A Proposal to Deregulate Banking: Comment on Thomas

Biagio Bossone

Hugh Thomas's proposal in the Fall 2000 *Cato Journal* for a comprehensive reform package to deregulate banking—with a view to strengthening market discipline on financial intermediaries, reducing their incentive to moral hazard, and enhancing public trust on money—has several drawbacks. In what follows, I will point to those drawbacks and argue that Thomas's proposal, if implemented, would suppress the major benefits associated with banks' power to create money.

Thomas's Proposal

The three main points of Thomas's proposal to deregulate banking are as follows:

1. The payment system should be operated on a real-time, gross-payment settlement basis by money market mutual funds. The mutual funds would act as narrow banks: they would receive cash deposits from (retail and business) customers and invest the cash entirely in safe securities. The mutual funds would place their securities in a depository institution and transfer ownership over them upon payment instructions from their customers.
2. Banks should be *demonetized* and transformed into nonbank financial institutions (FIs); that is, they could make loans but could not issue money deposits. While the FIs could finance their assets with short-term retail debt, they would be precluded

Cato Journal, Vol. 21, No. 2 (Fall 2001). Copyright © Cato Institute. All rights reserved.

Biagio Bossone is an official of the Banca d'Italia and currently serves as Advisor to the Executive Director of the International Monetary Fund. He is grateful to Frederic Mishkin and Larry Promisel for earlier in-depth conversations on the issues dealt with in this paper, and his wife Ornella for her support. The opinions expressed are his only, and do not implicate either of the two institutions.

from using any account but mutual funds to manage the receipt and remittance of payments for retail customers. A clear distinction would then be made in the eyes of the public between riskless money (held in mutual funds) and risky investments (held in FI liabilities).

3. The government should abolish all forms of support to the FIs (including safety nets and supervision), which would then be subjected entirely to market monitoring and discipline, since now any shock to individual FIs would be isolated and would not have systemic consequences through the payment system.

The financial system would thus feature strictly narrow banks for the provision of monetary and payment services, and strictly nonbanks for the lending business. The package would break the banking oligopoly. It would give risk-averse capital owners access to a fully risk-proof money instrument, alert the investors to the true risks behind lending intermediaries, and lead the latter to price risk efficiently and operate without undue state subsidies (through implicit or explicit safety nets).

Thomas defends his proposal against a host of possible objections, including the contention that his reform package would cause monetary contraction and reduce overall lending and liquidity in the system.

Why Banks Are Special

Thomas's proposal draws on the tenet that, since the special role of banks has outlived its usefulness, full bank deregulation can be pursued with significant benefits and at no social cost. Such a tenet, in turn, is based on the narrow definition he employs of a bank as an institution that takes deposits and makes payments. Yet unique social benefits can be shown to derive from banks once their deposit-taking and payment-making activities are considered jointly with their lending business, something that does in fact characterize banking as we know it: banks take deposits, make payment, *and* extend loans (see Bossone 2001a, 2001b).[1]

By lending, a bank essentially issues a new liquid liability that the bank commits to honor from the moment the borrower draws on her

[1]Important contributions to this literature, building on the concept of banks as deposit-taking *and* loan-making institutions, are those by Diamond and Rjan (1998, 1999), and by Kashyap, Rajan and Stein (1999). Padoa-Schioppa (2000) supports this approach and evaluates its regulatory implications.

loan account to make payments. The new liability adds to the existing deposit liabilities.

If payments would all hypothetically take place within the books of one single bank, they would not require high-powered money (reserve) transfers: deposit-taking and loan-making, together, would enable the bank to create money at zero (marginal) funding costs and with no risk of liquidity. On the other hand, when payments involve reserve transfers across accounts held with different banks, banks can still create money but at a higher cost. This cost varies depending on whether payments are to be settled on a gross basis through reserve money, or on whether banks can extend credit to each other (in the form of mutual overdraft and credit-line facilities and netting arrangements) and at what cost.

