The need for government and central bank intervention in financial regulation: Free banking and the challenges of information uncertainty

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ABSTRACT

Through a focus on the ever increasing need to address information asymmetries, as well as reference to the uniqueness of the degree to which systemic risks are triggered in banking, this paper aims primarily to highlight reasons why government and central bank intervention are essential and required in financial regulation.

The role presently assumed by regulation is not the same as it was thirty years ago. Deregulation and conglomeration have significantly altered the landscape in which regulation previously existed and to an extent, defined the role which it presently assumes. For this reason, arguments which were (and have been) directed against government, central bank intervention, as well as the role of regulation, require re-evaluation.

Deposit insurance and lender of last resort arrangements serve to instil confidence in depositors hence contributing towards safeguarding system stability and preventing unnecessary runs where panics occur. Such benefits are not only considered against those arguments advanced by antagonists of deposit insurance and lender of last resort arrangements, but also against those views which do not favour government and central bank intervention. In evaluating whether free banking is equipped with as many mechanisms and safeguards required in safeguarding the stability of the financial system, the urgency for such safety net instruments, which is attributed to the peculiar and unique nature of banking, will be considered. Contrary to the argument [that "if markets are generally better at allocating resources than governments are, then the differences or distinctions which exist between "money" and the industry that provides it (the banking industry) should not serve as bases for an assumption that money and banking are exceptions to the general rule"], it has to be highlighted (for several reasons) that the banking industry could not be equated to other areas of the financial sector. One of such reasons relates to the extent to which the impact of systemic runs differ within the banking sector when compared to other areas such as the securities markets.

The differences in the nature of risks which exist in banking and those which exist within the securities markets, constitutes another reason why the need for government and central bank intervention is advocated. Furthermore, even though the nature of banking risks warrants government and central bank intervention – as well as capital adequacy regulation, capital regulation should also be extended to the securities markets for many reasons – one of which is the ability to securitise assets.

If there was no longer a role for regulation, then re- regulation should not have occurred in certain jurisdictions which have adopted and successfully implemented consolidated supervision.

Key Words: asymmetric information; lender of last resort; central banks; systemic; regulation; deposit insurance; free banking

The Need for Government and Central Bank Intervention in Financial Regulation: Free Banking and the Challenges of Information Uncertainty.

Marianne Ojo[1]

Introduction

„Government failure does not constitute a good argument for government intervention“[2] - however information asymmetry and the degree of interconnectivity associated with some parts of the financial system merit such intervention. This being particularly the case where systemic risks which are consequential of information asymmetry involve “too big to fail” or “too interconnected to fail” firms. Moral hazard, a market failure which is associated with asymmetric information – as well as high levels of deposit insurance and lender of last resort arrangements, is defined as “ a situation whereby asymmetric information could induce borrowers to take action/s which erode the value of loans.”[3] Moral hazard could also be defined as adverse incentive effects – such as excessive risk taking levels, and the tendency for depositors to be less careful in the selection of their banks.

Forms of government and central bank intervention, such as deposit insurance schemes and lender of last resort arrangements, have been criticised for their capacity to induce higher risk taking levels than would otherwise have existed if such arrangements had not been in place. The existence of high levels of deposit insurance is also considered to serve as an incentive which compels banks to retain lower levels of capital. However a distinction needs to be drawn between the need for safety net mechanisms (such as deposit insurance and lender of last resort arrangements) and excessive or unduly high levels of deposit insurance and the provision of lender of last resort mechanisms to those banks who do not necessarily merit such intervention.

The role assumed by banks, that is, their continual monitoring of the creditworthiness of the borrower and their duty to ensure due diligence (from the start of the contract and throughout the monitoring process), not only enables and equips banks to “acquire and evaluate information about potential borrowers”, but also contributes to their capacity to reduce costs which are linked to moral hazard – since banks are considered to be more effective at monitoring the behaviour of borrowers after funds have been distributed.[4]

Capital adequacy regulation, another form of government intervention – which could also be regarded as signifying a move towards free banking (hence embodying a combination of government intervention and free banking), has also faced growing criticisms recently. Basel II has been criticised for its unduly and over sensitive internal credit risk models which have contributed towards inducing further pro cyclical effects.

