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Banking for the public good

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ABSTRACT

Bank shareholders cannot be expected to provide good stewardship to banks because there is a conflict of interests between the shareholder owners and a non-mutually owned bank's depositors; who provide the bulk of the funds in traditional retail banks and are willing to accept a lower return on their savings than shareholders, in return for lower risk exposure. Regulation is required to protect depositors where deposit insurance schemes are at best partially funded and underwritten by taxpayers, who in turn need to be protected, and to deliver financial stability, a public good. Once some banks become 'too big (to be allowed) to fail' (TBTF), they enjoy additional implicit public (taxpayer) insurance that enables them to fund themselves more cheaply than smaller banks, which gives them a competitive advantage. The political influence of big banks in the US and the UK is such that they can be regarded as financial oligarchies that have hitherto successfully blocked far reaching structural reform in the wake of the 'Global Financial Crisis' and lobbied successfully for the financial sector liberalisation that preceded it. The TBTF problem and associated moral hazard have been worsened by mergers to save failing banks during the crisis and as a result competition within a number of national banking systems, notably the UK, has been significantly reduced. Solutions alternative to making the banks small enough to be allowed to fail are considered in this paper, but it is difficult to be convinced that they will deliver banks that promote the common or public good. It is argued that regulating retail banking as a utility and pooling insurance against financial instability using pre-funded deposit insurance schemes, with risk related premiums that can also serve as bank resolution funds, should be pursued; and that capital leverage ratios and/or Financial Activity Taxes might be used to 'tax' the size of banks.

1. Introduction

The Global Financial Crisis (GFC) of 2007–09 can be regarded as result of the failure of bank management to impose effective internal risk controls and more generally of the regulation and corporate governance of banks[1] (Walker, 2009). There were many factors contributing to the GFC, including 'global imbalances', the 'miss-pricing' of risks by the credit rating agencies, and a 'growth imperative' (FSA, 2009; Greenspan, 2007; Rajan, 2010). These made the management banking risks more difficult following a period of progressive financial sector liberalisation and rapid financial innovation; culminating in the development of collateralised debt obligations (CDOs), which were initially designed to facilitate the management of credit risk exposures, but became risk enhancers (Tett, 2009).

Green (1989, Abstract p.63), a banking practitioner, warned that deregulation and financial innovation, which was linked to wider technological innovation, were "sharpening ethical conflicts". He went on to argue: that the "Bankers' role is one of stewardship based on trust" by their depositors and that bankers have a "duty to lend responsibly". The ethical conflicts arise because: "Banking is about rewards reflecting real risks and ethical considerations form an important part of our risk taking activities. The welfare of our borrowing customers in good times and bad is of major concern". He goes on to say that: "We depend on people to run our businesses and to reflect our ethical standards". He concludes: "A bank's responsibility extends to Government, customers, shareholders, staff and the community" and that the increasingly complex banking environment would "test our resolve and commitment to ethical behaviour". In the period leading up to the GFC, bankers failed to exercise good stewardship and lost public trust in the wake of it. Green (2009) expresses similar sentiments. Walker (2009) criticises institutional shareholders for failing in their stewardship role.

Carcello (2009) postulated that well governed firms are more likely to serve the 'common good', as defined by John Rawls (see Andre & Velasquez, 1992), in the sense that general conditions are achieved that are to everyone's advantage and they thus benefit society as a whole, or 'the public good'. Shareholders would then seek a return on their equity investments that is commensurate with their riskiness.

Mullineux (2006) reviews literature on the corporate governance of banking firms, and concludes that institutional shareholders are unlikely to deliver good corporate governance, or 'stewardship' (FRC, 2010) of big banks in the interest of the public good. This is because they will seek a return on equity, and thus an exposure to risk, that exceeds the levels that retail depositors, traditionally the main funders of retail banks, desire. Retail depositors thus need to be protected and bank

[1] In this paper, we take the banking system to include retail, wholesale, and investment banking activities (Casu, Girardone, & Molyneux, 2006; Matthews & Thompson, 2008) and 'universal banks' combine these activities.

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regulation is required. Depositor protection is commonly partially funded, and underwritten by taxpayers (Macey & O'Hara, 2003), and so the risk that shareholders face is in fact 'socialised' (Admati, DeMarzo, Hellwig, Martin, & Pfleiderer, 2010). This in turn creates a 'moral hazard' (Mishkin, 2009) that encourages shareholders to urge bank management to take even more risk, because it will be borne by others, including bank bondholders. To combat moral hazard, regulatory 'taxes', such as deposit insurance premiums, capital adequacy and liquidity ratio requirements, should be risk related (Merton, 1977). Most taxes are, however, distortionary (Mirrlees, 2010) and risks are difficult to assess in a world of rapid innovation and uncertainty, in the sense of Knight (1921). Excessive regulation and miss-priced regulatory taxes are likely to discourage 'good' (transaction cost reducing) financial innovation (Mullineux, 2010) and to encourage the migration of banking business from the regulated sector to the more lightly regulated, 'shadow', 'parallel' or 'secondary', banking sector (Pozsar, Tobias, Ashcraft, & Boesky, 2010).

2. The 'too big to fail' problem

Some banks are deemed by governments and regulatory authorities to be 'too big (to be allowed) to fail' (TBTF) because their failure is likely to cause substantial damage to the banking and wider financial systems as a whole and to spark a panic, or full blown crisis; with disruption to the payment system, on which economic activity depends. Recently, such financial institutions, mainly banks, have been dubbed systemically important financial institutions (SIFIs) by the Financial Stability Board (FSB, 2001). This reflects the view that, since the demise of Lehman Brothers in September 2008, some banks, even if not too big, can be too interconnected with the wider banking and financial systems, or systemically important, to be allowed to fail. A distinction is drawn between domestic SIFIs and international, or global, SIFIs (G-SIFIs); the failure of which could threaten the stability of not just the domestic banking or wider financial systems, but those of other countries too.

