The Need to Protect Depositors of Large Banks, and the Implications for Bank Powers and Ownership

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The issues that will be addressed in this article on the U.S. banking system are highly controversial and very much the subject of intense debate at this time. The positions presented here are solely those of the author, drawn from thirty-five years of experience in bank supervision and discount window administration.

Three fundamental issues should be carefully considered before making any decisions on altering the federal safety net or the structure of the U.S. banking system. The first is whether or not bank depositors and other creditors can exercise timely and meaningful restraint on excessive risk-taking by bank managements. Most of the proposals for "reform" of the deposit insurance system rely on the premise that market forces can selectively alter bank lending practices so as to avoid major or widespread bank failures. The counterargument is that the market recognizes serious credit problems only after severe or even fatal damage has been done, and belated market reaction often increases the exposure of the deposit insurance fund.

The second issue is whether the government should handle the orderly resolution of large bank failures in such a way that uninsured depositors and other bank creditors are protected, popularly if inaccurately known as the "too big to fail" policy. Here the argument hinges on the significance of systemic effects where, in the absence of an expectation of such protection, a perceived problem in one large bank would trigger a deposit flight, not only from that bank, but from other banks believed to have serious weaknesses. At issue is the ability of depositors, other creditors and supervisory authorities to assess the risks in the various banks on a timely basis. Another question concerns the special role of banking in the economy, and the critical elements of banking that give rise to the government's interest in controlling the resolution of banking problems. Still another aspect is the possibility of nonbanking firms or institutions requiring similar federal intervention under certain circumstances.

The third fundamental issue is the degree to which banking should continue to be insulated from other financial and nonfinancial activities. The debate here should center on the implications for the federal safety net of a broadening of bank activities or of the movement of nonbanks into banking functions. One question to be resolved is the reliance to be placed on artificial barriers, known as firewalls, in protecting the bank safety net from nonbanking risks. Also to be considered is whether U.S. banks can be sufficiently profitable to survive in world competition in the absence of a broadening of powers.

These three issues are so interconnected that a discussion of any one would be incomplete without the other two. For example, an argument in favor of market discipline through reduced deposit insurance coverage must presuppose that uninsured depositors of large banks need no longer be protected. Otherwise, lower deposit insurance coverage would serve only to drive small and mid-size banks out of business in favor of large banks. Conversely, an argument that the effects of systemic runs on large banks believed to be in hazardous condition will not be destabilizing rests in part on an assumption that the market can distinguish banks with dangerous risk concentrations from those with only superficial or transitory weaknesses. Decisions on broader banking powers have implications for the risks assumed by the safety net. More importantly, any decision to allow nonbanks into essential banking activities may broaden the range of firms that must be included under the federal safety net. Clearly, questions relative to the need for and nature of the safety net, and the dependability of firewalls, must be resolved before undertaking a major restructuring of the financial services sector.

A number of additional issues of importance bear on any restructuring of the banking system and bank safety net. Among these are: (1) the proper interpretation of the recent disastrous experience of the thrift industry and its supervisory and deposit insurance backstops; (2) the question of what to do about the use of brokered funds; (3) the value of proposals for mark-to-market accounting, risk-based deposit insurance premiums, private deposit insurance, early resolution of failing banks, narrow banks, required issuance of subordinated debt, much higher bank capital requirements, and the like; (4) the value of firewalls versus the importance of synergies; (5) the bank holding company as a source of strength to its banks; and (6) the potential for reducing the banking system's propensity for major loss concentrations through more forward-looking supervision. In the author's view, all of these issues can be considered as subsets of one or more of the three fundamental issues identified above.

This article will focus primarily on the second of the three fundamental issues identified, the too big to fail policy, and its implications for the third fundamental issue, banking structure. It will be necessary, however, to briefly explain at the outset the position the author has developed in previous works on the first issue, the ability of the market to recognize credit problems on a timely basis.

I. Timely Recognition of Bank Credit Problems

While several types of risk can lead to the failure of banks, the overwhelming majority of commercial bank failures can be attributed to credit risks in the loan portfolio. Indeed, with respect to large commercial banks it is hard to think of cases of failures or near failures primarily attributable to other causes. Centran (1985) and First Pennsylvania (1980) are the only recent examples that come readily to mind. Thus, the focus here will be on recognition of credit problems in bank loan portfolios.

The largest losses that the Federal Deposit Insurance Corporation fund has had to absorb to date have come from relatively large banks, say those ranking in the top one hundred banking institutions by size.

