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Financial Failures and Financial Policies

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The recent increase in the number of failures by financial firms has renewed interest in the fragility of firms in the U.S. financial sector. Finding the causes of fragility presumably leads to eliminating or reducing fragility wherever possible. For some people any financial failure is an evil to be avoided—a flaw, as it were, in the regulation or deregulation of the financial system.

The history of the U.S. financial system provides ample evidence of an association between financial panics, bank failures, and recessions. The association does not show that bank failures caused recessions. Typically, multiple bank failures occurred after a recession was already underway; the failures added to the depth and severity of some recessions but did not initiate them (Cagan 1965). Further, there are many examples of bank failures that did not culminate in panics or financial crises. During the mainly prosperous years 1923–29, bank closings, most of them in agricultural areas, occurred at the rate of 600 per per year.

U.S. and British monetary history provides a record of intermittent financial failures that has been studied many times. The best research suggests two important conclusions. First, there are many examples of bank failures that were not followed by financial panics. Second, the occurrence of financial panics always involved a failure by the central bank to discharge its duty as lender of last resort to the financial system (see Schwartz 1985; Bordo 1985). The problem
to be studied, then, is at the policymaking level. What is U.S. policy toward financial fragility? What procedures can depositors expect to see applied when financial failures occur? What policies should be applied, and what should the public expect policymakers to do?

The experience of the past two decades, during which the number of financial failures increased, reveals that the institutions responsible for the safety of the financial system do not have a stated policy or a set of procedures. The response by official institutions like the deposit insurance corporations and the Federal Reserve have been appropriate at times but inappropriate at other times. Even when the actions have been appropriate, they have not been based on principles known to the public and on which the public can rely. If the principles exist, there is not much evidence of their existence. They are unknown to the public. Failure to state these principles, or perhaps to define them, heightens uncertainty and encourages bank runs and financial panics.

**BAGEHOT’S POLICY PRINCIPLES**

A century ago, Walter Bagehot, the editor of the *Economist*, described the problem of crises in the British financial system and the need for a financial policy by the Bank of England (Bagehot 1873). Bagehot’s work was stimulated by the problems of the British banking system in the nineteenth century. The end of inflation after the Napoleonic wars was followed by the disappearance of 240 banks in 1814–16. The return to the gold standard eliminated another seventy banks in 1825. Expansion of bank powers, and the growing use of new instruments, including checking deposits, was followed by additional failures (Genovese in Bagehot 1962). These latter changes roughly correspond to the deregulation of our day. Further, banks on the continent and elsewhere held reserves in London. As the century progressed, London became the center of a world financial market, just as the U.S. banks have a major role in the world financial system today. Banks in London lent all over the world, in the developing countries of that day (including Latin America), just as U.S. and other banks have done in recent decades. From time to time problems arose with loans to firms in the developing countries of South America, North America, or elsewhere.
Of course, the parallels to our own time are not exact. We no longer have the gold standard, an important element in Bagehot's analysis. Many of the foreign loans are now to governments of foreign countries or are "guaranteed" by such governments. Speed of communication takes minutes instead of weeks or months, so markets are more closely linked. These and other changes do not reduce the relevance of the principles that Bagehot presented.

Bagehot's main concern was the universal problem of confidence in banks and the financial system. The problem arises from the nature of the fractional reserve system; banks hold much less in reserves than in deposits, and all but a very minor part of their reserves are required by statutes. The required reserves provide no protection against a run on the bank by depositors wishing to withdraw their deposits. Only the central bank—the Bank of England in Britain or the Federal Reserve in the United States—can supply sufficient reserves or currency to prevent a bank, or banks, from becoming illiquid when faced with large withdrawals by depositors concerned about a possible loss of wealth if the bank should fail.

Bagehot saw this issue clearly and prescribed for it in a classic statement: "The holders of the cash reserve [the central bank] must be ready not only to keep it for their own liabilities, but to advance it most freely for the liabilities of others. . . . In wild periods of alarm, one failure makes many, and the best way to prevent the derivative failures is to arrest the primary failure which causes them" (Bagehot 1962: 25). The rule that Bagehot enunciated for a gold standard was a remedy for an external drain of gold and a domestic demand for gold or government currency issues: "Very large loans at very high rates are the best remedy for the worst malady of the money market when a foreign drain is added to a domestic drain" (Bagehot 1962: 28). The high rate of interest attracts deposits and gold from abroad; the large loans convince the public that currency is available and that the banks can pay off depositors.

