Still Banking on the Market: A Comment on the Failure of Market Discipline

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Following the publication of my article *Banking On the Market: Relying On Depositors to Control Bank Risks*,[1] I expected an immediate rejoinder from proponents of market discipline. Concern over the increased rate of bank failure and the inadequacy of the deposit insurance funds, as well as pressure for deregulation, were providing impetus for revival of the notion that the market for deposits could play a greater role in controlling bank risk.[2] Yet no such reaction has taken place. Rather than moving to limit depositors' recovery in failing banks, the bank regulators have continued to arrange solutions that guarantee protection to all depositors.[3] Moreover, bank runs by fearful depositors have continued to occur.[4]

Nevertheless, the case for depositor discipline has now been made in an article by Jonathan R. Macey and Elizabeth H. Garrett.[5] Having been asked to respond, I welcome the opportunity to comment on these authors' suggestions as well as to note certain developments in the market for deposits that seem to me to make the chance of success for depositor discipline even more unlikely. My points may be summarized briefly. First, since a significant portion of uninsured deposits are maintained for reasons that have little to do with the risk and return associated with investments in particular banks, the majority of even uninsured depositors will not continuously monitor bank risk. Second, the structure of the deposit

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1. Garten, *Banking On the Market: Relying On Depositors to Control Bank Risks*, 4 YALE J. ON REG. 129 (1986).

2. Ideally, depositors would discipline banks that are engaged in excessive risk-taking by demanding higher returns, or risk premiums, on their deposits or by refusing to invest at all, forcing bank management to reduce risk-taking in order to attract funds. The idea of depositor discipline is not new. *See, e.g.*, Tussing, *The Case for Bank Failure*, 10 J.L. & ECON. 129 (1967). Nevertheless, recent interest in regulatory reform has led to fresh consideration of depositor discipline as an alternative to traditional regulatory handling of bank failure. *See, e.g.*, FEDERAL DEPOSIT INS. CORP., DEPOSIT INSURANCE IN A CHANGING ENVIRONMENT III-1 (April 15, 1983) [hereinafter DEPOSIT INSURANCE IN A CHANGING ENVIRONMENT].

3. *See FDIC Agrees to Assistance Plan for Texas BHC Subsidiary Banks*, [Current] Fed. Banking L. Rep. (CCH) ¶ 87,067 (Sept. 9, 1987) (FDIC assistance to First City Bancorporation of Texas to enable its subsidiary banks to remain open).

4. *See, e.g.*, *Depositor Run Speeds Closing*, Am. Banker, Sept. 15, 1987, at 6, col. 1 (run on Minnesota bank following newspaper story about alleged check-kiting scheme).

5. Macey & Garrett, *Market Discipline by Depositors: A Summary of the Theoretical and Empirical Arguments*, 5 YALE J. ON REG. 215 (1988).

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market provides strong incentives for all depositors to rely on the liquidity of their deposits, rather than analysis of bank disclosure, to protect themselves against risk. Third, for the same reasons, depositors as a group are unlikely to develop effective contractual mechanisms that will limit the inclination of bank management to take excessive risks. Finally, empirical studies of depositor behavior not only have failed to demonstrate that depositors will exert effective market discipline, but cannot explain why market discipline is not already working to constrain bank risk-taking. I conclude by offering some comments on the apparent conflict between efficiency and maintenance of public confidence as the proper goal of bank failure policy.

I. Depositors and Bank Risk

Initially, I note that in a number of areas, the views of Macey and Garrett as to the efficacy of depositor discipline are not so very different from my own. For example, we agree that depositors with accounts under $100,000, which are currently protected in full by deposit insurance, can never be expected to monitor and react to increases in bank risk.[6] These depositors therefore will not exert meaningful market discipline on their banks.