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The level of concentration of total banking assets in large institutions as a group, and the propensity for large banks to develop similar risk concentrations (as recently illustrated by loans to less developed countries, energy and shipping loans, highly leveraged transactions and real estate development lending), suggest that the relevant focus of our analysis should be on large banking organizations.

Banks exist as financial intermediaries largely because a broad class of borrowers cannot readily obtain credit directly in the market as a result of informational and collateral control factors. Banks must follow business borrowers closely in terms of changing loan balances, frequent credit analysis, customer contact and collateral handling—functions that the market cannot perform easily, except for the largest and strongest concerns. Bank examiners periodically review bank loan portfolios and also ensure that large banking organizations have internal loan review functions. Yet there has been ample evidence recently, particularly in the Southwest and New England, that even specialists with full access to loan records sometimes have difficulty in evaluating the potential losses in a bank's loan portfolio before a high degree of vulnerability has developed.

Market analysts, whether they represent bank stock investors or creditors, have relatively little to go on in forming a judgment on the potential for major losses in a bank's loan portfolio. They can follow nonperforming loans, provisions for bad debts and charge-offs, but these indicators lag the actual risk-taking by months or even years and are trailing indicators of the credit problems that eventually emerge. Furthermore, a sudden deterioration in such indicators has little predictive value since it is seldom clear whether it is the result of a housecleaning, or the tip of an iceberg.

It has been the author's experience that the best evidence of a potential credit problem is a rapid growth in a particular loan category with high inherent risk characteristics. An example would be a rapid growth in construction lending, resulting in a high concentration. If the concentration can be further narrowed, say to condominiums in a particular geographic area that appears to have the potential to be overbuilt, the negative implications become even stronger.

While greater emphasis on this type of analysis should help in timely evaluation of risk, standardized data pertinent to concentrations are limited. It is usually only in the later stages of risk-taking that the sophisticated market can clearly distinguish irresponsible overconcentrations from reasonable specialization. The typical depositor, and even the large depositor with analytical resources, has little potential for making timely judgments on bank risk-taking in loan portfolios.

To demonstrate that, in fact, the various market forces have not been able to identify serious credit problems on a timely basis, the author in an earlier study examined each of the forty large bank holding companies that developed a problem, as defined in the study, in the 1980s through mid-1987.[1] The study related the timing of stock price movements, stock analysts' warnings, and bond rating changes to the period when most of the damage was being built in by lending practices and rapid loan growth. Typically, the potential for serious credit problems developed over a period of three to five years before the actual problems became externally obvious through alarming increases in nonperforming loans or provisions for loan losses.

The evidence of the study clearly shows that market forces were not able to identify the emerging credit problems until substantial, sometimes fatal, damage had been done. The market never reflected the problem before the approximate time of the first clear external signal from the bank itself, through an announcement of high nonperforming assets or loan loss provisions. The study also showed that analysts usually were unable to determine whether such an announcement represented the full recognition of an isolated problem, or the first revolution of a death spiral.

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The issue here is not whether the market can see emerging problems in time to permit uninsured depositors to flee before the bank is closed, or to ensure that supervisors do not leave failing banks in operation after they have been fatally damaged. The point of market discipline is to prevent, or at least mitigate, serious problems, and to accomplish this it must be applied at the stage where unacceptable risks are being taken, so that management will be persuaded to diversify away from those risks before banking or economic factors can seriously damage the bank. Belated imposition of market pressure only complicates the efforts of the supervisory authorities to resolve failing banks so as to avoid systemic effects on other banks.

The author has, in the previous work cited, presented evidence that the market is incapable of fulfilling this role, and the recent experiences with various large bank holding companies in the Northeast strongly buttress the earlier findings. To the author's knowledge, no findings to the contrary have been published.

The argument is sometimes made that the ability of depositors to identify unsafe banks has not been tested because our current system has made it unnecessary for them to do so. It is contended that in a world without deposit insurance, or other elements of the federal safety net, depositors would have the incentive to determine bank risk either themselves, or by hiring professional services.

Once banks are recognized as problems, it would seem to be the supervisor's role to control further risk-taking through close interaction and frequent on-site review.

This argument presents problems. First, the issue is less a question of motivation than of useful information. As already noted, the best information on actual risk-taking is loan growth data by broad categories. While this information might stimulate analysts to question management about lending terms and to think about the bank's area of expansion relative to pertinent economic trends, it is hard to imagine analysts recommending deposit flight from non-problem banks based on such external risk evaluations.

On the other hand, it is just such evaluations by supervisory surveillance units that should prompt recommendations for on-site examinations to ascertain if risk-taking is reasonable. External analysis of risk-taking is also important to stockholders, who are immediately damaged when a supposedly strong bank announces a jump in its loan loss provision or level of nonperforming assets.

