



# Public Policy Brief

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## SHOULD BANKS BE “NARROWED”? An Evaluation of a Plan to Reduce Financial Instability

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Narrow banking legislation would require banks to back their liabilities with safe assets, such as government securities.<sup>1</sup> All other bank lending functions would be transferred to mutual-fund-like institutions that were not insured by the government. This arrangement would allow the government to scale back its costly deposit insurance programs without jeopardizing the safety of the banks. The institutions that inherited banks’ role in commercial lending would be loath to take excessive risks, because their own capital and that of their investors would be at stake.

This brief argues that conventional banking provides a number of economic benefits that would be sacrificed if banks were “narrowed” and that narrow banks would not be financially robust or immune to crisis. Under the current system, banks can simultaneously meet their depositors’ needs for liquid assets and provide “patient” money to borrowers. Narrow banks could not perform this function. Because banks have the privilege of creating money, they are able to provide a steady abundant supply of credit, which would be largely choked off by narrow banking. Banks are also able to monitor their borrowers closely for fraudulent or irresponsible behav-

ior; in contrast, because of their arm’s-length relationship with issuing firms, securities holders are often ill-informed about borrowers’ activities.

Certain practical problems suggest narrow banking proposals may be unworkable. For example, if the government were not running large deficits, narrow banks might not have an adequate supply of safe assets. This problem would be particularly acute in developing countries, where sovereign risk is significant. Another weakness in narrow banking stems from the fact that because commercial banking is profitable, incentives

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to circumvent or repeal narrow banking rules would be strong. These and other flaws in the argument for narrow banking indicate that the present system should be modified, rather than completely abandoned.

This brief offers an evaluation of the theory and policy of narrow banking and answers such questions as: Would narrow banking deliver greater financial stability? If so, at what cost? and Is narrow banking advisable for developing economies? The brief rejects narrow banking on conceptual and empirical grounds, concluding that it would deprive the economy of the key functions and benefits of conventional banking. It also finds no convincing support for the practicability of narrow banking proposals.

## Background

Narrow banking is the modern and more elaborated version of the “100 percent reserve banking” principle, invoked by early economists to correct the inadequacy of money reserves against the stock of banknotes in circulation. Narrow banking proposals most recently resurfaced in the United States in the 1980s, at a time when tumultuous financial innovation and financial crises demanded a reassessment of the extant banking regulatory regime. Modern narrow banking supporters offer varying proposals, from introducing a 100 percent reserve requirement that would bind banks to fully back transaction accounts with marketable short-term Treasury debt (Tobin 1985, Kareken 1986, Spong 1991, Mishkin 1999, Thomas 2000); to requiring banks to invest fully insured deposits in high-grade securities, including government paper or government-guaranteed securities of various maturities (Litan 1987, Herring and Litan 1995); to allowing banks the use of insured checkable deposits for short-term lending to consumers and businesses.

## The Case for Narrow Banking

The benefits of narrow banking seem straightforward and immediately evident. First, by locking bank assets in high-quality instruments, narrow banking regulation would minimize bank liquidity and credit risk. Second, since narrow banks would be prohibited from supplying risky loans and would collateralize deposits with high-quality assets, confi-

dence in the value of their liabilities used to make payments could not be weakened by changes in the value of loans. Third, with payment-system access restricted to narrow banks, payments would be fully secure, because payment-system participants would be protected against liquidity, credit, and settlement risks, and because any shock to nonbanks would be isolated, with no systemic fallout (Burnham 1990, Thomas 2000).

As a result, capital requirements for narrow banks could be reduced substantially, the potential recourse to the taxpayer for depositor protection would become infrequent, and the inequitable too-large-to-fail bailout clause would be removed by making the failure of large narrow banks less likely. There would thus be much less need to subject narrow banks to special regulation and supervision (Bruni 1995, Thomas 2000) and, since they would be protected from nonbank activities, a broader range of activities and a wider ownership structure might be permitted for their nonbank affiliates than is possible under current banking regulations in many countries (Spong 1993). Narrow banking also would obviate the need for a socially costly deposit insurance mechanism, eliminate the subsidies for certain forms of intermediation that currently skew savers’ incentives, and limit opportunities for banks to exploit the insurance system to cover overly risky loans.

Furthermore, a narrow banking regime would afford greater resiliency to the entire financial system. A failure of the market to elicit sound behavior from nonbanks would not have dire consequences for the monetary sector. Although the market would eventually punish untoward behavior by individual institutions or investors, money and the payment system would be unaffected by such behavior.

