Narrow Banking

FAQs

A full discussion of the specifics of narrow banking – how it would work, and the advantages of such a proposal, is contained in my paper *Narrow Banking*, which can be read at http://www.johnkay.com/2009/09/15/narrow-banking. Here are answers to some frequently asked questions.

What are the objectives of these reform proposals?

Their purpose is to ensure that taxpayers will never again be called upon to lay out unimaginably large sums of money to protect financial institutions, and to protect the real economy – non-financial businesses and users of financial services – from the consequences of mismanagement of financial services firms. The interests of the financial services sector itself are secondary to these primary objectives.

This order of priorities is central, and requires constant re-emphasis. It is depressing that both industry insiders and regulators seem to find it difficult to see the financial services industry organised in any different way from that which prevailed in 2007. They consequently seek to restore the status quo ante and envisage no very large change in the scale or structure of activities except that, by some inadequately explained process, the associated risks will be reduced. This perspective completely fails to recognise that the fragility which the industry displayed in the crisis was intrinsic to the structure which had emerged over the preceding twenty years.

The implementation of narrow banking is the first step in a process of financial services reform which would lead to a far more robust industry structure, with simpler institutions, less interconnectedness, and greater diversity of industry structure. It would be desirable to go further, and separate the various functions currently undertaken within investment banks, which are themselves stuffed with conflicts of interest. Only structural change holds out any realistic prospect in the long run of creating an industry which experiences fewer, and less traumatic, failures.

Is narrow banking a 'new Glass Steagall'?

In spirit, yes: but the financial world has changed since 1933 and the line drawn by the US Glass-Steagall Act between commercial and investment banking is no longer appropriate (as had become evident before the final repeal of Glass-Steagall in 1999). The objective of new legislation on functional separation would be to protect the utility bank – the payment and deposit taking systems – from losses incurred by banks in speculative trading in peripherally related activities – the casino. This contagion was what made the expensive bailouts of 2007-8 necessary.

So what is the purpose of narrow banking?

The purpose is to protect the non-financial sector as far as possible from the consequences of failures and instability within the financial sector. The purpose is not to prevent failures of financial companies,nor is it to protect major financial institutions from the consequences of failure of other major financial institutions. The objective of preventing failure of financial companies is not achievable, and would probably not be desirable even if it could be achieved, because it really would kill risk taking and innovation in the financial sector. Protecting major financial institutions from the consequences of the failure of other major financial institutions is achievable, with the aid of large government subsidies, and this is what has happened in the last two years. The outcome is not only very costly to taxpayers, but an incitement to financial institutions to take risks at the public expense. Further, it removes almost entirely the incentives for financial institutions to monitor each other's activities. Large bailouts must never be allowed to happen again. The only means of securing that objective is to separate the casino from the utility.

But surely better regulation will prevent major financial institutions from engaging in excessive risk taking in future?

If you believe that, you will believe anything.

But some of the institutions which failed in the recent crisis were narrow banks

It is extremely unlikely that a narrow bank which was an institution of the kind described in *Narrow Banking* would fail, and if it did it could be taken over by government or another bank at little or no cost to the taxpayer.

But an institution like Lehman, whose failure caused chaos, wasn't engaged in retail banking at all.

Exactly. The point is not to prevent Lehman failing. We should be delighted that Lehman failed – it was a badly run business, populated by greedy people, performed activities of little social value, and took big risks which did not come off. The right outcome is not that government should arrive with limitless sums of taxpayer's money to save an institution like Lehman: indeed it is extraordinary that such a proposition should even be contemplated, except perhaps on an interim basis while much more fundamental reforms are introduced. The objective should be that such a business can fail without major problems for ordinary savers and ordinary businesses. That is the objective of functional separation of Lehman's casino-like activities from the utility elements of the financial system we all need.

While narrow banking might be a good idea in principle, it's just not practical in the modern world

Narrow Banking makes a range of specific proposals and I've yet to hear a serious practical objection. We had functional separation of financial services activities through most of the twentieth century, with no significant bank failures in the UK, and the everyday needs of ordinary people and businesses for financial services were met.

Doesn't a big world needs big banks?

Can you be more specific please?

