Narrow Banks: An Alternative Approach to Banking Reform

by

Kenneth Spong*

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*Division of Bank Supervision and Structure, Federal Reserve Bank of Kansas City

Banks for many years have been regarded as the pillar of stability in our financial system. Over the last decade, however, significant portions of the industry have been at the forefront of each recurring crisis, whether it be energy, agricultural, real estate, commercial, or LDC lending. Bank lending helped foster a boom-bust cycle that went well beyond the basic economic fundamentals in each of these areas. These cycles all ended with increased bank failure rates and high loan losses. This result has further led to substantial declines in the bank insurance fund, causing many to question whether banking is headed in the same direction as the thrift industry with its continuing need for taxpayer funds.

These events provide a strong indication that banks may be suffering from something more serious than regional downturns or a run of bad luck. Recent banking problems demonstrate the need for significant and fundamental reform in the banking and financial system -- a reform which would extend well beyond the changes incorporated in recent federal banking legislation.

This article examines this need for further banking reform and takes a closer look at one alternative -- "narrow banking" -- which could dramatically change the structure and operation of the U.S. financial system. The first section of the article discusses the need for fundamental banking reform, as demonstrated by the basic weaknesses inherent in the U.S. financial system and in recent legislative efforts to reform it. The second part provides an overview of narrow banking, while the final section examines some of the more important questions that narrow banking might raise.

The Need for Banking Reform

Beginning with the 1980s, the U.S. banking system has demonstrated a number of weaknesses, which seem linked in many cases to the structure of federal deposit insurance. Most notable among these weaknesses are: (1) an inability to maintain a safe and stable payments system without significant taxpayer liability, (2) a banking system that doesn't respond quickly or optimally to market forces in allocating credit and other banking services, and (3) a regulatory and legislative framework that is confining banks to a declining and more risky piece of the financial marketplace. While these banking problems have led to several major pieces of banking legislation and many suggestions for further reform, nearly all of the approaches seem to involve significant compromises and would fail to correct the basic flaws in our banking system.

Payments system concerns

Since the 1930s, the United States has placed much reliance on federal deposit insurance, backed by the "full faith and credit of the United States Government," in ensuring depositors of the safety of their funds and in protecting the payments system. The possibility of systemic problems and threats to the payments system have further extended this protection to uninsured depositors in large failing institutions. Overall, this deposit insurance system was generally able to accomplish its objectives until the 1980s, when bank and thrift industry problems led to losses in the bank insurance fund and to the substantial deficit and need for taxpayer funding in the thrift insurance fund.

Because of the nature of deposit insurance, most recent and proposed efforts to reduce taxpayer liability for deposit insurance would conceivably sacrifice some of the stability in our payments system. The Federal Deposit Insurance Corporation Improvement Act of 1991, for instance, attempts to protect taxpayers by limiting the protection that uninsured depositors in failing banks can receive. Several other reform ideas would go beyond this and cut back on the existing levels of deposit insurance coverage.

While the motive for such changes is understandable, a number of arguments suggest another approach is needed. First, a safe transactions and clearing system is more critical to the nation's financial welfare than ever before. The volume and complexity of financial transactions have increased greatly across the economy, and these transactions rely on the existence of a widely acceptable stock of money and a smoothly functioning payments mechanism.

Also, the typical depositor is likely to have a strong preference and expectation of safety and certainty in financial transactions, particularly given the payments system technology available today and the level of resources devoted to the banking system and its regulation. Most depositors, moreover, hold checking accounts almost entirely for the services of making and receiving payments and have far less of a concern over the investment aspects of these accounts. Consequently, the likelihood of occasional disruptions to this transactions framework could reduce public confidence in the financial system, keep the level of business activity from reaching its full potential, and divert an inordinate volume of resources toward tracking transactions or using less efficient alternatives.

Another argument for taking a different approach is that depositor discipline and the threat of loss for uninsured depositors may be hard to enforce. Many large depositors, for instance, may have the ability to react more quickly than the regulatory authorities in problem bank situations. They may also be able to find ways to circumvent any deposit insurance changes and thus avoid being exposed to losses. In addition, recent experience with large bank failures in the United States has shown that depositor discipline will likely raise a number of significant concerns. Major deposit disruptions and losses, for instance, could be harmful to a wide variety of bank customers, regional economies and their credit bases, and the reputation of the U.S. banking and payments systems. These arguments thus imply that many proposals for reform may not only be inconsistent with the need for a stable payments system, but may face many practical and political difficulties as well.

Response to market forces

The need for a banking industry that is responsive to market forces has become quite evident with the lending problems that some banks have had in recent years. Banks have been at the forefront of nearly every lending crisis and have been extremely slow in working their way out of these problems and finding more favorable alternatives. Moreover, deposit insurance has given weak or high risk lenders virtually the same access to funds as the strongest lenders, thus diverting notable portions of bank lending toward less worthy ventures and away from alternatives more consistent with market needs.

The Federal Deposit Insurance Corporation Improvement Act of 1991 takes a few steps to encourage more market discipline and limit access to funding by problem institutions. Overall, however, this legislation appears to give bank regulators greater responsibility for controlling bank risk taking, while leaving less of a role for bankers and other participants in the marketplace. The act prescribes exceedingly detailed standards and enforcement actions for banks, but no matter how well this framework is conceived, it will never be a substitute for market forces and the proper management of a bank. In addition, this regulation seems likely to impose a substantial cost burden on both problem and sound banks, while turning much bank decision making away from bankers and more into the hands of bank regulators, examiners, and federal lawmakers.

