Title	*Taming the Casino Banks*
Description	In this podcast the experts discuss whether the 'casino' banks that are considered too big to fail are simply too big, and explain the arguments for and against splitting them up.
Presenter(s)	Jonathan Michie, Martin Slater and Linda Yueh
Recording	http://media.podcasts.ox.ac.uk/econ/credit_crunch/08_crunch-medium-audio.mp3
Keywords	credit crunch, economics, banks, bail-out, bail out, bank, banking, finance, recession, N310, L100, 1
Part of series	*The Credit Crunch and Global Recession*

Linda I'm Linda Yueh. I'm a fellow in economics at St Edmund Hall and my new forthcoming book is called 'The Future of Asian Trade and Growth'.

Jonathan I'm Professor Jonathan Michie, the President of Kellogg College and editor of the book 'The Handbook of Globalisation'.

Martin I'm Martin Slater. I'm also a fellow in economics at St Edmund Hall.

Linda This financial crisis has certainly raised the issue of how do we regulate banks.

Now there are a number of topics here but we thought in this panel that we would tackle the big one that's being discussed of late, which is if banks which are too big to fail, are they then considered to be too big? If so, then is the solution to split banks into narrow retail banks, the high street type banks that make loans and take deposits, as opposed to the investment banks or some have called those casinos disguised as banks?

And we will go through the pros and cons, the arguments for and against this idea of splitting banks into the government-guaranteed narrow banks versus keeping the two types of banks in one entity, which is what we have at the moment, but simply do what governments around the world are now proposing, which is to increase the capital requirements - in other words the amount of capital that banks have to hold, so the more risky banks are better capitalised.

Is that enough?

Jonathan I think you need a combination of measures. I should say that yes, I think it would be certainly a step in the right direction to split the banks between the regular consumer banking type activities on the one hand and the respective casino activities on the other.

And it's important to remember where that came from because, of course, that was introduced precisely as the reaction to the Great Depression of the 1930s and the 1929 Wall Street crash which has caused it. And that remained the case throughout that split, throughout the 1940s, 1950s, 1960s, 1970s.

And then it was just one of the many ways in which the financial sector lobbied during the 1980s for more deregulation, more freedom just to do what they want, really, and push this idea that growth in the bank and financial sector was just good for the economy; it was the way forward for the economy.

And they did, in almost every country, get governments to agree to deregulate, to privatise, to use several light touch regulation which has since turned out very much to be soft touch regulation.

So I think that would be beneficial virtually for the reason you say about you don't want to be in a situation where banks are too big to fail or indeed any company is too big to fail. Because it's important to recognise that one of the problems is just pure scale.

As has been said with the recent crisis, maybe some of the American car companies turned out to be too big to fail. If you have any companies of that scale it's difficult for a government to allow them to go bankrupt because of the hundreds of thousands of people who would lose their jobs and send the whole economy into a further downward spiral.

So breaking up the banks like that would certainly have that advantage, of making the companies smaller. But it also means that the purely speculative side of the banks could be allowed to fail if they bet the wrong way, lose their bets and do go bankrupt. Whereas the consumer banking side, which is less likely to fail if all it's doing is taking savings and making loans to consumers, but if for whatever reason it did get into trouble then that is much more of a case where government should step in.

So to answer that question, I think it would be beneficial to split them. But that shouldn't be seen as a cure all in itself. But I think we do need to ensure that lessons are learnt across the whole range of better regulation, certainly more capital requirements, tackling the bonus culture and these incentives to take risk and so on.

And actually a key point for all that should be to have a biodiversity of ownership and organisational structure in the financial sector so that if the economy is hit by a certain type of shock you don't have a domino effect where all the banks, all the financial institutions are affected in the same way.

And I've argued this particularly in the case of the UK economy where traditionally a lot of the financial sectors were owned not as privately owned banks but as so-called mutual building societies owned by their customers.

And one the ones which became famous internationally because of the media focus around the world was one called Northern Rock, which was very successful for many decades. It then demutualised, in effect privatised; just became a private bank. And then went into all the speculative activities of private banks which led up to the global credit crunch. And that was the one where there were the photos of the bankrupt people queuing up at the door all night in order to demand their money back the next morning; a picture everyone thought had been abolished forever.

