# *Safeguarding the Banking System in an Environment of Financial Cycles: An Overview*

*Richard E. Randall**

The theme of this Federal Reserve Bank of Boston symposium is captured in its title and in the following statement, distributed in advance to all participants:

> Various proposals to enhance the safety and soundness of the banking system have been debated in recent years, and some of these proposals have been enacted into law. But the debate, and the legislative changes, have generally focused on limiting losses to the deposit insurance funds in order to protect taxpayers, rather than on the broader implications for the banking system and its role in financial markets and the economy. Furthermore, most proposals have not been considered in the context of financial cycles, where changing economic circumstances may reveal risk exposures and the potential for widespread losses in important segments of the banking industry. Examples include the money center banks' exposure to loans to less developed countries around 1980 and the commercial real estate boom and bust cycles in New England and parts of the Mid-Atlantic region in the late 1980s.
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> The focus of the symposium will be to examine the likely effectiveness of the various proposals for change in the context of financial cycles and the role of banking in the economy.

In the first paper, Richard Randall of the Boston Fed described the recent financial cycles that severely damaged the United States banking system. The pattern of these cycles made clear, he argued, that actions to limit the damage to the banking system and the economy must come when risk concentrations are being built and well before a boom turns sour. Tough responses after problems become evident tend to be

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procyclical and can increase the ultimate damage. Randall argued that timely supervisory intervention against excessive risk concentrations could avoid or substantially moderate the distress caused by financial cycles.

The other three papers advocated enhancing market discipline as the way to protect the banking system. George Benston called for more capital in banks, with a significant proportion in the form of subordinated debt. Arthur Rolnick advocated coinsurance, where losses are shared between depositors and the insurance fund. James Pierce presented a proposal for functional banking akin to narrow bank and core bank proposals that had previously been made by others.

Both in the formal discussion of the four papers by Robert Litan and Alton Gilbert and in the general discussion that followed, sharp differences of opinion were apparent. Some attributed the banking problems primarily to euphoric overlending and lemming-like overconcentration in the same types of assets. Others stressed the moral hazard caused by the perverse incentives of deposit insurance, inadequate market discipline, and supervisors' forbearance with respect to failing institutions.

Many were skeptical that supervisors could be depended on to take unpopular actions against unwise risk-taking in a euphoric boom, but several felt that a combination of supervisory and market discipline responses to risk-taking was worth trying. Among the alternative market discipline proposals, none emerged as a clear winner. This overview summarizes the four papers and discussion, highlighting key themes and areas of controversy.

## *Safeguarding the Banking System from Financial Cycles*

The lead-off paper by Richard Randall of the Boston Fed describes financial cycles not as recurring phenomena but as cycles through various phases—as in boom and bust cycles. Typically, a number of banks developed abnormal risk concentrations during periods of rapid growth in a particular area of activity. As growth continued, the expansion became euphoric and credit standards deteriorated, although actual loan problems remained within normal bounds. Eventually the economic underpinnings of the activity weakened, as a result of external factors or overdevelopment. The market psychology turned negative, values collapsed, and losses developed that wiped out capital in numerous banks and seriously weakened others.

Randall catalogs the more destructive of the recent financial cycles, noting the timing and nature of successive phases, the economic forces responsible, and the resulting damage. He estimates that about three-quarters of U.S. bank failures in the past 20 years, as measured by assets

rather than numbers of banks, relate to financial cycles, and only about one-quarter to isolated situations. This estimate does not include the money center banks, which were severely damaged in the early 1980s by a financial cycle involving loans to less developed countries. Randall notes that those banks, with assets well in excess of the assets of all failed banks, eventually sustained losses on developing country credits nearly equal to their capital at the time when such loans peaked.

Randall argues that financial cycles have critical implications for policy options in safeguarding the banking system. Once risks have been built in and economic factors begin to weaken, little can be done to avoid future losses. But problems are not apparent before this point. Thus, to be effective, action to head off severe losses must be taken in response to excessive risk concentrations, and well before indicators such as nonperforming assets exceed normal levels. Capital ratios of banks weaken relatively late in the cycle, long after risk exposures have been built in and losses are inevitable.

