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FINANCIAL CONSOLIDATION: DANGERS AND OPPORTUNITIES

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ABSTRACT

This paper argues that although financial consolidation creates some dangers because it is leading to larger institutions who might expose the U.S. financial system to increased systemic risk, these dangers can be handled by vigilant supervision and a government safety net with an appropriate amount of constructive ambiguity. Financial consolidation also opens up opportunities to dramatically reduce the scope of deposit insurance and limit it to narrow bank accounts, thus substantially reducing the moral hazard created by the government safety net. Reducing the scope of deposit insurance, however, does not eliminate the need for a government safety net, and thus there is still a strong need for adequate prudential supervision of the financial system. Moving to a world in which we have larger, nationwide, diversified financial institutions and in which deposit insurance plays a very limited role, should improve the efficiency of the financial system. However, it is no panacea: the job of financial regulators and supervisors will continue to be highly challenging in the future.

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In the United States, we are currently in an era of rapid financial consolidation which is leading to larger financial institutions engaged in more diverse activities. I will argue that although this process of financial consolidation exposes the U.S. financial system to some important dangers, it opens up exciting opportunities for reform of the financial system that can enhance its safety and soundness.

I.
Some Basic Facts About Financial Consolidation

Before discussing the dangers and opportunities arising from financial consolidation, it is worthwhile to recount a few basic facts that outline what is happening in the financial services, and particularly in the banking, industry. We start by examining consolidation in the number of banking institutions and then examine the consolidation that is taking place across financial service activities.

Consolidation of Banking Institutions

From the 1950s until the 1980s, the number of commercial banks was quite stable, numbering between 13,000 and 15,000, while the number of thrifts (savings and loans and mutual savings banks) remained between 3,000 and 5,000. The first phase in the decline in the number of banking institutions occurred when the banking industry hit hard times in the 1980s and early 1990s. From 1980 until 1992, the number of commercial banks declined from over

14,400 to below 11,500 while the number of thrift institutions went from over 4,300 to 2,400 (Figure 1). Banking consolidation in this phase was driven by low profitability of the industry, which led to industry exit.[1]

With the return of the banking sector to profitability in the in the early 1990s, banking consolidation was driven by the continuing need for more cost-effective distribution networks and the entry of banks into new activities which increased incentives for the formation of larger banking units. This process was further stimulated by deregulation of restrictions on both interstate and within-state branching, culminating in the passage of the 1994 Riegle-Neal Interstate Banking and Branching Efficiency Act (IBBEA) which eliminated the restrictions on nationwide banking.

From 1992 until 1997, the number of commercial banks has fallen from 11,500 to 9,200 and with the advent of nationwide banking, the number of commercial banks is expected to fall to around 4,000.[2] At the same time the number of thrifts has declined from 2,400 to below 2,000. With the shrinkage of the number of banking institutions, individual banking organizations are getting larger and the banking system is becoming more concentrated: from 1980 until 1997 the share of total assets at the largest four banking organizations rose from 18.5% to 23.7%, while the share of the largest eight banking organizations went from 27.5% to 35.5% (Figure 2). Research by Berger et al (1995) suggests that consolidation will result in a banking system with more than ten banking organizations with assets in excess of $100 billion, with a share of total industry assets of somewhat more than 40%.

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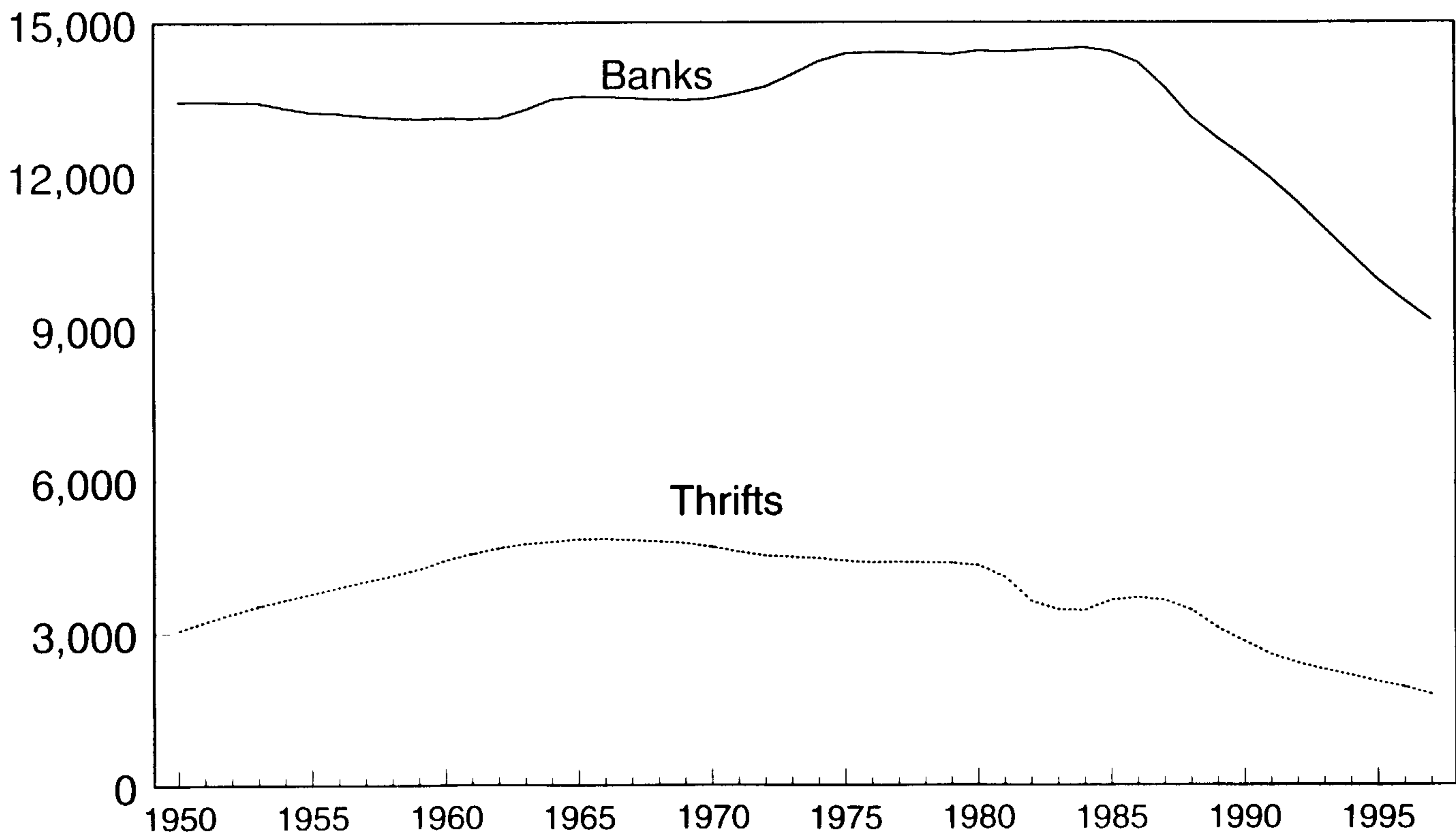
[1]See Mishkin (1996a) for a discussion of the forces driving bank consolidation in the 1980s and 1990s.

