

# UNREGULATED BANKING

*Also edited by Forrest Capie and Geoffrey E. Wood and published by  
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**FINANCIAL CRISES AND THE WORLD BANKING SYSTEM  
INTERWAR MONETARY EXPERIENCE**

# Unregulated Banking

## Chaos or Order?

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# Foreword

If any industry requires regulation it might be thought to be banking. The proposal for unregulated banking is the sort of thing one might expect from the very fringe of free market economics. But there is more to it than that.

In the US regulation of interest rates was one of the original causes of the current financial plight of the savings and loans industry. Further, the US regulations which have stopped banks from spreading risk, by diversifying either into other states or businesses, may have contributed to certain financial problems. Launches of lifeboats to rescue an individual bank have also led to the well-known problem of *moral hazard*. Also, regulators can hinder the private sector from assessing credit risk; if information is not published, the private sector may have no option but to rely on the regulator, and claims for compensation are bound to occur if a regulator slips up. More generally, there is considerable evidence from other industries that regulation ends up protecting producers rather than consumers; industries tend to encapture their regulators.

Whereas there may be doubts about the efficiency of banking regulation in general, surely the lender of last resort function of a central bank is above reproach? Even here it is possible that control of a central bank's own balance sheet might prevent financial bubbles from building up and, therefore, subsequent bursts and crises; such control might avoid the creation of the macro-financial conditions under which a chain reaction cannot be prevented if an individual bank is allowed to fail. But it would still be wise to retain a lender of last resort.

Finally, if competition between currencies is valid for Europe, is there a case for allowing competition within a country? Heresy!

The Midland Montagu Centre for Financial Markets was pleased to have underwritten the Conference. Do read this provocative book. The papers and the discussants' critical comments will stimulate thought.

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# Notes on the Contributors

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**Michael D. Bordo** is Professor of Economics at Rutgers University. He previously taught at the University of South Carolina (1981–9) and Carleton University (1969–81). Professor Bordo has published widely in major journals concerned with monetary economics, economic history and international finance, and has authored or co-authored several books. A Research Associate at the National Bureau of Economic Research since 1982, he also serves on the editorial board of two leading journals in economic history. He has a strong interest in economic policy. He was a visiting scholar at the



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**Charles A. E. Goodhart** is the Norman Sosnow Professor of Banking and Finance at the London School of Economics. Before joining the LSE in 1985 he worked at the Bank of England for 17 years as a monetary adviser, becoming a Chief Adviser in 1980. Earlier he had taught at Cambridge and LSE. He has written two books on monetary history; he has just revised his graduate monetary textbook, *Money Information and Uncertainty* (1989), and his institutional study *The Evolution of Central Banks*, was revised and republished (MIT Press) in 1988.

**Sir Peter Middleton, GCB**, is currently Permanent Secretary to the Treasury. He graduated from Sheffield and Bristol Universities. In 1962 he joined the Treasury as Senior Information Officer; in 1967–9 he was Assistant Director, Centre for Administration Studies; during 1969–72 Private Secretary to the Chancellor of the Exchequer; from 1972 to 1975 Treasury Press Secretary; in 1975 Head of the Monetary Division; and in 1976 Under Secretary. A Member of the Council, Manchester Business School, from 1984 he has been Governor, London Business School and from 1985 of the Ditchley Foundation.

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**Lawrence H. White** is Associate Professor of Economics at the University of Georgia. He is the author of *Free Banking in Britain* (Cambridge University Press, 1984), *Competition and Currency* (New York University Press, 1989), and numerous articles in professional journals and conference volumes. Dr White is presently at work on a book to be entitled *The Theory of Monetary Institutions* (Basil Blackwell).

**Geoffrey E. Wood** is Professor of Economics at City University, London. A graduate of Aberdeen and Essex Universities, he has taught at the University of Warwick, and been a member of the research departments of the Bank of England and the Federal Reserve Bank of St Louis. He has also written or edited several books, and is the author of over fifty articles on monetary economics.

# Introduction

The EC's Second Banking Directive (of 1988) has two aspects. There is a 'home country' rule for bank authorization, while 'conduct of business' rules are determined by the host nation. The distinction between the two types of rule is made very clearly in the report of the House of Commons Trade and Industry Committee (1989):

Regulatory régimes comprise two main components. First, arrangements to review the 'fitness and properness' of a firm's management; and to ensure that a firm has adequate financial resources – in terms for example, a capital and liquidity – to support the volume and character of the business it is undertaking; and second, a body of principles, guidelines or rules governing the relationship between the firm and its customers and the market (so-called 'conduct of business' rules). The regulatory requirements can distinguish between those who can be expected to look after themselves and the less sophisticated investors who cannot.

