General Discussion

*Summarized by Richard E. Randall**

Introductory Remarks by the Moderator

Federal Reserve Governor John P. LaWare began the discussion by offering some deliberately provocative statements to stimulate debate.[1] Noting that discussions of banking reform have tended to focus on the issue of deposit insurance and its effects on the banking system, he described deposit insurance as arguably the most negative legislative blow ever struck at the banking system. Deposit insurance provided the rationale for the subsequent overregulation of banks and their use by Congress for social goals. The original purpose of deposit insurance, to protect solvent banks from the contagion of consumer runs on insolvent banks, was well served; and no taxpayer money has ever been lost as a result of problems in the commercial banking system. However, the sorry spectacle of the thrift debacle prompted Congress to impose greater constraints on the commercial banks.

Governor LaWare sees the Federal Deposit Insurance Corporation Improvement Act (FDICIA) and its provisions for early intervention and prompt corrective action as the culmination of the trend toward overregulation. In an environment of vocal vilification of the concept of "too-big-to-fail," orderly and less costly resolution of failing banks was made more difficult, while Draconian recovery programs were imposed on struggling banks.

Governor LaWare posed the following questions:

* Vice President, Federal Reserve Bank of Boston.

[1] Governor LaWare made it clear that he was speaking for himself and not the Federal Reserve Board.

- Does deposit insurance foster moral hazard? Is risk-taking in the banking system greater than it was before deposit insurance?
- In connection with Richard Randall's proposal, how do we determine concentration limits? Is concentration per se the real problem, or is it the relaxation of pricing and terms on loans that is needed to increase market share?
- Are banks runs truly a thing of the past? LaWare noted that the proximate cause of closing Bank of New England was a run by *insured* depositors that depleted deposits by over $1 billion in a day and a half.
- Is a policy of too-big-to-fail inappropriate where failure would destabilize the financial system and impair the viability of other institutions? What is wrong with resolving failed banks with purchase and assumption transactions, which protect the large depositors, if it makes for a more orderly resolution of the banks?
- Would the integration of banks, securities firms, and insurance companies in financial service holding companies or even in universal bank structures tend to protect or further expose banks?

What limits will markets put on capital? Everybody makes the observation that if we just had more capital we would not have to worry. In the 1920s, the average capitalization of the commercial banks in the United States was between 12 and 15 percent of assets. Nonetheless, in 1924 in the midst of a developing boom economy over 600 banks failed. Capital alone is not the final answer. How far can we go in mandating higher capital standards? Demands for returns on capital are a limiting factor, so will not the market ultimately decide how much capital a bank can have?

Governor LaWare also invited comment on his own proposal to eliminate moral hazard: make deposit insurance voluntary on the part of the depositor. Depositors could buy as much insurance as they think necessary to protect their accounts, but they would pay the premiums directly. The premium would be "risk-based," reflecting the condition of the bank. The market would soon impose its discipline on bank managements, because deposits would move out of banks with poor condition ratings.

Bert Ely, banking consultant, questioned Governor LaWare about the possibility that with voluntary deposit insurance, "free rider" depositors in large banks deemed too-big-to-fail would let others pay insurance premiums, while they relied on the assumption that they would have time to bail out when a serious problem arose. The governor's response was that the failure of a reasonably large bank, with uninsured depositors taking losses, would end such behavior.

Summary of the General Discussion

The following is a summary of the general discussion as well as the question periods that followed each presentation. The material has been organized under subject headings, and comments are not necessarily in chronological order.

Financial Cycles and Bank Asset Concentrations

Lynn Browne of the Boston Fed raised the question of whether the equivalent of the LDC lending situation could take place in the future. How likely is it that several of the largest banks will make the same bets, as suggested in Randall's paper? She cited examples of many banks racing into the same activity, suggesting a type of herd mentality could occur again. She noted that her concern was for areas of concentration involving several banks, rather than a particularly high concentration involving only a single bank.

John LaWare reinforced this point, citing the current scramble by so many financial institutions into consumer finance. He deplored the emphasis put on market share, with the consequence that credit standards are lowered. Bert Ely saw the herd effect most clearly with regard to financial markets generally, with assets moving outside the banking system in part because of constraining bank regulations.