So that's now has been nationalised, owned by the government and they're wondering what to do with it. And I've written a report which any listener can get free of charge by downloading it from www.kellogg.ox.ac.uk where I and other authors argue for that being returned as a mutual organisation owned by its members. And part of the argument there is not just to increase competition in the sector but also to increase the diversity of ownership types and governance structures within the financial sector.

Linda Martin, can I ask you for an argument against the split of banks in this way?

So in other words the policy makers at the moment are all pretty much, with the rare exception, of going down the road of demanding higher capital requirements rather than splitting banks into retail and investment arms. Not to say there aren't those which propose it; the Bank of England governor is proposing that. But most governments are seemingly internationally not going down that road; they're going down the road of strengthening capital requirements.

So possibly could you air some arguments on the other side for us.

Martin Yes. Well, I think first of all there is no magic bullet. There's no single system that is going to guarantee against all bank failures or all the kind of nastinesses that might be associated with bank failures. Each particular system proposed have some things going for it and maybe not others.

Personally, I find the idea of separation and narrow banking quite attractive but there are difficulties in practice. I don't think they're insuperable but they would have consequences and one might want to ask whether those consequences are things one wants to live with.

One particular problem to begin with I think is that people have a rather simple idea that you can divide the financial sector into these two cosy categories. There's your high street retail utilities, as it were, which have a public function that we want to protect. And then, on the other side, there's the casino banks and the casino banks really it's much better if they're left unregulated, unguaranteed. They can do their speculating. If they fail, they go down and nobody sheds any tears. And that's the way they live and they will not actually bring high street banks down with them. That's the nice idea.

I don't think it quite works like that because really in a way there are the high street banks on one side, there's the casino industry on the other and in the middle, unfortunately, there's really what I would call the industrial banking sector which is a bit of both. And that is actually a very large volume and very important and it's not clear precisely which side of the divide that would be.

And the problem is that you really need, if you're going to have a separation into narrow banks, you need a very careful limitation of what these high street banks can actually do with their money. And the proposals that I've seen suggest that the high street banks would be limited to making ordinary consumer loans, that they could invest in very safe securities like government stock, but obviously they shouldn't be allowed to get involved in investing into these exotic financial products that have caused us such problems.

Well, that can be done. It has been done. Although history suggests that there are very strong incentives on the players to find ways of getting around that.

For instance, in the UK in the 1970s when we did have a form of separation in this way, we went through a period known as the secondary banking crisis where these carefully segregated high street banks had, of course, noted that there were very much more profitable things they could do with their money than these very safe investments that they were allowed to do.

They weren't actually allowed to make these investments themselves but they developed various ways in which they channelled the money through indirect routes. It eventually got to this highly profitable business and then that highly profitable business blew up. Then the high street banks discovered that actually, of course, they were heavily involved and, in fact, they didn't even know how heavily they were involved.

So that's a problem one has to be quite careful to see how you're going to control that.

The other kind of thing, the problem it produced was it produced a set of complaints from various players in the segregated sectors that, of course, they were at some kind of competitive disadvantage with regard to other people.

So supposing we have a situation in which there are, indeed, guaranteed high street banks but they are not actually allowed to invest their money in very profitable loans, then there will be other institutions which will grow up which will look very like guaranteed high street banks, will compete in the same market for deposits with those institutions, and they will not be subject to the limitations on what they can invest their money in. Therefore they will make more money. Therefore they will be able to offer more competitive deposit rates to the potential savers and they will begin to take money away from the guaranteed sector.

And that was exactly what happened in the 1970s and '80s and it was very much complaints from the guaranteed sector that gradually whittled away the restrictions and almost free for all was actually put in its place.

Well, clearly the counter argument to that is, of course, well the other institutions don't have the guarantee and therefore the potential depositors have only got themselves to blame if they put their money into , shall we say, the future equivalent of Icelandic banks because they give high interest rates and at a later stage you discover quite why it was that they were able to give you those high interest rates.

But that is the sort of thing that I think one has to think quite hard about.

And thirdly, I suppose, the other thing that recent history has taught us is that unfortunately the bankruptcy of non-banks can also be just as bad. Lehman Brothers was not a high street bank but when it went down it took lots of people with it. AIG was not a bank at all but its failure would have been disastrous for the financial sector as a whole.

So it's possible that if the casino side of the financial sector is made up of relatively small institutions which individually can fail without causing great knock-on effect, then we would get the beneficial effect.

But if, in fact, the casino side is still dominated by the large bodies, then when they get into trouble then I think the whole financial sector will be in trouble, irrespective of that.