That report went on to argue. 'To harmonise all conduct of business rules will be a long process since they are deeply rooted in local law and custom. The UK has therefore taken the view that conduct of business rules of this type should remain the responsibility of the host state, pending an adequate degree of harmonisation.'

Originally a simple 'home country rule', which would permit an EC bank to do anywhere in the EC whatever it was allowed to do in its home country, was proposed. The likely implications of this for the structure of the banking industry in Europe would have been considerable. But would the changes enhance or diminish the stability of that industry? What would the regulatory implications of the changes be? This conference considered the issue of regulation in banking and examined different historical experiences with types and extent of regulation. Understanding these experiences is of great importance in planning future regulation, and changes in regulation, of banking.

In this introductory chapter we first consider why banks are regulated. That leads to an examination of what restrictions bank regulators impose, and then to problems regulators face. First, a

definition of regulation is useful. George Stigler has provided a most useful one. It is, 'any policy which alters market outcomes by the exercise of some coercive government power'. Two features of that definition are worthy of note.

It distinguishes clearly between influences on outcomes by coercion and by incentive – tax and subsidy policy may well be intended to 'influence market outcomes', but it is not regulation. Second, and very important, it contains no hint of the *direction* of influence (towards or away from a competitive structure), or of who its beneficiaries might be.

Both features are important. The first narrows the area of discussion most usefully. The second reminds us that there are two sharply contrasting theories of regulation. What is best thought of as the economist's traditional view of regulation has recently been set out very clearly by John Kay and John Vickers (1988). They sum up the traditional view by a simple maxim: 'Competition when possible, regulation where necessary' (p. 287). Regulation, in that view, seeks to identify market failures that prevent an industry from functioning competitively, and to correct these failures.

Regulation can thus be of either structure or of conduct. There can be regulation by some public authority, self-regulation, or regulation within a statutory framework. But whoever does it, and whether it be of structure or of conduct, regulation should on this view be targeted on market failure. That is of course a normative theory of regulation – it tells us what regulation 'ought' to do.

The second approach is identified particularly with George Stigler. He asked, in a pioneering series of studies (e.g. 1962, 1964, 1971), what regulation actually achieves. Who does it benefit and who does it harm? Over a wide range of industries (not, it is worth emphasizing, including banking) he has found that regulation was either totally ineffective or worked to the benefit of existing firms in the industry. It did not eliminate harmful market failures. These results have led to the view that regulation, ostensibly intended to benefit the consumer, is often encouraged by producer groups as a way of restricting competition.

Both views of regulation are worth taking seriously; both yield predictions on the scope of regulatory constraints on the financial sector. Before we turn to discussion of these approaches, however, it is useful to consider just why that sector of the economy is thought to be so special.

## WHY BANKS MATTER

It is useful to clarify why there is concern with banks to a much greater degree than with other firms. The basic reason is that the failure of one bank can lead to the failure of another, perhaps the collapse of the whole system, and, via the working of the money multiplier, a collapse in the stock of money. This chain of events comes about because depositors are led to fear that their bank is not safe if they see one bank failing. They therefore fly to cash, and, as banks operate on a fractional reserve system, banks which are solvent, and liquid enough for normal times, are brought down by a surge in the demand for liquid money.

This danger was diagnosed, and the remedy set out, in the nineteenth century. Henry Thornton provided a clear but uninfluential statement of what to do. Subsequently Water Bagehot, by a series of articles in the *Economist*, and subsequently in *Lombard Street*, persuaded the Bank of England to act as 'lender of last resort'. This implies lending cash *on security to the banking system* in the event of a run for cash on the part of the public.

A vivid description of a central bank acting as lender of last resort is provided by Jeremiah Harman, a director of the Bank of England at the time of the panic of 1825:

We lent it (i.e. gold) by every possible means and in modes we had never adopted before; we took in stock on security, we purchased Exchequer Bills, we not only discounted outright but we made advances on the deposit of bills of exchange to an immense amount, in short, by every possible means consistent with the safety of the Bank, and we were not on some occasions over nice. Seeing the dreadful state in which the public were, we rendered every assistance in our power (quoted in Bagehot, p. 73 of the 1873 edition).

This policy worked then, and has worked subsequently. There is no need for central banks to go further, and engage in supervision and regulation to maintain the stability of the banking system. Such detailed inspection of banks is necessary to prevent moral hazard only if individual institutions are implicitly underwritten by the central bank, and it is a crucial part of the 'Bagehot Rule' that they are not. Why, then, are banks regulated?

