Bank Regulation: Strengthening Friedman's Case for Reform*

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In 1959 Milton Friedman proposed that the government free commercial banking from all regulation except a 100 percent reserve requirement on demand deposits.[1] He supported this proposal with a critical review of U.S. government involvement in banking up to that time. The increased aggressiveness of the banking industry since then lends further support to Friedman's proposal.

Are current regulations efficient?

Government regulation of commercial banking is now based on two generally accepted objectives. The government should control the supply of a medium of exchange, part being fiat money (money the issuer does not promise to convert into anything) and part being a safe bank liability. It should also prevent anticompetitive market practices in commercial banking.

Preventing anticompetitive activities in all sectors of our economy has long been an accepted role of government. But controlling the supply of money while insuring a bank liability has only recently become a policy objective. Since existing regulations were not necessarily designed to meet this objective, they may not be the most efficient possible.

Attempts to regulate banking began very early in this country. After much political and economic turmoil over two central bank experiments, however, in 1836 the federal government stopped regulating banks. From 1836 to 1863, the U.S. banking system was just private banks operating under widely diverse state laws.

The public eventually came to consider this system unsafe and unsound, so in 1864 Congress passed the National Banking Act. This act created national banks that would issue safe and uniform currency. To insure safety, national banks were to be examined and supervised by the comptroller of the currency, and they were subject to capital requirements, various loan regulations, and reserve requirements against their notes.

By the turn of the century, the public was again questioning the safety of the banking system. The banking panic of 1907 intensified the country's 1907-8 economic recession. During that time most banks stopped converting deposits into currency. In response to this crisis, Congress established the National Monetary Commission. The commission's 1910 report was the basis for the Federal Reserve Act of 1913.

This act gave the Federal Reserve System several responsibilities. One of the most significant was the authority to issue and control the stock of its own liability, Federal Reserve notes. Another was to regulate this money, through the Fed's discount window, so that it would fluctuate with the varying needs of the economy. The Fed also could impose a fixed reserve requirement on all its member banks and could

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[1]Milton Friedman, A PROGRAM FOR MONETARY STABILITY (New York: Fordham University Press, 1959).

supervise and examine them. (Only national banks were required to join the system; others could join voluntarily.) And in order to prevent financial panics, the Fed was to be the commercial bankers' lender of last resort.

The establishment of the Federal Reserve may have given the public the impression that bank liabilities were reasonably safe and backed in some way by the lender-of-last-resort power. But less than two decades later, the United States faced another major banking crisis when the Fed could not or would not meet its obligations. Unexpectedly, during 1930-33 two separate banking panics occurred in which more than 9,000 banks closed, almost as many as in the preceding 100 years. The stock of money (currency plus demand deposits) decreased more than 30 percent.

In response to both the great increase in bank failures and the steep decline in the stock of money and in an effort to finally provide a truly safe bank liability, Congress established the Federal Deposit Insurance Corporation (FDIC) in 1933. The FDIC was to insure the first $5,000 of each deposit account in a member bank, charging a small annual premium based on the volume of deposits.[2] Although the law required only deposits in national banks to be insured, in time virtually all commercial banks became members of the FDIC.

The FDIC seems to have worked. Since its establishment, fewer than 700 banks have failed and no financial panics have occurred. Simply insuring deposits seems to have done what the National Banking Act and the Federal Reserve Act were supposed to do through their examinations, reserve and capital requirements, and lender-of-last-resort backing.

But could insurance have done it alone? Would FDIC deposit insurance have kept the banking industry stable without government-imposed bank examinations, capital and reserve requirements, and other forms of government regulation? No, not as long as the FDIC charged a flat-rate premium based on the amount of deposits a bank held rather than the amount of risk it took. Profit-maximizing insurance companies consider risk a major operating cost; not to do so encourages risk-taking at the expense of the insurer. Hence, government examinations and regulations are needed to control the hazard in banking encouraged by flat-rate premiums.

Government insurance plus just the right amount of government examination and regulation appears, then, to have stabilized banking, significantly reduced bank failures, and produced a safe bank liability. So why the need for reform? Why tamper with a system that seems to be working?