Alex Pollock of the Federal Home Loan Bank of Chicago cited Charles Kindleberger's work on financial crises as evidence that we do not have long to wait for the next one. The risks in banking are substantial and largely opaque to the public. But if banks were required to fully disclose all risks in some detail, they would soon divide their assets and corresponding liabilities into risk classes. The result would be what Jim Pierce calls a functional bank but Pollock prefers to call collateralized money. Richard Aspinwall of Chase Manhattan Bank, on the other hand, asserted that the process of securitization has already made banks less opaque with respect to risk characteristics. It remains to be seen, however, whether supervisors have the resolve to react promptly to capital deficiencies.

Robert Listfield of BEI Golembe referred back to Randall's paper and the evidence that five separate events within a decade caused about two-thirds of the failures of U.S. banks (as measured by assets). Listfield was concerned, not about isolated random failures, but about times when systemic risks threaten large segments of the banking industry or other key financial industries or markets. Coinsurance would not have inhibited lending in the boom phase of the New England cycle, but it would have produced a major flight of deposits to banks in a stronger region, once the New England banking problems surfaced. Banks are special because they can either contribute to the health of an economy or destroy it. Countercyclical actions can help, but the rules of FDICIA, tied as they are to capital ratios, can destroy the banks they are designed to save. We can expect more such cycles in the future, and we must smooth the peaks if banks are to have a soft landing when the cycle turns.

LaWare questioned whether this was the responsibility of the supervisors or the bankers. Listfield replied, again using New England as an example, that bank supervisors should have developed the evidence that the market was moving into a feeding frenzy in commercial real estate development. They should have been more proactive in stopping this activity, not because of the actions of any one bank, but because a collection of institutions were moving in a direction that jeopardized them all. Individual banks cannot see the broader picture that is visible to the supervisors—if they are looking for it.

Genie Short of the Dallas Fed noted that in the early 1980s, the large Texas banks were funded through Euromarket CDs issued under lines of credit provided by New York banks, whereby the contract became null and void overnight should the borrowing bank use the discount window. With this safety valve, the New York banks did not require higher rates despite the obvious energy problems of the Texas banks. This broken link between those taking the risk and those paying for it enabled the Texas banks to move aggressively into the real estate market.

Robert Eisenbeis of the University of North Carolina suggested that highly improbable events sometimes happen and damage banks. Just because such events occur does not necessarily mean that the market failed to identify and price the risk. He questioned whether we should try always to have systems in place to prevent such unlikely events. George Benston of Emory University ran through the list of recent financial cycles that caused bank failures and concluded, with hindsight, that they were all predictable. But it would be very difficult to persuade market participants that they were being foolish for supporting booming activities. One answer is diversification, because you do not know where the next hit is coming from; you just know it will come. Another answer is to have enough capital to absorb the loss.

Frederick Furlong of the San Francisco Fed puzzled over the question of whether something inherent in the nature of banks draws many of them to the same risky areas. They shun diversification, for some reason. One explanation for this herd instinct is that banks know that if they all get in the same trouble at once, they will be protected. Bert Ely suggested that the bankers were acting rationally, for regulated institutions. Business strategies in unregulated industries focus on differentiation. Until we get away from one-size-fits-all regulation, we will continue to see the herd effect. Richard Randall of the Boston Fed suggested that more intensive competitive pressures on banks in recent years had much to do with so many banks focusing on the same risky activities.

Supervisory Intervention against Certain Asset Concentrations

Richard Randall was questioned by some participants about how to distinguish dangerous asset concentrations, how bank supervisors were defining concentrations for FDICIA capital provisions, and how supervisors could pursue an interventionist policy in the face of political pressures or when supervisory actions were curtailing bank profits. Randall stressed that the delineation of potentially harmful concentrations was too complex to be reduced to a formula for capital adequacy purposes, and Edward Ettin of the Board of Governors staff confirmed that the regulatory agencies had not been able to do that. Randall argued that some asset categories are inherently riskier than others and that we must be particularly concerned about concentrations in these types of assets, construction and development loans being an obvious example.

