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## **How to Avoid the Next Taxpayer Bailout of the Financial System: The Narrow Banking Proposal**

**Ronnie J. Phillips and Alessandro Roselli**

**Abstract:** As recovery from the present economic crisis begins, policymakers must address what reforms will be made in financial system in order to prevent the reoccurrence of a similar crisis in the future. What will Congress do in response? In terms of long-term financial reform, what is to be expected from Congress is passage of legislation that increases oversight and regulation by the federal financial regulatory agencies. The purpose of this policy brief is to explain and evaluate one proposal for reform of the financial system that would help mitigate the policy conundrum that often results from conflicting short-run and long-run policies. This proposal, known as “narrow banking,” would separately regulate and supervise the role of banks in providing a safe and stable means of payment from the system of credit creation by financial institutions. The heart of the proposal is to make checkable deposits as safe a means of payment as currency presently issued by the Federal Reserve System, but without the need for the elaborate supervisory and regulatory structure required when federal deposit insurance and the discount window are part of the financial safety net.

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## **How to Avoid the Next Taxpayer Bailout of the Financial System: The Narrow Banking Proposal**

**Ronnie J. Phillips and Alessandro Roselli**

As recovery from the present economic crisis begins, policymakers must address what reforms will be made in the financial system in order to prevent the reoccurrence of a similar crisis in the future. In formulating these reforms, policymakers will also have to address the heightened moral hazard and broadened too big to fail doctrine associated with the bailouts of financial firms. These policies to deal with the impact of the crisis have resulted in large federal government deficits, a monetary base expansion with the potential for future inflation, and the depletion of the Federal Deposit Insurance Corporation's (FDIC) Deposit Insurance Fund (DIF). What will Congress do in response? In terms of long-term financial reform, what is to be expected from Congress is passage of legislation that increases oversight and regulation by the federal financial regulatory agencies. Will the Federal Reserve System (Fed), or some other new or existing federal agency, be given additional regulatory and supervisory power to manage system risk? Will these reforms invite regulatory avoidance behavior by financial institutions or will financial innovation be stifled? These are the important questions that must be answered by any proposal to reform our financial system.

The purpose of this policy brief is to explain and evaluate one proposal for reform of the

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financial system that would help mitigate the policy conundrum that often results from conflicting short-run and long-run policies. This proposal, known as narrow banking, would regulate and supervise the role of banks in providing a safe and stable means of payment separately from the system of credit creation by financial institutions. The heart of the proposal is to make checkable deposits as safe a means of payment as currency presently issued by the Fed, but without the need for the elaborate supervisory and regulatory structure required when federal deposit insurance and the discount window are part of the financial safety net. The proposal is intended to provide a safe payments system and reduce the economic need, and therefore the political pressure, to bail out large financial holding companies.

***What caused the present crisis?***

Before presenting the proposal, a brief review of how we got into the present crisis will highlight the kinds of reforms that would reduce the likelihood of a similar crisis in the future. The present crisis began with the surge in delinquency in subprime mortgages that began in early 2007. This led to losses at large financial institutions and ultimately the failure of Lehman Brothers. As the problems spread to the mortgage market in general, and more institutions found themselves with bad loans, Congress responded in Fall 2008

with a \$700 billion capital purchase program to aid the financial institutions. After President Obama took office, Congress passed a nearly \$800 billion economic stimulus program. The Fed, blamed by some for the low interest rate policies during the period 2001-2004, responded to the financial difficulties by expanding the size and type of securities that are eligible for purchase by the central bank. As bank failures rose, the FDIC saw its DIF reduced from \$53 billion in January 2008 to \$6.5 billion in mid-2009. The FDIC also insured additional non-interest bearing transactions accounts, and created a Temporary Liquidity Guarantee Program (TLGP).

