Are banks still special?

*The **Governor** of the Bank, Eddie George, considers*[(1)] *whether banks continue to have a distinctive identity. He argues that beyond institutional identity lies the important question of whether banks continue to justify central banks' special concern for the stability of the banking system as reflected in both macro and microprudential oversight and in their role as lender of last resort. The **Governor** reviews changes in the make-up of banks' balance sheets, and contrasts these with the structure and functions of other financial institutions. He notes that, while in some respects banks may be less special than they were, they remain special in several important respects. He concludes that he would be very cautious about extending last resort liquidity provision to financial institutions not engaged in banking activity, particularly where banks' distinctive functions and the distinctive characteristics of banks' balance sheets did not clearly apply. While he does not think that such intervention can, realistically, be excluded altogether, he is concerned that an unduly liberal interpretation of systemic risk would increase the scope for moral hazard and ultimately weaken the safety and soundness of the financial system as a whole.*

Mr Chairman, I am delighted to take part in this well-directed and well-timed seminar. I am particularly pleased to be able to share with you my thoughts on the question you put to me 'Are banks still special?' That question is partly a matter of institutional fact; but beyond that lies the question of whether the institutional characteristics of banks still justify central banks' special concern for the stability of the banking system reflected in both macro and microprudential oversight and in their role as lender of last resort. So the answers to those questions could have far-reaching implications for the role of central banks themselves.

In offering my answers I will ask, first, why banks have been regarded as special? Then I will ask whether banks have changed, or whether other financial institutions have become more bank-like? I will save my conclusions until the end! I am conscious, in this international forum, that I speak from a British perspective—in terms of the institutional and legal contexts and their evolution in relation to banks. But I would hope that, while some of the detail may be specific to the United Kingdom, the broad substance will not be.

In what ways have banks been regarded as special?

Let me begin then by discussing why, and in what senses, banks have been regarded as special.

The term 'bank', historically and more than ever today, covers a multitude of sins. In practice it refers to a range of very different institutions which may, and do, within legal restraints, engage in a variety of different financial—and even some non-financial—activities whether on their own account or in an agency or advisory capacity. But banks have some key distinguishing characteristics in common. In particular they take unsecured deposits from the public at large.[(2)]

The particular characteristics of bank deposits are that they are capital certain and (more or less) immediately accessible to the depositor, so that they have come to be used as the principal means of making payments. In short, because of their convenience, bank deposits became the predominant repository for the immediately liquid asset holdings of the rest of the economy, and the predominant form of 'money'.

The attraction of these deposit and payments services depends upon depositors generally having a high degree of confidence that their funds will in fact be available on demand and it depends upon the cost of the services. In providing the services, therefore, the banks need to strike a balance between deploying their deposits in low-yielding, high quality, liquid assets to meet cash withdrawals, and riskier investments to generate a higher return. In this latter context banks have traditionally played a key role in financing the corporate and household sectors, earning their return by gathering information about, and assessing and monitoring, the creditworthiness of private sector borrowers, especially those who do not or cannot cost effectively provide the comprehensive, public, information that would allow them to access the capital markets. Much of the banks' lending, while nominally at short term, for example,

(1) In a speech given at the IMF Seventh Central Banking Seminar, Washington DC on Wednesday 29 January 1997.
(2) In the United Kingdom a bank is nowadays legally defined as an institution authorised by the Bank of England under the Banking Act to take deposits. This definition excludes a large group of specialist, mutual, institutions, the building societies, whose essential business is deposit-taking for lending for house purchase, and which are authorised by the Building Societies Commission under separate legislation. But this is an institutional detail, and it is notable that as they have extended into the money transmission business and diversified their lending activity. Furthermore, many of these institutions have elected to convert themselves into fully fledged banks.

in the form of callable overdrafts, is in practice illiquid and non-marketable. So a further distinctive characteristic of banks is that they typically function with a mismatch between their highly liquid liabilities and their less liquid, non-marketable, assets.