Lending terms and underwriting standards are also important, but more difficult to monitor than concentrations. When a bank that has never had more than 3 percent of loans financing construction and development suddenly has more than 25 percent, as often happened in New England in the 1985–89 period, it is time for some supervisory involvement, Randall declared. Some concentrations in banks with long-standing niche lending situations might be tolerated, while they would be inappropriate where many banks are competing for assets with the same type of risk. Supervisors need to identify the more important risk concentrations and then examine the underlying economic factors that will govern the risks in these areas in the future.

Jane D'Arista of Boston University's Center for Banking Law commented favorably on Randall's proposal, but preferred quantitative lending constraints to the kind of flexible decision-making on the part of supervisors called for in his paper. She suggested borrowing from the macro prudential policies of European central banks two decades ago, where specific sector limits were set. Banks then would have to convince supervisors that they could safely exceed such limitations. She also cited the rapid growth in derivatives as an area of concentration risk that should receive close attention.

Philip Bartholomew of the Office of the Comptroller of the Currency acknowledged that we live in a world of cycles and speculative bubbles, and that we need to learn to supervise banks in that context. This involves a different supervisory posture when bubbles are inflating than after they burst. Bartholomew believes the agencies can develop appropriate measures of concentration, but questioned how the supervisors are to convince the management of overconcentrated banks to back off, at a time when cash flows are strong and the herd mentality prevalent. Randall indicated that one approach could be speeches by agency heads and other forms of "jawboning." His preference, however, is for direct pressure on the most concentrated and aggressive banks—a shoot-theleaders approach. This would involve senior supervisory officials accompanying examiners to meetings, first with senior bank management and then with directors. Interagency cohesiveness among the regulators would be essential. While a little pounding on the table may be necessary, most banks will acquiesce. If they do not, supervisors will have to have the authority for formal enforcement action. Supervisors should have well-developed and coordinated policies, procedures, and training programs. Their policies, as well as the history of the recent boom and bust cycles they are reacting to, must be generally understood by the industry, the Administration, and the Congress.

Relevance of the Thrift Experience

John LaWare suggested that recent problems in depository institutions stemmed in large part from the regulatory environment. This was particularly true of the thrifts, which existed in a highly protected environment until they were thrust into a new environment without a clue as to how to respond. Richard Syron, President of the Boston Fed, questioned whether the thrift industry problem has implications for the Federal Deposit Insurance Corporation (FDIC), since thrift behavior and regulation differed significantly from that of banks. George Kaufman, from Loyola's College of Business, put much of the blame on regulatory forbearance, which FDICIA was designed to combat.

James Pierce of the University of California at Berkeley sees at least one lesson in the savings and loan debacle. The thrift industry had lost its economic function, but the government tried to keep the resources in that industry through increasingly desperate methods. This introduced great moral hazard and fostered the entry of new participants into the industry, including many contractors. Now banking is losing its economic function as others provide traditional banking products just as cheaply, yet the government is continuing to restrict the powers of banks and bank holding companies. We must not replay the savings and loan problem with the banks. The thrift industry repeatedly said that not one dollar of taxpayer money had been spent in backing its deposit insurance fund. In the same vein, the full faith and credit of the government is behind the FDIC. That has value so, in that sense, taxpayer money is being used to support the banks.

Randall noted again that the banking industry absorbs deposit insurance losses. Taxpayer dollars would become involved only when the whole banking system was so weakened that it could no longer absorb the losses. This occurred in the thrift industry, but it is not the case with the banking industry. Bert Ely challenged Pierce's comparison of banks to thrifts, which he characterized as a disaster waiting to happen. Ely does not see the banking function as dead or obsolete, but asserts that it is being strangled by government.