Bagehot's Lombard Street is timely reading not only for its classic statement of the rule for central banks but for its history of the experience with banking panics up to that time and its critique of financial policy during crises. The main criticism is repeated several times: "And though the Bank of England certainly do make great advances in time of panic, yet they do not do so on any distinct principle. . . . To lend a great deal, and yet not give the public confi-
dence that you will lend sufficiently and effectually, is the worst of all policies; but it is the policy now pursued" (Bagehot 1962: 31-32).

Bagehot understood that the central bank must state its principles in advance and must adhere to them. No distinction should be made—or can be made—about the quality of the troubled financial institution, its size, or its type of business. What matters is the collateral that is offered, the interest rate at which the central bank discounts, the speed with which the central bank acts, and the certainty about the policy that it conveys. The central bank must act to prevent a problem from becoming a crisis. To prevent a crisis, the central bank must follow two rules. Again, the statements are classic (Bagehot 1962: 97 (emphasis added)):

First. That these loans should only be made at a very high rate of interest. This . . . will prevent the greatest number of applications by persons who do not require it [assistance.] The rate should be raised early in the panic, so that the fine may be paid early; that no one may borrow out of idle precaution without paying well for it . . .

Secondly. That at this rate these advances should be made on all good banking securities, and as largely as the public asks for them. The reason is plain. The object is to stay alarm, and nothing therefore should be done to cause alarm. But the way to cause alarm is to refuse some one who has good security to offer. . . . If it is known that the Bank of England is freely advancing on what in ordinary times is reckoned a good security—on what is then commonly pledged and easily convertible—the alarm of the solvent merchants and bankers will be stayed. But if securities, really good and usually convertible are refused by the Bank, the alarm will not abate, the other loans made will fail in obtaining their end and the panic will become worse and worse. The only safe plan for the Bank is the brave plan, to lend in a panic on every kind of current security, or every sort on which money is ordinarily and usually lent.

The securities on which the central bank should lend include paper on which the central bank does not normally lend: “The amount of the advance is the main consideration for the Bank of England. . . . An idea prevails . . . at the Bank of England that they ought not to advance during a panic on any kind of security on which they do not commonly advance. But if bankers . . . do advance on such security in common times, and if that security is indisputably good, the ordinary practice is immaterial” (Bagehot 1962: 101).

Bagehot did not make the now common mistake of confusing the problems of an individual bank and the problems of the banking sys-
The aim of the central bank or monetary authority should not be to save an insolvent bank. Policy must prevent the effects of the failure from spreading to banks that are solvent and that will remain solvent and liquid if the financial crisis is prevented or properly managed by the central bank.

Insolvency occurs when the value of the bank's liabilities exceeds the value of its assets. Illiquidity occurs when a bank (or banks) cannot pay cash to redeem deposits. A liquidity crisis arises in a fractional reserve system if assets cannot be sold quickly at prices that permit the bank to repay liabilities on demand. Illiquidity is a temporary problem that arises only when there is a large increase in the demand for currency. If the central bank does not supply the currency, illiquid banks are forced to close. If the central bank supplies currency by buying assets at a discount, or lending at high rates of interest against collateral, illiquidity is removed and bank closings are avoided. The central bank is called the lender of last resort because it is capable of lending—and to prevent failures of solvent banks must lend—in periods when no other lender is either capable of lending or willing to lend in sufficient volume to prevent or end a financial panic.

I have quoted at length from Bagehot's rules for the lender of last resort, and his strictures about the lender's practices, because many of his criticisms and proposals are applicable in the circumstances in which we find ourselves. Let me summarize the main points:

1. The central bank is the only lender of last resort in a monetary system such as ours.
2. To prevent illiquid banks from closing, the central bank should lend on any collateral that is marketable in the ordinary course of business when there is no panic. It should not restrict lending to paper eligible for discount at the central bank in normal periods.
3. Central bank loans, or advances, should be made in large amounts, on demand, at a rate of interest above the market rate. This discourages borrowing by those who can obtain accommodation in the market.
4. The above three principles of central bank behavior should be stated in advance and followed in a crisis.

Nowhere does Bagehot suggest that all banks should be prevented from failing. On the contrary, he describes the failures of some lead-
ing financial institutions of his day, and he does not suggest that the failures should have been prevented. A main point of his book is that failures do not have large systemic effects if preannounced rules to prevent panic are followed. He cites several examples to show that when the Bank of England followed correct principles, without precommitment, financial panics ended within two days. He argued that precommitment would prevent the panic or reduce its length and severity.

