Discussant Comments

*Robert E. Litan**

Given my recent change in jobs, I am compelled to begin with a disclaimer that is stronger than usual. What I am about to say represents my personal views only and not those of the Clinton Administration or the Justice Department. And even with this disclaimer, I may get in trouble.

In addressing the issues discussed by these papers today, I feel a little like the man in the story who simply refers to his jokes by their numbers, and because everyone has heard them so often, they are expected to laugh. The same is true for all of you and the ideas for changes in bank structure. You have heard them all before: narrow banking is number 1, of course; universal banking, number 2; financial holding company, number 3, and so on. We could quit right now and take a vote on which number you would prefer; I even think I could guess the outcome.

So what is really new about the discussion we are having today? Well, one new thing is that I am not part of the game any more. At least temporarily, I have taken a time-out to worry about antitrust issues in the economy and will spend only a small part of my time worrying about banking. But while you will not have me to kick around any longer about narrow banking, you now have Jim Pierce. The idea has not gone away.

The second thing that appears to be new is that nothing is likely to happen on the legislative horizon in the United States to alter bank structure much, at least not for the next three years. If we had held this conference back in 1991, we would have been debating the far-reaching financial holding company concept proposed by the Bush Treasury. But

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that effort failed, as we all know. And now the Clinton Treasury has announced that this session it will support only a modest interstate branching bill, one that would "Douglasize" the McFadden Act but would not address the so-called "bank powers" issues. At least not now.[1]

The Proposals for Change

Today we are left to consider how not to repeat the 1980s; that is, how not to let the rate of bank and thrift failures get nearly out of hand. This seems like a mundane assignment, but the diversity of views represented in our papers suggests that it is more challenging than it might first appear.

Safeguarding Banks from Financial Cycles

Richard Randall begins by reminding us what went wrong in the 1980s that led to so many thrift and bank failures. His basic theme is that regulators failed to prevent excessive concentration of risks in time. Whether it was lending to less developed countries, leveraged buyout lending, or commercial real estate, banks and thrifts got carried away and when exogenous events turned sour or, in Randall's terminology, financial cycles hit with hurricane force, banks and thrifts were too exposed and many got washed away.

Randall suggests that the challenge for the future is to prevent such excessive concentration of risk-taking again—for future financial hurricanes will surely occur. He asks the fundamental question, are we going to rely on the market to do that, or are we going to rely on the regulators? Now in asking that question, Randall has implicitly ruled out an alternative approach for dealing with future financial hurricanes, namely more insurance or, equivalent in the banking context, higher capital standards. In fact, if we go toward the road of greater market discipline, in essence we would get higher capital, at least for those institutions that concentrate their risk-taking.

But Randall is skeptical of greater market discipline for a different reason: in his opinion, market participants—depositors, shareholders, and creditors—have not proved able to forecast as well as regulators. An example, by the way, that would have supported Randall's case, one that I am surprised he did not mention, is that in the quarter before Bank of New England failed, the shareholders of Bank of New England were buying its stock. I mean insiders, the management, were buying the

[1] Since these remarks were made, the outlook for congressional passage of an interstate branching bill before the end of the 1994 session has brightened considerably.

stock. Even the insiders did not know the bank was failing, whether because they were ill-informed or because they were unable to forecast as well as the regulators.

Market Discipline and Higher Levels of Capital

George Benston contests Randall's view about market discipline. But whether he or Randall is correct about the ability of market participants to warn of future danger has nothing to do with the demands that market participants almost certainly would make, in a world where deposit insurance was less generous, for depositories to have more capital than they have now. And precisely because they would have more capital, they would be less prone to failure.

For proof, you need simply look to the 1980s. Compare the handful of finance companies that failed with the thousands of banks and thrifts that failed. It is true that one large finance company, Westinghouse, had problems and has appeared to survive only on the strength of its well-capitalized parent. But this example only demonstrates how important it is that lending activity be backed by capital somewhere in an organization. And Westinghouse's creditors would not have continued doing business with the finance company, had the entire organization not been adequately capitalized. Without question, if we move in the direction of market discipline we get more capital. What is wrong with that?

