A Shorter Leash: Ideas for reforming the banking sector[1]

by Thomas Lines

The banking crisis was not universal

The UK is still going through a severe financial crisis, five years after the failure of its banking sector. However, none of the banking institutions that I use suffered serious adverse effects from the 2008 crisis. That is quite unlike the major banks. Why were those banks different? The answers to this question, I believe, hold the key to what happened during the crisis, where the banks went wrong and how they can be put on a better course.

I have a current account, a mortgage account and a small savings bond with a leading building society; a savings account with a Dutch-owned ethical bank; and a credit card with the Co-operative Bank.[2] I put these three institutions' resilience during the crisis down to three factors:

1. The form of ownership, at least in the case of the building society, which makes it more responsive to the needs of depositors and account-holders and less eager to pursue profits[3] for their own sake. After all, I am one of its owners, with a vote at annual general meetings; not merely a customer but a member of the Society.
2. Tighter rules affect building societies than commercial banks, in particular restrictions on access to money-market and interbank funding and consequently a greater reliance on deposits.
3. All three institutions pursue different policies than the biggest commercial banks: they are reluctant to use non-deposit funding and make only limited use of derivatives and securitisation.

What are banks for?

The services that I look for from banks and building societies are as follows, in order of their importance to me:

1. To safeguard my money, whether I need it for current use or to set aside as savings.
2. For the safe, rapid and reliable transfer of money on my behalf through the banking system, both in Britain and abroad (since I travel frequently and work for clients in other countries).
3. To enable me to buy a house.

[1] This commentary is based on the author's personal submission to the European Union's Liikanen Commission on reforming the structure of the EU banking sector in May 2012. It draws on his 2011 paper for Green House, 'The Dog That Didn't Bark: When banking crises did not occur and what we can learn from that', which can be downloaded at www.greenhousethinktank.org and www.tomlines.org.uk.

[2] This bank is undergoing a crisis of its own in 2013, although its balance sheet remained secure throughout 2007-08. It is overambitious attempts to increase market share – comparable to those of Northern Rock six years ago – that seem to lie behind this.

[3] Properly speaking, building societies do not make profits but surpluses, since they are not distributed but all go into reserves. On the other hand, the Co-operative Bank, as a subsidiary of the Co-operative Group and not in itself a cooperative at all, does have to make at least a nominal profit for its shareholder.

4. To maintain the value of my money, so that it at least keeps up with the general rate of inflation (not however successfully achieved on most savings accounts in the U.K., including my own, since 2009).

I have scarcely ever used banks or building societies for any other purpose, except to get local currency when I am abroad.

I also infer that these are the main functions of banks in general, in roughly the same order of importance to the general economy. I am aware that that is not what mainstream economic and financial theories say, but those theories did not stand up well to the banking crisis. One purpose of an article like this is to help in the necessary reformulation of them.

More precisely, I would describe the main functions of banks as these:

- **The primary function** is to safeguard their clients' money and facilitate transactions on their behalf. The network through which banks communicate might be called the plumbing of the market economy. As a closed system it is a natural monopoly and it provides an essential public service. It is not by accident that many countries have placed banks in the public sector at various times. This public function of banks must always be borne in mind when considering banking policy.
- It is a **secondary function of banks** to lend money. As a way of making profits, it helps them to pay for their primary activity.
- **The most important bank loans** are those which directly facilitate production and transactions in the wider economy. They are most often of short term, and include for example loans for working capital and trade finance.
- **The next level of lending** – still important, but not as essential to the wider economy – consists of longer-term loans and facilities for business investment, government or personal clients' convenience (such as overdrafts, mortgage loans, personal loans and credit cards). These are generally more risky since they less closely match the shorter terms on which banks' funding is generally supplied.
- **The least essential functions** are non-lending services supplied to companies, such as the underwriting of bond issues and advice on mergers and acquisitions, as well as all kinds of financial derivative and securitisation. In my opinion some of these functions are not needed at all, and others (particularly fee-based advisory functions) do not need to be carried out by banks and could be taken away from them without wider loss. Likewise, commodity trading and futures should once again become the preserve of traders and not financial operators like banks and hedge funds. The market economy operated without any financial derivatives or securitised loans until a generation ago, and it is hard to see that they should be considered essential products in any bank or quasi-bank.

