Rethinking the Roles of Banks: A Call for Narrow Banking

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Imagine that you park your car in a downtown parking lot. You tell the owner how long you intend to leave it there. The owner, thinking about an efficient use of capital, rents your car to someone. When you return to pick it up, you are told that your car was rented on a short-term basis, but not told to whom it was rented nor for what purpose. Sound odd? It should not. This is exactly what banks do.

You deposit money. The bank then lends your money to various "projects" according to the recommendations of its "experts." All this is done without even informing you, as the owner of these deposits, who has been using your money and for what projects. Academia has developed a fancy language to describe this process: banks provide the service of "delegated project-specific monitoring"—see Doug Diamond's 1984 paper in the *Review of Economic Studies*. Well enough. But depositors are never explicitly asked whether they want this service, and we have our doubts about whether they always do.

We wonder also: Do bank managers really work for the benefit of depositors? Do they take excessive risks?

There may be no better place to learn about the structural weakness of the current banking system than from watching the 1964 Disney classic movie entitled *Mary Poppins*. Dick Van Dyke, portraying a chairman of a bank who is a "giant in the world of finance," tries to convince the kids to hand him their tuppence for the purpose of opening a bank account. He sings:

If you invest your tuppence
Wisely in the bank
Safe and sound
Soon that tuppence,
Safely invested in the bank,
Will compound,

And you'll achieve that sense of conquest
As your affluence expands
In the hands of the directors
Who invest as propriety demands.

You see, Michael, you'll be part of
Railways through Africa

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Dams across the Nile
Fleets of ocean greyhounds
Majestic, self-amortizing canals
Plantations of ripening tea.

The old chairman ends his lecture by stating that "where stands the bank of England, England stands, and when falls the bank of England, England falls!" Eventually, the kids refuse to deposit their tuppence and create a panic leading to a run on the bank, so the kids' expectations become self-fulfilling.

Sadly enough, it seems that even with the unprecedented advance in computer and communication technologies, nothing has structurally changed in the way banks and central banks view their roles in financial markets. Our hunch is that neither the private banks nor the central banks have the incentives to make changes in the structure of today's banking industry. This is despite the fact that nowadays there is a very rich spectrum of mutual funds that seemingly cover every aspect of any lending purpose, and many other borrowing and lending opportunities like those created through the process of securitization, which did not exist during Mary Poppins' time.

Banks are still commonly viewed as the "right" institutions to bridge between lenders and borrowers, and to bridge among pools of depositors with different realizations of liquidity needs. However, this view does not take into consideration the prevalent emergence of (1) the extensive spectrum of mutual funds, (2) institutions supplying services which are substitutes to some of the financial services offered by banks, and (3) microbanking and the Internet.

BUNDLING RISK WITH DEPOSITS

Private banks and many central bankers would argue that the current structure of the banking industry is efficient, and that all that is needed for stability is to ensure that the banking industry earns sufficiently high profits so that bank failures are a rare phenomenon. We strongly disagree! Recent observations of the distressed financial markets, with Northern Rock as an example, seem to support our view.

Depositors who wish to obtain simple bank services, such as storage of money, payment services, money transfer, ATM, and card services, are forced to deposit their funds in risky accounts. Put simply, banks bundle deposit services with risk-taking.

What is wrong with this procedure? Only that risks are real and costly, and that no one asks depositors if they want to take these risks. The costs of bank failures are often blurred since under the current system it is not always clear who actually pays to bail out failing banks. Even if deposit insurance systems, such as the FDIC, are capable of bailing out failing banks, one may question the efficiency of such a mechanism whereby depositors end up paying high fees to banks (or receive low interest on their demand deposits and saving accounts) just for the sake of insuring the risk taken by the banks (and not by depositors, who actually own the money). Furthermore, deposit insurance easily makes depositors believe that the current banking system is safe. Secondly, as noted in Ron Feldman's and Art Rolnik's analysis of bank failures in the Federal Reserve Bank of Minneapolis annual report 1997, most banks are too big to fail, which means that governments generally do not have the political power to ignore bankrupt banks. The cost of bailing out failing banks falls on the shoulders of taxpayers who also happen to be the depositors. This is somewhat paradoxical in the sense that the deposit insurance system is ultimately

designed to protect precisely these depositors! Deposit insurance systems induce banks to engage in excessive risk taking and these systems tend to magnify the welfare costs associated with banks' bundling of risk with basic bank services.

Deposit insurance, which is explicit in many countries and implicit in many others is no doubt one of the principal reasons that unbundling is the exception and not the rule.

NARROW BANKING SERVICES

From the above discussion we conclude that the current banking system would be more efficient if depositors were given the opportunity to deposit their money in perfectly-liquid accounts. We propose what could be termed as a "generalized version" of narrow banking. Within this system, banks would be required to offer depositors 100% liquid accounts in addition to today's accounts. Then depositors could choose. Depositors who wish to maintain partially-liquid accounts subjected to the commonly-used reserve requirement could do so, for perhaps lower fees and in return for higher interest rates to reflect the bank's share of the returns generated by the funded projects. Perfectly-liquid accounts, on the other hand, would provide all the services currently enjoyed by depositors which include storage of money, ATM, debit cards, money transfers, payments, Internet access, and deposits. Why don't banks supply perfectly-liquid accounts today? One interpretation is that the market outcome means that these services are available only at such a high price that there is no demand. This calls for unbundling regulation, which is by no way unique for banking. It is very common in telecommunication services where the FCC requires cable operators to offer unbundled television, phone and Internet services. This means that cable operators are required to allow consumers to buy these services separately (and even mix services across different service providers). The conclusion to draw from this comparison is that unbundling of risk-taking from other basic banking services may require regulation of fees, at least until competition for these basic services is sufficiently strong.

Within the current banking environment the authorities for financial supervision impose prudential regulation with capital reserve requirements as the essential instrument. This type of stability-promoting regulation has recently been reformed by aligning regulatory capital requirements more closely to the underlying risks banks face within the Basel II Framework. In their recent study, published in *International Journal of Economic Theory* (2007), Oz Shy and Rune Stenbacka extend the set of instruments for the regulation of banks by adding the fraction of perfectly liquid accounts as a new regulatory instrument to complement the capital requirement imposed on partially-liquid risky accounts. The major advantage of this proposal is that risk would become a choice variable for depositors which is not the case under the present banking system, thereby inducing self-selection on behalf of depositors endowed with private information regarding their individual risk preferences. This establishes the source of a welfare improvement compared with a banking system which bundles risk-taking with other financial services.

In order to promote efficiency we also propose increasing the transparency associated with the banks' risk taking. We suggest that banks be required to report on their investments financed by partially-liquid accounts in the same way that mutual funds report to their investors. Under today's banking practice, depositors are

not informed on how their money is invested, so they can hardly assess the level of risk associated with today's deposit accounts. In addition, all obstacles against the entry of service banks, supplying only basic banking services, should be removed.

CONCLUSION

Most people utilize their bank for deposits and withdrawals, money transfers, and payments via the Internet. All these services can be provided by workstations, at modest cost, with limited human intervention. The era of the Mary Poppins-type of banks has ended. Of course, banks have strong incentives to block any structural changes to the current system which bundles basic services with risky deposits. Central banks unfortunately don't seem to make any effort to change the system. We argue that large segments of depositors would benefit from a separation between basic bank services and risk. Risk can and should be managed by transparent mutual funds, where individual investors can monitor the funds and control the degrees of risk taking and diversification. The current system which imposes risk on depositors (bundled with account services) benefits the existing banking industry, but not depositors.

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