Once banks are recognized as problems, it would seem to be the supervisor's role to control further risk-taking through close interaction and frequent on-site review. Nonetheless, much of the argument for the need to control "moral hazard" through greater market discipline seems to be in terms of banks that are publicly recognized to have problems. It is particularly difficult for even the most experienced external analyst to judge the potential for further material losses in a bank's loan portfolio after one or more announcements concerning loan problems have been made. After original judgments on loan concentrations and economic environment have been made, the acknowledgment of the problem by the bank seldom leaves the analyst with much basis for evaluating the extent of the damage. It often comes down to the credibility that management has with the analyst, and the banking history of the 1980s includes numerous instances where analysts' confidence in management's veracity was misplaced. In several cases management itself was blind to the real extent of the damage.

The conclusion that the actions of depositors and other creditors cannot prevent major credit problems in banks, but can only complicate the orderly resolution of failing banks, has several important implications. It follows that the various proposals to increase depositor/creditor-imposed market discipline will not reduce the potential drains on the deposit insurance fund, and some may have the opposite effect. A recognition that the loss potential in a bank's loan portfolio is not so measurable as to be readily expressed in an accounting sense should limit interest in marking such assets to market. Similarly, it should be recognized that no preset formula for risk-based premiums can capture risk-taking with sufficient discernment that a pricing scheme can be relied on to deter excesses. While the author supports risk-based premiums as a logical step, expectations of its impact should be realistic.

II. Protection of All Depositors in Large Banks

The phrase "too big to fail" is a useful shorthand for an informal policy that has been in effect for some time in this country, and in one form or another in all industrial nations. The phrase itself is inaccurate, so it is useful to explore just what the policy is and why it exists.

Too Big to Fail Concept

In the United States, large banks whose capital has been depleted are not prevented from failing. Some form of legal reorganization takes place so that the owners of the banks lose their entire investment before the Federal Deposit Insurance Corporation and the uninsured creditors of the banks suffer a loss. If the deposit insurance system works as intended, losses to the FDIC are not losses to the federal government or the taxpayers, but are met by the insured banks as their assessments replenish the insurance fund. The only way that the federal government (the taxpayers) would be required to absorb losses would be if the losses were so great, and the banking system so damaged, that the industry as a whole could not absorb these losses.[2]

The rhetoric on the issue often refers to the taxpayers "bailing out" the banks that get themselves in trouble. In fact, the policy under discussion is not designed to prevent nonviable banks from failing, and certainly not to protect either the stockholders or managements of failing banks. Taxpayer funds would only be called upon in the event of a "meltdown" of the entire commercial banking system, not to resolve individual banks.

The concept of too big to fail effectively extends insurance coverage to all depositors and creditors of large banks (or bank subsidiaries of large bank holding companies) as part of a supervisory reorganization. This is done to avoid runs on these banks that could lead to similar runs on other large banks perceived by the public to be in questionable condition. Such a policy is necessary because of a combination of several factors:

1. Uninsured bank depositors are not willing to risk losses, even relatively small ones, and in the absence of implied protection by the insurance fund, will withdraw funds as fast as possible from banks in questionable condition.
2. Bank creditors are unable to distinguish failing banks from damaged but viable banks, and will tend to shift funds to banks believed to be in safer condition on the receipt of bad news.
3. Supervisors, despite their superior access to information, will often require time to evaluate the viability of a large bank once a run begins.
4. Even after the authorities determine that a large banking organization is failing, it requires time, at least several weeks if not months, to arrange for its disposition. This is aside from any legal impediments to a determination of insolvency.

Thus, in the absence of implied protection, large-scale deposit runs would be possible in any large bank whenever the market was surprised by bad news. In a deteriorating environment with several large banks reporting increasing credit problems, market concerns for possible failures would probably be heightened, lowering depositors' tolerance for bank weakness. For banks that ultimately do fail, the elapsed period between a major deposit run and eventual resolution by the authorities will probably be several months. This would be true even if there are no legal constraints on the disposition of nonviable banks before they are insolvent in terms of book net worth. These banks, and other large banks that are troubled but are capable of surviving, will have to be supported through the discount window, or some other mechanism such as FDIC assistance, for a prolonged period, and potentially in very large amounts.

Myth or Necessity?