In short, even if market participants could not discipline depositories against excessive concentration of risk more effectively than regulators, the experience of the 1980s suggests that a stronger dose of market discipline could be useful in inducing depositories to be better capitalized. And all this would occur without regulators forcing banks to increase their capital.

The only possible objection to stronger capitalization for depositories is that it would raise the cost of lending and thus constrain economic growth. I am not sure I agree with this objection, for several reasons. First, as Benston has pointed out, if higher capital comes in the form of subordinated debt, with tax-deductible interest payments, any increase in capital costs will be mitigated. Second, as Fed research has discovered, more strongly capitalized banks tend to have lower deposit interest costs. So, it is not clear that higher capital is necessarily associated with a cost penalty. And even if higher capitalization raised lending rates, that increase would come about only because some portion of the current deposit insurance subsidy would have been removed. The result would be a more rational allocation of capital.

Nevertheless, Randall has a point when he states that regulators could do a better job in the future of warning banks of the dangers of excessively concentrating their risks, whether in particular types of lending, trading activity, or derivatives exposure. I also agree with him

that these warnings are best conveyed on a case-by-case, judgmental basis rather than on the basis of any hard-and-fast rules. In addition, alarm bells should go off when a bank expands its risks in any one area very rapidly.

Dangers of Exclusive Reliance on Regulation

I see no harm in the regulators trying, at least at the margin, to dissuade banks from going over the edge. But I believe it would be a big mistake to rely exclusively on better supervision to prevent the dangers of future bank problems. Just as financial cycles have contributed to bank failures, political cycles have deeply affected bank and thrift regulation in the past and inevitably will do so in the future. We just came through a political cycle where things were too lax. Politicians got upset and told the regulators they were too lenient, so they came down hard on banks. When the regulators tightened up, the politicians got upset because the regulators were too tough.

Randall tells us that regulators should be trusted to take the punch bowl away when the party gets going, and that may happen. But you can bet that when they do so, they will be criticized by many in Congress and perhaps by officials in the executive branch for dampening the recovery. Similarly, when banks start dropping, regulators will be excoriated for being too lax. You cannot just assume that regulators are going to be immune to this political pressure. This leads to a case for having more market discipline, because you cannot believe the regulators are going to be as perfect as you would wish.

Coinsurance

So, a strong case remains for injecting more market discipline. The three papers give us three options. Rolnick argues for protection for depositors through coinsurance. The problem here is a familiar one, namely, that any coinsurance plan entails the risk of runs. Whether one wants to accept this risk becomes something of a question of faith. My religion tells me that this is a risk that policymakers may be able to tolerate in the case of small banks, but it is simply not realistic in the case of large banks.

I know the familiar arguments: that a run is not a problem as long as depositors put their money back into some bank, and that the Federal Reserve can stop any systemic run by lending freely. The problem is that the Federal Reserve would not be enthusiastic about having to lend, if it were forced to do so, to hundreds of banks facing a potential run. Private sector participants may discount the worst case. For public policymakers, it is the other way around: The worst case is what scares them. To them this is not disaster myopia; if anything, policymakers

inevitably will tend to give more weight to the risk of worst case losses than may be justified. Therefore, I do not think that coinsurance for large banks is at all credible. In sum, relying on depositor discipline when the crunch really comes is like being willing to jump over an abyss; you might succeed, but you are understandably unwilling to take the leap. At least I am, and I suspect most Fed officials are too, in the real world.

Subordinated Debt

A second source of discipline, favored by Benston, is subordinated debt. In my view, this option clearly dominates depositor discipline because subordinated debt holders cannot run until their instruments mature. Facing a huge potential loss and a modest upside gain, subordinated debt holders are going to exercise a rather conservative influence on the bank. In fact, this option makes so much sense that I cannot understand why our regulators do not require all large banks, or at least those with access to the capital markets, to maintain some portion of their Tier II capital in the form of subordinated debt. It should be mandatory for large banks. I would not worry about the small banks, which may not be able to sell subordinated debt.

