THE FUTURE OF FINANCE

And the theory that underpins it

8 Should we have "narrow banking"?

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Chapter 8
Should we have 'narrow banking'?

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The credit crunch of 2007–8 was the direct and indirect result of losses incurred by major financial services companies in speculative trading in wholesale financial markets. The largest source of systemic risk was within individual financial institutions themselves. The capital requirements regime imposed by the Basel agreements both contributed to the problem and magnified the damage inflicted on the real economy after the problem emerged. The paper argues that regulatory reform should emphasise systemic resilience and robustness, not more detailed behaviour prescriptions. It favours functional separation of financial services architecture, with particular emphasis on narrow banking – tight restriction of the scope and activities of deposit-taking institutions.

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1. How we got here

The traditional role of banks was to take deposits, largely from individuals, and to make loans, mostly to businesses. Deposits were repayable on short notice but loans could not in practice be called in immediately. Even a well run bank was therefore potentially vulnerable if many depositors demanded their money back simultaneously. Banks maintained extensive liquid assets and the Bank of England, in common with other central banks, offered 'lender of last resort' facilities. The assumed willingness of the central bank to provide funds against good quality assets meant that a solvent bank need not fear failure.

In the modern era, financial innovation allowed banks to trade both credit risk and interest rate risk. These developments were at first called disintermediation and subsequently securitisation. The credit and interest rate exposures which traditionally had been contained within banks, and made banks inherently risky, could now be reduced or eliminated through markets.

There was early recognition that such disintermediation also undermined the traditional conception, and role, of a bank. Some thoughtful commentators believed that the financial institutions of the future would be narrow specialists. An important book published in 1988 by a young McKinsey partner, Lowell Bryan (now director of the company's global financial services practice) defined that firm's view at the time. The title was *Breaking up the Bank.*[1]

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[1] Bryan (1988). Litan (1988) expounded similar arguments.

Bryan was half right, half wrong. All of the individual functions of established banks (with the possible exception of SME lending) are now also performed by specialist institutions. In many cases these functions are best performed by specialist institutions. Dedicated mortgage banks, based on wholesale funding, have offered market leading products. Supermarkets have diversified into simple financial services, such as deposit accounts and consumer loans. Private equity houses (venture capital firms) have transformed the provision of finance for start-up businesses. Successful proprietary traders set up their own businesses, attracting institutional money to hedge funds.

But, seemingly paradoxically, the trend to specialisation was accompanied by a trend to diversification. Traditional banks became financial conglomerates. They not only sold a wider range of retail products but also expanded their wholesale market and investment banking activities. The bizarre consequence was that while the deposit taking and lending operations of banks could – and did – use new markets to limit their risks, speculative trading in the same markets by other divisions of the same banks increased the overall risk exposure of the bank by far more.

In 2007-8, the process by which retail banks became financial conglomerates ended in tears. Almost all the businesses concerned experienced share price collapses, raised emergency capital, and became reliant on explicit or implicit government support to continue operations. But these financial conglomerates not only failed their shareholders: their customers had been victims of endemic conflicts of interest for years. At the very moment in 1999 that the 1933 Glass Steagall Act which separated commercial and investment banking was repealed, the New Economy bubble was illustrating once again the abuse which had led to the Act's passage in the first place – the stuffing of retail customers with new issues from worthless companies which were corporate clients.

Within every diversified retail bank, there is evidence of the fundamental tension between the cultures of trading and deal-making – buccaneering, entrepreneurial, grasping – and the conservative bureaucratic approach appropriate for retail banking. It is a conflict in which the investment bankers and traders generally came out on top. These institutional conflicts are, perhaps, the heart of the matter. The attractions of financial conglomerates are more evident to the people who run them than to their customers, employees, shareholders – or the taxpayers who have been faced with bills of startling magnitude by their failure.

2. Lessons from the history of regulation

History shows that regulation works most effectively when it is targeted on a small number of clearly identified public policy problems. Most other industries are regulated, not supervised, and neither regulators nor the businesses concerned normally use the term supervision. Regulation monitors observance of a limited number of specific rules, and emphasises structure rather than behaviour.

The remit of supervision is general rather than specific. Supervision seeks to impose a particular conception of good business practice across the industry. In financial services, the terms regulation and supervision are used almost interchangeably. Yet they are not interchangeable. Supervision is, by its nature, wide-ranging: regulation is focussed.