## REGULATION

### The Traditional View

Traditional analysis distinguishes between externalities and market power as sources of divergence from the competitive ideal (see Bator, 1958). More recently, asymmetric information has been added as a third source of market failure. These information problems are the principal rationale for the regulation of financial services. But there are also important externalities in this area. There is one between customers, and another, closely related to the first, between firms.

If a large number of depositors all simultaneously seek to withdraw their funds from a bank, there is a possibility that the bank will have insufficient funds to meet their claims. There is a clear negative externality between depositors – one gains at the expense of another. Indeed, two sources of market failure are endemic to the financial system.

There is almost inevitably asymmetric information between buyers and seller – a bank management knows more about its balance sheet than even the best-informed depositor. Second, there is considerable benefit to the economy as a whole in sustaining confidence in the financial system. The maintenance of confidence in the banking system and the avoidance of bank runs are major benefits to the nation at large. (Any doubts on this are readily dispelled by reading Milton Friedman and Anna Schwartz's account of the consequences of a wave of bank failures in the United States. See Friedman and Schwartz, 1963, ch. 7.)

In terms of encouraging confidence in the system, and promoting its stability, the above argument would seem to point the following conclusions. Structure should be regulated so as to enhance the stability of the key elements of the banking system – these being banks which take deposits from the public and are responsible for maintaining the money supply. Measures of capital adequacy should therefore be developed, and attention devoted to developing measures of the riskiness of *portfolios*, i.e. both assets *and* liabilities. Deposit insurance could be important. There should be rules for capital adequacy because of the existence of externalities. We may wish to encourage competing regulatory domains, for consumers can then choose where to buy these services. There could be self-regulation; reputation is an investment, but self-regulation may be

required to produce adequate investment in it because of the externality aspects.

This view sees regulation as a way of eliminating or reducing market failure. The alternative view sees regulation, whatever its intentions, as in fact *producing* market failure – of producing monopoly profits. How is that done? The essence of monopoly is that new entry is difficult – in the (rare) case of natural monopoly, impossible.

### **The Stiglerian approach**

How could a regulatory regime discourage new entry to banking? There are three obvious routes, again concerned with regulation of structure and regulation of conduct. Essentially, all would operate to make entry, except on a large scale, very difficult.

Structure regulation would allow nationwide branching. With nationwide branch networks to compete against, a small entrant to commercial banking would find it difficult to threaten well-established firms. Substantial capital adequacy requirements would exercise a similar deterrent effect. There should be a good measure of self-regulation, for the existing members could make entrance to the club difficult. Thus it appears that self-interest would plainly lead to regulatory proposals similar in outline to those that would be produced by public interest.

## **THE QUESTIONS**

This brief review of the area leads to two main sets of questions. The first is plain. Bank regulation generally takes the form that self-interested monopolists would desire. Lender of last resort action, admitted so far as necessary, does not require supervision and regulation. So why is there supervision and regulation? Does it achieve some ends more widely desired than the protection of monopoly? Does it contribute in some way to the stability of the banking system?

Several of the papers in this volume address these questions by looking at particular episodes. See the papers by Lawrence White, Eugene White, Kevin Dowd, and Hugh Rockoff. George Benston also takes up these questions, and, on the basis of study of a range of US experience, directly asks the question, ‘Does regulation produce stability?’



There is also, however, another question concerning the stability of the banking system. The above discussion accepted that a lender of last resort was necessary to prevent financial crises. Several authors have recently argued that it is not; and that, indeed, monetary performance has been worse when a central bank is present than when it is not. Charles Goodhart focuses exclusively on this question; and discussion of it is also contained, with regard to particular episodes, in the papers by Lawrence White and by Eugene White, and by Hugh Rockoff.

Having thus outlined the main lines of discussion in this volume, we turn to a brief outline of the individual papers.

## THE PAPERS

In 1984 Lawrence White published his book *Free Banking in Britain*, a book that helped stimulate closer examination of the experience of free banking in Scotland. The traditional view of Scottish banking in this period was that its financial institutions and practices were essentially those of an unregulated free-market monetary system, and White lent support to this in his elegant study. The view did not go unchallenged. Critics offered alternative interpretations, pointing to the fact that important Scottish banks and the Bank of England played quietly controlling roles.

Lawrence White's paper in this volume tackles some of the previous criticisms. It accepts that some of them have been useful in drawing attention to special features of the Scottish case. But White insists that the traditional contrast between the restricted English system and the free Scottish system is warranted. The latter was competitive and efficient. The Bank of England was not a lender of last resort to the Scottish system before 1844, and neither was it a central bank in the sense of providing a reserve base of high-powered money held by the Scottish banks. At the very least from 1810 to 1844, Scottish banking fits the free banking model.

