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Cooperative Arrangements for the Regulation of Banking by Banks

Government is today the primary regulator of the US banking system. The Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), and corresponding state organizations formulate the rules by which banks compete for loans and funds. In the wake of the savings and loan crisis, many observers have begun to question whether government can police the system properly. In this article we suggest an alternative system for banking regulation: voluntary, cooperative arrangements among banks for self-policing and self-insurance.

Although it may seem odd to imagine voluntary banking leagues assuming a regulatory role, there are numerous examples of voluntary regulatory arrangements in the United States today. Many professional organizations in this country accredit members. The American Bar Association and the American Medical Association substitute for government agencies as regulators of their industries. In organized stock and futures markets, the exchanges themselves handle a major portion of the regulatory work and standard-setting.

Although self-regulation is not currently a major part of the US banking system, American banking history is full of examples of voluntary and cooperative arrangements. Bankers have organized themselves into leagues or entered into agreements with a view to specifying the rules by which banking was to be conducted. Examples of such arrangements include correspondent relationships between banks, clearing houses among banks in large cities, self-insurance schemes that encompassed whole states—and the

earliest arrangement, the so-called Suffolk System of New England.

We will outline some of the common arguments for and against self-regulating banking institutions. We will consider what the nineteenth century experience can teach us about the possibilities today for self-regulation of banks.

Cooperative Regulation versus Government Regulation

Regulation of banking by government serves three distinct and potentially separable functions: First, government agencies serve as *insurers*; second, they are *policers* of *bank quality and safety*; and third, they function as *macroeconomic policymakers*. The first two of these roles, insuring and policing, can also be carried on through private arrangements among the banks themselves. The third role, macroeconomic policy, is properly the province of the federal government.

Government as Bank Insurer

Most insurance in the United States is carried out through the private sector. Government insurance of banks is a notable exception. The government insurance takes two forms: the deposit insurance schemes of the FDIC and similar organizations, and the lender-of-last-resort role of the Federal Reserve Bank.

The best justification for the government's insurance role actually stems from macroeconomic considerations. Widespread bank failures in this country have been associated with widespread economic disruption. Thus, widespread bank failures have costs well beyond the financial system. Moreover, when

such failures are economy-wide, no private system will have the assets to make good on the resultant claims. The government has the biggest coffer of funds (and can always print more if necessary). Thus, it is the natural guarantor against economy-wide banking crises. Such guarantees build confidence. Indeed, to the extent that economy-wide crises result from lack of confidence in the banking system as a whole, the knowledge that the government will step in if necessary ensures that economy-wide disruption will not occur.

But these macroeconomic considerations do *not* justify the specific forms of insurance that have actually come into place. The government's role as a backup in the face of cataclysmic failures does not imply that government needs to be the guarantor of individual depositors in the face of isolated bank failures.

Government as Quality Police

The second role of government regulation, setting and policing standards, is also problematic. Through various (sometimes overlapping) agencies, the government formulates restrictions on the activities in which banks can engage and the types and proportions of assets that they may hold. Ancillary to this function are the tasks of inspecting, auditing, and enforcing the restrictions that have been devised.

In fact, the government's role as setter of standards for banking is, in large part, a side-effect of its role as insurer. Federal deposit insurance and the privileges of the discount window are attractive subsidies that distort the risk-taking decisions of bankers and reduce the care with which depositors choose their

banks for soundness. The structure gives banks the incentive to engage in excessively risky lending; the insurer therefore finds it necessary to take on the role of monitor and standard setter.

In this role the government faces natural constraints. When a regulator contemplates closing a troubled institution, a speedy decision is essential, because an institution's incentive to engage in risky practices increases as its problems increase. Recent experience demonstrates that regulators are likely to

be slow in responding to crises, showing excessive forbearance. At the same time, government agencies by their nature tend to be inflexible in responding to innovation, restricting new and useful forms of financial arrangements by forcing conformity to the old, and possibly inappropriate, regulatory standards.

Private Insurance and Policing

In contrast, private organizations have natural advantages in policing and standard-setting. If the private organization is acting as the insurer,

its incentives are to set standards that are in line with the insurance it provides. The bottom-line profitability of the insurance operation precludes excessive forbearance to troubled institutions; competition of other insuring groups forces rapid adjustment to innovation in the financial system and fosters the provision of new forms or levels of insurance as appropriate. Competition among insurance schemes provides an enriched menu of types of insurance and enables the institutions seeking insurance to provide

The Suffolk System: The Earliest Cooperative Arrangement

The earliest and most successful arrangement for bank cooperation was the Suffolk System, a network for clearing bank notes in early nineteenth century New England. Under the Suffolk System, virtually all New England banks maintained correspondent relationships with one or another of the Boston banks, which agreed to redeem peripheral banks' notes on prespecified terms. At the same time, Boston banks as a group agreed to make markets in each other's correspondent banks' notes on similar terms.