Based on his earlier research, Randall contends that market forces have not reacted to excessive risk-taking, only to actual evidence of problem loans. He finds no basis for relying on market discipline to head off future financial cycles. He further argues that proposals to increase market discipline generally also increase the vulnerability of the banking system to systemic crisis. In a context of financial cycles that simultaneously expose numerous banks, often including the largest, to failure and near-failure conditions, it would be unwise to experiment with changes that would increase the vulnerability of the system, he contends.

Randall proposes, instead, a program of direct supervisory action against excessive risk-taking by individual banks. Such actions were once understood to be part of the supervisor's job, he notes, and that role has taken on new significance with the prevalence of major financial cycles. He suggests that heading off financial cycles is the most critical task of bank supervisors. Such a program need not add to the regulatory burden, and can be controlled to avoid credit allocation on any basis other than risk.

Randall's proposal is intended to act countercyclically with respect to financial cycles (but not the business cycle, per se). He contends that the forces of market discipline tend to come too late and have a procyclical effect, aggravating the depressed phase of the cycle. The same is true of "prompt corrective action" tied to deterioration in capital ratios, higher capital requirements and deposit insurance premiums for banks with weakened supervisory ratings, and market value accounting.

The current focus on protecting the taxpayers from bank failures is misdirected, Randall argues. The banking industry supports the deposit insurance fund, and only if the banking industry were overwhelmed with losses would the taxpayer be called upon. The preservation of the country's banking system is essential to the economy, the payments

system, and the social fabric. The government must be prepared to do what is necessary to avoid chaotic failure of large segments of the banking system. This does not mean protecting individual banks from failure, but it does have implications for the way bank failures are handled and for avoiding unnecessary failures of marginal banks. According to Randall, "narrow" or "functional" bank reform proposals are designed to protect the deposit insurance funds and not the banking industry, and therefore do not address the real problem.

To summarize, Randall stresses the significance of financial cycles in recent banking problems and for bank reform. He advocates supervisory action against excessive risk concentrations as the only reform with a reasonable prospect for timely countercyclical action, while rejecting market discipline proposals as procyclical and potentially destabilizing.

## *Market Discipline: The Role of Uninsured Depositors and Other Market Participants*

George Benston of Emory University focuses on how to counteract the moral hazard engendered by the safety net of government-provided deposit insurance, and the relatively low equity capital ratios tolerated in the banking industry. He favors restricting deposit insurance as a means of generating market discipline and argues that objections to this approach are invalid. In particular, he takes issue with the following arguments:

1. Uninsured depositors are unlikely to be able to monitor banks or to do so in a timely fashion.
2. Even if they could do so, the additional interest that depositors would require on uninsured deposits would be insufficient to alter bank behavior.
3. Once weaknesses are noted, uninsured depositors are likely to withdraw their funds (run) rather than continue to monitor a bank.

In dismissing the first objection, Benston points out that much information on banks' performance is available. Banks must disclose considerable information, including nonperforming loans and loan loss provisions, and several private firms sell analyses and ratings of the condition of banks. The federal agencies examine banks in detail and summaries of their reports could be made available to the public. (They are not disclosed at present.) Benston also argues that most corporate financial statements are more difficult to analyze than those of banks, yet these corporations regularly issue debt that is not guaranteed by the government. Thus, depositors could assess the risk taken by their banks, at least to the extent that creditors of corporations generally can

do so. Benston notes that while the large bank losses on loans to real estate developers and oil producers were not predicted by the market for bank stocks, apparently they were also not predicted by bank managers or by the regulatory authorities.

With regard to the second objection, Benston observes that most studies show at least some risk penalty in the rates required to issue large certificates of deposit and subordinated debt. This has been so even though most of the banks studied were large enough to be considered "too-big-to-fail," and most depositors have had good reason to assume that they would probably be paid in full, if the bank failed. Thus, Benston concludes that truly uninsured deposits would require risk premia sufficiently large to influence the risk choices of banks.

