Reforming the financial sector [1]

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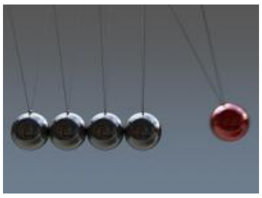

Banking is a tricky topic for liberals. The lines between state and private sector are blurred: if a private bank knows it will be bailed out by the government, it won't act with the prudence it should. Banks, trading in state-monopolized money, act as intermediaries between the state and the private sector, and can be the direct beneficiaries of monetary expansions by the Bank of England, like QE. Government interventions in the banking sector create bad incentives. Banks themselves aren't to blame for responding, rationally, to those bad incentives, but those responses can cause serious problems in the rest of the economy, as we saw in 2008.

Today, Steve Baker MP is proposing a ten-minute rule bill, to try to fix some of these bad incentives. The bill, says Baker, will:

- Enforce strict liability on directors of financial institutions
- Enforce unlimited personal liability on directors of financial institutions
- Require directors of financial institutions to post personal bonds as additional bank capital
- Require personal bonds and bonuses to be treated as additional bank capital
- Make provision for the insolvency of financial institutions
- Establish a financial crimes investigation unit

In a perfect world, I would object to special rules to increase bankers' personal liability ? fixing the principal-agent problem should be a private matter between banks' shareholders, directors and managers. But we don't live in a perfect world. It's virtually certain that the government would bail out any major bank that collapsed. That means that second-best provisions may have to be made to reduce the bad incentives facing bankers. Increasing their liability is a tough way to realign bankers' incentives along those of the bank itself.

The real key, though, is the fifth point. Making provision for bank insolvencies is the key to weaning banks off the government's teat. Governments will bail banks out whenever it's politically expedient. So, how do we make provisions for bank collapses without granny losing her savings? Sweden dealt with its financial crisis quite successfully in the early 1990s by taking a "bail-in" approach, where bank creditors are required to foot the bill instead of taxpayers, and debt-to-equity swaps are made, imposing haircuts on bank bondholders. If Baker's bill can start the ball rolling on this sort of reform, we'll all owe him a debt of gratitude.

Read more on Steve Baker's site:*Financial Institutions (Reform) Bill ? Liability of bankers and treatment of bonuses* [3];*Use of personal bonds and bonus pool to make good bank losses* [4];*Other measures* [5]

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