A Regulatory Placebo? or, The Strange Case of Dr. Kaufman and Mr. Seir

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About half of George Kaufman's recent (1996) article on bank regulation constitutes a welcome, sober diagnosis of the problem of bank failures, showing how many beliefs concerning the likely side-effects of such failures are based more on myth than on hard evidence. Kaufman observes: (1) that individual bank failures are generally no more harmful to the economy than failures of other business firms; (2) that bank-run "contagions" leading to systemic failure have been extremely rare; and (3) that serious problems in the banking industry have mainly been due, not to anything inherent in fractional reserve banking, but to faulty government regulations, including the very regulations that are supposed to guard against systemic banking system failures. Kaufman provides ample support for all these claims, using evidence drawn mainly from modern U.S. experience.

Hearing these arguments, a reader might expect Kaufman to conclude that banking systems would function best if governments dispensed with regulation, including prudential regulations, altogether. Yet Kaufman does not draw any such conclusion. Instead, he continues his article by spelling out events and circumstances that might cause a systemic banking crisis, neglecting his own arguments and evidence showing the improbability of such a crisis. Kaufman goes on to defend a limited set of prudential regulations—the SEIR (Structured Early Intervention and Resolution) program—designed to "further mitigate the likelihood of systemic risk in banking" (p. 29).

How is it possible for Kaufman to argue so convincingly the lack of any evidence of genuine market failures in the banking industry, and the counterproductive nature of past government intervention in

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banking, and yet still conclude that some government regulation of banks is a good idea? A careful reading of Kaufman's article reveals the answer: Kaufman defends prudential bank regulation, not because he thinks that banking systems are inherently prone to systemic risk (where individual bank failures turn into systemwide runs), but because banking is widely perceived by others to be vulnerable to systemic risk. In short, banks need to be regulated because many people *believe* they need to be regulated. Regulation serves as a soothing, hence beneficial, placebo.

Thus Dr. Kaufman, the exploder of bank market-failure myths, undergoes metamorphosis to become Mr. SEIR, the pragmatic advocate of a modified package of prudential regulations. But can Mr. SEIR coexist with his alter ego? I think not. To do so, he would have to show that the "widespread perception" of systemic risk he repeatedly refers to is in fact self-validating—that is, that the beliefs in question are ones that will in fact make a banking system vulnerable to systemic failure in the absence of some government response.

Now, it is true that a perception of systemic risk that is widespread among bank depositors can be self-validating: if enough depositors become convinced that, say, the failure of any single bank is likely to trigger runs and failures among all banks, then systemic runs and failures can become a reality. However, it is precisely this bank-run "contagion" thesis that Kaufman so effectively demolishes, showing instead that bank runs "tend to be informational and bank specific" (p. 21). Experience, in other words, offers no grounds whatsoever for assuming a "widespread perception" among bank depositors that systemic risk is a serious problem. Bank depositors generally do not behave as if tormented by visions of a collapsing payments system. They therefore have no need for a placebo to relieve them of their hypochondriasis.

If the public generally is not losing sleep over the possibility of systemic risk, who is? The regulators themselves, that's who. I cannot help thinking that Kaufman, in arguing that some bank regulation is essential given widespread fears of systemic risk, has the fears of bank depositors confused with those of bank regulators. There is, of course, no doubt that bank regulators themselves (with rare and always off-the-record exceptions) think that systemic risk is a problem inherent in banking, so that some government regulation is necessary. (Members of any social group tend to embrace beliefs that place that group in a favorable light.) But regulators' publicly held beliefs are, unlike the beliefs of bank depositors, not obviously self-validating: a banking system is not actually vulnerable to systemic risk just because govern-

ment regulators believe it to be so, except to the extent that the regulators' own interventions have made it vulnerable.

The systemic risk "problem" to which Kaufman repeatedly refers is, in short, a "problem" that exists mainly in the minds of bank regulators who, as Kaufman notes (p. 40), "have been among [the problem's] most vociferous expositors and prophets." As such, the "problem" is educational, not financial; the solution therefore is to reveal the inconsistency of regulators' claims with the facts of experience, not to pretend that the claims are valid. Regulatory schemes, no matter how modest, should not be propounded just as a sop to bureaucrats, to avoid hurting their feelings or to enlist their support.

Unfortunately Mr. SEIR neglects the distinction, so carefully drawn by Dr. Kaufman, between regulatory propaganda and actual financial system problems. Kaufman is thus driven, by his pragmatic alter ego, to spend several pages (pp. 25–28) examining "The Causes of Systemic Risk" (as if systemic risk were a genuine threat, rather than a remote possibility made into a bogeyman by regulators), and several more offering "Public Policy Remedies" (remedies to a largely hypothetical problem, that is).