The modern reason for permitting insolvent banks to fail is that an understanding by financial institutions that they will not be allowed to fail changes attitudes toward risk. Managements are encouraged to accept higher risks so as to earn higher returns. If managers are confident that the risk will be borne by the public and not the management and the stockholders, they face a one-way gamble: The owners and managers get the gains, and the taxpayers pay the cost of large errors.

Recent efforts by regulators to save insolvent banks suggests that a fifth principle is needed to clarify the conditions under which insolvent banks and financial institutions will be permitted to fail or be acquired by other financial institutions:

5. Insolvent financial institutions should be sold at the market price or liquidated if there are no bids for the firm as an integral unit. The losses should be borne by owners of equity, subordinated debentures, and debt, uninsured depositors, and the deposit insurance corporations, as in any bankruptcy proceeding.

Market discipline is essential for market efficiency, and failure is a form of discipline. An important point is to distinguish between (1) the risk of an individual firm or financial institution failing and (2) aggregate risk. Prevention of an individual firm or bank failure to avoid aggregate risk to the community accomplishes what it is intended to prevent. Society bears the cost and the increased risk. Individual firms are encouraged to take larger risks, since owners and lenders recognize that they can earn higher returns without paying the full price of the increased risk if it comes due. This encourages risk taking and leads to malallocation of resources and a mal-distribution of the returns from risk bearing.

Allowing banks or financial firms to fail is one part of a policy toward financial firms. The other parts—represented by the four Bagehotian principles—work to separate the risk of individual finan-
cial failures from aggregate risk by establishing principles that pre-
vent bank liquidity problems from generating an epidemic of in-
solvencies.

There have been many hundreds of financial firm failures in the
United States and in Britain. Only a few have been followed by
financial panics or crises, and many of these panics were short-lived.
The worst cases—but the ones that are engraved deeply in the pub-
lic memory—are those in which the central bank failed to act as
lender of last resort. These cases, particularly the banking failures of
1931–33 in the United States, arose because the central bank did
not follow Bagehotian principles. It is important, therefore, to ask
whether banking policy today is based on sound principles—or on
any discernible set of principles.

REGULATORS' RESPONSES

Regulators’ responses to some of the banking problems of the last
ten to fifteen years reveal a changing pattern that offers no reliable
guide to the future. At times regulators acted promptly and effec-
tively, but there is no evidence of a policy—a reliable set of proce-
dures based on established principles—for dealing with financial
failures.

From the many examples of banking policy in the last two dec-
ades, I have chosen six to illustrate some of the differences in ap-
proach. Two cases, Franklin National and First Pennsylvania, have
some common features but some differences also. Both banks con-
tinue to operate, but Franklin National was sold and operates as a
new institution. Penn Square was closed and liquidated. The Ohio
thrift associations were closed temporarily by state action, but many
of these institutions remained both liquid and solvent. They have
reopened, but most should not have been closed. The privately in-
sured Maryland thrift associations remained open, but the size of
withdrawals was restricted. Continental Illinois was taken over by the
government after large loans had been made by the Federal Reserve
and bankers across the country had been urged to lend money to
Continental Illinois.

The Federal Reserve’s loans to Continental Illinois at below mar-
ket rates of interest and the extended borrowing provision available
to other troubled banks continue the practice used at Franklin Na-
tional and First Pennsylvania. At both Franklin and First Pennsylva-
nia the bank's problems either resulted from, or were magnified by, 
speculation on asset prices. The management of First Pennsylvania 
speculated on a decline in long-term bond prices that did not occur. 
The Federal Reserve's policy of lending at below market rates, for 
extended terms, subsidizes behavior of this kind. A bank faced with 
the prospect of low earnings can anticipate that successful specula-
tion will raise earnings and that unsuccessful speculation will be sub-
sidized by the Federal Reserve if the bank is in danger of becoming 
insolvent.

The Federal Reserve did not attempt to save Home State Savings 
in Ohio. At first, nothing was done; the thrift association was left to 
rely on its own resources, and to the best of my knowledge, no pub-
lic statement was made about assistance. Several days after the prob-
lems at Home State became public, the policy changed. The Federal 
Reserve began to make loans against collateral. Since the portfolios 
at Home State and the other Ohio institutions faced with withdraw-
als consisted mainly of mortgages, the Federal Reserve accepted 
mortgages on one- to four-family homes, in good standing, as collat-
eral. Loans were not made at a penalty rate, and no effort was made 
to publicize the policy. I believe similar policies were followed in 
Maryland.

