Deposit Insurance

The Case for the Narrow Bank

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As the public debate over the future of federal deposit insurance gathers momentum, there is increasing danger that "incrementalism" will prevail—that modest steps to reduce deposit insurance coverage, to adjust premium schedules, and to limit activities funded by insured deposits will be hailed as genuine reform. In fact, the Treasury Department's recently released proposals represent just such an approach.

Something much more than incremental adjustment is needed, however, if recurrent taxpayer bailouts of federal agencies and individual institutions are to be avoided. If policymakers fail to move boldly now, they will lose a unique opportunity to set in motion an effective and far-reaching market-oriented reform of the nation's financial system.

The reform proposal developed in this article is based on the concept of "narrow banking"—the limitation of federal insurance to deposits invested solely in low-risk assets. Although other analysts, such as Robert Litan and Lowell Bryan, have developed the rough outlines of such a proposal, this essay details key features of a financial system with narrow banks and advances expanded arguments in favor of such a reform. Narrow banking may not be as revolutionary as some observers believe. Many elements of a narrow banking system are, in fact, emerging spontaneously in response to market developments. The approach suggested here is a practical and sensitive way to accomplish the twin goals of reducing taxpayer exposure and of fostering a sounder, more competitive financial system.

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Narrow Banking for the 1990s

A narrow bank, as the term is used in this proposal, would have the following six principal characteristics. First, narrow banks would be the only financial institutions, with the exceptions detailed below, eligible for federal deposit insurance. All deposits, regardless of size, would be fully insured. Second, narrow banks would be permitted to hold as assets only deposits with the Federal Reserve and with other banks (domestic and foreign) and U.S. government securities, including most government agency securities. The precise criteria might be equivalent to those now followed by the Comptroller of the Currency in determining what types of government securities can be purchased and held without limit by national banks. No other extensions of credit would be permitted. (A minor modification might make state and local government securities eligible assets.) Third, only narrow banks would have access to Fedwire, the dominant national system for making payments. Fourth, a narrow bank could be operated as an affiliate of another institution, but the narrow bank would be unable to accept deposits or payment instructions from its parent holding company or from any related affiliate. Nor could the insured narrow bank act as an agent in selling any product or security for another entity. Fifth,

an exception would be made for small financial institutions that wished to continue to operate as traditional commercial banks or thrift institutions. A sliding scale would leave institutions with assets of less than $100 million free to operate under current standards. Increasing percentages of "safe" assets would be required until a 100 percent level was reached at, say, $500 million. All such institutions would continue to be eligible for federal deposit insurance and to have access to the Federal Reserve payment system. Finally, the system of narrow banks would be introduced gradually, over a period of at least ten years. This would permit existing institutions to make studied choices as to how they wished to respond, and it would allow banks to adjust their asset portfolios and liability mixes gradually, with minimal impact on bank customers. For example, an institution with over $500 million in assets that wished to have its deposits federally insured might be required to keep at least 50 percent of its assets in eligible categories by 1995, 60 percent by 1996, and so on.

Implications

These six principles have several significant features and implications.

One Hundred Percent Insurance. Although there are strong theoretical arguments for requiring depositors to assume some of the risk and monitoring responsibilities of banking activities, there is also ample evidence that federal banking regulators will continue to provide de facto 100 percent protection to depositors at the nation's largest banks and at those banks with substantial foreign deposits. (Foreign deposits are regularly protected despite the fact that they are not part of the deposit base against which insurance premiums are assessed.)

By limiting federal insurance to deposits invested solely in low-risk assets, narrow banking will accomplish the twin goals of reducing taxpayer exposure and of fostering a more competitive financial system.

Protection for depositors at the largest banks is synonymous with the too-big-to-fail issue. Any proposal for deposit insurance reform that fails to address this question directly is avoiding a central issue in the need for banking reform. The narrow bank proposal, by incorporating 100 percent insurance, recognizes the reality of regulatory behavior. It also removes the inequity of the present system, in which large domestic depositors at small banks run a genuine risk of loss while similarly situated depositors at large banks do not.