What thus makes banks special is that, absent regulations barring the issuance of less than fully backed deposits, banks can issue debt claims on themselves that are accepted as money by the public, and can inject money into the economy by lending claims on their own debt. This is a pretty efficient and flexible (although, admittedly, not a risk-free) way to provide the economy with the needed new purchasing power to mobilize real resources.

Money creation differentiates banks from nonbank financial intermediaries since the latter can only *transfer* money already in the system. Put very simply in a stock-flow framework, banks create the economy's means of exchange through credit to production and consumption, while nonbank financial intermediaries help savings accumulated from generated incomes to flow to investment. These two types of institutions are complementary to each other and both are essential to the economy. Even the circumstance that traditional commercial banking has lost large market shares worldwide relative to nonbank financing does not make banks any less essential to the economy (Bossone 2001b).

How does Thomas's proposal fare in the light of these considerations?

The Cost of Thomas's Proposal

Thomas recommends the adoption of a real-time gross-settlement (RTGS) payment system, and the preclusion of the FIs from using any account but money market mutual funds to manage the receipt and remittance of payments for retail customers. While these two provisions would result in a considerable reduction of risks, they together would place the economy's money creation process under a

major inhibiting factor. This tradeoff has to be assessed carefully. I will discuss the effects of each provision separately.

Following the lead of the industrial countries, RTGS systems are being adopted widely across the world. RTGS systems remove the risk of payment settlement failures, but they do so at a cost. Under a RTGS system, banks can mobilize deposit claims to process payment orders only if they have sufficient cover funds in their accounts with the central bank. This is possible if the banks already hold enough reserves, or if they have access to central bank refinancing facilities. Alternatively, individual banks can wait to receive payment funds from other banks, or borrow reserves intradaily from the interbank market (if this market exists). Note, however, that these last two options do not stand for the system as a whole, which either holds enough total reserves or has to raise them somehow.

As a result, banks must either preaccumulate more capital (for any given volume of deposits to be mobilized) than they would have to under non-RTGS rules, or they would have to curtail their overall lending below the maximum level consistent with non-RTGS rules: RTGS systems raise the economy's cost to create money beyond what is feasible through interbank lending under correspondent relationships or netting arrangements.

The extra cost could be relieved only if the central bank were willing to lend uncollateralized reserves to support bank payment activity. This solution, however, would shift an enormous credit risk burden to the banking institution—i.e., the central bank—which least of all in the system has the capacity to manage such a risk on market criteria: an unjustified and positive or negative tax would result for the system from this solution.

As to Thomas's second provision, consistently with the spirit of his reform package, it fully inhibits the FIs from ever seeking to *monetize* their short-term debt liabilities. If the FIs were permitted to offer payment services by directly mobilizing such debt, like any conventional bank they would have an incentive to economize on the reserves needed to settle payments, to engage in mutual lending arrangements, and to issue new debt (via lending) that would de facto become money.

The fact is that, as history shows, there is a *natural* (private and social) incentive to banking, even independently of the existence of safety nets. It is rather surprising to see that, at times, even most ardent free-market advocates propose deregulations that in practice would regulate this natural incentive away, for the sake of risk avoidance.

Accepting Thomas's second provision raises a question: How is economic activity to be financed under his proposed regime, without

running into credit contraction? If the FIs fund their assets with short-term nonmoney debt, overall lending can be maintained only if the investors are willing to replace bank deposits with FI debt in their portfolio. But, all else equal, this would require a higher remuneration of the FI debt, which would make lending costlier and reduce the liquidity in the system (since, by regulation, the FI debt cannot be used as money). It should not be unexpected that suppressing conventional banking reduces private-sector lending *and* money (Bossone 2001c).

Alternatively, the FIs could borrow or purchase money from the central bank, against collateral or in exchange for securities, and on-lend it to the business sector. But, as discussed, the FIs' cost of lending would be larger than for conventional banks since the latter can fund loans by creating deposits. Still, the central bank could lend uncollateralized reserves to the FIs, but the negative consequences of this have already been noted.