Banks should be restricted to banking activities alone. They enjoy great privileges and should not be allowed to go beyond their own sphere. As an example, banks should not be allowed to trade on any commodity exchange or hold shares in any company that trades in physical commodities or commodity futures, even if they lend to that company. Nor should they hold shares in any company that performs any other function in the commodity sector, such as coal mines, port facilities, warehouses that serve a metal exchange or international shipping. Some global investment banks have recently bought equity in all of those fields. It is an abuse of their position.

Competition and interconnectedness

Maintaining the value of deposits is a separate issue from *safeguarding* them. It is not obvious that the former needs to be in the remit of banks, rather than the government's monetary policy. However, in general banks achieve it by offering interest on time deposits (which is usually – although not recently – above the rate of inflation). However, from the banks' point of view this is a commercial decision arising from the desire to attract deposits. As long as it is not allowed to become dangerously competitive, perhaps that is how it should remain.

But long experience demonstrates that competition between banks is not necessary for their good functioning and can be damaging. The banking system is inherently closed and monopolistic because of the universal payments system, and therefore competition can only operate at its margins. Competition brings with it the aim of maximising profits, which encourages risk, while a bank's first duty should be to minimise the financial risks faced by its clients. There is enough risk already in the mismatch of maturities (funding at short term and lending at long term) which exists on any bank's balance sheet.

Bank managements recognised this in the past but they have been allowed to forget it. In the 1950s and 1960s – a unique period in which there were no major bank failures anywhere in the world – the banking system in the U.K. was emphatically *not* very competitive. The high-street 'clearing banks' operated a cartel which fixed their commercial interest rates. For example, in the late 1960s they paid interest on deposit accounts uniformly at 2 per cent below the Bank of England's Bank Rate. The building societies operated a separate cartel in mortgage lending.[4] In Canada now there are six dominant banks, which operate in close liaison with the authorities in a system which remained stable throughout the recent crisis.

But in recent times – the LIBOR scandal notwithstanding – the banks have in general operated in ferocious competition. That has been officially encouraged since at least the late 1980s. However, the first casualty of the crisis in the world was Northern Rock in September 2007, which collapsed because, *for competitive reasons*, the bank had offered excessively high deposit rates and low loan rates, and was excessively dependent on external (wholesale) funding.

Banks are necessarily connected through the payments system, but the crisis arose in large part from different kinds of connection between them in the realms of funding and derivatives. In most countries outside the United States those connections did not exist in the past. The growing interconnectedness of banks was already discussed by banking experts in the 1980s, in tones that sometimes came close to alarm. In 1987 the Bank for International Settlements warned that the interbank market's 'potential for transmitting destabilising influences across the world should not be underestimated'.[5] That is precisely what happened 20 years later, much as predicted.

General conclusion

Banking and finance have become detached from the real economy. Arguably, so has money too, under the system of *fiat* money which has been universal since President Nixon ended the dollar's link with gold in 1971. As countless non-economists – and more than a few heterodox economists

[4] 'The Dog That Didn't Bark', *op. cit.*, p. 4.

[5] 'BIS sees slower interbank lending', *Financial Times*, July 29th, 1987. This is discussed further in 'The Dog That Didn't Bark' (and also in the author's M.Phil. dissertation of 1987, available on request).

too – have observed since long before the financial crisis, mainstream economic theory itself is based on a fantasy world which is at variance with the reality of economic life. That applies to the theories of banking and finance as much as any.

There is a spectrum of banking activities and a clear order of precedence between them. Regulations should reflect and reinforce this, encouraging banks to prioritise functions that are higher up the list. I would suggest this order of priority as a guide:

1. Safeguarding clients' money (in both current accounts and savings).
2. Maintaining an efficient payments system and the safe, rapid and reliable transfer of money through it on behalf of clients.
3. Loans which directly facilitate production and transactions in the non-financial economy (such as working capital and trade finance).
4. Loans for business investment and to government.
5. Loans for personal clients, including residential mortgages.
6. Other business services, such as the underwriting of bond issues and advice on mergers and acquisitions. There is a case for taking much of the consultancy type of work out of banks' hands altogether.
7. Commodity and financial derivatives in general, including securitised loans.