Consider for example how Kaufman concludes his review of the causes of systemic risk, by observing (pp. 27–28) that "If neither the running depositors nor the sellers of government securities perceive any bank in the country to be sufficiently sound to warrant a redeposit, then there will be a flight to currency. . . . In this scenario, banking becomes a special public policy concern." Well, it is also possible to come up with a scenario that would make midwestern earthquakes a special public policy concern. The question is whether the scenario is likely to play out in reality. Evidence gathered by Kaufman himself (Kaufman 1994) shows that a flight to currency is more likely than a major midwestern earthquake, but not much: currency runs have been rare in the past (the one major exception—the run on the U.S. dollar in the 1930s—was prompted by fears that the dollar would be devalued rather than by bank failures). Today, the fact that the dollar is freely floating, combined with the growing importance of nationally and even internationally diversified banks, makes a "flight to currency" less likely than ever.

Surely bank regulatory policies ought not to be promulgated in response to the mere possibility of a systemic crisis, if that possibility is remote. (We do not insist that skyscrapers in Kansas City be earthquake-proof, even though an earthquake might strike Kansas City.) To assume that government intervention is justified in banking so long as something might otherwise go wrong is to forget that government intervention itself often goes wrong, as Kaufman has so effectively

documented elsewhere (e.g., Benston and Kaufman 1995; see also Benston 1991 and Selgin 1989).

Given Kaufman's understanding that past regulations have generally been "counterproductive" (that is, have increased rather than reduced the likelihood of systemic failure), one would expect him to advocate a regulatory version of medicine's first Hippocratic commandment, "Do no harm." He might, for example, have started with the Federal Reserve itself, which over the last several decades has helped bankrupt large numbers of the nation's financial firms by subjecting them to dramatic changes in nominal interest and exchange rates. To be sure, Kaufman is well aware of the fact that central-bank inspired macroeconomic instability has been a major contributing factor in bank failures. Still Kaufman—in his Mr. SEIR persona—dismisses the suggestion that the Fed first put its own house in order, saying (p. 28) that "history has amply demonstrated that our current knowledge of macroeconomics is far short of what is required" to consistently avoid severe macroeconomic shocks. Granting that central banks do not have the knowledge needed to "fine tune" their economies, does it follow that they lack as well the knowledge to avoid the sort of drastic changes in nominal magnitudes that sounded the death-knell for so many U.S. financial firms? I do not believe it. What the Fed lacked until the 1980s was not knowledge, but political fortitude. And, if the Fed were in fact too ill-informed to know how to keep long-term nominal interest rates reasonably stable, how could we possibly expect it to be smart enough to implement and manage a reliable system of prudential regulations?

Kaufman skips over that dilemma in order to outline his own favored program for prudential regulation, which is based on the premise that "small" bank depositors should not suffer losses from bank failures, that is, the premise that "small" bank customers should not bear any adverse consequences from choosing to put their money into poorly managed banks. The first part of this program consists of "explicit full government deposit insurance" for such small depositors. Here again, Mr. SEIR prevails over Dr. Kaufman, passing up an opportunity to plead for the complete dismantlement of a regulatory arrangement which, in light of Kaufman's research, appears both theoretically unnecessary and historically disasterous. Regulators are therefore encouraged to continue offering something akin to the present insurance arrangement, with insurance limited to "small" depositors, on the grounds (1) that such depositors "are the most likely to run into currency and threaten systemic problems" and (2) that deposit insurance "is a political reality in almost all countries." The first ground neglects the crucial distinction between "most likely" and "likely";

the second neglects the distinction between "political reality" and economic good sense. (Twenty years ago high inflation, interest-rate regulations, and substantial barriers to branch banking were "political reality." Luckily, many economists—including Kaufman—did not make that fact a reason for adopting a complacent attitude toward any of them.)

It may be worthwhile to recall for a moment just how it is that deposit insurance became "political reality" in the United States. Before the Great Depression, the federal government did not insure bank deposits: several states had tried it, but always with unfortunate results. Federal deposit insurance was adopted in the course of the Great Depression, despite the poor record of state schemes, as a half-baked but politically "realistic" substitute for structural reform of the banking system, that is, for intrastate and nationwide branch banking. Insurance was rationalized on the false grounds that banks were failing because they were being run upon. The truth was, largely, the opposite: banks were run upon because they were failing, and they were failing in part because they were geographically underdiversified. Many experts at the time understood this, pleading for the elimination of restrictions on branching, while pointing out flaws inherent in government deposit insurance. Ironically, now that restrictions on branch banking have largely ceased being part of "political reality," deposit insurance itself has taken their place as a principal cause of structural weakness in the U.S. financial industry.

Kaufman does propose that deposit insurance premiums should be risk-based—a change that would eliminate many unfortunate consequences of insurance, including its tendency to transfer resources from less-risky to more-risky banks. But there are good reasons for doubting that such premiums either can or would be assessed by a monopoly provider of insurance. In practice government deposit insurance is toxic even in "small" doses.