Yet it is also apparent that a significant group of large depositors whose accounts are not fully insured are equally poor monitors of bank risk. Such depositors usually hold demand deposits that do not pay interest, so, as a practical matter, they cannot discipline riskier banks by demanding a higher return on their investments. More fundamentally, such depositors typically have chosen their banking relationships for reasons such as convenience or the availability of other services that have very little to do with risk.[7] Since risk reduction is a less important consideration in choosing a bank than these other factors, these depositors simply will not respond to increased risk in the way proponents of market discipline would hope.

As an example of such a depositor, I chose the payroll depositor. The typical payroll account is a transaction account that is not maintained to earn a return. Employers instead tend to choose their banks on the basis of the package of payroll services the bank can offer them. Frequently, an employer may actually be required to keep compensating balances in the

6. *Id.* at 217 n.8.

7. I called these depositors "involuntary depositors" to distinguish them from the ideal investor for whom risk and return are the most important considerations in choosing a bank. Garten, *supra* note 1, at 134. Of course, involuntary depositors are not forced to keep their funds in a bank that is failing. Nevertheless, risk reduction is an economic good that can only be purchased at a certain cost. If the depositor must buy other goods, such as a package of banking services, that depositor simply may be unable to afford to pay for risk avoidance as well.

bank to offset its loans. Finally, employers may not always be able to control balances in their payroll accounts on a daily basis. For these reasons, even some proponents of increased market discipline have suggested that payroll deposits of any size should be protected from losses by deposit insurance.[8] The motivation is not simply to protect these depositors from risk, but to prevent the destabilizing effects of these depositors' "discipline."

Of course, even payroll depositors are not blind to the danger that they may lose their money if their bank fails. Put another way, at some point the risk of loss may become so great that it will outweigh other considerations that affect these depositors' choices of banks and they will withdraw their funds. Nevertheless, as I discussed at length in my article, the reaction of these depositors tends to be sudden, severe, and occasionally irrational, in response to the thinnest of rumors.[9] Since these depositors do not spend the time or money necessary for careful monitoring of bank financial condition, their discipline is hardly likely to be accurate.

II. Consequences of Depositor Discipline

I also agree with proponents of market discipline that some sophisticated depositors theoretically have the ability, the inclination and the information necessary to assess bank risk. Nevertheless, depositors' sensitivity to bank risk does not automatically produce effective discipline on bank risk-taking. Two important realities about the deposit market may prevent market discipline from ever working in practice. First, it is simply cheaper for depositors to withdraw their funds from a bank at the first sign of trouble than to expend energy or cash to monitor bank risk. Changing banks may not be costless, but what matters is the relative expense of withdrawing and reinvesting funds compared with the cost of monitoring financial condition. The fact that deposits can be liquidated and redeposited elsewhere virtually without cost is one of the most attractive features of the deposit instrument as an investment.[10] Second, depositors are extremely concerned about what I have called liquidation risk: the

8. *See* DEPOSIT INSURANCE IN A CHANGING ENVIRONMENT, *supra* note 2, at F-1; *see also* Tussing, *supra* note 2, at 147 (proposing increase in deposit insurance ceiling to $1,000,000).

9. Garten, *supra* note 1, at 136–37. Moreover, the continued occurrence of bank runs suggests that these depositors apparently are not reassured by the complaint frequently voiced by proponents of market discipline, that when banks fail, even uninsured depositors usually are protected in full.

10. Macey and Garrett suggest that it may be costly for a depositor to search for alternative investments. Macey & Garrett, *supra* note 5, at 230. This is surprising, in light of the ease with which deposits can be made: banks are always ready and able to accept new funds. Thus, depositors have a wide variety of choices. More important, the very availability of these options makes individual bank risk, particularly long-term risk, less significant to the depositor. Rather than trying to assess a bank's chance of failure over the next six months or six years, depositors can rely on their ability to move their funds virtually costlessly should the possibility of failure become a probability.

risk that, in the event their bank runs into trouble, the regulators will choose to liquidate the bank rather than arranging for a merger or other solution that will preserve the ability of large depositors quickly to liquidate and transfer their funds.[11] Since this important component of bank risk remains unpredictable, depositors cannot accurately evaluate the risks associated with investments in different banks.