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[2] K Dowd, „Does Asymmetric Information Justify Bank Capital Adequacy Regulation?“ *Cato Journal*, Vol. 19, No. 1 (Spring/Summer 1999) at page 9

[3] JC Trichet, „What Role For Finance“University lecture by Mr Jean-Claude Trichet, President of the European Central Bank, at the Universidade Nova de Lisboa, Lisbon, 6 May 2010 at page 3 of 9 < http://www.bis.org/review/r100510a.pdf>

[4] see ibid at pages 2 and 4

Whilst the rationale for bank regulation has been questioned and has constituted the topic of various debates, the securitisation of loans and its effects in "reducing lenders' incentives to undertake prudent screening and continuous monitoring"[5] constitutes a further reason for capital adequacy regulation to be extended to the securities markets.

The first section of the paper aims to enlighten, as well as bring to recollection, some of those arguments which have supported or criticised the rationale for safety instruments such as deposit insurance schemes and lender of last resort arrangements. In defending the rationale for such safety net instruments, the need to have an appropriate level of such safety net instruments (as opposed to excessive levels) operating in the financial system is re-iterated. Furthermore, the role played by central banks and governments in facilitating financial stability and supervision, as well as the inability of free banking mechanisms to provide similarly effective attributes, constitute further reasons why central bank and government intervention is advocated.

The second section considers how capital adequacy requirements, another form of state intervention, has contributed towards addressing problems attributed to information asymmetries. However, it is highlighted that this proposal and measure only serves as a partial solution to the issue of asymmetric information. This was not only demonstrated during the most recent financial crisis, but has been realised over the past years – resulting in the Basel Committee's initiatives and introduction of the three pillar system which is still relevant for the Revised Framework for the International Convergence of Capital Measurement and Capital Standards: namely, capital adequacy requirements, supervisory review and market discipline.

The third section then considers reasons advanced in favour of and against free banking. Section four not only provides an analysis of reasons why central bank intervention is deemed necessary in regulation but also considers the benefits and detriments which are attributed to central banks' assumption of all encompassing roles of supervisor, monetary policy setter and lender of last resort. Even though the option of government owned central banks is accepted by Benston and Kaufman, the possibility that private central banks could serve as a better option to government owned central banks is not excluded.[6]

For reasons not only attributed to accountability, but also the possibilities that political interference in central bank decision making might occur, private central banks are preferred. Furthermore, it is important for central banks to become more independent in the conduct of monetary policy procedures and less politically involved when assuming supervisory roles. However, central bank independence will not constitute a topic of detailed discussion in the present paper.

[5] Even though Trichet also argues that stock markets can perform the duty of monitoring the behaviour of borrowers – thereby contributing towards the reduction of moral hazard, he acknowledges the difficulties (in monitoring) which arise where loan securitisation occurs. See ibid at pages 2 and 4. Also see DW Diamond and RE Verrechia "Optimal Managerial Contracts and Equilibrium Security prices" (1982) Journal of Finance, Volume 37 at pages 275 – 287 and M Jensen and K Murphy "Performance Pay and Top Management Incentives" Journal of Political Economy Volume 98 at pages 225 - 263.

[6] See GJ Benston and GG Kaufman „The Appropriate Role of Bank Regulation" (1996) Economic Journal Volume 106 (May) at page 696.

A. Forms of Government and Central Bank Intervention in Bank Regulation.

I. Deposit Insurance and Lender of Last Resort Arrangements:

Deposit insurance and lender of last resort arrangements serve to instil confidence in depositors hence contributing towards safeguarding system stability and preventing unnecessary runs where panics occur. Such benefits are not only considered against those arguments advanced by antagonists of deposit insurance and lender of last resort arrangements, but also against those views which do not favour government and central bank intervention. In evaluating whether free banking is equipped with as many mechanisms and safeguards required in safeguarding the stability of the financial system, the urgency for such safety net instruments which is attributed to the peculiar and unique nature of banking will be considered.

Furthermore, the differences in the nature of risks which exist in banking and those which exist within the securities markets, constitutes another reason for the need for government and central bank intervention. Even though the nature of banking risks warrants government and central bank intervention – as well as capital adequacy regulation, capital regulation should also be extended to the securities markets for many reasons – one of which is the ability to securitise assets.

The rationale for bank regulation in the form of safety instrument arrangements for consumers (deposit insurance) and banks (lender of last resort arrangements) and whether such safety instruments actually contribute to the development of the banking system have constituted the subjects of controversial debates in several sources of the literature.