One of the principal areas of contention is the degree of difference between the Scottish and English systems. It may be that it comes down essentially to the limitation imposed on the English system by virtue of the six-partner law. But that may nevertheless be of considerable importance.

Eugene White draws our attention to the somewhat surprising fact that in Revolutionary France there are examples of free banking. In

the 1790s the revolutionaries failed to balance the budget and issued assignats. But there was a need for small denomination currency and the need was met by the organization of *caisses patriotiques* (patriotic banks) where the assignats could be exchanged for notes of smaller denomination.

These banks flourished in the laissez-faire climate of the revolution, when old regime regulations were eliminated. There were more than 1600 banks of this kind by 1791 with a substantial note issue. They quickly moved from being 100 per cent reserve banks to a fractional reserve system, and they enjoyed almost complete freedom to operate. White exonerates these banks from many of the charges that were laid at their door. There was counterfeiting but only on a small scale, and there was fraud, but again nothing that the reputable banks could not cope with. But most important of all he exonerates them from the charge of being the basis of inflation. Proponents of free banking argue that such a system should help to stabilize the price level. There was galloping inflation in the 1790s in France and the banks were an easy target, but White has shown that the chief cause of inflation was the excessive issue of assignats – the outside money of the system.

An interesting feature of the French experience is that, unlike the Scottish experience, it took place without the discipline of a commodity standard. The implication is that if only the authorities controlled the issue of outside money, the system could indeed be stable, competitive and efficient and deliver price stability.

The English banking system that evolved in the nineteenth century has provided the model for many countries around the world since. It was a three-tiered system, with the Bank of England at the top, and the discount market as a sort of buffer between that and the commercial banking system. The banking system moved from one of many hundreds of small units at the beginning of the century to one of a few dominant large banks, headquartered in London, with hundreds of branches scattered across the country. It was undoubtedly stable, in part as a result of this structure, which allowed a completely diversified portfolio. Behind this stood the Bank of England, which accepted the role of lender of last resort somewhere around the early 1870s.

At the beginning of the nineteenth century there were various pieces of legislation that set the framework for the system to operate within. But there was considerable freedom, and the banking oligopoly that evolved by the end of the nineteenth century took on the

appearance of a club that disciplined errant members – a form of self-regulation. It is Dowd's argument that this system did not evolve naturally as the optimal solution to the needs of the nineteenth-century economy, but rather that legislation was important, and it was provided by a state desiring a certain outcome.

Implicit too in Dowd's argument is that the periodic crises that characterized the nineteenth century might have been avoided had a freer system been allowed to develop.

Hugh Rockoff considers America's experience with banking in the nineteenth century, concentrating particularly on the decades immediately preceding the Civil War. This period was chosen because, he observes, it contains in an actual banking system some of the features which are being discussed, and in some cases held up as desirable models, by theorists who are examining and proposing monetary reforms.

His study of this period leads him to consider whether it is desirable to return to 'free banking', i.e. to a completely unregulated system. His conclusion is that the evidence is neither wholly in favour nor wholly against. There were plainly some good features of the banking system in this period. Growth of the monetary base was, in this phase, controlled by a 'semi-automatic mechanism' – the bimetallic standard. This produced growth of the base which was both steadier and slower than has been the US experience with fiat money.

A notable example of this experience, supposedly highly inflationary, was the 1850s' gold rush. High Rockoff observes that this produced monetary base growth scarcely faster than the 1980s in the US. His conclusion from this evidence is that, whatever the details of microeconomic regulation of the banking system, the constraint provided by the monetary base should be regulated by a monetary rule.

A second feature of the period was the absence of a lender of last resort. Here the verdict is less favourable. The crises of 1857 led to a severe recession and a wave of business failures. But against this, systems with extensive bank branching were for all practical purposes unscathed by that episode. Branching certainly ameliorates bank panics; whether it eliminates them cannot, however, be demonstrated. (This conclusion is, of course, in accordance with the UK experience. For discussion of this see Schwartz (1986).) In contrast to the present, banks could (and did) issue currency. Rockoff suggests this proved to be an attractive feature of the system. Of particular importance, it dampened the effects of changes in the note-to-money

ratio on the money stock. Like now, the system also protected the unsophisticated. The method, however, was different; part of the money stock was collateralized.

Finally, and very important in view of the restrictive form regulation takes, there was free entry to banking. This, he suggests, certainly facilitated the development of New York as the main financial centre and Chicago and New Orleans as regional centres.

