The Problem with Banks

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About the Authors

Lena Rethel is Assistant Professor of International Political Economy at the University of Warwick and her research work includes mainly Capital market development, the emergence and challenges of Islamic finance and the relationship of finance, debt and development.

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About the book

Over the last five years a lot has been written about problems of the banking sector. This book offers a thoughtful contribution to the debate on various problems banks face before and after the sub-prime crisis. The authors argue that banks are very troublesome institutions, they borrow short and lend long. They look for short term and ignore long term benefits of the society. They don't take any decision in public interest but when they fail they are bailed out with public money. US sub-prime crisis bailout has cost the public over $5 trillion. The book draws the reader's attention towards political and economic issues. The authors have tried to seek answers to some of the central questions. What is the Problem with Banks? Why do they seem to be at the center of economic and financial turmoil down through ages? What is the difference about the most recent banking crisis? Deeper information is catered with the help of large number of referenced academic studies to support the arguments that make the book interesting.

Review

The book explains the circumstances that have driven the banks towards self regulation.

It was expected that self regulating free market will bring well-being and overall development but financial crisis has proved it wrong. Recent financial crisis was a result of the profit making lust that was linked to risk taking. Compensation was based on risk taking, therefore identification, calculation, pricing and packaging of risk was at the heart of modern financial market. Banks have become speculator with others' money without any accountability and liability. Banks' attitude towards risk has changed. Risks of banks have increased many folds as they have started taking higher risk for making more money. Authors are of the opinion that the government not only regulates banks but also creates and shapes their behavior and role. According to the book, government debt has increased by 86% during the three years following the sub-prime crisis. Various strict domestic and global regulations could not prevent banks from global financial crisis that has eaten away tax payer's money in bailout packages. Finally the book gives an overview of what is happening in financial markets. The book is divided into six chapters to explore various dimensions to understand the problem of banks, and suggests solutions.

Chapter 1 describes how the evolution of banking sector/ financial institutions and framing of regulations by government have systematically influenced the sector. The evolution of bank-like financial institutions can be traced back to around 2000 BC in Babylonia where lenders were based in temples doing transactions of accepting deposits and sanctioning loans. First financial instability was witnessed during 33 AD when lenders were losing confidence in the institution. The then Roman Emperor Tiberius stepped in as a lender of last resort and brought the confidence back. Europe is linked with many banking and financial crises historically. The growth of industrialization brought frequent banking crises such as the collapse of BCCI and Barings in Britain in mid 1990s. These collapses have compelled the state to develop tools necessary to regulate the financial markets. The concept of central bank emerged during the late seventeenth century, when the Bank of England was incorporated in 1694 by royal charter as a private company. United States too has witnessed a number of financial crises; in 1792 Bank of New York had witnessed a bank run, followed by bank failure in 1818-19 and financial crisis during great depression of 1930's. Further US also faced a saving and loan crisis in the late 1980's and the sub-prime crisis early in the twenty-first century.

The Great depression of 1930's made banks to split on the basis of types of operation after enactment of Glass-Steagall Act, 1933. The Act has not proved effective in making the banks "Crisis Proof". A series of bank failures and success of European style universal banking model compelled repeal of the Glass-Steagall Act in 1999. After Europe and USA it was the turn of Asia to be hit by various financial crises. Banking crisis of Japan in 1927 affected its colonial dependency. Another big financial crisis in Asia started in Japan during 1990s. This crisis spread wider across the East Asia region and continued till 1997-98, and demonstrated how financial instability in one country can affect other interlinked countries. These banking crises in all continents shaped the boundaries of future financial arrangements and gave way to the government to step in as a regulator to protect the savings of people. The development of democratic setup has also pressurized the government to avoid cost of future bailouts.