Criticism has been directed at the rationale for having banking regulation in the public sector – in particular, to high levels of deposit insurance.[7] According to Dowd, the Lender of Last Resort support to the financial system "directly encourages the very behaviour", that is, "greater risk-taking and weaker capital positions – which a sound banking regime should avoid."[8] This being the case since (in his opinion), the availability of the lender of last resort arrangement would always encourage a situation where bad banks are protected from the consequences of their "own" actions (as the mechanism is intended to be a source of liquidity to banks which cannot otherwise obtain such liquidity) and since "good" banks will always have access to loans which are required to sustain their liquidity levels.[9]

In serving as a kind of life-line to weaker banks, the lender of last resort facility, it is further contended, has the potential to i) "reduce incentives for good banks to adopt the virtuous strategy of building themselves up in anticipation of winning weaker banks' market share", as well as ii) stimulating the incentives of "otherwise good" banks, under these circumstances, to take on greater risks.[10]

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[7] See JS Alworth and S Bhattacharya, Paper presented at the 32nd Annual Conference on Bank Structure and Competition , sections 1 and 3.2

[8] K Dowd, „The Case For Financial Laissez-Faire" May 1996 The Economic Journal Volume 106 at page 683

[9] ibid

[10] Dowd argues that the lender of last resort facility, ironically, could trigger the very instability which supporters of central banking often claim could arise under free banking and that furthermore, anyone observing such instability could easily and erroneously consider it to be a consequence of market activities – as well as falsely believing that the banking system actually required the LLR mechanism (which in actual fact, was undermining it). ibid

Furthermore, the capacity of deposit insurance to serve as an impediment to forces of market discipline has been highlighted. In illustrating its impact on market discipline, Kaufman states that the substantial and easily relatively reduced losses to bank depositors, federal deposit insurance corporation, loan customers and users of the payments system – as well as the reduction in levels of bank failures (generally), may result in the potential for "even temporary disruptions in either bank-loan customer relations or the payments system (through increasing capital requirements and enforcing prompt regulatory corrective intervention and least cost resolution provisions)."[11] He also adds that federal deposit insurance requires the application of additional special legislation and regulation to banking and that banking, as a result, is unique – not solely because of its potential to trigger systemic contagion, but also because of federal deposit insurance.[12] It is also argued that in the absence of deposit insurance guarantees, banks which recognise risks which are attributable to transaction costs and asymmetrical information discounts (such transaction costs and information asymmetry having the capacity to contribute to costs for banks that have experienced large scale withdrawals - which might result in insolvency for such banks) and are able to provide for these risks through the retention of adequate amounts of capital – to prevent simultaneous withdrawal of funds by depositors, are unlikely to be penalised by the market (whilst banks which do not recognise or make provision for such risks are likely to be penalised).[13]

Other ways through which market discipline could be impeded include "the aggressive expansion of central banks' balance sheets – which may serve as substitute for markets for longer than intended."[14] In elaborating on this point, it is further argued, that central banks could impair the operation of the money market if they were to drain the supply of high quality collateral required by market participants and that as a result, "central banks need to

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[11] "Such provisions", in Kaufman's opinion, "attempt to mimic forces of market discipline in an insured depositor environment." GG Kaufman "Bank Contagion: A Review of the Theory and Evidence" Journal of Financial Services Research Volume 8 No 2 at page 143 and 144; Also see GJ Benston, and GG Kaufman, *Risk and Solvency Regulation of Depository Institutions. Past Policies and Current Options.* New York: Salomon Brothers Center Graduate School of Business, New York University. 1988.