A low interest rate policy by the Fed is not the sole culprit in the financial crisis. Lax banking regulation and accounting standards and China's growing balance of payments surplus are also often mentioned as contributing to the global nature of the financial crisis. Banking has undergone an extraordinary evolution in the past decade as banks became aggressive in wholesale markets and securities trading. Various factors have affected the on-balance sheet and the off-balance sheet activities of financial institutions. On the assets side, banks shifted from an originate and hold model — where the bank generates loans and holds them to maturity — to an originate and distribute, or credit distribution model — where the bank generates loans but securitizes and transfers risk to

other entities. These other entities include other financial intermediaries and institutional investors and this has a deep influence on the structure and growth of the credit market.

The financial system became characterized by both a blurring between credit (loans) and securities and the less perceptible differences between bank and non-bank financial intermediaries. Banks remain crucial as deposit-takers with access to the central bank's liquidity, but their involvement in the process of credit creation, as a transaction-oriented activity, has notably changed. More and more, the traditional distinction between commercial banking and investment banking has given way to another distinction, between retail banks and banks as corporate finance providers, where any activity of business financing (loans, securities, derivatives) is carried out in a kind of universal banking scheme that may differ from country to country but is essentially the same.

The loan participation market, where a loan originated by a bank could be sold, with or without recourse, to other banks, has evolved into a new connection between retail and wholesale banking through the pooling of loans into securities, especially mortgage and consumer loans. Asset-backed securitization (ABS) involves the pooling of similar assets

into a special purpose vehicle (SPV). These are legal, bankruptcy-remote entities, created for bookkeeping purposes to exploit regulatory capital and tax advantages. They have permitted an enormous expansion of private debt. Their use by commercial banks, or other mortgage lenders, represents an important link between retail banking and financial markets. The extensive use of derivatives, based on these securities, has added complexity and risk.

On the liabilities side, deposits, which in previous decades were the almost exclusive source of funds, have had a diminishing role in bank funding. Banks, therefore, appear to be exposed to unexpected changes in conditions in the volatile wholesale market, increasing the possibility of bank runs by depositors. International connections on the wholesale market only enhance the fragility of this business model. The gap between bank lending funded by deposits and total lending by banks has increasingly been funded in the wholesale market.

Investment banks have further expanded their asset share in the financial industry due to a little noticed decision of the U.S. Securities and Exchange Commission (SEC)

(Appendix E to Rule 15c31 in 2004) that deregulated investment banks by permitting a substantially higher leverage through the use of private risk management techniques. Just two of the five biggest broker/dealers who benefitted from the SEC decision survived by restructuring themselves as financial holding companies and being funded by government money.

In the U.S., the financial assets of the security broker/dealers increased in the period 2000-2007 by 153 percent, or as a percentage of the commercial banks assets, by more than 30 percent. The share of credit market instruments in the portfolio of the broker/dealers grew in the same period from 18 to 26 percent. The ratio of total assets to equity (leverage) increased greatly at the independent investment banks (i.e., those not belonging to financial holding groups), thanks to the SEC amendment concerning their capital gearing, as mentioned above. The sudden decline of the ratio of broker/dealers assets to banks' assets in the most recent period is due to the precipitous deleverage of the broker/dealers. Mortgages climbed above 30 percent of commercial banks' total assets. Deposits, which in previous decades were the most important source of funding for banks, declined to 40-50 percent of their total liabilities. (Source: Federal Reserve, Flow of Funds Accounts of the United States, Tables F.109, F. 110, F. 129, L. 109, L.110, L.

129; June 11, 2009).

In the current turmoil, what seems to be emerging is that the system cannot avoid bank runs without a substantial expansion of the government guarantee and a huge potential cost to the taxpayer, and that even non-bank institutions can be too big, or too interconnected, to fail. The wholesale market in a global financial system has assumed a paramount importance for maintaining stability.

Perhaps the most striking development occurred in the assets held by issuers of ABS or SPVs, as mentioned above. These assets, according to the originate and distribute model, are transferred from the balance sheets of banks to the balance sheets of SPVs (mostly, mortgage pool securities and other types of loans, like student and business loans, and consumer credit). The obligations issued by the SPVs are claims against the above mentioned assets and are serviced by the bank that originates the loans for a fee. These SPVs now equal nearly 40 percent of commercial banks' on-balance sheet assets. The peak year of SPVs activity was 2007. In that year, just 29.7 percent of SPV assets and commercial banks' assets were backed by demand and time deposits, while the rest were funded by wholesale, often volatile, funding. It's a very different picture even from that

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of the '90s, when ABSs were a very minor segment of the market and remained so until the early 2000s.