The concern by higher level federal banking regulators for foreign depositors (a concern typically mirrored by overseas banking regulators for *their* banks' foreign depositors) has been evident in every significant near or actual banking failure since that of U.S. National Bank of San Diego in 1973. These concerns were echoed in the bailout of Continental Illinois in 1984, and most recently in the handling of the National Bank of Washington and the Bank of New England failures. It is argued that any loss by foreigners at a failed bank would have substantial spillover effects on other U.S. banks active in foreign markets. While the exact definition of "excessive" spillover is different for each analyst, participants in the international money market are well aware that credit "tiering" occurs on the basis of no more than a bank's nationality.

Senior banking regulators, unlike some academic students of banking, are not "boundary blind." National frontiers and concepts such as "national competitiveness," however imprecise, will continue to be an important factor in determining how banking authorities respond to problems. By providing explicit 100 percent insurance, the authorities should be able to allay fears about a loss of U.S. banking competitiveness arising from a narrow banking system.

Limiting Investments. The practice of customers' limiting bankers' use of their deposits is already well established. The federal government and most state and local authorities normally require banks to earmark specific collateral (typically U.S. Treasury securities or, in the case of state and local governments, their own securities) against their deposits.

Limiting investments for all insured deposits through a narrow banking requirement would reduce credit or default risk by eliminating all private-sector lending (other than to other banks). Thus, the potential risks to the bank insurance fund would be substantially reduced despite the nominal expansion in insurance coverage. Consequently, capital requirements could probably be reduced as well.

Unlike some narrow banking proposals, the approach taken here would permit narrow banks to hold long-term as well as short-term government securities. Such flexibility would tend to increase

the banks' revenue potential. This feature would be politically advantageous as well, because narrow banks could thus act as a source of funds for the residential mortgage market through holding government-insured mortgages and pass-through securities, in much the same manner as commercial banks do today.

Some risks would remain. Because deposits with other banks would be permitted (to facilitate the operation of the payment system), there would be exposure to credit risk from foreign commercial banks as well as from other narrow banks. Risk would also arise from payment and overdraft risk (when money is paid out on behalf of a customer against a payment expected later the same day) and as a result of changes in the market value of longer-term securities ("interest rate risk"). Interest rate risk has led to the downfall of more than one sizeable bank. (Bank of the Commonwealth in 1972 and First Pennsylvania Bank in 1980 are two nontrivial examples.) These risks are much easier to monitor and evaluate, however, than are those presently borne through the regular extension of credit to private parties. Federal regulators would no longer have to worry about private-sector risk factors, such as shopping mall vacancy rates, developing country creditworthiness, and oil prices.

Access to Fedwire. By making narrow banks the exclusive point of access to the payment system, the risk of a major payment system failure would be reduced substantially. Concern over such a failure has grown in recent years as the volume of transactions has increased and as weaknesses among financial institutions have become more apparent.

Since temporary extensions of credit are a normal feature of most payment systems, the participation of institutions other than narrow banks in the Fedwire system (or any successor system that involved a Fed "backstop") would be inconsistent with, and would threaten to defeat the purpose of, the narrow bank concept. At the same time, their exclusive membership in the Fedwire system would encourage firms and individuals to keep deposits with narrow banks.

A Genuine Chinese Wall. By prohibiting narrow banks affiliated with holding companies from accepting deposits and payment instructions or acting as agents in any capacity for affiliated entities, the tortuous problem of constructing "firewalls" between insured narrow banks and uninsured holding-company affiliates would simply be eliminated. With the exception of capital account transactions, such as the payments of dividends, intraholding company financial transactions would be forbidden.