Regarding the likelihood of depositor runs, Benston does not appear to be concerned about runs on seriously damaged individual banks, but he carefully analyzes the potential for systemic bank runs. He argues that if depositors believe that their funds are at risk, market pressures will force banks to increase their capital and diversify their risks to provide assurance to their customers, just as nonbanks do. And under the provisions of the Federal Deposit Insurance Improvement Act of 1991 (FDICIA) for prompt corrective action, discount window constraint, and on-site supervision, banks will be closed promptly when capital falls below the minimum level, thus reducing the supervisory caseload. Moreover, solvency evaluations will always be current for all banks with more than $10 billion in assets.

Faced with a market test, banks would structure themselves to avoid runs, differentiating themselves from problem banks, raising additional capital or merging with stronger banks, or even liquidating themselves to avoid progressive weakening. Benston also cites studies showing that there is little evidence that bank runs have been contagious, causing the failure of solvent banks. Nevertheless, he concludes that the scenario of likely runs on a number of large banks, as presented by Randall in an earlier article, is overstated but plausible. However, Benston sees this risk as stemming from banks' low capital ratios and the fact that some banks are considered too large to have their costs inflicted on uninsured depositors, both conditions that Benston has consistently proposed eliminating.

Benston reviews various methods of limiting deposit insurance coverage, noting that if deposit runs are of concern, coinsurance might be less desirable since depositors will wish to avoid losses on even a portion of their funds. He also cites various reasons why it may not be fully effective to limit insurance to demand or very short-term deposits, or to give preference to depositors over other creditors.

In sum, Benston finds that uninsured depositors can provide timely market discipline and that the danger of systemic runs on solvent banks, if it exists, can be removed by actions taken by these banks. Neverthe-

less, he concludes that the incentives affecting bank regulatory authorities will cause them to continue to act in most cases to prevent losses to depositors of large banks. Consequently, he suggests turning to another source of market discipline—subordinated debt.

Benston calls for considering subordinated debt on a par with equity capital, as it serves to absorb losses that would be imposed on the Federal Deposit Insurance Corporation (FDIC). Such debt should have a remaining maturity of at least two years. Because the holders of such debt cannot run and do not benefit if the bank does well, they have every incentive to require a higher rate of interest if the bank takes more risks. Equity holders are less desirable sources of market discipline because they have upside as well as downside potential and, particularly in banks with low or declining capital, may have incentives to encourage greater risk-taking. Furthermore, subordinated debt can probably be sold at a cost lower than that of issuing additional equity.

Benston's earlier proposal (jointly with George Kaufman) for structured early intervention and resolution has been largely, but insufficiently in Benston's opinion, adopted in FDICIA. The Benston/Kaufman concept calls for capital to be measured after adjusting assets and liabilities to market values. Banks would attract supervisory concern when capital fell below 10 percent of assets, and the level of concern and stringency of supervisory constraint would increase as capital ratios fell. In the final category, capital below 3 percent of assets, quick recapitalization, merger, or liquidation would be the alternatives.

With adequate capital and the market discipline imposed by the holders of subordinated debt, deposits could be fully insured in order to avoid the inequity imposed on smaller banks by the "too-big-to-fail" practice. Furthermore, banks with adequate capital could be relieved of close supervision and of almost all restrictions on assets and on banking activities.

Thus, while Benston believes that depositor discipline, in conjunction with higher capital and early intervention in failing banks, could protect the banking system, he fears that the actions of regulatory authorities in handling large troubled banks will nullify depositor discipline. He therefore opts for subordinated debt holders to be the providers of market discipline, permitting full insurance for all depositors.

## *Market Discipline as a Regulator of Bank Risk*

Arthur Rolnick of the Minneapolis Fed traces the history of banking panics from the free banking era that began in 1837 up to the establishment of the FDIC in 1934. Deposit insurance brought stability to banking and an end to banking panics, but it created another problem—moral hazard.