## Narrow Banking vs. Banking: Insights from Theory

An important strand of research, conducted by Diamond and Dybvig (1983, 1986), stresses the role of banks as insurers against “liquidity shocks,” or unexpected needs for money. Banks perform this function by transforming illiquid assets (those that are difficult to convert quickly and cheaply into cash) into liquid deposits. The averaging out of withdrawal demands from a large number of depositors allows banks to stabilize their deposit base and transfer deposit ownership without liquidating the assets.

From this angle, the social benefit of banking derives from an improvement in risk sharing (i.e., the increased flexibility of those who have an urgent need to withdraw their funds before the assets mature).

In fact, the benefit of banking cannot be fully appreciated if either the asset or the liability side of the bank balance sheet is considered in isolation. A synergistic benefit results when banks use their stable deposit base to finance time-consuming production technologies that yield goods and services. The essence of Diamond and Dybvig's theoretical advances is that production requires patient money and involves risk, while agents with money may not be as patient and risk-inclined to lend it to firms; banks provide a mechanism to reconcile both sets of preferences by generating liquidity. Narrow banks are designed precisely not to do so.

Moreover, unlike most depositors, banks have the resources to acquire private information about the creditworthiness of borrowers. In the absence of banks, individual investors might be unable to distinguish between good borrowers and bad, an inability that would divert resources from their most productive uses and discourage people from lending. A related advantage of the current system is that bank depositors can be confident that banks will not exploit their lack of information, because depositors retain the power to costlessly redeem their balances at full value.

Banks, as financial intermediaries, transfer resources from their depositors to their borrowers. Viewed in this way, banks appear similar to mutual funds. But banks can do more; they can create new money. They do so each time they credit a borrower's account in the amount of a new loan. This leads to a third theoretical point. By suppressing banks' money-creation power, narrow banking would make credit to the private sector scarcer and more costly because nonbanks would be able to fund their assets only to the extent that investors were willing to hold nondemandable debt or nondebt instruments, such as stock. This would make lending costlier and reduce liquidity in the system since, by regulation, nonbank debt cannot be used as money.

Thus, theory strongly suggests that dealing with the difficulties generated by traditional banks by eliminating them entirely would dissipate the significant benefits associated with the current system—benefits derived from making

demandable deposits available to finance a relatively broad range of assets.

### Potential Consequences of Narrow Banking

Aside from the theoretical considerations already described, important operational issues surround the impact of narrow banking on finance and the real economy. For example, all narrow banking proposals must confront the question of whether the economy contains enough assets of the kind that are eligible to be used as collateral for transaction deposits. If narrow banks were required to hold government paper only, the supply of money would depend on the government's debt-management strategy. If deficits were too small, banks would not be able to produce an adequate amount of money (Schinasi, Kramer, and Smith 2001).

Uncertainties also surround the claim that narrow banks would not need government safety nets. Narrow banks are clearly as good as their assets. However, even under regulations requiring narrow banks to hold only short-term government paper, full safety cannot be achieved in the absence of a credible commitment from the issuing banks to convert, on request, all deposit holdings into cash, at their full stated value. To the extent that narrow bank collateral is not accepted in the economy as money, there remains a chance that depositors will rush to their banks if they perceive that their collateral is losing value or becoming illiquid, or if they fear that other depositors might do the same.

Perceptions of less-than-full safety may become significant when fluctuations in the market value of government paper are marked and when the risk of government default is not negligible, as in the case of many developing economies. (Consider the case of Argentina in 2001–02.) Permitting narrow banks to hold foreign assets might mitigate this problem, but this would introduce a dimension of foreign exchange risk.

In the end, as in the case of conventional banking, only an insurer (in the form of a deposit insurance mechanism or a lender of last resort) could guarantee banks would not default. Alternatively, narrow banks could be required (even more stringently) to hold only central bank notes or deposits. But even this option could not protect them from

runs on the currency (unless the central bank held a 100 percent foreign reserve collateral).

Does narrow banking eliminate the need of nonbank intermediaries for safety nets? Narrow banking advocates maintain that if checking accounts were fully protected, the rest of the financial system could be left to operate without public protection mechanisms. But this belief contradicts the historical facts, which show that the earliest banks developed without safety nets, let alone regulation, by conducting maturity and liquidity transformation, and by issuing bank notes in excess of reserves, much as they do today. History thus shows the existence of a natural incentive for some firms to finance dynamic portfolios of opaque assets with relatively short-term liabilities (Flannery 1994). This incentive has led to the establishment of intermediaries that specialize in the supply of liquidity and asset-transformation services (Mussa 1987) and the emergence of special intermediaries (banks) that are capable of financing loans by creating money.

Under narrow banking, such natural incentives would lead some intermediaries to compete for the provision of conventional banking services, eventually replicating the financial world that existed before narrow banking. The public would again demand safety nets for its short-term liabilities, and government guarantees would tend to migrate, along with depositor funds, to the new intermediaries. If the modern banking system did not exist, we would have to invent it.