The Federal Deposit Insurance Corporation Improvement Act (FDICIA)

George Kaufman spoke in defense of FDICIA. He indicated that in selling to Congress the concepts of early intervention and prompt corrective action, his intent, and that of other members of the Shadow Financial Regulatory Group, was to codify what supervisors should be doing. He noted that they had been doing the right thing 90 percent of the time, but that lapses had occurred. He cited Penn Square Bank and Bank of New England as examples of lapses that necessitated making appropriate actions mandatory. He is disappointed in the supervisory response; the proponents thought at the time that supervisors would welcome the law to deflect political or industry pressure to forbear.

Kaufman noted that the Act is having the intended effect: uninsured depositors took losses in only 10 percent of failures in 1991, 50 percent in 1992, and in 1993 to date, nearly 100 percent. The signal is filtering through to the market. Capital ratios have improved tremendously, partly because of economic conditions conducive to profitability, but also because of market discipline. According to Kaufman, the experience cited by LaWare of numerous failures in the 1920s of banks with high capital ratios involved mostly very small banks. It is rare for economic capital to be depleted quickly, so strong capital ratios are very important. Kaufman is disappointed that supervisors specified such low capital thresholds in carrying out FDICIA provisions.

LaWare responded that supervisors like the additional authority to close banks before they become insolvent. The problem is that often they have little choice but to close banks when their capital gets down to 2 percent, even when they can be resuscitated.

Richard Syron argued that earlier closure of Bank of New England would not have reduced the loss to the FDIC. Kaufman responded that prompt corrective action is intended to prevent firms from getting into Bank of New England's condition in the first place. Syron replied that to do that, one would have had to focus on loan concentrations, because if one focused on capital ratios, intervention would have come quite late.

George Benston argued for greater disclosure so that the public can decide when loan concentrations become unreasonable. In addition to loan concentration numbers, he advocated disclosing banks' CAMEL ratings.[2] Richard Randall pointed out that commercial real estate concentrations were publicly identifiable from bank condition reports in each of the regional real estate cycles of the 1980s. Also, the CAMEL

[2] Bank supervisory ratings based on Capital, Asset quality, Management, Earnings and Liquidity.

ratings did not reflect the developing problems until about the time that they were reported in the newspapers.

Bert Ely suggested that higher capital standards increase the incentive to securitize lower-risk assets, thus increasing the proportion of higher-risk assets on bank balance sheets. George Benston replied that investors, particularly acquirers of subordinated debt, will price the risk and thereby influence the level of risk-taking bankers choose. Benston would like to see capital requirements as high as 15 to 20 percent of assets.

Hal Scott of Harvard Law School questioned imposing much higher capital ratios on U.S. banks as compared to Japanese banks. Benston cited the NAFTA debate, arguing that U.S. consumers should not subsidize U.S. banks (by tolerating lower capital ratios) so that they can compete with foreign banks that are being subsidized by their taxpayers.

Paul Horvitz of the University of Houston argued for the strict rules of FDICIA, indicating that forbearance seldom works. He acknowledged that two or three of the largest banks in the country might have been closed in the 1980s, had FDICIA rules been in place, but he suggested that with clear rules, the banks might not have gotten into such a situation. He cited congressionally mandated forbearance by the FDIC on about 300 banks in the mid 1980s, expressing the view that the agencies did not do well in selecting banks likely to recover if given more time.

John LaWare objected to the word "forbearance": the use of supervisory discretion by the banking agencies is clearly distinguishable from the notorious regulatory forbearance of the savings and loan problem. He stated that without the leeway to deal with the LDC crisis in the way that we did, we would have experienced a much more serious financial crisis. Imposition of write-downs on LDC loans in 1982 and 1983 on the basis of perceived collectibility would have wiped out the capital of perhaps the 10 largest banks in the country.

Robert Eisenbeis argued that it was not valid to judge the FDICIA rules on the basis of what might have happened in a past situation, without considering the effect of penalties and potential consequences of risk-taking in averting the problem. He also referred to an earlier study by Allan Berger of the Federal Reserve Board staff that associated high profitability with high capital. Eisenbeis inferred that the profitability of Japanese banks currently is low because of very low capital levels.

Market Discipline

Hal Scott contested a statement by George Benston that uninsured depositors in U.S. banks do not take hits, noting that they did lose in the majority of failures in 1992. Benston speculated that in a future Continental-size failure the authorities would not allow depositors to take losses.