Prompt action, promptly announced, is a means of reassuring the 
public, thereby reducing uncertainty and discouraging withdrawals at 
other institutions. A penalty rate prevents excessive demands for 
borrowing. The Federal Reserve deserves praise for lending to non-
member institutions in Ohio and Maryland against collateral that it 
does not normally accept. But it did not announce the principles on 
which the loans would be made—forestalling problems elsewhere, 
and perhaps in Maryland—and it delayed taking action, thereby in-
creasing the alarm.

The Continental Illinois experience suggests a failure by the regu-
lators to agree on a banking policy. Since the problems with foreign 
loans came to public attention about three years ago, active public 
discussion of the financial system has focused attention on fragility 
and the potential failure of a relatively large bank. Although foreign 
loans were not the major source of problems at Continental Illinois, 
the lack of policy to deal with the prospect of failure by a large bank 
became apparent.

None of these recent cases shows evidence that the financial regu-
lators fully accept the policy proposed by Bagehot or have developed
an alternative. These experiences suggest that the central bank's function as lender of last resort to the financial system is either not well understood or is not fully accepted. The request to private banks to lend to Continental Illinois raises questions, of a different kind, about the functioning of the central bank as lender of last resort.

The request to private banks to lend to Continental Illinois is puzzling and, I believe, was counterproductive. It raised questions about the quality of the collateral: Was the Federal Reserve unwilling to lend against the collateral at Continental Illinois? It raised doubts about the degree to which the Federal Reserve understood its function as lender of last resort: Why were commercial banks asked to accept the risk however small, of participation in the losses? And it mixed issues of the soundness of the banking system with the growing concern about the soundness of an individual bank.

The public effort to sell the bank further eroded confidence and heightened uncertainty. The news media carried frequent stories about the discounts demanded by prospective buyers and hints about the negotiations between the insurance corporation and prospective buyers. Reports and rumors of this kind do little to convince depositors that they should retain their deposits at the bank or make new ones.

These actions suggest confusion between saving the bank and preventing a panic in the financial system. A policy of lending on demand, at a penalty rate, against ordinary financial assets eliminates many of the concerns that delay response, encourage inaction, and foster bureaucratic hesitation. Because the rate is a penalty rate, the central bank limits demand and makes loans only when others are unwilling to lend in sufficient quantity to prevent a bank run. The only judgmental issue is the quality of the collateral. If there is not sufficient collateral eligible for discount, or the discount from book value is too large to pay current claims, the financial institution is insolvent and should be closed promptly. A central bank should not prevent insolvency; its responsibility is to prevent financial panics.

Past experience, particularly the experience with bank failures in the early 1930s, clouds the issue and may mislead regulators. The failure of a single bank or financial institution is no greater calamity for society and imposes no greater loss than the failure of any other firm of comparable size. (See also Kaufman 1985.)

There is a need to distinguish between the individual's problem and the social problem. To the individual who is a depositor (creditor) or who owns shares, an isolated bank failure involves a loss of
wealth. Those who work in the bank or use its services suffer a temporary loss of income and services. These losses in wealth, income, and services are not different in principle from the losses individuals experience in a theft or a fire, the bankruptcy of a manufacturing or retailing firm, and many other events that occur commonly. If the failure of one bank was unrelated to the failure of other banks, losses to depositors could be insured privately just as losses from theft, fire, or accident are insured.

A collective interest in the problem of failures arises if the failure of one bank, or the anticipation of a failure, alarms the depositors of other banks. Uncertainty about the safety of a large class of banks leads to withdrawal of deposits by depositors at many banks. In a fractional reserve banking system, simultaneous deposit withdrawals can produce the wave of failures and closings anticipated by frightened depositors unless a lender of last result provides currency by discounting financial assets. A private insurance company cannot underwrite the losses from the series of bank failures that constitute a banking panic. Only a central bank, able to produce currency at close to zero marginal cost, can prevent the spread of failure and the social loss.

The U.S. regulatory system divides responsibility for banking policy among state regulators, the deposit insurance agencies, the Comptroller of the Currency, the Federal Home Loan Bank Board, the Federal Reserve; and a few others. This system makes it appear that the function of lender of last resort is not vested in a single agency: This is misleading.

