Financial thought crimes [1]

Type: **Think Pieces**[2] Written by **Deri Hughes** | Monday 3 December 2012

Introduction

The most tangible policy response to the ?main? financial crisis of 2007-9 has been the series of (on-going) reforms of the system of financial regulation in those countries that were most affected by the crisis in question. The need for such reform, and the nature of the reform that is thought to be required, have both been adopted as received wisdom by the majority of policy-makers. However, given the risks normally posed by received interventionist wisdom, it is worth giving some thought as to whether or not the current approach is, in fact, the most appropriate one. Accordingly, the purpose of this article is to consider the nature of the current reforms, and then to set out some alternative, and rather different, policy prescriptions.

Litigious Albion

In the United Kingdom, the attention that the financial crisis has received has been intense. Accordingly, the political and official appetite for reform has not waned. For example, as of November 2012, the Financial Services Bill is before Parliament, a Parliamentary inquiry into ?banking standards? is under way, and the draft Banking Reform Bill has been published. In addition, a Financial Stability Board (FSB) working group, led by the Chairman of the Financial Services Authority (FSA), the main British financial regulator, has announced its intention to focus on the activities of the so-called ?shadow banking system?.

The regulatory reforms that have been, and are being, implemented can be divided into two broad categories.

Firstly, *those relating to conduct*.

Secondly, *those relating to stability*.

In essence, conduct regulation relates to the way in which financial services providers interact with clients, counterparties and the public at large. Its range is very broad, covering virtually every aspect of financial businesses? commercial activities, and applying to businesses ranging from a self employed financial advisor to a universal banking behemoth.

There are, of course, ample reasons for becoming exasperated with the way in which conduct regulation has developed. However, it is a subject that warrants substantive consideration in itself, and it is not intended for this article to cover it in anything other than summary form. Instead, the rest of this article will concentrate upon financial stability regulation.

Financial Stability

The financial crisis threatened the stability and survival of numerous financial businesses, of various types and sizes. However, the ones that were of most significance were the commercial banks, whether ?pure? commercial banks or the commercial banking arms of universal banks. The reason for their significance is the nature of some of the roles that commercial banks play in the modern economy, as follows.

Firstly, they provide the bedrock of the economy's payment transmission system.

Secondly, they are the creators and guardians of a substantial proportion of the economy's money supply.

These two factors explain the Government?s willingness, at the time of the crisis, to intervene in order to prevent the failure of individual commercial banks, and of the commercial banking system as a whole. After all, a full commercial banking collapse would have destroyed the bulk of the country's payments system, and would have caused a large proportion of the money supply to evaporate. Clearly, the consequences of such a failure would have been very serious indeed.

However, the Government?s intervention came at a heavy price. The most frequently cited cost is that of (re)capitalising certain banks. However, the total cost of the intervention was much higher, and the cost is an on-going one. After all, using monetary policy as a means of providing systemic subsidy will inevitably introduce serious distortion, as indeed will rescuing failing financial businesses.

Naturally, the Government is keen to avoid such costly intervention in the future, as well as avoiding the controversy and opprobrium of being seen to subsidise and rescue an extremely unpopular industry. That, alongside a desire to avoid the economic disruption that banking crises tend to entail, explains the Government?s interest in financial stability regulation.

In essence, stability regulation is regulation that is intended to ensure that financial businesses are less likely to fail, or at least are less likely to fail in a manner that causes widespread disruption. This applies both to individual businesses and to the financial system as a whole.

On a firm-specific basis, financial stability regulation effectively involves monitoring and intervening in the way in which a business is structured and run, in order to ensure that the business in question operates in a way that the regulators consider to be prudent. On an economy-wide basis, it effectively involves moulding the financial system's structure and activities, with the aim of ensuring that the system operates in a way that the regulators consider to be prudent, stable and orderly.

A Matter of Philosophy

The theory that underpins financial stability regulation is largely as follows.

The commercial banking system will eventually become unstable if it is left to operate in a normal commercial manner. Given that the wider economic costs of a systemic banking collapse are likely to be serious, the Government will always have a duty to ensure that the commercial banking system does not fail. Therefore, Government supervision of the system is required: firstly, to ensure that bank failures are less likely to occur; secondly, to ensure that any failure can be managed or contained; and thirdly, to ensure that the costs of any Government rescue are minimised, and preferably eliminated. Furthermore, Government supervision of the broader financial system is required, in order to ensure that the commercial banking system is not imperilled by the failure of other financial businesses.

Given what is known about the wisdom of Government regulation and intervention in general, the theory outlined above is not very reassuring. After all, replacing potential commercial misjudgements with potential regulatory misjudgements is hardly a recipe for success. Furthermore, the theory is thoroughly dispiriting in its myopia, pessimism and timidity.