Recent developments thus seem incompatible with increasing the responsiveness of the banking system to market forces. Such developments, moreover, may tend to focus too much supervisory intensity on past banking problems and recent political and regulatory sentiments, thus leaving banks vulnerable to the next crisis -- a crisis that will undoubtedly generate a call for even more detailed regulations and stronger intervention.

Future role of banks

Changes in the financial marketplace appear to be occurring in a direction counter to the traditional intermediary role of commercial banks. Over the last decade, the availability of financial information for individual investors and nonbank lenders has increased dramatically. In addition, substantial declines have occurred in the transaction costs for making many different types of investments. These developments are giving investors a greater ability to bypass traditional financial intermediaries and directly place their funds in the marketplace.

The same factors are further encouraging the creation of new financial instruments and an expansion in certain financial markets. Several examples of this are securitization of mortgages, consumer loans, and other financial paper; introduction of derivative financial instruments; rapid growth in stock and money market mutual funds; and expansion in commercial paper and other securities markets. In particular, the commercial paper market grew from less than $125 billion in obligations to over $560 billion in just a 10-year period.[1]

At the same time these developments were taking place, commercial banks began facing some changes that made them less able to compete. Compared to investors placing their funds directly in the market or through mutual fund alternatives, the use of banks as

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[1]The types and variety of borrowers using this market have also expanded rapidly. For more on the growth of this market, see Mitchell A. Post, "The Evolution of the U.S. Commercial Paper Market since 1980," Federal Reserve Bulletin 78 (December 1992): 879-891.

intermediaries has involved such additional costs as deposit insurance premiums, nonearning reserves, capital standards, corporate taxes, and the burden of regulation.[2] In general, these costs appear to be rising with the higher insurance premiums, capital standards, and more extensive regulation brought on by the 1991 federal legislation and recent industry problems.

As a result of these changes, banks have been losing much of their prime corporate customer base to the commercial paper market and other direct sources of credit. Banks, in fact, have gone from once having over 90 percent of the short-term business credit market to now having about 60 percent of this market.[3] The added costs of intermediation compared to direct investment are also prompting banks to securitize and sell many of their other top quality assets.

This loss of business is even more notable because banks have not found many good substitutes. More and more, typical bank borrowers have become those with a very limited access to direct market funding, a need for specialized types of financing, and a risk exposure that is difficult to assess according to usual market

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[2]The FFIEC's 1993 study on regulatory burden lists previous research as showing that regulatory costs alone might represent 6 to 14 percent of total bank noninterest expenses, or a total of between $7.5 billion and $17 billion for the industry in 1991 (Federal Financial Institutions Examination Council, "Study on Regulatory Burden," January 1993, pages 3 and 4 of the Executive Summary).

[3]For these statistics, as well as additional information on the role of banks and changes in financial intermediation, see Gordon H. Sellon, Jr., "Changes in Financial Intermediation: The Role of Pension and Mutual Funds," Economic Review (Federal Reserve Bank of Kansas City), Third Quarter 1992, pp. 53-70.

standards. This shift in lending thus appears to be leaving banks with a less stable asset backing for deposits and a more volatile risk structure.

In addition to these lending changes, banks also have had difficulty in maintaining their share of the household savings market. Pension funds and mutual funds -- stock, bond, and money market -- have been capturing a rising portion of this market at the expense of bank deposit products.[4] Money market mutual funds gained rapidly when banks were constrained by deposit interest ceilings in the 1970s and early 1980s. These and other deposit alternatives, though, have continued to grow by offering investors an efficient and diversified means of access to financial markets. This broader choice of alternatives makes it unlikely that bank deposits will ever regain the importance they once held in the portfolios of bank customers.

The current banking framework and recent reforms are thus unlikely to give the public a banking system that is stable, responsive to market forces, and capable of adapting quickly to ongoing changes in the financial marketplace. Nonbank competition and financial innovation are taking away important pieces of the banking business that have previously provided much of its stability. Many of the commonly suggested banking reforms would increase the level of bank regulation, thereby hastening these trends and taking banking further away from the market process. In

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[4]For a more detailed presentation of the changes in household savings patterns, see Sellon, "Changes in Financial Intermediation: The Role of Pension and Mutual Funds."

addition, ideas for reforming deposit insurance would typically place depositors and payments system stability at risk -- all at a time when payments system technology should be capable of creating a more efficient and stable transactions framework. This result suggests that a different solution is needed -- a solution that will make the banking system more flexible and move it back toward the market process, but still protect the integrity and confidence in our payments system.

Narrow Banking as a Solution to the Deposit Insurance Problem

Overview of narrow banking

Narrow banking is one measure that could be more compatible with monetary stability, market discipline, and ongoing financial developments. The term "narrow banks" refers to banks that would offer deposit accounts and would back these accounts entirely with either marketable securities of extremely low risk or currency and equivalent holdings. Narrow banks would thus ensure a safe payments system through the risk-free nature of their balance sheets. The assets backing narrow bank deposits would provide ready funds to meet deposit withdrawals and would make narrow bank deposits the functional equivalent of currency. As a result, depositors could be confident about the safety and availability of their deposits, without putting taxpayers or others at risk.[5]

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[5]For several examples of narrow banking proposals, see James B. Burnham, "Deposit Insurance: The Case for the Narrow Bank," Regulation 14 (Spring 1991): 35-43; John H. Kareken, "Federal Bank

Narrow banks would receive income from the interest on their securities and from any fees they charge for transaction services. This income should enable them to cover operating costs and make interest payments on deposits.[6] Because of their need for only minimal amounts of capital, narrow banks could operate on low margins and still have a chance to achieve competitive returns on equity. In addition, narrow banks would encounter very little regulatory burden. They would only need to make frequent reports of their assets and deposits, subject to a quick regulatory verification on occasion.