Some economists and representatives of large banks have argued that the need for protecting creditors of large banks is a myth.[3] They contend that very large failing banks could be disposed of, with depositors and creditors absorbing losses, without significant repercussions for the banking system or the economy. They note that, while deposit runs may occur in particular large banks, large-scale conversion of deposit balances to currency or to foreign currency deposits is unlikely, leaving monetary aggregates and the level of economic activity essentially unchanged. They argue that any systemic bank runs could be handled by the Federal Reserve as the lender of last resort.

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If one imagines the isolated closure and liquidation of a single very large bank with well-known problems at a time when the domestic and international banking systems are in unquestioned good health, it could be argued that the disruption that would result, while considerable, would be transitory with limited systemic effects and no prolonged negative impact from a macroeconomic point of view. (A counterargument would be that even if such action causes no immediate difficulties, it could be taken as precedent and result in instability at a later time when several large banks were in trouble.) This scenario of an isolated failing large bank cannot be assumed, however, and is not the model to use in considering this major policy issue, since the most serious banking troubles are apt to stem from economic events that affect a number of large banks at about the same time. Recent examples include the Southwestern energy recession, various regional real estate gluts, the economic failures of heavily indebted developing countries, and bank exposure from loans to highly leveraged borrowers.

A more appropriate scenario to consider would involve several large banks in danger of failing at about the same time, including some money center banks and perhaps a few major foreign banks. Problems would likely stem from the impact of some economic event on several banks, and banks could be adversely affected by more than one economic event because of a coincidence in timing. There would likely be a high degree of public uncertainty as to the depth of the underlying economic problems and the timing of recoveries. Most uninsured depositors and other bank creditors would be concerned about the possible failure of particular banks, and would be prone to hasty reaction to rumors and misinterpretation of information. Adverse developments in one bank could cause instability in other banks perceived to have similar problems.

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Supervisors would face similar uncertainties, even though they had much more information on the weaknesses of specific banks. While the depositor need only decide that the situation warrants pulling funds from one bank and putting them into another, the supervisor must determine if a particular bank is likely to fail, quantify the degree of any potential insolvency, and devise and execute a strategy for resolving the institution. A careful evaluation of the credit exposure of a troubled major bank involves a significant portion of the available examiner resources, and evaluations must be updated frequently as conditions change. When a number of large banks are in trouble at once, the supervisors will not necessarily be in a position to know the viability of a particular major bank when a deposit run develops. In a chaotic situation where depositors are rapidly shifting deposits from bank to bank, and creditors of banking concerns are refusing to roll over notes, the authorities must decide whether to seize particular institutions or support them, in some cases without a current evaluation.

The consequences of seizing an institution that is damaged, but still viable, are fairly serious, so the temptation will be to support banks in questionable condition until a reassessment can be made. Such support may involve heavy discount window lending on increasingly uncertain collateral. This problem should be mitigated, but will not be eliminated, by prompt resolution techniques.

In the payments area, sudden runs on a number of major institutions could place great pressure on banks and the Federal Reserve System to limit daylight and overnight exposure to other banks and customers. It is not hard to visualize scenarios in which the payments system would cease to function efficiently for an extended period while multiple runs on large banks continued. This could produce a snowballing of defaults and delinquencies, and lead to failures of weak firms and disruption of business generally. The effect could be to depress economic activity for a number of months.

Numerous borrowers would abruptly be forced to try to find other lenders as their usual banks experienced major deposit runs and were forced to suspend lending activities. Defaults could occur on bank and bank holding company debt as well as that of other firms, leading to a flight to quality and likely disruption in various markets. Some funds could flow to foreign banks in search of safety, disrupting normal intermediation patterns even where the funds continued to be denominated in dollars.

The contagion of uncertainty could cause runs on any major foreign banks that were believed to be in difficulty, further adding to the general confusion. Bank supervisory, deposit insurance, and discount window personnel could become overwhelmed by the combination of failures of nonviable banks and liquidity crises in viable banks. This could result in delays and misjudgments that increased the costs to the insurance fund, the banking industry and the public, and prolonged the period of disruption.

It is probably true that, even in a chaotic situation such as that described above, the total volume of deposits of the banking system would not be substantially reduced by direct conversion to currency or foreign-denominated balances. The amount of funds available for loans, however, could be substantially reduced. As deposits run from weak banks to stronger banks, the banks receiving the sudden influx of deposits cannot be expected to increase loans quickly, taking on customers squeezed out of other banks. Much of the influx would be considered temporary funds and invested accordingly. Capital adequacy considerations and the time necessary for information gathering, credit analysis, and loan approval would also limit the ability of healthy banks to absorb the lending activity of the weak and failing banks. Thus, a period of significantly reduced bank lending would result, with negative implications for the level of economic activity.