Recent developments convince me that these realities about the deposit market are truer than ever. Technological advances have increased the ability of large depositors to liquidate quickly and transfer their funds among many different short-term investments. Although information about banks also has become more widely available and comprehensive, sophisticated depositors in search of the best rates simply may not have time to evaluate increasingly complex disclosure concerning bank risk. This may be a problem particularly for foreign investors, who must act on the basis of summarized versions of lengthy bank disclosures that are responsive to bank accounting principles and regulatory standards that may be completely unfamiliar to them.

At the same time, improved disclosure undoubtedly has awakened formerly complacent depositors to the presence of serious risk at almost every bank. Prior to the liquidation of Penn Square Bank in 1982, the stellar record of the regulators in insuring that both insured and uninsured depositors in failed banks recovered almost all of their investments[12] may have caused depositors to believe that investments in all banks were reasonably safe. Subsequent near failures and rescues of giant banks such as Continental Illinois may have reassured some few depositors that the regulators are committed to protecting all depositors in large banks,[13] but it is more likely that these rescues have made all depositors aware that even the largest banks are not immune to financial difficulties. Thus, the increasing ease with which deposits can be withdrawn and reinvested, plus the growing public awareness of bank risk generally, may lead large depositors simply to switch banks more frequently rather than to choose banks more carefully.[14]

11. *See* Garten, *supra* note 1, at 148-52.

12. *See id.* at 148 n.111. The Penn Square liquidation was at the time the largest liquidation in the history of the FDIC.

13. For the reasons I stated in my article, I do not believe that most uninsured depositors really count on protection against big bank failures. Sophisticated depositors are aware that the regulators' choice of solutions, liquidation (which may lead to losses for uninsured depositors), closed bank merger or open bank assistance (both of which generally result in the protection of all depositors), is not totally discretionary, but depends on a weighing of the relative cost of each alternative. *Id.* at 149-50. These depositors recognize that some day a solution that protects all depositors will simply be impossible or too costly for the regulators to arrange.

14. The conclusion that depositors will choose to rely on their liquidity rather than monitoring bank risk to protect themselves from losses has led many experts on bank regulation to question

Moreover, since my article was published, uncertainty about liquidation risk has increased greatly. Bank regulators have struggled to come up with new techniques for handling bank failures, but still have not settled on any predictable policy.[15] The regulators recently rescued a banking organization with assets of $12 billion,[16] but have denied that they are in fact committed to rescuing all banks over a certain size.[17] Thus, uninsured depositors have no more reason to believe that they are guaranteed protection in any bank failure than they have to believe that their deposits are always at risk. This continued uncertainty increases the incentive for depositors simply to depend on their ability to run quickly as their best protection against losses.

III. Effectiveness of Contractual Mechanisms

Proponents of depositor discipline such as Macey and Garrett appear to recognize these stumbling blocks to effective market discipline, since they see the need for some incentives to pressure depositors into engaging in sustained risk analysis. For example, Macey and Garrett suggest that depositors could protect themselves from uncertainty before they invest by obtaining contractual promises from their banks to limit their risk-taking, like covenants in bond indentures.[18] This suggestion will come as a surprise not only to depositors, but to their banks. Short-term debt, including both deposits and competitive investments such as commercial paper, is typically issued without covenants of any sort. Investors do not need to insist on contractual safeguards because they are protected by the very short term of their investment.[19] If they become concerned about the is-

whether market discipline can work. *See, e.g.*, Benston, *Financial Disclosure and Bank Failure*, FED. RESERVE BANK OF ATLANTA ECON. REV. 5, 9 (Mar. 1984); Wall, *The Future of Deposit Insurance: An Analysis of the Insuring Agencies' Proposals*, FED. RESERVE BANK OF ATLANTA ECON REV. 26, 30-31 (Mar. 1984).