The Federal Reserve is the only agency empowered to supply unlimited amounts of currency on demand, and so it is the only one of the financial regulatory agencies that can serve as lender of last resort. The government’s insurance corporations can pay out claims arising from single bank or thrift institution failure, or a series of failures, but they cannot prevent runs on financial institutions. Because there are no rules stating the circumstances under which a problem in the thrift industry or among insured, nonmember banks becomes a responsibility of the Federal Reserve, there is unnecessary ambiguity about the conditions under which the Federal Reserve, as lender of last resort, accepts responsibility for lending against collateral offered by institutions that are not members of the Federal Reserve system. Recent experience in Ohio and Maryland suggests that delays can be avoided if policies are agreed on in advance and implemented
promptly. Experience also suggests that policies will not be formulated as precommitted strategies unless the administration, Congress, or the public demands some agreement among the regulators in advance.

The deposit insurance system developed in the United States after 1930 because the central bank failed to function as lender of last resort. Deposit insurance reduces the risk to individual depositors of losses from bank mismanagement, error, excessive risk taking, and fraud. It does not and cannot insure the safety of the financial system. In a financial crisis, the insurance agencies, like the institutions they insure, can obtain currency only from the Federal Reserve—the lender of last resort.

Many have noted that there is a flaw in the deposit insurance system. The flaw results from the use of fixed insurance premiums. Since premiums are unrelated to the risks accepted by financial institutions, opportunities for shifting risk to the insurance agencies arise. The problem is more serious in the current less-regulated financial system, than in the past, and the problem is most serious when an institution is close to insolvency. The fixed insurance premium permits the management to accept large risks, to earn higher returns, without paying a risk premium. If the speculation is successful, the owners and managers gain, but if the speculation is unsuccessful, the insurance agencies pay the losses. Under current conditions, with many financial institutions holding portfolios of assets that have much lower market value than their book values, this problem is more important than it was a generation ago. Nearly twenty years ago, I proposed that deposit insurance premiums be related to portfolio risk (Meltzer 1967: 482–501). A reform of deposit insurance to relate premiums to risk is a more pressing need now.

RISKS IN BANKS AND FINANCIAL INSTITUTIONS

The problem of financial fragility will not disappear, at least not soon. Many of the thrift institutions own portfolios that the market values far below their book values. Banks in agricultural areas hold mortgage loans on farms with market value below mortgage value. At current prices for agricultural products, some of these loans will continue to go into default. Banks with foreign loans, particularly
loans to governments, continue to carry the loans at book value if payment is current. In the market, Latin American loans sell for no more than 70 to 80 percent of their book value, an increase in recent months, but a substantial discount from book value. Energy loans and loans to land developers, in many cases used to speculate on rising prices of oil or land, are an additional source of losses that are not fully recognized on many banks' balance sheets.

To gauge the size of some of the differences between the market value and the book value of bank portfolios, I use a sample of banks drawn from the Value Line weekly financial service. The issue for March 22, 1985, reports on forty-one banks. One bank is in the process of reorganization, so it was omitted from my calculations.

To measure unrecorded losses on a bank's balance sheet, I used the ratio of reported book value (on December 31, 1984) to the "recent" market value of the common stock shown by Value Line. A ratio of book value to market value below unity indicates that market is willing to pay less than a dollar for a dollar of assets. I used the ratio to compute the implied reduction in the bank's loan portfolio by multiplying the ratio by the loan portfolio. The result is a market estimate of potential loss or shrinkage. I compared the implied shrinkage in value to the bank's net worth. Value Line also reports the percentage of foreign loans in the portfolio, which allows us to compare banks with a large percentage of foreign loans to other banks.

For the sample of forty banks, the mean ratio of market value to book value is approximately 1 on the date I used. If this sample, consisting of larger banks with publicly traded shares, is representative of the industry, there is no difference on average between book and market values. This number hides the considerable diversity within the sample. The ratio of market value to book value ranges from .55 to 1.77 for individual banks. The characteristics of the banks differ also.

