

# Bank Failure, Macroeconomic Risk, and the Expansion of Banking Activities

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## Introduction

Business failure is a normal feature of a competitive economy. Firms that cannot respond to changing consumer preferences, technological developments, or more efficient competitors may lose customers and eventually leave the market. Their failure releases labor, capital, and other resources that can be transferred to more productive businesses. Governments should therefore not protect every unsuccessful company merely because its owners, employees, or investors would prefer it to remain open.

Banks, however, are not ordinary businesses. A bank accepts deposits that customers expect to withdraw on demand, provides payment services, supplies credit to households and firms, and connects with other financial institutions through lending, settlement, derivatives, and securities markets. These functions mean that the failure of one bank can affect people and organizations that never invested in it or conducted business with it directly.

The principal macroeconomic risk is not simply that the bank's shareholders will lose money. The greater concern is that its failure may trigger depositor runs, interrupt payment services, reduce the availability of credit, force other institutions to sell assets, weaken public confidence, and spread financial distress throughout the economy. The Basel Committee consequently evaluates the systemic importance of banks using factors including size, interconnectedness, complexity, cross-border activity, and the availability of substitutes for their services.

Banks should not automatically be rescued from the consequences of poor management. Nevertheless, authorities need special procedures for resolving them because an uncontrolled bank failure may impose costs on the entire economy. Banks may also be allowed to enter securities, insurance, payment, advisory, and technology-related businesses when these services benefit customers. Such expansion should occur only under strong capital, liquidity, consumer-protection, governance, and resolution requirements.

## Why Bank Failure Is Different From the Failure of an Ordinary Business

When a restaurant, clothing manufacturer, or retail store fails, its owners may lose their investment,

employees may lose their jobs, and suppliers may not receive full payment. These are serious consequences, but they are usually concentrated among people directly connected to the company. Competitors can often serve its customers, purchase its assets, and employ some of its workers.

A bank failure can also harm shareholders, employees, and suppliers, but its effects may spread much further. Banks operate at the center of the monetary and credit system. Their liabilities are used by customers as money, while their assets consist largely of loans and securities that may take years to mature. A sudden loss of confidence can therefore create an immediate demand for cash that the bank cannot meet without selling assets, borrowing emergency funds, or calling in loans.

Other industries can also become systemically important. The collapse of a major electricity provider, telecommunications network, or critical supplier could produce broad economic disruption. The difference is that banks combine high leverage, runnable liabilities, payment obligations, opaque assets, credit creation, and extensive connections with other institutions. This combination makes financial distress unusually capable of spreading quickly.

## Maturity Transformation and the Risk of a Bank Run

One of the most distinctive features of banking is maturity transformation. Banks fund long-term or relatively illiquid assets, such as business loans and mortgages, with liabilities that customers can withdraw at short notice. This arrangement benefits the economy because savers receive liquid accounts while borrowers receive longer-term financing.

However, maturity transformation also creates vulnerability. A bank may be solvent in the sense that the long-term value of its assets exceeds its liabilities, yet it may not possess enough immediately available cash to satisfy a sudden wave of withdrawals. If depositors believe that others are about to withdraw, they may rationally rush to remove their own money before the bank runs out of liquid funds.

Diamond and Dybvig's (1983) influential model demonstrates how deposit contracts can provide useful liquidity while also making banks vulnerable to self-reinforcing runs. Fear of failure may encourage withdrawals, and those withdrawals can force the bank to liquidate assets at unfavorable prices, making failure more likely. Deposit insurance and central-bank liquidity can reduce this risk by reassuring depositors that they do not need to withdraw immediately.

The spring 2023 failures of Silicon Valley Bank, Signature Bank, and First Republic Bank illustrated how rapidly modern deposit runs can develop. A 2026 Federal Deposit Insurance Corporation study found that depositors with substantial uninsured balances were much more likely to withdraw funds, while fully insured retail depositors generally did not run before the banks failed. Digital banking and electronic transfers can accelerate withdrawals because depositors no longer need to visit a physical

branch to move large amounts of money.

An ordinary company does not generally promise thousands of customers that their money will remain immediately available while investing most of that money in longer-term assets. This feature makes the loss of confidence especially dangerous for banks.

## Disruption of Payments and the Money Supply

Bank deposits are not merely investments. Households use them to pay rent, mortgages, utilities, taxes, and everyday expenses. Businesses use deposit accounts to pay employees, purchase inventory, receive customer payments, and settle obligations with suppliers.