There is no need, I think, to labour the importance to the economy as a whole of these distinctive banking functions, or the damage that would be caused if the banks' role—as the repository of liquidity, as the core payments mechanism, and as the principal source of finance to at least a large part of the economy—were seriously interrupted. That in itself helps to explain the public interest in the effective functioning of the banking system, or why banks collectively have been regarded as 'special'.

But beyond that, the distinctive banking characteristics that I have described, of liquid liabilities and less liquid assets, give rise to special needs.

Given the banks' role in the payments system they may need late access to liquidity to square their positions *vis-à-vis* each other after executing payments instructions on behalf of their customers. This explains why, in their routine monetary operations to relieve shortages in the money market, central banks in many countries tend to confine their (late) lending to banks even when they accept a wider range of counterparties in providing liquidity through open market operations.

The same distinctive characteristics make banks especially dependent upon public confidence. Bank depositors are not generally in a position to monitor or assess the financial condition of their bank, so that any suggestion that a particular bank may not be in a position to meet its liabilities is likely to lead to the panic withdrawal of its deposits. This can precipitate the suspension of payments as a result of lack of liquidity even when a bank is solvent as a going concern; and the forced realisation of illiquid assets may in itself result in insolvency. Moreover, any suggestion that one bank is in trouble may be taken—perhaps wholly unjustifiably—as evidence that other banks are likely to be facing similar problems, especially when they are engaged in similar activities. Bank runs can for this reason become contagious. And the risk of contagion is increased by interbank exposures, including those arising from the banks' role in the payments system. So the 'special' nature of banks has reflected not just their distinctive functions, and the importance of those functions to the wider economy, but also their peculiar vulnerability to liquidity pressures. Central banks evolved in response to this vulnerability, which gave rise to a readiness to act as lender of last resort to the banking system in situations in which substantial systemic disturbance could otherwise occur and to an on-going concern for the macroprudential characteristics of the banking system. And while this concern relates to the banking system as a whole, last resort assistance, when it is judged to be necessary, is extended to individual banks because problems of course arise in the first instance at the level of the individual bank.

Now, the fact that central banks (in conjunction as necessary with governments) are prepared, in certain circumstances, to extend support in this way encourages bank intermediation; it represents in effect a form of subsidy, implicitly justified as being in the wider interest of the economy. It helps to preserve public confidence; and it enables the banks to take on more maturity transformation or risk than they could otherwise, so lowering the effective cost of their intermediation. But it has long been recognised that if central bank support is made available too liberally—in situations where there is no genuine systemic risk, so that it comes to be relied upon as a matter of course, then that would give rise to 'moral hazard'. The extent of bank intermediation would be unjustifiably expanded. On the one hand, the banks themselves may be encouraged to take on excessive risks; while, on the other, depositors may be encouraged to ignore risk and to become literally care-less as to where they place their deposits. So, both the safety and soundness of the banking system, and its competitive efficiency, and that of the financial system more generally, may be undermined.

Central banks' macroprudential concerns for the stability of the banking system have necessarily meant that they have taken a close interest in the risk characteristics of individual banks as the component parts of the system. But more recently (at least in the United Kingdom—with the coming into force of the first Banking Act in 1979) individual banks were brought under formal banking supervision for the first time, and non-bank depositors provided with limited deposit insurance. Such microprudential supervision of each individual bank, of course, also helps to reduce the risk of instability in the system as a whole, and even limited deposit protection may reduce the risk of bank runs, at least in the form of the sudden withdrawal of retail deposits. This, too, of course, can give rise to moral hazard problems if it is perceived as tantamount to a guarantee. But microprudential supervision and deposit insurance were introduced in the United Kingdom at least (though not in the United States) with the distinct, social, purpose of providing individual, small, depositors with a degree of protection against the sudden loss of their principal liquid asset holdings. This made banks, and bank deposits, special in a different sense insofar as similar formal supervision and asset protection were not (at that time) extended to other financial intermediaries or their liabilities.

These then are the respects in which banks have hitherto been regarded as special. Let me now move on to consider whether, or to what extent, the banks have kept their distinctive characteristics, or to what extent other financial institutions have developed similar characteristics so that banks are no longer special in that sense.

To what extent have banks changed?