[2]See Berger et al (1995).

Figure 1

Number of Insured Commercial Banks and Thrifts

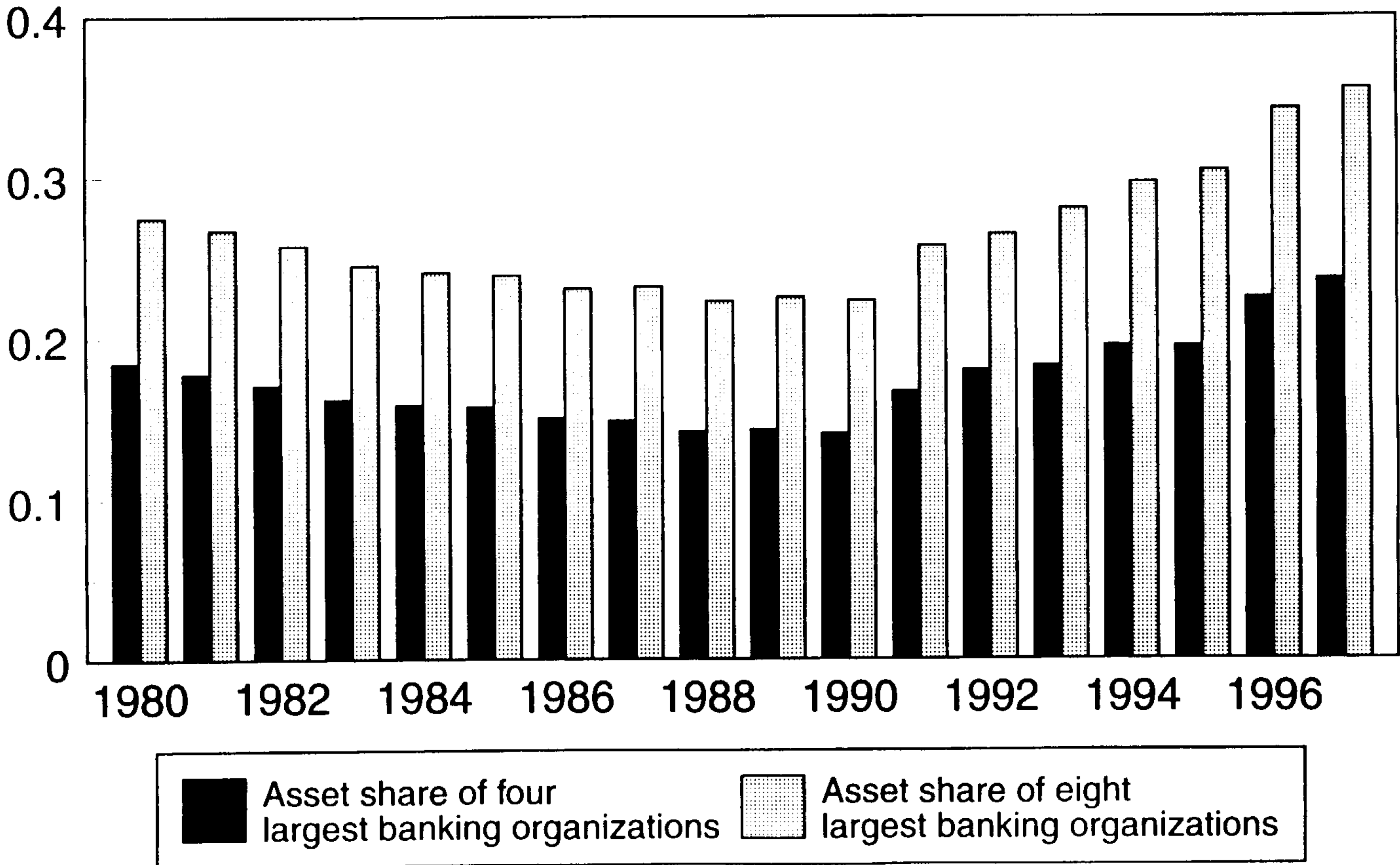
1950 to 1997



Sources: FDIC and OTS

Figure 2

Market Share of Large Banking Organizations



Source: Call Reports

As we can see in Figure 3, nationwide banks are also beginning to emerge. The four multistate bank holding companies with the largest geographic presence now spread out over many states. As the recent announced merger of BankAmerica and NationsBank suggest, consolidation in the banking industry should eventually lead to banking organizations with operations in almost all of the fifty states.

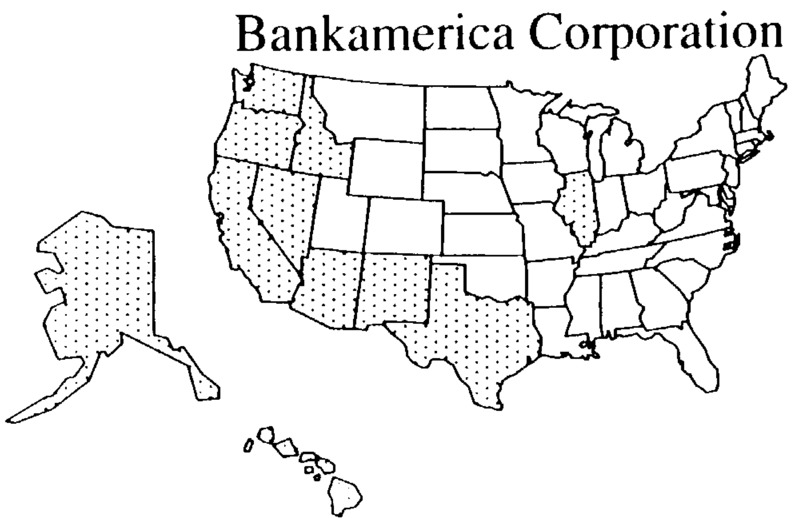
Consolidation Across Activities

An important feature in the past of the structure of the financial system in the United States has been the separation of the banking and securities industries resulting from the Glass-Steagall Act of 1933. Glass-Steagall allowed commercial banks to sell new offerings of