Randall may be right that subordinated debt holders are not better monitors than the regulators. But he may be wrong as well, especially as banks are forced to disclose their assets and liabilities on a marked-to-market basis. If the Basle Accord is the only thing holding us back from imposing a subordinated debt requirement, then we ought to go ahead and do this now, alone.

Narrow Banking

This brings me to the third market-based alternative, which is narrow banking, or monetary service companies, if you will. Now, some may question this characterization but, in fact, narrow banking is the ultimate market solution to the banking problem, since it would require all lending to be supported by uninsured funds and thus to a market test. In effect, this option would totally remove the deposit insurance subsidy from lending. In addition, narrow banking would remove supervision of lending and put it in the market and, in the process, remove the political cycle problem from the lending process. We take away the bank supervisors and let the market do their work for us.

I know there are objections to narrow banking and without belaboring them, I think Pierce handles them. The big objection to narrow banking is the one that Pierce talks about, the Chicken Little problem. What are you going to do about the potential risk of a run in the commercial paper market that is backing all these loans and the

monetary service company world? This is an easy thing to answer. Suppose you have a run on, say, "Chase Manhattan Financial" in the narrow bank world; in my opinion, no obvious justification exists for bailing out the uninsured creditors of this hypothetical outfit. The question is, will the run spread to other commercial paper holders in other well-financed or well-capitalized companies? If you are worried about that, the Fed has a very easy solution. It can use open market operations it has always used, to drive down the T-bill rate and widen up a gap between T-bills and commercial paper rates; then people will come back and buy commercial paper of other well-financed companies. The Fed does not have to bail out anybody's creditors. All it has to do is engage in generalized liquidity support of the kind that it practices all the time.

Two more political objections, however, stand between narrow banking and reality: First, what to do about Community Reinvestment Act requirements? These could be imposed on the holding company, but would still be a problem. Also, the adjustment costs of a shift to narrow banking would be large, and I would therefore implement any narrow banking requirement slowly. Narrow banking may seem too radical, with too much reliance on market discipline and perhaps too much disruption to existing lending relationships.

These fears can be handled through appropriate transition measures, although I disagree with Pierce that the way to transition is to provide coinsurance because, in my opinion, coinsurance for large banks entails a danger of runs. Instead, I would implement the transition by requiring a gradually increasing portion of the existing loans on the balance sheets of banks to be transferred to uninsured affiliates. I would not tamper with the insurance on the right-hand side of the balance sheet. I would gradually force the banks to move their assets, other than commercial paper and Treasury bills, to the uninsured affiliate. This could be done over a five- or ten-year period. That is one key difference between us.

A second difference is that I am not sure I would impose narrow banking on small banks. This is purely a political judgment. Small banks provide a lot of loans to small businesses, and narrow banking would generate an increase in the cost of funds for small business, perhaps on the order of 50 basis points. I would take 50 basis points as an acceptable cost, but politically this may be a problem. If small business wants to go to small banks, then it should be permitted to go to small banks. I would not impose narrow banking on small banks. In other words, I would not mandate it for all banks. I would start out with narrow banking as only a voluntary requirement, for institutions that want broader powers. The broader powers would be the benefit associated with converting to a narrow bank.

Cross-Guarantees

A final option, cross-guarantees, which Bert Ely can speak to, deserves discussion. This is another form of private discipline, but by agents of banks as insurers. This is the notion of, in effect, replacing the monopolistic Federal Deposit Insurance Corporation, which is the current government insurer, with a series of syndicates or private insurers that would be capitalized by existing banks and also by nonbanks. Plus, to protect against the possibility of a run on the system, the Fed would still be there as a backstop source of liquidity for this entire program. The idea or the motivation here clearly is to provide market discipline by people who have their money on the line in a way the FDIC does not. You would essentially break down the monopoly in supervision that you now have with the FDIC or the bank supervision system at large.