Finally, a system like that envisaged by Thomas, which relies so heavily on reserve money, is vulnerable to a serious potential problem: in the event of net overall reserve shortages, the financial institutions need eligible paper to raise reserves, but they might not be able to buy or borrow the paper precisely because they don't have reserves. To be sure, the class of eligible securities can be broadened to allow wider access to reserve money, but in most cases the units with surplus holdings of eligible securities would have to either lend securities directly to deficit units, or use them to raise cash from the central bank and lend it to the deficit units, in both cases bearing the credit risk. Once more, there is a natural need for somebody in the system to have the power to flexibly create liquidity (money or securities, as necessary), at a risk.[2]

Rather than splitting the system into narrow banks and strictly nonbanks, a more efficient, free-choice regulatory solution would be one that authorized banks to issue insured narrow-bank deposits *and* uninsured conventional deposits (Mishkin 1999). While not suppressing the risks inherent in conventional banking, this solution would retain the money-creation power of conventional banks, avail risk-averse investors of a full risk-proof money instrument, and leave financial institutions and customers free to opt for conventional and/or narrow banking instruments based on their own economic conve-

[2]Note that the *liquidity creation* in this example rests on the regulatory fiat that broadens the class of paper eligible for conversion into cash. Note also that systems with net settlement arrangements and conventional banks are much less vulnerable to the type of problem just discussed.

nience, provided that banks were required to offer their services transparently.

Conclusion

Thomas's proposal builds around the mistaken premise that risks in finance can be eliminated by (de)regulation at no tradeoff costs. His package, if implemented, would remove bank risks simply by suppressing banks, much as if the motor vehicle administration in a country sought to reduce car accidents by limiting car speed to zero.[3]

Banks have evolved over history into money-creating institutions precisely because there are market incentives and social benefits associated with issuing debt through lending, and with having this debt accepted by the public as money. Bank money creation improves the return to the society if it is carried out on sound finance principles.

This ultimately relies on the banks' capacity to connect money creation to creditworthy borrowers and to safe businesses. But this is also why money creation cannot be left to anybody to perform and requires, instead, an *oligopoly* of selected agents. What matters is that the oligopoly be contestable; that entry and exit from it be based on strong reputational/financial/technical criteria; and that these criteria be fully and fairly enforced. This requires strong market discipline and an efficient financial infrastructure (including public sector supervision) to promote information transparency and rule compliance.

References

Bossone, B. (2001a) "Circuit Theory of Banking and Finance." *Journal of Banking and Finance* 25 (5): 857–90.

Bossone, B. (2001b) "Do Banks Have a Future? A Study on Banking and Finance as We Move into the Third Millennium." *Journal of Banking and Finance* (forthcoming).

Bossone, B. (2001c) "Should Banks Be *Narrowed*? An Enquiry into Narrow Banking as a Way to Greater Financial Stability and Efficiency." IMF Working Paper (forthcoming).

Diamond, D.W., and Rajan, R.G. (1998) "Liquidity Risk, Liquidity Creation and Financial Fragility: A Theory of Banking." NBER Working Paper No. W7430 (December).

Diamond, D.W., and Rajan, R.G. (1999) "A Theory of Bank Capital." NBER Working Paper No. W7431 (December).

Kashyap, A.K.; Rajan, R.G.; and Stein, J.C. (1999) "Banks as Liquidity Pro-

[3]I borrowed the analogy from Neil Wallace (1996).

viders: An Explanation of the Co-Existence of Lending and Deposit-Taking." NBER Working Paper 6962.
Mishkin, F. (1999) "Financial Consolidation: Dangers and Opportunities." *Journal of Banking and Finance* 23: 675–91.
Padoa-Schioppa, T. (2000) "Licensing Banks: Still Necessary?" The William Taylor Memorial Lectures, No. 5. Washington: The Group of Thirty.
Thomas, H. (2000) "A Proposal to Deregulate Banking." *Cato Journal* 20 (Fall): 237–53.
Wallace, N. (1996) 'Narrow Banking Meets the Diamond-Dybvig Model." Federal Reserve Bank of Minneapolis *Quarterly Review* 20 (1): 3–13.