AFTER THE CRISIS
Revisiting the "Banks are Special" and "Safety Net" Doctrines

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The Great Recession of 2007–2009 led many to question whether banks are special and deserve different financial regulation than other financial institutions. As policymakers sought to bring a swift end to the financial crisis, the safety net traditionally reserved for banks was expanded to cover a broad range of financial institutions. Following the crisis, the Dodd-Frank Act presented an opportunity to apply a more coherent approach to the question of the place of banks within the financial system. Instead, Congress further muddled the distinction between banks and other financial institutions.

In a new paper for the Mercatus Center at George Mason University, author Vern McKinley argues that banks are not special and never have been special. Furthermore, banks do not deserve a bank-specific safety net. The safety net should be dramatically reduced in a much more effective manner than under Dodd-Frank.

To read the paper in its entirety and learn more about its author, see "After the Crisis: Revisiting the 'Banks are Special' and 'Safety Net' Doctrines."

BACKGROUND ON THE "BANKS ARE SPECIAL" AND "SAFETY NET" DOCTRINES

The primary analysis justifying the special nature of banks came from the president of the Federal Reserve Bank of Minneapolis, Gerald Corrigan, who argued in 1982 that banks are special for three reasons: (1) they offer transaction accounts, (2) they are the backup source of liquidity for all other institutions, and (3) they are the transmission belt for monetary policy.

Corrigan argued that these traits qualify banks for the public safety net, which includes deposit insurance, access to the discount window for borrowings in the form of lender of last resort loans, and access to the Federal Reserve's payment services. In exchange, banks accept reserve requirements and mandates regarding community reinvestment, safety and soundness regulation and

For more information, contact
Kate De Lanoy, 703-993-9677, kdelanoy@mercatus.gmu.edu
Mercatus Center at George Mason University
3434 Washington Boulevard, 4th Floor, Arlington, VA 22201

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supervision, separation of commercial and investment banking, and operating restrictions. Solvency support—also known as bailouts—can be considered part of the safety net as well.

SUMMARY AND POLICY RECOMMENDATIONS

The history of bank regulatory policymaking shows that justifications for banks being special and deserving government support have been arbitrary, appear created to justify current government policy, and have not led to promised financial stability. Some have criticized the notion that banks are special by arguing that any specialness is sustained by government assistance and policy rather than by any inherent difference between banks and nonbank financial institutions. As government policies may have created the specialness of banks, banks and their customers have become dependent on continuing subsidies and protections. By encouraging banks to accept government assistance through federal deposit insurance, discount window loans, and government-directed closure systems, policymakers have removed banks from the discipline of the market system.

Moreover, the financial crisis of 2007–2009 saw the application of the safety net to a broader range of financial institutions, further eroding the argument for banks' specialness. The application of the safety net to banks and nonbanks has had both stabilizing and destabilizing repercussions, but has increased the government's exposure to financial crises of the future. While the expansion may have averted or curtailed certain crises, there are new demands to expand the safety net even further, which could lead to even greater instability.

It is necessary for policymakers to narrow the scope of the safety net. Specifically, while the safety net for individuals should largely remain intact—because small, individual demand creditors are the most likely to run and withdraw from the financial system—larger depositors should be responsible for managing their own risk if their financial institution fails. Deposit insurance and discretionary payments to large creditors should be discontinued.

CASE STUDY: BEAR STEARNS

The financial crisis brought about an expansion of the safety net beyond traditional banks. One financial institution—the investment bank Bear Stearns—received a significant bailout from the government in 2008.

- *Bear Stearns was not a commercial bank*. It did not supply credit as a backup source of liquidity, nor did it take deposits through transaction accounts. Additionally, Bear Stearns was not subject to reserve requirements, as commercial banks are.
- *Bear Stearns's "bank-like" qualities earned it a bailout*. Despite its differences from banks, analysts contended that the institution's bank-like qualities, such as the rapid run on repurchase agreements and its interconnectedness with counterparties, merited an extension of the bank safety net in order to avoid catastrophic damage to the financial system.
- *But there is little evidence that Bear Stearns presented the same risk to the system as a bank would have*. Evidence is lacking that a run on Bear Stearns implied a complete withdrawal from the financial system. Moreover, no coherent argument was made at the time supporting

the idea that interconnectedness of a nonbank financial firm, such as Bear Stearns, would cause a systemic breakdown. Despite this, the application of the safety net to Bear Stearns was used as precedent for its application other firms, such as American International Group.

DODD-FRANK AND A CONFUSED REGULATORY SYSTEM

The Dodd-Frank Act sought to reduce the safety net for financial institutions in the wake of the financial crisis. Instead of repealing the multiple, ad hoc bailout provisions, Dodd-Frank codified their structure with what its authors believed to be tighter, stricter limitations. Provisions included the following:

- *Broad-based support programs for financial institutions.* These widely available programs through the Federal Reserve and the Federal Deposit Insurance Corporation are intended to support solvent financial institutions by extending federal credit to them, but could also be used to support insolvent institutions as bailouts.

- *Orderly Liquidation Authority (OLA) for nonbanks.* OLA is supposed to be an alternative to bankruptcy for nonbank financial institutions. According to Corrigan's analysis, banks also required their own liquidation system. OLA's creation indicates that nonbank financial institutions have become so bank-like that they, too, need their own separate liquidation process.

- *Bank-like oversight of nonbanks.* Dodd-Frank imposes extended oversight and standards regarding risk-based capital and leverage on nonbank financial institutions. Like banks, these firms can be designated by the government as systemically important, meriting bank-like regulation and supervision.

Despite these departures from Corrigan's understanding of banks, current regulatory efforts still attempt to solidify the notion that banks are special:

- *Volcker Rule.* Commercial banks are prohibited from engaging in proprietary trading or activities that involve speculation, such as owning a hedge fund or a private equity fund. This prohibition is intended to reduce the assumed risk banks take on, in order to prevent future demands on the safety net. However, the rule perpetuates the idea that financial regulatory agencies can reduce risk in banking while it also encourages banks to cut back on risk reduction activities in order to avoid regulatory scrutiny.

- *Calls for a return to Glass-Steagall.* Some policymakers have called for a return to the regulatory regime of the 1930s through 1990s, under which commercial banks could not be associated with investment banks. Reform-minded legislators neglect important historical facts relating to Glass-Steagall, the 1933 law that separated commercial and investment banking. Risky investments by commercial banks cannot be sufficiently defined, nor can such investments be entirely separated from traditional banking.

CONCLUSION

The Dodd-Frank Act was intended to reduce the size of the safety net by giving financial authorities wide regulatory discretion, but the right approach to rein in the safety net would be to cut back its beneficiaries. Financial institutions of all kinds are subject to risk, but the government cannot and should not assume the risk for institutions that are capable of assuming it themselves.