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From 'more and better capital' to structural reform

by Matt Salisbury and Benny Spooner

President Obama strode ahead of the pack of international governments and regulators with what has been called his "$30bn speech" (reflecting stock market falls within minutes) on financial regulation reform. Details remain hazy, but the big strategy is clear – the structure of the financial system needs a major overhaul. For those who have followed the unfolding regulation produced to date, Obama's speech marks a watershed, with the focus of reform moving on from a 'more and better capital' to a 'structure reshaping' strategy.

The aim of reform has been and remains simple: to create a more robust financial system. Since the UK government stepped in at the height of the crisis to recapitalise Britain's banking system, the first and most immediate need was clear – more and better quality capital holdings. This resulted in the firefighting measure of emergency increases in capital followed by a plethora of new regulations, particularly for risk in the areas of liquidity, market risk and procycliality of capital requirements. More recently, policymakers have begun addressing concerns that simply increasing the amount of capital requirement held and tightening up regulations may not be enough to prevent the need for more large bail-outs.

Deposit takers and casino capitalism

Going beyond the 'more and better capital' strategy means ensuring risky trading is not insured by the state along with ordinary peoples' deposits. This is the so-called 'moral hazard' problem that the 'Volcker Rule' outlined in Obama's speech aims to avoid.

> The 'Volcker Rule':
> *"Banks will no longer be allowed to own, invest, or sponsor hedge funds, private equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers."*
> President Obama, 21 January 2010

The government has to protect savers in deposit taking institutions because the banking system lives (and dies) from confidence. However, if these institutions can engage in risky trading rather than standard lending to homebuyers and businesses, for example, moral hazard comes into play. Bankers can get big payouts if risks pay off and the state picks up the tab if they don't. Regulators are asking 'Where's the incentive not to take on more risk?'

In the UK policymakers have been divided over whether to propose a solution similar to that announced by Obama, which would involve investment banking functions being split from deposit-taking banks via legislation. Alistair Darling has ruled out such a move, despite it having broad backing from Mervyn King and George Osborne. For the FSA, Adair Turner has indicated a preference for regulation which would make engaging in risky trading too expensive for retail banks. This would include buttressing the 'pricing them out' method by forcing institutions that do both to simplify their structure, so that the trading arm could be left to fail and the deposit taking bank saved (the 'living wills' agenda).

To date there has not been a clearly-articulated basis for a strategy weighing incentives of deposit takers considering risky trading activity against the costs of capital. The FSA expects new requirements to triple capital required for a trading book, but is this enough to outweigh the advantages of the protection afforded by being wedded to a deposit taking institution? Is the market competitive enough to mean that these costs could not be absorbed in the margins made by investment banking arms in good times? How might a regulator let one part of an institution fail and save the other?

A problem for any strategy to separate risky traders and deposit takers is interconnectedness. As the Lehman bankruptcy showed, letting a large investment bank fail can have wide-ranging consequences if they are closely connected to others in the system. Ultimately, the US government had to effectively stand behind the other stand-alone investment banks and allow them to take deposits so they could access government support. It won't be enough to say that deposits are safe so investment banks and hedge funds can go down and we won't worry about them anymore.

The financial system will always experience periodic crises. Much has been done, following a 'more and better capital' strategy, to make the system safer when a crisis arises. Yet unless something is done in respect of a strategy to address structure, the financial system remains open to a repetition of debilitating crisis perpetuated through high risk trading.

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