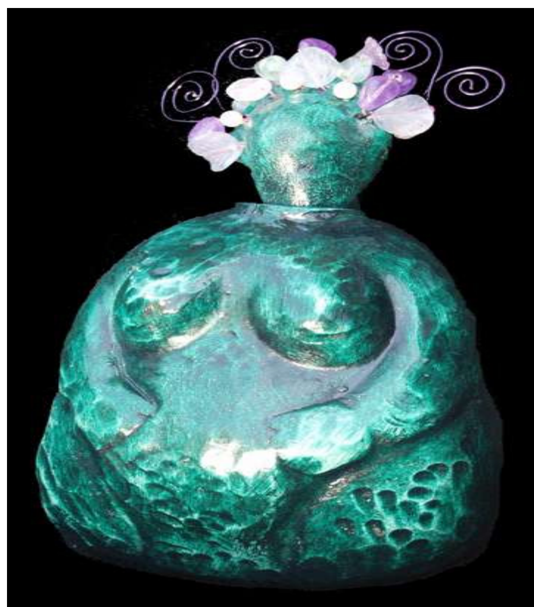
The Case for Narrow Banking

By

Kevin R. James



 ©Kevin R. James

The Case for Narrow Banking

The views I express in this presentation are my own, and do not necessarily represent those of the Bank of England. The Bank of England does not accept any liability for misleading or inaccurate information or omissions in the information provided.

I. The Problem with Banks

What Are We Trying to Do?

- Financial regulators (should) act to ensure that the real economy has access to the services that the financial sector provides
  - Money as a store of value
  - Raise and sustain investment
- Banks have traditionally been central to providing both services
- So we spend a lot of time attempting to keep the banking system stable

 ©Kevin R. James

The Cost of Failure

- If we fail and a banking/financial crisis does occur, the costs are huge
  - A country selected at random has an 8% (on average) chance of being in crisis
  - A crisis imposes an average loss of 9% of GDP
  - Poverty increases dramatically (Chen and Ravallion [2001])
  - Women and children suffer most (Atine and Walton [1999])
    - Source: Bordo, Eichengreen, Klingebiel, and Martinez-Peria [2001]

The Problem With Banks

- We supervise banks/financial systems because banks have strong private incentives to take bigger than efficient risks (as they gamble with depositor wealth)

- Regulators must then stop them from acting in their own self-interest

- We're not particularly good at that

Stop!

- ❖ Regulators can constrain banks in two ways:
  - – Hammer on the financial system
  - – Intrusive Supervision
- ❖ Neither method is very satisfactory

Hammer on the financial system

- If the domestic financial market is very tightly controlled, then there is much less chance that currency mismatches/lending booms (etc.) will set in train events that lead to a crisis

- Regulating in this way will dramatically reduce the level of financial development…

❖ …Imposing massive costs on the economy

- Beck, Levine, and Loayza [2000] find that increasing the level of financial intermediary development enhance total factor productivity growth
    - "Finance and the Sources of Growth", JFE

- Bekaert, Harvey, and Lundblad [2003] find that equity market liberalization increases GDP growth by 1% over a 5 year period
    - Columbia University Working Paper

Intrusive Supervision

- Alternatively, one can let banks do what they want subject to close monitoring

- The problems are obvious
  - Formal frameworks are highly imperfect (Basle I, Basel I.5, Basle II…)
  - Supervisors find it difficult to fully understand what is going on in a big bank
    - Deutche Bank is run as a single economic entity, but it consists of almost 2000 legal entities

- Powerful regulators tend to screw up the system
  - Who supervises the supervisors?
  - Barth, Caprio, and Levine [2005], *Rethinking Banking Regulation: 'Till Angels Govern*, Cambridge U Press

II. Mu!

Student: Does a dog have a Buddha nature?

Teacher: Mu!

If you can’t get there from here…

- Question: How can we ***efficiently*** and ***effectively*** regulate banks subject to strong moral hazard incentives?

- Answer: we can’t.

…Let's start from somewhere else!