If a bank closes without an orderly resolution process, customers may temporarily lose access to transaction accounts and payment services. Even when depositors ultimately recover their money, a delay can prevent a business from meeting payroll or paying a supplier on time. This disruption can spread from the bank's customers to employees, landlords, vendors, and other creditors.

Banks are also linked through payment and settlement systems. A bank that cannot meet its obligations may expose other institutions to unexpected losses or liquidity needs. The failure of an ordinary company may leave invoices unpaid, but a bank can be responsible for processing and settling a vast number of payments for people who are not its investors.

This is why financial authorities attempt to preserve critical banking functions even when the institution itself is allowed to fail. Resolution policy should protect access to insured deposits and essential payment services without guaranteeing shareholders or executives against the consequences of poor decisions.

## Contraction in Credit and Economic Activity

Banks collect information about borrowers, assess creditworthiness, monitor loans, and develop long-term relationships with customers. When a bank fails, this organizational knowledge can be lost or disrupted. A replacement lender may not immediately understand the borrower's business, collateral, repayment history, or local market.

Bernanke (1983) argued that widespread bank failures during the Great Depression damaged the economy through more than a reduction in the money supply. They also increased the cost of credit intermediation and disrupted relationships between lenders and borrowers. The breakdown of the banking system therefore contributed to the contraction in output.

A reduction in bank lending can affect businesses that are unable to issue bonds or sell shares directly to investors. Small and medium-sized firms often depend heavily on banks for working capital,

equipment financing, and expansion loans. If banks become uncertain about their own liquidity or capital positions, they may tighten lending standards even when many potential borrowers remain financially sound.

This process can produce a credit crunch. Firms postpone investment, reduce production, stop hiring, or dismiss workers because financing is unavailable or too expensive. Households may also find it more difficult to obtain mortgages, automobile loans, and other forms of credit. Lower borrowing and spending then weaken aggregate demand, business income, employment, and tax revenue.

The failure of a nonfinancial company can reduce production in its particular industry. A broad banking crisis can reduce financing across many industries simultaneously.

## Contagion Through Interconnected Financial Markets

Banks lend to one another, hold similar securities, use shared payment networks, and enter contracts involving derivatives, foreign exchange, and securities financing. These connections improve efficiency during normal conditions because institutions can distribute liquidity and risk. During periods of stress, however, the same connections may transmit losses.

Allen and Gale (2000) demonstrate how financial linkages created to share liquidity can also allow a disturbance in one part of the banking system to spread to other institutions. If one bank cannot repay another, the creditor bank may experience a loss. If that bank is already highly leveraged or short of cash, it may reduce lending, sell assets, or fail to meet its own obligations.

Contagion can also occur without direct contractual exposure. Depositors and investors may interpret one failure as evidence that other banks with similar business models or asset holdings are unsafe. They may then withdraw deposits, refuse short-term funding, or sell the shares of otherwise viable institutions.

Public confidence is therefore economically important. As Mishkin (2007) observed, “confidence is essential to an efficiently operating financial system.” When confidence collapses, market participants may withdraw from transactions that normally direct savings toward productive investment.

## Fire Sales and Falling Asset Prices

A troubled bank facing withdrawals may need to sell securities or loans quickly. If several institutions are under pressure at the same time, they may attempt to sell similar assets into a weak market. The resulting fire sale can push prices below the assets’ long-term economic value.

Lower market prices then affect banks that did not originally need to sell. Accounting losses, reduced

collateral values, or investor concern may weaken their financial position. Those institutions may respond by selling additional assets, reducing credit, or seeking more capital. This creates a negative feedback loop between declining prices and declining financial strength.

Federal Reserve research identifies leverage, maturity transformation, interconnectedness, and complexity as vulnerabilities that can generate fire-sale dynamics and an inefficient contraction in credit after an adverse shock.

A manufacturer's liquidation may reduce the price of machinery used in its industry. A bank fire sale can reduce the price of widely held securities, affecting balance sheets throughout the financial system and influencing the cost of borrowing across the economy.

## Fiscal Costs, Deposit Insurance, and Moral Hazard

Bank failures can create costs for deposit-insurance systems and, in severe crises, can require extraordinary government intervention. Deposit insurance serves an important purpose because it protects ordinary depositors and reduces the incentive to participate in a bank run. In the United States, the FDIC insures eligible deposits at member institutions and resolves failed banks.