Edward Kane of Boston College recommended distinguishing between coinsurance and reinsurance and establishing when "too-big-to-fail" began to imply essentially unlimited deposit insurance. Arthur Rolnick of the Minneapolis Fed replied that this was so at least from the time of the Continental failure. Both Benston and Rolnick emphasized that the authorities should impose substantial "haircuts" on uninsured depositors in future failures of large banks.

Myron Kwast of the Federal Reserve Board staff reported that, based on surveys, the percentage of U.S. households with potentially uninsured bank deposits has risen from about 2 percent to over 5.5 percent in 10 years. While this suggests that the potential for market discipline has been increasing, Kwast recommended that we learn more about the characteristics of these uninsured depositors before relying on them for market discipline.

Hal Scott interpreted Kwast's report of increased holdings of uninsured deposits by households during a decade of severe banking problems as evidence of just how secure the current deposit insurance system makes people feel, and how much stability it provides the economy. He sees it as a warning that making radical changes in the system could be disruptive. Maybe these people are foolish for having kept their money in U.S. banks these past 10 years, but imagine the alternative, had they all decided to take their funds out. Rolnick responded that we must consider how the nature of uninsured depositors would change as we increased the likelihood of their taking losses. We have given too much security to depositors at the expense of the taxpayer; moral hazard must be taken seriously.

Subordinated Debt and Coinsurance

James Pierce elicited from George Benston assurances that subordinated debtholders would, in effect, be designated loss-takers for the purpose of stimulating market discipline. They would have no protection except the cushion provided by stockholders and covenants such as restrictions on dividends or the power to replace the board of directors. Philip Bartholomew noted that the market for subordinated debt of small banks is very limited.

Robert Eisenbeis sees little marginal benefit in terms of market discipline in having small depositors at risk. He noted the point made by Arthur Rolnick, that imposing heavy hits on larger depositors might simply tempt supervisors to keep large banks open. If this is indeed the case, then Eisenbeis suggested that this implies that the basic deposit insurance coverage is too low, not too high. Alton Gilbert of the St. Louis Fed argued that, with coinsurance, the bulk of the deposits are insured by the government-backed fund, and this implies government supervision. If this supervision proves to be so bad that large losses occur, it is not inappropriate for the government to be at risk.

The Risk in Functional Banking

Robert Eisenbeis questioned the wisdom of creating a riskless asset by providing full deposit insurance for transaction accounts in monetary service companies. We need some form of riskless asset in the economy, but why not let Treasury bills serve that function? James Pierce responded that his proposal accomplishes a great deal, including the elimination of the need for most supervisory functions by the creation of a federally insured money fund. Twenty years from now, consideration can be given to eliminating that government guarantee. While the functional bank would not totally be riskless, the risk can be priced and is therefore insurable.

Jane D'Arista suggested that, by acquiring commercial paper, the monetary service companies would be funding finance companies that make opaque loans in competition with banks (financial service companies under Pierce's proposal). The finance companies require credit enhancements on their paper from the banks, which currently benefit from deposit insurance. She asks who will coinsure in the future. Pierce is not concerned that private entities will coinsure each other. The monetary service companies will not be able to give credit enhancements. He considers these essentially liquidity enhancements, and notes the importance of access to the discount window.

In response to a question by Bert Ely, Pierce indicated that a financial institution that holds opaque loans was probably insurable, but the federal government need not be the insurer. No externality prevents the private funding of opaque loans. Hal Scott wondered what the functional banking scheme would do to the cost of credit for firms that currently borrow from banks. Pierce suggested that, on the basis of finance company interest rates and the downward trend in the volume of opaque loans, the implications for the cost of credit would not be great.

Hal Scott also raised the issue of potential failures of the "broader banks," or financial service companies in Pierce's parlance. They could experience runs in non-transaction accounts and average people would lose money, giving rise to pressure on Congress for a bailout. Robert Litan of the U.S. Department of Justice saw this as a lesser problem than a run on the commercial paper market. To avoid the small savers problem, financial service companies could be required to issue their liabilities in larger units, at least initially, so as to be funded by institutional investors.