It is certainly true, as I noted earlier, that banks engage in a range of financial activities besides those which I have described as distinctively 'banking' activities. Major banks everywhere have increasingly diversified the products and services they offer, built up investment banking businesses and trading activities, extended into life insurance, and so on, sometimes on a single balance sheet or sometimes in separate non-banking entities. In the present context, however, the question is whether these developments have fundamentally altered the characteristics of the 'banking' part of their balance sheets. It seems to me that the answer, generally speaking, is that they have not.

On the liabilities side, while there may have been (indeed in some countries, where close substitutes for money, such as money-market mutual funds have taken off, there certainly has been) some erosion of the banks' market share as a repository for liquid asset holdings, that erosion has generally been very gradual. In the United Kingdom, for example, bank (and building society) deposits still account for 42% of personal sector liquid asset holdings against 50% a decade ago; the proportion would be very much higher if liquid assets included only those that are capital certain. And the vast bulk of the banks' liabilities remain in the form of unsecured, short-term, deposits. Despite the rapid development of (secured) repo markets, only some 3% of the major UK banks' funding (in sterling and foreign currency together) was secured (from information provided last autumn) through repo; and the figure for all UK banks, including the business conducted in branches and subsidiaries of overseas banks, which have less direct access to deposits, was only around $8\frac{1}{2}$%. The proportion of secured funding is below 5% for other major internationally active banks that we have looked at, with the exception of JP Morgan and Bankers Trust—both somewhat special cases—where the proportion is very much higher (25%–35%). And even in those special cases it is still well below that for the major US securities firms (typically 55%–80%).

Banks remain, too, at the heart of payments systems. Payments may be made directly across bank accounts through instructions, for example, in the form of cheque or debit card; or they may be made indirectly, through, for example, the use of credit cards, the balances on which are subsequently settled using a bank account. Even where disintermediation creates new chequing facilities, as for example, in the case of money-market mutuals, these are still cleared through settlement banks. It is true that new forms of money transmission—e-money—are being developed, sometimes outside the conventional banking system. But I suspect that they, too, will typically depend upon clearing through the banking system. To the extent that they come to involve the creation of what are effectively direct deposits, they will represent 'banking' in a different form and become special, and logically subject to regulation, in much the same way as conventional bank deposits. In the payments system context, too, important progress is being made to reduce interbank exposures (through the introduction of real time gross settlements systems in many countries, for example, and through the netting of foreign exchange settlements) but those exposures, as well as interbank exposures incurred in direct interbank transactions—the large bulk of all of which are unsecured—remain extraordinarily large. Individual interbank limits can substantially exceed 25% of capital (the normal supervisory limit for large exposures), and as an example of aggregate interbank exposures the major UK retail banks currently place some £115 billion, or 16% of their total assets, with each other or with other UK banks.

Turning to the assets side, there is some evidence of a gradual erosion of the role of banks in financial intermediation. One measure in the United Kingdom is a decline in the banks' (and building societies') share in the assets of the whole financial sector (including securities firms, collective investment vehicles, and life assurance and pension funds' investments etc) which has fallen fairly steadily over the past ten years, from close to 70% to some 55%. I believe that in the United States, where financial innovation has probably been even greater, comparable figures also show this decline, from around 45% in the mid-1970s to about one third now.(1)

In the United Kingdom, bank lending to the corporate sector has fallen, erratically, from some 27% of total corporate borrowing outstanding (including all forms of debt as well as equity issuance) in 1985 to less than 17%. This mainly reflects the increased access of larger corporate borrowers to the domestic and international capital markets for short and longer-term corporate paper, where they often have a better credit rating than banks. Smaller corporates, on the other hand, remain very heavily dependent upon bank finance—for well over half their overall needs. Meanwhile the banks' share of net external finance of the personal sector has not changed much at all over the past decade, at around 80%.