This new problem did not clearly manifest itself until it was recognized that deposit insurance was in reality unlimited, particularly at the larger banks. The authorities' handling of the Continental Illinois failure in 1984, when all depositors were protected, made this clear, if it had not been earlier. Between 1985 and 1990, fully 99 percent of uninsured deposits at all failed banks were protected by the FDIC.

With full insurance, depositors have no reason to worry about the risks their banks take, and banks need not pay a risk premium on deposits. Assuming that riskier assets generally yield higher returns and that bank stockholders are so well diversified that they are risk neutral or can readily hedge their risk, it follows that banks best serve their shareholders by taking on the riskiest portfolio possible. This is the essence of moral hazard, the incentive to increase risk beyond what would otherwise be considered prudent limits.

Rolnick contends that the experiences of both the savings and loan and the banking industries in the 1980s provide evidence of moral hazard induced by deposit insurance and of the failure of the regulators of both industries to contain that moral hazard. While regulation might be improved, regulators cannot control risk, because without a profit test they have no basis for determining the optimal amount of risk. Furthermore, when banks gamble in their risk-taking, regulators cannot monitor banks closely enough to close them in time to avoid losses to the insurance fund.

Rolnick goes back into history again to support his argument that, in the absence of full deposit protection, the market can discipline bank behavior. Depositor exposure reintroduces the possibility of bank runs, so a trade-off exists between moral hazard and bank panics. But Rolnick sees the Federal Reserve System as better able to contain panics than it was in the 1930s, so the trade-off today is less severe.

Nevertheless, Rolnick is concerned that regulatory authorities will consider it advisable to protect uninsured depositors when a large bank is failing, even though the appropriate long-term strategy calls for introducing more depositor discipline by not protecting them. He therefore advocates coinsurance, because the commitment to impose losses on depositors can be made more credible where individual depositors lose only a fraction of their exposure.[1] The probability of widespread bank runs following the failure of a large bank would be reduced because far more of the funds of large depositors would be covered. Consequently, the authorities would have little rationale for protecting uninsured depositors.

[1] An example of coinsurance would be for depositors to be insured for 80 percent of their deposits. Because coinsurance can be phased in gradually, Rolnick notes that it would not be necessary to determine the optimal level in advance.

In sum, Rolnick seeks a means of limiting the moral hazard engendered by deposit insurance, while minimizing the risk of either banking panics or supervisory reluctance to force losses on depositors of large banks. He concludes that coinsurance is the best alternative.

## *The Functional Approach to Deposit Insurance and Regulation*

James Pierce of the University of California at Berkeley proposes a radical restructuring of the financial system in terms of deposit insurance, supervision, powers, and the federal safety net. The concept is similar to "narrow bank" and "core bank" proposals.

After a transition period, what are now called banks would be divided into two parts, monetary service companies and financial service companies. Monetary service companies could accept only transaction accounts, which would be guaranteed by the government and on which they could pay interest. Monetary service companies would be limited to holding high-quality, short-term assets and would be closely supervised. The financial service companies, on the other hand, could accept any type of deposit, but without deposit insurance, and would be unrestricted in their lending activities.

These two "companies" could operate as integral parts of a broader financial entity engaged in any combination of financial services. No "fire-wall" requirements would be imposed, so that synergies need not be impaired.[2] But a monetary service company could not be the creditor of any other parts of the organization or be responsible for their debts, and it would have to be adequately and independently capitalized.

Thus, the functional approach is designed to isolate a unique and critical bank function that regulators believe must be protected to avoid payments system disruptions in a time of general bank distress. Pierce points out that the efficiency of the payments system would be significantly diminished if sellers of goods and services had to verify the soundness not only of buyers, but also of the buyers' banks, and therefore he proposes 100 percent insurance of transaction accounts. He sees no need to offer deposit insurance on time deposits, and accordingly no need to supervise the quality of credit or the adequacy of capital in the non-monetary portion of the organization.