In the Suffolk System, a peripheral bank paid fees to its correspondent in Boston, usually in the form of zero interest on interbank balances, with extra charges for overdrafts. Each Boston bank was charged with regulating the circulation and monitoring the operations of its correspondents, and each Boston bank was liable to the other Boston banks for any losses they incurred in clearing the notes of its correspondents.

This privately organized system was the first clear example in US financial history of an organization in which the authority to regulate banks had been put in alignment with the incentives for maintaining standards and policing them. Boston banks undertook the risk of making markets in other banks' notes. To avoid creating perverse incentives for excessive leverage and risk-taking by correspondents, market makers kept track of correspondent banks' activities, required interbank deposits as collateral, and developed means for returning excessive issues of bank notes rapidly. The common knowledge that excessive issues were not feasible under the discipline of the Suffolk System made bank notes of members more readily accepted as a medium of payment and kept exchange rates uniformly at par.

The system began in 1819 as the scheme of Boston's Suffolk Bank. The bank agreed to make a market for

peripheral banks' notes in Boston. In some cases, peripheral banks were given favored treatment in return for agreeing to deal exclusively through the Suffolk Bank. Seeking to expand its hold on the market, in 1824 the Suffolk Bank appealed to all Boston banks to finance a joint effort to return the currency of New England banks that had not agreed to its terms.

Clearly, the Suffolk Bank's intentions were not altruistic; its initial goals were to limit competition from peripheral banks and to profit from forced deposits. In its 1824 appeal to other Boston banks, it argued that Boston banks could increase their share of the loan market by forcing the contraction of the country banks. The 1824 redemption campaign prompted a "bank war" in New England in which the Suffolk Bank used the threat of random redemptions of large amounts of notes to coerce banks to join its system. In some cases, the Suffolk Bank clearly was selling "protection" against its own threats, and many country banks clearly resented the monopoly power the Suffolk Bank enjoyed.

On the other hand, the system effectively made New England a uniform currency area, with all bank notes trading at par throughout New England as early as the late 1820s. Many sanguine observers commented that the discipline brought by the Suffolk Bank increased the demand for country banks' notes, by reducing default risk and enhancing note liquidity. Some commentators argued that the increased demand for country banks' notes more than offset their expenses from membership in the system. Banking commissioners in Connecticut and Maine in fact praised the Suffolk System for its discipline and stability during the Panic of 1837.

an enriched menu of financial instruments to their depositors.

If these privately arranged insurance schemes take the form of co-insurance by banks, there are additional benefits from the relationship. There is an inherent economy in having banks monitor each other. Banks specialize in information-gathering; a bank's profitability depends on the officers' ability to make sound judgments about the credit-worthiness of borrowers and the riskiness of asset portfolios. Who could be better qualified to judge the solvency of a bank than other banks? Indeed, banks are constantly making such judgments in their day-to-day dealings with other banks. And if those banks engage in arrangements for mutual insurance, who has better incentive? The speed with which coalitions of bankers can and do act against individual member banks contrasts with the deliberateness typical of public regulation in this country.

In short, if normal deposit insurance is privatized, there will be a tendency for the standard-setting aspects of regulation to be taken on by the insurers. And given the specialized skills of banks in monitoring the soundness of portfolios of illiquid loans, the setting of standards and their monitoring will produce a natural advantage for mutual insurance schemes among banks. In such an environment, the policing of bank adherence to standards can also become the job of private agents: Where the government ensures compliance with its standards through legal sanctions, a mutual insurance scheme can ensure compliance through the threat of being dropped from the coalition.

The Remaining Role for Government

This is not to say that cooperative arrangements among banks can be entirely self-regulating. The government, through the courts, must remain the ultimate enforcer of such contracts as bank charters, or the insurance agreements established by

cooperatives. For example, it will still be the government's role to enforce the rules for bankruptcy or for taking over a bank that is unable to meet its depositors' demands for liquidity. As in the case of any other business, in banking there will still remain a possibility of fraud, and government must provide sanctions against it. But in all of these situations, the government ceases to be an active player on the day-to-day level. Instead, the government becomes a force in the background, whose very presence makes its actual intervention unnecessary.