Trends in the liquidity of bank assets are difficult to assess because liquidity itself is so hard to judge simply from balance sheet categories. The advent of securitisation and the direct sale of loans ought to have helped.(2) But except in the United States, securitisation has in fact so far made only limited progress, and debt sales have been focused mainly on impaired developing country or corporate debt. One reason why prime corporate loans are not so far traded is the importance that both banks and borrowers still attach to their mutual relationships. My guess is that the liquidity of bank assets by these means will gradually increase; and that process may be helped by the development of techniques such as credit derivatives. But for the time being—and indeed some time to come—bank loans are, for the most part, likely to remain illiquid in most countries.

(1) J H Boyd and Mark Gertler ('Are banks dead? Or, are the reports greatly exaggerated?', Federal Reserve Bank of Chicago, 30th Annual Conference on Bank Structure and Competition, May 1994) suggest however that the banks' share has in fact been stable if you adjust for off balance sheet activity and for the activities of foreign banks.

(2) Boyd and Gertler—*op cit*—estimate US bank holding company loans securitised or sold down in 1993 at $135 billion; other estimates ('Remarks by the Vice Chairman of the Board of Governors of the US Federal Reserve System, Alice M Rivlin', at The Brookings Institute National Issues Forum in Washington DC, on 19 December 1996) suggest that now it may be of the order of $200 billion or more. These figures compare with loans and advances remaining on the banks' balance sheets of some $\$2\frac{1}{4}$–$2\frac{1}{2}$ trillion.

We can nevertheless look at the crude balance sheet data, and, for what they are worth, we have looked at the share of loans to non-banks in total assets as a measure of the liquidity of the asset portfolio for a range of different types of institution. These data show that:

- for some representative small, domestic, UK banks the loan ratio is still some 70%–80% of the total, apparently with no particular trend;
- for large, internationally active, UK banks the share of loans is currently around 50%, having fallen quite sharply from some 65%–70% some five years ago, perhaps reflecting the expansion of their investment banking activity; and
- for large continental banks the share of loans is either side of 50%, having fallen more gradually.

Again JP Morgan and Bankers Trust are outliers. Their loan ratio to total assets is down to around 12% from around 50% in 1985 and 30% only five years ago. That is still much higher than the illiquid asset ratio for the large US securities firms which has fairly consistently been around 2%.

The conclusion that I draw from all of this is that while there certainly have been important changes affecting the banks, and the environment in which they operate, they have not yet, at least, been such as to affect fundamentally their relevant key functions or the importance of those functions to the economy; nor have they altered fundamentally the distinctive characteristics of either the banks' liabilities or their assets.

To what extent have other financial institutions become more like banks?

So, then, to what extent have other financial institutions developed similar characteristics to the distinctive characteristics of the banks as I have described them?

The question, let me be quite clear, is not whether other financial institutions perform economically or socially important functions—clearly they do—and those functions may equally be 'special' in their own distinctive ways.

It is also obviously true that, with the upsurge in financial innovation and globalisation that we have seen in the past 10–20 years, there has been substantial blurring of the boundaries between different types of financial institution and the increasing emergence of multifunctional, multinational, financial groups, so that non-bank institutions have taken over banks or offered banking services just as banks have entered substantially into non-'banking' financial activities. But that is not the issue either. The question is whether the distinction between banking and non-banking financial functions has been eroded—whether those functions are carried out in separate entities or on the same balance sheet. I do not think it has.

Take, for example, long-term savings institutions—life insurance companies and pension funds. They clearly perform a vital economic and social function, and they are subject to separate functional regulation because of their 'special' importance as homes for the long-term savings of the personal sector and as providers of long-term capital. But their liabilities are totally unlike the very liquid liabilities of banks, and the liquidity of their assets and liabilities are much more closely matched—indeed their marketable assets tend to be more liquid than their liabilities. The distinction remains even where these activities are carried out in a banking group, though in this case the different businesses have to be conducted on ring-fenced balance sheets and subject to different prudential tests, reflecting the quite different nature of the contracts and the different risks involved. That is not to deny that there may well be risks running from one part of the group to another—for example reputational risks or operational risks arising from shared systems or personnel and so on. It is not to deny either that there can be large cross-functional financial exposures. That, of course, is why the respective supervisors need to take an interest in all parts of a financial group and in intra-group exposures. But none of this, it seems to me, means that long-term savings institutions have taken on the distinctive special characteristics of banks.