Attempts to standardise financial services regulation intentionally did lead after 1987 to attempts to agree a common set of minimal rules. Yet the Basel accords based on capital requirements proved worse than useless in the years before the crisis of 2007-8. The rules stimulated regulatory arbitrage and the use of off balance sheet vehicles, which made the nature of the activities banks were conducting opaque even to the management of these institutions themselves. Even more seriously they relieved executives of management responsibility for determining appropriate capital requirements. Capital adequacy requirements failed to restrain imprudent behaviour in the years up to the credit crunch and aggravated the recession by enforcing contraction of lending when the credit crunch hit. The belief that more complex versions of the Basel rules would be more effective in future represents the triumph of hope over experience.

That experience, from other industries as well as from financial services, shows that such attempts at regulation become steadily more extensive in scope, without being more successful in their practical results. Supervision is subject to creep – a tendency for its scope to grow. Supervision involves a form of shadow management; but it is almost inevitable – and wholly inevitable in the financial services industry – that shadow management will be at a disadvantage to the real management in terms of the competence of its staff and the quality of information available to it.

Supervision is subject to regulatory capture, an inclination to see the operation of the industry through the eyes of the industry and especially through the eyes of established firms in the industry. Because the supervisor’s conception of good practice is necessarily drawn from current practice, supervision is supportive of existing business models and resistant to new entry. Extensive and intrusive: yet ineffective and protective of the existing structure of the industry and the interests of its major players. That describes financial services regulation in Britain (and in other countries) today.

There is also a public interest in the promotion of a profitable and internationally competitive financial services industry. This activity, usually called sponsorship, should be distinguished from regulation and kept separate from it, as it is in most other industries. Examples of the dangers of blending sponsorship and regulation abound. In the BSE crisis over infected beef, a government department responsible for both consumer protection and industry sponsorship voiced misleadingly reassuring statements until the problem because too serious to ignore. In the long run, the results were damaging to both the interests of the industry and the interests of the public. Much the same has been true in financial services.

Textbooks of regulatory history point to the lessons of the US airline industry.[2] The need for regulation to secure passenger and public safety has been evident from the earliest days of civil aviation. It seems plausible – it is true – that planes will be better maintained by strongly capitalised companies with sound business models. It is only a short further step to perceive a need to review pricing policies, the qualifications of prospective new entrants, and the need for their services. And so on. Airline regulation spread to cover almost all aspects of the operation of the industry. Industry leaders met to discuss issues such as seat pitches and the composition of meals.

In the United States in the 1970s, this structure was swept away by a broad based Congressional coalition. The right believed that market forces would serve customers and promote innovation better than regulatory solutions. The left believed that regulation had become a cartel, a racket operated on behalf of large, inefficient, long-established companies. Both these beliefs were justified, as subsequent experience showed. The deregulated market, initially unstable, grew rapidly. There were many new entrants: some incumbents failed, others thrived. Consumer choice expanded, and prices fell. Passenger needs are today generally better served, while aircraft are safer than ever.

The financial services industry should follow this example. Regulation should seek to work with market forces, not to replace them. Not because free markets lead to the best of all possible worlds – in financial services, as in many other activities, they plainly do not. But it is much easier to channel a flow of water into appropriate downhill channels than to push it uphill. That is why structural regulation, which emphasises the incentives given by regulatory measures, is often preferable to regulation which seeks to control behaviour. Competition where possible, regulation where necessary, and supervision not at all, should be the underlying principle.

There many lessons to be learnt for financial services from both the management and regulation of other industries. We need to stop thinking of financial services as a unique business, whose problems are *sui generis*, and whose economic role is one of

[2] Kahn (1988, second revised edn.).

special privilege. The historic deal, which limited competition in banking in return for an expectation of prudent behaviour, has been abrogated by the actions of banks and bankers. Today, both consumer protection and macroeconomic stability will be best served by the policies to promote competition which are rightly favoured in other sectors of the economy.

3. Regulatory structure

The appropriate regulatory strategy in financial services is one which has been followed in other industries, notably utilities. Define, as narrowly as possible, the areas in which uninterrupted supply is essential, or in which natural monopoly is inevitable and for which close regulation is therefore required. Sponsor competitive markets, more lightly regulated, in areas to which these conditions do not apply. Impose structural separation to reduce conflicts of interest and to establish a system that is resilient and robust, in which failures can be contained.