One aspect of regulation in which government must maintain an active role is antitrust policy. Under a system of cooperative agreements among banks, government will need to ensure the continued existence of several competing cooperatives, in order to prevent monopolization of the banking sector from robbing society of the benefits of competition.

Protecting the Public?

Politicians often argue that the real role of government in banking is "protecting the public." They make the analogy with the role of government consumer protection programs, which inspect products and certify their safety and quality. But the importance of such a role for government would be greatly reduced in markets in which private groups organize to certify quality and set standards. Coalitions of banks will have incentives to maintain their reputation by enforcing their own standards and making them publicly known. Banks would compete for customers through the quality of the insurance they provide and through their membership in the standard-setting organization most attractive to their depositors. Unlike the current regulatory situation, this would foster greater diversity, allowing depositors with diverse needs and preferences to bank with institutions conforming to different standards.

The Debate about Self-Regulating Coalitions

Given the advantage inherent in self-regulating coalitions of banks, we might have expected the advent of inter-bank agreements and institutions to meet with general support. In fact, nineteenth century observers of cooperative self-regulatory banking arrangements were sharply divided in their views of the effectiveness of these relationships. Some observers took a sanguine view, emphasizing the stability and efficiency of these arrangements. Others took a jaundiced view, arguing that they were primarily coercive and exploitive. According to the jaundiced view, the profitability of banking coalitions derived from their ability to limit supply and engage in monopoly pricing. Any gains were at the expense of the public as a whole and accrued in particular to the large banks in the cooperative arrangement at the expense of the smaller banks.

The opinion of the public at large was also divided. Many of the dramatic instances of regulatory changes in nineteenth century banking were fueled by the jaundiced view of cooperative arrangements among banks. For many champions of federal government intervention into the banking system, the primary goal was the elimination of the power of city banks through their clearing houses, their correspondent relations, and their concentration of reserves.

The sanguine and jaundiced views of bank coalitions were well represented in the qualitative evidence collected by contemporary accounts of the Suffolk System. Observers have agreed that the system was effective in creating an area of uniform currency throughout New England and in promoting stable banking thanks to the disciplinary role of the Boston banks. They have disagreed about whether the benefits of the system went exclusively to the city banks or were

shared by country banks and the public at large.

In order to go beyond these qualitative assertions about the performance of the Suffolk System, we have gathered evidence comparing

the performance of the banks of the Suffolk System with banks in nearby states. Our evidence derives from two sources: Congressional documents provide information on the balance sheets of state banks as

based on the records of state regulators; and various bank note "reporters" are the source for discount rates on notes.

The evidence of the note discounts indicates that the Suffolk

Other Cooperative Arrangements

Clearing Houses

The New York Clearing House was founded in 1853 to facilitate check clearing among New York City banks. It soon developed features for co-insurance, providing for members to make markets in each other's liabilities and to pool resources in response to financial panics. During times of financial disturbance, members of the clearing house continued to clear checks, to assist each other through loans, and even to issue joint liabilities. These forms of co-insurance were made possible by the fact that they were aligned with the individual banks' incentives. The procedures were combined with substantial group authority to regulate behavior of individual banks, including reserve requirements, portfolio guidelines, and other restrictions on banking practices. Because membership in the coalition was valuable and because banks had an economic interest in enforcing regulations, the threat of expulsion for violations was a powerful and most credible disciplinary device.

Clearing houses developed in other major northern cities during the 1850s (Boston, Philadelphia, and Baltimore) and spread to cities throughout the country after the Civil War. But these coalitions were typically confined to banks operating in the same city. By so limiting membership, clearing houses ensured that their member banks maintained the incentives for efficient behavior, avoiding the temptation of member banks to "free ride" on the coalition. Monitoring could be accomplished easily so long as banks were not too distantly located. Furthermore, by keeping the numbers in a coalition small, the coalition ensured that member banks would continue to find it valuable to monitor one another, since the marginal benefit of monitoring a neighbor falls with the number of banks in the coalition.

State Insurance Schemes

While clearing houses are the best-known examples of coalitions of mutually regulating, co-insuring banks, they were not the only examples. In three antebellum state banking systems, Indiana, Ohio, and Iowa, state-wide coalitions of banks were created by statute. While these states' legislatures created the insurance systems, they did not run them. The law required members of the coalition to participate in the

setting and enforcing of regulatory guidelines. More important, it created an incentive for banks to do so by making them mutually liable for any loss to banks' liability holders. The self-regulatory authority was granted the powers to set reserve guidelines and standards for banking practices. It also had the power to close offending banks. The number of banks was also limited in each of these states, so that the incentives to monitor were maintained.