Several different variations of narrow banking have been proposed as a means of reforming the financial system. One suggestion is to establish separate narrow banking entities which

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Regulatory Policy: A Description and Some Observations," Journal of Business 59 (January 1986): 3-48; Robert E. Litan, What Should Banks Do? (Washington, D.C.: The Brookings Institution, 1987); James L. Pierce, The Future of Banking (New Haven: Yale University Press, 1991); Alex J. Pollack, "Collateralized Money: An Idea Whose Time Has Come Again," Challenge, September/October 1992, pp. 62-64; and James Tobin, "The Case for Preserving Regulatory Distinctions," in Restructuring the Financial System (a symposium sponsored by the Federal Reserve Bank of Kansas City, 1987), pp. 167-183.

Many narrow banking concepts, such as safe banks and minimizing regulatory intervention, can also be traced back to earlier proposals for 100 percent reserve banking developed by such individuals as Henry Simons (Economic Policy for a Free Society (Chicago: University of Chicago Press, 1948), pp. 62-65) and Milton Friedman (A Program for Monetary Stability (New York: Fordham University, 1959), pp. 65-76). These proposals would have restricted bank assets to cash and Federal Reserve Bank balances, thus providing complete control over the money supply.

[6]Because of their limited powers and liquid asset structure, narrow banks would primarily offer transaction accounts and services. Narrow banks could also be allowed to offer savings accounts, but the terms on such accounts would probably not differ much from transaction accounts in a competitive marketplace.

would only offer transaction accounts and related services. Any additional activities, such as traditional bank lending, would have to be split off into separate affiliate organizations funded on an uninsured basis. Because of the risk-free nature of narrow banks, these affiliate activities would not put narrow bank depositors at risk. As a consequence, a broader range of activities and a wider ownership structure might be possible for affiliates compared to current banking limitations. In addition, affiliate activities could be left to the discipline of the uninsured investors and general market forces. These affiliates would thus have the freedom to adapt to ongoing financial developments and innovations.

Other narrow banking alternatives include "deposited currency" and "collateralized or secured money." Banks or, in some cases, the federal government would have authority to offer these deposits. This set of alternatives would not require banks to be split into separate transaction and lending entities. Banks would be required to back their transaction accounts with liquid, low-risk securities, much as they do now with many public deposits. They could continue to offer other financial services or a selected group of such services, provided the funding for these activities was on an uninsured basis.[7]

[7]Separate narrow banks are suggested in Litan, What Should Banks Do? and in Burnham, "Deposit Insurance: The Case for the Narrow Bank." The case for a deposited currency or collateralized money is discussed in Tobin, "The Case for Preserving Regulatory Distinctions" and in Pollack, "Collateralized Money: An Idea Whose Time Has Come Again."

A final alternative would be a variation of narrow banking and 100 percent reserves. Under this option, narrow banks would hold their securities with the Federal Reserve or would back deposits with Federal Reserve accounts representing a proportionate interest in the System's portfolio of securities. This alternative would allow regulators to monitor directly a bank's security holdings.

The following analysis will focus primarily on narrow banks as separate banking entities, since this alternative provides the clearest distinction between transaction services and other financial activities. However, the other narrow banking alternatives would have virtually the same effects with respect to reforming the financial system and achieving the benefits of narrow banking.[8]

Comparative benefits of narrow banking

Compared to recent legislation and other proposals for deposit insurance reform, narrow banking would offer two significant benefits. First, narrow banking would eliminate the fundamental problem in the current banking system -- deposits available at par and on demand that are backed with illiquid and risky loans. This traditional bank asset/liability structure violates the basic principles of financial management by failing to provide an asset

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[8]Narrow banking should, however, be distinguished from core banking proposals, which allow banks to continue most traditional lending activities but with restrictions on the size of individual loans and on deposit interest rates (see Lowell L. Bryan, Breaking Up the Bank (Homewood, IL: Business One Irwin, 1988). While core banks might be of some benefit in limiting bank risk taking, they would still not lead to the type of nearly risk-free deposits characteristic of narrow banking proposals.

base with sufficient liquidity and security to support withdrawable deposits.[9]

Because of this structure, the survival and stability of the banking system depends on an extensive governmental support system -- a system that seems to expand over time in response to banking crises, financial innovation, and the development of new bank assets and off-balance-sheet activities. Major elements in this safety net now include: (1) deposit insurance to give depositors confidence, (2) discount window lending to compensate for the illiquid assets at banks, and (3) detailed regulation and supervision to control bank activities and risk taking. Narrow banking would correct this unstable structure by requiring banks to match their deposits with assets that are liquid and of inherently low risk. Consequently, depositors could look directly to the narrow bank for safety and would no longer have any real need for

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[9]For a more detailed discussion of this issue, see John H. Kareken, "Ensuring Financial Stability," in <u>The Search for Financial Stability: The Past Fifty Years</u> (a conference sponsored by the Federal Reserve Bank of San Francisco, 1985), pp. 53-77.