There are many interconnected networks in the economy, and failures within them cannot be prevented. The appropriate objectives in the control and regulation of all such complex processes are to establish modularity, redundancy and alternative provision throughout the system: to create firewalls which prevent problems from spreading. These measures entail costs, of course – perhaps substantial costs - but these costs are dwarfed by the collateral damage imposed by wide-ranging failures in the electricity grid, or the telecommunications network, or by the financial crisis of 2007-8.

The appropriate regulatory strategy, therefore, is one that focuses on structure rather than behaviour: that distinguishes between the parts of the financial system where light regulation is essential and those in which the public interest is best served by competition and diversity. The overriding aim is not to prevent failure, but to limit its impact.

The present debate simply fails to address the issue posed by the emergence of managerially and financially weak conglomerate institutions, mostly based on retail banks. Even if the assertion that supervision will prevent future failure were credible – and it is not - the outcome would not deal with either the political problem or the economic problem that ‘too big to fail’ raises. ‘Too big to fail’ is not compatible with either democracy or a free market. An organisation ‘too big to fail’ can show disdain for its investors, its customers, and for elected officials – and the rows over bonuses are a clear, if trivial, illustration that such behaviour is a reality. On the other hand, supervision that succeeded in ruling out even the possibility of organisational failure would kill all enterprise.

The development of such mechanisms to combine competitive markets with resilient systems is not only the route ahead, but the only possible route ahead. Government underwriting for all or most financial sector counter-party risk in wholesale financial markets is not acceptable. Not just because this is not an appropriate government expenditure, but because the existence of such support undermines the imposition of risk disciplines within financial institutions and the evolution of market mechanisms to deal with counter party risk. The problem is not simply, or even primarily, that the belief that the government will rescue failing institutions encourages these institutions to take more risk. The belief that the authorities will intervene in this way substitutes ineffectual regulatory supervision of risk-taking behaviour for the far more effectual monitoring of risk exposures by private sector counter parties. The notion that supervision will in future prevent failures such as those of Long Term Capital Management or Lehman and therefore these problems of moral hazard will not arise is an engaging fantasy.

There should be a clear distinction in public policy between the requirement for the continued provision of essential activities and the continued existence of particular corporate entities engaged in their provision. In today's complex environment, there are many services we cannot do without. The electricity grid and the water supply, the transport system and the telecommunications network are all essential: even a temporary disruption causes immense economic dislocation and damage. These activities are every bit as necessary to our personal and business lives as the banking sector, and at least as interconnected.

But the need to maintain the water supply does not, and must not, establish a need to keep the water company in business. Enron failed, but the water and electricity that its subsidiaries provided continued to flow: Railtrack failed, and the trains kept running. The same continuity of operations in the face of commercial failure must be assured for payments and retail banking.

Financial services companies should therefore be structured so that in the event of an overall failure of the organisation the utility can be readily separated from the casino. That means the establishment of distinct narrow banks. These might operate as standalone entities or as separately capitalised and ring-fenced subsidiaries of financial holding companies. The claim that innovation in modern financial markets makes it essential to have large conglomerate banks is precisely the opposite of the truth – these innovations make it possible <u>not</u> to have large conglomerate banks. The activities of managing maturity mismatch, and spreading and pooling risks, which once needed to be conducted within financial institutions, now can, and should, be conducted through markets.

A special resolution regime should enable the activities of the narrow bank to be continued under public supervision or administration – supervision is obviously appropriate at this point – while the remaining activities of the company are liquidated. In some cases, the operation of the utility activity may require injection of public funds. In no circumstances should there be public support, or government underwriting, of non-utility activities. Government supervision of risk management in complex financial institutions is neither possible nor desirable, and

There should be no 'too big to fail' doctrine, and no government insurance of counter party risk in wholesale financial markets. The normal principle should be that financial institutions that cannot function without government support or subsidy, including so called 'lender of last resort' facilities,[3] should be put into resolution. If such institutions are unable to rectify their problems without public assistance the corporate entities concerned should be wound up and their senior management removed. In order to secure proper monitoring of the behaviour of financial institutions, it is important that creditors as well as shareholders expect to lose money in such an event. The market mechanism for securing competent management is the prospect of failure. Government supervision of risk management in complex financial institutions is neither possible nor desirable, and regulation will never be an adequate substitute.

4. Regulating the utility

The utility element of the financial services system is the payments system. Like the electricity grid or the telecoms network, failure even for a few hours imposes economic damage. The payments system is inherently a natural monopoly, like the electricity grid or the telecoms network. There are alternative, and to some degrees competing, payments systems but – as with telecoms networks – all are ultimately dependent on the core clearing and settlement systems.