In effect, the proposal for cross-guarantees is designed to break the regulators' monopoly as a supervisor. But this option also poses several problems. First, since the Fed would backstop the system for liquidity purposes, the syndicates would have to be regulated. This in turn would probably require an examination of the health of the banks supporting them. So, you could end up with the existing bank supervision system backstopping another private supervision system. I am not sure what would be gained in the end.

And, as a practical matter, the syndicates might force banks to have higher capital or move to narrow banking. My own experience with attempting to form a business insuring commercial loans of banks suggests that private actors are very skittish about insuring lending portfolios of banks, which they view as blind asset pools. The lesson is that private people will not willingly insure anybody unless the banks have a lot more capital and a lot more liquid assets and a lot fewer loans; in other words, unless they look more like narrow banks. The reality is that if you end up in a world where you are going to rely on private insurers, I think it will look very much like the one I have already, in essence, endorsed, which is a world with higher capital requirements or narrow banks. This may not be such a bad outcome.

Conclusion

The bottom line is that I would try to combine the proposals of Benston and Randall. A mandatory requirement of subordinated debt for large banks is the most practical and realistic proposal for now. I also would try Randall's proposal for having regulators attempt to warn of excessive risk concentrations. Those measures together would give us an improved system, but I still have a fondness in my heart for my slimmed-down form of narrow banking, even though it might not be politically palatable now. As a voluntary quid pro quo for broader powers, it might be, however.

Discussant Comments

*R. Alton Gilbert**

We have heard four proposals for changing bank supervision and regulation. As a discussant of these papers, I now give my opinion on who won: that is, which speaker made the best case for his proposal.

To judge the entries, I turn to the assignment for the participants at this symposium: "The focus of the symposium will be to examine the likely effectiveness of various proposals for change in the context of financial cycles and the role of banking in the economy." With this focus, the clear winner is Richard Randall. In his proposal, supervisors would assume authority and responsibility to stop boom and bust cycles in the operation of the financial system by limiting risk concentrations in bank portfolios. The contest is not very interesting, however, because Randall wins by default. The other speakers did not discuss the implications of their proposals for financial cycles and the role of banking in the economy, and that is too bad. Advocates for reform proposals should be expected to discuss all of the important implications of their proposals.

Regulation based on capital requirements or on depositor discipline may make bank lending procyclical. Problems with credit quality tend to reduce bank capital when economic activity declines, constraining bank lending under systems of bank regulation based on capital. Under a system of regulation that relied on depositor discipline, depositors would tend to withdraw deposits or require higher risk premiums during periods of declines in economic activity. These implications of regulation, whether based on capital requirements or on depositor discipline, need further exploration.

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Before comparing the proposals, I will mention one way in which they are similar: Not one emphasized interstate banking or expanded powers as important safeguards for the banking system. This similarity is striking, given the importance of interstate banking and expanded powers in much of the current discussion of banking reform in the United States. The authors should be asked to defend the assumption, implicit in their proposals, that their proposed reforms are more important than interstate banking and expanded powers for safeguarding the future of the banking industry. If they are correct, much of the emphasis in the current discussion of banking issues in the United States has the wrong focus.

To make the search for a winner more interesting, let us narrow the basis for the best proposal to the implications for banking risk. In comparing the four proposals, it is useful to divide them into two groups, with the first three papers in one group, the last paper in a second group. The papers by Randall, Benston, and Rolnick retain at least some form of deposit insurance for time and savings deposits, whereas the paper by Pierce calls for restricting deposit insurance to transactions accounts only. Each of the first three papers has a unique set of problems, however.