The supervisory authorities have good reason not to commit to payouts of only insured depositors of major banks. The potential for unleashing forces beyond their control is simply too great.

The banking system is central to the payments mechanism and the provision of short-term credit, and also affects the financial markets and the transmission of Federal Reserve open market operations.[4] The discussion above suggests that the level of disruption to the banking system and bank customers and creditors that could result from a crisis of confidence in the major banks could significantly depress the level of economic activity. It could also increase the losses to be absorbed by the banks, increasing the risk that the banking system itself could be overwhelmed and unable to support the deposit insurance fund.

Thus, the supervisory authorities have good reason not to commit to payouts of only insured depositors of major banks. The potential for unleashing forces beyond the control of the supervisors is simply too great. The authorities do not necessarily have to make an explicit commitment to safeguard the uninsured depositors and other creditors of large banks, although 100 percent insurance is a viable alternative. The current level of uncertainty about implied support seems to have produced no great problems. It should be recognized, however, that even if deposit insurance were to be eliminated entirely, the government would probably still decide that it could not allow the largest banks to be closed and liquidated. Support for creditors of large banks is necessary because of the special role of banks in the provision of short-term credit, in the payments system, and in the transmission of liquidity through the economy.

Co-Insurance

Various proponents are recommending co-insurance, under which the bulk of deposits would be protected by the insurance fund, but all deposit balances over a specified amount would share in any loss.[5] For example, all deposit balances over $100,000 might be given a 10 percent haircut, subject to further disbursements later if losses (in excess of those absorbed by capital) prove less than this. If the haircut proves to be insufficient to cover the net loss, the balance would be absorbed by the insurance fund.

The major problem with such a proposal is that most large depositors are likely to run from a bank about as fast when their exposure is 10 percent as when it is 100 percent. Thus the scenario for instability envisioned above is just as much a threat with co-insurance as without it. While one cannot be certain that this is what will happen, corporate and institutional treasurers have a reputation for being risk-averse in their cash operations and have little motive to gamble on a distressed depository. Since the proposal involves an explicit assurance that the authorities will resolve large banks in such a way as to impose the fractional loss on depositors, the potential would be created for extreme sensitivity to adverse developments. It would seem to be incumbent on the proponents of co-insurance to demonstrate that their proposal will not leave the banking system subject to dangerous deposit volatility. This is quite aside from evidence that the market discipline aspects of the proposal are unlikely to come in time to influence risk-taking, as discussed in the first part of this paper.

Policy Ambiguity versus Full Insurance

The practice in the United States, and apparently in the other industrial countries, is to be ambiguous about special protections given to creditors of large banks. This country has no written policy, no clear demarcation of how large a bank must be to qualify for protection, and no certainty that the authorities will not some day experiment with a payout of only insured deposits in a relatively large bank. Despite these deliberate ambiguities, deposit instability has not been excessive to date as the market has assumed that the too big to fail policy is operative. While the United States has not experienced excessive deposit volatility when large banks have announced problems, it might take only one misguided attempt to make banks more vulnerable to market pressure to create a much less stable environment.

An alternative approach to the current ambiguity would be to fully insure all bank creditors.[6] Since the creditors in large banks appear to be de facto insured now, and payouts of only insured depositors in small banks are rare, 100 percent insurance would not materially increase the real burden on the insurance fund. Furthermore, an argument can be made that it would have no significant impact on so-called moral hazard, as long as supervisors control growth and asset quality in known problem banks. Since uninsured depositors in large banks (1) are not able to exercise timely market discipline and (2) currently tend to behave as though they are protected, at least until the risk of failure becomes quite visible, little constructive depositor pressure would be lost with 100 percent insurance.

In the author's view, there is no good reason not to go to 100 percent insurance, and doing so would eliminate unnecessary ambiguity and strengthen the competitive position of small and mid-size banks. On the other hand, there is probably no compelling reason to push for such a change at this time and the current wisdom probably would have to be altered significantly to gain wide support for this concept.

Protection of Nonbank Entities

If the government must concern itself with the orderly disposition of banks, must other entities be given comparable treatment? Other industries have no industry-supported insurance funds comparable to the bank insurance fund to protect their creditors, but this is not the key factor.[7] Bank creditors would have to be protected in order to prevent systemic runs, even if deposit insurance did not exist. Are there other industries where systemic risk factors create the potential for broad-based and prolonged disruption of the real economy, financial markets, or the medium of exchange? Should a firm be considered for government intervention simply because it is a very large employer, or because many individuals would lose insurance coverage or invested funds?