A practical concern about narrow banking involves the cost of breaking long-standing multifunction banks into specialized and (legally and physically) separate corporations (Benston and Kaufman 1993). It would be necessary to build new structures or redesign old ones, and employees would have to be reassigned to each organization. The accumulated knowledge that banks and their customers have about each other, which reduces the costs of intermediation, would be squandered.

Economists and bankers also question the profitability of narrow banking. How attractive is the narrow banking business? Based on the experience of money market mutual funds, Spong (1993) argues that once freed from major regulatory burdens, narrow banks should be able to offer depositors a return competitive with other low-risk invest-

ment alternatives. From the opposite stance, Ely (1991) believes restricting the range of investment activity would reduce narrow banks' size and income. This tendency, he contends, would be magnified if small banks were exempted from narrow banking regulation, a provision that would prompt the formation of many small banks, especially in urban areas. The income losses associated with the smaller scale might be significant in light of recent findings on scale economies in the banking industry. Another negative is a loss of efficiency gains resulting from the joint production of deposits and loans.

Opponents of narrow banking argue that not enough credit would flow to the private sector if traditional banks were converted into narrow ones. Credit would become scarcer and more costly, most notably for smaller (firm and consumer) borrowers, because noninsured financial companies would be motivated to invest in larger enterprises. Narrow banking proponents, on the other hand, assert that the entry into the market of finance companies, investment banks, and institutional investors, as well as the increasing use of alternative financing instruments to deposits (e.g., securitization, equities, and junk bonds) should maintain the supply of credit as needed.

However, the importance of the banks' role in money generation belie this argument. Unlike banks, nonbank intermediaries cannot rely on the ability to create money in order to provide credit. Also, no efficient nonbank intermediation would be possible without bank liquidity services and money creation.

### **Policy Discussion and Conclusion**

From the foregoing analysis it seems fair to conclude that narrowing the scope of banking would, at best, produce uncertain benefits in terms of greater financial stability while at the same time exacting heavy costs in terms of efficiency and credit availability. Narrow banking would sever the link between liquidity, money, credit, and economic activity, a link that banking has a natural incentive to establish efficiently.

By suppressing bank money as an instrument to finance lending to the private sector, narrow banking would create what economists call "market incompleteness," a condition

that occurs whenever mutually beneficial trades of goods or services are prohibited. The consequent economic losses would lead other financial firms to fill in the gap by undertaking conventional banking activities. This would defeat the very purpose of narrow banking because it would replicate conditions as they existed originally and resurrect the risks that narrow banking was supposed to eliminate.

The economic costs of narrow banking could be particularly significant for developing countries, where the need for an efficient banking system is vital as an engine of economic growth and a support for the development of a strong nonbank financial sector. Potential pitfalls for narrow banking in the developing world include the absence of a well-developed secondary market for government securities, a highly volatile environment for securities prices, the existence of sovereign risk, and an inability to make a credible government commitment to refrain from insuring deposits or widely held financial instruments.

While mandatory narrow banking regulations should be rejected, nothing should stand in the way of individual institutions' offering narrow banking services to their customers on a voluntary basis, or creating narrow bank subsidiaries that would be segregated from other businesses within the same bank holding companies. Along these lines, Mishkin (1999) has proposed an efficient, free-choice regulatory solution that would allow banks to provide customers with a choice between safe accounts and traditional ones. Another appealing alternative was offered by Bryan (1991). In his "core banking" model the scope of banking would be narrowed to activities in which banks have a demonstrated comparative advantage: issuing checking, savings, and money market deposit accounts; providing payment, trust, and custody services; and offering loans to individuals, small businesses and medium-sized companies.

Two other (not mutually exclusive) approaches would provide additional incentives for banks and depositors to exercise prudence and, at the same time, would preserve conventional banking. Banks could issue uninsured deposits bearing an option clause whereby in the event of liquidity problems the bank could suspend deposit convertibility for a predetermined interval while it liquidated its assets in an orderly fashion. During that time, the bank's deposits would continue to circulate in the payment system.

Banks could also issue subordinated debt, as proposed by Keehn (1989), Wall (1989), and, recently, Calomiris (1999). In the event of insolvency, a bank would have to make good on its subordinated debt only after depositors were reimbursed. Presumably, the market value of these securities would provide the community with a valuable signal as to the relative stability of the issuing banks, thereby lessening the need for regulation.

These alternatives to narrow banking would contribute to increased financial market completeness, spur competition within the banking sector, and strengthen market discipline, without suppressing conventional banks. The patient's health would be restored through good medicine, not euthanasia.

### Note

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