Chapter 6

Right-Sizing Finance

"The disproportionate growth of the financial sector and the dominance of 'Wall Street' over 'Main Street' played a significant role in the scale of the credit crunch"

The loss figures cited for this crisis are in the trillions of dollars – so large as to be unfathomable to ordinary citizens. Financial markets and financial institutions had grown so large as to become too big to bail with governments being forced to come up with ingenuous ways of providing support, transferring to the public sector not just actual losses but even more enormous risks. With turnover in the main equity, bond and currency markets being many multiples of total global GDP, there is a suspicion that this size reflects excessive gearing, leveraging and churning. Questions also arise as to whether there is feedback from the size of the financial sector on to the nature and quality of regulation.

The mushrooming of the financial sector in recent years was accepted by politicians, regulators and voters alike because of the widespread belief that the financial sector was the most efficient allocator of resources across different economies and across sectors within economies. Therefore, a more developed financial sector produces a higher level of allocative efficiency and the securitisation of assets was understood to be a measure of economic sophistication and overall systemic efficiency.

This role of being the 'final and exclusive arbiter' of allocative efficiency gave the financial sector and its managers the right to sit in judgment over almost all else and be themselves above any control or supervision by anyone else. This was compounded by the growth of the investment banks and brokerage houses who it was thought, performed this role without directly risking the 'common man's deposits', relying instead on disintermediated capital from high net worth individuals, cash surplus corporates or countries, institutional savings institutions, like pension funds, insurance companies, and increasingly from debt provided by the banks. The freedom from 'retail deposits' put investment banks above consumer protection regulation, and, where they existed, leverage ratios, while the recourse to debt from the banks provided an almost unending supply of funds for expansion.

Another related reason for the excessive growth of the financial sector was that market participants were able to persuade regulators in the early 1990s, that they had developed sophisticated and complex mathematical models that better and more transparently measured and monitored risks.

Too Big to Fail?

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This financial crisis has highlighted not only the links between finance and the 'real' economy but also, the special role that financial institutions play, and are seen to play within economies. As part of crisis management, rescue deals have been put in place to save financial institutions from collapse using public funds, while takeovers and mergers have been actively encouraged, to the possible detriment of rigorous competition rules. These actions have often been explained on the basis of the systemic importance of the financial institutions in question (banks or otherwise), citing size and interconnectedness as key factors. Commonly, these institutions have been labelled 'too big to fail'. Crisis management has, if anything, produced more of those institutions. Consolidation within the financial industry has created, in some cases, even greater financial conglomerates, while reform proposals thus far have been timid on the issue. And as regulatory and supervisory structures are being adjusted to allow for greater focus on systemically important institutions, this emphasis on process, while appropriate, leaves many outstanding questions. What makes an institution too big to fail? And has the implicit safety net afforded to financial institutions been altered by the crisis?

What is 'too big' or 'systemic'? The crisis has shown that systemic is not about size alone but also about interconnectedness. Allowing such institutions to fail, the official sector feared, would cause depositor unease and have unacceptable effects on creditors and to some extent shareholders, and trigger the panic and disorderly resolution that followed the collapse of Lehman Brothers. Instead, by opting to support bail-outs and buy-outs, financially and politically, state authorities have put themselves in a position where their regulatory credibility has been seriously challenged, and the finances of the state significantly affected. This alone has been a stark reminder that regardless of the transnational character of much financial activity, resolutions are mostly a national affair. While interconnectedness issues are addressed by reform proposals in play, the size of conglomerates and the potential for capture that such size might afford are not adequately dealt with, while few advantages of the size of these institutions are actually identified. Outside finance, the challenges paused by large conglomerates are seldom tolerated in the long run, for reasons of competition as well as for the weakness that a potential failure might bring to the system. In the world of finance, this does not appear to be the case. One need also consider that in some cases, large cross-border financial institutions are part of a broader financial and political project, as in the case of the European Union, where pan-European banks are seen as a key driver of economic integration.

The Commission's account of the working of the financial system does not address 'too big to fail' head-on but is more honest as to the seriousness of the topic and the political limitations of dealing with the issue. The reform proposals advocated, and specifically the Report's focus on host regulation limits surprises to regulators and depositors alike and thus decreases potential demands on public funds for bail-outs (the European context being one that necessitates consolidation of regulatory and supervisory functions). The recommendation to ensure more appropriate risk allocation also goes some way towards allowing both regulatory standards and financial innovation to develop in a context that does not privilege large financial conglomerates alone.