[12] GG Kaufman "Bank Contagion: A Review of the Theory and Evidence" Journal of Financial Services Research Volume 8 No 2 at page 143; Based on various hypotheses on the literature, industry and firm specific contagion (whether individual or in association with one another), are considered more likely to occur in banking owing to the fact that depositors are generally considered to be less informed about the financial state of both their own banks and those of other banks in the industry than creditors of firms in non bank industries. This is attributed to a number of reasons, namely:
"One, many depositors have only small claims and thus find credit evaluation of individual institutions relatively costly. Two, many bank assets, liabilities, and activities are considered to be unique and not have readily marketable counterparts, and some bank activities are cloaked in confidentiality so that information is scarce. As a result, valuing these activities at market is likely to be more difficult and less accurate for banks than for non banking firms, and depositors are assumed to view banks as more or less homogeneous with respect to their financial health. Three, because the market values of these activities can change quickly, costly frequent and possibly even continuous monitoring is required to differentiate adequately among institutions. Four, product and market differences are hypothesized to be less important than in other industries, particularly since the introduction of federal deposit insurance, so that banks are viewed as being more homogeneous." See GG Kaufman "Bank Contagion: A Review of the Theory and Evidence" Journal of Financial Services Research Volume 8 No 2 at page 127; also see CW Calomoris and G Gorton, "The Origins of Banking Panics: Models, Facts and Bank Regulation" in GR Hubbard ed *Financial Markets and Financial Crises* (1991) Chicago : University of Chicago Press at pages 109-173; FS Mishkin, "Asymmetric Information and Financial Crisis: A Historical Perspective." In R. Glenn Hubbard, ed., *Financia! Markets" and Financial Crises.* Chicago: University of Chicago Press. 1991, pp.69- 108.RE Randall, "The Need to Protect Depositors at Large Banks, and the Implications for Bank Powers and Ownership," *New England Economic Review,* Federal Reserve Bank of Boston, September;/October I990, pp. 63-75.

[13] GJ Benston and GG Kaufman „The Appropriate Role of Bank Regulation" (1996) Economic Journal Volume 106 (May) at page 692

[14] J Caruana, "The Great Financial Crisis: Lessons For the Design of Central Banks" 2010 Bank for International Settlements Publications at page 2 of 9

strike a balance between the need to protect their financial position and the broader policy objective of making markets work."[15]

II. Empirical Evidence Which Suggest that Banking is Only Slightly Unique.

Although it is argued that "a review of the empirical literature reveals very little support for the claim that depositor runs on solvent banks cause insolvencies" (Kaufman, I984)[16], it is generally acknowledged that the impact of contagion and failure is more serious within the banking industry than other industries. As well as examining reasons why bank contagion and failure are considered to be more serious in the banking industry, Kaufman evaluates empirical evidence which he used as a means of investigating why such contagion "occurs faster, spreads more broadly within the banking industry, results in larger number of failures, results in larger losses to creditors (depositors) at failed banks and spreads more beyond the banking industry – causing damage to the financial system as a whole."[17] He concludes that "bank failures with no or only minimal losses to depositors and no interruptions in lending arrangements or the payments system are neither more contagious nor more damaging than the failures of non bank firms."[18]

B. Capital Adequacy Regulation: A Hybrid of State Intervention and Free Banking

Another form of government or central bank intervention other than the above mentioned, as argued by David Miles[19], is namely capital adequacy regulation. This form of intervention is intended to "compel banks to retain higher levels of capital than they otherwise would."[20] The adoption of capital adequacy ratios is also considered to signify a move which is evidential of free banking since the expansion of banks' credit requires the fulfilment of criteria aimed at demonstrating that such credit expansion is required.[21] The explanation to Miles argument (that capital adequacy serves to induce banks to retain higher capital levels), as stated by Dowd, consists in the fact that "if depositors cannot assess the financial soundness of individual banks, then banks will maintain lower than optimal capital ratios ."[22] Miles argues that a solution to such problem triggered by information asymmetry could be for a regulator

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[15] "Private financial institutions will prefer counter parties of unquestioned soundness during periods of financial crisis and it may prove difficult to control the dependency of such private financial institutions on the central bank"; ibid at pages 2 and 3.

[16] GJ Benston and GG Kaufman „The Appropriate Role of Bank Regulation" (1996) Economic Journal Volume 106 (May) at page 692

[17] GG Kaufman "Bank Contagion: A Review of the Theory and Evidence" Journal of Financial Services Research Volume 8 No 2 at page 124

[18] ibid at page 144

[19] K Dowd, „Does Asymmetric Information Justify Bank Capital Adequacy Regulation?" *Cato Journal*, Vol. 19, No. 1 (Spring/Summer 1999) at page 2

[20] ibid

[21] Furthermore, Dow adds that the market has demonstrated a lack of responsiveness (as well as lack of ability to predict with accuracy, the consequences of increased sovereign debt) in relation to very obvious implications of debt crisis. That free banking enthusiasts might argue that such „sluggishness" in response is attributable to the sense of security provided by the State. See S Dow, "Why the Banking Industry Should Be Regulated?" May 1996 Volume 106 No 436 The Economic Journal at page 702