Pierce envisions the Federal Reserve as the supervisor of the monetary service companies and the FDIC as its subsidiary to administer a federal insurance program for transaction accounts. The other bank

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[2] For instance, the same employees could handle transactions in both companies.

and thrift regulators would be eliminated. While monetary service companies would have normal access to the discount window, financial service companies would have only emergency access in the event of a severe loss of liquidity. Insolvent institutions could not be bailed out.

Pierce argues that the functional approach probably would not adversely affect the supply or cost of business loans, but even if it did, he favors subsidizing such lending directly rather than financing it with insured deposits. He asserts that small banks would not be hurt by the loss of deposit insurance on the bulk of their liabilities.

Pierce also rejects arguments that the absence of prudential supervision would increase the danger of financial instability in the financial service companies. Deprived of deposit insurance and the protection of "too-big-to-fail," large creditors might be expected to withdraw funds at maturity if they perceive a problem. Monetarist economists should not be concerned because the central bank can maintain the money stock and bank monetary functions would be completely protected. Other economists might be concerned that a breakdown in the stock market or commercial paper market would result in a "flight to quality." Borrowers with asymmetric-information problems ("opaque" loans) would face higher rates or be rationed out of the market.[3] But Pierce argues that the Federal Reserve can soften these effects by providing liquidity. To the extent that financial service companies are unable to roll over maturing debt, or are forced to sell opaque assets at substantial losses, some may fail. But even during a panic, when creditors demand payment from a number of financial service companies, few will demand currency and a large part of the withdrawn funds will be invested in the securities of solvent financial service companies. Furthermore, the monetary service companies may use funds borrowed from the Federal Reserve to buy market instruments issued by sound financial service corporations.

Market discipline in financial service corporations will result in stronger capital positions, better control of failures, and avoidance of stampedes into risk concentrations such as those experienced in the 1980s. Pierce contends that occasional interventions by supervisors to protect creditors of large institutions, in extraordinary circumstances, would not nullify market discipline once functional banking is achieved. He hopes, however, that with money and payments safe, the authorities would be no more likely to bail out a financial service company than they would an auto company, a defense contractor, or a city.

[3] As financial intermediaries, banks make business loans that cannot be readily handled by markets directly. The business loan portfolio of a typical commercial bank consists of numerous loans of various types and in various industries, involving detailed financial information, non-standard terms, and often collateral handling and periodic on-site visits and inspections. Such loans are sometimes referred to as being "opaque," in contrast to more "transparent" credits that trade in the commercial paper market.

Thus, Pierce would create a mechanism so that today's banking functions could be carried on within any type of financial firm, with deposit insurance limited to transaction accounts and market discipline replacing supervision in safeguarding the riskier activities.

## *Prepared Discussant Comments*

The first discussant, Robert Litan of the U.S. Department of Justice, was not convinced by Richard Randall that supervisors can forecast future problems better than bank depositors, shareholders, and creditors.[4] Although he saw no harm in supervisors doing their best to dissuade bank managements from overly risky concentrations, he also saw the possibility that politicians would pressure supervisors to back off. He agreed with Randall that warnings by supervisors are best conveyed on a case-by-case, judgmental basis.

Litan stressed the importance of higher capital ratios as a major benefit of greater market discipline. He rejected coinsurance because it entails the risk of runs, which policymakers would not tolerate in the case of large banks. Litan sees subordinated debt as clearly the superior source of market discipline. He would require all large banks to have outstanding a minimum amount of subordinated debt.

Litan, a long-time supporter of narrow (or functional) banking, regards this approach as the ultimate in market-based solutions because all opaque lending would be subject to a market test. Narrow banking would remove most of the need for supervision and what Litan calls political cycles from the lending process. But the possibility remains of a run in the commercial paper market, which would be largely funding the financial service companies. Litan believes that the danger of systemic runs could be handled by open market operations and the discount window, but the concerns of policymakers are likely to delay serious consideration of the concept.