Now, again it's the question of interconnectedness. Why was Lehman Brothers a problem? It was because it was heavily interconnected with everybody else.

A counter example, of course, if you go back a little further in the UK, we had the failure of Barings Bank, which again was almost a classic casino bank. It was broken by one disastrous decision, disastrous throw of the dice. And actually it went down, lost all its money overnight and it really had very little knock-on effect on the other parts of the financial sector.

So that was a bank that was small enough within the context of the whole financial sector and not too connected with everybody else in the financial sector to make this segregation work.

But what it would mean, I think, is that not only would we want to make sure that there was a, as it were, vertical separation between banks but we would want to actually keep banks small. We would still have to regulate to stop massive accretions of power in that casino side of the banking sector.

Linda I think two issues which always struck me throughout this crisis was one, deposit insurance and two, the opacity of the linkages within the financial sector; the so-called broker dealer model.

So the bank run of Northern Rock that Jonathan mentioned, certainly one of the problems was that Britain had a very low payout at the time of deposit insurance. So people were worried about losing their money. And probably even worse for many people, they never got their money very quickly out again from the government, even from the deposit insurance scheme.

Whereas if you contrast that to the United States, lots of American banks go under, retail banks, deposit-taking banks. And there are no bank runs because the bank goes under on Friday, you get your cheque on Monday from the FDIC insurer that the banks themselves pay into and support.

So one of the reforms which they have discussed in this new set of banking regulation is to insure deposits up to a much higher level across Europe so you also get harmonisation and a faster payout. So, in a sense, it could take away some of the concerns of even the failure of retail banks if deposits are protected.

So shareholders lose if they are publicly traded companies but depositors don't. And many would say that was why Northern Rock was bailed out, was to protect depositors. Not because it was big or systemically important but because of deposits.

And the other issue of the opacity of the sector I think ties into what Martin was saying about size and complexity and knock-on effects, is the idea of a living will which is now increasingly debated and looks to be on the road of acceptance, despite a lot of complaints by banks, which is to make every bank disclose the amount of their linkages with other financial entities.

So therefore if you have a casino-type operation or you take a great deal of risk, yes you need financial regulation of risk on top of that and if you have any retail division, the deposits are taken care of. However, even a hedge fund can bring down a financial system. And, in fact, many argue that long-term capital management, a US hedge fund run by two Nobel laureates in economics, when it was rescued in the last 1990s in the aftermath of the Asian financial crisis, it was because the American government at the time thought this could trigger a financial crisis.

So if banks can disclose how they would wind down in the event of bankruptcy, then you would probably naturally get a limit on size because banks have to simplify what it is that they do, or raise so much capital that they can have an orderly bankruptcy type of procedure; for instance converting some of their bonds which can be converted into equity in times of distress.

So in that sense, a failure of a casino bank may not jeopardise the entire financial system. In fact I think Lehman Brothers, in retrospect, for the US government is a horrible instance where they did not think, I don't think, at the time that had Lehman failed there would be this trigger of a global financial crisis, loss in confidence which reverberated around the world.

So I completely agree with everything which has been said. I think the arguments for having either narrow banks or the practicalities of not being able to do that certainly has a lot of other facets which have to be also considered.

But Jonathan, let me come back to you because I know you do argue for a return to mutual societies. Are you enamoured of the notion , the argument put forward by Adair Turner, the Chairman of the Financial Services Authority in the UK, who has written a very influential report, the 'Turner Report', which argues that banks should be socially useful given their special place in society and that, for the most part, we now know that governments are unlikely to allow banks to fail, despite many of the things that we have talked about today?

Jonathan Absolutely. I think he's absolutely right to say that we should question the social usefulness of the size and scale of the financial sector in any economy. That, if you do that, then certainly the UK would be one where you question well, is the financial sector perhaps rather bloated and the manufacturing sector rather too weak? Are too high a percentage of our Oxford graduates going into casino-type activities in the City of London and too small a proportion going into manufacturing and research and development and teaching and so on.

And, indeed, that's so and I agree with him and I think it is important to have a diversification of the economy away from just the financial speculative area into the real economy and hopefully into developing green technologies and so on.

Linda Is it possible though to promote this kind of banking model where you have narrow banks funding socially useful funding of the economy? Is that workable, his idea of saying that we should go back to an era of mutualisation because bank managers may actually know their customers? Are there practicalities involved there we have to think about.