Supervisory Safeguards

First, the problems with Randall's paper. His assumptions about the basic cause of the banking risk problem make his paper unique in this symposium and in the literature on banking risk. The cause is not moral hazard, created by deposit insurance. Instead, banks are subject to financial cycles of boom and bust because of the irrational animal spirits of business people, who get caught up in investment euphoria. We cannot rely on market participants to discipline the risk assumed by banks, because all market participants are subject to the same irrational animal spirits as the bankers. It is the role of bank supervisors, with their more sober judgment, to stop the cycles of boom and bust by telling bankers when they are beginning to hold dangerous asset concentrations in their portfolios and by forcing the bankers to change their lending patterns.

Randall's world view and his proposal have sweeping policy implications. According to his view, there is no reason to limit the power and authority of bank supervisors to banks. Capitalism is unstable; financial cycles of boom and bust damage the economy. Supervisors should be given power over all lenders, all forms of financial intermediation, in order to impose their more sober judgment. This expanded supervisory role disturbs me in considering Randall's proposal, given the abundant evidence in this country, and around the world, that

market participants do a better job of allocating resources than government agents.

Increased Capital Requirements

In his proposal, Benston endorses depositor discipline in principle but concludes that supervisors will not actually place uninsured depositors at risk. As an alternative to depositor discipline, Benston endorses higher capital requirements, with subordinated debt included with equity as capital. Supervisors would enforce capital requirements through a system of structured early intervention and resolution that would impose progressively more severe sanctions on banks with lower capital ratios.

The regulatory scheme for enforcing capital requirements in Benston's proposal is similar to the system of prompt corrective actions mandated by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Moreover, banks tended to behave as though such a system was in force even prior to passage of FDICIA.[1] The aspect of Benston's proposal that is assumed to enhance the effectiveness of market discipline is the level of the capital requirement necessary to qualify for minimal supervisory scrutiny: capital (including subordinated debt) equal to at least 10 percent of assets.[2] What is missing in Benston's proposal is evidence that this proposed threshold for well-capitalized banks would have the assumed effects on the market discipline of banks.

Coinsurance

And now the Rolnick proposal: a system of coinsurance, in which depositors' insurance coverage would be some fixed percentage of their deposits. Depositors would have a stake in how a bank invests its assets, he writes, and banks that held riskier portfolios would have to offer these depositors a higher rate of return. To accept the Rolnick proposal, however, it must be assumed that the Fed will always act with the wisdom and skill necessary to deal with any systemic bank runs. This assumption makes me uncomfortable.

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[1] See Gilbert (1991, 1992b, and 1993) and Randall (1993).

[2] It is not possible to make a direct comparison between the capital requirement proposed by Benston and the current capital ratios required of "well capitalized" banks under FDICIA. Benston's capital ratio is calculated by summing equity and subordinated debt, and dividing that sum by total assets. Under FDICIA, as implemented by the federal bank supervisors, the capital measure that includes at least part of a bank's subordinated debt is divided by a risk-weighted measure of total assets.

Is there a better way? Can we have a safe payments system, with no risk to the government and no government intervention in the allocation of credit by the private sector? This question brings us to the Pierce proposal, which seems to be the solution.

Narrow Banking

Pierce's proposal falls under the general category commonly called "narrow banking." Table 1 lists what appear to be the assumptions that underlie such proposals. The first three assumptions separate the narrow banking advocates from the laissez-faire banking advocates, who would have no role for government in regulating banks. Most criticisms of the narrow banking idea have focused on the fifth assumption. For instance, Randall believes that the government has a vital role in regulating bank risk-taking. Benston has commented on a loss of economies of scope in banking under the narrow banking proposals.

I will address the fourth assumption, which I have not seen discussed by critics of narrow banking proposals. To aid in a discussion of possible connections between payments services and credit risk, I will use the balance sheet of a hypothetical monetary service company, as proposed by Pierce. The company has $100 in transactions deposit liabilities, which are fully insured by the Federal Deposit Insurance Corporation (Table 2). Assets of the monetary service company include $10 in reserves to meet reserve requirements, and $93 in high-quality, liquid securities, which are marked to market values each day. The company has some equity to absorb possible changes in the market value of the securities. It pledges its reserves and securities to the FDIC, in return for insurance of its deposit liabilities. Full government insurance of the transactions deposits of each monetary service company

