Fixing the banks
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How can we avoid a repeat of the global financial crisis? While the Australian financial sector has come through in good shape, taxpayers in the United States and the United Kingdom have ploughed about two-thirds of a year's worth of gross domestic product into shoring up their financial sectors. Some of this money will be repaid over time, but this is a stunning and totally unexpected failure that caught the authorities flat-footed.

To make matters worse, the US financial sector not only proved fragile under stress, but it is clear the sector performed its core functions poorly in the relaxed years leading up to the crisis. It channelled resources into unsustainable NINJA loans (No Income, No Job or Assets), lending to people who could not afford to repay. A well-functioning market should establish stable prices based on underlying fundamentals, not volatile asset bubbles in which price increases feed on themselves. Risk was mispriced, misunderstood and misallocated. And for this performance the financial sector paid itself a king's ransom.

The cost is measured not simply in terms of the bail-out. The proper metric is the damage to the economy: lost output and opportunities forgone.

Thus the twofold policy response is to make the financial sector more robust while improving the efficiency of financial markets in carrying out their basic functions. And when things go wrong next time, the taxpayer should not be dudded.

Financial crises are not new. Nor is the idea that governments have to rescue ailing banks. Banks are special in several ways. They are inherently risky, borrowing short and lending long to fund illiquid assets. As well, if a prominent bank gets into trouble, there are runs on all banks: problems are contagious. At the same time, well-functioning banks provide a vital community service, similar to utilities such as telecommunications or public transport. They provide a safe repository for those who need risk-free investments (so-called widows and orphans). Banks supply the payments system which facilitates daily transactions. And they carry out the essential intermediation that funds businesses (matching savers and borrowers). The banking sector differs from other industries because it is susceptible to implosion and contagious failure yet is essential to the community.

Banks which are big enough to trigger a systemic crisis are usually considered "too big to fail" (TBTF). They simply cannot be allowed to shut down.

Government bail-out solves this problem but creates another, in the form of moral hazard. If bank managers know they will be bailed out, they have an incentive to misbehave. They are tempted to take extra risk, knowing that if things go well, they will make more profit but if things go wrong, the government will pick up the tab. Their shareholders have no incentive to discipline them, because they are beneficiaries as well.

Over the years elaborate contrivances were developed to fudge this moral hazard. The authorities asserted that banks would not be rescued or, at least, enough ambiguity was generated to make bank managers nervous (ie more careful). With any luck, the problems would be confined to one or two banks, and, in the regulated era, the authorities were adept at arranging a marriage between a weak bank and a stronger one. No one failed; the offending management was blackballed; moral hazard was held in check.

With the financial deregulation of the past quarter-century came a belief that real progress had been made in taming these inherent risks, and ironing out the disruptive economic cycle. In the US in particular, deregulation involved shifting the financial heavy lifting away from banking intermediation (traditionally the source of systemic risk). The substitute was capital

markets which link investors and savers more directly, packaging investments into suitably diversified bundles through securitisation. Risk could be divided into its functional components using derivatives and allocated through the market to those best able to bear it.

The hope was that capital markets would minimise official responsibility because regulation here would be based on disclosure rather than intrusive prudential supervision. It would be left up to investors, equipped with full information and the liquidity of the capital markets, to take responsibility for managing their own portfolios. They would have no particular reason to withdraw funds from a doubtful institution, because the market value of their asset already fully reflected the reassessed risk. Nor would there be any reason for the authorities to save a foundering institution.

How different the real world turned out to be.

Paradoxically, TBTF and the accompanying moral hazard is now well-and-truly out of the box, specifically because of one institution that was saved (US insurer AIG) and another that wasn't (financial services firm Lehman Brothers). And neither of them was a bank.

A key problem, of course, was that TBTF was not confined to the banks, but spread also to the shadow banking system – lightly regulated non-banks which performed banking functions. The banks themselves had expanded outside their original domain, conglomerating to provide one-stop shop financing, with deep links into capital markets. The issue was not just too big, but also too complex, too difficult to manage and too interconnected. The failure of one institution would bring down others, polluting markets with toxic assets and spreading uncertainty about the creditworthiness of just about every counter-party. Lehmans was not a proper bank, and not even the largest of the financial houses, but its failure was devastating. Runs happened not just on banks, but on the money market as a whole.

Two broad approaches are now needed. First, tighter regulation to constrain what banks can do, combined with counter-cyclical prudential supervision to rein in asset-price euphoria. Second, restructuring of the financial sector to make it more robust.

For some, the structural answer is that "any bank that is too big to fail is too big", and it should be broken up. But even if banks were broken up (in the same way that the US American Telephone & Telegraph Company was broken up into the Baby Bells for competitive reasons), the failure of one would cast doubts on other look-alike institutions and cause runs (something that doesn't happen in telecom companies). A variant on this sort of restructuring envisages a core group of super-safe banks – so-called narrow banks – which could hold only government debt and would make no loans. With riskless assets, these banks would be bullet-proof so contagion would not be a problem. They would provide a safe repository for the widows and orphans. They could provide adequate payments services. But they would not provide the third vital utility element – simple intermediation. This intermediation would have to be provided by other institutions which would soon become TBTF.

