Separation part of the fix for troubled banks
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Given the damage done by the global financial crisis, it's surprising how little has been done to ensure it doesn't happen again. The interim report by John Vickers from Britain's Independent Commission on Banking is a reminder of the unfinished task.

The main contribution of the report is to address the "too big to fail" (TBTF) problem, and its variants - too important to fail and too interconnected to fail. While TBTF has been discussed endlessly since 2008, mergers and failures in the United States have left the largest banks even larger, more complex, more conglomerated and probably more unmanageable.

Walter Bagehot's dictum that central banks should lend freely to troubled banks provides the uncomfortable starting point. Troubled banks have to be kept going because they are the repositories of the public's hard-earned savings, because they are the heart of the payments system, and because the failure of just one bank could easily set off runs on a financial system.

This logic still holds. But as banks expanded into complex areas of finance, they took the benefit of this implicit guarantee with them. When banks trade on their own behalf, issue derivatives and options, underwrite floats, guarantee commercial borrowing, facilitate complex financial engineering, manage funds or provide insurance, it's less clear that all these activities should have taxpayer-sponsored protection.

In some cases, a troubled bank can be "resolved", either by a merger with another bank or closed down in an orderly way, and depositors transferred to another bank without loss. This addresses the moral hazard problem because shareholders and non-deposit creditors can be left with the losses, and the management without their jobs.

The closure of Barings in 1995 shows that this can be done.

If, however, the troubled bank is large, international, interconnected and complex, merger options are limited and closure risks triggering a systemic crisis.

The alternative is to separate retail banking from other activities. When things go wrong, the authorities can either resolve the retail bank or, if its closure would be systemic, keep it going. Other activities of the bank group have to sink or swim.

In the US, the Glass-Steagall Act did just that, by separating retail banking from investment banking. But self-serving deregulatory pressure from Wall Street brought about the repeal of the Act in 1999.

Separation in itself doesn't solve all problems. Northern Rock showed that conventional banks can get into fatal trouble.

As well, unprotected activities may still be important enough to be systemic. In the US, the shadow banking system was bigger than the regulated sector. The Federal Reserve's liquidity umbrella was spread over investment banks such as Goldman Sachs. The insurer American International Group was saved. Only Lehman Brothers was allowed to fail. The disruption that this caused means that next time, even a faltering Lehman Brothers-like institution will be saved.

Aside from the banks themselves, hardly anyone regards this as a satisfactory outcome. In the US, the Dodd-Frank Act tried to strengthen the resolution powers. But the head of the New York Fed was quick to say this could not cover international resolution. The result is that the top banks and their web of complex foreign transactions are left at risk.

Dodd-Frank also acknowledged the idea put forward by former Fed chairman Paul Volcker of separating the propriety trading of banks. But no one is relying on this. For US Treasury Secretary Timothy Geithner, the answer is capital, capital and more capital. Having more of this loss-absorbing buffer will help in times of trouble, but the sort of capital increases being contemplated would not have been enough to save these institutions in 2008.

Britain seems to be making a more determined attack on the TBTF problem. Bank of England governor Mervyn King has highlighted the problem of international banks: they live globally, but come home to die, at taxpayers' expense.

Tough talk is one thing. Putting it into practice is another. The Vickers Committee interim report acknowledges that a Glass-Steagall-like separation is not feasible. Barclays Bank threatened to leave London if it was forced to separate its investment bank from the group (it ironically includes most of the residual of the old Lehman empire).

The Vickers alternative is to ring fence the retail part of banking groups: the part that operates in Britain. Funds could still be shifted from banking to non-banking activities within a group, provided that the statutory minimal capital was maintained in the retail unit.

This alternative would allow quick separation of the various activities in the event of trouble, and give authorities the option of keeping the retail banking function going while other functions are cast adrift to fend for themselves. It should end the free ride that the non-bank activities have in raising funds: the government guarantee raises the rating of a bank by three notches compared with an investment bank.

Would this quarantining withstand a systemic meltdown? Banks will always want to save related enterprises even when they don't have a legal obligation to do so (Bear Stearns propped up two of its hedge funds, and made its own demise more certain).

And regulators are often too lenient, especially early in a crisis. So Bank of America was permitted to take on all the impending mortgage disasters of Countrywide.

While separation doesn't solve all problems, some form of split seems essential, if only on the moral grounds of protecting the taxpayer from bailing out activities that have little social value (which, judging from 2008, might encompass quite a bit of banking activity). More capital would help, as would better resolution. But some separation of parts not vital to society is necessary.

Having identified parts that will not be protected, the next step is to make this clear to the public. If it can be done for cigarette packs, why not include endorsements on documents issued by the unprotected sector that say "your money is at risk here"?

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