Break up the Banks: A practical guide to stopping the next global financial meltdown

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Progress on national and international agendas for reform in the aftermath of the financial crisis has slowed down. As Shirreff in the book reviewed here puts it, "In the years since the initial, post-crisis burst of enthusiasm, financial sector and banking reform has lost its way", with only "stumbling, half-blind" progress towards the solutions he considers necessary.

Continuing disquiet focuses on various shortcomings of results so far. Accountability amongst bankers perceived as responsible for the financial crisis is widely viewed as having been too limited – with only a few legal cases and formal disqualifications from working in the financial sector for high-level decision makers. Although fewer people are now employed in some of the financial sector's activities, the remuneration of senior staff still in place remains elevated, especially in relation to that of their non-financial counterparts. Consolidation in response to institutional fragilities revealed by the crisis has actually led to increases in bank size and with it greater lobbying power. New controls over complex financial instruments do not go very far. Revelations of fraud and malpractice continue to surface.

This is not to deny that useful reforms have been introduced. Banks' balance sheets are stronger than they were pre-crisis as a result of more capital and better liquidity cushions. Risks of insolvency are correspondingly less. There have been steps in the European Union (including the United Kingdom)towards structural reform involving the separation of banking entities according to their involvement in the traditional activities of commercial banking, on the one hand, and in the riskier activities of investment banking, on the other. So long as it survives whittling-down by the new United States administration, the mammoth Dodd-Frank Act will reduce or eliminate some of the worst features of banking practice in the United States. Nevertheless the Act has serious critics amongst those who share its overall objective of a safer financial sector better serving the real economy. Moreover the complexity and length of the Act is posing formidable problems for translation into applicable regulatory rules.

Measures so far adopted or proposed have not relieved concerns that regulators are still vulnerable to being outmanoeuvred by the bankers they regulate. Not least, finalisation of negotiations on the Basel III framework for banks' capital and risk management, linchpin of the global reform agenda, seems to recede forever into the future. A final point especially important for emerging-markets and other developing countries, it has been argued persuasively that the new global regulatory framework is not appropriate for banks with less sophisticated operations, and that a version better adapted to the needs of such institutions is needed.

Shirreff describes his book as "a call for revolution – a revolution to reduce complexity in global banks, to split them into manageable chunks, and to change the self-serving nature of the culture that dominates them". On the face of it Shirreff is an unlikely revolutionary. Cousin of General Sir Richard Shirreff, NATO's Deputy Supreme Allied Commander Europe 2011-2014, he was a long-time financial journalist with *Euromoney* and the *Economist.* In his more entrepreneurial roles he

was a co-founder of the semi-technical *Risk* magazine and author of inaccessible and sceptical guide to financial risk management published in 2004 (*Dealing With Financial Risk*, London, Profile Books).

The great strength of Shirreff's proposals is their range and his critical attitude towards the shibboleths which still dog policy discussion. What will probably be considered the most radical of his proposals concerns the relationship between the reform of banks' structures–leading to legal separation into three groupings of activities -and of their corporate governance. Proprietary trading would be limited to investment banks. Caps on bankers' remuneration would be introduced. More generally, the new international regime for bank regulation would be considerably simplified: complex regulatory requirements currently in place or envisaged would be replaced by much simpler standards for capital and liquidity.

What would the steps advocated by Shirreff look like in a little more detail?

The structural changes would introduce legal separation among banking functions which, combined, have been conducive to client abuse and conflicts of interest. Shirreff's underlying vision of the financial systemic as a utility – non-financial analogue which he cites being the sewage system and electricity distribution. The key functions of banks for ordinary people in his view are to facilitate payments and to safeguard and keep track of cash balances. These functions are performed primarily by retail banks, which should thus be in separate institutions with capital levels and deposit insurance rendering failure almost impossible. The returns to investors on investments in such banks would be lower than recent levels but safe. Shirreff notes that such a regime for retail banking would not exclude the possibility of public ownership, though care would be necessary to avoid control by politicians which, like bad management in the case of private banks, is always a potential problem for publicly owned banks.

The second of the three major institutional groupings in Shirreff's scheme is corporate/wholesale banking. The core activities of such banking would be lending, cash management, and standard foreign-exchange and interest-rate hedging services. These could be accompanied by limited and carefully defined support to investment banks with restrictions designed to ensure avoidance of the interconnectedness which made the collapses of Bear Stearns and Lehman Brothers so potentially dangerous. The aim would be to prevent commercial/wholesale banks making their balance sheets available to investment banks, private-equity firms, and other minimally regulated financial institutions as places where these institutions can "park" underwriting positions and trading exposures. Corporate/wholesale banks would be subject to capital and liquidity rules but not necessarily the same ones as retail banks.