Of course, it cannot be denied that commercial bank failures are, at present, a very serious threat. In addition, it cannot be denied that certain established features of commercial bank operations render such banks fundamentally unstable: fractional reserve banking; high leverage; and asset / liability mismatches all pose a threat to a commercial bank's stability. Furthermore, it is certainly the case that the status quo ante was not acceptable.

However, is there a plausible alternative to closer supervision and regulation? Arguably, there is.

In essence, the commercial banking system suffers from two major weaknesses.

Firstly, the system is highly concentrated.

Secondly, commercial banks currently operate in a manner that is too risky and unstable.

Those two weaknesses will now be considered in turn, and suggestions will be made as to how the situation might be improved.

Concentration

The most robust defence against a systemic collapse of the commercial banking system would be for the system in question to comprise a much larger number of participants, and for those participants to be somewhat more equal in size and ?weight?. That would, of course, represent a marked change from the current situation, in which a small number of large banks dominate the system.

Therefore, one Government objective should be the fragmentation of, and increased competition within, the commercial banking system and market. After all, the rewards of such fragmentation and competition would be great indeed; the banking system would be more robust, and bank customers would enjoy the usual benefits of increased competition. To its credit, the Government does appear to be aware of this. However, more work is required.

The basic ?problem? that has led to the emergence of a small number of large banks is that commercial banking tends to benefit markedly from economies of scale, especially as far as ?utility? activities such as running a branch network, collecting deposits and transferring payments are concerned. However, technological developments do mean that smaller banks should now be better able to compete than was the case in the recent past; a large branch network is less important than used to be the case, and inter-bank payments are relatively simple and efficient. Therefore, there is certainly potential for the relative advantages derived from economies of scale to be eroded.

How might the Government encourage the fragmentation and increased competition referred to above?

Firstly, it should refrain from the temptation arbitrarily to decide on the ?optimal? structure of the commercial banking system. Competition law should certainly be used when appropriate, but of itself, competition law is not going to have much of an effect in the absence of more fundamental changes.

Secondly, it should ensure that small commercial banks are not arbitrarily prevented from obtaining direct access to the main inter-bank payment systems.

Thirdly, it should reduce the regulatory barriers to entering the commercial banking system and market.

The commercial barriers are high enough as it is, but regulation is making the situation much more difficult than needs to be the case. Accordingly, bank regulatory requirements should be lightened, and the regulatory treatment of small banks should be particularly lenient.

Fourthly, it should implement those reforms that are necessary in order to reduce the tendency for commercial banks to be run in an unstable fashion; arguably, the tendency in question is more beneficial to larger banks than is the case for their smaller competitors. More precisely, the factors that contribute to that tendency are more beneficial to larger banks than they are to smaller ones.

Instability

As indicated above, certain features of commercial bank operations render such banks fundamentally unstable. Of course, it would be impossible to eliminate all of those features, for they are largely integral to the commercial bank business model. However, the degree of risk involved would almost certainly be reduced if commercial banks were subject to stronger commercial discipline.

One basic advantage that commercial banks enjoy is the fact that in ?normal? times, most of their creditors, and short term creditors especially, pay insufficient attention to those banks? stability and creditworthiness. This allows commercial banks very easily and quickly to raise large amounts of debt capital at low rates of interest, thereby encouraging rapid growth and large amounts of leverage. It also tends to render such banks able and willing to acquire assets at rates and prices that do not fully reflect credit risk. In short, it encourages risky behaviour.

One reason for a lack of attention to bank creditworthiness is the trust that most members of the public have in commercial banks; after all, they are willing to treat commercial bank deposit liabilities as money. That, of course, is their choice. However, the situation is not helped by the fact that certain Government activities not only discourage vigilance on the part of bank creditors, but also encourage more aggressive and less disciplined action on the part of commercial banks. Accordingly, one of the most decisive steps that the Government could take in order to improve commercial bank stability would be to cease such activities.

The Government should take the following policy measures.

Firstly, it should be very clear that no commercial banks, or indeed any other financial businesses, would be rescued in future.

Secondly, it should eliminate Government-backed bank deposit insurance.

Thirdly, it should cease supporting the illusion that stability regulation can avoid bank failures.

Fourthly, it should avoid undermining the ordinary principles of insolvency law, as applicable to banks; a commercial bank is a business, and the failure of a commercial bank should be regarded as an ordinary business failure.

Finally, the Bank of England should eliminate its role as the lender of last resort; a central bank should regard the concept of emergency lending to a commercial bank with as much scepticism as the concept of emergency lending to a grocery shop.

Conclusion

Most of the policy measures outlined above are, by the standards of current received wisdom, highly unorthodox, and probably even heretical. However, it is to be hoped that they might, at the very least, encourage policy-makers to begin to regard commercial bank stability as an ordinary commercial problem, and one that might be solved by the sensible application of ordinary commercial and economic principles.