- If we can't be sure of our ability to prevent banks from acting upon their natural (given the current structure) moral hazard incentives…

- …Let's transform the incentives themselves

 ©Kevin R. James

Narrow Banking

- The moral hazard problem exists because banks can invest in more or less anything with depositor cash
- So, let’s eliminate the problem by requiring a bank to depositor wealth in only safe assets
- If depositor wealth can only go into safe assets, then there is no moral hazard problem
- A bank that can act in this way is a “Narrow Bank”

Finance Houses

- ❖ If banks invest in only safe assets, then other institutions—Finance Houses—must arise to invest in risky projects
- ❖ These institutions will raise their capital on domestic and international financial markets
- ❖ Shareholders will then have the right incentives to monitor them, so there will be no need for intrusive supervision

The Advantages

- Narrow Banks
  - Provide liquidity services (as banks do now)
  - No moral hazard problem
  - Reduced chance that a financial crisis wipes out people's savings

- Finance Houses
  - Provide investment services
  - No temptation/ability to gamble with depositor wealth
  - Suppliers of capital (with the right incentives) monitor the institutions
  - So, no need for (ineffective and inefficient) government supervision, reduced chance of a financial crisis

The Classic Narrow Bank Papers

- The case for narrow banks has been put forth by
  - Litan [1987]
  - Pierce [1991]
  - Bryan [1991]
- Here I am interested in the idea of narrow banking rather than the nature of the optimal narrow bank
  - See Kobayakawa and Nakamura [2000] for a comparative analysis of the proposals

Narrow Banks: The Critiques

The Triple Threat

- Narrow banks are not practical
  - The pool of safe assets is too small to back narrow banks
  - The world pool of liquid savings is too small to support finance houses (or: investment must be financed from local deposits)

- Narrow banks are not efficient
  - Narrow banking destroys a key liquidity provision externality

Narrow banks have nowhere to invest deposits

Can Narrow Banks provide liquidity services?

- What will narrow-banks invest in?
  - A leading candidate is Money Market Mutual Funds
    - Assets: commercial paper, government securities
  - Miles (2001) investigated the properties of MMMF's, and found that they stable liquidity provision both to depositors and to the commercial paper market
    - "Can Money Market Mutual Funds Provide Sufficient Liquidity to Replace Deposit Insurance?", *J. of Economics and Finance 25, Fall 2001*
- Thus, narrow banking will work on the narrow bank side

The world pool of liquid savings is too small to sustain finance houses

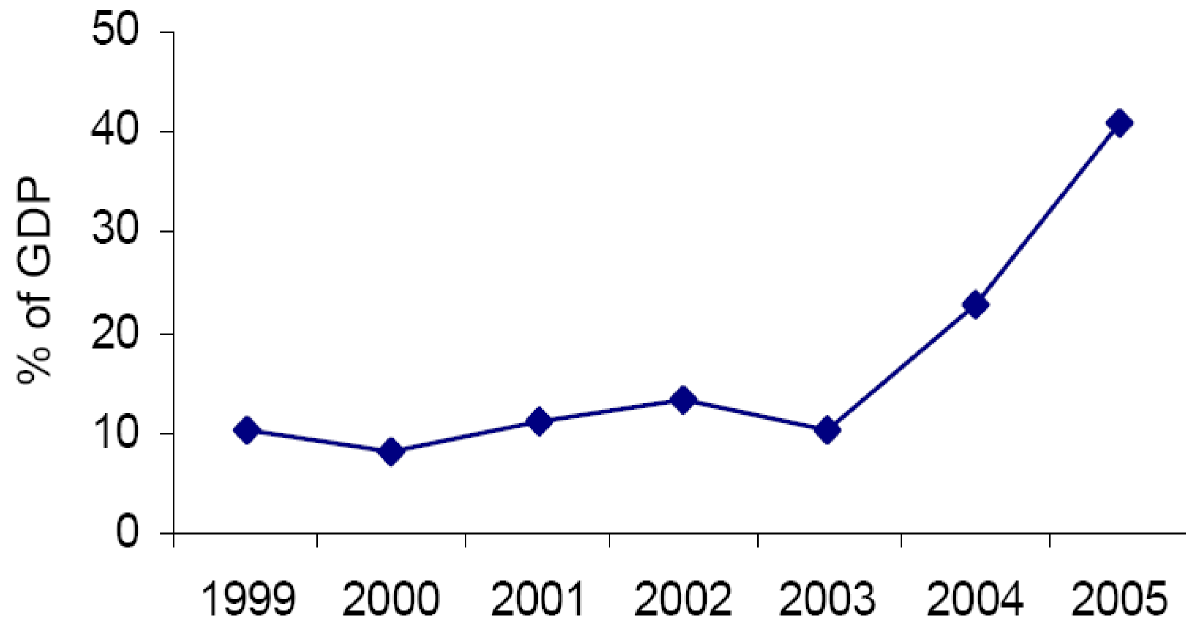
The Savings Glut

- Far from facing a shortage of liquid savings to invest, the world is suffering from a lack of good investment opportunities
  - Rajan, "Is There a Global Shortage of Fixed Assets?", *IMF Speech, 1 December 2006*