The Treasury Department's proposal in this area is severely deficient. The dividing line between insured and uninsured activities should be drawn as starkly and precisely as possible to prevent the insured status of a narrow bank from "rubbing off" on an affiliate. Such a policy would imply clear physical separation of public operations as well as various restraints on public communication and advertising. These might include limiting the use of the word "bank" to describe only "narrow banks" and mandating use of the phrase "insured deposit" whenever a narrow bank wished to use the word "deposit." Ample precedent for such restrictive and proscriptive use of language is found in both state and federal laws. An approach that included strict prohibitions on narrow banks' acting as agents in selling any product or security for other affiliated entities should make it difficult for investors in uninsured and worthless securities to claim later that they "thought" they had federally insured status.

By providing explicit 100 percent insurance of deposits in narrow banks, regulators should be able to allay the fears about a loss of U.S. banking competitiveness arising from a narrow banking system.

Under a narrow banking approach, most of the issues associated with the repeal of the Glass-Steagall Act (separating commercial banking from securities underwriting) would thus become moot. Because only narrow banks would retain federal deposit insurance and direct access to the payment system, uninsured chartered depositories would no longer enjoy any potential subsidies or government-created advantages in competing with securities firms. By removing the bulk of private-sector risk from the insured banking system and by limiting access to Fedwire to narrow banks, the liquid savings and primary means of payment of households and businesses would be protected from risks associated with underwriting securities or providing other financial servicies. Similarly, the existence of genuinely effective "Chinese walls" should also relax U.S. banking authorities' longstanding, but probably counterproductive, opposition to "combining the businesses of commerce and banking."

Table 1: The Impact of Narrow Banking (institutions potentially affected)*

Asset Size	FDIC-Insured Commercial Banks	FSLIC-Insured Commercial Institutions	FDIC-Insured Savings Banks	Credit Unions
		Number of Institutions		
Less than $100.0 Million	10,308	1,462	151	13,559
(%)	(78)	(50)	(31)	(98)
$100.0–499.9 Million	2,249	1,046	222	304
(%)	(17)	(35)	(45)	(2)
$500.0 Million or More	582	423	119	15
(%)	(4)	(14)	(24)	(**)
Total	13,139	2,949	492	13,878
(%)	(100)	(100)	(100)	(100)
		Assets (in billions of dollars		
Less than $100.0 Million	379	70	8	102
(%)	(12)	(5)	(3)	(58)
$100.0–499.9 Million	440	233	51	53
(%)	(14)	(17)	(18)	(30)
$500 0 Million or More	2,312	1,049	225	20
(%)	(74)	(78)	(79)	(11)
Total	3,131	1,352	284	175
(%)	(100)	(100)	(100)	(100)

*Data as of December 1988.
**Insignificant.
Sources: *Statistical Abstract of the United States, 1990*, Table 799, p. 494.

Exemptions for Small Institutions. The exemption permitting financial institutions with under $100 million in assets to continue as diversified private lenders and the partial exemption for institutions in the $100 million to $500 million range reflect the fact that the viability of the federal deposit insurance system is unlikely to be threatened by smaller institutions, even if occasional failures do occur. If a narrow banking system with these exemptions had been in place in 1988, more than 10,000 banks (nearly 80 percent of the total) holding $379 billion in assets (or just 12 percent of total assets) would have been totally exempt from the narrow bank restrictions. (See Table 1.)

Because only narrow banks would retain federal deposit insurance and direct access to the payments system, uninsured depositories would no longer enjoy any potential subsidies or government-created advantages in competing with securities firms.

These size exemptions also reflect the fact that narrow banks are likely to exhibit certain economies of scale. It is unlikely that a narrow bank could operate profitably with a small deposit base. Thus, small, locally owned, federally insured deposit-taking institutions could disappear without the exemption. Most credit unions, for example, would lose their insured status without the exemption. Given 1988 data, only 15 credit unions would have been forced to convert to the narrow bank form. (See Table 1.)

Transition Period. Contrary to the concerns expressed by a number of analysts, the adjustment process suggested by the narrow bank proposal detailed here need not be traumatic, particularly if phased in over a ten-year period.