The unstable nature of the current banking structure and its divergence from market principles is obvious in other ways. Financial institutions that operate without a federal safety net have been forced by the market to adopt a much different balance sheet structure than banks. Uninsured lenders, for instance, must typically maintain longer term and more stable funding and somewhat higher capital standards. Similarly, those institutions that offer investment accounts with transaction privileges, such as money market mutual funds, generally confine their asset holdings to low-risk, short-term marketable securities.

deposit insurance and a complex system of governmental protection.[10]

A second and related benefit of narrow banking is that it could eliminate much of the need for extensive governmental involvement in bank lending and other policy decisions. The present banking system is a classic case of where governmental oversight has expanded from an important public policy objective -- protection of depositors with transaction accounts and thus the payments system -- to less appropriate objectives -- review of private lending decisions and intervention in managerial and bank policymaking functions.

This credit and managerial oversight by public authorities can add its own distortions to the financial system and divert funds away from normal market channels. Deposit insurance contributes further distortions to the credit granting process by giving the weakest bank lenders the same access to funds as the strongest. While the $200 billion cost of the thrift bailout, along with recent losses in the bank insurance fund, provide some indication of the magnitude these distortions can assume, the total losses to the economy have undoubtedly been several times larger. These

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[10]For this level of safety to be realized, narrow banks and their customers would not only have to refrain from credit transactions, but would also have to be limited in their ability to overdraw any of their accounts during the business day and over longer periods. For a narrow bank, daylight overdrafts would pose a risk to customers and the payments system whenever the overdrafts could exhaust bank capital. In many ways, these payments system issues are similar to those that currently exist in the banking system and might require many of the same steps toward reform. However, the low capital requirements of narrow banks and their "fail safe" nature could make these reform steps even more urgent.

additional losses arise from the fact that the capital and assets of poorly managed banks and thrifts might have been directed by market forces into other pursuits yielding much higher returns to the overall economy.[11]

Narrow banking could eliminate much of this need for governmental intervention into bank lending and policy decisions. Lending and other risk taking functions would be shifted into uninsured affiliates where they would have no influence on depositor safety. Furthermore, affiliate activities could be subject to market discipline, which should provide more direction in channeling funds to the better lenders, curtailing funding access for others, and allowing banking organizations to adapt to market changes.

Questions That Might Be Raised By Narrow Banking

Narrow banking would require a significant restructuring of our financial system. Bank insured deposit and transaction activities would no longer be tied directly with credit activities, thus changing many customer relationships. The roles of many financial institutions would also change with the development of new lenders and the removal of competitive barriers between banks

[11] In reference to the federal outlays for recapitalizing the bank and thrift insurance funds, Benjamin Friedman stated, "In this era of shrunken capital formation, [these outlays are] approximately equal to three entire years' worth of net additions to our stock of productive plant and equipment" ("The Nature and Necessity of Financial Reform," a public policy forum of The Jerome Levy Economics Institute of Bard College, April 6, 1991, p. 7).

and other financial firms. This transformation of the financial system consequently raises many specific questions, which must first be addressed before the overall benefits, weaknesses, and implementation concerns of narrow banking can be judged.

Are there sufficient low risk assets available to support a narrow bank concept? The feasibility of narrow banking will depend on whether organizations can obtain enough low risk assets, such as short-term U.S. Government securities, to back their deposits. This might appear to be a rather dramatic leap for many banks, but somewhat surprisingly, perhaps, recent balance sheet information indicates that many organizations could reasonably make the transition.

To accomplish this, banking organizations must either already hold enough appropriate assets or be able to obtain any additional assets needed. In this regard, U.S. commercial banks had $888 billion in domestic holdings of cash, reserves, balances with other institutions, and securities at mid-year 1992. This compared to domestic transaction deposits of $710 billion. In general, these numbers indicate that many banks may already have a good start toward constructing the type of asset base needed for a narrow banking system.[12]

Several changes, though, might be necessary in the securities held by banks. Since many of these securities now consist of notes, bonds, and mortgage-related debt with maturities of several

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[12]For greater detail on the current structure of U.S. banks and the type of balance sheet changes that would be required under a narrow banking system, please see the Appendix to this paper.

years or longer, a shift toward shorter maturities would be necessary to minimize any interest rate exposure for narrow banks. Also, a few of the securities held by banks may not have the marketability or nearly riskless credit characteristics that would be desirable for narrow bank assets. Another limitation is that not all of the cash assets and securities should be viewed as freely available for supporting narrow bank deposits. Some might be used to support the operations of uninsured affiliates or to cover deposit runoffs and affiliate funding shortfalls in the transition to narrow banking.

Even with these qualifications, narrow banks and their parent organizations could conceivably make the necessary adjustments with only moderate changes in their operations and in securities markets.[13] Although short-term federal debt -- the most plausible asset for narrow banks -- barely exceeds the current volume of bank transaction accounts, the U.S. Treasury would seemingly have the flexibility to supply additional amounts. This could include more short-term debt issuance or somewhat longer term debt with a variable rate structure. Moreover, as narrow banks added to the demand for such instruments and banks sought to sell some of their longer term securities, market conditions would provide support for

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[13]For a similar type of analysis, see Burnham, "Deposit Insurance: The Case for the Narrow Bank," pp. 41,42; and Litan, <u>What Should Banks Do?</u>, pp.169-173.

this shift in U.S. Treasury funding.[14] A transition period for narrow banking could further ease any market adjustments.

Another possible alternative would be to expand narrow banking assets to include a somewhat broader range of federal, state, and local government securities and short-term, highly rated corporate obligations.[15] Taken together, these instruments could amount to as much as $5 trillion, although narrow bank restrictions on asset maturity and marketability would result in a smaller volume of "appropriate" securities. There are also other possibilities, including derivative investment products structured to have some payment streams of shorter maturity and very little credit risk. Several of these alternative investments, however, could leave narrow banks with a limited exposure to interest rate or credit risks -- risks that would have to be controlled by higher capital standards, closer monitoring of assets, diversification across the assets, and efforts by debt issuers to create safer securities.