Table 1
Assumptions That Underlie Narrow Banking Proposals

1. Fractional reserve banks, with deposits payable on demand, are vulnerable to runs by depositors.
2. Disruptions in the operation of a nation's payments system disrupt its economic activity.
3. A valid reason for government regulation of banks is to avoid disruptions in the operation of the payments system.
4. The government can ensure safe operation of the payments system without assuming risk by insuring all transactions deposits, but not time and savings deposits, and requiring collateral against the transactions deposits.
5. These narrow banking restrictions will not diminish the efficiency of intermediation. Elimination of federal insurance of time and savings deposits and elimination of supervision of banking risk actually would make intermediation more efficient.

Table 2
Monetary Service Company

Reserves	$ 10	Transactions deposits	$100
Securities	93	Equity	3
	$103		$103

makes the payments system safe, and the value of their assets protects the deposit insurance fund.

Pierce emphasizes a functional approach to bank regulation, with regulation focused on the functions of banks that are important for public policy. I will follow that emphasis by focusing on the functions of the monetary service companies. Their customers would use their deposits for making payments, and the companies would process the payment orders of their customers. Monetary service companies would need some mechanism for settling for the value of payment orders cleared among themselves. Banks hold deposits with each other for purposes of settling the payment orders of the deposit customers. Monetary service companies would also hold balances with each other, for the same purpose.

A monetary service company, therefore, could not perform its basic functions with the balance sheet in Table 2, since it includes no balances at other banks. Table 3 presents a modified balance sheet, with $10 of securities shifted to balances due from banks. If the FDIC would permit the monetary service company to meet its pledging requirements by pledging its balances due from banks, the FDIC must deal with some issues in supervising credit risk. If the company holds its balances with other monetary service companies covered by these narrow banking restrictions, no credit risk issues would arise. Many banks, however, hold balances due from foreign banks, which they use in settling foreign exchange transactions. The monetary service company could suffer a loss from the failure of one of the foreign banks with which it holds balances. Thus, a company involved in offering foreign exchange services

Table 3
Monetary Service Company

Reserves	$ 10	Transactions deposits	$100
Balances due from banks	10		
Securities	83	Equity	3
	$103		$103

Table 4
Monetary Service Company

Start of day:			
Reserves	$ 10	Transactions deposits	
		Big Co.	$ 5
		Others	95
Balance due from banks	10		
Securities	83	Equity	3
	$103		$103
Noon:			
Reserves	$ 0	Transactions deposits	
		Big Co.	$ −5
		Others	95
Balance due from banks	10		
Securities	83	Equity	3
	$ 93		$ 93

to its customers, an important function in the payments system, would assume some credit risk by holding balances due from foreign banks.

There are ways to protect the FDIC from this credit risk. Perhaps the management of the monetary service companies could convince the FDIC that this risk exposure is not a problem, since they hold balances with the strongest foreign banks, and their capital is more than adequate to cover any reasonable losses. Such analysis by the FDIC, however, sounds like traditional bank supervision, and the narrow banking proposal was supposed to make analysis of credit risk by the supervisors unnecessary.

Table 4 illustrates another aspect of credit risk assumed by a monetary service company. The table specifies the balance sheet of the company by time of day. At the beginning of the day, the balance sheet is like that in Table 3, except that transactions deposits are divided between one customer called Big Co., with an opening balance of $5, and others whose opening balances sum to $95. Given this balance sheet at the start of the day, the government is protected from losses due to its insurance of transactions accounts, since the market value of cash plus securities exceeds the value of transactions deposits.

But now consider the balance sheet at noon. Big Co. has made a payment of $10 and the monetary service company has a reserve outflow of $10, leaving the transactions account of Big Co. overdrawn by $5. Big Co. anticipates an inflow of cash that will make the balance in its account positive by the end of the day. The monetary service company allows Big Co. to overdraw its account during the day as a service that permits Big Co. to hold an end-of-day balance that is small, relative to

the dollar value of transactions that flow through its transactions account.