government securities but prohibited them from underwriting corporate securities or from engaging in brokerage activities. At the same time, it prohibited investment banks from engaging in commercial banking activities. Despite the Glass-Steagall restrictions, the pursuit of profits and financial innovation has stimulated nonbanking institutions to end run Glass-Steagall and encroach on banks' traditional business. For example, brokerage firms have been able to pursue traditional banking activities with the development of money market mutual funds and cash management accounts. Also nonfinancial companies like General Motors, Ford and General Electric have become major lenders by providing installment loans to their customers through their finance company subsidiaries.

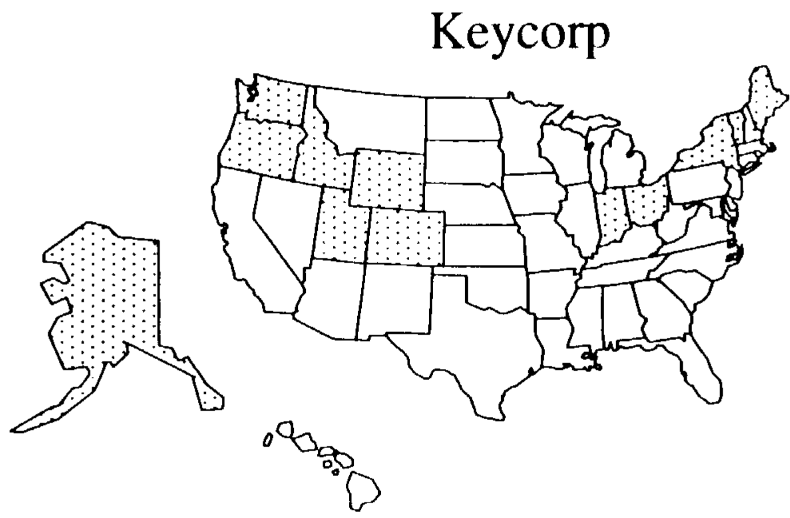
Because commercial banks' market share in financial services had been falling substantially, in 1987 the Federal Reserve decided to make use of a loophole in Section 20 of