In order to use the payments system, individuals and businesses must make deposits, or have access to associated lines of credit. Provision of these facilities can be, and should be, a competitive industry. Ownership and control of the network should be separated from ownership and control of these deposits. If there is vertical integration from deposit taking into transmission, deposit takers will use the economic power such vertical integration gives them to distort competition in their favour – to the advantage of a single firm which is owner of the network, or to the benefit of established firms at the expense of entrants if ownership is collective. That distortion of competition is what currently happens.

Narrow banks are institutions that have access to the payments system and take the deposits necessary for that access. There is a strong case and a political necessity for

[3] The traditional lender of last resort function, as described by Bagehot in 1873 after the collapse of Overend Gurney, has been made redundant by deposit protection and disintermediation. The term is now used in a general way to describe central bank support of failing financial institutions.

government guarantee of the deposits of narrow banks. The scope of such guarantees is open to discussion, but it should cover normal transactions balances and the modest savings of individuals. Theoretically, the guarantee of deposits in the UK and some other countries is provided by the financial services industry, but both the perception and the reality is that the UK government is the guarantor, and this should be made explicit. The fiasco of the collapse of the Icelandic banks exposed the fiction, in both Iceland and the UK: in Iceland the compensation scheme collapsed, and the UK (and other European) governments met the shortfall and are demanding reimbursement from the Icelandic government. The costs of the failures of British banks (including the British subsidiaries of Icelandic banks) to the UK Financial Services Compensation Scheme were met through a 'loan' from the Bank of England. There are no current proposals for the repayment of this 'loan'. If financial services activities are to be subject to a special tax, this can and should be done in other ways.

Only narrow banks could describe themselves as banks, take deposits, or access the payment system. Narrow banks would state that their deposits were guaranteed by the UK government (to the extent that they were) and all other financial institutions would be required to indicate on all statements and promotional material that funds entrusted to them were not underwritten by the UK government. The simplest rule is that all deposits with narrow banks are guaranteed and only deposits with narrow banks are guaranteed. Narrow banks would be required to restrict the investment of such deposits to safe assets. The definition of safe assets would be in the hands of regulators, not rating agencies: the privatisation of this activity manifestly failed.

In the light of recent experience, there is a good case for restricting the category of 'safe assets' to UK government securities, or (possibly) securities of major OECD member governments. Such a regime would allow some exposure within the bank to maturity, or perhaps currency, mismatch, but not credit risk, and relatively modest capital requirements should be sufficient to cover these. Such elimination of credit risk is the only means of minimising the cost to taxpayers, and of minimising the competition distorting advantage to banks which are covered by deposit protection or the current government implied guarantee of bank liabilities.

These provisions would be significantly more restrictive than a simple restoration of the situation that existed before the aggressive diversification of UK retail banks and building societies from the 1970s. Such more extensive restriction is inevitable because during that period the treasury activities of retail savings institutions metamorphosed from the purpose of meeting the routine financing needs of everyday banking into functions that were treated as profit centres in their own right.

The direction of change proposed by the 'Volcker rule' – the separation of proprietary trading from banking – gets to the heart of these issues: but the difficulty of defining 'proprietary trading' becomes evident if speculative trading on the bank's own account is intertwined with the ordinary practices of cash management. Such linkage has enabled institutions such as the (former) investment banks claim that proprietary trading is a small part of their activities even though trading in general is a major part of their activities and a large part of their declared profits: these banks define proprietary trading essentially as what takes place within a department labelled 'proprietary trading'. Only a stringent view of what constitutes the ordinary activities of a bank can solve the problem of effective distinguishing the utility from the casino. The implications of such restriction for the financing of conventional narrow banking activities – such as mortgages and SME financing – is discussed further below.

In a market economy, the degree of government involvement in underwriting the supply of goods and services may be graduated into three broad categories:

- *utility* – even very brief disruption causes systemic disarray and extended economic loss. (e.g. the electricity grid, telecoms network)
- *essential goods and services* – continued supply is necessary but partial or temporary disruption can be accommodated (e.g. food, fuel)
- *nice to have* – free markets can and should generally be allowed to define market price and availability. If the market does not provide, too bad (most goods and services)

Public intervention in utility markets, which are generally natural monopolies, has as its primary goals regulation of prices and of access and the assurance of continued supply. The mechanism for achieving the latter objective is normally a combination of special resolution procedure (which has continued service to the public as its primary purpose) and firewalls which enable the utility assets to be readily separated from any other assets of the business in the event of the failure of the overall corporate vehicle. Such procedures were involved in cases such as the failures of Railtrack, Metronet and of Enron (owner of Wessex Water and some UK electricity companies). The absence of any specific resolution regime for financial services companies substantially aggravated the problems created by the failures and near failures of UK retail banks in 2007-8.