These three midwestern co-insurance systems were extraordinarily successful. They suffered virtually no bank failures or fraud. Banking problems were detected early and corrected by the group leadership. During regional or national panics, in which suspension of convertibility was widespread, these banks typically maintained it. The performance of these three state systems is in sharp contrast to the uniform failure of government-run state bank liability insurance systems of the nineteenth century.

Informal Coordination

Finally, some banking coordination occurred in more informal ways, through ad hoc arrangements during crises. The antebellum South, with its small number of large branching banks, is the quintessential example. During the Panic of 1837, representatives of banks from all over the South met in Charleston, S.C., to agree on a plan for maintaining inter-bank convertibility in the face of general suspension of convertibility. Rules limiting banks' growth and activities in the interim accompanied agreements to make markets in each other's notes and deposits. Similarly, during the Panic of 1857, southern banks seem to have cooperated more effectively to pool reserves, support one another, and limit the disruptions due to suspension of convertibility.

The relative success of the South seems attributable, in part, to the greater ease of communication and monitoring in a system dominated by a relatively small number of geographically overlapping, branching banks. Unlike the many scattered unit banks of the North, southern branching banks could pool resources, monitor behavior, and reduce the transaction and information costs inherent in forming coalitions, without having to set up formal structures to do so.

System improved the acceptability of notes of *all* New England banks. The evidence from the banks' balance sheets also tends to confirm the view that the gains in efficiency from the Suffolk System were widely shared.

We find that the banks of New England were able to provide notes backed by lower levels of specie, but that the public regarded these notes as perfectly safe. Evidently public confidence in the New England banking arrangements enabled the banks to economize on holding of expensive reserves.

At the same time, the banking system had a higher penetration into the economies of the New England states than into the economies of the rest of the northeast. Apparently banks were better able to provide services for the population in the Suffolk System states; the natural conclusion is that the increased efficiency allowed the public at large to benefit from the advantages inherent in the system.

The results are not entirely rosy: There is evidence of greater disparity in the degree of banking services available in the areas of New England than in the Middle Atlantic states. Nonetheless, in absolute terms, even the least developed portions of New England were, for the most part, as well served as those in the Middle Atlantic area. In short, the preponderance of evidence supports the sanguine view of banking coalitions as beneficial to the economy as a whole.

Lessons for Current Regulatory Reform

The Problem and a Solution

In the wake of the difficulties of the savings and loan institutions, recent studies of deposit insurance funds have focused on the perverse incentives created by mispricing of deposit insurance. Insurance encourages excess risk-taking by existing banks, particularly if prior losses leave them with little capital to lose. Thus, insurance provides a potential

for unscrupulous, or merely inexperienced, entrepreneurs to enter banking as a means to finance their risky enterprises. Insurance tends to remove the discipline of the market, which normally would prevent such entrepreneurs from having access to funds: Depositors of insured institutions have little incentive to discriminate between responsible and irresponsible management when deciding where to place their funds.

Nonetheless, the insurance of bank liabilities exerts a desirable stabilizing influence. Banks, more than other institutions, are vulnerable to panics induced by depositors' uncertainty. How then can we provide credible protection of the banking and payments system without creating costs associated with the incentives for excessive risk-taking? It is here that the historical success of self-regulating, co-insuring systems of banks provides a possible solution.

The critical distinction between self-regulating agreements and government-run schemes is this: Only in the self-regulating agreements were the regulations aligned with incentives for the banks to maintain and police standards. By making banks as a group bear the costs for insuring depositors—and the savings from handling insurance more effectively—we can achieve more effective regulation.

Pitfalls along the Way

There are at least three challenges to a successful application of the lessons of self-regulating bank coordination to current banking reform: First, how can we ensure that banking coalitions will not degenerate into monopolistic cartels, using their powers of coordination to reduce the competitiveness of the banking industry? Second, given preexisting regulatory arrangements and vested interests in their maintenance, is it realistic to imagine politicians dissolving current agencies and relinquishing

authority to the banks? Third, are today's banks prepared for the responsibility—that is, do they have the resources to make co-insurance credible? Each of these concerns is legitimate; together they dictate important limitations on any attempt to incorporate self-regulatory features into the current system of federal deposit insurance. We will examine them in order:

- First, the problem of limited competitiveness. The record of the Suffolk System makes it clear that, while the potential for monopolization need not be an overwhelming concern, it is a legitimate one. In any new regulatory regime, the government must maintain an anti-trust role, ensuring freedom of entry for new banks and competition among co-insurance arrangements. Ideally, there would arise a handful of parallel groups, each with several nationwide branching banks. So long as no group has a geographic monopoly, no alarm need be raised; but this dictates that special attention be paid to the problems of local market monopolization should the co-insurance arrangements be leagues of unit-banks.