What would happen to credit availability? Narrow banking would redirect the existing credit functions of depository institutions toward bank credit affiliates and other market lenders. To a significant extent, a shift toward other market lenders is already occurring and seems likely to continue, based on

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[14]Because the total volume of federal debt in private hands is now approaching $3 trillion, the U.S. Treasury would have a large base for starting to make these maturity changes.

[15]A broader range of securities, particularly with respect to private sector issuers, would help to limit any added preference that narrow banking would give to U.S. Government securities in the marketplace. Unless the list of acceptable securities were greatly expanded, though, the market effects would likely be marginal.

the added costs banks face as regulated intermediaries. Narrow bank lending affiliates could give banking organizations the opportunity to avoid some of these costs and restructure their lending operations under a more efficient and flexible framework. At the same time, though, narrow bank affiliates would have to find sufficient uninsured funding before they could take over the lending roles now performed by the banking system.

To attract funding, narrow bank affiliates would have to meet the same market standards as other lenders for capitalization, asset quality, and other relevant performance measures. With the low risk inherent in narrow banks, much of the equity now in the banking system could be directed toward credit affiliates, provided bank stockholders were willing to make this change. If this equity were to be shifted and the lending affiliates were to assume most bank lending operations, the affiliates as a group would be near, but still somewhat below, the equity ratios of comparable finance companies or short-term business lenders.[16]

Consequently, lending affiliates would need to take some steps to raise additional capital, reduce loan portfolios, or achieve an asset quality higher than other lenders. In many cases, these

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[16]The Appendix to this paper provides a more detailed comparison of the lending affiliates of narrow banks and other types of lenders.

On a more limited basis, many banking organizations already have experience managing uninsured lending affiliates through the bank holding company structure. This experience includes holding company subsidiaries operating as finance, mortgage, leasing, and factoring companies. As uninsured lenders, these companies typically must meet the usual market standards.

pressures are similar to what banks are already beginning to face under risk-based capital standards and 1991 banking legislation. A more flexible lending framework could help narrow bank affiliates attract additional capital, and the affiliates could also use securitization and asset sales or placements to reduce overall capital needs.

Other related considerations include whether lending by smaller banking organizations would be restricted due to a limited access to market funding and whether affiliate lenders would be willing to take on the many different types of loans offered by banks. Smaller organizations would presumably lack direct access to major credit markets and thus would have to obtain much of their funding from local investors, other lenders, bank customers that previously held time and savings deposits, and any new funding sources that might develop. While these sources could conceivably meet most needs, any shortfalls might require a small bank exemption from narrow banking or a lengthy transition period for these organizations.[17]

The type of lending by affiliates could differ in a number of ways from that of banks because of differences in funding and market pressures. Although banks seem destined to change part of their lending focus, they have traditionally been viewed as filling a number of borrowing needs not met by other market participants and serving as a back-up source of liquidity for many borrowers.

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[17]A small bank exemption is discussed in Burnham, "Deposit Insurance: The Case for the Narrow Bank," p. 38; and in Litan, What Should Banks Do?, p. 182.

Market pressures might limit the ability of narrow bank affiliates to fill these roles. However, a strong demand for such services would presumably entice some affiliates or other lenders to maintain the capital backing and funding base necessary to serve different customers and provide various forms of credit enhancements.

A final factor that should lessen credit concerns under narrow banking is the decline in any advantages banks may have once had over other lenders. In recent years, the credit-granting abilities of nonbank lenders have increased substantially with the growth of securitization, commercial paper, and other securities instruments. In fact, nonbank sources now represent the predominant force in most parts of the credit market, and this seems likely to continue in step with improvements in financial disclosure and the amount of credit reporting available to investors and nonbank lenders.[18]

As a result, nonbank lenders, investors, and narrow bank affiliates would seem to be capable of fulfilling most, if not all, of the general credit needs of the economy. In a number of areas, funding could even be expected to improve if narrow bank affiliates were given the freedom to participate more extensively in debt and equity markets. In particular, with increased market discipline, the better lenders and the more creditworthy customers could

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[18]The information that bank lenders presently gain from knowing a customer's deposit history need not be lost under a narrow banking system. Narrow banks, for instance, would be free to disclose such information to their lending affiliates or to other lenders.

actually be expected to gain better access to funding under a narrow banking framework.

Would narrow banks be competitive with other financial firms? The competitiveness of narrow banks is important if they are to be a lasting part of the financial system and discourage other firms from developing new transaction or deposit substitutes. From a financial perspective, narrow banks, if free of major regulatory burdens, should be able to offer their depositors a return competitive with other low-risk investment alternatives.[19] Most of the potential competitors for narrow banks, such as money market mutual funds and cash management accounts, are structured in much the same manner as narrow banks and would thus have few, if any, natural competitive advantages. Moreover, since narrow banks would be free to offer a complete range of payments services to the banking public, they might even have a competitive advantage over these other institutions.[20] Some of these competitors, in fact, could be expected to convert into narrow banks in order to gain access to the payments system.

From a stockholder's standpoint, efficiently operated narrow banks should also be competitive with other investments. Because

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[19]For narrow banks to be free of major regulatory burdens, their capital requirements and degree of regulation would have to fully reflect their low level of risk and they would have to receive a competitive return on any reserves they were required to hold.