The third of Shirreff's groupings is "pure" merchant and investment banks which would provide advice and transaction services, underwriting the placement of shares and bonds, and taking equity and lending stakes in new and existing ventures. This would obviously include trading in financial instruments. Of special importance is the proposal that the corporate form for institutions in this grouping should be partnerships, long a common form amongst investment banks. The partnership in his view achieves a better alignment of interests between a bank and its top management. Guidelines for employees are less likely to accommodate or encourage risky trading since losses will be met by banks' owners, i.e. the partners. There would be no capital

requirements for this group – as there would not be either for the hedge funds, private equity, and other sophisticated financial institutions with which the banks might trade. Regulation would be light, consisting principally of conduct-of-business and stock-exchange rules. But this would not exclude ad hoc regulatory measures considered necessary, for example, to restrain over heated property markets which are frequently harbingers of crisis situations.

Shirreff believes that much of the structural change required by banks would be achieved by the proposal for separation of the three groupings - retail, corporate/wholesale, and investment banks. But he acknowledges that sheer size, which he does not believe can be justified by economies of scale for banks with assets in excess of USD 100 billion, makes effective management difficult, as exemplified in several instances both before and since the outbreak of the financial crisis, and complicates relations with regulators, politicians and the general public. Thus ceilings on bank size would probably have to be a part of Shirreff's agenda. If this means breaking up the largest banks, so be it.

Another major reform proposed about which Shirreff clearly feels very strongly is capping bankers' total remuneration -now for investment bankers approximately four times that of skilled workers in other sectors such as retailing, health care and construction - which its recipients have come to regard with an unjustified sense of entitlement. This has so far been dealt with in reform agendas by provisions for postponement and claw-back of bonuses. Shirreff favours going much further, not only abolishing the bonus pool but also capping total remuneration at all banks with access to the central bank's discount window. The cap would not apply to investment banks set up as partnerships, where in Shirreff's view the partnership form itself can be relied on to prevent the most egregious excesses of remuneration.

It should be noted here that Shirreff is sceptical that initiatives targeting banking standards (such as the independent banking standards body proposed by United Kingdom banks) will achieve major reform of the sector's conduct and ethics. However, he does not have an analogous proposal of his own for this purpose. He clearly believes that the most effective steps here would be the legal separation of banking into three groupings, the return to unlimited liability for partners in investment banks, and caps on total remuneration.

Shirreff also proposes more competition for the sector through the encouragement of new banks, scrapping of the Basel capital framework in its present form, restrictions on the issuance of credit derivatives, and introduction of a financial transactions tax.

The creation of new banks in all three of Shirreff's groupings would be encouraged. This would mean, he hopes, a more diversified banking sector populated by more mutual banks, cooperative banks, communal savings banks, credit unions, and lending operations taking advantage of innovations made possible by information technology, as well as by standard high-street and small-town banks. He sees value for the corporate/wholesale sector in banks with a business model which would be a reformed version of the German Landesbank. And he makes the case for a state-owned bank providing partial guarantees and other support to corporate/wholesale

institutions. Here he is probably influenced by witnessing the operations of the Kredit Anstalt für Wideraufbau (KW) when he worked for the *Economist*in Frankfurt and Berlin[1].

Basel II and Basel III would be scrapped. Like Sheila Bair, the outspoken former chairman of the United States Federal Deposit Insurance Corporation, Shirreff is opposed to the use of risk-weighted assets as supervisory indicators. As Bair puts it, these overcomplicated rules "were subject to rampant gaming and arbitrage prior to the crisis and still are" (Bair, 2014: 131).In place of risk-weighted assets Shirreff supports reliance on cruder measures like the leverage ratio. Banks' internal models can be used for their own trading advantage but not for supervision.

Shirreff would like to ban the writing and trading of credit derivatives by regulated banks and insurance companies. These instruments enable counterparties, often financial institutions, to buy protection against the default of assets such as loans or bonds. In return for supplying such protection for a periodic fee the seller undertakes either to acquire credit-impaired assets at a specified price or to pay the difference between that price and current value of the impaired assets after "a credit event". Shirreff sees such products as a lazy way of incurring credit exposure without studying or researching the underlying credit risk – an instrument which "takes us away from a world in which banks have firsthand experience of the companies and other borrowers they do business with". Owing to their proliferation in the new millennium, credit derivatives were a major concern to authorities during the credit crisis regarding, for example, the systemic risks which might have to be faced if a major counterparty to credit-derivative contracts failed.