15. Prior to the rescue of Continental Illinois, the regulators briefly experimented with modified payoffs that subjected uninsured depositors to partial losses. *See* Garten, *supra* note 1, at 165 n.190. Nevertheless, it remains unclear whether the regulators still view the modified payoff as a technique that could be used in every bank failure.

16. *See supra* note 3 (First City Bancorporation of Texas). First City had a total of 62 bank subsidiaries.

17. *See* Trigaux & Lagesse, *Bailout Revives Controversy Over FDIC Role*, Am. Banker, Sept. 11, 1987, at 1, col. 4.

18. Macey and Garrett, *supra* note 5, at 229-30.

19. Liquidity also is provided by the active trading market in short-term debt such as commercial paper and, to some extent, bank certificates of deposit. In fact, the existence of this secondary trading market originally made commercial paper a more attractive short-term investment than bank deposits other than certificates of deposit issued by the largest money center banks. *See* McKinney, *New Sources of Bank Funds: Certificates of Deposit and Debt Securities*, 32 L. & CONTEMP. PROBS. 71, 77 (Winter 1967). Nevertheless, the secondary market in short-term debt can be disrupted by the failure of a major issuer or other event that causes a run on the market, as illustrated by the effect of the Penn Central bankruptcy on the commercial paper market in 1970. *See* W. MELTON, INSIDE THE FED: MAKING MONETARY POLICY 157-58 (1985). In these cases, holders of short-term debt can protect themselves by "running," or simply not renewing their investments at their maturities.

suer's future inability to repay its debt, they can easily liquidate their investment and choose an alternative.[20]

Even if depositors did choose to demand such contractual provisions prior to investment, it is unclear exactly how such covenants would be negotiated and enforced. Since it would be impossible for each depositor to negotiate a separate agreement with the bank, depositors would have to be represented by the equivalent of an indenture trustee who would monitor the bank's compliance.[21] The bank would have to prepare a disclosure document similar to a prospectus in connection with each "issue" of deposits to disclose the terms of the contract to potential investors.[22] Such procedures would make deposits far more expensive and cumbersome for the bank and, since these new costs of issuance would be shared with the investors, for its depositors. Yet it is very unlikely that the additional safety provided by these debt covenants would justify this increased cost. The cause of most bank failure continues to be fraud and mismanagement,[23] which cannot be prevented by objective covenants. Thus, banks would rapidly lose funds to competing investments, such as commercial paper, that provide sufficient safety through liquidity without the inclusion of covenants.

Macey and Garrett also suggest that banks could correct depositors' inclination to rely on their liquidity rather than on their assessment of financial data to protect themselves from losses by putting restrictions on depositors' right to withdraw their funds.[24] Apart from the legal difficulties such an action might create for the bank,[25] limits on the liquidity of

20. Stringent indenture covenants are becoming infrequent even in longer term corporate debt. *See* McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 424-28 (1986). Moreover, typical indenture covenants may restrict mergers or the sale of a significant subsidiary (such as the bank in the case of bank holding company debt), but rarely restrain a firm's "production/investment policy" or otherwise control day-to-day risk-taking. Efforts to obtain the sort of detailed contractual provisions suggested by Macey and Garrett, such as a covenant requiring the matching of assets and liabilities, see Macey & Garrett, *supra* note 5, at 230, not only would be thoroughly objectionable to the average bank, but, if adhered to strictly by bank management, would also be very poor banking policy.

21. It is unclear what the trustee would do to enforce the covenants. If a violation occurred, would the trustee insist on acceleration of the debt? That may not mean much in the case of fourteen-day deposits.

22. Deposits are not currently covered by the registration and prospectus requirements of the Securities Act of 1933, since securities issued by a bank are exempt from registration. *See* § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1982). Moreover, deposits are not generally considered to be securities. *See* Marine Bank v. Weaver, 455 U.S. 551 (1982).