The supply of credit to small and medium sized enterprises, and for consumer lending and mortgages, fall into the second category: of essential services, for which hiatuses in supply can be handled so long as they are of brief duration. The characteristic, and appropriate, strategy for government involvement in securing supplies is very different. That strategy is to stimulate a competitive market with diversity of providers. The proper role of government in these sectors is to promote competition, and to seek to minimise dependence on any single source of supply. More detailed regulation (other than for reasons of consumer protection and safety) is not normally required. There should be – as there is for commodities such as food and fuel – the capacity to declare emergency in the face of fundamental disruption to the supply of credit. A public agency would assume responsibility for the direction of supply normally with the cooperation of management but without it if necessary in these extreme circumstances. The objective is to withdraw and restore market forces as soon as possible.

Such emergency powers to direct the supply of credit were lacking in 2007, and are all too evidently lacking still. UK government influence on lending policies, even of banks which the government substantially owns, or whose credit the government has substantially underwritten, has amounted to pushing on a string. Supplies of credit for many ordinary business purposes have remained severely constrained well after the immediate crisis has passed. Regulatory interventions have emphasised the financial health of providers rather than the supply of services to customers. It is as though, when consumers were faced with fuel shortages, the government had released stockpiles to oil companies, which promptly used the supplies to rebuild their own stocks and then sold the remainder at a profit on international markets.

Most other financial services fall into the third, 'nice-to-have', category. Their provision, or otherwise, should be left to market forces. I doubt whether much securitisation would take place in the absence of gains from regulatory arbitrage and the extensive risk mispricing which occurred in 2003-7. It is commonly argued that since much (for example) mortgage debt was funded through securitisation, mortgages would not be provided on any scale in the absence of securitisation.[4] But this claim rests on an elementary confusion between the channels of intermediation through which capital is provided and the availability of capital itself, Although Tesco accounts for a significant share of sales of cornflakes, cornflakes would continue to be supplied even if Tesco did not sell them. The mortgage market existed in Britain for many years before the wide use of either securitisation or swaps, and that period covered the largest extension of home ownership in British history. Securitisation should neither be supported by government, nor actively discouraged, and the same is true of most other wholesale financial market activities.

5. Restructuring the financial services industry

Many people think that narrow banks would be boring. They would be boring for people whose aspirations are to welcome chief executives to panelled meeting rooms to plot global acquisitions, or for those who enjoy securities trading or the profits derived from them.

[4] Crosby, J. (2008) Mortgage Finance – a report to the Chancellor of the Exchequer, HM Treasury, 24 November.

Retail banking is, however, a retail activity, as its name suggests, and the consequence of disintermediation is that the skills needed to run a retail bank are increasingly those of the retailer, not the traditional skills of the banker. Bank managers have long ceased to be the knowledgeable and influential figures in local communities they once were, and the function of credit assessment has largely been taken out of branches and replaced, perhaps excessively, by centralised and mechanical credit scoring systems.. Narrow banks would compete, as retailers do, on product design, cost efficiency, and customer service, which is what most people who occupy management positions in retail banks want to do. At present, however, traders and investment bankers dominate the power structure of most conglomerate banks and are the dominant influence on the culture of the organisation.

High street retailers are focussed on establishing the needs of their customers and aggressively demand that suppliers meet these needs with good products at low prices. High street financial institutions mostly promote the services the wholesale divisions of the same institution want to sell. Customers currently rate their banks unfavourably relative to other retailers on the trust they place in them and on their quality of service and with good reason. One of the probable effects of narrow banking would be to change these perceptions by facilitating new competition and encouraging innovation in the segment of the financial service industry where such innovation generates real benefit to customers. Strikingly, and erroneously, the industry at present appears to see this loss of trust as a problem of public relations rather than the product of its own behaviour.