These questions have no easy answers and it appears that this is the appropriate area for policy ambiguity. In order to minimize potential exposure to the taxpayer, the safety net should be limited to banks. On the other hand, authorities should be alert to any situations that have the potential for raising questions about appropriate federal intervention.

For example, it might be unwise to allow the privatization of the federal secondary market-makers in mortgages, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, if a likelihood existed that they would have to be recapitalized someday by the taxpayers. Conceivably this could become necessary in order to prevent a nationwide crisis, perhaps in the form of a shutdown in the origination of new mortgage-backed securities and widespread defaults on existing securities.[8] Another example might be a concentration in a particularly vulnerable asset category that could threaten reserves of several of the nation's largest life insurance companies, for instance, junk bonds or particular categories of commercial real estate loans.

Every effort should be made to minimize any exposure of the government, and to remove public expectations of government support, keeping open the mechanisms to act if a situation should ever develop where governmental support was absolutely essential. The implications of this desire to limit the federal safety net to essential functions should be a key factor in considering changes in the interrelationships between banking and other industries.

III. Implications for Limitations on Bank Activities and Ownership

Banking organizations in this country have been limited to certain activities for many years, and the type of entity that can own a bank has been similarly restricted. The recent trend has been to gradually expand the range of permissible activities, but this has generally been done through administrative rule-making rather than by congressional action.

Pressure is increasing, mostly from the large domestic and foreign banks, for this country to adopt some form of universal banking system. Some would like to see the legal recognition of a financial services industry, with banks, investment bankers, insurance companies, and various other types of financial institutions free to engage in one another's traditional activities and to acquire firms so engaged. A more extreme position espoused by several of the largest banks calls for a complete breakdown of distinctions between banking and commerce by allowing combinations of banks and any other type of business.

Some proponents acknowledge that banking is special and that the federal safety net must be maintained for banks, but would not like to see it extended to other activities in which banks may engage. Some argue that this can be done through administrative firewalls. Others complain that firewalls would nullify most of the advantages of the synergies that make interindustry combinations attractive. They tend to downplay the need for a federal safety net and seek to reduce the role of deposit insurance. They see no need to protect the creditors of large banks.[9]

The federal safety net should be maintained with respect to banking institutions and every effort made to avoid extending it to other types of firms.

Most proponents of these various degrees of deregulation of bank powers and ownership make one or more of the following arguments:

1. Large U.S. banks cannot compete internationally if they remain restricted and will continue to shrink in relative size.
2. Large U.S. banks are relatively unprofitable because of activity restrictions.
3. Ownership restrictions increase the cost of capital for U.S. banks by limiting the range of potential purchasers of bank ownership or reducing the franchise value of a bank charter.
4. The risk of failure in a firm diversified across several industries is substantially reduced, lessening concerns about risk to the federal safety net.

Thus, proponents attempt to make a case that it is imperative and urgent that the United States open up the banking industry or face a continuing decline of the industry and this country's economic well-being.

The thrust of this article is that the federal safety net should be maintained with respect to banking institutions and that every effort should be made to avoid situations that would require extending the safety net to other types of firms.[10] It is beyond the scope of this article to consider the full implications of these conclusions for bank powers and ownership, but three questions will be explored briefly:

1. Can the safety net's exposure be limited within a multi-industry firm through the use of firewalls, and will firewalls or Chinese walls nullify synergies?
2. Is it feasible to develop a compromise banking structure that limits risk exposure to the safety net while permitting banks to take advantage of natural synergies in nonbanking activities?
3. How valid are arguments that banks must diversify to compete?

The Effectiveness of Firewalls and the Restraints of Chinese Walls

Firewalls are administrative segregations of functions designed to prevent losses in one area of a firm from being transmitted to another area. Typical firewall devices include corporate separation of functions, separate work forces, separate funding sources, prohibitions on certain transactions between units, and the like. Firewalls may be distinguished from so-called "Chinese walls" by the purpose they serve. Chinese walls, as the term is typically used, are to prevent improprieties, such as the use of privileged information by another branch of the firm for corporate gain, or violation of a fiduciary responsibility in the process of avoiding a loss in another unit.

From the standpoint of protecting the bank safety net from having to cover losses in nonbanking activities, the fundamental question is whether firewalls can be depended on in extremis. When a multi-industry firm is struggling to survive, the senior management and owners will be under great pressure to avoid failure, and the temptation to shift assets from a bank subsidiary to a troubled nonbank subsidiary may prove irresistible. The risk of subsequent detection and punishment may count for little compared to surviving a crisis and saving the enterprise. Thus we should treat firewalls with considerable skepticism as a basis for allowing activities that would otherwise be denied.