Effects of Functional Banking on the Payments Mechanism

Under James Pierce's functional banking proposal, monetary service companies would hold all transaction accounts, fully insured by the

FDIC, but they would be allowed to take only very limited risks. Pierce envisions that such corporations not be allowed to incur daylight overdrafts. Alton Gilbert argued that you cannot just prohibit daylight overdrafts without making radical changes in corporate cash management.

Edward Ettin agreed with Gilbert but suggested that the risks of losses on daylight overdrafts are insurable. Pierce prefers to avoid having monetary service companies grant daylight overdrafts because the risks would necessitate regulatory review. For the same reason, he does not think such companies should be involved in settling foreign exchange transactions. Sheila Tschinkel of the Atlanta Fed reminded the group that all transactions are ultimately settled through the banking system.

Runs on Banks

George Benston asserted that the banking *system* is not dependent upon the confidence of depositors, even though individual banks may be. People are going to put their money somewhere. Even if they shift to currency, the central bank could offset such a move. It is only a run to gold that creates a problem.

George Kaufman worries about runs to currency by small depositors, and therefore he would limit coinsurance to amounts above some minimum level, say $10,000. The large banks do not need deposit insurance protection over $100,000, because large depositors will not run to currency. Large depositors impose market discipline, and the losses incurred in large bank failures have been very small. They would be still lower if troubled banks were closed before their capital reached zero.

The Lender of Last Resort

Robert Eisenbeis made the point that providing liquidity to banks through the discount window does not necessarily relate today to protecting the level of the money supply or to preventing sustained runs on institutions, but, rather, seems more related to protecting the flow of transactions through the payments system. Markets are becoming more global, and all transactions must clear against good balances. Government intervention in financial markets, such as occurred when Chrysler's problems led to concern about the commercial paper market, is a separate issue and not related to clearing specific transactions. James Pierce's functional banking proposal does not address this distinction between settling payments system transactions and meeting more fundamental liquidity needs.

Richard Aspinwall questioned whether the lender of last resort was truly accessible to large banks with liquidity problems in 1990 and early

1991. In this period of anxiety over bank solvency, large banks borrowing at the window would have been assumed to be in trouble and subject to runs.

George Benston questioned whether there should be a lender of last resort. Open market operations can deal with a systemwide liquidity crisis, while individual banks that cannot manage to borrow in the private market should be allowed to fail. If banks had that possibility to worry about, they would behave differently.

Private Deposit Insurance

Bert Ely's answer to a problem that affects many banks in a particular region at the same time is his cross-guarantee proposal, whereby the various guarantors price the risk for individual banks. Guarantors would have strong incentives to watch the whole financial marketplace through their syndicate agents, and they would price the option on their capital so as to promptly raise the cost of credit going into speculative bubbles. Ely noted that the private insurance proposal cannot be implemented until a critical mass of subscribers has been achieved. He also stressed that large institutions would be allowed to fail, even though one objective is to avoid destabilizing failures.

Richard Aspinwall thought that Robert Litan had not adequately presented the case against private insurance in his discussion. Several participants had already referred to inadequate capital in the banking industry, so the proposal to establish syndicates so that banks can insure each other sounds like a financial shell game. Also, enormous conflicting incentives would be created, whereby large banks would not criticize each others' practices for fear of return criticism. Risk would shift from the government to the private sector, but it would not stay there for very long.

Edward Kane argued that we need not and should not seek to pick a single device to rely on for bank safety. Private reinsurance, coinsurance, collateralized deposits, uninsured deposits, and subordinated debt could all contribute at the margin. He maintained that government supervisory efficiency could be substantially enhanced by assigning the first tier of depositor losses to a coinsuring private entity (a "surety"). This would put at risk an entity whose debt and stock values would depend squarely on capital-market estimates of the quality of bank supervision.

