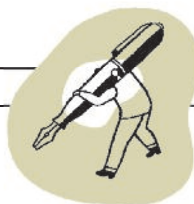
LETTERS  LETTERS

Dear Editor,

The analysis and conclusions of the articles on scale economies by Loretta Mester and Robert DeYoung would have been persuasive if published in 2007. But the articles are appearing in the fall of 2010. [See "Scale Economies in Banking: A Symposium" in the September 2010 issue of *The Region,* online at minneapolisfed.org.] Mester notes that research has become more sophisticated regarding scale economies by including risk management in the analysis. The new and improved research concludes that scale economies extend to the very largest banking institutions. Surely the fact that the top 10 banking firms in the United States went bankrupt in 2008 should lead to a far different conclusion. The fact that these firms were bailed out by the federal government does not invalidate that conclusion. The marketplace concluded that these banks should go out of business. The fact that this conclusion applied to virtually every single very large bank but only to a small fraction of the other banks should certainly give pause to those who argue that scale economies go on forever.

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Editor's note:

The writer argues that the support offered to creditors of financial institutions during the recent financial crisis proves that economies of scale don't exist in banking. We disagree.

Why? A bank could well be fully solvent, with a solid balance sheet, yet face a liquidity crisis if it's unable to pay immediate bills because assets cannot be sold quickly enough to cover them.

In this season, we need look no further than television to find a clear illustration of the insolvent/illiquid distinction. George Bailey's predicament in "It's a Wonderful Life" was one of illiquidity: He ran a solvent bank with a solid balance sheet that—due to a bank run—faced a severe cash flow crisis. Fortunately, Bailey's friends, family and larger community rescued the bank with a cash infusion.

To the degree that the 2007-09 financial crisis had features of a bank run, the presence of scale (or not) has little to do with the bailouts provided. Yale's Gary Gorton argues in our December issue that the recent crisis was a classic banking panic, a run on financial institutions sparked by an unexpected collapse in housing prices. Prevention of bank runs is the rationale behind government insurance for deposits in solvent banks.

The writer raises an important issue, nonetheless, about letting market discipline close down financial institutions that are truly *insolvent*—that is, allow markets to determine an insolvent bank's fate without providing government assistance for its creditors. We agree.

We have offered many recommendations to minimize bailouts by reducing the spillover effects of bank collapse. Interested readers can visit http://www.minneapolisfed.org/publications_papers/studies/tbtf/index.cfm for an extensive discussion.

Letters are welcome at letters@mpls.frb.org.