Mr. Kelley looks at the extent to which banks are still special Remarks by Mr. Edward W. Kelley, Jr., a member of the Board of Governors of the US Federal Reserve System, at the Seminar on Banking Soundness and Monetary Policy in a World of Global Capital Markets sponsored by the International Monetary Fund and held in Washington on 29/1/97.

I would like to say first that it is a pleasure for me to be here today to participate in this conference and to have the opportunity to exchange views on the important issues addressed by this session in particular. I also want to thank Governor George for his fine survey on the question of whether banks remain special; his paper makes many good points and I agree with virtually all of what he has to say. As a consequence, my comments will be more in the nature of expanding upon his remarks, rather than in taking issue with any of his main points.

As Governor George noted, the degree to which each of us regards banks as "special" is bound to be colored by the history and development of banking in our respective countries. Of course, the U.S. banking is quite unique in many respects. Relative to the U.K., for example, we have many more depositories (on the order of 25,000 or so) and they operate with more regulatory restrictions on their activities than in the U.K. and many other countries. Also, our system of deposit insurance is more generous than in the U.K. Bearing these differences in mind, I will attempt to address aspects of our subject today that apply more or less generically in all countries, but I will draw on U.S. experiences for illustrations.

To begin, let me say that I found the seemingly simple question "Are banks still special?" to be deceptively difficult. In reading Mr. George's paper and organizing my own thoughts on the subject, I was compelled to answer for myself a series of even more basic questions such as: "How do we define a 'bank'?", "What do we mean by 'special'?", and "If banks are indeed special, what does this imply about the proper stance of government vis-à-vis the banking industry and other types of financial services providers?"

For the purposes of this discussion, I will define a bank rather broadly as any financial intermediary that accepts deposits and extends loans to households or businesses. In the United States, this definition encompasses domestic commercial banks, branches of foreign banks operating in the United States, savings and loan associations, and credit unions.

Defining what constitutes "specialness" is more difficult. In general terms, analogous to Governor George's definition, I will define a "special" aspect of banking as one in which there is a clear and pronounced public interest exceeding that present in other types of business and commerce. As I will note more fully in the following, my definition of "special" does not necessarily imply that the special aspect of banking in question should be isolated or insulated from competition with other financial service providers. There are at least three general aspects of banks and banking that have been deemed special by many observers -- the liquidity transformation function of banks, the provision of basic financial services such as credit extension, deposits-taking, and payments processing, and the linkage between the banking system and the conduct of monetary policy. In the following, I will take up each of these "special" aspects of banking in turn.

So, is the liquidity transformation function of banks still special? By the term "liquidity transformation function" of banks, I refer to the typical balance sheet structure of banks that often features a sizable volume of highly liquid liabilities -- those that can be withdrawn at par on demand such as balances in checking accounts -- in combination with a

portfolio of generally longer-term assets that often are difficult to sell or borrow against on short notice.

It is probably fair to say that there is considerable agreement among central bankers and other economic policymakers that this unique balance sheet structure creates an inherent potential instability in the banking system. Rumors concerning an individual bank's financial condition -- even if ill-founded -- can spark a run by depositors and other creditors that may force the bank to unload assets at firesale prices and, in extreme situations, suspend payment on withdrawal requests. Especially if the distressed institution is large or prominent, the panic can spread to other banks, with potentially debilitating consequences for the economy as a whole. Most countries with private banking systems have experienced episodes of bank panics to some degree, and in the United States, such panics occurred with some frequency in the late nineteenth century and were a major factor exacerbating the Great Depression of the 1930s. While institutional regimes differ, most countries have established safeguards against banking panics that rest on three basic pillars -- some form of deposit insurance (explicit or implicit), a program of banking supervision and regulation, and an institution that can act as lender of last resort.