Besides deposit insurance, SEIR involves a system of minimum capital requirements on banks. But there would be no need for such regulation of capital in the absence of deposit insurance which, as Kaufman and others have noted, acts as a substitute for private capital. SEIR also calls for sanctions that would punish banks as their performance deteriorates. Again, in the absence of explicit deposit guarantees, it seems to me that the market would dole out all the punishment needed to discipline bad banks, in some cases by confronting them with (non-contagious) runs.

Finally, SEIR requires an explicit "closure rule" to shut down banks before their net worth falls below zero. I see no harm in such a rule, but once again doubt it would be needed in the absence of other

regulatory procedures that presently keep insolvent financial firms on life-support. (Dr. Kaufman interjects here, by the way, that timely resolution itself makes deposit insurance "effectively redundant," supplying the reader yet another reason to wonder why Mr. SEIR insists on endorsing the continuation of such insurance.)

The last part of Kaufman's article looks at payments system risk. Kaufman outlines a payments system crisis—an "unwinding" scenario, where a major end-of-the-day default in the payments clearing process forces the reversal of a series of intraday transfers. He then goes on to consider various solutions, including (1) nationalization of all interbank clearings through Fedwire, where the Fed guarantees payment finality; and (2) simultaneous or real-time gross settlement.

Here again, I question both the likelihood of the imagined crisis actually occurring under private arrangements, and the efficacy of government interventions recommended to solve the purported problem. Why, in a private clearing arrangement, where payments are not guaranteed "final" until the end of the day (and where, as Kaufman says, promises of finality would not be credible anyway), should banks behave recklessly by treating intraday credits as equivalent to collected funds? Why would banks in such a private arrangement not hold precautionary reserves sufficient to cushion themselves against settlement defaults that may occur, reducing their exposure, and any consequent risk of "unwinding," to some reasonably small level? (What are reserves for, anyway?) What, precisely, is the nature of the market failure that supposedly justifies nationalization or regulation of the clearing system? And, finally, where is the empirical evidence of private clearing system failures? (The standard reply offers the Bank of New York computer glitch in 1985—an episode only a regulator could interpret as justifying drastic government intervention in the clearing system.) Frequently repeated statistics showing the large value of interbank transactions by themselves prove very little. What matters is not the value of such transactions alone, but their value relative to the value of reserves banks keep on hand as protection against default risk.

If the case against having a fully private interbank payment system is weak, the claim that either Fed guarantees of payment finality or a switch to real time gross settlement is better is even weaker. Instead of "solving" the problem of payments system risk by providing guarantees of finality, central banks that offer such guarantees (especially in combination with subsidized intraday overdrafts) merely reduce commercial banks' incentives to maintain adequate reserves or to limit interday lending and borrowing. The costs of (inevitably increased) defaults are then borne not by "the sponsors of the clearing facility,"

as Kaufman claims, but by the general public, through inflation. In other words, the government cure for the hypothetical disease of private clearing system unwinding has a moral-hazard side effect that may well be worse than the purported disease itself.

Because Kaufman understands the moral-hazard problems present in a system, such as Fedwire, that combines net settlement with central bank guarantees of payment finality, he proposes "simultaneous payments and receipts" or "real time gross settlement" as a substitute for net (end-of-the-day) settlement. Although it is typically presented as a very modern, high-tech approach to settlements, a real-time gross settlement system would in at least one sense be a step back to the middle ages, in so far as it would eliminate reserve-holding economies associated with net settlement. (Central banks have reason to welcome the idea, because it increases the demand for base money and, along with it, their seigniorage earnings.) To state the point another way, although gross settlement eliminates any risk of systemic failure related to the "unwinding" problem, it also subjects individual banks to large intraday reserve losses, thereby increasing their exposure to settlement default unless they compensate by starting each day with a much higher balance of prudential reserves. We thus have another example of a "solution" to a potential flaw in market arrangements that is itself not merely potentially but actually flawed.

In criticizing Kaufman's policy recommendations, I do not at all mean to suggest that they would be anything short of a vast improvement over existing regulatory arrangements. Nevertheless, Kaufman's seemingly harmless placebo—no less than the present, more toxic, regulatory arrangements—perpetuates the myth that banking systems are inherently crisis-prone, and that only a regulatory cure can help. This is a bad thing, because it diverts attention from the fact that every sickness ever suffered by the U.S. financial system has been the consequence of some toxin administered to it by the government, usually in the guise of medicine. Take U.S. banks off this quack regimen. Give them a stable macroeconomic environment (meaning, simply, low inflation), the ability to branch freely, and freedom from portfolio regulations; subject them to open competition with foreign-based firms, and assign them full responsibility for meeting their own obligations to their customers. Then you will have a healthy U.S. banking industry. That, at least, is the cure implied by Kaufman's painstaking empirical research. I only wish the good doctor would prescribe it.

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