23. *See* J. SINKEY, PROBLEM AND FAILED INSTITUTIONS IN THE COMMERCIAL BANKING INDUSTRY 19 (1979) (noting that major cause of problem and failed institutions has been weak or dishonest management). *See also* Doherty, *Who's Minding the Fraud?*, Am. Banker, Sept. 21, 1987, at 15, col. 1 (fraud is increasingly important factor in recent bank failures).

24. Macey and Garrett, *supra* note 5, at 231.

25. A bank could only take this action prospectively, since it is very unlikely that a court would allow the bank to change the terms of outstanding deposits.

deposits remove the most attractive feature of a deposit as a investment. If a bank placed significant restrictions on the liquidity of its short-term deposits, depositors would not start reading bank disclosure documents, but would switch their funds to alternative investments, such as deposits in other banks or even commercial paper, that offer superior liquidity. Therefore, I do not believe that depositors can be tricked or cajoled into exerting effective market discipline.[26]

IV. The Empirical Evidence

My disagreement with Macey and Garrett and other proponents of market discipline is much deeper than my quarrels with their specific suggestions for improving market discipline. Macey and Garrett assert that the issue of market discipline is an economic question that "can best be ascertained through empirical data."[27] I do not believe that is the case, nor does their own evidence bear out this assertion. First, empirical studies of how depositors actually react to bank risk remain very inconclusive. Although some depositors may demand premiums to invest in certain banks, the lesson to be derived from this evidence is not entirely clear. Many studies have found any rate differences to be very short-term.[28] Moreover, fluctuations in rates appear generally linked to bank size: the market will penalize all large banks, or all regional banks, fairly equally.[29] This suggests that depositors may react to adverse news concerning banks generally, but may not differentiate carefully among banks on an ongoing basis.[30]

Moreover, the explanation of rate differentials may be more complex than differences in individual bank risk. One interesting study of the spreads between yields on three-month certificates of deposit issued by

26. Macey and Garrett also revive the suggestion that risk-based deposit insurance premiums would force some discipline on bank management. Macey & Garrett, *supra* note 5, at 238. Yet previous proposals for risk-based premiums have been frustrated by the fact, noted by Macey and Garrett, that bank regulators simply are not as effective as bank management in measuring risk in individual bank portfolios. The problem is not so much a function of the "regulatory capture" discussed by Macey and Garrett as that of information asymmetry; the regulators simply will not have access to the same information as bank management concerning the risk composition of the bank's portfolio. *See* Kanatas, *Deposit Insurance and the Discount Window: Pricing under Asymmetric Information*, 41 J. FIN. 437 (1986). In any case, a risk-based deposit insurance scheme would have to rely primarily on the bank regulators to determine the optimum levels of risk banks should be taking. Yet this is exactly what proponents of market discipline are seeking to avoid.

27. Macey & Garrett, *supra* note 5, at 233.

28. *See* Chessen, *Market Perceptions of Bank Risk*, ISSUES IN BANK REG. 3, 12 (Autumn 1985).

29. *See* Gilbert, *Disclosure and Market Discipline: Issues and Evidence*, FED. RESERVE BANK OF ATLANTA ECON. REV. 70, 71-72 (Nov. 1983) (describing this rate tiering).

30. Recent improvements in bank disclosure may improve depositors' ability to distinguish among individual banks within size categories, and occasionally banks have been singled out by the market, notably Continental Illinois following the Penn Square Bank failure. *See id.* at 72. Nevertheless, depositors may still find it cost effective simply to use size as a rough measure of financial standing.

large banks and yields on treasury bills with comparable maturities over a five year period examined a chronology of events that might have accounted for changes in spreads.[31] For example, the rise and successive fall in the spread between rates on certificates of deposit and treasury bills between April and August of 1984 coincided with the problems and subsequent rescue of Continental Illinois. But the narrowing spreads in August also coincided with a general decline in short-term interest rates.[32] Other differences in spreads coincided with economic events such as fluctuating interest rates and the removal of credit restrictions rather than increases in risk levels at banks.[33]