What will be the likely long-run policy response from Congress to these problems? There is little doubt that Congress will pass legislation to more closely regulate the activities of financial intermediaries and further empower the federal regulatory agencies to take actions when they believe financial stability is threatened. The Fed will also come under more scrutiny in its conduct of monetary policy and may face increased difficulty in reducing the high level of bank reserves that have resulted from Fed actions during the crisis. Congress will also have to evaluate the success of the system of federal deposit insurance. The FDIC will undoubtedly need to raise insurance premiums and alter the guidelines for the minimum size of the deposit insurance fund. If history is a guide, we will increase the regulatory burden on financial institutions in an attempt to avoid the problems that led to this crisis. There will be some marginal changes in policy, and some substantial reforms as well. The next section will examine one recommendation for policy change that would address both the long-term reforms and improve the policy response whenever a crisis erupts.

*An alternative way to deal with the problems: Narrow banking*

Do we need special financial institutions, such as banks, to serve both a depository and lending function? If so, then there will continue to be extensive government regulation and supervision to mitigate the effects on the economy of their illiquidity or insolvency, as well as economic and political pressure to bailout those institutions. However, if other kinds of financial institutions could safely separate both depository and lending services, why would we need the extensive regulatory structure for banks with the large resource costs to the economy? The policy question is whether there is a way to assure a safe and stable payment system without the danger of another large taxpayer bailout. At the same time, we do not want to lose the benefits of innovation in the financial system in terms of better allocation of resources, lower cost of credit, widened credit availability, and higher economic growth. The best policy option would be to strike a balance between these two goals — safety and innovation — in order to save both of them (Spong 1996).

During the savings and loan debacle in the 1980s, Robert Litan of the Brookings Institution put forward a proposal which he labeled narrow banking as a solution to the moral hazard problem of banking. A kindred proposal was put forward in the 1930s but ultimately lost out to the New Deal proposals for deposit insurance and reform of the Fed

(Phillips 1995). Litan proposed to create monetary service companies — institutions that would serve strictly a payments function and would hold only safe assets such as cash, government securities, and high-grade commercial paper. Previously, Nobel Prize winning economists Milton Friedman, James Tobin and Maurice Allais all supported the idea of narrow banking. Tobin proposed the creation of deposited currency, which would combine the convenience of a checking account with the safety of currency. Also during the 1980s, the late L. William Seidman, then head of the FDIC, proposed what he termed “two-window banking.” A two-window banking firm would allow savers to choose between “insured” and “uninsured” windows in which to deposit their funds.

The safe banking proposal, or narrow banking, would require that the money supply,  $M-1 = \text{Currency} + \text{Checkable Deposits}$ , be backed by safe assets, most likely government securities. This is the same principle used in the National Banking Act in 1863 and, previously, in the Peel Act regarding the Bank of England in 1844. Until the present crisis, the Federal Reserve Banks were effectively narrow banks because their liabilities (Federal Reserve Notes or currency and commercial bank reserves) were backed almost 100 percent by holdings of federal government debt. Under the narrow banking proposal, private sector financing would be funded either by a separate window of the bank, where

non-insured deposits would be collected, or through separate affiliates of the same holding company that would control the narrow bank, that may be called finance houses. It would also be possible for such safe accounts to be held directly at the Federal Reserve Banks, perhaps with commercial banks as agents just as there once existed a postal savings system in the U.S. (Jessup and Bochnak 1992). Narrow banks could come about either through mandatory legislation or voluntary change. Deposit insurance for these institutions could be maintained, but since it is redundant (short-term government securities are safe assets), it would be mainly for fraud purposes, and therefore at a minimal cost and risk. The separate window of the bank or the separate section of the holding company (the finance house) could be allowed to engage in any activities, as long as there is a clear distinction between insured deposits and uninsured deposits or other financial instruments. The result would be a reduction in the regulatory burden for narrow banks while maintaining a safe and stable deposit function.