So far, I would hope, so good in the sense that perhaps most of you would agree that this particular distinction remains. But have I chosen this extreme example as an Aunt Sally?

Well perhaps to a degree I have. So let me take some less obvious cases.

What about money-market mutual funds, for example? Surely they at least have some of the characteristics of banks? They, too, act as a repository for liquidity and it is possible to make payments from some of them, which looks very like a banking arrangement? And so it does. But in fact I think this appearance is deceptive, for three reasons:

- first, investments in money-market mutuals are not, as I understand it, in principle capital certain (though in practice they may be supported by the fund's sponsor); nor are they covered by deposit insurance (though this may not always be understood by the investor);
- second, as I mentioned earlier, money-market mutuals are not themselves at the heart of the payments mechanism, but in effect piggy-back on the banks which are;
- and, third, money-market mutuals do not undertake maturity transformation by making illiquid loans; like all collective investment schemes they put their investors' funds into marketable instruments in accordance with the rules of the fund.

Whereas money-market mutuals have something of the character of banks on the liabilities side of their balance sheets, but not on the assets side, the converse is true of non-bank finance companies. They do make illiquid loans, much as banks do. But they typically fund themselves in capital markets or from the banking system, and do not offer capital-certain, immediately available, liabilities to the public at large which are in any way comparable to bank deposits. Nor do they typically offer payments services.

But what about the free-standing securities houses—and in particular those of American and Japanese parentage that have, up to now, been separated from commercial banking activity by the Glass-Steagall Act and by Article 65? They, surely, have both liquid liabilities and engage in maturity transformation; and, of course, they do actually operate partly through banking entities outside their home jurisdictions.

Again, however, I think appearances may deceive. The liabilities of the houses are not in fact a bit like bank deposits. While it is true that the houses have increased the extent of their unsecured funding, for example through public issues, the bulk of their liquid liabilities are still secured—with, as I said, some 55%–80% of the total funding of the US houses we have looked at typically in the form of repos. Nor do the houses hold themselves out to take deposits from the public at large. Nor, finally, are their liabilities directly usable as a payments medium. In all these respects the houses' liabilities are non-monetary—even if they can rapidly be turned into money.

On the assets side of the balance sheet, the securities houses continue to invest primarily in liquid, marketable assets which can readily be sold. This is partly a reflection of the nature of investment banking business, in particular trading, underwriting and so on, and of regulatory requirements, but also of funding uncertainty: the securities house protects itself by being able, if necessary, to contract the size of its balance sheet very rapidly. Illiquid assets continue to be a small proportion of the total, generally of the order of 2%, and the houses mitigate the maturity transformation risk in holding these, and marketable assets of more doubtful liquidity (such as some emerging market instruments), by matching with long-term borrowings.

What is certainly true is that the securities houses have expanded their activities enormously—with balance sheets extending to $100–200 billion, which puts them in this respect on a par with large international banks. And, given their focus on trading activity—in money, capital and foreign exchange markets—they are, of course, huge counterparties of the banks, with very large exposures both among themselves and between them and the banks, but with the important distinction that exposures between, or to, securities houses are more typically secured.

Size in any event does not in itself mean that the securities houses now have the special, distinguishing, characteristics of banks—any more than the long-term savings institutions or the money funds or indeed large non-financial corporates, which may also have huge balance sheets and which may also have large Treasury operations in-house to manage the funds for own account.

Systemic risk

So it seems to me that banks are indeed still special insofar as they continue to perform distinctive economic functions and insofar as their liabilities and assets still have distinctive characteristics. This means that there is still a distinct public interest in the activities of institutions that are engaged in banking—as defined—whether as free-standing entities or within a broader group structure. That interest includes a microprudential concern to provide some measure at least of protection to public depositors, reflected in the supervision of individual banking institutions and in deposit protection schemes. But it includes also a macroprudential concern with the stability of the banking system as a whole, because of its peculiar vulnerability to contagious—systemic—disturbance, reflected in central banks' preparedness to provide liquidity to the system where that is judged to be necessary.