A more practical approach would be to return to the idea of the US's Glass-Steagall Act, introduced in the Great Depression to separate commercial banks from investment banks – but abandoned in 1999. The key distinction in the Act is between banks providing utility services (essential functions, such as payments, safe-repository function and basic intermediation) and institutions providing risky casino-like functions (such as trading on their own account, credit insurance, underwriting, exotic derivatives or high-risk loans). The authorities would protect the former but leave the latter largely to their own devices. Greatly simplifying financial institutions (or deconglomerating them) would not only make them easier to understand and regulate, but simpler to manage.

Of course these banks would need to be intensively and intrusively supervised to make sure they stick to their knitting and minimise risk. Trickier still, the border between the safe core banks and the rest of the financial sector would need to be quarantined and policed, so the risky sector cannot permeate and contaminate the safe core. To further complication matters, the border will shift over time.

In practice the separation could not be precise: banks have to take some risk in the normal course of their business. The answer is to impose very heavy capital requirements on the risky things banks do, to encourage these activities to shift to other institutions. Then the trick will be to stop these institutions from becoming TBTF.

Nor would it be easy to make a simple black-and-white distinction between bank-style institutions in the safe core and those institutions outside it. This non-core territory could not become some lawless badland. Rather, it might consist of differently-regulated groups of specialised institutions (insurance, funds management, central counterparties, credit rating agencies) each with functions defined and regulated, depending on the specific risks which, unchecked, might allow this sector to become systemically critical. There would also be a lightly-regulated, disclosure-only or buyer-beware segment: the financial sector must cater for the full range of funding requirements.

This still leaves the vexed issue of moral hazard for the core banks, which have to be kept going to avoid systemic failure. The answer is to preserve the ongoing institution but punish the individual risk takers. Management must lose their jobs and shareholders must lose their investments.

The GFC demonstrates how hard this is to do in practice. Governments can threaten that management will be unceremoniously sacked and shareholders will lose all their investment. But in the US, with few exceptions, failed managers left in their own good time, with full wallets and heads held high. Nationalisation proved infeasible and shareholders kept a stake. It shouldn't be this hard. Vital utilities such as water, airports or electricity can dismiss managers and shareholders lose their money without the provision of services being disrupted.

It is clear, too, that over the past quarter century prudential supervision lost the closeness, the insights and the authority to arrange the timely forced marriages which saved the system without dipping deeply into the taxpayers' pockets.

This close surveillance was replaced by a presumption that efficient markets would do the job, and so the old skills were not needed. The US regulators were dispersed, many with confused mandates and without political backing. They had simply not contemplated anything of great magnitude happening. To get the flavour, one has only to read the extraordinary diaries of the 10 days in September 2008 when the US financial system did seem about to descend into the maelstrom, while the authorities twisted the Rubik's cube of different institutional combinations, searching for forced mergers that might work.

This suggests that the answer to TBTF within the core banking sector is to have clear and detailed crisis management protocols for each of the core banks. For these TBTF banks, the issue is not how to wind them up expeditiously(as envisaged in the "living wills" currently under discussion in the UK ¬see story, right). These institutions will be kept going. Rather, it is more an operational plan for nationalisation. Nationalisation would be followed later either by resale to the private sector or progressive liquidation at a time and pace that avoided systemic problems.

This still leaves the dismal performance of the financial market under stress. The promise of the efficient markets hypothesis is that all existing information is incorporated into market prices, so prices should move only when news arrives. Combine this with the idea that market participants are rational and they use current price variability to forecast future price behaviour, and you have the basis for dangerous over-confidence about market stability. Markets work well most of the time. However when something goes wrong, self-reinforcing price movements are set off, as herding sellers unload assets into crowded markets where everyone is doing the same. As lower asset prices put balance sheets under pressure, more assets are dumped.

The authorities will have to be ready, next time, to repeat the daring "market maker of last resort" (buying underperforming securities) which the US demonstrated in 2008. This guaranteed the money market, supported the government bond market (and Fannie and

Freddie paper) and meant spending $US800 billion shoring up the mortgage market ¬poisoned though it was with toxic assets. Other countries' central banks also intervened in the mortgage-backed paper market over the course of the GFC, and should stand ready to repeat this action. The global financial sector cannot work if its basic markets freeze up.
Some things will reform organically, without new policy measures: NINJA lending in the US is unlikely to revive anytime soon and debt-driven mergers and acquisitions will be on the back burner for some time.

The GFC was not a trivial event, quickly put behind us. The deficiencies it revealed remain. It's amazing to hear US banks ready to resume business-as-usual, with scant regard for getting the fixes in place. Their heavy dependence on government bail-outs is forgotten, as they demand to be left alone to get along with their business. The best assurance against over-regulation is ready acknowledgement that wide-ranging changes are needed. First among these is to provide the US regulatory authorities with the political backing and organisational structure that would allow them to assert authority over a congenitally self-confident Wall Street.

Memory is the best counter to repeating mistakes, but memory lasts only so long. When it fades, either we will have better regulation in place including protection against the moral hazard of TBTF, or we'll be holding the financial system back from the abyss, again at taxpayers' expense.

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