- Thus, intermediaries with access to good projects in sound economies should have no trouble attracting the funds they need to finance the projects

- In other words, investment need ***not*** be financed from domestic savings

If you build it, they will come



Source: Patrick Honohan, "Small Countries Coping with EMU: The Case of Ireland"

Kashyap, Rajan, and Stein: Scarce Liquidity and Wide Banks

Economies of Scope in Liquidity Provision

- Kashyap, Rajan, and Stein argue that the two sides of a wide bank are really in the same business, viz., that of supplying liquidity
  - Depositors: Draw down demand deposits to meet liquidity needs
  - Borrowers: Draw down lines of credit to meet liquidity needs

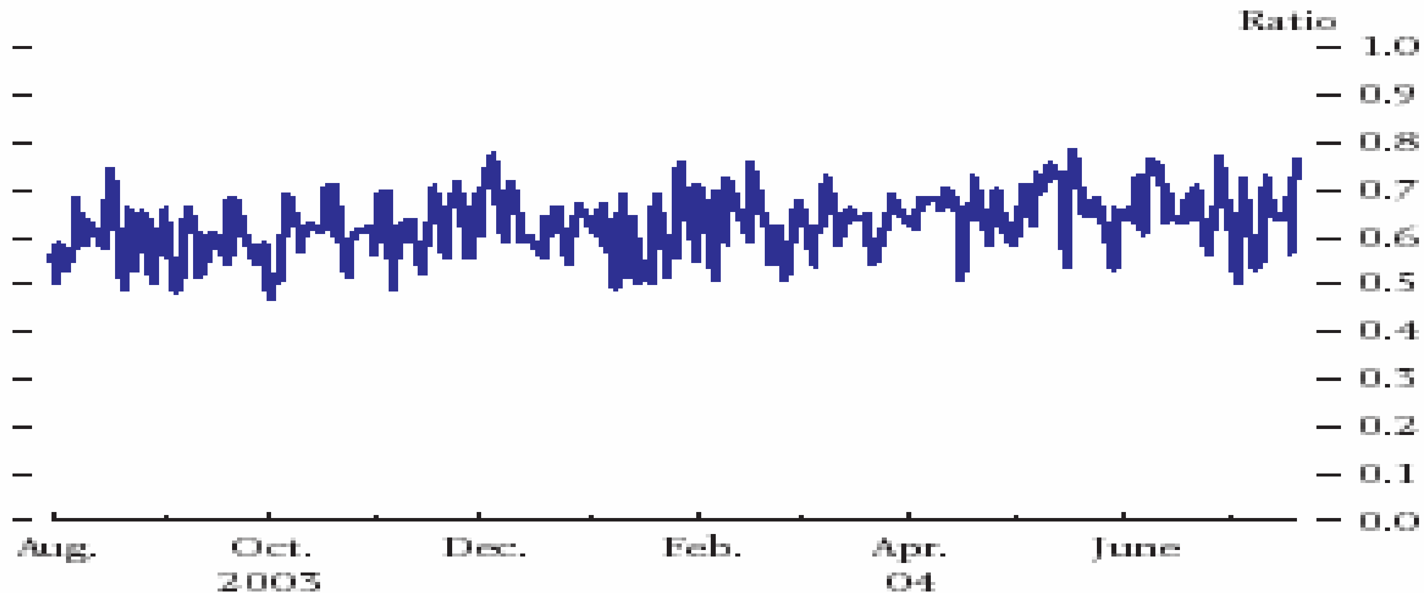
- In order to meet this (stochastic) demand, banks must keep a supply of liquid assets on hand

- If the depositor and borrower demands for liquidity are not perfectly correlated, then a single bank offering liquidity services to both types of customers can meet both demands with a smaller pool of (costly) liquid assets