Litan's ideas for the transition to functional banking differ somewhat from Pierce's, and he would not impose narrow banking on small banks. Rather, Litan favors starting with a voluntary program tied to the acquisition of broader bank powers.

Litan also commented on a proposal being advanced by Bert Ely, consultant, and others for private deposit insurance through cross-guarantees. A serious problem with the concept is that while the risk will be assumed by various insurance syndicates, the government will be backstopping the system. It is inevitable, then, that government

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[4] Litan made clear that he was presenting his own views and not those of the Clinton Administration or the Justice Department.

authorities would want to supervise the syndicates, and to do that they must have knowledge of the condition of the larger bank and nonbank syndicate members. So, what do we gain in the end? Litan related his personal experience in attempting to establish a company to insure pools of bank loans. Potential financial backers viewed banks as blind asset pools, and the attempt was unsuccessful.

In conclusion, Litan suggested a combination of mandatory subordinated debt and supervisory warnings of excessive risk concentrations and perhaps, in the future, a transition to narrow banks.

The other discussant, Alton Gilbert of the St. Louis Fed, expressed disappointment that the three papers proposing market discipline reforms did not discuss how their proposals would safeguard the banking system in an environment of financial cycles. He sees a potential for procyclical lending behavior associated with strict enforcement of higher capital requirements or steps being taken to obtain depositor discipline. He agrees with Randall that some FDICIA provisions are akin to "shooting the wounded."

Gilbert has reservations, however, about the ability of supervisors to measure risk concentrations and overcome political interference. But his more fundamental concern is Randall's view that the basic cause of bank risk problems is the irrational animal spirits of people caught up in boom-time euphoria, rather than moral hazard stemming from deposit insurance. This view, unique in the literature of banking risk, could have sweeping policy implications because it could be interpreted to mean that the danger is not confined to depository institutions. This could, in turn, suggest that the supervisors' role should be expanded to moderate financial cycles in all forms of financial intermediation. This possible interpretation disturbs Gilbert, given the abundant evidence worldwide that market participants allocate resources better than government agents.

With respect to Benston's proposals, Gilbert is skeptical that a modest increase in capital ratios would help much. He also questions the value of "prompt corrective action," noting that very few failing banks have taken on additional risk once they became seriously damaged.

Gilbert devotes most of his remarks to one critical assumption underlying James Pierce's functional bank proposal: that the government can ensure the safe operation of the payments system by insuring only transaction accounts and supervising only the risks related to such accounts and the offsetting assets. Gilbert argues that monetary service companies will have to hold balances at other banks, including foreign banks, and thus will assume some credit risk. Monetary service companies will also need to extend intraday credit to customers, including financial service companies, to facilitate the smooth functioning of the payments system. In these areas ongoing credit analysis and corre-

sponding supervisory overview will still be required. Thus, Pierce's proposal does not deliver what was promised: protection of the payments system and elimination of supervisory review of bank credit risk.

Gilbert's choice among the proposals for bank reform is coinsurance as proposed by Arthur Rolnick. Coinsurance would enhance market discipline by making it more palatable for supervisors to close the largest banks. Closing a bank with a high percentage of deposits covered by insurance would be less disruptive to the banking system under a system of coinsurance than with the current limits on coverage.

## *General Discussion: A Summary*

The symposium participants represented a wide range of views regarding bank reform. While many, if not most, of the participants support some form of expanded market discipline as the preferred ingredient for a safer banking system, they have long debated among themselves the merits of various proposals. Several were prominent advocates of the concept that the principal underlying cause of the extraordinary banking and thrift problems of the 1980s was moral hazard, induced by deposit insurance, low levels of bank capital, the idea of "too-big-to-fail," and regulatory forbearance toward failing banks. Their focus was protecting the taxpayer from future losses related to deposit insurance, and it was largely because of their success in pushing their ideas that Congress passed FDICIA.