Shirreff does not include any proposal other than that for credit derivatives which would involve control over financial innovation through the creation of new financial instruments. This is perhaps a surprising omission in view of historical experience. Under the Act of 1974 the Commodity Futures Exchange Commission promulgated a guideline for economic and public-interest requirements for new contracts in commodity markets. This was eventually watered down in practice to accord the market, the decisive judgement as to contracts' viability (Markham, 1987: 74,78, and 144). The same approach, i.e. without the public-interest requirement, has been retained in recent overhauls of United States commodities regulation (Parker and Perzanowski, 2010: 551). None the less, there is the precedent just mentioned for incorporating public interest in the vetting of proposed new contracts. Shirreff might take the view that, apart from his proposed restrictions on credit derivatives, the reformed framework for investment banking would provide sufficient oversight of complex new financial products without any additional requirement.

Shirreff supports the introduction of a financial transactions tax. He sees such a tax as discouraging what he calls "empty" trading between financial intermediaries often with no end user in sight and with little connection to the production of economic value. He has little time for the argument of opponents that such a tax would adversely affect short-term financing within the financial sector in forms such as repurchasing agreements and securities lending. On balance he views such financing as potentially destabilising through its effects on interconnectedness within financial

[1]During the initial period of the West German economic recovery after 1945 the KW complemented private banks as a supplementary source of fundsfor bottleneck investment. Subsequently its role has been more that of a long-term development bank financed partly by public funds and partly through its own resources and borrowings, much of its investment supporting regional policies and small and medium-sized business.

markets and as providing opportunities to institutions for window-dressing their assets in financial reports. Unsurprisingly, in view of his scepticism concerning the social benefits of financial trading without economic value, he is not concerned by the likelihood that such a tax might reduce the amount of high frequency financial trading.

So how does Shirreff's blueprint hold up on its own terms? And which parts might be influential or at least be in approximate accord with current reform efforts. The two questions are related.

On some of his proposals, more detail would have been helpful. Shirreff would replace Basel II and Basel III with cruder but simpler, standardised rules on leverage and liquidity. Even though the replacement of capital requirements by leverage rules accords with proposals of some other regulators and commentators, one would have liked something a bit more specific as to the level of the leverage ratio – presumably higher than that which is already included in Basel III. And would Shirreff be more or less satisfied with the rules on liquidity management already part of Basel III?

Shirreff's proposals are clearly a response to what he perceives as the defects of the current reform agendas for the banking sectors of major advanced countries such as the United States and those of the European Union. An important question regarding these agendas concerns their global applicability. A corresponding question concerning Shirreff's blueprint is how far it is successful in meeting the shortcomings on this front of these agendas.

One example here might be the Basel capital framework. During the early stages of the negotiation of Basel II the text contained passages which acknowledged – explicitly or implicitly – the problems of applying such a framework to banking systems at different levels of development. For example, the text of June 2006 contained an annex on the simplified standardised approach which collected in one place the simplest options for calculating risk-weighted assets for the estimation of capital requirements for credit risk. However, since the initial publication of Basel II.5 in July 2009, revisions of the framework, with the exception of the overdue rules on liquidity risk, seem largely directed at sophisticated banks with little allowance for problems of applicability at smaller, simpler banks, which are to be found not only in the banking sectors of developing countries but also in those of advanced countries. Shirreff would short circuit the problem of the increasing complexity of the Basel framework by scrapping Basel I and Basel II and replacing them with something simpler. Thus a proposal undoubtedly inspired by problems of the reform agenda in advanced countries would probably be much appreciated by regulators in many developing countries.

Other similar examples might be cited. Here too simplification facilitating global application can often be achieved by simply extracting from a regulatory blueprint, such as that of Shirreff, features of limited or non-existent relevance to the banking sectors of many countries. But there are also important problems which a truly global reform agenda would need to address but which are missing from Shirreff's blueprint. Examples might be lesser regulatory capacity in many developing countries and lower degrees of transparency as reflected in accounting standards and reporting to regulators which greatly complicate the tasks of regulators, supervisors and investors.

No attempt will be made here to assess the potential influence of Shirreff's ideas in the advanced countries – their principal target. But remarks on two subjects indicate the distance separating an

alternative blueprint like Shirreff's from official initiatives which have been accepted or are actually being – or likely to be – negotiated.

Firstly, take Shirreff's structural proposals concerning legal groupings which separate activities currently or until recently carried out in integrated institutions together with reforms in corporate governance. As Shirreff acknowledges, some separation of banks' activities has been legislated or is under consideration in the United Kingdom and other countries of the European Union. But there are indications that such reforms have been or will be introduced only in watered-down form. And there are no signs of the separation of pure investment banking activities into separate institutions to which the partnership form would apply. There are rumblings in the United States about restoring the separation of commercial and investment banking along the lines of the celebrated Glass-Steagall Act of 1933, but they remain just rumblings.

Secondly, burdened by ever greater attention to the drafting and revision of detailed rules, the effort to finalise Basel III (sometimes now referred to as Basel IV) continues. In view of the huge intellectual and political capital now sunk in this framework, it is hard to envisage radical simplification let alone something more like the scrapping supported by Shirreff.

References

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