Kane noted that such private coinsurance is essentially a performance bond and that the bond need not be provided only (if at all) by syndicates made up of banks. Locating the proactive supervisory activities of bank examination and insurance eligibility in the private sector would put healthy pressure on federal regulators to better manage their second-tier risk exposure. Capital-market monitoring of surety debt and stock value would make more transparent the consequences of politically or bureaucratically driven forbearance decisions. Kane saw promise in performance bonding over subordinated debt, because the bonding company would have its own supervisory force and receive better whistle-blowing information on risk-taking as a result of the regular interaction between the bonding agents and the banks.

A Concentrated Banking System

One of the discussants had complained that the symposium papers did not address sufficiently the subjects of interstate branching and broader banking powers. Randall observed that branching and expanded powers imply greater concentration of the banking or financial services industries. He stated that it would be prudent to develop a better understanding of financial cycles and ways to control them before adopting changes that would accelerate the trend toward concentration.

John LaWare challenged this view by citing a lower failure rate in such highly concentrated banking industries as those of Canada, England, and other large European countries. James Pierce would add Japan to the list but cautioned against drawing inferences from the bank mortality rates in these countries, because behind-the-scenes arrangements are made to keep the banks whole. He warned that in a highly concentrated banking system a very large troubled bank might be able to push the government around.

Calls for a Broader Focus

Jane D'Arista argued that the symposium papers focused too narrowly on only a part of the financial system, particularly with respect to financial guarantees. She noted that we have developed a broader system of guarantees relating to securities, insurance, and pensions in addition to bank deposits. She proposed that the government provide limited protection against the failure of financial institutions directly to each individual, by Social Security number, and allow the individual to decide how to allocate the amount. The limit might be $100,000 or some other number. In addition, all transaction balances at banks would be fully guaranteed.

Edward Ettin raised the possibility of a broader safety net, one that might to some extent encompass the life insurance, securities, and pension industries. He noted that deposit insurance is constantly in the way, creating moral hazard, ensuring that future calamities involving banks will arise, and conflicting with allowing banks into new activities. Nonetheless, it is becoming more difficult to distinguish banks from other financial institutions, and Ettin is concerned that some of the problems that gave rise to the safety net for banks have shifted elsewhere. We should be thinking about the potential for systemic risk arising from the activities of other financial institutions. This implies thinking about limited supervision and discount window access for certain nonbanks to minimize systemic risk concerns, but without extending the federal safety net or regulation unnecessarily.

In the context of the functional bank proposal, Myron Kwast is concerned not only about payments and settlement, but about the public good externalities of the financial intermediation function. He notes that this function is moving to all kinds of institutions. What remains in the banking system would be segregated from the narrow banks and normal access to the discount window. Kwast questions how you limit access to the discount window for functions considered important to the public interest.

James Pierce responded that you first have to address the argument that systemic problems can be handled with monetary policy. Systemic problems that cannot be handled in this way may be susceptible to the provision of ample liquidity through the discount window. He would have no trouble with lending to insurance companies in an emergency, as long as rules were well defined. This is consistent with the functional approach he advocated in his paper.

Arthur Rolnick suggested that the term systemic risk may be overused, calling attention to work by George Kaufman on the rarity of bank panics and the question of whether bank runs are good or bad. Rolnick asked whether failures of banks or other financial institutions represent market failures, and indicated that we should start talking about solutions only to the extent that they do. He doubts that we have seen a market failure in the insurance industry, and suggested that even in the banking industry, what occurred may have been less a market failure than something of a more political nature.

Relationship between Bank Failures and the Real Economy

Robert Eisenbeis suggested that we started out being concerned about the implications of systemic bank failures for the real economy, and now need to consider ways to protect the banking system from real sector problems. Bert Ely argued that feedback of the real economy to the banking system arose because a lot of mispriced credit flowed out of the banks, thrifts, and insurance companies into the real sector, causing overbuilding and speculation. Once the bubble burst, the problems came back on the financial system, so a circularity exists between banking and the real economy.

Philip Bartholomew observed that many bank failures have occurred recently in several foreign countries. Situations such as those in Norway, Sweden, and Finland amounted to the virtual failure of the whole system, and have created real problems in getting the economy back on its feet.