[20]Although many of the banking organizations establishing narrow banks might maintain more of an office structure and have higher fixed costs than money market funds or other potential competitors, the added expenditures, if wisely invested, should help attract customers or generate more fees.

narrow banks would need only limited amounts of capital to cover fixed assets and protect against fraud and other risks, they could operate with low margins and still achieve competitive returns on equity. Possible synergies between the transaction services at narrow banks and other financial products offered by affiliate companies would further increase the investment value of narrow banks.

A final competitive question is how narrow banking would compare with the current banking system. While some banking analysts have argued that narrow banking would suffer in comparison, this reform could conceivably offer several significant advantages.[21] Narrow banking would finally recognize checking accounts for what they actually are -- a service in which balances are maintained to provide the liquidity necessary to carry out transactions. In addition, this reform would put all other banking functions into a separate and more flexible format, thus eliminating many of the restrictions and regulatory burdens banks currently face. Recent evidence further indicates that traditional lending activities at many banks have not been highly profitable and, in some cases, have not even kept up with bank investment portfolio yields when overhead expenses and credit losses are

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[21]For articles discussing the advantages of the existing banking structure, see Randall J. Pozdena, "The False Hope of the Narrow Bank," FRBSF Weekly Letter (Federal Reserve Bank of San Francisco, November 8, 1991); and Bert Ely, "The Narrow Bank: A Flawed Response to the Failings of Federal Deposit Insurance," Regulation 14 (Spring 1991): 44-52.

considered.[22] Narrow banks would also have an advantage in offering their depositors complete safety in contrast to recent legislative provisions which seek to put uninsured bank depositors at greater risk.

A final competitive consideration is that narrow banking may be more consistent with recent and future trends in the financial system. Electronic banking, automated payments, and declining transaction costs are putting added emphasis on safety and liquidity in the payments system. With their entire focus on transaction accounts and services, narrow banks might represent the best structure for developing a more efficient and stable payments system. The ongoing shift toward direct investment and nonbank savings products can also be expected to leave banks with a declining role as a financial intermediary, and the narrow bank affiliate format would likely provide more flexibility in adjusting to this environment.

What would happen to financial and credit market stability? Under the present framework, banks are viewed as a source of liquidity during financial crises and as a support to credit markets. This liquidity and support comes from the protection banks receive under the federal safety net, their access to the

[22]For a comparison of the net earnings on bank lending and investment activities, see Bruce W. Morgan, "Financial Services after the Decline of Deposit Banking," Banking Policy Report 10 (October 21, 1991): 1, 12-15. For additional information on the net returns to various banking activities, see Functional Cost Analysis, National Average Report - Commercial Banks, Federal Reserve System.

discount window, and the various commitments, guarantees, and contingent obligations of banks that back up the financial system.

With a narrow banking system, there has been some concern that key elements of this support would be lost to the detriment of financial stability. A related concern has been that narrow bank lending affiliates would not be immune from the types of problems that have been inherent in the traditional banking system, including depositor panics, liquidity squeezes, and difficulties in resolving failing institutions. According to those holding such concerns, much of the existing regulatory framework would just have to be reestablished for narrow banks and their affiliates, thus eliminating any potential benefits.

A number of sound arguments suggest that these concerns either are not likely to be realized or can be prevented with a much simpler safety net. First, narrow banking would provide the means to create an extremely stable payments system, thus correcting an important historical source of instability in the U.S. economy and in the credit system.

Another important piece of evidence is that the vast majority of credit transactions already take place outside of the banking industry, leaving credit stability largely dependent upon these other, less regulated markets. These same markets, moreover, have shown a high level of stability in past years while dealing with economic fluctuations and credit problems.[23] In a number of ways,

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[23]An important factor in this record is that credit markets have grown to where they now serve a wide variety of borrowers and investors, thus providing many opportunities for diversification,

this record stands in contrast to the problems that have been encountered in thrifts and banks, which have been under close regulation and the protection of the federal safety net.

Narrow bank lending affiliates would be subject to the same type of forces that have helped stabilize the private credit markets. For instance, lending affiliates of narrow banks would typically need strong capital backing and a longer term debt structure in order to attract and retain uninsured investors. These changes could conceivably lead to a sounder financial structure for lenders, to more stable and conservative lending policies, and to investors more capable of judging risk exposure and providing a disciplinary influence. Public disclosures would further serve to reinforce these policies.

Market forces, in fact, would give narrow bank credit affiliates and their stockholders and creditors strong incentives to curtail funding of speculative activities. Investors that are fully at risk would be far less likely to fund questionable loans than in the case of bank depositors, who have insurance protection and a much shorter term focus. These same incentives would help credit affiliates resolve in a more orderly and efficient manner any problems that might arise. One indication of how credit problems might be resolved can be found in recent investor workouts associated with corporate takeovers and "junk" bond financing. These workouts, in nearly every case, have proceeded without the same crisis atmosphere and inefficiency associated with the S & L

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additional liquidity, and products for specialized needs.

collapse and subsequent RTC operations. Although painful for some investors, these private resolutions have engendered their own corrective forces, free of governmental intervention and taxpayer exposure.

Since credit markets would continue to fluctuate in response to the economy and a variety of other factors, a final source of credit stability could continue to be the Federal Reserve discount window. Under narrow banking, this "lender of last resort" function could no longer be provided through traditional banking channels. However, the Federal Reserve could provide liquidity directly to credit affiliates and other uninsured lenders in the event of a systemic credit collapse. Although such temporary assistance might pose a variety of administrative issues, it would keep the discount window consistent with its original purpose of maintaining a stable economy.[24]

How would monetary policy be affected by narrow banking? Narrow banking raises many monetary policy questions with regard to open market operations, reserve requirements, and discount window credit. In addition, it could influence the structure and relationship of the monetary aggregates, the behavior of the short-term securities market, and the manner in which money is created and expanded.