The existence of a public safety net creates a policy dilemma. If authorities refuse to intervene during a systemic crisis, the resulting contagion may cause widespread economic damage. If they protect all creditors and investors from every loss, market participants may assume that large institutions will always receive support. This expectation can weaken discipline and encourage excessive risk-taking.

This problem is known as moral hazard. Bank executives may pursue risky strategies if successful outcomes produce private profits while catastrophic losses are expected to be absorbed by deposit insurers, other banks, or taxpayers. Creditors may also lend too cheaply to a large institution if they believe the government considers it too important to fail.

The appropriate objective is therefore not to prevent every bank from failing. It is to make failure possible without destroying essential financial functions. Shareholders should normally lose their investment, responsible managers should be removed, and uninsured creditors should remain exposed to losses unless a legally justified systemic-risk decision requires different treatment. At the same time, insured depositors, payment services, and viable lending relationships should be transferred or restored quickly.

## Comparison of Bank and Nonfinancial Business Failure

| Issue                        | Failure of a typical nonfinancial company                                                  | Failure of a bank                                                                    |
|------------------------------|--------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------|
| Main liabilities             | Trade debt, bonds, wages, and ordinary contracts                                           | Deposits, payment obligations, wholesale funding, and financial contracts            |
| Speed of customer withdrawal | Customers can change suppliers, but do not usually demand repayment of company liabilities | Depositors and short-term creditors may withdraw funds immediately                   |
| Asset structure              | Assets may include inventory, buildings, and equipment                                     | Assets often include long-term and difficult-to-value loans and securities           |
| Effect on payments           | Usually limited to the company's own bills and receipts                                    | May interrupt payments for households, firms, and other institutions                 |
| Effect on credit             | Usually concentrated in one firm or industry                                               | May reduce lending across households and multiple industries                         |
| Contagion risk               | Usually limited, except for critical suppliers or infrastructure firms                     | Can spread through interbank claims, common assets, payment systems, and confidence  |
| Public safety net            | Usually limited                                                                            | May include deposit insurance, central-bank liquidity, and special resolution powers |
| Macroeconomic effect         | Often localized or sector-specific                                                         | Can reduce investment, consumption, employment, output, and financial stability      |

## Benefits to Consumers When Banks Enter Other Lines of Business

Allowing banks to offer additional financial services can create meaningful benefits for consumers. A bank may combine deposit accounts, loans, investment services, insurance, payment products, retirement planning, and financial advice within one organization. Customers can obtain several

services through a familiar institution rather than searching for a separate provider for each need.

This convenience can reduce transaction and information costs. A customer applying for a mortgage may also need property insurance, payment services, and financial planning. An integrated provider may process these services more efficiently, although customers must remain free to compare alternatives rather than being pressured into purchasing tied products.

Broader authority can also encourage innovation. Banks may use partnerships with technology firms to provide faster payments, improved mobile applications, automated financial tools, fraud detection, or services for communities that lack convenient access to physical branches. Federal banking agencies recognize that third-party relationships can give community banks access to new technologies, delivery channels, expertise, products, and markets.

Economies of scope may arise when one organization uses the same branch network, technology, customer information, or compliance infrastructure to offer several related products. These efficiencies can potentially reduce prices and improve service. Competition from banks may also pressure established insurance, brokerage, payment, and advisory firms to improve their own offerings.

Diversification may provide a bank with several sources of revenue. A bank that earns income only from the difference between lending and deposit rates may be highly exposed to interest-rate movements or a downturn in one loan market. Fee income from payments, asset management, or advisory services could, in principle, reduce reliance on traditional lending.

The Gramm-Leach-Bliley Act of 1999 expanded the ability of qualifying U.S. financial holding companies to affiliate with securities and insurance firms. The policy reflected the view that modern customers and financial markets could benefit from organizations offering a wider range of financial services.

## Risks of Allowing Banks to Diversify

The potential benefits of diversification do not guarantee that every expansion will improve consumer welfare or financial stability. A bank entering an unfamiliar business may lack appropriate expertise, technology, internal controls, or compliance systems. Management attention can become divided across activities with very different risk profiles.

Evidence also suggests that noninterest income does not always stabilize banks. DeYoung and Roland (2001) found that fee-based activities could be associated with greater revenue and earnings volatility. Stiroh (2004) similarly concluded that noninterest income was relatively volatile and offered less diversification benefit than commonly assumed.

Financial conglomerates can become difficult for managers, regulators, creditors, and customers to

understand. Laeven and Levine (2007) found evidence of a diversification discount in financial conglomerates, indicating that markets may value a collection of different financial activities less than comparable specialized firms. This result suggests that organizational complexity and agency problems can outweigh expected economies of scope.