- Second, the issue of political feasibility. It is fanciful to expect Congress all at once to scrap the existing system and replace it with nationwide, privately managed, bank groupings. Nonetheless, there are practicable steps in that direction that would reduce the costs of government deposit insurance by enlisting the assistance of banks in supervision. For example, banks could be allowed to form groups for mutual monitoring. These groups could be granted rewards in the form of reduced insurance premiums for agreeing to engage in monitoring and assessed penalties in the form of higher premiums for any failure to detect or report violations or insolvencies of banks in their group. At the very least this would provide a strong counterbalance to political encouragement of excessive forbearance by creating

Why Didn't Cooperation Extend Nationally?

If cooperative arrangements are good, it would seem that widespread cooperative arrangements would be even better. A nationwide group of branching banks would have been able to achieve substantial advantages, since the ease of coordination and greater diversification would have reduced banking fragility and financial panics. The failure to develop nationwide banking coalitions seems attributable to restrictions on branching.

Cooperative arrangements benefitted from and required mutual monitoring. There is, thus, a natural limit to the size of a cooperative arrangement.

The benefits of cooperative arrangements could not be achieved in a system composed of several thousand geographically separate unit banks. While inter-regional correspondent relations continued to play an important role in the national payments system, and correspondents often borrowed and lent to each other, such bilateral activity was not part of any co-insurance relation. The unique vulnerability of the US financial system and the unusual frequency and severity of banking crises in the United States testifies to the weakness of nationwide unit banking in that era as a structure for preserving system-wide stability.

an interest group whose incentive is to monitor banks and blow the whistle early on insolvent institutions. As the advantages of the system become more apparent, more substantive reforms in the direction of self-regulation might become more feasible.

- Finally, the question of banks' capacity for co-insurance. Historical studies of losses to banks during financial crises emphasize that, apart from losses attributable to mismanagement of insurance schemes, bank capital has always been large relative to aggregate bank losses. Thus, the capacity is available. Even the Great Depression may be only an apparent, not a real, exception: Large bank losses during the Great Depression may be primarily a testimony to the government's ability to destroy an economy through deflationary policy, not a measure of the inherent vulnerability of the banking system.

Suppose, however, that we conceded that in some extreme circumstances the government must stand ready to support the financial system. We would still argue that the government's proper role is as a back-up to private schemes, through a system of shared responsibility. Lesser shocks should be the responsibility of private, self-regulating groups, with the government

providing stop-gap protection against systemic collapse.

How might this be arranged? The government's back-up plan could provide that co-insurance among banks would be relied upon entirely to reimburse depositors in cases in which fewer than a specified number of banks fail, but the government would share increasingly in subsequent losses. By restricting the government's role to "catastrophe coverage," adequate incentives are retained for interbank discipline of banking coalitions without risking widespread failure.

Such an explicit division of responsibility has additional advantages. Since it is likely that the government will intervene in severe crises even in the absence of an explicit commitment to do so, it will be desirable to have the commitment spelled out. This offers the best chances for limiting congressional temptations to intervene in the pursuit of an individual banker's interest but against the interest of the public at large.

Summary

Cooperative arrangements among banks are an alternative to current regulation of the banking system. Theoretically, cooperative arrangements are better able to align the incentives of the banks in

the system with the regulations adopted for maintaining standards of quality. This theoretically predicted match-up was, in fact, a characteristic of nineteenth century cooperative arrangements. In particular, the Suffolk System of New England was a significantly more efficient banking arrangement than those found in neighboring states, and the benefits of the system were enjoyed by the public at large, not just by the large banks of Boston.

The lessons of the nineteenth century experience are relevant for the late twentieth century. Cooperative arrangements can and should play a role in current reforms of the institutions for deposit insurance. Encouragement of the growth of cooperative arrangements for self-regulation is both economically desirable and politically feasible. Perhaps the regulation of banking by banks is an idea whose time has come again.