The Lender of Last Resort, whose importance was accepted by Rockoff on the basis of his study of one period, is the focus of Charles Goodhart's paper. He concludes that a lender of last resort is indeed essential. Before setting out the main points of his argument it should be observed that his concept of a lender of last resort is somewhat different from the classical, Bagehotian, one. Bagehot thought the central bank should lend *to the market* during a panic – that is, it should lend on security to whoever brings in the security. Charles Goodhart believes it should bail out individual institutions. This possibly quite major distinction is taken up by his discussants. His paper starts by observing that the traditional case for a lender of last resort may have a major weakness. The case is that because bank deposits are redeemable into monetary base on a first come first served basis, any doubts over the value of the bank's portfolio will lead to a run for cash, as banks hold, and are known to hold, only a small fraction of their assets as cash.

This argument can be circumvented by requiring bank asset portfolios to be continually marked to market, with supervision such that banks are always closed before their own capital is exhausted. This prompt closure would protect depositors. Depositors, meanwhile, aware of this protection, would not panic and there would be an end to bank runs.

His response to this is that banks cannot behave in the way described. They cannot do so because they serve in part to make loans where no market exists – so these assets at least cannot be marked to market. He observes that bundles of such loans are starting to be gathered together and 'securitized', but notes that the scale is still small, and shows signs of remaining so. Banks, he therefore concludes, cannot be made run-proof. Does this matter? He concludes that it does. A wave of bank failures will cause a severe monetary contraction, and induce a debt-deflation spiral. Accordingly, then, waves of bank failures should be prevented.

His review of ways of doing this leads to the conclusion that only a lender of last resort can serve. Clearing houses can help provide

stability, but, he argues, only to some extent; and in addition they can and often did act as barriers to entry.

Accordingly central banks are necessary. They act as lender of last resort and, in addition, he argues, can regulate banks so as to prevent the kind of behaviour – running herd-like after apparently profitable opportunities – that can cause banking crises. (He notes they need not have greater wisdom than commercial banks to prevent that but only a different incentive structure.) But their primary function, one restated in his conclusion, is not regulation but provision of lender of last resort facilities. Goodhart's arguments lead him to conclude that central banks are essential for the stability of a banking system.

George Benston's paper complements that by Charles Goodhart, in that it focuses on regulation. It starts by distinguishing two aspects of stability: systemic and the stability of individual banks. The effect of the failure of individual banks on the stability of the financial system is considered first. This leads to the conclusion that the central bank alone can maintain systemic stability. Although individual bank failures may set off runs that result in multiple bank failures, this outcome can be prevented by central bank actions, even when very large banks fail. The role of the Federal Reserve in preventing systemic collapse is then analysed and found wanting.

Payments system risk also is considered. Regulations that restrict branching have given the Fed a monopoly over nationwide cheque clearance, which George Benston concludes has exacerbated the risk.

Regulation affects individual bank stability in four main ways: constraints on diversification, effects on profitability, limiting opportunities for and attitudes of bank owners and managers toward risk taking or avoidance, and monitoring and supervising to prevent fraud and grossly incompetent management. Each of these influences is discussed. The general conclusion is that regulation tends to be destabilizing because diversification is restricted, profitability is reduced, and risk-taking is encouraged (as a consequence primarily of deposit insurance). While supervision may be necessary, it has not generally been adequate.

Finally, alternative explanations for regulation are considered. This part of the analysis lends support to the Stiglerian view of regulation. Benston points out that regulation preceded concern about financial stability by several centuries. What prompted such regulation? He suggests it was a way of capturing seigniorage; it increased bank profits, and thus gave a bigger tax base.

He also reviews some recent arguments, such as the need to encourage economies of scale, and the desirability of providing banking to particular groups and to ensure that there is lending to particular groups or areas. None of these arguments for regulation, he finds, can be supported by evidence. His conclusion is that 'regulation is imposed to redistribute wealth to those with political power'.

## OVERVIEW

At the opening of this introduction we raised two main questions. Is there a role for bank regulation? And is a lender of last resort necessary? The answer provided by these papers is clear cut to the first. Regulation seems to bring very few benefits, and is costly. Only a limited defence of it could be presented. The answer to the second question is less clear. Several papers concluded that a lender of last resort was necessary. But it was observed that institutional features, such as nationwide branching, can sharply reduce the frequency with which such lenders may have to act. In addition, it appears that one episode, that studied by Eugene White, found a stable banking system operating well in most difficult circumstances without a lender of last resort.

The papers in this volume plainly have important implications for the future of bank regulation and banking system structure.

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