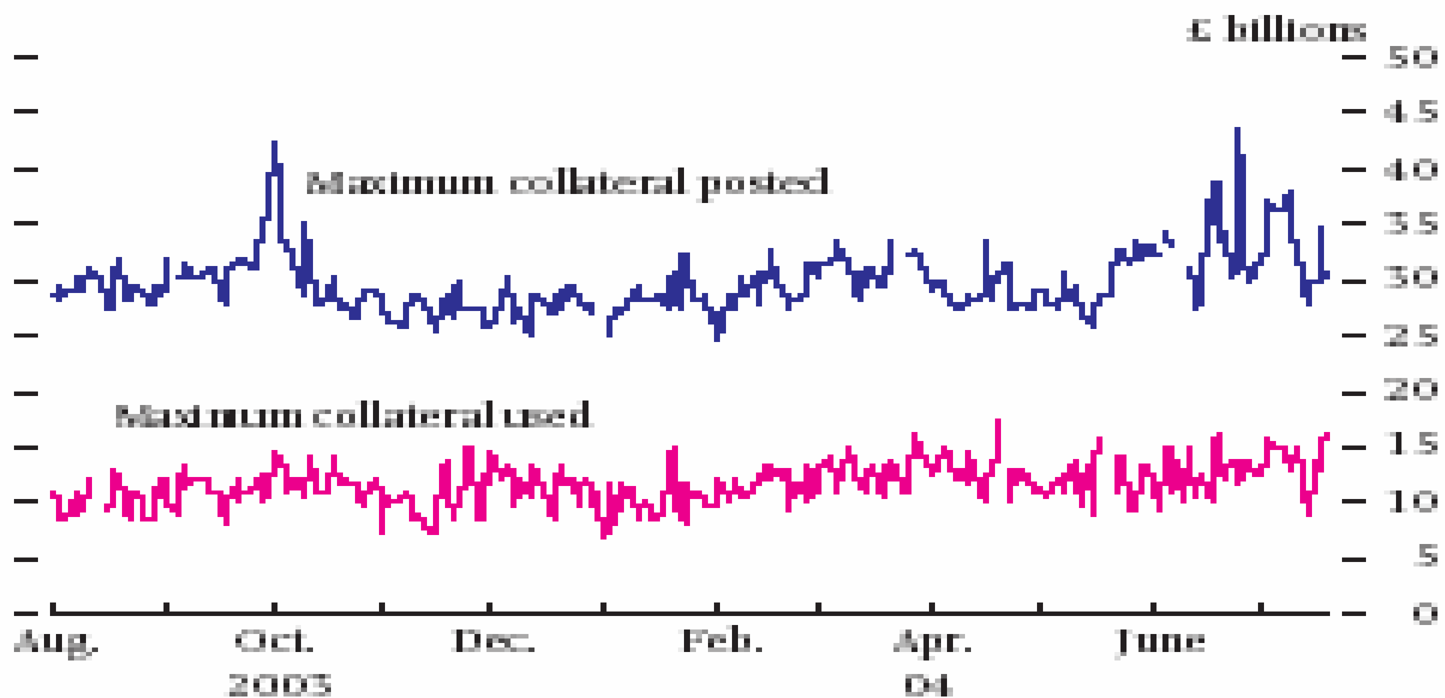
- Hence, wide banks enjoy a natural economy of scope
  - Kashyap, Rajan, and Stein, “Banks as Liquidity Providers: An Explanation for the Coexistance of Lending and Deposit Taking”, JF, 2002

©Kevin R. James

Do banks in fact behave as if liquidity is costly?



From James and Willison, "Collateral Posting Decisions in CHAPS Sterling", *Financial Stability Review*, December 2004



From James and Willison, "Collateral Posting Decisions in CHAPS Sterling", *Financial Stability Review*, December 2004

Why don’t banks economize on liquid asset holdings?

- Banks (at least in the UK) use an average of only about 60% of the liquidity they post in the payment system

- Holding liquid assets is cheap
  - The gap between the secured lending (Repo) and unsecured lending (LIBOR) rates averages only about 7 basis points

- So, banks are willing to hold liquid assets on their balance sheets on the off chance they may need them

The provision of liquidity as an economy of scope

- Since banks do not behave as if providing liquidity is costly, the empirical magnitude of the liquidity economy of scope can not be very big
- Hence, this economy of scope probably does not explain why banks look the way the do…
- …Nor does it constitute an argument against narrow banks

III. Conclusion

 ©Kevin R. James

Keep your eye on the ball!

- ❖ Banks that lend out depositor wealth (especially insured depositor wealth) are inevitably subject to strong moral hazard incentives

- ❖ Since banks can resist everything but temptation…

- ❖ …We supervise them (ineffectively) to prevent them from acting upon those incentives

- Let’s just exploit the marvelous developments that modern finance has created to simply eliminate those incentives!

- Narrow banks provide the crucial “store of value” and payment services aspects of a financial system

- Finance houses have the right incentives to allocate and monitor capital…

- And all of this can be done without requiring either intrusive supervision or crippling restrictions on financial system development