[22] In this respect, the optimal capital ratios are regarded as "those ratios which the banks would have observed if the depositors had been able to assess their financial positions adequately and properly." See K Dowd, „Does Asymmetric Information Justify Bank Capital Adequacy Regulation?" *Cato Journal*, Vol. 19, No. 1 (Spring/Summer 1999) at page 2

to "assess the level of capital which the bank would have retained in the absence of such information asymmetry and compel it to retain this level of capital."[23]

Such a possibility for the regulator to asses the level of capital which the bank would have retained (given no existence of information asymmetry), in Dowd's view, should also provide depositors with the capacity to obtain sufficient information in order to assess banks' capital adequacy – with the resulting consequence that regulation would not be necessary.[24] Dowd's view however, raises two contentious points:

i)Whether and when it would be appropriate to provide depositors with information obtained by the regulator. Not all depositors are able to distinguish appropriately between those banks which are truly and likely to fail and the premature release of financially sensitive bank information may trigger a bank run – even before the central bank is able to perform its role as lender of last resort.

ii) There will always be a role for regulation – since capital adequacy requirements on their own, would still not suffice to address problems attributed to information asymmetry.

The impact of the failure of one bank or a small group of banks is illustrated through the effects of rapid deposit withdrawals and the fears which as a result, could be instilled in the "most trusting bank customer" as a result of such withdrawals.[25] Little evidence, it is further added, exists to support the general belief that bank contagion could trigger domino like effects which could result in the failure of solvent banks, the financial system, and even the entire macro economic system – even in the absence of deposit insurance.[26]

According to Benston and Kaufman, the possibility of solvent banks being rendered insolvent is likely to occur where costs are imposed on such solvent banks (which have been subjected to massive withdrawals), as a result of transaction costs and asymmetric information discounts.[27] Furthermore, they argue that short - term depositors of both solvent or insolvent banks have the capacity to withdraw all their money at the same time only if their banks are able to sell necessary assets or secure required funds quickly.[28]

Even though Dowd argues that safety net instruments have weakened the banking system and that during a period where unregulated systems existed, banks with strong capital positions retained depositor confidence, such an argument does not take into due consideration, the problem of asymmetric information. In acknowledging Miles' argument, Dowd admits that regulators could play a role by imposing capital requirements which would address asymmetric information.[29] Even then, Miles' proposal would not address asymmetric

[23] ibid
[24] ibid at page 8
[25] Such need and ability of depositors to take rapid protection is explained by way of the short term nature of deposits – which as a result, instigates depositors to take protection actions aimed at ensuring a safe (rather than sorry) position. See GG Kaufman "Bank Contagion: A Review of the Theory and Evidence" Journal of Financial Services Research Volume 8 No 2 at page 127
[26] ibid at page 143
[27] See GJ Benston and GG Kaufman „The Appropriate Role of Bank Regulation" (1996) Economic Journal Volume 106 (May) at page 692
[28] ibid
[29] Information asymmetry, as argued by Dowd, leads to a bank capital adequacy problem. "Miles' solution is for a regulator to assess the level of capital the bank would have maintained in the absence of the information asymmetry, and then force it to maintain this level of capital. If depositors cannot assess the financial soundness

information in its entirety. If banks were compelled by regulators to retain such levels of capital that would have been retained if asymmetric information did not exist (and if the depositors had been able to asses their financial positions with sufficient transparency),[30] this would not necessarily guarantee depositor confidence. Liquidity risks and systemic risks triggered as a result of asymmetric information justify the fact that regulation will still be required even where adequate capital cushions appear to exist – since such cushions on their own, are not adequate enough to combat liquidity, systemic risks and bank runs which eventually result in genuine market failures within the financial system. As well as constituting a fundamental foundation of prudential supervision, the Basel Committee recognised the inability of capital adequacy requirements to thrive efficiently on its own – thereby creating two other complementary pillars, namely, supervisory review and market discipline. Even though banks' strong capital positions serve (to an extent) as a formidable means of addressing asymmetric information, not all market failures resulting from asymmetric information will be addressed. Furthermore, deposit insurance and lender of last resort arrangements, if administered according to levels which are not excessive or unwarranted, will certainly help to contribute some degree of stability to the financial system where depositors and banks are offered some form of assurance which would limit the occurrence of bank failures or bank runs.