Furthermore, efforts to protect the safety net with strong firewalls may nullify the value of synergies that made the combination of bank and nonbank functions seem desirable in the first place. For example, large banks want to have the same people who meet with commercial customers to discuss a potential loan be able to arrange a security issue or a combination of the two if that fits a customer's needs. Strict segregation of lending and investment banking personnel for firewall purposes would make that impossible.

A further complication is whether Chinese-wall considerations should dictate such a segregation anyway. It is noted that Switzerland's banks appear to be moving toward the American position of separation of commercial and investment banking largely because of Chinese-wall-type considerations.[11]

Alternative Banking Structures

If one does not accept the reliability of firewalls, but does believe that it is necessary to protect the creditors of large banks, it is difficult to see how banking organizations and other financial services companies can be allowed to combine without broadening the coverage of the federal safety net. Perhaps that would be an acceptable consequence to those who are convinced that it is important to move toward universal banking with respect to financial services. However, the issue of extending the safety net to nonbank financial firms has not been raised by proponents of expanded powers or made part of the debate on financial restructuring.

Some argue that we must choose between complete separation of bank and nonbank financial firms on the one hand, and unrestricted entry on the other, with no middle ground. Since banks have some investment banking powers now, the former position would mean a rollback from current practices. Neither this alternative, nor an expansion of the federal safety net to cover much of the financial services area, seems very attractive.

It might be worthwhile to search for a compromise solution that would avoid the least desirable aspects of the two extreme positions. For instance, if it were possible to devise a structure whereby commercial and investment banking could coexist in an institution without destroying the advantage of synergies, consideration might be given to allowing certain investment banking functions to coexist with commercial banking without firewalls, even though the effect would be to broaden the activities covered by the bank safety net. This might be seen as a reasonable compromise that would not nullify synergies or place unrealistic faith in firewall safeguards, and have the advantage of not forcing banks to retreat from the level of investment banking involvement they have already attained. The different risk characteristics of commercial and investment banking would argue for maintaining separate accounting and applying separate capital adequacy standards, even though personnel separation was not required.

While permitting banks to engage in a financial activity without protective firewalls would broaden the safety net coverage, this might be considered acceptable if the inherent risks were not much greater than various bank lending activities, and if it were felt that these risks could be evaluated and controlled through the supervisory process. However, if nonbank financial firms were free to enter banking, then the safety net might soon be broadened substantially as large nonbank financial firms acquired banks, and it became necessary to protect creditors of the entire entity. Since this would seem to be undesirable, it suggests that consideration might be given to an asymmetrical structure in which banks would be permitted limited involvement in those nonbank financial activities where natural synergies are strong and conflicts and risks containable. However, banks would not be permitted to acquire major nonbank firms in certain industries (such as investment banking). Nonbank financial (and nonfinancial) firms would be excluded from owning banks or having direct access to the payments mechanism, and would continue to be outside the protection of the safety net.

Such a compromise structure would be vulnerable to criticism that it is unfair to some parties, and that it employs arbitrary limits on activities. Generally such solutions are to be avoided. Furthermore, the suggestion is made solely on conceptual grounds without careful consideration of how Chinese wall aspects might nullify synergies, or of the relative risk factors in various financial activities. It also does not attempt to deal with the complex question of how the line should be drawn between permissible and impermissible activities of banking institutions. Nonetheless, some compromise along the lines suggested above may be the only way to permit broader banking activities without greatly increasing the exposure of the taxpayer implied in an expansion of the safety net to other industries.

Evaluation of the Compulsion for Universal Banking

It is beyond the scope of this article to present a detailed analysis of the relative profitability or competitiveness of American banks. However, a few observations can be made. Earnings of large American banks were depressed during much of the 1980s by unusually high loan loss provisions and loan nonperformance. While large foreign banks suffered from some of the same problems, particularly exposure to less developed countries, the American banks suffered heavily from the effects of energy price changes on the economy of the Southwest and a succession of severe regional real estate problems. We should adjust bank earnings for this period of extraordinary credit problems and reexamine competitiveness before concluding that American banks are at a disadvantage due to restrictions on activities.

No evidence has been offered that earnings would have been better had our banks been allowed unrestricted entry into investment banking, insurance or other proscribed financial activities.[12] In fact, investment bankers in this country are currently experiencing a period of severe unprofitability and retrenchment, and concerns have been expressed recently about the credit risk in the loan and investment portfolios of some insurance companies.[13] It is by no means clear that our larger banks would be stronger today had they not been constrained from full participation in these industries.