Further, reliance on empirical evidence to prove the point that depositors can exert market discipline on their banks creates a logical inconsistency for proponents of market discipline. If, as these proponents claim, rescues of failing banks have caused even uninsured depositors to behave as if their investments are riskless, why are these depositors bothering to distinguish among banks at all? If such depositors do not feel protected, why isn't market discipline already effective in controlling bank risk? This suggests that if depositors do demand different rates from different banks, they may be motivated by many different factors, ranging from the secondary market for the bank's deposit instruments[34] and rates offered by competing investments to concerns about the fate of that particular bank and the entire banking system. Rates even may reflect sophisticated depositors' fears that bad publicity will cause less sophisticated depositors to flee the bank, or that the regulators are changing their policies about handling bank failures. Thus, empirical testing does not occur in a vacuum, but must take account of the realities of the deposit market and of regulation.[35]

31. *See* Chessen, *supra* note 28, at 4.

32. *Id.* at 12.

33. *Id.* at 10. Macey and Garrett suggest that studies of bank stock price movements, including several I discussed in my article, support the proposition that depositors will exert effective market discipline. *See* Macey & Garrett, *supra* note 5, at 233. These studies, however, deal with shareholders, not depositors. Even if depositors theoretically can obtain access to the same information about bank risk that is available to shareholders, that does not demonstrate that depositors will use that information in the same fashion as shareholders. In fact, the very purpose of my article was to explain why depositors do not act like shareholders in disciplining their banks.

34. *See supra* note 19.

35. The point occasionally has been made that market discipline worked reasonably well before the advent of deposit insurance and regulatory intervention to save failing banks. *See* Macey & Garrett, *supra* note 5, at 233 n.73. The problem is that the banking system of the 1980s is very different from that of the 1880s. In 1888, bank shareholders had more reason to exert their own market discipline than shareholders today, since shares of national and many state-chartered banks were subject to assessment in the event of the insolvency of the bank. *See* United States v. Knox, 102 U.S. 422 (1880) (national bank shareholders). Thus, shareholder discipline may have worked to protect depositors. Today, proponents of depositor discipline seem to hope that depositor discipline will fill the gap left by bank shareholders, whose own market discipline has been inadequate to control bank risk.

Finally, empirical studies have not demonstrated that if depositors are routinely exposed to losses in the event of bank failure, they will react to this increased risk by choosing their banks more carefully. Instead, depositors may simply shorten the maturity of their deposits, or divide their deposits into insured portions that can be spread among several banks.[36] So long as these efforts produce more safety at less cost than monitoring information, depositors will continue to find ways to avoid risk. Thus, simply increasing depositors' exposure to risk will not necessarily force market discipline upon them. The consequences for other aspects of the regulatory system, such as deposit insurance coverage, must be taken into account.

Conclusion

Perhaps these and other aspects of the bank regulatory scheme could be changed sufficiently to produce the optimum environment for market discipline. Nevertheless, in the end, that result may not necessarily be desirable for the banking system. Proponents of market discipline see as their primary goal the need to make the deposit market more efficient. The present failure of depositors to exert market discipline on banks is said to create a "moral hazard," since bank management is not constrained by the market from excessive risk-taking.[37] Theoretically, this constraint should be supplied by government regulation that is designed to protect the insurance fund against losses. In fact, in the past, critics of the deposit insurance system occasionally have blamed this regulation for causing banks to take too few rather than too many risks.[38] In either case, critics have complained that regulation is an inefficient method of determining how much risk any particular bank should be taking.