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[24]On an operational level, discount window lending might also be needed if narrow banks maintained required reserves or clearing balances with the Federal Reserve and had to replenish these accounts after large, end-of-day clearing activities.

These monetary policy questions involve a variety of technical issues that have yet to be considered in a thorough fashion. Some questions, such as the need for reserve requirements and the relationship of the monetary aggregates, involve a number of the same issues and problems posed by the current banking system. Other aspects of narrow banking, including its effect on the securities market and on money and credit expansion, may entail several new considerations. While narrow banking does not appear to have any obvious drawbacks with regard to monetary policy, many of its policy effects will need to be analyzed more carefully before implementation.

What international banking issues would arise with narrow banking? If the United States were to adopt narrow banking on its own, a number of issues could arise concerning foreign entry into the United States and expansion abroad by domestic organizations. Foreign banks entering this country would need to establish narrow banks and carry out other activities here through uninsured affiliates. This would thus give them the same powers as U.S. banks and would allow them to continue or even expand their existing operations through the use of affiliates. For U.S. banking organizations with narrow banks, foreign activities would have to be conducted through foreign-chartered banks or affiliates isolated from the narrow bank.

Since much of U.S. banking expansion abroad is through branches, the United States may need to create special international banking charters, much like that of Edge

Corporations, and allow these "banks" to establish branches abroad. Such banks would be separate from narrow banks, thus allowing U.S. organizations to branch and conduct international operations without compromising the safety of narrow bank depositors. While foreign banking activities would be subject to the regulatory restrictions of the foreign country, U.S. authorities might also have a limited oversight role in order to protect the reputation of the U.S. banking system.

Summary

Recent banking problems have prompted a variety of proposals for reforming deposit insurance and the banking system. Nearly all of these proposals, however, suffer from a common flaw -- they would fail to create a banking system that is both stable and free to respond to market forces and financial developments.

Narrow banking offers a possible means for accomplishing these objectives. Narrow banking would create a stable payments system by backing transaction deposits with only those assets that are truly appropriate for this task -- marketable securities with virtually no interest rate or credit risk. As a result, narrow banks would essentially be "fail-safe" institutions and could operate without the inherent weaknesses of the current system. They would not pose a risk to depositors, taxpayers, or federal authorities and, unlike commercial banks, would not require extensive governmental support and intervention. These features of narrow banks would allow market forces to guide everyday banking decisions and the activities of any affiliated firms, thus returning the market to its proper role in allocating financial services.

In many respects, narrow banking mirrors another banking reform that took place in the 1860s -- the use of U.S. Government securities to back national bank notes. This earlier reform and the following change to Federal Reserve Notes collateralized largely by U.S. obligations have produced a stable currency and ended any public concern about its acceptability. This success provides strong evidence that narrow banking is a workable system that could stabilize our deposit system and its transactions function.

Narrow banking, much like this earlier reform, appears to involve a dramatic change in the banking system. However, recent financial trends are making narrow banking a less radical change than commonly believed. In addition, most of the other approaches to recent banking problems entail a movement toward greater regulatory and governmental control of our financial system and its credit allocation functions -- a response that is unlikely to make banking a vibrant, competitive industry. All of these factors thus suggest that narrow banking deserves careful consideration in efforts to reform the financial system.

APPENDIX

Possible Bank Industry Balance Sheet Changes in Shifting to a Narrow Banking System

To establish narrow banks, banking organizations in the United States would have to divide their banks into several separate entities. A narrow bank would take over the transaction accounts and much of the liquid assets and securities from its traditional bank predecessor. A credit affiliate would assume responsibility for the bank's loan portfolio and would obtain funding on an uninsured basis from market sources. In addition, an international banking entity might be needed to continue the activities that major U.S. banks now conduct through foreign branches.

A number of changes in these activities could be expected once banking organizations converted to narrow banking. For instance, some shifts in transactions accounts might occur as narrow banks establish rates on deposits and compete with each other to provide the most efficient services. Also, as they begin to face greater market discipline, credit affiliates may pursue a different direction in choosing to hold, sell, or securitize loans. In a similar fashion, organizations may alter their lending functions if they receive authority to provide a broader range of debt and equity financing. For simplicity, however, the following analysis will look at the banking industry as it is structured today and how bank assets, liabilities, and capital might be apportioned among narrow banks, credit affiliates, and international banks.

This analysis looks at the entire banking industry and the aggregate changes that would be involved in shifting to narrow banking. For individual banks, the ease in making this transition will depend on their current balance sheet structure and overall condition relative to that of the typical bank. While these individual bank considerations would be important in implementing narrow banking, no attempt will be made here to examine the effects on certain banks or particular groups of banks.

In the following analysis, all domestic transaction accounts, cash assets, and reserves held by U.S. banks are assumed to be passed on to the narrow banks, along with a sufficient level of securities to back deposits and enough capital to create a two percent capital-to-asset ratio.[25] The credit affiliates of narrow banks would receive any remaining, domestically held securities and all of the domestic loans and other assets now held by banks.[26] These credit affiliates would then attempt to replace the deposits and other liabilities supporting bank loans with various sources of market funding. International banking affiliates would hold all of the foreign assets and foreign deposits. Credit affiliates and international banking entities are assumed to divide the remaining

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[25]This capital level is based primarily on the need to finance the facilities and fixed assets that narrow banks might require in their operations. From a supervisory standpoint, narrow banks would only need to maintain enough capital to discourage fraudulent activities and to cover any minimal levels of risk in their asset portfolios.