As just noted, small institutions would be exempt from the requirements, and most medium and large size deposit-taking institutions are already organized within a holding company framework. Although there are roughly 4,000 banks unaffiliated with a holding company, these institutions average only $50 million in assets. Thus, few unaffiliated banks would need to comply with narrow bank rules.

Larger banking organizations that wished to remain in the commercial and consumer lending

business could simply transfer any existing loans to a new or an existing affiliate. Many banking organizations already have finance company and specialized lending or leasing affiliates. In fact, at the end of 1988, 35 of the 100 largest finance companies (ranked by total capital funds) were affiliated with banks. A logical response by a commercial bank required to shed its private-sector credit exposure would be simply to transfer it to an existing or newly established finance company.

Concern has also been expressed that changes would be required of bank customers. This concern overlooks the extent to which larger banks have already ceased to be genuine relationship lenders. A consumer may keep a checking or NOW account at a bank and make payments on a residential mortgage, installment loan, or credit card facility through that bank. But thanks to the securitization of credit, the actual lender of those funds is increasingly likely to be an institutional investor of whom the customer has never heard. Business customers, even of relatively small size, are increasingly being solicited by a wide variety of nonbank lenders. Furthermore, any changes would be phased in over a ten-year period, certainly not a recipe for disruption.

Evolution of the Financial System

The chief elements in the evolving financial system can be grouped as shown in Table 2. Note that the system includes uninsured "chartered depositories." These would be the uninsured successors to today's larger commercial banks, savings and loans, mutual savings banks, and credit unions. Such institutions (as well as the Federal Reserve and the Comptroller of the Currency) existed long before federal deposit insurance was introduced, and it seems reasonable to permit their continued existence. Narrow banks and an expanded finance company sector would, of course, subject uninsured institutions to significant competition.

Table 2: Basic Organization of a Financial System with Narrow Banks

- Insured Institutions
  - Narrow Banks
  - Traditional Deposit-Taking Institutions with Less than $500 Million in Assets
- Uninsured Institutions
  - Chartered Depositories
  - Near Banks
    - Finance Companies
    - Money Market Mutual Funds
- Securities Dealers
- All Others

In a number of important but generally unrecognized ways, the U.S. financial system is already moving in the direction of narrow banking. On the deposit side advances in computer technology and communications have facilitated the development of money market mutual funds with the equivalent of checking privileges. Although some funds invest in private-sector commercial paper and are vulnerable to losses, a number of funds invest exclusively in short-term U.S. government securities. A total of $68 billion were invested in such funds as of November 1990. Operating costs appear to be significantly below those experienced by banks, so that these mutual funds can pay higher yields (which are also frequently exempt from state and local taxes) than are available on federally insured bank money market accounts.

The adjustment to a narrow banking environment need not be traumatic, particularly if phased in over a ten-year period. Small institutions would be exempt from the requirements, and most medium- and large-size deposit-taking institutions are already organized within a holding company framework.

In addition to money market funds backed by short-term government securities, there are a substantial number of mutual funds that invest in longer-term government securities. These funds had over $80 billion in assets at the end of 1989. Recent concerns over bank creditworthiness have probably resulted in additional inflows to both types of funds.

On the lending side the diminishing role of traditional banks has been widely noted. Although still large, the banking industry's share of private lending has declined significantly under constant pressure from the commercial paper market, rapid growth by finance companies, and innovations in securitization that permit consumer and business loans to be financed by a wide range of nonbank institutions.

More recently, mutual funds have begun to acquire portions of bank-originated loans. Funds now occasionally seek to be part of the original underwriting group for some of the larger, syndicated credits. Thus, mutual funds are not only displacing commercial banks on the deposit-taking side of the balance sheet, but are acting as increasingly aggressive—and

"Before we discuss our short-term interest rates, perhaps you could let me know how many hours you'll need the money for."

successful—competitors on the commercial lending side as well.

In view of these developments, a system that, after a suitable transition, limited deposit insurance to smaller institutions and narrow banks would be unlikely by itself to subject the financial system to serious strains. The most significant development would undoubtedly be a faster rate of growth for institutions offering uninsured deposit-type financial instruments to fund private-sector borrowing needs, either in the mutual fund format or as bank-type finance companies.