To come back to our basic question of whether the liquidity transformation function of banks and the associated instability remains "special," I would say that there is simply no doubt about it. Wherever banking panics have occurred, their effects on economic performance have been crippling. Thus, developing institutions and mechanisms that can prevent or short-circuit bank panics remains an important and "special" goal for economic policymakers. Having said this, however, recent experiences in the United States and elsewhere have underscored the importance of going about this task in a way that does not overextend the banking "safety net." In the United States, this lesson was painfully conveyed during the 1980s and early 1990s by the hundreds and hundreds of bank and thrift failures that occurred in these years. While this phenomenon was extraordinarily complex, many have argued that underpriced deposit insurance and relatively lax supervision contributed to the problem by distorting the incentives banks and thrifts faced in assessing the risks of their business decisions.

In response, U.S. federal banking agencies have implemented changes that trim the banking safety net somewhat -- for example, by requiring prompt closure of troubled institutions, by applying stricter rules governing the payoffs of depositors and other creditors in bank failures, and by curtailing the practice of allowing regulatory "goodwill." In addition, new bank capital regulations such as the Basle risk-based capital standards, which have been implemented in the G-10 and have served as a blueprint for capital regulation in many other countries, have helped to provide better incentives for banks in their business decisions.

To summarize, I would argue that banks remain quite special in their susceptibility to runs and in the severe consequences that a large-scale banking panic would involve today. Balancing the need for a banking "safety net" to defuse potential bank runs with the need to create the right incentives for banks in assessing and assuming risk is one of the most difficult challenges we face as central bankers.

A second way in which banks have been deemed to be "special" is in the provision of basic banking services such as credit extension, deposit-taking, and payments processing. There is little question that these functions are critically important throughout society. Consumers turn to banks for safe investments such as time and savings deposits, for transactions deposits, for processing payments, and for short- and long-term credit. Large and small businesses rely on banks for payment processing, short-term credit, and backup credit

lines. And governments rely on the banking system to conduct payments, distribute currency, safeguard tax receipts, and to serve as a conduit for monetary policy. In short, the basic business functions of banks are at the heart of the financial system and the economy overall. By the definition I put forward earlier, I would have to say that these basic functions performed by banks are and will remain special. However, it is far from clear that these functions can only be performed by banks or that there is always a "special" public purpose in ensuring that banks' role in performing such functions is protected.

Indeed, as Governor George noted, nonbanks have made impressive inroads in markets that previously had been largely banks' domain. For example, money market mutual funds and stock and bond mutual funds have lured billions of dollars that formerly had been placed in staid bank investments such as certificates of deposits. Most mutual funds now also offer some "banking" services such as checkwriting privileges. The advent of asset securitization has allowed nonbank mortgage companies to compete successfully with banks in the home mortgage market, and nonbanks have also been important players in the explosion of new financial instruments such as derivatives and structured notes.

For the most part, this blurring of the traditional lines between banks and nonbanks seems to be a positive development. New competitive forces have been unleashed, financial innovation has accelerated, and businesses and households now enjoy a far greater range of choices on their menu of financial services than they did only a decade ago. Banks have responded vigorously -- and I would say successfully, given recent trends in profitability -- to the challenges posed by nonbank competitors. To be sure, such rapid changes have also posed new risks. It is critical in this environment that policymakers stay abreast of market developments to ensure that banks and nonbanks face the right incentives in assessing the risks of their business decisions, and likewise to ensure that consumers and investors have the best possible information available to them when choosing among financial services and products. Thus, while I agree that the basic functions of banks in making credit available, in providing safe investment choices (deposits) for households, and in processing payments are special, I see little to be gained by insisting that banks always be the only type of entity that can provide such services.

The case of electronic money helps to illustrate the point I am trying to make. It remains to be seen how popular this form of payment will become in the United States, but the question of whether nonbank institutions should be allowed to issue electronic money is actively being debated in many countries. Some argue that issuing money is a special bank function and that electronic money should properly remain exclusively a bank product. For the time being, however, I along with other policymakers at the Federal Reserve have concluded that any decision to reserve the nascent market for smart cards and other forms of electronic money as a province for banks alone might well stifle both competition and technological innovation in this area. Thus, while most would agree that providing efficient payment media for small dollar transactions is a "special" function that banks currently perform, it does not follow that only banks should be allowed to perform the function.