The GFC led to mergers of weaker with stronger banks, often encouraged by the financial authorities, in a number of countries, including the UK and the US. This aggravated the TBTF problem and reduced competition in the industry, particularly in the UK. Further, widespread government intervention to 'bail-out' banks using taxpayers' money has potentially aggravated the moral hazard problem by making it evident that a number of banks are indeed too big or strategically important, to be allowed to fail.

This 'TBTF problem' is perhaps the major challenge facing bank regulators (Mullineux, 2011). The most direct solution would be to break up the big and complex banks into smaller and simpler units that can be allowed to fail and to reduce complexity by separating different types of banking activities, such as investment banking from commercial banking, as required by the US Glass–Steagall Act (1933) following the major US banking crisis in the early 1930s. It was repealed in 1999 by the Gramm–Leach–Bliley Act that allowed the development of more complex 'universal banking' holding companies. Alternatively, retail banking could be 'ring fenced' in separate, more adequately capitalised, subsidiaries; as proposed by the UK's Independent Commission on Banking (ICB, 2011a, 2011b) and to some extent by the EU's Liikanen (Group) Report (2012). Additionally, bank size itself could be discouraged using progressive regulatory 'taxes', such as non risk weighted capital leverage ratios and Financial Activity Taxes (IMF, 2010).

3. Fundamental restructuring of banking systems

It seems unlikely that a fundamental restructuring of the banking systems in the UK and US, or the EU, will be instituted by governments in the wake of the GFC. Indeed an IMF Staff Discussion Note (Classens et al., 2011) has cautioned that, in comparison with previous crises, governments have moved slowly to restructure their banking systems and may have missed the 'window of opportunity' to substantially reduce the probability of another damaging crisis.

In the UK and the US, financial 'oligarchs', have particularly powerful connections with government (Cohen, 2011; Johnson & Kwok, 2010) and engage in extensive lobbying. It is widely believed in the US and the UK that 'Wall Street' and 'The City' have 'comparative advantages' (Ricardo, 1817) in the provision of financial services through their financial centres in New York and London, respectively. In recent years, particularly since the post 2001 'Enron crisis' (McLean & Elkind, 2003) enactment of the Sarbanes–Oxley Act (2002) in the US, the two international financial centres have competed vigorously for business.

As the acute stage of the GFC abated from March 2009, the UK government expressed concern that the UK had suffered from the 'Dutch disease', in the sense that the success of The City had pushed up the value of the pound sterling to the disadvantage of other industries, particularly in the manufacturing sector; much as the rise in North Sea Gas production had done in the Netherlands in the 1970s. There was talk of a need to 'rebalance' the UK economy in order to reduce its reliance on the financial sector. Prior to the crises, the UK financial sector yielded tax revenue proportionately much greater than its share of Gross Domestic Product (GDP). However, its contribution to GDP and its productivity in the boom times were overestimated, became a significant proportion of booked transactions and 'deals' in the end lost money during the financial crisis. The City was perceived to be a 'golden goose', and the banking oligarchs increasingly successfully argued that the proposed post GFC restructuring and re-regulation would kill it, to the detriment of the public good. Instead, they argued, bankers should be allowed to get back to 'business as usual' as soon as possible, and the government should take actions to protect the competitiveness of The City; particularly from proposals emanating from 'Brussels', such as the Financial Transactions Tax (FTT). To strengthen their case, a politically sensitive failure of SME lending to thrive despite various UK government initiatives and low central bank interest rates was blamed on regulatory tightening.

Restructuring proposals and tougher consumer product regulation, and other regulation of financial derivatives, were contained in the US Dodd–Frank Act (2010), but this too has been progressively weakened in response to the lobbying of senators and regulators tasked with operationalising the Act. A similar process was underway in the UK, where the Independent Commission on Banking (ICB, 2011b) recommended the 'ring fencing' of the retail, or 'utility' banking (Mullineux, 2009) operations of UK banking conglomerates. Integrated universal banks, such as Barclays and Deutsche, regard the combination of investment and commercial banking, and perhaps also insurance, as providing efficiency enhancing economies of scale and scope and risk diversification opportunities. This is contested (Haldane, 2010), and the increased scale and complexity are in fact problematic from both managerial efficiency and regulatory perspectives. Werner (2013) goes further in stressing the diseconomies of scale in banking resulting from increased bank size and concentration in banking, which is costly to the economy and society due to a decline in 'productive' lending and an increase in 'unproductive' lending to fund purely financial transactions; stoking asset price inflation which can inflate 'bubbles' and cause financial crises. Calomiris (2013), however, makes a strong case for retaining the efficiencies engendered by universal banking and advocates alternative means of dealing with the TBTF problem based on the issuance of contingent convertible ('co-co') bonds inter alia. Calomiris does, however, support restructuring aimed at increasing competition in banking and in an IMF working paper, Ratnovski (2013) takes a similar line in arguing that banking competition policy should be re-orientated to deal with the TBTF problem.

The UK banks further argued that fundamental restructuring will reduce The City's comparative advantage in finance and Barclays and other UK based international banks (Standard Chartered and HSBC) threatened to move their head offices to other financial centres if they were in danger of becoming 'over-regulated' or 'over taxed'. The big