Neither narrow banking nor any other proposed solution to the deposit insurance problem can promise to eliminate the threat of inflation and financial instability faced by central banks. The narrow banking system would not prevent the Federal Reserve from taking appropriate action in the event of severe instability among uninsured, bank-like financial institutions.

Challenges for the Fed

The growth of uninsured, deposit-like activity appears to be the greatest cause of concern among banking regulators who have considered narrow banks. As Federal Reserve Chairman Alan Greenspan puts it, "We might end up with the same set of challenges we face today, refocused on a different set of institutions."

This concern is largely a straw man, however. The basic challenges faced by central banks—the threat of inflation and financial instability—have remained fairly constant despite continuing institutional changes. The widespread adoption of narrow banking would simply eliminate a glaring imperfection in the financial structure—a poorly designed deposit insurance system—by reinforcing a structural change already underway in the financial system. Neither narrow banking nor any other proposed solution to the deposit insurance problem can promise to eliminate the basic challenges facing central banks.

Nor would any feature of the narrow banking system proposed here prevent the Federal Reserve from taking appropriate action in the event of severe instability among uninsured, bank-like financial institutions. First, those deposit-taking institutions with under $500 million in assets would continue to have access to the Federal Reserve's discount window and would still be federally insured. Second, uninsured chartered depositories could also be allowed continued access to the discount window. Such access was available before deposit insurance was introduced, after all. Finally, there is ample precedent for Federal Reserve intervention to stave off serious problems in the nonbank financial sector.

The collapse of Penn Central in 1970 triggered a run on the commercial paper market, not on the banking system. The Federal Reserve intervened to protect major commercial paper borrowers from financial failure. Although this intervention was carried out through the banking system, *nonbank* institutions were still the Federal Reserve's immediate concern. In 1985, following the collapse of the deposit guarantee fund for Ohio savings banks, the Federal Reserve opened the discount window to a number of state-insured thrifts. In October 1987, fears of illiquidity at certain investment banks and mutual funds spurred a similar response by the Fed. Not only do ample precedents exist for central-bank lending and support to distressed nonbank financial institutions, but the Federal Reserve also has the power to lend to nonfinancial firms.

The Federal Reserve, of course, might seek to gradually assume supervisory responsibility and regulatory control over any nonbank institutions that might need assistance from the discount window. But the solution to this potential problem is straightforward: discount window loans should be made only against unimpeachable, deliverable

collateral, namely market-valued U.S. government securities. This would ensure that the Federal Reserve would not become another backdoor route to the U.S. Treasury in the manner of the Federal Savings and Loan Insurance Corporation.

A strict collateral requirement would also eliminate the need to attempt to determine quickly whether an institution is merely illiquid or actually insolvent. All firms and the public would be advised that Federal Reserve advances would only be made against market-valued collateral to which the Fed had immediate access. Thus, there would be little risk of loss to the Fed—or to taxpayers—and little justification for any expansion of detailed supervision or unwise extension of the Federal Reserve's "safety net" to failing institutions. Indeed, given such a collateral requirement, primary dealers—the government security dealers through whom the Fed carries out its own operations in government securities—could become the new transmission mechanism for discount window lending to the nonbank sectors of the financial system.

Competitive Concerns

Some analysts have expressed concern about the potential impact of a narrow bank requirement on the international competitiveness of U.S. banks. It is argued that if trade finance, commercial loans, and other extensions of credit could no longer be financed with insured deposits, American institutions would be at a serious competitive disadvantage. Furthermore, since narrow banks would not be allowed to make markets in foreign exchange, money market instruments, or government securities, such activities would seem to be simply conceded to foreign institutions.

Substantial adjustments in how financial institutions are organized would be required by the introduction of a narrow bank system, but there is little basis for fears that U.S. institutions would be placed at any long-term disadvantage as a result of these changes.