The ten banks with the lowest ratios of market value to book value include several of the largest banks in the country. Their average size, measured by reported net worth, is $2.1 billion, and they range in size from $200 million to $5 billion. For these banks, market value is less than two-thirds of book value (0.64), and the range of the ratio is from 0.55 to 0.75. On average, one-third of the loan portfolio of these banks is in foreign loans, but the banks differ in this respect; the proportion of foreign loans ranges from slightly
above zero to 62 percent. Using the ratio of market to book value to estimate shrinkage in the loan portfolio, there is an implied loss equal on average to 5.6 times the reported net worth of these banks. The market’s estimate of hidden portfolio losses, or shrinkage, is somewhat lower for these banks than the market valuation of loss on Latin American loans that are sold.

The banks with the highest ratios of market to book value have very different portfolios. Foreign loans are 2 percent of total loans for the group. Not a single bank has more than 8 percent of its portfolio in foreign loans, and many banks have either a negligible percentage or none at all. The banks are much smaller; their net worth is $400 million, about one-fifth the net worth of the banks with lowest ratios of market to book value. The market values each of these banks above its book value, so there is no portfolio shrinkage. Market values range from 129 to 177 percent of book value.

Differences in foreign loans do not explain all of the differences in market valuation. Many of the smaller banks are regional banks in areas with relatively strong economic growth. Some are possible candidates for acquisition if interstate banking is allowed to spread. These circumstances or prospects attract buyers of the shares.

Two main lessons can be drawn. First, the problems of the banking industry are problems of individual banks. There is no evidence in these data that the banking system has a serious problem. The problem for the financial system will arise if regulators fail to function as lenders of last resort in the event of loan defaults or failures by insolvent banks or financial firms. Second, the market appears to discriminate between banks. Banks with high percentages of international loans sell at discounts (often substantial) from book value. The market appears to have appraised bank portfolios and recognized anticipated losses. Although I have not computed the market’s estimates of portfolio values for publicly held savings and loan associations or for banks with relatively large portfolios of agricultural loans, the market probably values these shares at substantial discounts from book value also.

Managements’ reluctance to recognize portfolio losses has not hidden the problem. Regulators’ delays have raised the level of risk borne by society. And the absence of a clearly stated, widely known set of procedures for responding to financial failures adds to uncertainty and heightens the public’s concern about financial fragility.
SOME PROPOSALS

The safety, or soundness, of the payments systems is, properly, a matter for public concern, because maintenance of an efficient payments system benefits the public as a group more than it benefits individuals acting alone. In the United States and a few other countries, banks are the principal agencies operating the payments system, so that lack of safety or insolvency of banks and other financial institutions is a threat to the payments system. An individual bank or financial failure imposes losses on depositors; an epidemic of failures weakens the payments system and imposes losses to society as well as to individual depositors.

Events of the past few years have shown that, while most financial institutions remain strong and profitable, some have failed and others seem likely to fail in the future. The reasons for failures vary, but many of the current problems have common causes. Inflation encouraged speculation in land and housing, much of it financed by banks and thrift associations. Many, including some bank and thrift institutions, favored deposit rate regulation that weakened the structure and its institutions. Presidents, Congresses, regulators, and many others, including some of the banks and thrift institutions themselves, resisted changes in policy that would have prevented the inflation of the 1970s and therefore the demand for disinflation in the early 1980s. Disinflation both contributed to and revealed the major problems in the U.S. financial system. Although some of the problems would have developed following declines in the relative price of oil and changes in the tax code that raised the expected after-tax return to investment in the United States and thus raised real interest rates, many of today's problems are the result of past inflation, disinflation, and uncertainty about future inflation.

The fact that not all banks and financial firms are experiencing difficulties suggests an element of choice or managerial discretion. Many banks have small portfolios of foreign loans. Many banks avoided the real estate loan problems, the agricultural loan problems, and the energy loan problems by following such time-honored principles as scrutinizing assets for quality, relating risk and return, or diversifying portfolios. I do not know of any major money market fund, for example, that was willing to forgo taking possession of securities to earn an additional 1/4 percent interest. We know, of
course, that not all institutions were as prudent; the problems of the Ohio thrifts were the result of that lack of prudence.

Bank managements are not always prudent. Major banks with large foreign loans have been slow to recognize their losses. Dividend reductions to increase retained earnings are a relatively rare event. Since dividend payments are, currently, 5 to 6 percent of market value, a policy of eliminating dividends, if adopted in 1982 when problems with Mexican debt came to public attention, would have increased retained earnings by 15 percent of current market value and 10 percent of book value. By building capital in this way, managements would have recognized two problems that markets have recognized. First, many of the international loans are not likely to be repaid; second, interest earnings on international loans are paid in many instances only because the bank lends the debtor country the amount of the interest payment when the payment is due. If major banks reduced or eliminated their dividend payments, their reserves would be larger. The banks would be less risky because a major loan default would be less likely to be followed by insolvency. It is not clear that the market price of bank shares would fall. The market recognized the losses long ago.