Big banks can reduce risks by diversification

They can, but that is not what happened. Diversification can reduce risks, but that does not mean that all diversifications reduce risks. In particular, the diversifications by narrow banks such as RBS and Halifax into proprietary trading and low quality corporate lending greatly increased the risks to which they were exposed. Diversification led to their failure.

Corporate customers want to find one bank that can fulfil all their banking needs

Probably some of them do. But narrow banks could refer people on – even to other divisions of the same institution. The minor inconvenience involved is a small price to pay, set against the hundreds of billions of pounds that have been spent in support of failed financial conglomerates.

Surely much less radical reform could achieve our objectives

To repeat: the principal objectives are (or should be)

- to protect the non financial sector (both depositors and non-financial businesses) from the consequences of instability in the financial sector
- to ensure that taxpayers are never again asked to give large subsidies or guarantees to institutions engaged in speculative trading in securities markets

If we set aside the fantasy that regulation will in future ensure that institutions that are 'too big to fail' never do fail, then the only means of achieving these objectives is to restructure the industry in a way which allows financial institutions to fail without either substantial cost to taxpayers or major disruption to the non-financial economy. Any alternative proposal must answer the question 'how have you eliminated the 'too big to fail' problem? If the answer is 'by regulatory control of risk taking in financial institutions' then the proposal should not be taken seriously.

Any major reform of regulation must await international agreement

International agreement on the future shape of regulation is unlikely to extend much beyond rhetorical declarations and agreement on the need to have many more international meetings in agreeable locations. Saying we must wait for international agreement before acting is a recipe for inactivity, and most of the people who say it do so with that outcome in mind. The Basel accords are in course of being elaborated, but these measures have always been one step behind financial innovation, and this is likely to be true in future as in the past. It is important instead to emphasise that deciding appropriate capital ratios is first and foremost a management responsibility. The EU focus on extending regulation to hedge funds is profoundly depressing. The crisis was principally caused by the failure of hedge funds which were already regulated because they were part of regulated financial institutions.

But we couldn't impose narrow banking unilaterally

Not only could we, we must. At present, UK taxpayers are faced with

- potential bills for liabilities incurred by UK based institutions operating outside the UK. There is not the faintest reason why UK taxpayers should be expected to underwrite these private sector operations

- potential losses to UK depositors as a result of foreign institutions operating within the UK which the home government – quite reasonably – may refuse to pay.

Put more bluntly, the impositions on Icelandic taxpayers should not on some future occasion be analogous impositions on UK taxpayers. The only way to protect ourselves against such potential liabilities is to insist that UK regulated institutions operate overseas through subsidiaries (not branches) and that foreign based institutions which take UK deposits maintain sufficient assets within the jurisdiction of the UK authorities to meet their UK liabilities in the event of failure. That takes us a long way down the road to narrow banking.

Wouldn't the plans for 'living wills', combined with a proper resolution regime for insolvent financial institutions, do the trick?

If they were implemented sufficiently fiercely, they probably would. To be effective, they would require radical restructuring and simplification of the corporate structures of financial conglomerates. That outcome would effectively amount to narrow banking – in particular, such a regime would require that the assets, financial and operating, needed to run a retail bank would be separated by a firewall from the rest of a financial conglomerate. If you can do that, you have effectively established a narrow bank.

Why are banks so opposed to narrow banking?

If you were an investment banker and could get your hands on hundreds of billions of pounds of retail deposits and the assured profit stream that goes with it, wouldn't you? If you were a trader, and the government guaranteed your liabilities because they rank equally with the bank's retail deposits, wouldn't you think that gave you an edge? Many of the people in retail banking I've talked to would love to see narrow banking – it would get the traders and investment bankers off their backs and even allow them to devote some time and effort to customer service. We should never forget that by allowing narrowly focussed building societies to disappear and an important element in the UK financial services system, we reduced competition and removed the main force for improvement of provision of retail financial products. At the moment it is the investment bankers and traders who call the shots – and walk away with the profits.

But isn't everything all right now that investment banking is very profitable again?

I've drawn the analogy between trading and tailgating – tailgating pays, so long as you manage the cognitive dissonance that separates the occasional accident from the routine time-saving. What I hear banks saying today is 'now that the government has cleared up the mess at the side of the road, tailgating still pays'. That's scary.