Chapter 2 provides a glimpse of what exactly banks are. What is the nature of the banks? In reality banks are not strong rooms or counting houses. They don't store money safely for their customers. Banks have to pay interest on the deposits so they lend most of the fund in the market and earn interest on it. They keep approximately 10percent reserve to meet customers' requirements. Most of the deposits accepted by banks are lend out but problem arises when they borrow for short term and lend for long term. This creates maturity mismatch and increases doubt on the bank's ability to cover demand on depositor's funds. Sometimes banks lend more than they borrow which creates additional pressure on the banking system. Confidence on the banks could not be built based on its efficiency of operation but state participation alters the rule. State and other participants have made banking like a musical chair game, everybody (citizen, business and government) dances while music plays and runs towards a chair when the music stops. But the regulator understands that chairs are not sufficient for everybody, so they try to keep the music playing. Once confidence is lost (as happened in 1930s and 2007-09) bank runs occur which may lead to financial paralysis. To maintain confidence at times of crisis, state always stands ready as a lender of the last resort. Banks' balance depends upon confidence; those institutions not doing well would have different values than those doing well.

Chapter 3 focuses on the impact of financial disintermediation on banking. Disintermediation and financial innovation have taken place in banking sector post 1990s. Because of disintermediation, banks have to compete with efficient and cost effective capital markets. Liberalization and deregulation during this period have encouraged borrowers to seek alternative forms of finance by borrowing directly from the market. Disintermediation, which is the process of eliminating the middlemen, has benefitted both borrowers and lenders. Borrowers can obtain funds from outside at a lesser cost and lenders can earn more than what they earn from banks. The cost of bank intermediated loan is always more as banks need to maintain a certain ratio of reserve assets to loan outstanding, and they also charge for infrastructure cost as well as for NPA of funds. Bond market has flourished because of its cost effectiveness and got further boost from Asian financial crisis of 1997-98; this development has led to significant decline in the share of banks' lending over the last decade. So what is the way out for banks? Should banks give away the traditional role of intermediation and become active as market participants? Now they have a new role to play i.e. trade, securitize the loans and device new types of financial products. This process has forced the banks to give up their role as a gatekeeper in the financial market and made them to reduce the margin approximately from 2.5 percent to 1.5 percent.

Repeal of Glass-Steagall act provided the much needed support, banks moved into the market with full speed by strengthening their investment banking business. For example: Deutsche Bank acquired Banker's Trust

Corporation, merger between Chase Manhattan and JP Morgan in 2000 and acquisition of Bank America Corporation by Nationals Bank. Banking has transformed as a shadow banking system (investment banks, hedge funds, money market funds and insurers) and started creating complex financial engineering that was a main cause of the sub-prime crisis. Structured finance in the form of security of package of debts (credit card borrowing, car loans & mortgage) started selling like hot cakes in the financial market. The owner of this security has a claim on the revenue of these debts. This process of securitization helped in converting illiquid consumer debt into financial market assets. These securities were then sent to credit rating agencies for rating. Rating agencies rated the instruments (most often "AAA") on the basis of their past performance without having any clue towards future paying capacity. Sub-prime crisis made Lehman Brothers bankrupt and US government had to bailout by paying $182 billion to the insurance company, America International Group (AIG). Further to revive the market, US Federal Reserve followed easy money policy to keep the cost of borrowing cheaper. This policy led to the decline in interest rates thereby reducing the margin of the banks. Naturally this made banks to look for products that can earn them higher returns.

Chapter 4 explains the impact of self regulation on the behavior of the banks. Government has liberalized regulations and has tried to push responsibility for prudent behavior onto the institutions themselves. States will intervene only in case of market failure. Banks' regulation develops in the social and political environment locality at contemporary periods. Regulation related to banks and financial institutions have changed substantially over the last few decades since the collapse of Bretton Woods system. Financial disintermediation took off in 1980s and regulation became external to market operation. Interference of regulator has reduced drastically in the day to day functioning of the market. Authorities allowed financial institutions to set, enact and adjudicate rules of game. Banks were allowed to decide the scope of their operation, risk taking capacity and own compensation package. Decision of compensation which includes performance linked bonus was left to the market forces. Most often, remuneration was linked to risk taking capacity of investment bankers. Bankers' focus shifted towards taking more risks and earning more, rather than safe keeping of deposits.

