WHAT IS, OR SHOULD BE, A BANK?

Kevin Davis

Department of Economics,
University of Adelaide

In most nations of the world, a legal distinction is drawn between financial institutions labelled as "banks" and other "non bank financial intermediaries" (NBFIs). But the elasticity of the grounds on which that distinction is based - in terms of activities permitted, constraints placed, and privileges given to "banks" - simply serves to illustrate a crucial, and often forgotten, point. Banks are different from other financial institutions mainly because of legal restrictions and privileges applied to holders of bank licences.

Once it is recognised that the special status of banks stems from the nature of their relationships with government, appropriate policies towards financial regulation can be formulated. Two implications of this argument are immediately obvious. First, there is no *a priori* case for banks having freedom of action equivalent to that of NBFIs. It may be possible to make such a case, but it needs to be firmly based upon demonstrating that the privileges arising from the special government-bank relationship are not extended into other areas of financing for which they are inappropriate. Second, given the problems caused by special government-bank relationships, the basis for such relationships needs to be ascertained.

These issues have not received sufficient attention from either our practitioners of financial deregulation (Messrs Howard and Keating et

al.), or the Campbell and Martin committees whose reports have provided the intellectual cornerstone for our recent deregulatory experience.

In two areas, banks in Australia have a special role based on legal restrictions and privileges. One is the perception of banks as risk free institutions resulting from *de facto* government guarantees of bank deposits. The other is the banking sector's monopoly of the supply of cheque and related payments systems.

Quite sensible arguments can be advanced to justify government promotion of a group of institutions within the financial system which provide risk free deposit facilities. Without some form of support/ guarantee facilities, the inability of customers to assess an institution's solvency can expose institutions to unwarranted "runs" of depositors and increase the possibility of financial crises.

But where institutions (banks) get a government guarantee of safety (however vague that guarantee may be - as is currently the case) several conditions need to be ensured. First, bank owners and bank customers who thereby benefit should pay an appropriate premium - as would occur with any explicit insurance policy. Second, the government should (as would any decent private insurer) impose conditions on bank activities which limit the undertaking of risk increasing activities. Third, the limits of any such guarantee should be made explicit.

Without some such constraints there is little chance of a financial sector emerging which caters for all tastes, covers the whole risk spectrum and is generally efficient. The government "guaranteed" institutions have too strong a competitive advantage. Exactly what set of constraints would give an appropriate balance of costs and benefits from government "guarantees" cannot be outlined here, but is an issue from which deregulators should not shirk - as they have so far done.

The other area in which banks have a special role is the provision of the payments system. Given modern technology it is far from obvious that this should remain the preserve of an exclusive club of "banks".

Can other "non guaranteed" institutions be allowed to participate in the payments mechanism, or would this threaten its integrity? The answer to the latter part of this question is no. *Operation of the payments system and the safety of participating depository institutions (such as banks) are largely separable issues.* These issues become entangled only when the payments system involves lags in settlement.

To understand this, it is important to recognise that in essence the payments system is simply a mechanism whereby the transfer of ownership of financial claims (deposits) on "banks" is arranged. It thus constitutes basically an accounting system, whereby such ownership changes are recorded, complemented by a settlements process whereby banks exchange ownership of particular assets in reflection of the *net* outcome of all of their customers' accounts.

Only when lags in settlement occur (as in the current cheque based system) do participants in the system need to be concerned about the safety of the institution upon which those cheques are drawn, and upon which they hold a temporary claim until settlement is effected. In contrast, under modern technology which utilises electronic signals to (virtually) instantaneously affect transfer of ownership and settlement, the recipient of funds will be able to obtain value immediately. Problems involving the paying institution's insolvency or the state of the account will show up immediately and prevent the transaction taking place.

Even under a paper based system of cheques the risk of a cheque issuing institution's failure prior to the settlement and crediting of value to an account at the recipient's preferred institution should be trivial relative to the possibility of a cheque "bouncing" because of insufficient funds in the writer's account. And any problems involving outstanding settlement claims between cheque-issuing institutions can be mitigated by insurance type arrangements. Such arrangements could be markedly superior to the current prevention of risk by strict barriers to entry associated with bank licensing and bank ownership of clearing house facilities.

The other argument commonly advanced for limiting entry to the payments system is that costs increase as the number of participants rise. The system, it is argued, is more efficiently run and costs minimised by involving only a small number of large institutions.

That may have merit if a two stage clearing process involves lower average costs than a one stage process. For example, each bank currently operates its own internal clearing system between its own branches and submits to the clearing house items drawn on branches of other banks. An alternative one-stage system (along the lines of unit banking) would involve each branch submitting directly to *the* clearing house items drawn on other branches of both its parent and other banks.

The relative costs of these two systems would seem to be strongly dependent upon the nature of existing technology, with the internalisation within banks of inter-branch clearing consistent with lower costs in the past of a two stage system. Whether, given likely technological developments, that cost advantage will (or does) remain is an open question. But in any event it is only of relevance to the

question of how and not whether small institutions should be able to interface with the clearing system.

If our financial system is to involve a privileged group of institutions (perhaps called banks) it is important that those privileges be justifiable and appropriately "paid" for. The current restrictions on provision of payments services have not been justified. Nor have Australian governments properly sorted out what type of "guarantees" (if any) should be available to which types of institutions and their customers, or what the appropriate *quid pro quo* should be for such privileged status. Until these problems are rectified a truly competitive, efficient, and equitable financial system is unlikely to emerge in Australia.