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Comments on Reforming The Financial Sector

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John Kay*

* Council of Economic Advisers, Scottish Government

In the early 1990s I became involved in the process of reconstruction of the Lloyds insurance market in London after its near collapse. Lloyds is extensively engaged in reinsurance. In the 1980s, there had been explosive growth of complex reinsurance contracts. Syndicates would reinsure either the total losses of a syndicate, or the total losses of a particular investor (or 'Name'). Other reinsurers might reinsure the aggregate losses of a syndicate that had insured such policies. And so on.

It quickly became impossible – even if you wanted to try – to drill down and establish the underlying structure of risks. Agents had modelled the pattern of returns that such policies had been issued in the past, and found that most would never have had to pay out anything at all. That was enough reassurance for many Names.

Nemesis began when, in 1987, an oil rig called Piper Alpha caught fire in the North Sea. Nearly two hundred people were killed, the installation destroyed, and the outcome was the largest single insurance claim ever made at Lloyds. These losses triggered reinsurance contracts, which triggered other reinsurance contracts, and so on, and on, and on. Each $ of initial claim led to gross claims of $16. People who had never heard of Piper Alpha discovered that they had insured it over and over and over again.

Lloyds taught me a specific lesson about processes and a more general lesson about markets. Risk trading in securities markets was not necessarily about better and more efficient risk allocation. In trading risks at Lloyds people who understood a little about the risks they were incurring transferred them to people who understood less. The outcome proved to be not a spreading of risk, but a concentration of it in the hands of the weakest players.

That was how some of England's stately homes came to be sold to meet the losses of Lloyds' Names. For five years as a different version of the same process has unfolded. And that is why the question in my mind throughout has been 'who are the owners of the stately homes?' The answer, surprising in degree if not direction, is that today's stately home owners are the major banks. The list of people who bought complex debt products is very similar to the list of people who sold them.

The present crisis is not an act of God, unpredictable to and unpredicted by ordinary mortals. The crisis was not caused by loose monetary policy in the United States. Nor was the crisis the result of the American and European love affair with housing, or the proclivity of English-speaking consumers for excess credit. The crisis was caused by sub-prime mortgage lending in the United States only in the same sense that Lloyds' problems were caused by Piper Alpha, or the First World was caused by Princip's assassination of the Archduke Franz Ferdinand.

Just as there were many contributing factors to the outbreak of the First World War, there were many contributing factors to the outbreak of the credit crunch. But the cause of the crisis was unsuccessful speculation by large banks in wholesale money markets. That was the cause in the specific sense that such failed speculation was both necessary and sufficient for the crisis. Necessary, in that in the absence of this wholesale market activity events in the housing market, or other economic disruptions, could not have been amplified to a degree that would threaten the survival of major banks around the world. Sufficient, in the sense that given the scale of the poorly controlled inter-bank trading which has now become evident some trigger would, sooner or later, have led to events like those which have unfolded.

We attached a casino – proprietary trading activity by banks – to a utility – the payment system and the management of the deposits and lending that are essential to the day-to-day functioning of the non-financial economy. The losses in the casino have threatened to bring the utility to a halt. If we are to emerge with any confidence from the financial crisis, we need to put in place measures which will prevent these events happening again. The way I have framed the problem points directly to the solution – permanent separation of the utility and the casino.

Financial services regulation is generally reviewed in isolation, as a specialist, *sui generis*, problem. But there is well documented experience of regulation of other businesses: the regulations we have to assure public safety, to monitor prices charged and investment plans of public utilities, and across many other areas of business life. From such experience we have learnt that regulation works best when it is carefully targeted on specific market failures. We have also learnt that structural regulation is generally to be preferred to behavioural regulation - regulation of the scope of business activity is more effective than regulation of the conduct of business activity. By focussing on the opportunities for misconduct rather than directing the conduct itself, regulators can minimise the unintended consequences of their actions, avoid the pitfalls of superficial conformity but substantive disregard of regulatory principles, and focus their energies on the evils that made regulation necessary in the first place.

We have comprehensively failed to apply these lessons to financial services. We claim to impose general prudential supervision of these businesses. Such an activity fails all the tests of good regulatory practice I have described. Such supervision encourages institutions to treat prudential regulation as constraints to escape rather than a guide to good practice, and it leads us to control many things without controlling the things that most concern us. In practice, financial services regulation is mostly concerned with what is derisively called 'box-ticking' – ensuring compliance with detailed administrative rules. And, given the political power of large financial institutions – the most effective industry lobby in western economies today - and any realistic view of the skills likely to be available to regulatory agencies, it cannot be otherwise.