As a corollary, I would also say that there is not a "special" public purpose in constraining banks from competing in many other markets traditionally dominated by nonbank financial institutions. This is a subject which is especially topical in the United States because our domestic banks are more restricted in the business activities in which they can engage than are banks in many other countries. As you know, the Federal Reserve has pushed to expand banks' ability to compete with investment houses in underwriting securities, and the scope for U.S. banks to sell insurance-related products has also expanded recently.

The third general aspect of banking that is often deemed special is the linkage between the banking system and monetary policy. Of course, this is a topic that has spawned a truly vast economic literature. Without venturing into this thicket, I would simply like to note as fact that through much of the 1990-1994 period, growth of the broad U.S. monetary aggregates such as M2 was quite at odds with historical relationships to nominal income growth. Perhaps the most important factor underlying this development has been a fundamental realignment of household financial assets away from bank deposits in favor of bond and stock mutual funds and other capital market investments. This "decoupling" of banking system deposit liabilities and nominal GDP became so pronounced during the first half of the 1990s that the Federal Open Market Committee downgraded the status of M2 as a policy variable. Today M2 remains only one of the many variables reviewed by the FOMC in the course of its policy deliberations.

I raise this example because financial innovations and shifts in financial structure affecting the monetary aggregates in other countries have similarly created complications in their implementation of monetary policy. Indeed, the difficulties in guiding monetary policy during periods of rapid financial innovation have been a factor contributing to greater experimentation among central banks with alternative targets such as inflation or nominal GDP growth. Thus, I believe one could argue that the growth of aggregate bank deposits or money is probably less "special" today as a policy variable in many countries than in the past.

Ironically, while the growth of bank deposits may be less special as a policy guide, the special role of the banking sector as the primary vehicle in implementing monetary policy in most countries remains unchallenged. Most central banks seek to achieve their objectives through some form of interest rate management. Control over short-term interest rates is achieved in every case I am aware of by manipulating the supply of central bank reserves available to satisfy banks' demand for reserves. Banks' demand for reserves is similarly influenced by central banks either directly by setting reserve requirements or indirectly by allowing only banks to access the payment system and then setting the rules regarding the management of their central bank accounts.

To conclude, I would like to return to one of the questions posed at the outset of these remarks: If banks are special, what does this imply about the proper stance of government vis-à-vis the banking industry? As I hope my previous comments make clear, regulatory and supervisory policies must recognize the dynamic forces at play in the financial sector. Such policies must promote and exploit the competitive process in order to foster efficient delivery of services while encouraging financial and economic stability. These objectives are not likely to be achieved by regulations that arbitrarily identify and rigidly segment bank and nonbank financial markets. Rather, our goal as policymakers should be to establish rules of the game that provide proper incentives for financial institutions to accurately assess and manage the risks inherent in their business decisions. Likewise, we should foster reporting standards and information flows so that the consumers of financial services and products are as well informed as possible about the risks and returns of the financial services and products they buy. To the maximum extent possible, market forces should determine which bundles of financial services and products are provided by banks and other types of financial service providers.

As a final comment, I would note that sound macroeconomic policies are one of the most important ways to encourage the efficient delivery of financial services and the safety and soundness of financial institutions. Conversely, policies that result in significant macroeconomic imbalances frequently have serious adverse implications for financial institutions and banks in particular. In reviewing the past two decades in the United States, for example, one cannot help but notice that the most severe problems in our banking and thrift

industries during the 1980s stemmed from serious macroeconomic imbalances -- including the accelerating inflation of the late 1970s and the costly but necessary steps to reverse that trend in the 1980s. By contrast, macroeconomic policies that encourage sustainable economic growth with low inflation -- like those in recent years -- have a strong positive influence on the overall health of the banking sector and other financial institutions as well.