Figure 3
Geographical Scope of Superregionals
1997

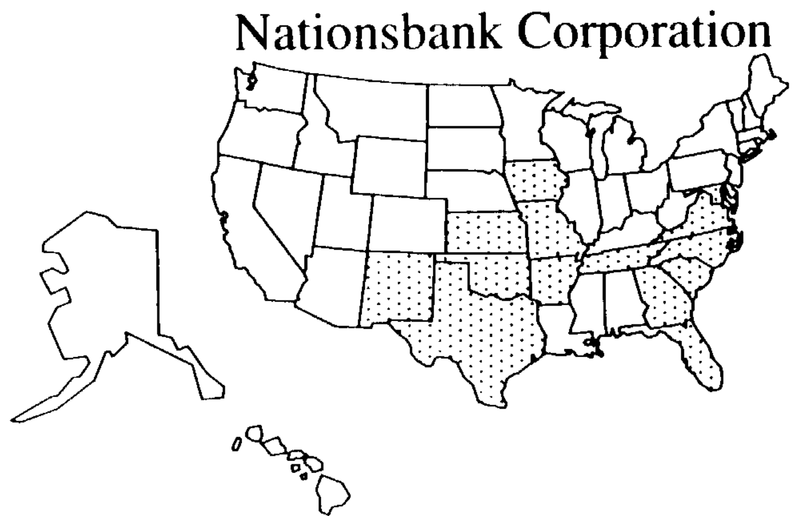
Bankamerica Corporation



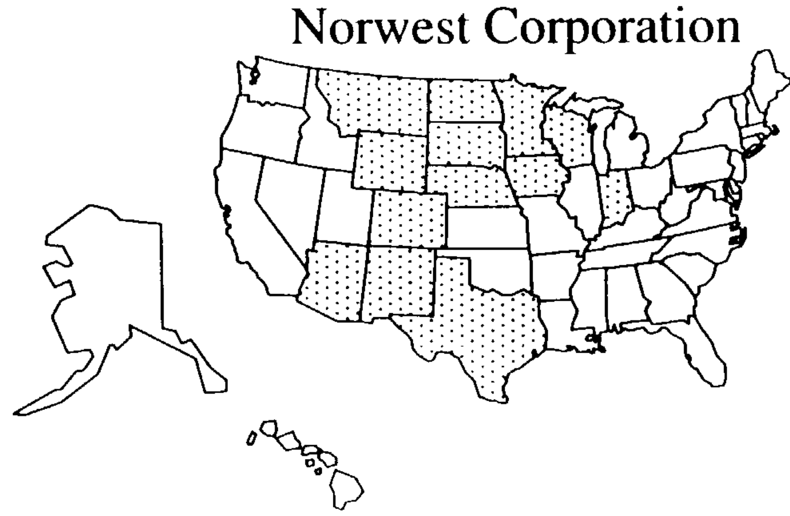
Keycorp



Nationsbank Corporation



Norwest Corporation



the Glass-Steagall Act to allow bank holding companies to underwrite several previously prohibited classes of securities. The Section 20 loophole allowed affiliates of approved commercial banks to engage in underwriting activities as long as the revenue didn't exceed a specified amount of the affiliates total revenue, initially 10%. The remainder of the affiliates revenue can be obtained by underwriting municipal bonds and selling Treasury securities, activities that were never precluded under Glass-Steagall. After the U.S. Supreme Court validated the Fed's action in July 1988, the Federal Reserve took the historic steps of allowing a commercial bank holding company, J.P. Morgan, to underwrite corporate debt securities (in January 1989) and to underwrite stocks (in September 1990), with the privilege subsequently extended to other bank holding companies. In addition, the Section 20 limit has been raised to 25% as commercial banks bumped up against the initially lower limit. In recent years, the Federal Reserve and other regulatory agencies have also allowed banks to invest in real estate and to engage in some insurance activities.

The outcome of the response of the regulatory agencies to the process of financial innovation which has been undermining Glass-Steagall has been that consolidation has not only been taking place in terms of the number of banking institutions, but also across financial service activities. Banks are increasingly engaged in nontraditional activities, and the trend away from the separation of banking and the securities industry is therefore likely to continue. Indeed, the demise of the Glass-Steagall Act may not be far off. Bills to overturn Glass-Steagall have been appearing in every session of Congress in recent years, and given proposed mergers such as the recently announced Citicorp-Travelers merger, it is growing ever more likely that one of these bills will come to fruition and the separation of the banking and securities industry will be

eliminated.

II.
Dangers

One consequence of financial consolidation in the United States is that the Glass-Steagall restrictions preventing banks from engaging in investment banking and other activities are being eroded. The presence of a government safety net that protects depositors creates a well-known moral hazard problem because depositors have little incentive to monitor the bank and withdraw their funds if the bank is taking on too much risk. As a result, banks protected by a government safety net have the incentive to take on greater risks than they otherwise would. One lesson learned from the savings and loan crisis of the 1980s is that when financial institutions are allowed to enter new lines of business in which there are more opportunities for taking on risk, the moral hazard created by the government safety net can result in a substantial increase in risk-taking that eventually leads to large losses for these institutions. The expansion of banking activities that is underway in the financial consolidation process thus presents the danger that banks will engage in excessive risk taking which can weaken the fabric of the financial system.

As we have seen, a further result of financial consolidation is that there will be a substantial increase in the size of many financial institutions. The presence of larger institutions presents a danger to the safety and soundness of the financial system because a failure of a large

institution exposes the financial system to systemic risk. When a very large institution fails it puts substantial strain on the financial system because it can directly impose losses on other institutions and can also create doubts about the health of other institutions. Concerns about contagion from the failure of a large institution is one reason that governments and regulators are reluctant to let large institutions fail. Indeed, with a greater number of large institutions resulting from financial consolidation, the pressures to follow a too-big-to-fail policy, in which depositors and other creditors are fully protected against any losses, increases.[3]

The increased moral hazard problem created by a too-big-to fail policy are also well known. Once depositors and creditors of large financial institutions know that they are likely to be completely protected if the institution fails, they have even less incentive to monitor the institution and pull out their funds when it takes on too much risk. Because of this lack of monitoring, large institutions might take on even greater risks than they otherwise would, thereby making failures of these institutions more likely. The presence of a too-big-to-fail policy in the United States, which was announced in the aftermath of the Continental Illinois insolvency in 1984, seems to have encouraged increased risk taking on the part of large banks. As Boyd and Gertler (1993) point out, large U.S. banks did take on riskier loans than smaller banks and this led to higher loan losses for the large banks. In addition, large banks had smaller amounts of capital relative to assets than smaller banks, further increasing the risk that they faced. The expansion of the number of large financial institutions thus increases the potential for more severe moral hazard problems created by too-big-to-fail.

