Opinion

In defense of «narrow banks»

To prevent bank runs, a system change to maturity-congruent banks a.k.a. narrow banks is recommendable: These keep all their deposits in the form of reserves at the central bank. In addition, «normal» commercial banks could continue to offer their services.

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We just had a new bank crisis, a small one that did not spread much for the time being. This could not have come as a surprise. As central banks raise interest rates following a long period of very low for very long levels, something had to happen. Too many commercial banks had grown accustomed to the situation and adopted strategies that made sense at the time. Even though the central banks were bound

and would get caught. The real surprise is that so few have suffered the consequen-ces up to know.

Judging from reactions by policymakers, they take these events seriously. Yet, it is worrisome that the discussion is mostly about finetuning existing regulations and strengthening supervision. In contrast with 2008, which was a solvency crisis, the current one is a liquidity crisis. Silicon Valley Bank, First Republic Bank and Credit Suisse were solvent, until they were doomed by deposit withdrawals. The apparent paradox is that bank failures have occurred in the midst of a sea of liquidity created by QE. This is a reminder of a very old understanding that no bank can survive a wave of deposit withdrawals.

The current mantra was, and still is, that the banks are resilient. They are subject to regulations that impose large loss-absorbing capacities and the larger ones are subject to frequent stress tests as specified by their supervisors. But we don't need stress tests to see what happens when deposits are being withdrawn suddenly, we know that it is the end, no matter how resilient the banks are. What we don't know is why bank depositors suddenly run. It may be because of good reasons or it may be because of unfounded rumors. In the end, it does not matter, because it is bound to happen again and again, as has happened since banking was invented centuries ago.

Money is a public good

The challenge should be to eliminate bank runs or, if they still happen, to make sure that depositors will be made whole. This should be the purpose of any response to this crisis. When all bank depositors, households and firms, need to routinely use money, money is a public good. It can be provided publicly in the form of 100% secure cash – maybe one day CBDC, but this is another story. Most of the money is privately provided by commercial banks, and it is not secure at all, at least above the part that is guaranteed.

The standard logic for not guaranteeing large deposits is that it is incumbent upon large depositors to monitor their banks, but they don't and they can't, just think what the supervisors can and do. The US Treasury has implicitly accepted that this logic is deeply mistaken when it wondered aloud whether to guarantee all deposits, a tempting way to reduce the risk of bank runs. But, even leaving aside the costs of this measure, which would be paid ultimately by depositors, we must think about moral hazard, the inescapable consequence of any insurance scheme. Banks would surely be happy to take more risk if bank runs become very unlikely.

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There is a better way to rule out bank runs. The idea is not new. It is nearly one century old, having been promoted after the Wall Street crash by Irving Fisher and many others under the name of the Chicago plan. It envisions «narrow banks» that keep in the form of reserves held at the central bank all the money that they collected as deposits. Narrow bank deposits are strictly the same as cash, except that they are much more practical for storage and everyday use. Competition would determine whether interest is paid on deposits.

Not a very profitable business

Narrow banks would coexist with normal banks that do what they do now, so that the whole range of existing and possible future banking services would be on offer. Now and then, some normal banks would fail, but this would be of limited concern. Nowadays, a failing bank is a direct threat to uninsured bank deposits, which challenges the perceived safety of money by customers, most of whom are unaware of how deposit guarantees work. In the new arrangement, money deposited in narrow banks could not be affected, while depositors could not ignore anymore that normal banks are risky and prone to runs.

They would turn to normal banks exclusively for financial reasons. They would borrow and they would invest, including in interest-yielding deposits and other instruments on offer, accepting the associated risks. To be sure, normal bank failures could still be highly disruptive, pretty much like financial market crises, but the latter are a magnitude less threatening than banking crises.

Why has such a simple solution never been adopted? Even the Glass-Steagall Act did not go that far since deposits banks were still allowed to grant loans. One reason is that narrow banking is not very profitable since the only source of income is the spread between the remuneration of reserves at the central bank and the zero interest paid to depositors. This problem can be solved through subsidies, possibly stable interest on reserves. It would be reasonable to pay narrow banks to offer the public good of safe money and transaction services.

It’s about how overall financial risks are shared

A more serious objection is that part of national saving would be removed since deposits at narrow banks would not be available for maturity transformation. Indeed, at the end of January 2023, fully liquid bank deposits in the euro area amounted to €9.741 trillion while total credit to households and firms stood at €15.423 trillion. Even if a significant part of liquid deposits would migrate to normal banks, the shortfall would be large. However, the normal banks could still finance the same volume of loans by borrowing from the ECB.

This would increase their costs, including the need to offer customers higher interest on their deposits. Everything else remaining equal, bank lending could become more expensive. But everything else would not remain the same because the central banks would adjust their policy rates to achieve their desired stance. In addition, regulation should be adapted, reducing liquidity requirements while emphasizing resilience.

Banks are bound to strongly object to giving up access to cheap and usually stable financing. They would also have to compete more directly with other financial institutions. Quite probably, the financial sector would be profoundly transformed. The issue, however, is not about specific private interests, rather it is about how the overall financial risks are shared. At present, the vast majority of households and firms are exposed to risks that they do not take and are not even aware of, which in practice means that they need to be protected, if need be at taxpayer's expense. Once these depositors have parked their money in safe narrow banks, the overall financial risk will be borne by the minority of households and firms that willingfully choose to play the financial game. It is not just fair, it is also efficient.

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0 Kommentare