Although this may be the case, the principal goal of the deposit insurance system, including the very significant authority for the regulators to assist failing banks,[39] is not to achieve the efficient number of failures, but

36. Depositors are already doing this through money brokers who package large deposits into fully insured pieces. *See* Harless, *Brokered Deposits: Issues and Alternatives*, FED. RESERVE BANK OF ATLANTA ECON. REV. 14 (Mar. 1984) Limitations on insurance coverage of brokered deposits that have been proposed by the regulators from time to time, *see* Benston, *supra* note 14, at 9, would simply cause depositors to find another loophole in the deposit insurance scheme. So long as the cost of these techniques is less than the cost of monitoring bank risk, depositors inevitably will opt for the cheapest means of risk avoidance.

37. *See* E. KANE, THE GATHERING CRISIS IN FEDERAL DEPOSIT INSURANCE 14-15 (1985).

38. *See* Scott & Mayer, *Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform*, 23 STAN. L. REV. 857, 872-73 (1971).

39. The FDIC was first given the authority to facilitate mergers among insured banks in order to eliminate weak institutions in 1935, only two years after the creation of the federal deposit insurance system. Although the FDIC may have refined its approach to handling failed banks largely through administrative action, Congress has implicitly endorsed the FDIC's current policies by broadening the

to maintain public confidence in the banking system.[40] This goal remains politically important, suggesting that much thought must go into how it can be reconciled with increased depositor discipline that inevitably will result in more bank runs and failure. For example, will exposing depositors to the full fury of bank failure actually cause them to shift their funds to better managed banks, or will the consequence be a flight of funds from the banking system? Although the problem of maintaining public confidence in the banking system is rarely mentioned by academics as an important consideration, it has to affect the regulators when they deal with the reality of each successive bank failure.

What role then can market discipline realistically play in controlling bank risk? My own proposal for handling failed banks tried to address what I see as the greatest practical stumbling blocks to effective depositor discipline. First, I suggested that the regulators must adopt a consistent approach to the handling of failed banks in order to reduce the uncertainty that currently surrounds the fate of uninsured depositors.[41] If depositors could predict their risk of loss in the event of failure, they may be less inclined to react to rumors by joining bank runs.

Second, I suggested that the regulators' choice of banks to be rescued, as well as the extent of the protection to be guaranteed to uninsured depositors, should be directly related to the bank's asset value.[42] Since asset value is relatively easy for depositors to monitor, depositors may be persuaded to select banks with strong assets in order to increase their chances of protection in the event of failure. Moreover, depositors would be encouraged to prefer those banks that will impose the lowest costs on the government in the event of failure. This very controlled market discipline

agency's authority to provide novel forms of assistance to keep failing banks open. *See* Isaac, *The Role of Deposit Insurance in the Emerging Financial Services Industry*, 1 YALE J. ON REG. 195, 202-03 (1984) (discussing development of current policies).

40. The goal of maintaining public confidence is based on the need to promote the stability of the banking system. As has frequently been noted, there has been a remarkable consensus as to the continuing validity of this goal, as well as the success of the deposit insurance system in achieving it. *See id.* at 198 (former FDIC chairman quoting Milton Friedman and John Kenneth Galbraith as to success of deposit insurance system).

41. Garten, *supra* note 1, at 166.

42. *Id.* at 167. As I discussed in more detail in my article, in setting these standards, bank regulators would look not simply to the absolute value of a bank's performing assets, but would develop a formula that takes into account overall risk composition and profile and loan concentrations. *See id.* at 168 n.198. These standards obviously are not intended as an absolute proxy for bank risk, but would provide a way for depositors easily to distinguish between banks that will be liquidated and banks that will be rescued in the event of failure. Since, as I have previously argued, depositors are already sensitive to this liquidation risk, especially when a bank run by unsophisticated depositors is imminent, such an asset-based test will at least point depositors in the direction of those banks with relatively solid assets—which are the very banks for which federally assisted mergers are the easiest to arrange. This is not exactly market discipline as envisioned by its proponents, but it may be a way for the regulators to reduce the costs of handling bank failures.

would enable the regulators to explore what in reality the deposit market can do in responding to bank risk.