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[3]The too-big-to-fail policy is somewhat misnamed since the institution is actually allowed to fail although depositors and other creditors are fully protected against any losses.

III.
Avoiding the Dangers

Although financial consolidation raises dangers for the financial system, they are not new ones. The problem of too-big-to-fail has been with us for a long time and the entry of banks into investment banking activities has been ongoing for quite a number of years. How can these dangers be avoided?

Vigilant Supervision

One solution to these dangers is vigilant prudential supervision of financial institutions, with special attention focused on the largest ones. Bank capital standards have been beefed up in recent years, particularly for large banks, and the prompt corrective action provisions of the Federal Deposit Insurance Corporation Act (FDICIA) of 1991 has gone a long way to making sure that banks are adequately capitalized. FDICIA has also increased the amount of supervision and has made supervisors more accountable for their actions, making it more likely that supervisors will do their job properly and prevent excessive risk taking on the part of banks.[4]

As pointed out in Estrella (1995), capital standards have their limitations in a world in which financial institutions' activities become more complex. A focus on whether banks are meeting capital standards is no longer adequate in today's world in which new markets and

[4]See Carnell (1997), Kaufman (1997) and Mishkin (1997a) for a discussion of how well the FDICIA legislation has worked to reduce excessive risk taking.

instruments make it easy for banks and their employees to make huge bets easily and quickly. In this new financial environment, a bank that is more than adequately capitalized at a particular point in time can be driven into insolvency extremely rapidly, as was forcefully demonstrated by the failure of Barings in 1995.[5]

This change in the financial environment has resulted in a major shift in thinking about the bank supervisory process. Supervisors are now placing far greater emphasis on evaluating the soundness of a bank's management processes with regard to controlling risk. New methods for supervisors to assess the risk management processes of the institutions they supervise are being developed. These methods can be modified to evaluate whether management has the proper internal controls in place to prevent excessive risk taking in the new activities opening up because of the breakdown of Glass-Steagall.

Total Elimination of the Safety Net

Another solution to the potential for increased moral hazard resulting from financial consolidation is to limit the government safety net. Some economists, such as Edwards (1996), have suggested that the safety net should in effect be entirely eliminated, with the view that the markets would impose sufficient discipline on financial institutions so that these institutions would be deterred from taking on too much risk.[6] One benefit would be that the need for

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[5]This problem is illustrated by the fact that ratings agencies (Moody's and S&P) are more likely to disagree about the ratings of banks engaged in trading than banks engaged in more traditional activities (Morgan, 1997).

[6]See also Litan (1987) and Pierce (1991) for similar views.

prudential supervision and regulation would decrease, which could promote a more efficient financial system.

I have two serious doubts about this proposed solution. First, I believe that it is naive to think that bailouts of banking institutions, particularly large ones, will not occur when they get into trouble. The recent history of banking crises throughout the world suggest that whether a government safety net is explicit or not, the government still steps in to bail out the financial system when there is a crisis. Thus, *de facto*, even if not *de jure*, a government safety net exists and markets know this. Despite what the government says about the elimination of the safety net, markets will continue to take the view that a government safety net exists and are thus unlikely to impose sufficient discipline on financial institutions to make sure that they are safe and sound.

Second, because financial crises are inherently unpredictable, markets are often unable to foresee and therefore prevent them. Furthermore, the history of financial crises suggests that the potential damage to the economy from financial crises is extremely large. Thus, in Mishkin (1991, 1994, 1996b, 1997b) I have taken the view that there is a strong rationale for government intervention to prevent financial crises. The total elimination of the safety net would be a radical step that could be extremely dangerous.

Constructive Ambiguity

Given the existence and need for a government safety net, we are left with the problem of the moral hazard that the safety net creates, particularly for the increasing number of large

banking institutions resulting from financial consolidation. One partial solution to this problem is to impose so-called "constructive ambiguity" onto the safety net: in other words there should be substantial uncertainty about whether uninsured depositors and other creditors will be fully protected when a bank fails. (The wording "constructive ambiguity" may have a somewhat negative connotation because it seems to imply advocacy of randomness in the supervision process. The constructive ambiguity advocated here is closer to a contingent rule, but one in which some judgement needs to be applied by supervisors.)

If depositors and creditors of a bank are not sure that they will be paid off in full when a bank fails, they will have much greater incentives to prevent that institution from taking on excessive risk. This will be particularly important for large banks which might be viewed as being too big to fail, and so constructive ambiguity might severely hamper the ability of these institutions to take on excessive risk. But how would constructive ambiguity work, particularly for large institutions?