With its characterization of recent financial cycles, the lead-off paper suggested a very different explanation for recent banking problems and made a case for drawing separate lessons from the banking and thrift crises. As discussant Alton Gilbert pointed out, Randall sees the problem as primarily one of excessive growth and concentration of risk in a euphoric boom, not moral hazard. In the general discussion, several people commented on the apparent herd mentality of bankers, which resulted in similar risk concentrations in many banks. Those who commented on financial cycles generally agreed that we should expect to see more cycles of this type in the future. The strongest supporters of the moral hazard theory advanced their positions forcefully, but generally did not respond directly to the implications of financial cycles.

Randall's proposal for supervisory action to head off dangerous risk concentrations drew only limited, qualified support as a substitute for market discipline, but somewhat broader support as an idea worth trying in conjunction with changes to enhance market discipline. Market discipline supporters dismissed the notion that supervisors could forecast better than markets, and they doubted that supervisors could stand up to political pressure when the time came to slow credit growth in a boom. The discussion featured interplay between those anxious to

enhance depositor-imposed market discipline and those concerned about the potentially destabilizing effects of increasing depositor exposure.

A sharp divergence of opinion also emerged concerning the relevance of the thrift experience in designing safeguards for the banking system. Some supported Randall's contention that the regulatory environment of the savings and loans was unique, and that the focus of inquiry should be on what went wrong with the FDIC-insured banks. Others put much of the blame on regulatory forbearance, which FDICIA was designed to combat, without distinguishing between bank and thrift experiences.

Several participants criticized the early intervention and prompt corrective action provisions of FDICIA. They viewed them as procyclical, in that supervisory actions are tied to declines in capital ratios, a lagging indicator. These provisions were blamed for aggravating the "credit crunch" that accompanied the New England banking failures, and for making it more difficult for damaged banks to recover. Some complained that FDICIA represented overregulation and was unnecessarily inflexible.

George Kaufman of Loyola University and others defended the law and indicated that it is having its intended effect of forcing more losses on uninsured depositors. Capital ratios are improving rapidly, in part because of enhanced market discipline, and regulatory forbearance is less evident.

James Pierce's proposal for functional banking inspired considerable discussion. On the one hand, it was suggested that the proposal did not go far enough because it called for full insurance of transaction accounts. On the other, concern was expressed about the effects of widespread failures of uninsured financial service companies and of possible runs on the commercial paper market, where these companies would obtain much of their funding.

Discussion also followed Alton Gilbert's comment about the risk to monetary service companies in maintaining clearing balances with foreign banks and allowing daylight overdrafts. A question remains as to whether monetary service companies can be protected from the risks in settling the myriad of transactions flowing through a major bank without seriously damaging the efficiency of the payments mechanism.

Disagreement also emerged on the likelihood and desirability of bank runs, and how much the discount window can moderate systemic liquidity problems in banks. One view holds that few bank runs have taken place in recent years, and that systemic runs on a broad scale are unlikely because depositors will not demand currency, much less gold. Also, bank runs are a desirable form of market discipline.

Participants arguing on the other side of the issue cited significant runs in New England in the recent banking crisis including some with systemic potential, at least on a regional basis. All appeared to agree that

withdrawn deposits are likely to remain within the banking system. But deposit flights from regions and classes of banks could still occur in the loss recognition phase of financial cycles. With numerous banks in some degree of trouble, and uncertainty as to solvency, deposit churning could materially curtail credit availability, deepening economic problems and increasing the likelihood of unnecessary bank failures.

A similar divergence of views emerged on the level of reliance to be placed on the discount window. Some who considered bank runs a remote possibility assume that the Federal Reserve lending operations could handle any liquidity problems that might arise, and one participant suggested that this might be done through monetary policy alone, eliminating the need for the discount window.

The contrary view holds that discount window administrators would have difficulty distinguishing failing banks from other damaged banks in a major financial crisis. The task of providing liquidity to stabilize the system has been made more complicated by the discount window restrictions imposed by FDICIA.