There have been improvements in the financial position of some major debtor countries, but not all debtors have used the recent strong expansion in the United States to increase their ability to service debt. Even in those countries where exports and current account balances increased at a rapid pace in 1983 and 1984, the cost of servicing external debt is large relative to exports. And substantial risk remains because much of the improvement in Mexico and Brazil reflects the combination of strong expansion in the United States (which has now ended) and one-time reductions in imports that cannot be repeated. Bank management can reduce the risk to the payments system and their bank’s risk of insolvency by reducing or passing dividends, by increasing capital, and by selling some of their foreign loans to financial and nonfinancial institutions willing to accept the risk at the rates of return implied by current market prices for these loans.

The most alarming feature of the international debt problem is the failure to recognize that errors were made and that losses have occurred. Instead of carrying loans at face value, banks should write down the value, increase reserves against default, and sell many more of their loans to others including nonfinancial corporations. Several
years ago, I recommended that banks offer to exchange debt for equity in government corporations in Brazil, Mexico, or even Argentina. Many of the state-owned corporations are profitable. The shares would command a market. Of course, the banks would have to discount the debt, but in exchange they would have a better claim than they now have. By reducing the burden of Latin American debt, they also would improve their own and others' prospects of receiving interest and principal payments on the remaining debt.

Public policy has a role in lowering risk in the financial system. Regulators must improve their system of crisis management. Their concern must be with the risk of a financial panic leading to simultaneous withdrawals from many banks and financial institutions. I recommend that they develop and announce rules of procedure to replace the present ad hoc nonsystem.

The rules should clarify the conditions under which the deposit insurance agencies can discount at Federal Reserve Banks or call for assistance. The deposit insurance agencies have an important role with respect to individual institutions, but at many institutions they must have help in a crisis from the Federal Reserve. The Federal Reserve is the only institution that can lend unlimited amounts in a crisis, so it must function as the final lender—the lender of last resort.

The position of foreign banks in the United States and of U.S. banks or branches abroad should be clarified. The Federal Reserve can function as lender of last resort only for financial institutions with dollar liabilities, so it should not undertake responsibilities that may require large loans to foreign branches of U.S. banks with liabilities mainly in foreign currencies. The Federal Reserve is the only lender of last resort for foreign financial institutions in the United States that issue dollar liabilities. There is need for an agreement between the Federal Reserve and foreign central banks that delineates responsibility for foreign branches in advance of a problem. Current agreements on lending facilities are more ambiguous and subject to greater discretion than seems desirable.

The rules for domestic institutions should specify the types of collateral that will be accepted, the financial institutions that are eligible to use the facilities of the lender of last resort, and the price to be charged. A penalty rate is an effective means of reducing demands for emergency borrowing and is an effective warning system that alerts regulators to problems in the financial system.
A century ago, Walter Bagehot criticized the central bank for not stating its policy for lending in a crisis. His criticisms and the principles he recommended to the lender of last resort are as relevant now as when he wrote them. The lender of last resort should lend freely at a penalty rate against any collateral that is marketable in the ordinary course of business. The Federal Reserve should accept these Bagehotian principles and remove the ambiguity that now exists about the circumstances under which it lends. Further, the Federal Reserve should stop lending at below-market rates to troubled institutions. Loans made at below-market rates encourage risk taking.

The current system of deposit insurance also subsidizes risk taking by financially weak institutions. Premiums for deposit insurance should be related to the risk of a financial firm's assets. This reform would reduce the incentive for weak institutions to acquire risky assets at high rates of return as a means of increasing earnings or delaying insolvency.

The current fragility of the U.S. financial system is, properly, a cause for concern. The risk of loss to depositors, creditors, and owners imposes a burden that can be avoided by appropriate action by the managements of troubled institutions and by regulators. Recent experience shows that there are flaws in the system for handling bank runs and protecting the solvency of institutions that are temporarily illiquid. Experience during the last three years suggests that many bankers and the banking agencies have been slow to adjust their policies so as to reduce the risk of financial failures. These problems can be reduced without imposing costs on the much larger number of safe, well-managed financial institutions.

REFERENCES


