magazine raised a telling question: "What would happen," he asked, "if the banking industry simply disappeared tomorrow?" Considering the question led us to acknowledge that there are readily available substitutes for almost every service offered by banks, and over the past decade banks have, as a rule, lost market share. Captive finance companies, consumer finance companies, mortgage finance companies, short-term business credit companies, supplier financing, the corporate paper and junk bond markets, cash management accounts, and mutual funds of all kinds are increasingly meeting the demands of individuals and businesses for credit and savings instruments. Only checking accounts are not widely supplied by nonbank firms, but the use of credit cards and cash machines, the growth in money market mutual funds, and innovations waiting in the wings, such as debit cards and point-of-sale terminals, make it possible to imagine how transaction services might be provided outside banks. Banks are unlikely to disappear overnight, but those who argue that banks are inherently special should be given pause by the fact that such an eventuality can be contemplated. Other firms appear ready, indeed eager, to provide traditional banking services through new instruments and in new combinations.

We need not eliminate the banking industry, of course, to make the point that we need not artificially protect it either. It is important to understand that the banking system has evolved in response to government solutions to a long history of government-created problems. The weight of this historical government intervention now threatens the U.S. banking industry. It is time to free banks from the visible hand of government and to allow them to evolve in response to market forces. Individual consumers, business customers, and the economy would all benefit.

Selected Readings

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