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RAHN: Regulators causing bank failures

Returning banks to free market would strengthen economy

By Richard Rahn

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Beware Greeks bearing debt - or any other country that has too much of it. Despite ever-increasing government regulation of banks, which often are required to hold government debt as reserves, the systemic risk of a failure in the global financial system is growing rather than diminishing. There are solutions that require less, rather than more, regulation.

Some banks have been around for a couple of centuries or more, particularly in Switzerland, and yet they continue to thrive without government help. Only one Swiss bank out of 350 required state intervention in the financial crisis of the past few years. If you look at the big banks that have been in trouble or the banks that regulators and others worry about being in financial trouble, you will notice that virtually all of them have a corporate form of ownership and are heavily regulated. They also increasingly are being forced to be tax collectors for governments. Yet banks that are organized as general partnerships, such as Swiss private banks, where the owners of the banks have unlimited liability, have, in almost all cases, avoided failure or having to go to the government for a bailout.

To understand why some banks have avoided problems and others seem to have a continuing problem, it is useful to review the basics of banking. Traditionally, a bank takes deposits from individuals and institutions and then lends the money to others, receiving interest from its loans and paying interest on its deposits. If some loans or investments go bad, or if many depositors suddenly want all of their money back, the bank must have reserves to cover such problems. These reserves can be made up of the capital supplied by the owners of the bank, retained earnings and/or government bonds. Bank regulators typically want banks to hold more reserves, while bankers often wish to hold fewer reserves, given that they make little or no money on their reserves.

Bank regulators at the state, national and even global level try to establish minimum reserve requirements for banks to put them on a level playing field and keep them from taking on too much risk. The problem is that every bank has a different risk profile and the regulators have no idea how risky the various assets the banks hold are. One of the fatal conceits held by the political and regulatory classes is that somehow they think they know how risky a bank's asset portfolio is. The politicians and regulators, in part, rely on rating agencies, which have proved to be almost useless in many cases. If a bank's liabilities exceed its reserves, the bank is insolvent, and in the absence of deposit insurance, there likely will be a "run" on the bank.

Banks that are organized as general partnerships have had fewer problems because the partners have a very strong vested interest not to take on risks they do not fully understand because it is they who take the hit if something goes wrong. On the other hand, corporate banking executives and, in particular, bank regulators usually don't take a personal financial hit if something goes wrong on their watch, and hence they are less careful.

There is an alternative form of bank ownership that is likely to lead to fewer problems and avoid the "too big to fail" problem, and that is mutual-fund banking. Former Federal Reserve governor and now University of Chicago professor Randall S. Kroszner and George Mason University professor Tyler Cowen foresaw the oncoming banking crisis and proposed mutual-fund banking 20 years ago. Their proposal is more relevant than ever. A mutual-fund bank would be somewhat analogous to a credit union or a mutual savings bank but would differ in one key respect. "In both mutual banks and mutual-fund banks, the depositors constitute the banks' 'shareholders.' One becomes an 'owner' of the bank by making a deposit and ceases to be an owner only by withdrawing the deposit." Depositors would be residual claimants and hold a direct claim to the assets of the mutual-fund bank, thus earning a return tied to the performance of the underlying investment portfolio. In contrast, depositors in mutual savings banks and credit unions receive a predetermined interest payment.

Unlike traditional banks, mutual-fund banks could not fail if the value of their assets declined. A decline in asset value would be shared on an equal percentage basis by all of the depositors, like a mutual fund. The value of the deposit, either loss or gain, would be reported each day like other mutual funds. Deposits (i.e. ownership) in such a mutual-fund bank would not be appropriate for individuals or institutions that could not take the risk. However, governments and the public would not have to be concerned about how big such banks grew because mistakes by the bank, such as buying Greek bonds, would not pose a systemic risk to the system, as the potential loss would be borne by the individual depositors/shareholders, who would understand from the beginning that they were at risk. Compensation plans for the managers could be designed to be aligned with the returns to the depositors, encouraging them to act more like the general partners in Swiss private banks.

The current regulatory approach to the "too big to fail problem" of ever more costly regulations and more regulators is doomed to failure. Governments instead ought to stop turning banks into tax collectors and should be encouraging innovations in ownership and management structures of financial institutions that reduce systemic risk.

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