Diversification can also create conflicts of interest. A bank might recommend an investment product because an affiliated company earns a fee, not because the product best meets the customer's needs. It might use lending relationships to pressure businesses into purchasing insurance, underwriting, or advisory services. Customer data collected for one purpose could be used to market unrelated products in ways that compromise privacy or informed consent.

Another concern is that the public safety net supporting insured banking could subsidize risky nonbank activities. If an insurance, securities, trading, or technology affiliate experiences severe losses, the financial group may attempt to transfer resources from the insured bank. Even if formal legal barriers exist, reputational pressure may lead the bank to support an affiliate to protect the wider brand.

A larger range of activities can also make the institution more systemically important. Its failure may then disrupt lending, payments, investments, insurance, and market-making at the same time. Expansion can therefore increase the probability that authorities will consider the organization too complex or interconnected to resolve through ordinary bankruptcy.

The Office of the Comptroller of the Currency requires banks to introduce new or expanded activities consistently with sound risk management and the institution's overall strategy. It emphasizes the need for due diligence, testing, monitoring, legal review, financial projections, and controls proportionate to the activity's risks.

## Should Banks Be Allowed to Enter Other Lines of Business?

Banks should be permitted to enter related financial businesses, but their authority should not be unlimited. A complete prohibition would prevent consumers from receiving convenient and innovative services and could leave regulated banks unable to compete with technology firms, securities companies, insurers, and nonbank lenders.

At the same time, unrestricted entry into commercial and highly speculative activities would expose insured deposits and essential payment functions to risks that customers and public authorities may not be able to monitor effectively. The central policy question is therefore not whether banks should diversify at all, but which activities they should conduct, through what legal structure, and under what safeguards.

A sound framework should include several principles.

First, the activity should be financial in nature or genuinely complementary to financial services. Banks should not be allowed to use the advantages of deposit insurance and central-bank access to build unrestricted commercial empires.

Second, the insured bank should remain strongly capitalized and liquid. New activities should not be financed by weakening the institution that holds protected deposits.

Third, risky activities should be placed in separately capitalized affiliates when appropriate. Transactions between the insured bank and its affiliates should be limited, documented, and conducted on fair terms.

Fourth, regulators should supervise the consolidated financial group rather than examining each subsidiary in isolation. Risk can move through guarantees, shared technology, common management, reputational commitments, and internal funding arrangements.

Fifth, consumer-protection rules should prevent deceptive cross-selling, unfair tying, unsuitable recommendations, discriminatory access, privacy violations, and hidden fees.

Sixth, institutions should prepare credible resolution plans. Authorities must be able to preserve deposits, payments, and other critical services while imposing losses on shareholders and eligible creditors.

Finally, bank expansion should remain subject to competition policy. A financial institution should not be permitted to acquire so much market power that consumers lose meaningful choice or authorities become unable to allow it to fail.

## Conclusion

Bank failure creates macroeconomic risks that are generally more extensive than those produced by the failure of an ordinary business. Banks fund long-term assets with short-term and withdrawable liabilities, operate payment systems, create credit, hold interconnected financial claims, and depend heavily on confidence. Their failure can trigger runs, contagion, fire sales, payment disruption, and a broad contraction in lending.

These risks do not justify protecting every bank, executive, shareholder, or creditor from loss. Doing so would weaken market discipline and encourage institutions to take greater risks. The objective of public policy should be to allow poorly managed banks to fail while maintaining essential financial services and preventing disorderly contagion.

Allowing banks to enter other financial businesses can benefit consumers through convenience, innovation, broader access, competition, and potential economies of scope. However, expansion can

also increase complexity, conflicts of interest, operational risk, earnings volatility, market concentration, and the possibility that public protection will subsidize private risk-taking.

Banks should therefore be allowed to offer securities, insurance, advisory, payment, and technology-related services only when they possess the expertise, capital, governance, and controls required to manage those activities safely. Diversification is not inherently beneficial or dangerous. Its consequences depend on the type of business, the structure through which it is conducted, and the quality of regulation.

A competitive economy should permit failure, including bank failure. Yet because banking performs functions essential to money, payments, and credit, bank resolution must be more carefully managed than the closure of most other businesses. The correct policy is neither unconditional rescue nor complete regulatory separation. It is controlled diversification combined with credible resolution, strong supervision, and protection of the public functions on which the wider economy depends.

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