The supervisory agencies would need to make it clear that there is a strong presumption that when there is a bank failure, uninsured depositors would not be fully protected unless this is the cheapest way to resolve the failure. It is important to recognize that although large banking institutions may be too big to liquidate, they can be closed with losses imposed on uninsured creditors. Indeed this is exactly what FDICIA suggests should be done by specifying that, except under very unusual circumstances when the a bank failure poses "serious adverse effects on economic conditions or financial stability", a least-cost resolution procedure will be used to close down the bank. Ambiguity is created about the use of this systemic-risk exception to the least-cost-resolution rule because to invoke it requires a two-thirds majority of both the

Board of Governors of the Federal Reserve System and the directors of the FDIC, as well as the approval of the secretary of the Treasury.

An important concern is that the systemic-risk exception to least-cost resolution will always be invoked when the failing bank is large enough because the Fed, the FDIC and the secretary of the Treasury will be afraid to impose costs on depositors and other creditors when a potential financial crisis is looming. Thus too-big-to-fail will still be alive, with all the negative consequences for moral-hazard risk-taking by the largest institutions. One way to cope with this problem is for the authorities to announce that although they are concerned about systemic risk possibilities, there will be a strong presumption that the first large bank to fail will not be treated as too-big-to-fail and costs will be imposed on uninsured depositors and creditors when the bank is closed. Rather than bail out the uninsured creditors at the initial large bank that fails, the authorities will stand ready to extend the safety net to the rest of the banking system if they perceive that there is a serious systemic risk problem.

The advantage of announcing such a stance is that it creates constructive ambiguity for the large banks because their uninsured depositors and creditors now have to worry that if this bank is the first one to fail, they will not be bailed out. As a result these depositors and creditors will now have an incentive to withdraw their funds if they worry about the soundness of the bank, even if it is very large, and this will alter the incentives of the bank away from taking on too much risk. Clearly, moral hazard still remains in the system because the authorities stand ready to extend the safety net to the rest of the system after the initial large institution fails if its failure creates the potential for a banking crisis. However, the extent of moral hazard is greatly reduced by the use of this form of constructive ambiguity. Furthermore,

the cost of this remaining moral hazard must be balanced against the benefits of preventing a banking crisis if the initial bank failure is likely to snowball into a systemic crisis.

One potential criticism of a presumption that only the first large bank to fail will impose costs on uninsured depositors and creditors is that creditors have incentives to pump capital into a failing institution to prop it up just long enough so that it will not be the first one to fail. There are several reasons to discount this criticism. First is that the free-rider problem strongly mitigates the incentive for creditors to prop up the bank: each creditor individually is quite happy to let the other creditors pump funds into the bank in order to delay the failure, and so the incentive of creditors to prop up the bank is greatly weakened. Second, is that constructive ambiguity does not guarantee that delaying the failure of the bank will do any good. If the regulatory authorities decide that failure of a second bank does not present the financial system with systemic risk, they may not decide to protect the creditors. Thus the incentive for creditors to prop up the bank temporarily will be further weakened.

Another potential criticism of a presumption towards allowing the first large bank to fail is that there is a substantial risk of contagion through the payments system. The payments system relies on substantial extensions of intraday, overnight and longer-term credit between banks. Failure of a large bank or one that is intimately involved in the large-dollar payments system could then lead to a systemic shock that could cause the payments system to freeze up or, at a minimum, lead to substantial losses at other banks. Thus attention needs to be paid to reduction of potential payment system and contagion problems.

The FDICIA legislation of 1991 has taken important steps to deal with these problems through several provisions. FDICIA directed the Board of Governors of the Federal Reserve

to develop a regulation which would limit interbank credit exposure, and the Board of Governors responded with Regulation F, which restricts the interday exposure to a not adequately capitalized correspondent to less than 25% of the bank's capital. To prevent a systemic liquidity problem from developing because other financial institutions might not have immediate access to their funds at a failed bank, FDICIA also authorizes the FDIC to make a final settlement with creditors when it assumes receivership of a failed bank. The settlement rate is based on the FDIC's average recovery experience. In addition, FDICIA explicitly recognizes contractual netting agreements and holds them legally binding, thereby reducing short-term credit exposure and making the clean up after a bank failure substantially easier.

Not only do these FDICIA provisions to limit interbank risk make it more likely that a large bank failure will not produce a systemic problem, but they also improve the incentives for the regulatory agencies to allow the first large bank to fail because the failure has less potential to do damage to the banking system. Thus, they increase the credibility of the presumption that the first big bank will be allowed to fail and incur costs on the depositors and creditors, an essential feature of constructive ambiguity.

It is important to recognize that because constructive ambiguity still leaves a good part of the safety net in place, which is exactly what is intended, there is still an important rationale for prudential supervision. This is why constructive ambiguity must be combined with vigilant supervision, particularly of the large financial institutions. This combined system of constructive ambiguity and vigilant supervision of the type described above can lessen the dangers posed by the ongoing process of financial consolidation we are experiencing today.

III.
Opportunities

So far we have focused on the dangers from financial consolidation, but we also need to recognize that financial consolidation has important benefits that open up some exciting opportunities.

