**THE WESTERN BANKING CRISIS II: Remedies**

 **By**

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My last column had outlined a systemic problem in the western banking system. Banks have taken on too much risk, with the costs socialized through an ever expanding public safety net, whilst the returns have accrued to short term traders in the banks’ shares and their managers. What are the remedies?

We begin by recognizing that in Western democracies, insurance of deposits at commercial banks can no longer be rescinded. This means that some means must be found to prevent the banks from gambling with their publicly insured deposit base. The Glass-Steagall Act- introduced at the same time as deposit insurance in the US during the Great Depression- by separating commercial from investment banking, performed this function. Alternatives such as the complicated Basle Rules cannot do this, being easily gamed, as Andy Haldane has argued in his recent paper for the 2012 Jackson Hole conference (“The Dog and the Frisbee”, www.bankofengland.co.uk/publications). The Basle Rules which allow banks to use internal models to calculate regulatory capital against market risk, apart from allowing banks to ‘self calibrate’ risks, also increased the complexity and opacity of the regulatory system, with millions of calculations required to determine the parameters of dubious risk models from limited data.

Haldane’s major conclusion is that, simple rules are better than complex ones when the environment is complex and uncertain (rather than risky). So instead of the regulatory route that Basle has followed, simple regulatory commandments like “ ‘thou shalt not’… are likely to be less fallible than: ‘thou shalt provided the internal model is correct’. This is why Glass –Steagall lasted for 60 years longer than Basel II” (p.23)

But, even the simple “thou shalt not” rules are likely to be sabotaged by the complexity which political lobbying by banks will seek, as in the enactment of the Volcker Rule : “Thou shalt not engage in proprietary trading”. The consultation document accompanying the rule “runs to 289 pages”. Contrast this with the 37 pages of the Glass-Steagall bill. The same fate is set to befall the UK ‘s Vickers rule, which seeks to enforce the commandment: “Thou shalt not co-mingle retail deposit-taking and investment banking”. The simplest route would be to reenact the Glass-Steagall bill in the US, and hope other Western banking regimes follow suit.

As Tim Congdon has argued, though there may be a case for universal banks (which combine the deposit taking of commercial banks, the diversifying of risk by insurance companies, and the underwriting of securities by investment banks) based on the benefits of “diversification and organizational synergy”, the conflicts of interest between these functions will lead not to social benefits, but to the benefits being looted by managers and short term traders. (“The trouble with investment banks”, *The Financial Regulator*, June 2003).

The second remedy is to end the policy of “too big to fail” (TBTF) through extending the public safety net. TBTF concerns not the size of financial institutions but their *interconnectedness* with other financial firms, which could trigger losses to a large number of counter-parties from their demise, who might in turn default, leading to cascading defaults and an implosion of the financial system. But is this fear realistic? The Lehmann bankruptcy provides the answer. Before it, there was concern that it would be difficult to unwind all the derivatives for which Lehmann was a counter party. But, these concerns proved unfounded. As the New York Times and Financial Times reported, “hundreds of traders who placed bets on Lehman Brothers’ creditworthiness before it went bankrupt have settled their positions ‘without incident’, according to a company which tracks derivatives contracts…The overall system appears to have borne the shock successfully” (Robert Hetzel: *The Great Recession*, Cambridge, 2012, n.15, p, 253). A bankrupt Lehman did not bring down the interconnected financial system. Neither would the bankruptcies of LTCM or Bear Sterns (which led to markets to expect TBTF bailouts) have led to this outcome.

Nor was there any justification for bailing out AIG after the Lehman collapse. AIG’sinsurance policies were regulated. An AIG bankruptcy would still have protected its policyholders, as their policies were written by its separate subsidiaries, with assets to pay claims. Testifying before the House Financial Services Committee, the New York Superintendent of insurance, said “‘There would have been solvency’ in AIG’s insurance companies ‘with or without the Federal Reserve’s intervention’” (Hetzel, p.272). It was the risky bets made by AIG Financial Products (AIGFP) in London which were its undoing. AIGFP should have been put into bankruptcy, as it was clearly insolvent, and should have been shut down on Bagehot’s rules for a lender of last resort.

The third remedy would be to remove the tax deductibility of debt, and allow firms to deduct an allowance for corporate equity from profits. This would switch the incentives for banks to finance themselves through equity rather than debt.

The fourth is to remove the asymmetric payoffs caused by the switch to limited from unlimited liability in banking. Contingent convertible securities (CoCos), which are debt in good times and convert to equity in bad, could combine the risk incentives of debt and equity, having a combined payoff schedule mimicking unlimited liability. But there would have to be an automatic non-discretionary trigger for the conversion, well before bankruptcy. Haldane shows this is best provided by equity prices. “Equity prices called the crisis early and differentiated the sick from the sound. Market discipline worked” (p.16). Moreover, remunerating bank CEO’s in CoCo’s, would provide a potent incentive to avoid risky bets, to prevent equity from conversion if their equity price signaled their bank was in distress.

But my major conclusions from this and earlier columns is that, to avoid a repeat of the GFC the Glass-Seagall Act should be re-enacted, despite the opposition of the banks. Whilst, in the face of the balance sheet recession resulting from the Hayekian bust , open market operations should be used by the Central Bank to increase the broad money supply to keep nominal GDP on a steady course (with possibly a complementary inflation target), but with no attempt at credit allocation. For the financial system, there should be no obeisance to TBTF. The Bagehot ‘lender of last resort rules’ should be applied to all the financial institutions in distress, with illiquid but solvent institutions being provided loans at a ‘penalty rate’, and those deemed insolvent being put into receivership under the equivalent of the US’ FDIC.