Would narrow banking imply lower interest rates or higher charges for those who hold accounts with narrow banks? In the first instance, the answer to that question is certainly yes, because narrow banking effectively withdraws the subsidy currently provided to banks through the free deposit insurance. (Deposit insurance is not entirely free, because some part of compensation costs is recouped from the industry, but experience in the UK with deposit protection and in other countries with explicit insurance schemes is that this fraction is small. To the extent that deposit insurance is currently paid for, the impact on customers of the withdrawal of the subsidy would be reduced).

We do not know the extent to which the benefit of deposit insurance is currently split between higher interest rates to lenders, lower interest rates to borrowers, or absorbed in bank profits or inefficiencies. In normal circumstances, however, the size of the subsidy – essentially the difference between inter-bank and central bank interest rates – is not large, although it has reached substantial levels in the last two years and is likely to remain at levels significantly above the historic norm.

Companies, and individuals with substantial balances, might wish to give up the government guarantee in return for somewhat higher interest rates and associated risks.

Charles Goodhart, in particular, has emphasised 'the boundary problem', the line between guaranteed and non-guaranteed deposits. Such a boundary problem exists unless all bank liabilities are guaranteed, or no bank liabilities are guaranteed: neither of which are acceptable solutions. The worst of all worlds is one in which there is continuing uncertainty about the actual scope of the government guarantee – the present situation. US experience with Fannie Mae and Freddie Mac has demonstrated just how costly such ambiguity can be.

It is important, therefore, that there be an unequivocal distinction between balances that are, and are not, underwritten by government. Some measures that might help sustain that distinction would be

- only narrow banks could call themselves banks, or call their activity deposit taking
- non-guaranteed cash balances would be invested only in money market funds, registered as OEICs, or under a similar regime, and subject to corresponding requirements for disclosure and spread of investments
- both guaranteed deposits and non-guaranteed money market funds would clearly describe their status on all promotional material and on statements of account
- funds could be offered only on an accumulation basis and no explicit promise or implied assurance that they could not fall in value would be given
- funds would be required to state prominently that redemptions might in emergency be suspended for up to (say) three months
- funds would not be marketed through branches of narrow banks, but only online or by post or telephone.
- funds should have a substantial minimum investment (eg £10,000 or perhaps higher).
- funds would not be permitted to invest in liabilities of the fund manager or in associated companies.

Such money market funds would be expected to make a substantial contribution to the finance of mortgages and SME lending, either via securitisation or direct funding of specialist mortgage or SME lenders. The emergence of such specialists should be a deliberate policy objective: some lenders would be subsidiaries of financial holding companies with narrow banking subsidiaries, others might be stand alone institutions. Obviously, however, there could be no express or implied guarantee of the obligations of such institutions by narrow banks in the same group.

Goodhart has expressed views that the boundary might provoke instability – funds might shift *en masse* from one side of the boundary to the other, depending on the state of the cycle and investor psychology. Market variations in the premium between insured and uninsured deposits should, however, take care of the issue. A range of different funds would offer different risk profiles, with corresponding implications for the quoted yields. In optimistic phases of the cycle, these spreads would compress: in pessimistic ones, they would widen.

The splitting of utility and casino banking is not the last word on functional separation of financial services activities. Investment banks, whether standalone institutions or divisions of financial conglomerates, are themselves conglomerates. They are market makers, traders on their own account, issuers of securities, asset managers, and providers of advisory services to large corporations. Each of these functions potentially conflicts with the others. The conflict is a reality, and is not adequately addressed by claims for the effectiveness of Chinese walls. Deregulation in Britain and the United States from the 1970s to the end of the century allowed the creation of financial conglomerates (and encouraged many continental European universal banks to transform themselves into similar institutions). Such deregulation and restructuring has proved to be a mistake and one which imposed large costs on the global economy by reducing the overall resilience of the financial system. It is time for that deregulation to be reversed.

6. Issues and problems

Could narrow banking be implemented unilaterally by the UK? In my paper *Narrow Banking* (2009) I discuss this issue and suggest that measures towards narrow banking would be necessary to protect UK taxpayers in the absence of action elsewhere – i.e. that the failure to take similar steps in other countries adds to, rather than detracts from, the urgency of such action in the UK. The Turner Report by the FSA reaches a similar conclusion. With nothing to add to that discussion, I refer the reader to it.[5]

Other questions raised about the implementation of narrow banking fall into three main groups

– the proposal is unnecessarily radical, since other measures, including but necessarily confined to; more demanding capital requirements, more intrusive supervision, extension of the scope of regulation, better international coordination, and the implementation of better resolution procedures; will be sufficient to secure the future stability of the financial system

– narrow banking could not have solved the problems which emerged in 2007-8; in particular, Northern Rock failed although it was a narrow bank while the failure of

[5] Kay, J.A. Narrow Banking (2009), CSFI.