The Case for Reform

In 1959 Friedman examined the U.S. banking system and its history and pointed out two critical weaknesses. Government intervention into bank lending and investing was extensive. And the fractional reserve system was complicating the Federal Reserve's job of controlling the stock of money by making the public's decision about how to hold money affect the amount available to be held.

Since 1959 another argument has surfaced, one implicit in Friedman's writing though not exploited. The FDIC insurance scheme requires extensive government intervention in activities he felt should be left completely to the market. But even if we don't oppose intervention, how do we know how much is really necessary? The flat-rate premium encourages risk-taking, so bank regulations must be designed to offset this behavior, which has increased dramatically since Friedman wrote. But how much risk-taking should we allow? And how much regulation does that require?

Today's network of regulators and regulations is already large and unwieldy. Five distinct government institutions enforce a multitude of restrictions on banking activities. Commissioners charter, examine, and supervise

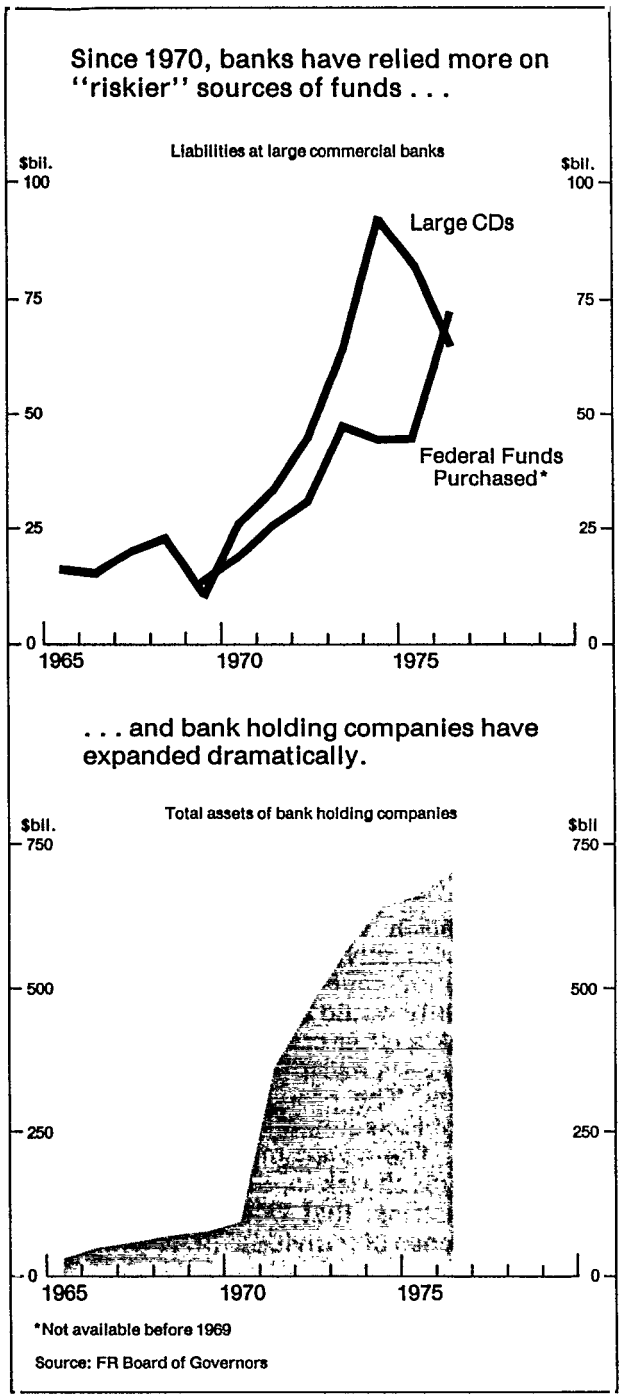
[2]Today most accounts are insured up to $40,000; state and local government deposits, up to $100,000.

state banks in their areas. The comptroller of the currency does the same for national banks. The Federal Reserve also examines and supervises all national banks and those state banks that are members; the FDIC examines and supervises most nonmember state banks. And the Department of Justice intervenes when issues related to monopoly practices are involved. These institutions enforce capital and reserve requirements, interest-rate limits on certain liabilities, and restrictions on the kind and amount of assets banks can hold in their portfolios.

Despite this extensive body of regulators and regulation, the banking industry seems to have become more aggressive. Some are even worried that it has already taken on too much risk.[3] Their major concerns are growth in bank liability management and holding company affiliation (see charts.)