Other forms of financial activity also perform distinctive functions, and have distinctive characteristics which make them special in their own different ways. And these special features equally may—and often do—give rise to special public interests. The public interest in these other financial activities may be driven by a social concern to protect consumers (for example the prospective beneficiaries of pension funds or life insurance policy holders, or investors, whether in collective funds or individually, through different kinds of intermediary, in capital markets), which is similar to the social concern relating to depositor protection. And it may extend to other aspects of the particular activity, including aspects of business conduct as well as the financial integrity of the institutions involved. In fact the public interest in non-banking financial activity has certainly increased in this sense—both in terms of the range of activities covered and the standards of protection demanded—as is reflected in the spread of financial regulation over the past 10–20 years as the activities themselves have expanded. Our own Financial Services Act, for example, which provides for formal regulation of investment business dates only from 1986. A corollary of this broadening public interest is that multifunctional financial services providers are bound to be subject to a broadening range of functional regulation—however such regulation is structured.

What I think is less clear is the extent and nature of the public macroprudential interest in non-banking financial activities. I have argued that other, non-banking, financial activities are not—because of the different characteristics of the related liabilities and assets—subject to runs in the same way as banks, and that they are not therefore subject to contagious—systemic—disturbance in the same sense as banks. But that does not mean that non-bank financial institutions cannot face liquidity pressures. It does not mean either that the failure of a non-bank financial institution could not—through its direct credit or settlements exposures to other financial institutions (bank or non-bank)—have damaging knock-on effects. Conceivably, too, such a failure could have such serious consequences for the liquidity of—or price level in—some particular sector of the financial markets, that concerns would arise for the liquidity, or solvency, of other bank or non-bank institutions that were known, or believed, to be heavily exposed to that market. In this sense size does matter—and, whether or not one chooses to describe the risk of this happening as systemic, there is no doubt that a sufficiently large disturbance originating in the non-banking activity of one financial institution could put others in difficulty. This possibility must be of concern to financial regulators, including central banks, concerned with the stability of the financial system as a whole. It certainly, in my view, provides macroprudential justification for regulatory oversight of the activity of (large) non-bank financial institutions, and of the non-banking activities of banks—quite apart from microprudential regulation in the interests of consumer protection. It provides justification, too, for some form of consolidated prudential oversight of multifunctional financial groups and for monitoring large exposures, both intra-group and to outside counterparties. Where a problem of this sort does arise, it may well justify technical central bank intervention to help contain it—for example by facilitating payments and settlements to minimise market disturbance. But, I would be very cautious about extending last resort liquidity provision to financial institutions not engaged in 'banking' activity, and where the particular justification for it, based upon banks' distinctive functions and the distinctive characteristics of banks' balance sheets, did not clearly apply. While I do not think such intervention can, realistically, be excluded altogether, I am concerned that an unduly liberal interpretation of systemic risk would increase the scope for moral hazard and ultimately weaken the safety and soundness of the financial system as a whole.

Conclusion

Mr Chairman, my answer to your question 'Are banks still special?' is essentially that while in some respects they may be less special than they were, they remain special nonetheless. They remain special in terms of the particular functions they perform—as the repository of the economy's immediately available liquidity, as the core payments mechanism, and as the principal source of non-market finance to a large part of the economy. And they remain special in terms of the particular characteristics of their balance sheets, which are necessary to perform those functions—including the mismatch between their assets and liabilities which makes banks peculiarly vulnerable to systemic risk in the traditional sense of that term. Perhaps the day will come—and I do not at all exclude the possibility that other financial activity will continue increasingly to be carried on alongside banking activity, even on the same balance sheet, indeed I expect that to happen. That, in my view, does not reduce the special public interest in banking activity; although it may well affect the appropriate substance of banking supervision; and it certainly extends to banks' other, different, functional public interests, including different regulatory interests. On the other hand I am not persuaded that the special public interest in banking activity extends to non-banking financial institutions, though different functional public interests in many cases clearly do. What is absolutely clear, in a world of increasing financial integration, is that neither the financial regulators nor the central bankers among you can expect an easy life!