C. Arguments in Favour of and against Free Banking

Free banking is favoured by Dowd who argues that if markets are generally better at allocating resources than governments are, then the differences or distinctions which exist between "money" and the industry that provides it (the banking industry) should not serve as bases for an assumption that money and banking are exceptions to the general rule.[31]

Whilst Dowd is in favour of free banking, Dow advances many reasons to justify her support for the restriction of regulation to deposit insurance and the "generalised provision of lender-of-last-resort" arrangements to the entire system.[32]

Arguments against Free Banking

2 principal arguments advanced by Dow, which could be considered as reasons attributed to the need for government and central bank intervention are as follows:[33]

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of individual banks, then banks will maintain lower than optimal capital ratios, where the optimal capital ratios are those banks would have observed if depositors could have assessed their financial positions properly. Intuitively, if depositors can assess a bank's capital strength, a bank will maintain a relatively strong capital position because greater capital induces depositors to accept lower interest rates on their deposits. However, if depositors cannot assess a bank's capital strength, then a bank can no longer induce depositors to accept lower interest rates in return for higher capital, and the bank's privately optimal capital ratio is lower than is socially optimal." K Dowd, „Does Asymmetric Information Justify Bank Capital Adequacy Regulation?" *Cato Journal*, Vol. 19, No. 1 (Spring/Summer 1999) at page 2 of 9

[30] The levels that would have been retained are "the optimal capital ratios which those banks would have observed if depositors had been able to assess their financial positions properly" – that is, if information asymmetry did not exist. See ibid

[31] Even if the industries are "different" in some ways, Dowd adds, ("because public policy has made them so"), "that still does not tell us that the industries are intrinsically different or that the intervention that makes them different is justified." K Dowd, *Laissez Faire Banking* 1993 Routledge London at page 1

[32] She does not support complete deregulation of banking. See S Dow, "Why the Banking Industry Should Be Regulated?" May 1996 Volume 106 No 436 The Economic Journal at page 705

[33] ibid at pages 700 and 701

i) Presumed absence of uncertainty of information

Dow highlights the flaws inherent in the reasoning adopted by many advocates of free banking[34] and states that the basis of her argument is not to justify the fact that asset values can never be predicted, but that the valuations are dependent on uncertain values.

Failure to acknowledge or observe the actual level of uncertainty is of vital significance since in Dow's opinion, the nature of the demand for money and the propensity for systemic instability, as well as the operational feasibility of a free banking system, are dependent thereon.[35]

Furthermore she adds:

"Free banking proposals rest crucially on the market's capacity to value bank assets. In the absence of state regulation and supervision, it is the market which has the responsibility to discipline banks into adopting prudent portfolios. Yet free bankers have not demonstrated that the market can actually generate the knowledge required to assess banks' risks levels."[36]

Even though Dow acknowledges that free banking would certainly provide the incentive to depositors to acquire more information about banks, she draws attention to concerns which relate to whether even information which is regarded as "complete", under free banking,[37] is adequate for the correct assessment of risk.

ii) Difficulty encountered by central bank supervisors in determining whether a bank has liquidity or insolvency problems

The alternating shifts between illiquidity and insolvency is acknowledged as having numerous consequences – one of which is namely, the fact that, provision of liquidity by a central bank to a distressed bank, may allow some of the banks' creditors to "escape" before insolvency actually occurs.[38]

Another reason put forward by Dow as evidence of the fact that prudential regulation needs to be backed up by the lender of last resort facility, is attributed to the extreme difficulty encountered by central bank supervisors in determining whether a bank has liquidity problems or insolvency problems.[39]In this context she refers to Davis' earlier observations and findings on issues related to asymmetric information.[40] In highlighting the need for some form of assurance to depositors and the importance of insurance, she also draws attention to Goodhart's earlier observations[41] that private sector deposit insurers would face insurmountable difficulties in gathering adequate information on market values and other

[34] Dowd for instance, she argues, was able to arrive at the conclusion that banks "can actually detect overvaluation of assets" as a result of a presumption of the absence of uncertainty
[35] ibid at page 700
[36] ibid
[37] Freebankers, according to Dow, use the word „knowledge" advisedly. Instead of a consideration of complete or incomplete information, terms such as "ability" to predict market values correctly (even within a probability distribution and even in principle) or "probability"are frequently used. Such terms can be regarded as ambigous and uncertain.
[38] J Caruana, "The Great Financial Crisis: Lessons For the Design of Central Banks" 2010 Bank for International Settlements Publications at page 2 of 9
[39] S Dow, "Why the Banking Industry Should Be Regulated?" May 1996 Volume 106 No 436 The Economic Journal at page 701
[40] See EP Davis, *Debt, Financial Fragility and Systemic Risk* (1992) Oxford: Clarendon.

financially relevant data and that such task would even prove more difficult for small deposit holders.