The consolidation in the banking industry and the move to nationwide banking has the important benefit that it will lead to more diversified loan portfolios which make bank failures less likely. One of the features of the banking system up until recently was that lending activities were restricted to one region of the country, with the result that bank failures were often concentrated in states with weak economies. For example, after the decline in oil prices in 1986, all the major commercial banks in Texas, which had previously been highly profitable, found themselves in deep trouble. At the same time, banks in New England were doing quite well. On the other hand, when the 1990-91 recession hit New England very hard, it was the turn of New England's banks to start failing. A key benefit of nationwide banking is that a bank could make loans in both New England and Texas, and thus would be less likely to fail because when the loans were going sour in one location, they would potentially be doing well in the other. Thus consolidation of the banking system into units with lending activities nationwide should create a healthier banking system that is less prone to banking crises.

We can get a flavor of how this would work from Figure 3 which we discussed earlier.

Three of the most geographically diverse bank holding companies operate banks in Texas, so that Texas banks are now part of holding companies with banks in the midwest, the west and the southeast. Thus as long as weakness in the economy in Texas occurred at the same time as the economy was strong in the west, midwest or southeast, then these banking organizations would be likely to remain healthy. Indeed, there are bank holding companies that currently operate banks in both Texas and New England: Chase being one of them.

Consolidation across activities also has the potential to increase diversification and lower the likelihood of failure of financial institutions. For example, if a financial institution is engaged in both the banking and the insurance business, when it faces an unusual amount of insurance claims, its banking business is just as likely to be strong; while when the banking business is weak, it is unlikely that it will be subject to a large amount of insurance claims. This increased diversification of activities therefore lowers the riskiness of profits, making the institution less prone to failure.

The benefits of increased diversification opens up opportunities for reform of the banking system because it makes broad-based deposit insurance less necessary and weakens the political forces supporting it. Over fifty years ago when federal deposit insurance was first adopted, Congress debated the choice between two quite different banking systems. One involved a system with branching restrictions and thus many small undiversified banks, along with government deposit insurance. Without government deposit insurance these undiversified banks were prone to failure and so they needed it to be viable. Thus, not surprisingly, they strongly supported federal deposit insurance. In the second system, there would be no deposit insurance and branching restrictions would have been eliminated, resulting in a much smaller number of

large, nationwide, diversified banks. (Indeed this was the system existing in Canada in the 1930s which weathered the Great Depression period much more successfully than the U.S. banking system (see Haubrich, 1990). Because of pressure from small banks who recognized that the second system would lead to many of them going out of business, Congress chose the first system.[7]

As we have seen in section I, financial consolidation is now moving us toward a banking system with a smaller number of large, nationwide, diversified banks, thus making the second system, the path not chosen in the 1930s, more viable. Because the banking system we are moving to has better diversified banks that are less likely to fail, deposit insurance is no longer as needed. Even more importantly, with a decreasing number of small banks, the political support for federal deposit insurance as we see it now will shrink.[8] Thus it becomes of practical importance for us to contemplate whether a financial system with a far more limited form of deposit insurance would be better for the economy.

One of the most important disadvantages of deposit insurance is that it not only protects depositors against situations of systemic risk but also against idiosyncratic risk at the bank in which their deposits reside. If most risk-taking is idiosyncratic, deposit insurance has the

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[7]See Calomiris and White (1994) and Economides, Hubbard and Palia (1996).

[8]Although there will be a substantial shrinkage in the number of small banks, these small, so-called community banks are unlikely to disappear. For example, when New York State liberalized branching laws in 1962, there were fears that community banks upstate would be driven from the market by the big New York City banks. Not only did this not happen, but some of the big boys found that the small banks were able to run rings around them in their local markets. Similarly, California, which has had unrestricted statewide branching for a long time, continues to have a vibrant set of community banks. Community banks are likely to remain viable because they serve a niche in the market which larger banks cannot fill: some segments of the public are willing to pay more for dealing with a small local institution that has a personal touch with the customer, and, furthermore, community banks may have better information about small businesses which gives them inherent advantages in small business lending.

undesirable feature that it is an extremely inefficient way of protecting against systemic risk. Indeed, the experience during the savings and loan crisis suggests that most of the excessive risk taking during this episode was of the idiosyncratic variety.

An alternative way to provide a government safety net for the banking system is through a lender of last resort. For example, the United Kingdom has avoided financial crises since 1866 by having the Bank of England exercise this role, and yet for most of this period it has not had government deposit insurance. A major advantage of providing the safety net with a lender of last resort is that the lender of last resort can stand ready to insure against only systemic risk rather than idiosyncratic risk. Indeed, if most risk taking by banking institutions is idiosyncratic, as is likely to be the case, then insuring against systemic risk only will dramatically reduce the moral hazard problem created by the government safety net.

It might be claimed that if an institution is large enough then the too-big-to-fail doctrine may come into play, causing the lender of last resort to insure against idiosyncratic as well as systemic risk. However, as we have seen, a judicious use of constructive ambiguity can help minimize this problem, by making it clear that even the largest banking institutions are unlikely to be protected if they are the first one to fail. Indeed, without deposit insurance, constructive ambiguity should be much easier to execute because there would be no presumption that depositors should be protected in all situations.