The narrow bank can keep safe the core deposits of the banking system. Because bank deposits are commonly used as substitutes for currency, and governments have sought to protect currency, there is a rationale for protecting bank deposits in a similar manner to the way currency is protected, namely, backing by safe assets. Deposit insurance, or an

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implicit government guarantee of all deposits for large banks (too big to fail policy), is an *ex post* remedy. It is based on the assumption that systemic instability consequent to a lack of government intervention in a crisis would impose a cost higher than the cost involved in the public bailing out of the institution. The idea of narrow banking would radically reverse this point of view: bank deposits must have *ex ante* the same level of government protection as currency. The basic money supply is currency issued by the Fed and checkable deposits. Not to assure the same level of protection given currency to money deposited in an insured account would potentially encourage bank runs, loss of trust in the currency, capital flights in search of safe havens, and a destabilization not only of the banking system, but of the monetary system as well. Any form of deposit insurance aims at partially preventing these risks at a cost to the banking industry and, as we are seeing now, ultimately for the taxpayer. Narrow banking aims at the full prevention of the same risks at almost no direct cost, thus shrinking the scope of the public safety net.

There is also a social component in this approach that was stressed by James Tobin through the above-mentioned idea of a deposited currency. Stressing the similarity of currency and deposits, as components of the money stock, he said:

Currency and coins are the basic money and legal tender of the United states. They are generally acceptable in transactions without question. But they have obvious inconveniences – insecurity against loss or theft, indivisibility of denomination – that limit their use except in small transactions (or in illegal or tax-evading transactions.) These disadvantages, along with zero nominal interest, lead to the substitution of bank deposits for currency... assuming statutory limits on insurance of other deposits are made effective, depositors who wish safety and liquidity on larger sums would be protected. (Tobin, 1987, pp. 172-173).

This kind of narrow bank, limited to just safe assets, and funded exclusively by checkable, demand deposits, would be the core of the payments system. The remuneration of these deposits would be quite low or nonexistent, but the depositors, both less affluent and risk-adverse people, would be willing to accept it in exchange for total safety. The comparative advantage over the Treasury bills in which the bank is invested would be represented by the right to transfer funds by checks and by a higher liquidity.

In summary, the implications of narrow banking are as follows:

(1) A narrow bank is more like a public utility and would be akin to the postal savings system that operated in the U.S. before the Great Depression and continues to exist in some countries today such as Japan;

(2) The impact of monetary policy on credit to the private sector would be altered and likely reduced, though this depends upon whether the narrow banks invest in safe short-term government securities or are required to hold 100 per cent in central bank liabilities. If the banks hold reserves in central bank liabilities, then the M-1 money multiplier would be one. The monetary base and the basic money supply would be the same. This is the meaning of putting checkable deposits on the same level as currency. Under this version of the narrow banking plan, the central bank would have the same degree of control over the basic money supply that they presently have over the monetary base. However, if banks are able to hold government securities, then obviously credit could be affected by monetization of the money supply. The Fed's control over the basic money supply would not be much different than the present institutional arrangement whereby bank deposits are backed by central bank liabilities, government securities and private sector loans, except that private loans would no longer make up any of that backing. This is the situation today since changes in monetary policy through

open market operations impact financial institutions whose liabilities are backed by government debt (Phillips 1995);

(3) Capital requirements for a narrow bank will be reduced assuming government securities backing the narrow bank have near zero maturity;

(4) There will be less of a need for federal deposit insurance because the solvency of the bank would rarely be challenged. Within the narrow bank, given the safety of the deposits, the current discrimination in favor of the depositors at banks too big to fail and against depositors who wish safety and liquidity on large sums, would be phased out (Burnham 1991 and Tobin 1987);