This commentary makes a brief attempt to think afresh about these questions, as a way towards rethinking the framework in which banks should be allowed to operate in the future. It started unashamedly with the author's own requirements as a banking customer, in order to think through what banking is *really* for rather than what current theory says it should be for. From this arose a clear order of priorities among banking functions, which I suggest should be used as the basis for future regulation of the banking sector.

Some guidelines for reforming the banks

Finally, here are some more detailed ideas for reforming the banks to meet the economy's actual needs, not those of the banks alone or the private interests of their traders and directors. New regulations for banking should include the following requirements:

1. **Legally restrict banks to strictly banking activities**, namely the taking of sight and time deposits, carrying out transactions on behalf of clients, lending money at interest, and a limited number of the corporate services traditionally carried out by investment or merchant banks.
2. In general, **prohibit proprietary trading by banks and their ownership of shares** in non-bank companies. The only possible exception might be minority shareholdings in companies that a bank *lends* to, following German practice, in the interests of strengthening relationships between a bank and its clients.
3. **Promote mutual and state ownership (locally, regionally or nationally)** as preferable to profit-seeking commercial ownership. However, all banks which provide any non-lending business services should be partnerships, with the partners bearing full financial responsibility, along the lines of London's merchant banks and New York's investment banks until less than a generation ago.
4. **Place all directors** of banks and building societies – whether in mutual, corporate or state ownership – **under a fiduciary duty to their depositors**, which would precede their responsibility to any external shareholders.

5. **Forbid any bank to be owned by any corporate entity** (domestic or foreign) **which has any interests outside banking**, as defined above. This would include the Co-operative Bank, which might be expected to live up to its name and become a true client co-operative itself.

6. **End the expectation that banks have to compete**. In banking, oligopolistic structures appear to be safer. In this area of the economy, competition should not be seen as necessarily desirable.

7. **Ensure that 'utility' banking becomes once again the dominant part of the sector**, rather than investment or wholesale banking. The Vickers Commission in 2011 calculated that between 64 and 82 per cent of British bank assets would remain outside the retail banks which it proposed to 'ring-fence' for safety purposes.[6] This would leave socially useful 'utility' banking as the minority and therefore less influential of the two branches. An important goal of regulation should therefore be to sharply cut back the size and scope of the non-utility sector. Much of this should come from strict limits on what is permitted in that field, as described elsewhere in this essay.

8. **Limit and discourage activity in riskier areas** of banking, including the outright prohibition of many derivatives. All derivative instruments – those that already exist as well as any that are invented in future – should require approval by a licensing authority. The proposer would have to satisfy the authority that the instrument serves a useful purpose and does not risk any grave economic harm, along similar lines to the rules that apply to medicines.

   In the particular case of securitised loan instruments, as a retail client I do not want any loan to me to be sold on to another party. I would regard that as a breach of trust by my lender, especially if it was done without my knowledge or permission. In Europe the selling and securitisation of loans are recent innovations, mistakenly introduced in emulation of U.S. practice. A lender which has to hold its loans until maturity is likely to be more careful in assessing credit quality before lending.

9. **Sharply reduce interbank lending and funding from commercial money markets**: to this end, require loan-to-deposit ratios to be kept within strict limits, to be gradually reduced until the value of loan assets does not exceed a bank's deposits, without any risk weighting. The aim is eventually to make every bank self-reliant, using its own deposit base – just as they were in safer days in the past. That way a banking problem will be limited to the bank where it arises and not transmitted to others. This is an essential requirement for making banks truly resilient.

10. **Require banks to undertake credit assessment** (due diligence) **for themselves** rather than relying on external bodies, in particular credit rating agencies.

11. **Review and strictly regulate relations between authorised banks** on one hand **and the world of 'shadow banking'** on the other.

[6] Independent Commission on Banking (2011), 'Interim Report: Consultation on reform options', p. 53, Fig. 3.5. Downloaded at http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf, September 2011.