Other Reasons why Free Banking May Encounter Problems in attempting to Foster System Stability.

Procyclical Effects

Even though it could be argued that the regulator or standard setter's imposition of capital adequacy requirements also contributes to pro cyclical effects – as is evidential of Basel II, central banks, standard setters and governments still have vital roles to play in countering such pro cyclical effects. The capacity for economic cycles to be aggravated further during their peaks (economic booms) or troughs (recessive periods) – given the absence of state or central bank supervision and provided that such procyclical effects occur under free banking mechanisms, would provide the perfect recipe for systemic instability whose effects could trigger immeasurable and potentially damaging consequences.

In establishing monetary policies, central banks (which are responsible for monetary policy as well as supervision) would need to know how and when cyclical developments would be likely to influence macro prudential policies, which in turn would affect economic prospects.[42]

The Benston-Kaufman proposal for a modified free banking scheme (whereby there would still be a central bank whose purpose would be the supply of adequate liquidity to the banking sector, as a means of redressing the issue of system wide instability up to a point), is considered by Dow to be the most superior (when compared with other free banking proposals).[43] It is considered by Dow to be more superior to the other free banking proposals given the fact that "in a situation of a reversal in expectations about the asset values, an increased supply of liquidity into the system by the central bank, is the best policy for limiting the potential for instability."[44]

D. Central Bank Intervention

I. Characteristics and functions of central banks which provide it with unique attributes required to address asymmetric information and undertake functions aimed at safeguarding system stability include:[45]

[41] See also CAE Goodhart, 'Bank insolvency and deposit insurance: a proposal.' In *Money and Banking: Issues for the Twenty-First Century*. (ed. P. Arestis) (1993)London: Macmillan.
[42] See J Caruana, „ The Great Financial Crisis: Lessons for the Design of Central Banks" May 2010 BIS Publications at page 4 of 9
[43] See S Dow, "Why the Banking Industry Should Be Regulated?" May 1996 Volume 106 No 436 The Economic Journal at page 702
[44] Other conditions attached to this proposal by Benston and Kaufman include i) "there would be no direct lending of last resort to individual banks and no supervision (supervision is seen as being superseded by risk-assessment carried out by competing federal agencies) and ii)it would be up to the inter bank market to decide on the terms on which reserves might be borrowed." Ibid.
[45]See J Caruana, „ The Great Financial Crisis: Lessons for the Design of Central Banks" May 2010 BIS Publications at pages 2 - 4

i) Their key roles in overseeing the inter bank payments and settlement infrastructures – since such systems are fundamental to the modern financial system

ii) Their unique ability to provide almost unlimited system-wide liquidity at very limited notice. In order to perform their roles as lenders of last resort, central banks will require more information about the condition of individual banks before a crisis – for example, knowledge of the levels of risk-taking and maturity transformation of some banks (which may require broad information sharing between agencies and the capacity to obtain information directly from financial firms).

iii) The considerable amount of resources which are committed by central banks towards the analysis of macro economic and financial trends.

An important reason for advancing the argument that central banks should retain their roles as bank supervisors whilst serving as lenders of last resort arrangements therefore relates to the extent to which synergies and complementarities exist between monetary policy and financial stability – such that it would not only be impracticable, but also extremely difficult to isolate these policies from each other.[46]

II. Separation of lender of last resort function of central bank from its role as supervisor:

The separation of the lender of last resort function of the central bank from its role as supervisor has the potential to prevent a situation whereby conflicts of interest could occur.[47] Furthermore, where close collaboration exists between a separate supervisory agency and the central bank, the existence of such collaboration and links between the supervisory agency and the central bank, make it more desirable for a separate agency to undertake supervisory functions for purposes of timely, accurate, transfer of information between both authorities. Where a central bank has to undertake wider responsibilities aimed at incorporating greater macro stability based policies, the assumption of such a role will require greater accountability "since functions related to financial stability are by nature, more political than monetary policy decisions."[48]