Major banks in the United States have developed systems to track the demand deposit balances of their business customers throughout the business day, and those customers that the banks consider to have good credit ratings are permitted to overdraw their demand deposit accounts during the day, as illustrated for Big Co. in Table 4. Bank credit officers are actively involved during the business day in determining which customers may overdraw their accounts, and by how much. Freedom to temporarily overdraw demand accounts gives customers greater freedom in cash management than would be available under a requirement of no intraday credit.

The monetary service company assumes credit risk by allowing Big Co. to overdraw its demand account at noon. At that time, the sum of cash and securities ($93) is less than the $95 of transactions balances of other customers. If Big Co. never repays the $5 overdraft, the monetary service company fails, and the government loses $2.

One obvious solution would be to forbid customer overdrafts at monetary service companies. That prohibition, however, would be almost impossible for the FDIC to enforce. And if, somehow, the FDIC could enforce a prohibition on overdrafts of customer transactions deposit accounts, that change would have a major impact on the nature of business cash management.

Suppose the FDIC concludes that it is not possible or appropriate to prohibit customer overdrafts at monetary service companies. How can the FDIC protect itself from exposure to losses? Perhaps the management can convince the FDIC that it uses a system that permits overdrafts only by customers of the highest credit rating, and that its capital is more than adequate to cover any losses. Such analysis by the FDIC, however, sounds like traditional bank supervision, and the narrow banking proposal was supposed to make traditional bank supervision unnecessary.

A monetary service company that offers foreign exchange services would assume credit risk not evident from these balance sheets. I assume that monetary service companies would engage in foreign exchange transactions, since foreign exchange is an important aspect of the payments system, payment from one currency to another. A company active in the foreign exchange market would have outstanding transactions to settle tomorrow, the next day, and so on into the future. If, for some reason, the FDIC took possession of this monetary service company today, would it make the payments tomorrow that would be necessary to settle the foreign exchange transactions? I think it would make those payments, because of its commitment to protecting the operation of the payments system.

There are risks to the FDIC in assuming responsibility to settle the

foreign exchange transactions, and yet the monetary service company provides no collateral to cover that risk.[3] Perhaps the monetary service company and the FDIC could come to terms on the amount of additional collateral it would hold to cover the risk inherent in settling foreign exchange transactions. The company would finance the addition to collateral by issuing more capital or uninsured debt. To determine the appropriate amount of additional capital, the FDIC would assess the nature of management practices in conducting foreign exchange transactions and choosing counterparties. This, however, sounds like traditional bank supervision, and the narrow banking proposal was supposed to eliminate the need for traditional bank supervision.

Conclusion

This analysis eliminates Pierce's proposal as a winner, since it does not deliver what was promised: It does not protect the payments system, eliminate government risk, and eliminate the need for supervision by government agents of the credit risk assumed by banks. This leaves me again with the first three candidates as possible winners. The options are as follows:

(1) Greater authority and responsibility for bank supervisors to use their judgment in dealing with banking risk (Randall proposal);
(2) A system for the enforcement of capital requirements that is not much different from what we have now (Benston proposal); and
(3) Coinsurance (the Rolnick proposal).

My chosen winner among these options is the coinsurance proposal. That proposal would enhance market discipline of banks, because it would change the options of supervisors in ways that make a complete bailout of the uninsured depositors of large banks less likely. If supervisors have to choose between liquidation of one of our largest banks, under the current limits on deposit insurance coverage, and a bailout of uninsured depositors, the supervisors will tend to choose the bailout. Liquidation would be too disruptive. Closing a bank with a high percentage of all deposit accounts covered by deposit insurance would be less disruptive to the banking system than liquidation under current limits on coverage. Coinsurance changes the options of supervisors in a way that makes the choice of the bailout less likely.

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[3] See Gilbert (1992a) for an analysis of the risk assumed by banks in settling foreign exchange transactions.

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