Lehman caused a major international crisis even though Lehman was not involved in retail activities

– that the proposal is impractical, in the sense that the financial services industry could not feasibly be organised in a manner so substantially different from the current structure, or could not be so organised without imposing very large transitional and ongoing costs.

Each of these objections derives from a common implicit, but false, premise: that the existing structure of the industry and its products is basically appropriate and that the primary requirement is to put in place a set of measures which, if it had been implemented in 2003, would have prevented the developments which occurred between 2003 and 2007 and which led to the subsequent crisis. It is common for regulators to be concerned to shut the particular stable door through which the horse has recently bolted, but this argument represents a particularly egregious form of that error.

The events of 2003-8 were not a unique aberration, but a manifestation of an underlying problem. Financial services have become the main source of instability in the global economy. Although there is long experience of financially induced crises, advanced societies have become much more resilient to the consequences of natural disasters and geopolitical crises, which were historically the major causes of economic disruption. The increase in the ability of wealthy democratic states to resist natural and political events appears to have been accompanied by increased vulnerability to financial disaster.

The global economy has experienced three major shocks in the last fifteen years – the Asian and emerging market debt crisis, the New Economy bubble and its aftermath, and the credit expansion and crunch. The same underlying factors have been at work in each case, even if the proximate manifestation has been different. The process is characterised by competitive herd behaviour which has produced widespread and gross asset mispricing which has been eventually and dramatically corrected. In each of these crises, the activities which gave rise to them has enriched many individuals involved, while the aftermath imposed substantial and widely dispersed costs on people outside the industry. These economic losses are partly direct loss of savings or pension expectations, or higher taxes to finance public subsidies for the liabilities of failed institutions. But the indirect losses resulting from downturns in economic activity precipitated by the effects on business confidence and the disruption in the supply of financial services to the non-financial economy have in each case been far larger.

These recurrent events frame the argument for imposing functional separation, seeking simplification, and aiming to create smaller, more specialist institutions of more diverse character in the financial services industry. Thus the test of narrow banking and alternative reform proposals is not 'would these measures have averted the credit crunch?' but 'would they establish a structure more robust to the next shock, which will certainly arise from a quite different, and currently unpredictable, source?'

The packages under discussion undoubtedly include measures which are relevant to these questions: in particular, the extension of the scope of central clearing and the introduction of resolution procedures. 'Living wills' would, if sufficiently rigorously implemented, represent a big step towards creating a more robust system for dealing with failing conglomerates, but it is evident the measures introduced fall far short of this. To be effective, living wills would require the same kind of functional separation involved in narrow banking. In fact an effective living will would introduce narrow banking.

While some current proposals are helpful, other post-crisis measures aggravate potential problems. In particular, the doctrine of 'too big to fail' has unfortunately been made more explicit. That doctrine put government in the position of unpaid insurer of counter party risk incurred by systemically important institutions in their dealings in wholesale financial markets: an indefensible situation which not only imposes direct and indirect costs on taxpayers, but aggravates the problem of moral hazard. The moral hazard created is not just the incitement to risky behaviour by 'too big to fail' institutions themselves: of more importance is the undermining of incentives for surveillance of 'too big to fail' institutions by their own counterparties. Perhaps most seriously, the 'too big to fail' doctrine gives substantial advantages to large incumbent firms over entrants and smaller competitors, regardless of their relative efficiency or capacity for innovation.

Narrow banking is neither necessary nor sufficient to prevent bank failures: Northern Rock was a narrow bank and failed, while regulation of narrow banks would not have affected behaviour. As a matter of fact, Northern Rock was not a narrow bank in the sense defined here, and would not have failed if it had been. But this is not the main point. That point is that the objective of reform is not to prevent bank failure – to do so would have many adverse consequences – but to allow banks to fail without unacceptable or unmanageable consequences by creating a more resilient financial system. The requirement is therefore to put in place measures which would have enabled effective resolution of a failure like Northern Rock – the regulator and/or administrator should, as at the utilities described above, have power to take over the ring-fenced assets and liabilities. Trading on wholesale financial markets was Lehman's principal activity. The notions that public agencies can and should regulate businesses like Lehman's so that they cannot fail, and that taxpayers should underwrite the trading risks assumed by the counter parties of such a company, are both preposterous. The objective must be not to prevent such entities from going bust, but to limit the consequences for essential economic activities when they do.