No evidence has been offered that earnings would have been better had our banks been allowed unrestricted entry into investment banking, insurance or other proscribed financial activities.

The push for universal banking in the United States today is reminiscent of the movement in American industry toward conglomerates in the 1960s and early 1970s. By the mid 1970s the markets had become convinced that managements are not generally successful at managing widespread, multi-industry firms, and divestitures became commonplace.[14] In fact, much of the leveraged buyout lending and junk bond issuance of the 1980s related to continuing divestitures by multi-industry firms. One might well question the economics of universal banking in the United States in view of this history. Indeed, the markets could reflect the negative experience with conglomerates in such a way that the cost of capital would actually be higher for universal banks than banks that adhere to more traditional activities.

IV. Conclusions

This article started with the premise, based on the author's earlier work, that market discipline cannot be effective in deterring excessive credit risks in banks. This is because the market cannot recognize and properly evaluate such risks on a timely basis, and belated market reaction is counterproductive.

The main thrust of this article is that the authorities must continue to handle large bank failures in such a way that they do not trigger a systemic flight to perceived quality. This requires that all depositors of such banks be given at least implicit assurance that their funds will be protected. This protection is provided by an industry-supported insurance mechanism, and the burden would fall to the taxpayer only in the event that the banking industry as a whole was unable to absorb the level of losses generated.

While situations could develop where it would be necessary to use taxpayer funds to absorb losses in nonbanks, efforts should be made to avoid or minimize the potential for such needs. We should be very concerned with the potential for expansion of the safety net to large nonbanks as a consequence of a broadening of bank powers and entry into banking. These safety net concerns cannot be alleviated by administrative firewalls, and attempts to limit safety net exposure by building firewalls are apt to nullify whatever synergies may exist between particular banking and nonbanking activities. Chinese walls to prevent improprieties may also nullify synergies, further casting doubt on the real value of broadened powers.

Various arguments have been presented by proponents of universal banking as to the necessity and urgency for creating a financial services industry or breaking down barriers between banking and commerce. These arguments seem vulnerable to challenge with respect to complaints about the inherent uncompetitiveness of American banks and the presumption that multi-industry firms are more profitable and safer than single-industry firms.

In sum, the United States should not draw back from the current implicit backing given creditors of large banks. Bank involvement in investment banking and other financial activities should be limited to areas where synergies need not be nullified by Chinese walls and where risks are acceptable without imposing prudential firewalls. We should not hesitate to continue to restrict entry into banking by nonbank firms in order to avoid broadening the safety net, even if that means asymmetrical treatment of banks relative to nonbanks.

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[1] See Randall (1989).

[2] This is what happened in the 1980s with respect to the thrift industry and its insurance fund, and it happened on such a massive scale that the cost to the taxpayer will be very painful. However, the thrift industry, its supervisors, and the administrators of its insurance fund all operated under different rules, in a different industry culture and a different political environment, from the banking industry.

This is not to deny that a major disaster could befall the banking industry someday, but the banking industry is less vulnerable to many of the particular problems that beset the thrift industry, while having its own set of stress points. It will be more productive to focus on areas of real vulnerability in the banking industry and its insurance fund rather than to revisit the series of calamities that essentially wiped out the thrift industry.

In order to minimize the possibility that the deposit insurance fund could be exhausted while banks remain able to replenish it, assessments should be raised promptly to reflect, and even anticipate, any abnormal losses that must be absorbed by the fund.

[3] See in particular American Bankers Association (1990) and Kaufman (1989).

[4] See Corrigan (1987) for a discussion of why banks are special.

[5] See American Bankers Association (1990) and Federal Reserve Bank of Minneapolis (1990).

[6] See Independent Bankers Association of America (1990).

[7] The Pension Benefit Guaranty Corporation and the Securities Investor Protection Corporation have some similarities to deposit insurance but are not considered comparable.

[8] Presumably the current market assumption of government backing stems from both the status of these entities as government-sponsored corporations and their dominant role in the secondary mortgage market.

[9] Representative of the variety of views on this subject are American Bankers Association (1990), Corrigan (1990), Reed (1989), Rideout (1990), *The Economist* (1990), and Weatherstone (1989).

[10] The safety net essentially consists of the following elements: deposit insurance, full protection of depositors in large banks (implicit), discount window access, and Federal Reserve backup of Fedwire settlement.

[11] Kraus (1990).

[12] See Boyd and Graham (1988) and Kwast (1988) for research in this area.

[13] See Garcia (1990) and Power (1990) for recent examples of news stories on the troubles of nonbank financial institutions.

[14] See Clark (1990) for a summary of this phenomenon.