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Are banks too big? A round-table on whether it is time to cut the banks down to size, with Pete Hahn (Cass Business School) Philip Augar, Peter Thal Larsen (*Financial Times*), and John Hitchins (PricewaterhouseCoopers) held on Wednesday, March 5, 2008, at Wax Chandlers Hall, 6 Gresham Street, London, EC2V 7AD, from 12:30-2:15pm.

Before deciding whether a bank is too big - whether to fail, rescue or manage - it is worth asking why banks are so large. The first speaker said reasons might include the need to pursue growth by acquisition rather than organic growth and market demand. However a cynic might ask whether it is driven more by the prospect for higher remuneration and that regulators and governments prefer to deal with big banks. As far as shareholders are concerned, big banks deliver lower p/e ratios. Academic research shows efficiency peaks among second tier and focused banks, while it is fair to say bigger banks make bigger mistakes.

If one believes there is a "right" capital size, how do we get there? Regulating salary structure is a non-starter as it would simply create a bureaucracy, while increasing capital requirements adds costs to customers and pushes assets off balance sheet. The answer is to redefine banks along a line between lending and trading. Deposit-taking banks must be strictly regulated because of their wider stability function. One member said this sounded like the "narrow bank" concept that had never got off the ground. The speaker said in this case the split would be according to what regulators were happy to regulate.

The second speaker said historically there was a certain level above which banks were too big to fail. He cited Northern Rock and Barings as being either side of that line. Each decade brought its own bank to big to fail – the secondary banking crisis in the 1980s, then Johnson Matthey in the 1980s and Midland Bank in the 1990s. Bank failure is not new. What is new is that the shape, scale and complexity have changed. He described the current mess as "financial radiation" whose fall-out was impossible to trace. Something, he said, clearly must be done.

Up until last year people thought that market forces would resolve it. Now they await benign intervention. Better supervision is one option but smart people and smart money will always be one step ahead of regulators. Similarly capital adequacy rules imply add costs to customers. The best solution is to separate activities that contain conflicts of interest from the others that perform core lending functions. This would lead to smaller institutions, as conglomerates were broken up. He revealed he had offered his thoughts to bank CEOs two years ago but they had told him to keep them to himself for his own sake!

Some members asked about the importance of risk management. The speaker said in theory it should lead to smaller banks. However he said shareholder pressure and executive reward structures would always incentivise managers to work on the edge of risk.

He said he was disappointed the markets had failed to learn from the 1994 bond market crash. One member said Lloyds of London's ability to survive 9/11 and Katrina showed it was possible for complex institutions to learn lessons. The first speaker queried whether a CEO of a global bank would be able to grasp all the risks of all its products in all countries at all times.

The third speaker said the test for whether a bank was too big to fail varied according to whether it took deposits. That was the distinction between Barings and Northern Rock, not their relative size. One member said in the case of the Rock, the risk was systemic as failure to resolve it would trigger queues at Bradford & Bingley, Alliance & Leicester and HBOS. The test was not whether it was acceptable if the bank closed its functions. The speaker said the real problem was that managers had not understood risk appetite.

On the broader question he said it was impossible to regulate global banks – it was up to shareholders to seek a break-up of the bank as some were doing at HSBC. A distinction between trading and lending would be impossible to maintain, he said. He said attempts to limit bank size would fail since – aside from nationalisation - a bank can only be rescued by a larger bank, so over time bank size will always increase. One member said this was why sovereign wealth funds were so relevant, because only they had funds to inject new capital into troubled banks.

The last speaker said that the failure of Barclays' bid of ABN Amro to prevent a break-up of the Dutch bank that came with the RBS takeover was a momentous event as it raised questions about the shape of the banking industry. The only reason banks have not been broken up in the past was a political need to have "national" banks. But the globalisation of financial capital has changed that. Likewise regulators only operate on national bases and need to develop new radar screens or hope that bodies like the IMF can improve their surveillance.

When it comes to systemic risk, the test is relevance rather than size. Minus the political concerns, Northern Rock was not too big to fail. At the other end of the scale it was inconceivable Goldman Sachs would be allowed to fail. One member insisted there should be no return to the US Glass-Steagall Act that blocked the creation of conglomerate banks. Instead regulators needed powers to hive off sections of a bank with systemic risk. They should establish areas of potential vulnerability such as corporate loan portfolios, especially in the light of the fact that the failure of BCCI in the UK took down 2,000 small businesses.

What did the panel think would happen over the next few years? The second speaker forecast regulatory "tinkering", an increased focus on risk management, and the emergence of activist hedge funds that identified an effective model and engineered a bank break-up to achieve that. The first speaker said regulators would spend their time attempting to catch up – but failing. The third speaker warned regulators' reaction would determine what the next crisis would be, just as loose monetary policy after the dot.com crash led to the current crisis. The last speaker said that while securitisation would return to life and regulators would tinker, there would be another bail-out in five years – but of an institution whose name we do not even know yet.