[26]Credit affiliates would also need to hold some cash assets in order to conduct their operations. However, for most credit affiliates, these assets would only need to be of a marginal amount based on the typical holdings of most nonbank lenders today.

bank equity base evenly in proportion to their adjusted asset holdings.

Table 1 reflects the banking assets, liabilities, and capital held by all U.S. banks at mid-year 1992. The hypothetical balance sheets in Table 2 reflect what these organizations would look like as a combined group if all the above steps toward narrow banking were to take place. Because these steps reflect simplified assumptions, Table 2 should be viewed primarily as a general guide to the types of adjustments that might occur in a transition to narrow banking.

The balance sheets indicate that three factors would be important in implementing narrow banking. First, if banks could retain much of their liquid assets and securities, they would already have much of the backing they would need for transaction accounts under a narrow banking system. A shift toward shorter term securities would likely be necessary, but banks would not need a major expansion in their securities portfolio.[27]

Second, the credit affiliates would have to obtain a vast amount of uninsured funding from market sources. Some of this funding could come directly from the customers that previously held CDs and other savings instruments at commercial banks. The funding could also come indirectly from these depositors as they move their money into commercial paper, mutual funds, and other alternative

[27]The level of securities held by banks has increased over the last few years in response to declines in loan demand and changes in regulatory policy. Securities holdings in prior years, though, would have also provided much or all of the deposit backing needed for narrow banks.

instruments. Credit affiliates would also have the opportunity to develop new types of debt and equity offerings. Overall, a key factor in these financing efforts would be the ability of credit affiliates to meet the same market standards as other private lenders.

Finally, to meet market standards and secure funding, credit affiliates would have to maintain an equity base similar to other lenders. The figures in Table 2 indicate that the existing capital in banks would give credit affiliates an equity capital-to-asset ratio of nearly 8.7 percent. This assumes that current bank stockholders would be content to invest in credit affiliates in much the same manner as they were with commercial banks. If these affiliates concentrated on lending and did not retain many of the other assets now held by banks, this equity ratio could rise to as much as 10 percent. In comparison, domestic finance companies and short-term business credit companies have maintained average capital ratios between 8.5 and 13.7 percent, depending on the definition of capital, the time period, the types of companies included, and the degree of perceived parent company support.[28] At year-end 1990, for instance, the ten largest finance companies

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[28]For more information on the capital ratios of other lenders, see Federal Reserve Bulletin 78 (November 1992), Table 1.51, p. A34; "Recent Trends in Commercial Bank Profitability: A Staff Study," Federal Reserve Bank of New York (1986), p. 278; "Modernizing the Financial System," Department of the Treasury, February 1991, pp. 12-13; American Banker, December 11, 1991, p.8; and "Finance Companies, Bank Competition, and Niche Markets," Quarterly Review (Federal Reserve Bank of New York), Summer 1992, p.36.

not affiliated with banks had equity capital equal to 10.7 percent of assets.[29]

These capital ratios imply that a simple division of present banking industry portfolios between narrow banks and their credit affiliates could leave the affiliates with capital ratios several percentage points below that of comparable lenders. To narrow this gap, credit affiliates would need to raise additional capital, reduce their holdings of loans and other assets, or achieve an asset quality higher than other lenders.

In summary, present bank balance sheet figures do not indicate any insurmountable difficulties in moving toward a narrow banking system. The banking industry would appear to be capable of finding an asset base to support narrow bank deposits. Some additional capital and new funding sources could be needed to finance credit affiliates. However, similar changes are likely to occur with or without narrow banking as banks face tighter capital requirements and as investors and savers continue to make greater use of a variety of market investment instruments. The narrow banking format could, in fact, give banking organizations more flexibility in making these adjustments.

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[29]The ten largest finance companies owned by banking organizations had capital ratios similar to those of the finance companies not affiliated with banks. Thus, banking organizations appear to have had some success in meeting market standards in their nonbank operations.

Table 1

Assets, Liabilities, and Capital in all U.S. Commercial Banks
Mid-year 1992
(All figures are in billions of dollars)

U.S. Commercial Banks

Cash, reserves, and due from balances		Domestic transaction accounts	710
Domestic	191		
Foreign	84	Other domestic deposits	1626
Securities		Foreign deposits	304
Domestic	697		
Foreign	30	Other liabilities	531
		Total liabilities	3171
Loans			
Domestic	1759		
Foreign	208		
Other assets	449		
Total assets	3418	Equity capital	247

Table 2

U.S. Commercial Banks
Under a Narrow Banking System
Mid-year 1992
(In billions of dollars)

Narrow Banks

Cash, reserves, and due from balances	191	Transaction accounts	710
Securities	519		
Facilities and fixed assets	14	Equity capital	14
Total assets	724		

Domestic Credit Affiliates

Loans	1759	Liabilities (Commercial paper, uninsured deposits, long-term debt, etc.)	2057
Securities	178		
Other Assets	315	Equity capital	195
Total assets	2252		

International Banks

Foreign holdings of cash and due from balances	84	Foreign deposits	304
		Other liabilities	100
		Total liabilities	404
Foreign securities	30		
Foreign loans	208		
Other assets	120	Equity capital	38
Total assets	442		