Liability management refers to banks actively seeking deposit liabilities by, for example, issuing certificates of deposit (CDs) or borrowing federal funds from other banks. Because these liabilities are not fully insured, banks may be more vulnerable to losing such funds during periods of financial difficulties.[4] And as the chart shows, the growth in these liabilities has been quite dramatic since 1970.

The growth in bank holding company affiliation has also increased significantly since 1970. Through corporations like these, banks can get involved in nontraditional and possibly risky activities. Bank holding companies today are doing such things as issuing credit cards; underwriting life, accident, and health insurance; acting as dealers in banker's acceptances and brokers for credit extensions; and issuing bank-



[3]A leading advocate of this position is Hyman P. Minsky. See his "Financial Resources in a Fragile Environment," CHALLENGE, July-August 1975, pp. 6-13.

[4]Federal funds are not insured by the FDIC while most CDs are insured only up to $40,000. For a discussion of the implications of liability management on bank failures see R. Alton Gilbert, "Bank Failures and Public Policy," REVIEW, Federal Reserve Bank of St. Louis, November 1975, pp. 7-15.

related commercial paper.[5]

How should the government respond to banks' increased aggressiveness in the face of so much regulation? Several economists and legislators advocate even more regulation. Others recognize that flat-rate insurance premiums encourage risky behavior and argue for a variable rate scheme. Some simply want more and tighter government surveillance.

To argue for any of these, however, we first need to know how much risk is too much, and how can we determine that? Finding just the right amount of regulation is therefore difficult, if not impossible. We simply have no way of knowing what is an acceptable level of risk and how much regulation that requires.

Following Friedman's suggestion, however, we could require all banks to maintain 100 percent reserves against a bank liability; that is, make each bank set aside at the Federal Reserve (or in its own vaults) enough money to pay all its demand depositors. We could then drop all other government regulations, including reserve requirements on other liabilities, capital requirements, interest rate ceilings, restrictions on asset holdings, government insurance, and government-imposed bank examinations, except those to enforce the 100 percent reserve requirement.

This proposal clearly meets the government's main objective for bank regulation: the supply of money could still be controlled and the bank liability would be safe. In case of bankruptcy, a bank's other creditors could not claim any reserve assets except those exceeding demand deposits. The proposal avoids, furthermore, the problems inherent in an FDIC insurance scheme. The government would not need to know how much risk to allow in banking. As in other industries, that would be determined by the preference of individual investors.

Will it work?

Is this one of those simple plans that may work in theory but not in practice? Isn't banking a complex business requiring complex regulations? Won't unregulated banks take on "too much" risk, induce bank panics, and destabilize our economy?

A plan is good in theory only if it is good in practice. Whether banks will incur more or less risk under this alternative system is unclear and in a sense irrelevant. The important point is that banks will take on only as much risk as their stockholders and depositors (other than those holding fully backed deposits) are willing to bear.

Some people may argue that unregulated banking activities will surely cause panics like those of the early 1930s. But existing regulations such as reserve and capital requirements and bank examinations did not prevent those crises.

In fact, several economists have persuasively argued that those panics were mostly caused by a government policy that promised but failed to provide a safe bank liability. And under the 100 percent plan, government's role as an insuring agent would be explicit. In effect, only the fully backed deposits would be insured. For other deposits, banks would be left on their own with stockholders and depositors bearing the risk and sharing the profits.

Conclusion

In proposing this program in 1959, Friedman argued that the shift from the current system to 100 percent reserves could be accomplished easily and quickly without any serious repercussions in financial or economic markets. Today, after nearly 20 more years of trying to regulate an increasingly aggressive banking industry, the case for that shift is even stronger.

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[5]Holding companies do permit banks to diversify their activities, which may increase—not decrease—the soundness of the banking industry. For a discussion of both sides of the holding company issue and a look at the empirical evidence see Dale S. Drum, "Nonbanking Activities of Bank Holding Companies," ECONOMIC PERSPECTIVES, Federal Reserve Bank of Chicago, March/April 1977, pp. 12-21.

The views expressed herein are those of the author and not necessarily those of the Federal Reserve Bank of Minneapolis or the Federal Reserve System.