(5) The need for the lender of last resort facility of the Fed comes into question. In the most extreme view, this safety net would disappear since it is not needed in the narrow bank scheme because of the safeness and liquidity of the narrow bank's assets. Since the finance houses would not be supplying a means of payment, the Fed need not be a lender of last resort to the finance houses because this would be inconsistent with a policy of allowing market discipline for such institutions. If narrow banks are permitted a limited exposure to the non-government assets or longer-term government assets, then the need for a public



safety net resurfaces to a certain extent, especially if it is believed that there is a systemic risk problem with the narrow banks. The present problem with banks serving a dual deposit and lending function resurfaces in a somewhat different and perhaps less virulent form. However, there may be those who believe that because the finance houses may generate systemic risk, it would be necessary to provide access to the discount window of the central bank for those institutions (see (7) below);

(6) Regulation of the narrow bank would be fairly simple, given its streamlined structure, though supervision of its compliance with its very strict limits of activity would be more delicate, because of the strong incentives to gamble in order to get higher returns, and because of the firewalls to be erected between the narrow bank and the finance house authorized to engage in a much broader range of activities, if both are affiliates of the same holding company (Padou 2004). More supervision, less regulation would characterize the narrow bank, but the overall regulatory burden to institutions would be reduced (Phillips 1995);

(7) The regulation of the finance house, however, would be a very different matter. Friedman and the monetarist school argued in favor of a totally unregulated system. Pierce (1991) and Pollock (1993) supported, without explicit

reference, this view, however admitting that finance houses should have a limited access, under stressful circumstances, to the Fed discount window. Even today, a skeptical view of the regulator's ability to check the bankers' moral hazard through "hammering" the financial system by "intrusive" regulation and supervision, proposes the narrow bank as a way to eliminate moral hazard, while the finance house would be subject to the market discipline imposed by its shareholders, without any need for intrusive supervision (James 2007).

### ***Objections to the narrow banking proposal***

Numerous writers have put forth objections to the narrow banking proposal. Critics argue that the credit to the economy would shrink and be therefore more costly, and that rather than eliminating systemic risks, embedded in the scheme is a potential systemic instability. In simple terms the problem arises because the ability of narrow banks to create money would be constrained. Though as noted, this depends upon whether bank deposits are backed by government debt or central bank liabilities. However, the finance houses, in order to extend an equal amount of credit as a conventional bank, would need to attract more customers' funds by a higher remuneration than that paid by a conventional bank on insured deposits (Bossone 2001). Finance houses could create

financial assets that are close substitutes for money, but the important point is that they would not have deposit insurance. Private lending rates may go up as a result. At the same time, prices of Treasuries — as eligible assets of the narrow bank — would swell, and their yield would go down. However, the finance houses would not be subject to regulatory costs that either raise the cost of funds or lower the rate of return on the assets of conventional banks (Litan 1987, pp. 180-1).

In an experimental setting, Bossone has shown that the restriction of credit would not be dynamically offset through alternative supplies of funds and that, as narrow banking increases its dimension, no alternative forms of credit on the financial markets emerge to counterbalance the reduction of bank credit (Bossone 2001). A more elaborate view has been expressed, based on the observation that depositors with uncertain liquidity needs, who are totally risk-averse, in the current system have to place their money with banks that are exposed to credit risk, investment risk, and bank runs: they are unable to find riskless, even if no-return, banks. According to this view, a substantial welfare loss occurs when banks bundle together deposit accounts with risk-taking. In the context of a well-developed securities market, if a narrow bank policy is adopted, the severe lending restrictions associated with total safety will expand consumers' saving and investment

opportunities (Shy 2008). A risk-free, zero-return opportunity is an additional choice. However, other theoretical models suggest that imposing narrow banking is an inferior solution to allowing the mixing of payments and lending (Cao and Illing 2009).

By leaving the safe harbor of the deposit-taking institution, the consumer should be well aware of the relative riskiness of other available retail financial products. But we know how this awareness is difficult to achieve in the absence of a full financial education, therefore a simple caveat emptor is unfair and impractical. For example, in the increasing number of countries where the state pension is in retrenchment, people have to rely on private — occupational or personal — schemes. If small savers have to invest their savings in view of, or during, their retirement in vehicles, trusts, funds other than bank deposits, the political pressure to a government protection actually increases.