The objective of reform is not to support the existing structure of the industry, but to change what people do, and the culture of the institutions in which they do it. Most people within the financial services industry, and many outside it, either find it hard to believe that the industry could be organised in a significantly different way, or do not wish to contemplate that the industry could be organised in a significantly different way. But plainly it could, and historically it was. To repeat an earlier example, the UK mortgage market operated without securitisation for decades and could do so again.

The counter argument must be that there would be substantial cost, both transitional and continuing, from any restructuring. It is not sufficient to suggest that there might be such costs: these costs have to be compared to the scale of costs imposed by the recent crisis, which amount to several percentage points of national income – costs sufficiently large, in fact, as to more than offset any plausible estimate of the benefits of recent financial innovation.

There is evidence of economies of scale in retail banking, but also evidence that they are effectively exhausted at size levels far below those of large retail banks[6]. The suggestion that there are gains to shareholders and the public when banks reduce risks through diversification is theoretically capable of being valid, but was refuted by recent experience: diversification led to the failure and near failure of several universal banks through contagion from activities that were poorly understood and controlled. The more relevant claim is that there are economies of scope in financial services, mainly in allowing individuals and businesses to obtain a range of financial services from a single provider.

Representatives of consumers and SMEs are inclined to emphasise the benefits of competition rather than the advantages of a 'one stop shop'. Descriptions of the benefits of cross-selling by retail financial institutions tend to emphasise the gains to the institutions themselves rather than their customers. While there might be benefits to large corporations from the existence of a single point of contact for their financial services, in finance as in most other specialist activities large companies tend to employ that point of contact themselves and rely on him or her to find the most appropriate provider of particular services. There may be advantage, for example, in being able to buy a complex derivative instrument from a trader who participates in the market for all the elements that go into the construction of that derivative, but it is easy to envisage alternative arrangements that would produce that result. In general, market arrangements are likely to emerge to enable any different structure to meet the needs of customers – that capacity for adaption is one of the fundamental strengths of markets.

[6] Ferguson, R.W. et al,(2007), International Financial Stability, CEPR.

7. Conclusions

The case for narrow banking rests on the coincidence of three arguments. First, the existing structure of financial services regulation (supervision) has failed. Consumers are ill served, the collapse of major financial institutions has created the most serious economic crisis in a generation, and the sector has been stabilised only by the injection of very large amounts of public money and unprecedented guarantees of private sector liabilities. It is time to learn lessons from the more successful regulation of other industries. Those lessons point clearly to the need to retreat from supervision and to regulate through the mechanism of relatively simple, focussed structural rules.

Second, the most effective means of improving customer services and promoting innovation in retail financial services is market-oriented. That approach is based on the ability of strong and dynamic retailers to source good value products from manufacturers and wholesalers and to promote consumer oriented innovations. The growth of financial conglomerates, a consequence of earlier measures of deregulation, has not been in the interests of the public or, in the long run, of the institutions themselves.

Third, a specific, but serious, problem arises from the ability of conglomerate financial institutions to use retail deposits which are implicitly or explicitly guaranteed by government as collateral for their other activities and particularly for proprietary trading. The use of the deposit base in this way encourages irresponsible risk taking, creates major distortions of competition, and imposes unacceptable burdens on taxpayers. Such activity can only be blocked by establishing a firewall between retail deposits and other liabilities of banks.

This is a game for high stakes. The financial services industry is now the most powerful political force in Britain and the US.[7] If anyone doubted that, the last two years have demonstrated it. The industry has extracted subsidies and guarantees of extraordinary magnitude from the taxpayer without substantial conditions or significant reform. But the central problems that give rise to the crisis have not been addressed, far less resolved. It is therefore inevitable that crisis will recur. Not, obviously, in the particular form seen in the New Economy boom and bust, or the credit explosion and credit crunch, but in some other, not yet identified, area of the financial services sector.

The public reaction to the present crisis has been one of unfocussed anger. The greatest danger is that in the next crisis populist politicians will give a focus to that anger. In the recent European elections, these parties of dissent gained almost a quarter of the British vote, and made similar inroads in several other European countries. The triumph of the market economy was one of the defining events of our lifetimes. We should be careful not to throw it away. It is time to turn masters of the universe into servants of the public.

[7] A powerful exposition is provided by Johnson (2009).

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