It’s easy to make bank deposits safe, at last

It’s sometimes better to keep things simple, and banking is a good place to start. Over the years, banking regulation has become more sophisticated, including a range of requirements on asset holdings, the regular running of stress tests or the redaction of living wills. Each of these measures makes sense. But the recent banking crisis, which may not be over yet, shows the limits of regulation. The talk now is about refining rules et enhancing supervision, adding new layers over previous layers so that the previous crisis would not have occurred. All fine, but what about the next crisis?

At the risk of excessively simplifying, it is worth noting that banking crises really matter because they affect masses of innocent bystanders. Almost everyone holds a bank account and uses it through various means of payments many times a day for small and large expenditures. For this reason, bank accounts are a public service. This unglamorous part of banking should be treated as such. The plumbing part of payments works reasonably well, which is why cryptocurrencies do not take off. What does not work well, is the regular occurrence of crises, which are unavoidable because other banking activities are inherently risky. As is well known, any event with a positive probability of occurrence will occur for sure if we wait long enough. Bringing to zero the probability that deposit-taking banks fail should be the aim of any reform to come. This is simple to achieve: deposit-taking banks should not be allowed to use the money collected from customer deposits to make loans. This routine activity is called maturity transformation because deposited money can be withdrawn at any time, but banks are stuck with loans that will not be paid back for a while. Maturity transformation is inherently risky because a bank facing a run on its deposits systematically fails.

Making deposit-taking banks 100% safe is not the route taken so far. Most people equate banking with maturity transformation and regulation is designed to reduce the risk of crisis and to make banks able to withstand the risks. Asset requirement regulations do that and deposit insurance limits means that the innocent bystanders are protected, up to a limit. We have seen, one more time, that even insured depositors run when alarmed by rumors of possible bank failures. We have also seen that many depositors hold more money than the insured amount so that they have a good reason to run. The theory is that they should monitor their banks, but they don’t. In fact, they can’t, unless the supervisors do it for them and make the relevant information public, which they don’t and probably can’t. Anyway, no matter how good regulation and supervision are, any bank may fail, for good or bad reasons.

The only definitive solution is for the public service of bank deposits to be safe, with zero probability of failure, except for unlawful behavior. That requires eliminating maturity transformation, by requiring that banks that take deposits from its customers invest the proceedings into safe liquid assets such as deposits at the central bank or short-term treasury bills. This is the concept of narrow banks. It is not new, drawing back about a hundred years and backed by luminaries such as Irving Fisher or Milton Friedman. A substantial literature has been devoted to narrow banking. So far, this idea has never been accepted, for two main reasons.

One reason is that it is not profitable. Safe assets yield low interest while running deposits is costly. Now that most central banks serve interest on commercial bank reserves, it may not be as unprofitable as it used to be. If that still is the case, the banks providing this public service

should be rewarded by the state in the form of a subsidy. An alternative is for deposit banking to be provided by a state entity, but it is likely to be less efficient, and therefore more costly, than when it is provided by a number of competing private actors. The level of subsidy should be such that it is enough to allow for enough competition.

Another reason is that a significant portion of private savings would not be available for lending, possibly reducing productive investment and growth form lack of maturity transformation. This argument is probably wrong. Narrow banks would coexist with 'normal' banks, which would take in unsecured deposits, that they would remunerate competitively, and transform them into loans and investments. These banks would operate as all banks do now, with the same kind of regulation and supervision. Depositors in normal banks would know that they are taking risks. If these banks fail, the impact would not be systemic in the sense that countless innocent bystanders are hurt. In fact, there would be no innocent bystanders. Would savings be reduced? With quantitative easing, we have now experimented with large excess reserves. Central banks have learned how to provide banking systems with vast amounts of liquidity and to achieve any interest rate that they wish. They could lend to normal banks whatever deposits they receive from the narrow banks. This would not be inflationary since the narrow bank deposits would not be recycled as loans since they would be used exclusively to carry out payments. They could increase and sustain more spending when depositors take up loans from the normal banks, but lending would remain under central bank control.

This is a reminder of the 1933 Glass-Steagall Act in the US, which separated deposit-taking from investment banks, but still allowed deposit-taking banks to lend to their customers. It was repealed in 1999. Other proposals would allow banks to both take deposits and to invest but require that these activities be separated by a Chinese wall. These arrangements fail to make deposits 100% safe. They are inspired by the view that deposits are a source of reliable and cheap funding for banks, which allow them to offer attractive loans. These deposits are not reliable, they are subject to arbitrary runs. True, they are cheaper than borrowing from the central bank, but that is only because normal banks use their monopolistic competition power to not offer decent interest to their depositors. They use cheap deposits to cross-subsidize their risky operations. This is certainly inefficient, as it runs against the widely held view that risk must be remunerated and borne on a case-by-case basis, not across asset classes.

Proposals to establish narrow banks flourish in the aftermath of banking crises because, each time, we wonder why the latest one occurred. They have been studiously ignored so far because, each time, the instinct is to improve on existing regulation and supervision. And, each time, we leave banks open to a nonzero risk of runs. After the 2008 crisis, the then-governor of the Bank of England, Mervyn King, stated that banking should heretofore be 'boring'. Surely, narrow banking is boring, but it can and should coexist with glamorous normal banking.