Regarding the availability of permissible assets in relation to the size of deposits at the narrow bank, and the sudden swings between safe deposits and other financial instruments in case of financial distress, there is the question of the overall stability of the financial system with narrow banks and finance houses. We would probably have an

optimal balance if the supply of permissible assets matched the demand for them by the narrow bank, fuelled by its deposits, and if the demand for credit by the private sector were matched by the finance house in a variety of technical forms. Most probably, neither condition would be met.

Wallace (1996) noted that, in the U.S., “the magnitude of short-term safe assets outside the banking system exceeds the magnitude of bank demand deposits,” but, for instance, in Italy, Treasury bills (if they are considered as the typical, or exclusive, permissible asset) have been in the last three years well below 20 percent of the demand deposits at Italian banks. Therefore, the classes of permissible activities should be necessarily extended. The existence, size and composition by maturity of the government debt are important; at the same time, it would be inappropriate to adjust debt management policies to narrow banking objectives (Bossone 2001).

If we counterbalance safe deposits at the narrow bank to less protected financial instruments at the finance house, letting the finance house fail would raise concerns when its situation deteriorates, possibly causing a flight to safety into the narrow bank. The

deposit/other credit instruments ratio would increase abruptly (a concern strongly signaled in the past by Friedman). Another key goal of the narrow bank concept — to shrink the scope of the taxpayer safety net — would be defeated, if the government were obliged, because of systemic preoccupations, to open the discount window to stabilize the outflow from the finance house (Ely 1991).

More importantly, we are accustomed to associate systemic risk with the typical commercial bank structure: not by chance, the U.S. federal safety net, or similar institutional arrangements in other countries, was restricted to that structure, in the belief that other, riskier financial activities could well deal with their problems, while the government intervention was mostly confined to the conduct-of-business/transparency supervision, enacted by a separate authority (the SEC, in the U.S.). Recent events are evidence that, with the blurring of boundaries between institutions, the widespread financial innovation, the enormous size taken by some investment companies, and the new players of the shadow banking system, a systemic problem could come from any segment of the financial system, insurance firms included, particularly if involved in derivatives transactions as credit default swaps. The recent extension, in the U.S., of the lender of last resort support to investment banks and to insurance companies makes it

hard to believe that a kind of prudentially unregulated financial activity can be unleashed outside the territory of the narrow bank. The problem of reconciling government intervention with new forms of moral hazard would resurface in other areas of the financial industry.

The size of a flight to quality in times of financial turmoil, one of the most mentioned arguments against narrow banking, that would generate increases in the ratio of checkable bank deposits/other financial products, should be empirically tested in reference to previous phases of financial turbulence. The supply of checkable bank deposits is relatively inelastic so the adjustment outside the narrow bank would be larger.

The opposite situation might also occur: a flow from deposits at the narrow bank, to riskier assets, in case of a benign financial environment. In advanced countries, deposits have lost their pre-eminence as a percentage of financial assets. In general, the likelihood that the narrow bank would retain the same volume of deposits as conventional banks currently have is small, because bank customers would be willing to exchange some portion of their deposits for higher yielding securities issued by non-depository

institutions (Litan 1987). In a narrow bank system, depositors should have to reassess their views about a trade-off of yield for safety. It is possible that the above mentioned ratio proves to be stickier, also in times of financial stress, than one could think in terms of purely rational behavior.

### *A tripartite system*

If we rule out the idea of a totally unregulated finance house, a question must be raised about how to regulate activities that are fairly different. In particular, what we might call the commercial bank or traditional bank sits uncomfortably both in the narrow bank model, and in a universal bank scheme. Drawing on Tobin's proposals, a kind of tripartite banking structure can be envisaged, possibly within the same financial group, where the narrow bank could coexist with a commercial bank, appropriately redefined, and an investment bank. Though allowing this tripartite system is not the best solution, it may be what is political acceptable. The difficulty is finding a way to gradually move away from a financial system in which too big to fail results in government action to bailout any large financial institution.