Fannie Mae and Freddie Mac were probably the most intensively supervised private businesses in the world, scrutinised by a specialist staff of over two hundred. The staff was in aggregate paid less than Franklin Raines, the former Fannie Mae CEO. Raines was, indeed, very successful in expanding the scope of Fannie Mae's business. He had the relevant skills to deal with the regulatory regime: he was a man of Washington rather than Wall Street, more distinguished for his connections on Capitol Hill than for his financial acumen. Understanding that history gives you understanding of why the demand for tighter prudential supervision of banks, which will no doubt be met - will be as ineffective in the next crisis as it was in the last.

The regulatory question raised by Fannie Mae's failure is not whether Fannie Mae should have been more extensively supervised, but whether such an organisation should have existed at all. Until we are prepared to approach financial services regulation in the frame of mind that emphasises structure not conduct, we are whistling in the wind. So let me turn to these structural issues.

We are at the end of what we should regard as a failed experiment in structural deregulation. Until the 1970s both Britain and the United States had largely specialised financial institutions: such specialism the result of a mixture of convention and regulatory restriction. These conventional and regulatory restraints were successively relaxed, allowing the emergence of the large, diversified conglomerates we see today.

These large, diversified financial conglomerates are, in the popular phrase, 'too big to fail'. They are also riddled with conflict of interest. A basic conflict of interest exists between the buy side and the sell side, between the purchasers of securities and the issuers of securities. The conflict between retail and investment banking is the fundamental conflict which Senators Glass and Steagall identified in 1933 when they reviewed the experience of the Wall Street crash and the Great Depression.

But legislation enacted at the same time introduced a second potential conflict between retail and investment banking. That second conflict was the result of deposit insurance, and would prove central to the current crisis. The deposits of the retail bank, effectively underwritten by the taxpayer, could be used as collateral for the trading activities of the investment bank. Deposit insurance introduced the large and ultimately prohibitively costly subsidy to investment banking which we are all now meeting through our taxes.

In addition to these conflicts – call them the Glass-Steagall issues – there were the conflicts of interest within investment banking itself. The modern investment bank – including the investment banking activities of commercial banks – gives financial advice to large corporations, offers asset management services, engages in market making, issues securities, and undertakes proprietary trading on its own behalf. The customers of every one of these activities have interests which conflict directly with the interests of the customers of every other.

The claim made was that market forces bolstered by internal and external regulation through Chinese walls, would mitigate these conflicts, and allow conglomerates to reap the informational advantages of conglomeration without the associated disadvantages. This claim has proved false. Worse, the tensions between functions were aggravated by clashes of organisational culture. At its most extreme, it is hard to imagine two more diverse business styles than the individualistic opportunistic aggression required in proprietary trading and the routine bureaucratic processing of millions of daily transactions needed for retail banking. In practice, these financial conglomerates, characterised by incompatible baronies and unfathomable complexity of interactions between products, were unmanageable and, effectively, unmanaged. That management failure is the central explanation of why we are where we are today.

I have only a short time to move from diagnosis to cure. We need to restore narrow banking – to ensure that the casino cannot again jeopardise the utility. That means ring-fencing the payments system, the routine deposit taking and the lending to consumers and to small and medium sized businesses. There are several measures that might help towards this objective and a combination is probably appropriate. I suspect such an outcome will now be best achieved by taking the failed banks into direct public ownership for a period. Measures to re-establish narrow banking will necessarily involve the divestiture or closure of the investment banking activities of retail banks. Such restrictions will provide an opportunity to reintroduce measures of structural separation between fundamentally incompatible wholesale financial activities.

My diagnosis, and my proposed solutions, are determinedly microeconomic. They require international agreement only to the extent that an international consensus on the sources and solutions provides a necessary background to national measures of reform. There are large problems of financial imbalances in the world economy, which demand radical solutions, and which will be discussed later today: but although these form the background to our current urgent concerns, they are not the cause of our current urgent concerns, nor are the solutions to our urgent concerns to be found in such measures. The causes of the crisis, and the remedial measures now required, are embedded in the structure of the modern financial services industry.

Addressing these structural issues, which will require high political courage, is a prerequisite of policies to prevent a similar crisis re-emerging a decade from now.