Furthermore, Caruana argues that the need to differentiate the central bank's responsibilities from those of the government (since central banks stand in a position where they are nearly almost always first in line – when a financial crisis occurs) is not the only issue which arises in considering governance arrangements required for central banks to fulfil their role in facilitating financial stability.[49] "Central banks also need to have realistic financial stability objectives which are consistent with their primary monetary policy responsibilities – as well as the powers and instruments to meet such objectives."[50]

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[46] ibid at page 8 of 9

[47] See Research Papers (1999) Houses of Parliament Research Paper 99/68 "Financial Services and Markets Bill" [Bill 121 of 1998-99] at page 13; see also C Briault, 'The Rationale for a Single National Services Regulator' (1999) Financial Services Authority London Occasional Paper 2 May 1999 at page 28, where arguments in favour of a transfer from the central bank to a separate agency include the fact that a situation whereby the central bank acts as lender of last resort and sets monetary policies, as well as supervisor, may give rise to conflicts of interest.

[48] See J Caruana, „ The Great Financial Crisis: Lessons for the Design of Central Banks" May 2010 BIS Publications at page 8 of 9

[49] ibid at page 1 of 9

[50] ibid at pages 1 and 2

E. Conclusion

Even though certain merits are to be derived from a system which operates on the basis of free banking, the role of central banks and the governments in facilitating system wide stability and the inability of free banking to serve as an effective substitute for such a role, adds weight to the decision to favour a modified free banking scheme (whereby there would still be a central bank whose purpose would be the supply of adequate liquidity to the banking sector, as a means of redressing the issue of system wide instability up to a point).

It would have been ideal if markets could intervene naturally, precisely and promptly when banks are confronted with a situation where their reserves are significantly reduced. However this, as past crises have revealed, is not the case. Prompt responsiveness is best provided by central banks. Rather than banks retaining the option not to redeem their liabilities, as proposed by Dowd,[51] the central bank, in certain situations,[52] could "offset the reduction in bank reserves with open market operations and the central bank would be held accountable for any (if) resulting economic collapse." It is presumed that in such cases as the latter proposal - where banks are allowed to fail, such banks' failures are not considered to have such systemic importance that they would merit government bail outs.

Even though it has been argued that banks have been able to retain strong capital positions when regulation did not exist, and that historical records reveal that government or central bank intervention have actually contributed to financial instability, to concede to these arguments would imply a lack of consideration of global developments which have occurred – particularly over the past three decades. Namely, the rise in conglomeration, more advanced information technology and the growth of complex financial products such as derivatives whose nature and existence further contribute to problems related to asymmetric information. Where conglomerates are involved in complex financial transactions, and such enterprises are "too interconnected" or "too big" to fail, then government intervention - as well as central bank intervention, may be necessary to prevent a downward spiral of the financial system and the entire economy.

The role which regulation presently assumes in the financial system has become more formidable because of the increasing prominence of the structure of financial regulation. The importance attached to the structure of financial regulation stems principally from the central and unique position held by banks – as well as the nature of risks in banking. The adoption of the principle of consolidated supervision has enabled supervisors to assess more adequately the overall strength of a banking organisation and to monitor its susceptibility to risks based on the totality of the business – wherever conducted.[53] Such a consolidated approach to regulation would also help mitigate risks and market failures attributed to asymmetric information.

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[51] Such option clauses being invoked in the absence of insolvency problems and when there is a reduction in bank reserves. See K Dowd, *The State and the Monetary System* (1989) Hemel Hempstead: Philip Allan.

[52] This situation is applicable to where depositors take their funds out of the banking system and where the banks in which funds are re deposited kept higher reserve ratios. Benston and Kaufman argue that if depositors were to re deposit their funds in other banks and these banks kept reserves at about the same ratio to deposits as did the failed banks, there would be no reduction in aggregate money or credit. See GJ Benston and GG Kaufman, „The Appropriate Role of Bank Regulation" Economic Journal Volume 106 at page 693

[53] Organisation for Economic Co-operation and Development, „Trends in Banking Structure and Regulation in OECD Countries" (1987) at page 14

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