Financial consolidation thus opens up the opportunity to reform the government safety net and substantially reduce the moral hazard that it creates. One potential problem with financial consolidation and the elimination of deposit insurance which probably provides a subsidy for small banks is that it might lead to a reduction in bank lending to small businesses

because of the reduction in assets at small banks. Small banks specialize in small business lending because restrictions on the fraction of their capital that can be lent to any one borrower necessarily mean that they cannot make large loans, which is what is often required by big businesses. The fear is that an acquisition of a small bank by a larger bank will result in a decline in lending to small businesses because the large bank will pay less attention to this kind of lending. Because small businesses may be particularly dependent on bank lending to finance their activities, the reduction in small business lending to banks could hurt the efficiency of the economy.[9]

The evidence on whether bank consolidation will lead to a reduction in small business lending is however quite mixed. The fact that large banks have a smaller fraction of their business devoted to small business lending does not mean that when they acquire smaller banks they will reduce this lending if it is profitable. Some research finds that small bank lending is unlikely to be reduced as a result of bank consolidation while other research comes to the opposite conclusion.[10] However, even researchers who point out that bank lending to small business might decline are not sure that this would reduce economic efficiency. The subsidy provided by deposit insurance which has helped many small banks stay in business may have produced more small business lending than is socially optimal. The implicit subsidy to small

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[9] Recent evidence from the National Survey of Small Business Finance confirms that small businesses use banks for credit more than they use nonbank sources of credit. See Cole and Wolken (1995).

[10] Strahan and Weston (1996) find no decline in small business lending, on average, following bank mergers that occurred between 1993 and 1994. On the other hand, Peek and Rosengren (1995) find a decline in small business lending for a small sample of bank mergers that occurred in New England during this period.

banks from deposit insurance might have been passed onto some small businesses who would not have obtained loans otherwise.

Another problem with eliminating deposit insurance is that it is highly popular. It serves the laudable purpose of protecting consumers, which has value in and of itself, and it also would be political suicide for any politician to advocate abolishing it completely.

How can we move to a system in which the safety net is provided by a lender of last resort rather than by deposit insurance? An answer is provided by provision of deposit insurance that is almost superfluous for the economy because it creates almost no moral hazard incentives. Deposit insurance which is restricted to narrow bank accounts, sometimes also referred to as collateralized bank accounts fits this bill. Narrow bank (or collateralized) deposit insurance is insurance which would apply to accounts which are very similar to money market mutual fund accounts: assets backing these accounts would be restricted to be ones of very high quality whose value is very transparent because they would be marked to market frequently.

It is important to be clear that narrow bank deposit insurance differs from narrow banking which restricts the bank from engaging in making conventional loans. Banks with uninsured deposits that make conventional loans would also be able to issue insured narrow bank deposits that are backed by assets like those in money market mutual funds. An important objection to narrow banking proposals is that they would prevent banks from taking advantage of possible economies of scope between bank lending and deposit issuing which result from informational advantages that accrue to the lender because it obtains information from the checking account activities of the borrower. Narrow bank deposit insurance would allow these economies of scope to be exploited, but it would eliminate any subsidy for combining lending with deposit

issuance. If there truly is a synergy between bank lending and deposit issuance, then banks would continue to find it advantageous to combine these activities and uninsured deposits would continue to be issued by banks. If the economies of scope are small, we might find that narrow bank deposit insurance would lead to a substantial reduction in uninsured deposits, but this would still be consistent with no loss of efficiency because the deposits that disappear would only have been issued in large amounts because of the deposit insurance subsidy.

An important advantage of narrow bank deposit insurance is that it would create only a slight amount of moral hazard because the restrictions on the assets would leave little opportunities for risk taking. Indeed, the major purpose of deposit insurance would be to protect against fraud; otherwise it would have little impact on the financial system. Another important benefit is that consumers would have access to accounts that were one hundred percent safe, something that they clearly want to have. Thus, politicians could advocate this reform to deposit insurance without being subjected to attacks that they do not care about the safety concerns of depositors, particularly small ones.

Many proponents of narrow or collateralized banking suggest that it solves the moral hazard problem because it eliminates the need for a government safety net. However, as argued above, there is still an important need for a government safety net for the uninsured part of the banking system. The problem of contagion risk and the threat of severe financial crises is still present: clearly there will be no runs on narrow bank accounts, but there is a definite threat of runs on uninsured banking. Furthermore it is naive to think that bailouts won't occur, whatever the government says initially, and this is particularly the case if the imminent failure is of a large institution that is considered to be too big to fail. Thus narrow bank deposit insurance does not

eliminate the need for a government safety net and so all of the regulation/supervision issues discussed earlier are still present. Narrow bank deposit insurance is by no means a panacea, but it can help create a more rational form of the government safety net that provides adequate safety but does not lead to excessive risks in the financial system.

IV. Conclusions

The basic theme of this paper is that financial consolidation raises some dangers because the resulting larger institutions engaged in potentially risky activities expose the financial system to increased systemic risks. However, these can be handled by vigilant supervision and a government safety net with an appropriate amount of constructive ambiguity. Financial consolidation also presents us with some exciting benefits and opportunities. Financial consolidation is producing more diversified financial institutions which should be less prone to failure, making broad-based deposit insurance a less necessary (and less politically supported) part of our financial structure. This opens up the opportunity to dramatically reduce the scope of deposit insurance and limit it to narrow bank accounts, thus substantially reducing the moral hazard created by the government safety net. Reducing the scope of deposit insurance, however, does not eliminate the need for a government safety net, and thus there is still a strong need for adequate prudential supervision of the financial system. Moving to a world in which we have larger, nationwide, diversified financial institutions and in which deposit insurance plays a very limited role, should improve the efficiency of the financial system. However, it is no panacea:

the job of financial regulators and supervisors will continue to be highly challenging in the future.

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