The banking crisis: cause and effect
The banking collapse in context

Martin Upton
Hello. I'm Martin Upton from the Open University. I'm here with colleagues Jonquil Lowe and Alan Shipman and we are here today to discuss developments in the banking industry since the recent financial crisis.

Alan – you've heard of plans to introduce a possible banking tax – what are your views on this?

Alan
It seems to me that the further we get from the crisis and the more the banking sector begins to return to normal the more reluctant people are to consider either substantially changing the regulation of the banking sector or imposing additional taxes on it. The great problem I think is that banks are still in some ways fragile, especially commercial banks still recovering from a lot of bad loans. Putting extra tax burdens on them at this stage is a bit like putting extra tax on the economy in general. It may be too early given the stage of the recovery.

And I think one problem as well is if we introduce a bank tax in the UK and our overseas competitors don't then some of our major competitors don't then some of the major banks who operate internationally may think twice about operating from London.

It is a fair point that banks can move globally. They are a foot loose industry. And the great danger is that although every one accepts the logic of taxing banks internationally to stop them locating in tax avoidance it's – it really incentivises each government to push the regulation and the tax a little bit lower in order to get banks moving in their direction.

Martin
Jonquil I just wanted to have your views on the developments in regulation in respect of banks since the financial crisis. Do you think it's all been a knee jerk response or has there been some good and long-term thinking behind what's come out from the FSA and the government and the Bank of England in the last few months.

Jonquil Lowe
I think there is long term planning here. It isn't just knee jerk reaction. But having said that I mean if you look historically of course we've seen bank crises over the centuries recur again and again so it's clear that this is a very difficult area to regulate. What we are seeing at the moment is the Volcker plan being proposed in the US. It's had very mixed reception. The prime elements are a cap on the banks' more risky assts and that for example is being criticised because how exactly do you identify these risk assets. Regulation is very difficult in this area.

Martin
One other significant development in the last twelve months has been how quickly the banks have moved back to increased profitability or at least decreased losses. And the government is a major shareholder now in the Royal Bank of Scotland and Lloyds Banking Group.

Alan – do you think they will be looking to offload those share holdings quickly?

Alan
It's tricky for the government because it needs to bring it's borrowing down as rapidly as possible and the debt down and selling assets on that scale could be quite a useful way to do it. On the other hand the more these banks recover the greater their sale price will be and possibly by waiting governments will get a lot more back for taxpayers later on. There is a

further problem that the rapid recovery and profitability of these banks is really a testament in part to the way that their commercial and investment bank arms are still linked. And that makes it difficult for those reformers who want to return to a situation where investment banking is legally separated or operationally separated from commercial banking. It rather goes against the successful recovery trend that the banks have got at the moment.

Jonquil
I think that's right. If you look the big profits coming through are from the investment banking arms so if you separate those off you know are we going to have a profitable enough just straightforward commercial banking sector.

Alan
And I suppose the question arises can it be done because we saw banking throughout the 2000's really going in the direction of commercial banks developing investment banking operations in order in the good times to bring down their cost of capital and that made them more competitive and that allowed those commercial banks to go out and win business from smaller banks and building societies. So to lose all that, to lose the proprietary trading, to lose the derivatives it might insulate them from a crisis but it might also make the whole commercial bank operation more costly and less competitive.

Jonquil
And again going back to that Volcker plan one of the problems there again is one of definition. How do you define what proprietary trading is because a lot of the banks normal activities in turning deposits into profitable business could really be classified as proprietary trading. It's not clear where that divide would be.

Alan
And I suppose if we look at the financial institutions still having problems in Britain, America and elsewhere many of them are smaller and more specialised and particularly smaller building societies, which don't have that access to the wholesale market. Those now seem to be the ones that are struggling more and it does raise the question again is it safe to separate larger banks from their investment banking side or does that make them more vulnerable.

Martin
Certainly the smaller financial institutions are going to be very hard hit b the new regulations on liquidity, the assets which financial institutions have to hold to turn into cash if there's a run on their cash reserves. I'm afraid that it means that for many of those smaller organisations the smaller building societies there be grave doubts about the continuation of their independence

Alan
Yes and we've seen through 2009 early 2010 that this continued need for some small financial institutions to link with others to avoid capital and liquidity problems.

Jonquil
But this is quite perverse really because one of the problems with the banking sector is that many of the banks are too big to fail and yet the regulation, certainly the increasing of the liquidity requirements, seems to be driving banks to become bigger.

Martin
Indeed and of course one consequence of the improvement of the profitability in banks has been the return of bonuses, which has attracted all sorts of headlines. The government introduced a tax on bonus payments in its autumn statement last year but one of the consequences for the banks, who are owned at least in part by the government, is well - should those banks that have been bailed out by the government be paying bonuses to their staff?

Alan

Well there has obviously been an objection, very understandably, to bankers who continue to collect bonuses when their banks have virtually collapsed and needed government rescue. But I suppose what some of those banks would say is that they were unlucky rather than unskilled and they just happened to be hit by the one moment when a normally safe operation became dangerous. There was still a lot said in favour of the re-trading of risk that those banks were engaged in – the securitisation of their mortgage debt, the derivatives that they were using supposedly to transfer risk to those who wanted to hold it. It seemed to work for a long time and there are still those who would argue that it does work fifty-nine years out of sixty. So that raises the question since there can be these odd moments when a very serious problem develops with that situation, should we rule it out and have tougher regulation or should we live with the occasional problems within the banking sector on that scale. Is it a risk worth taking?

Martin
Do you think Jonquil that there is a basically an unwritten guarantee for a banks in the UK?

Jonquil
Well as long as they're too big to fail then yes deo facto there is. but we've seen the bail out this time can we assume it will happen again? Probably not if it happens within the next decade say but fifty years on I suspect we would be in a very similar situation to now.

Alan
I suppose the question arises could governments afford to do it again and clearly if another crisis of that magnitude developed in the near future government couldn't because they are already very much in debt having rescued them last time round. But I suppose one can envisage if the government can pay down this current debt through re-selling it's banking assets and getting a healthy banking sector that it can tax a bit more then governments might gradually rebuild the capacity to rescue banks in an emergency as long as the emergencies are not too frequent. So one could suspect that over time that old complacency could come back and banks once again will realise they're too big to fail and take a lot of risks in pursuit of profitability in the mean time.

Jonquil
There is a lot of reluctance on the part of governments though to deliberately tax in order to build up a bail out fund because of the problem of so called moral hazards. It removes from banks the need to take care

Alan
Yes it is one aspect of the Volcker plan that banks would be taxed on their liabilities to provide a fund that could rescue them if they ran into trouble. But as you say if they know that facility is there it encourages them to take risks and the moral hazard returns to the system.

Martin
Because one thing we do forget is that bank crisis aren't new. I mean, the events of 2008 and 2009 were staggering but you only need to go back to mid 1970's to see another period when the banks were in crisis. These things do reoccur.

Final thoughts on the subject –

Jonquil
Well inherently banking of course is very risky. It's the old classic case of borrowing short and lending long so inevitably there is going to be risk in the banking system. You can regulate but you can't take the risk away.

Martin
Alan, your final thought –

Alan
Well certainly banks need to take those risks in order to supply liquidity to the economy in order to fund investment. And if we restrict them too heavily yes, we will avoid any crisis but

we will also slow our growth rate and make it a lot more difficult for businesses to get funding. So a balance is there to be struck and one suspects that in the end although a lot of reform plans have been floated the world of banking tomorrow is not going to look too dissimilar from the world today and the world as it ------