First, the narrow-bank restrictions would also apply to any foreign banks' branches or subsidiaries operating in the United States. Second, the proposal permits U.S. financial institutions (but not narrow banks) to establish overseas banking subsidiaries that could carry on all traditional commercial banking functions under one roof. Existing money center banks would probably encourage major customers seeking continued government insurance to split their liquid deposit balances between U.S. narrow banks and overseas subsidiaries. Overseas subsidiaries, of course, would participate in whatever deposit-insurance regime exists in their country of operation.

With respect to trading and market-making activities, there are already important and successful nonbank market makers in all such instruments. These include the major investment banks and nonbank government securities dealers. The existence of these competitors makes it clear that deposit insurance and direct access to the Fed are not necessary for success. Existing commercial bank operations in these areas could thus be reorganized along the lines of existing nonbank dealers.

Substantial adjustments in how financial institutions are organized would be required by the introduction of a narrow bank system, but there is little basis for fears that U.S. institutions would be placed at any long-term disadvantage as a result of these changes.

Impact on Securities Markets

Some analysts have expressed concern about the potential impact of narrow banks on the level and structure of interest rates. It is suggested first that because narrow banks' investments would be limited to government securities, the spread between yields on government and private securities would increase significantly as narrow banks' demand for government securities depressed their yields. It is also argued—somewhat inconsistently—that the interest rate paid on deposits at narrow banks would be so low that the demand for such deposits would fall significantly, reducing the overall level of safe and liquid financial assets in the economy. Finally, some analysts fear frequent and volatile shifts of deposits between narrow banks and other institutions as investors respond to interest rate movements and credit concerns about uninsured institutions.

It does seem reasonable to expect a somewhat larger demand for short-term government securities in a narrow banking world. U.S. government security holdings, reserves at the Federal Reserve, and vault cash at commercial banks at the end of 1989 were equivalent to only 83 percent of checkable deposits. (See Table 3.) Comparable figures for credit unions and mutual savings banks were on the order of 90

Table 3: Checkable Deposits and Narrow Bank–Eligible Assets as of 12/30/89 (in billions of dollars)

Institution	Total Narrow Bank–Eligible Assets	Checkable Deposits	Assets/ Deposits (%)
Commercial Banks	460	556	83
Savings and Loans	205	33	621
Mutual Savings Banks	36	40	90
Credit Unions	18	20	90
All Depository Institutions	719	649	111

*Consists of U.S. government securities, reserves at Federal Reserve, and vault cash.

Source: *Flow of Funds*, Federal Reserve Board, September 1990

percent. Savings and loans held nearly six times as many government securities as checkable deposits, however. As Table 3 also shows, therefore, as of the end of 1989, eligible assets exceeded the combined depository institutions' checkable deposits by some $70 billion. Thus, depository institutions as a group already hold sufficient assets to provide backing for the core liquid assets and means of payment.

Small time and savings deposits at narrow banks are another matter, however. These accounts totalled some $2.2 trillion at depository institutions at the end of 1989. In attempting to retain these deposits,

A ten-year transition to a narrow bank system and the expectation of continued large budget deficits and off-budget agency financing make it unlikely that any major shift in average yield differentials of government and private securities would take place.

narrow banks would be in direct competition with other financial institutions, particularly money market mutual funds. At the moment, it would appear that the money market funds have developed a far more efficient transaction processing system than many existing commercial banks possess. Money market mutual funds cover their management costs with charges to shareholders ranging from just .5 to 1 percent of invested assets. On the other hand, many banks already provide record-keeping and clearing services to such mutual funds, and these banks would appear to be advantageously positioned.

In the final analysis, however, a ten-year transition period and the expectation of continued large federal budget deficits and off-budget agency financing make it unlikely that any major shift in *average* yield differentials would take place, though there might be an increase in the yield differentials for securities with the shortest maturities. Reduced yields on short-term government securities might then lead the Treasury Department to rely more heavily on short-term borrowing, but such an adjustment is unlikely to have any major adverse impact on debt management or monetary policy.