The commercial bank would be engaged in a relatively wide range of activities, mostly short-term, but longer-term assets might include variable rate bonds and mortgages. It would be prevented, in principle, from investing in equities or taking stakes in non-financial companies. Derivative products would be used for bona fide hedging transactions only (Tobin 1987, pp. 174-5; Wilmoth 2002). It could not invest in complex structured products. This commercial bank would be subject to strict regulations on capital adequacy, would be deposit insured within certain limits, and would have access to the discount window.

Beyond it, the third leg of the banking structure would be the investment bank that, for the reasons mentioned above, could not be unregulated, and would be subject to a layer of supervision that would cover not only transparency and conduct of business, but also stability issues. These issues would have to be faced also in reference to the insurance component of the group.

Any discussion about the appropriate architecture of regulation goes well beyond the scope of this policy brief, but it can be said that we would have three concentric circles of

regulation and supervision: regulation would be tight, but also relatively simple, in the inner circle; more prudentially articulated in the medium circle of the commercial bank; while the regulation of the outer circle – the securities and insurance business – would have an ample focus on conduct-of-business but should not escape the prudential side. The lender of last resort would be, in principle, not necessary in the inner circle; would be a basic feature of the medium circle; and probably would be unavoidable in the outer circle. For a recent discussion on a comparative basis of the current regulatory architecture in nine advanced countries, see Gola C., and Roselli A., 2009, sect. 2 of chapter 8.

### ***Conclusion***

Reform of the financial system is once again on the agenda for Congress and the President. Bankers are rightly concerned that a return to New Deal-style regulation, while solving some immediate problems, may adversely affect banking operations in the long run. At the same time, the public is concerned about the safety and security of their money and their savings. Since the 1930s, the nation has relied on FDIC-insured banks to provide a safe and convenient payments system, while also channeling funds from savers to borrowers. The Fed has sought to maintain a monetary policy consistent with price

stability and economic growth. As we have recently witnessed, our financial system has provided an unstable and risky banking structure which is supported through an extensive federal safety net. The recent taxpayer bailouts of the financial system indicate some of the weaknesses in this safety net. Would the separation of the deposit and credit functions provide a better financial system?

First, the Federal Reserve Board would be better able to control the basic money supply, currency and demand deposits under a narrow banking system. The question remains whether such control would be economically relevant in a world of financial innovation and instantaneous transfer of financial wealth. Whether a monetary growth rule or policy discretion is adopted would still have to be decided by the Board and agreed to by Congress. Though the narrow banking system would obviously allow for some financing of government deficit spending by money creation, there would be greater transparency.

While regulation of narrow banks could be reduced, it would not mean the end of all financial system regulation, because regulation of lending or transaction-oriented institutions should continue. However, if the only insured deposits are in narrow banks, then the potential costs to the DIF would be greatly reduced. Though deposit insurance is

redundant for narrow banks, it could be maintained with reduced premiums.

Under a narrow banking system, credit would be supplied by finance houses, separate lending institutions that could be mutual funds, finance companies, even separate windows of the bank — as suggested by Seidman — or, if desired, government owned corporations. An example of the latter is the Reconstruction Finance Corporation of the 1930s, which both took ownership stakes in private companies and provided direct loans to the private sector. A particular problem may be the availability of funds for small business loans and consumer loans. Alex Pollock of American Enterprise Institute has proposed that the Home Loan Banking Act be revived to create community-oriented lending institutions. These organizations would be established as mutuals, with members as shareholders and therefore owners of the institution, and would be oriented toward community needs.

Should government policy attempt to maintain the current role of banks in offering deposit and lending functions with federal deposit insurance or begin the evolution toward a financial system that separates the respective banking functions? A narrow banking system would not only protect depositors and forestall future bailouts but also

create a way for bankers to compete in other areas without being hindered by too intrusive regulatory burdens.

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