After the Latin American debt crisis, the Savings & Loans crisis and the Scandinavian bond crisis, regulators were open to the idea that models based on quantitative data and independent credit ratings would be better and more transparent at measuring risks than the grizzled bank credit officers. Regulatory acceptance of these models (for instance in the 1995 market risk directive of Basel I) prompted the development of new and sophisticated financial products that were seen by all – including regulators – to better manage and spread risks. This eliminated a key reason for restraining the growth of the financial sector. Risk taking was supporting growth, spreading capitalism to the poor while risks were being diversified outside the banking system across professional savings institutions. The crises that arose after these models were in operation – the Asian Financial Crisis (1997-98), LTCM (1998), and the Dot Com Bezzle (2000-01) were intense and yet, outside of the emerging markets, banks came out of the crisis largely unscathed. No major bank in the OECD failed or was on the verge of failure as a result of these crises. This reinforced the idea that financial innovation spread risks and made the financial system more resilient. The zeitgeist of the time was that a large, liberal financial system was a safer system, reinforcing calls from bankers for greater liberalisation.

Supermarket Banking and Limiting Leverage

The mathematical models and the risk transfers that they facilitated supported the false notion that there was one thing called risk and that the banks had superior ways of managing risks, and so the firewalls between different categories of products and depositors should be eliminated. This led regulators to support the call from large banks to create a 'level playing field' by removing segmentation within the financial system and to pressure the non-bank financial system to adopt the same risk models. This resulted in the emergence of financial sector super markets that covered all product and depositor categories and grew to enormous sizes, with balance sheets often larger than the GNP many mid-sized economies. These financial supermarkets not only became 'too big to bail' but also provided the main players within these markets – the banks – the human and financial resources and networking clout to capture the regulators. The results of this regulatory capture are amply evident (see the previous Chapter).

The disproportionate growth of the financial sector and the dominance of 'Wall Street' over 'Main Street' played a significant role in the scale of the credit crunch. A useful direction for future research and inquiry could be to estimate an optimum size of the financial sector and of the combination of size and leverage that would make an individual firm too big to bail.

Canada is the only G7 country not to have bailed out or guaranteed its banking system, in part because of its limits on house lending and its leverage ratio ceiling of 20 applied to all banks. (A leverage ratio compares the value of a bank's assets as a multiple of the value of its capital.) This and other experiences with the leverage ratio led the G-20 to urge its more comprehensive adoption, and we support this call.

A leverage ratio will provide some limit to the growth and size of the financial sector as a whole, but it would still permit individual institutions to be systemically important, whether through their size or interconnectivity. We support the idea that regulators must identify systemically important institutions and that these should have higher capital requirements, thereby internalising the social costs of their systemic risk.

How we define systemically important institutions will be a source of controversy because of the costs for an institution of being so defined. There will be pressures on regulators that are likely to lead them to underestimate what is systemic but right-sizing of the sector and of individual firms is essential and urgently required if we are not to revert to business as usual. If banks were confined to particular product categories or markets they would neither grow too large nor be interconnected so widely as to cause systemic problems. Regulators could determine systemically important institutions by looking at the results of single stress tests that they ask all financial firms to carry out a few times a year.

It is clear that the pressure for reforms will decline as financial conditions improve with cyclical upturn. It would be a pity if the

opportunity for making the financial sector more resilient and less capable of achieving regulatory capture and systemic distress was lost.

Right-sizing could be achieved by suggestions included in this report. First, mandating counter-cyclical capital provisioning norms will prevent banks from building assets too fast and too big. Second, a leverage ratio for all financial institutions should provide some further restraint to excessive growth. Third, going back to segregating different categories of finance, but along the lines of risk capacity, and re-establishing 'unlevel playing fields' will surely reduce interconnectedness and restraint the emergence of 'financial super markets.' Fourth, raising capital requirements for systemically important institutions should create the necessary disincentive for institutions to grow to that point where they pose substantial risks to the financial system.

A fifth idea is to use financial transaction taxes (like Stamp duties or Tobin taxes) to limit short-term and churning activity. Banks profit more from high-turnover than low turnover and consequently they are likely to over-invest (relative to a social optimum) in activities and instruments with high turnover and underinvest in activities and instruments with low turnover. If you establish a buy and hold fund you may never meet a banker; if you have the same size fund, but decide to adopt a strategy of turning over the portfolio every week you will find it hard to get to your desk through the throng of bankers offering a 'partnership'. This is a social externality and the classic economist response is to tax the activity. A common reaction to such ideas is that they may be a good, but they are not feasible. However, financial transaction taxes are common – in the U.S., the Securities and Exchange Commission is financed by one – and have been made more feasible through the moves towards centralised clearing and settlement allowing the tax to be collected at a central point through which the majority of trades are flowing, and creating substantial costs to those trying to get round the tax by avoiding central clearing and settlement.

Key features of all of these ideas are a degree of automaticity and the introduction of rules which slow down the growth of balance sheets and prevent them from becoming so large that they pose a systemic risk overhang on the real economy. Issues of systemic risk and optimal size are complex and appear to deserve intelligent discretion, but we fear discretion is too prone to regulatory capture and greater adherence to a set of structural rules will help the financial sector play its due role in achieving sustainable and equitable growth.