Jonathan Absolutely. That was one of the strengths of the mutual building societies in the UK: the fact that they were owned by their customers. But also they tend to be quite local or regional so that the bank manager would actually know the industries, the local companies that were borrowing the money and so on. And obviously `[[I agree with Mark 0:22:06]]` about the importance of industrial banks of lending to companies.

Maybe we should have a threefold division. On one hand the high street banks for individuals. Secondly, industrial banks to promote investment in research and development and so on for companies. And then thirdly, just the casino banks.

And what would be asked of the casino banks is not only ask that they write a living will to explain what they'll do when they go bankrupt but maybe also ask what their purpose is. Are they serving any purpose other than to try to make the clever kids who go in there, make them rich? Is there any purpose to them whatsoever other than just to try to make money?

And if there is no other purpose than that, well certainly if you're a fully employed economy and so that you have to question where your graduates are going to, then if they're going to that purely casino bank side of the economy you can question what the usefulness of that it and take that into account when you're thinking about taxation levels for the sector as well as things like bonus culture. If you abolish bonuses then maybe that will make that a less attractive option than going into industry or teaching or health sector, a relatively more attractive sector.

So as well as all that, on your particular question there's then in the real sector of the economy, if you like, a number of countries have had different very successful financial institutions which aim particularly to support, say, equitable businesses or green investment or local investment.

And certainly in the UK the Co-operative Bank, which has long held ethical policies - they refused to invest in apartheid South Africa 20 years before anyone else caught on to the idea. They've continued to do extremely successfully throughout the global credit crunch and the current depression, despite the fact that they will not invest in any unethical business and they don't involve themselves in these purely speculative casino activities.

Linda Martin, can I come to you for some - again, sorry to put you on the side that's making arguments against this, but it seems to me that many of the sceptics might argue that we cannot return to an era without financial innovation. You cannot roll the clock back. And even if Britain goes back to the era of mutualisation, surely all of our financial sector will just go abroad to countries which have never had a tradition of mutualisation policies and believe in free markets and financial innovation, but regulated. So, for instance, the United States.

Martin Well, perhaps this goes back to the other question about what is the social value of the financial system. If one takes the view that the basic social function of banking is A, essentially to provide a utility payment system that keeps transactions going from the economy and B, to act as a vehicle for bringing together lots of small saver and small savings that people individually all want to keep, so far as they're concerned, in the relatively liquid forms but can be actually wholesaled together by the banking system into much larger quantities which can actually be then moved into industry as relatively long-term investments.

That's the great social advantage of a fractional banking system, that it actually allows the social utilisation of a lot of savings in that kind of way.

Now, if those are the things that stay with us, and if we think that the casino banking is essentially a zero sum-game, then it isn't terribly obvious what the loss to the UK economy is of a lot of that going abroad.

Linda Taxes?

Martin Well, a certain amount of taxes. But taxes that come with, as we see, a contingent liability. So yes, we may make money in taxes out of bankers in most good years but if we have the cost of that to bail them out every few decades at an enormous rate, then we may find that isn't actually a very profitable trade in that kind of way.

So clearly a lot of that will possibly leave.

Being a little more subtle and absolutely more cynical you might say well, supposing most of the casino banking is really about managing international funds rather than UK funds; Russian billionaires, foreign sovereign wealth funds and the like. Well if our UK bankers are exploiting the foreigners mercilessly in that kind of way, then that is a very good thing for the UK economy, although it may not be a very good thing for the world as a whole and from the point of view of the review of the UK economy.

If that's all that is going on and, indeed, if there were not potentially nasty knock-on effects in the UK economy, then one would say yes, we want to keep the casino banking onshore and we want these people to make money exploiting nasty foreigners and we will tax them accordingly and therefore we would be a little concerned about them leaving and going to Switzerland and places like that.

Linda There's a lot more to talk about. The loss of confidence with the Dubai credit crisis tells us that this issue is going to run and run.

I think this panel, if I might say, please do disagree, is rather sympathetic to the idea of a separation between the socially useful banks and the others. And it will, I think, as I say, run and run.

But I think what has become very clear is we now see that with the banks, and other institutions, which are systemically important, if we don't get a handle on how to regulate the sector then we will doom ourselves to repeated financial crises, maybe not as large as this one but certainly the history of financial crises around the world is they do erupt every few years.

And perhaps this is a time to make a change in that.