US was first to adopt self regulation. Initially it was slow in Europe, yet they implemented Basle accord of 1988 in the second banking coordination directive in 1989. Further they have also adopted Basle II accord in 2006. Basel II was based on three principles: a) Risk weighted minimum capital requirement b) Periodic supervision, and c) Market discipline. Basel II also pushed the idea that, bigger the bank the better equipped they are to handle worst situations. Self regularization has helped Regulatory in decreasing their strength. Federal hiring is reduced by 20%. Malaysian central bank has reduced the staff by 50%. Reduction in staff has reduced the regulatory check, and impact was visible in the form of financial crisis. Market driven remuneration system has further increased turnover of the regulatory staff. They move towards private sector as they offer much more attractive compensation than the state owned regulatory authority. For example, Secretary of UK Treasury was drawing £.18 million whereas CEO of Royal Bank of Scotland had drawn £4.2 million in the same year 2007.

Things were different in East Asia; policy makers were pragmatic and things like credit control, capital control and variable reserve requirement were in force. In the aftermath of financial crisis, South Korea, Thailand, Indonesia & Malaysia became much more proactive towards market disintermediation.

Chapter 5 elaborates proposals of reforms in banking sector and why these reforms are not solving the problems of the banks. Three areas have been discussed in detail: macro prudential policies, ban on proprietary trading and proposal about breaking up of the banks. As regard to macro prudential policy, the authors are of the opinion that formation and implementation of regulation is not sufficient to get rid of the problems of the banks. Simply obeying the rule is not enough in a professional culture. Reforms can be achieved by institutionalizing the profession of banker. Specified education and training with certificate can make them professional like any other professionals. Volcker rule was implemented to ban proprietary trading by the banks. But the rule has failed to control risky behavior of the banks. The bankers were not in favor of breaking up of the banks. They thought bigger banks are better as government will not allow big banks to fail. Bigger the banks, bigger the systematic risk it poses considering its potential collapse. Therefore there is more likelihood that it will be bailed out by the government. This possible bail out guarantee of government serves as a incentive to the banks to go for merger and acquisition to become bigger. Banks readily pay premium to become big. Banks indulge in much more riskier activities as there is no fear of collapse, thinking "Too big to fail".

Chapter 6 concludes with the authors' argument that banks are not ordered, sensible institutions as suggested by those who run and those who regulate. It has created problem for borrowers and lenders many times. Even after global financial crisis of 2007 very few people or policymakers have realized it. Investigative reports and policy briefs produced by various agencies also do not deal with the problems of the banks though, they can help in dealing with some of the issues created by the banks. They are of the opinion that more sharp changes are needed in the banking institutions. A broad societal consensus and more creative solutions are required. Creation of a separate organization for safe keeping of deposits and the generations of funds for investment, who can take calculated risk, can help. Banks have been managing short term liabilities and long term assets, and have been surviving. They have been under pressure by cheaper and multiple sources of funding. Capital market and money market has also eaten up the business of banks. To make good returns, banks also started using capital market through proprietary trading. Banks have changed character and behavior. It has posed risks for the financial system; therefore living with the current arrangement is foolish.

Finally, the authors have concluded that problems with banks is not going away any time soon. Banks are rich, problematic and fast moving institutions to produce maximum profits. Banks are under great depression. States have helped them to perform better but systemic risk caused by them can no longer be neglected. Banks cannot work on serving their purpose at the cost of society. Banks have to come forward to reduce their own problems and cannot ignore the public rage that started after 2007. State, as a maker of the banks, has to play the role of a re-maker.

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A few heart whole, sincere men and women can do more in a year then a mob in a century.

- Swami Vivekananda