Robert Litan had raised the issue of the private deposit insurance proposal advanced by Bert Ely. He thinks the idea deserves public discussion because it substitutes the market judgments of insurance syndicates for that of the FDIC. Richard Aspinwall of Chase Manhattan Bank argued against the proposal on the ground that the system of insurance syndicates, made up essentially of banks, can be no stronger than the capital supporting the banking system. Incentive conflicts could also inhibit large banks, in their role as syndicate members, from criticizing each others' practices. Edward Kane of Boston College supported the concept, if used in conjunction with subordinated debt, because of concerns for the actions of federal regulators in "political cycles." His vision of the syndicates could include nonbanks and could take the form of bonding, reinsurance, or subordinated debt.

Several participants discussed the implications of structural changes in the financial services sector, including greater competition in traditional banking services from nonbanks and increasing concern for government guarantees relating to nonbanks. Edward Ettin of the Federal Reserve Board staff expressed concern that some of the factors that gave rise to the safety net for banks now apply to other providers of financial services, including a propensity for systemic risk. This suggests consideration of limited federal supervision and discount window access for some nonbanks. Concern was also expressed about disruption of financial intermediation by nonbanks in a crisis. Jane D'Arista of Boston University advocates a limited government guarantee for each individual against the failure of any type of financial institution, including banks. This would be in addition to a guarantee of all transaction balances in banks.

## *Conclusion and Commentary*

The United States has experienced extraordinary problems with depository institutions in the past 15 or so years. The debate has been vigorous over what changes should be made to prevent recurrences. Discussion of the causes of the various banking crises has been dominated by the view that most problems stemmed from moral hazard and inadequate market discipline, both consequences of the perverse incentives of deposit insurance, and from the supervisory practice of safeguarding uninsured depositors in large banks. As a consequence, much of the debate about reforms has revolved around alternative means of limiting depositor protections and otherwise enhancing market discipline.

One objective of the symposium was to force a careful examination of the nature and patterns of the several banking crises. The lead-off paper attempted to do this and concluded that most of the damage was done as a consequence of a few financial cycles. A characteristic of such cycles is that preventing losses requires curtailing risk-taking before economic forces cause a turn in the cycle. In discussing this paper, several participants acknowledged that most recent cycles involved euphoric excesses by bankers and borrowers, although no consensus emerged as to the underlying reasons. It was suggested that widespread euphoria in boom periods was a competing explanation for the cause of recent banking problems, along with the more familiar moral hazard view.

Five alternative proposals to moderate future problems were discussed in some detail, of which four were designed to enhance market discipline. The remaining proposal was for direct supervisory action to avoid excessive risk concentration in banks during boom periods. A number of participants were skeptical that supervisors could stand up to political pressures during a euphoric boom, but few saw harm in supervisors trying to discourage overconcentration.

No evidence was cited that market forces have reacted against cyclical risk-taking before it peaked and problems emerged. But market discipline solutions generally intend to put bank creditors more at risk, in the expectation that they will then exert timely pressure on bank management to curtail unwise risk-taking. Proposals advanced at the symposium were intended to do this with the least potential for initiating systemic instability. But participants were divided on the potential for bank runs, undesirable failures of damaged but viable banks, and procyclical effects on credit availability and economic activity as a result of bank problems.

Some participants expressed concern that coinsurance would leave the system vulnerable to systemic problems if depositors at large banks were forced to take losses. Some feared that the functional banking

proposal would weaken the efficiency of the payments system (by eliminating daylight overdrafts), while leaving the bulk of what we now call banks vulnerable to further financial cycles. Fewer commentators expressed negative views concerning reliance on subordinated debt, but questions were raised as to its applicability to smaller banks and the mechanics of achieving frequent market tests. Related issues include the potential for instability in a time of crisis if maturing subordinated debt cannot be rolled over, and the fundamental question of whether the theory will work in practice and produce timely risk-avoidance.

While opinions expressed at the symposium varied widely as to whether FDICIA will have a positive or negative effect on bank soundness, there seemed to be a clear consensus that further changes are needed to safeguard the banking system. The symposium and these proceedings are intended to be useful in reframing the debate and keeping attention on the need for further action, even as the banking problems of the 1980s fade.