With respect to the second issue of whether consumers and businesses would significantly reduce their demand for narrow bank deposits, there is a longstanding tendency by both business firms and households to minimize balances in low- or non-interest-bearing deposits. Frequent funding of checking account balances is a well-established practice. Corporations have been practicing zero-balance checking for well over a decade, and the sizeable holding of money market fund balances by households testifies to their interest in similar practices. It may be that checkable accounts could not be easily reduced much below their current levels. Time and savings accounts would be much more vulnerable to leakage into the uninsured sector. But the shift of these financial resources should roughly match the shift of private-sector lending from insured narrow banks to other bank-type institutions.

Finally, on the question of frequent and volatile shifting of balances between narrow banks and other institutions, it is hard to understand why such activity should be any greater than it already is. Sudden shifts into Treasury securities when events such as Penn Central or the October 1987 stock market crash take place are well documented, and market participants are well aware that lesser events frequently trigger similar but more short-lived fluctuations.

Cost of Credit

Some skeptics of the narrow bank proposal argue that it is not sufficient to demonstrate that alternative sources of private credit would fill the gap when commercial banks are turned into narrow banks. They argue that the cost of private-sector credit would be sharply higher.

Where large borrowers are concerned, the evidence is clear: alternative sources of credit are

already fully competitive with bank borrowing. Commercial paper, bonds, finance companies, and life insurance firms offer competitive rates in many areas of commercial finance.

At the consumer level, nearly all large retailers as well as the automobile companies compete on financing terms. Greatly increased activity by consumer-oriented finance companies would be likely in a narrow bank world. The marginal cost of funds to such lenders would be little different from that paid currently by commercial banks that rely on the national money market. Recent annual data on the relative standardized borrowing costs of three-month finance company paper, commercial paper, bank certificates of deposit, and Eurodollar deposits show little difference after adjustments for bank reserve requirements and FDIC premiums. The cost of funds to smaller banks, which seldom draw on the national money market, may be somewhat lower, but these institutions would not be forced to divest themselves of private-sector lending activities if they remained of sufficiently small size. Even if it could be shown that some private-sector borrowing costs would increase by 10 to 20 basis points (.1 to .2 percent) without funding by government-insured deposits, the difference seems a reasonable price to pay for a sounder financial system.

The Challenge of Change

Market forces within the U.S. financial system are leading to major structural changes. The challenge for policymakers is to make the corresponding changes in the elaborate and complex regulatory structure that has developed since the 1930s. In the final analysis the central issue is not the capacity of private financial institutions and their customers to make adjustments, but the ability of regulators and lawmakers to adjust *their* mindsets and policies.

Banking regulatory authorities find it difficult to contemplate genuinely new arrangements or strategies, in large part because past policies have become embodied in existing concepts, habits, and organizational arrangements. The cost of change in internal adjustment and transitional uncertainties looms painfully large to long-established agencies and their managers.

The central issue with regard to narrow banking is not the capacity of private financial institutions and their customers to make adjustments, but the ability of regulators and lawmakers to adjust their mindsets and policies.

Perhaps the history of airline deregulation can provide useful insights. Without sacrificing the core function of safety oversight, federal agencies withdrew from their intimate involvement in the structure of competititon and subsidies, airports served, and prices charged. As a result, there has been a radical reshaping of the industry, although a high level of safety for passengers has been maintained throughout the transition. Most of the problems—airport congestion and more frequent flight delays—are a result of the success of the new policies. New competitors have emerged in both domestic and international markets, and the capacity of the U.S. airline industry to serve the public has been vastly improved. Improved service to the public is, after all, the ultimate test of sound public policy, not the year-to-year financial viability of the industry or the absence of an occasional business failure.

The introduction of officially recognized narrow banking would reinforce the trend toward equally significant changes in the structure and functioning of the U.S. financial system. The longer such recognition is delayed, the greater the ultimate cost of the necessary changes will be.