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A "Safe Bank" Proposal By Prof. Acharya, Univ. of Illinois

Dr. Sankarshan Acharya, in a 2003 article here, describes a "Safe Bank" proposal that makes a lot of sense considering the recent failure of the banking system.

In simple terms Prof. Acharya argues that setting strict capital requirements with other sanctions essentially prohibiting leverage, can produce "safe banks" that will be immune from bank panics without the need for expensive FDIC deposit insurance.

"Define "safe banks" as those whose assets comprise only government securities and cash, who accept no more deposits than liquidation value of assets at any point in time and who issue no liability (like debt and notes) other than preferred stock and common stock. It is optimal for taxpayers to have enough number of safe banks to serve panic-prone depositors and to let other banks operate as universal banks without government supervision. The extent of government regulation taxpayers need is that safe banks do not deviate from their charters," Acharya proposes.

In short such a bank could only make loans equal to deposits plus equity capital. It would be bullet proof because it's liabilities would, by definition, never exceed it's true equity. Such a bank would obviously not pay the same interest on deposits compared to a "universal bank" which would not operate under such strict restraints. But a deep number of "safe banks" throughout the country would, in effect, give savers a safe bank without the need of government insurance. Part of Acharya's argument is that deposit insurance is part of the problem. Banks figure they can game the system and not worry about having to bear the risks because the deposit insurance forces the government to come to the rescue.

With sufficient number of safe banks, says Acharya, "potential shifting of massive risks to taxpayers by bank managements will cease to occur."

Universal banks would only be lightly regulated, and their depositors would be taking some risk in the event the bank isn't well managed and conservative.

It's an interesting proposal, but FDIC insurance is still probably needed. The FDIC rates would be less for "safe banks" simply because their chance of default is so small. And we doen't share Acharya's faith that unregulated, universal banks still couldn't crater the world's financial systems, "safe" banks or no.

Acharya's article does provide a decent explanation of the current problems the government faces because of bank mismanagement.

"The global banking industry has now accumulated a total $217 trillion in face values (sic) of credit derivatives and other financial instruments. The true economic worth of these financial instruments is less, maybe about one tenth of face amount, but still very significant. Such instruments allow banks to raise massive sums through special purpose vehicles called conduits and master trusts against incomes from consumer and credit card loans in their portfolios. Banks effectively sell off the icings of their cakes while holding enormous residual risks for taxpayers. This allows banks to generate massive short-term profits, while effectively passing on the risk to taxpayers."

The safe bank restrictions are important to understand all by themselves. These types of restrictions on leverage reflect safety and the "utility" function of basic commercial banking. If someone wants to get an extra 2% on their savings account, or on a CD, go for it at a universal bank. Just don't expect FDIC insurance.

Tags: Acharya, Conduits, Master Trusts, Safe Bank

This entry was posted on Sunday, March 15th, 2009 at 2:47 pm and is filed under Economics. You can follow any responses to this entry through the RSS 2.0 feed. You can leave a response, or trackback from your own site.

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