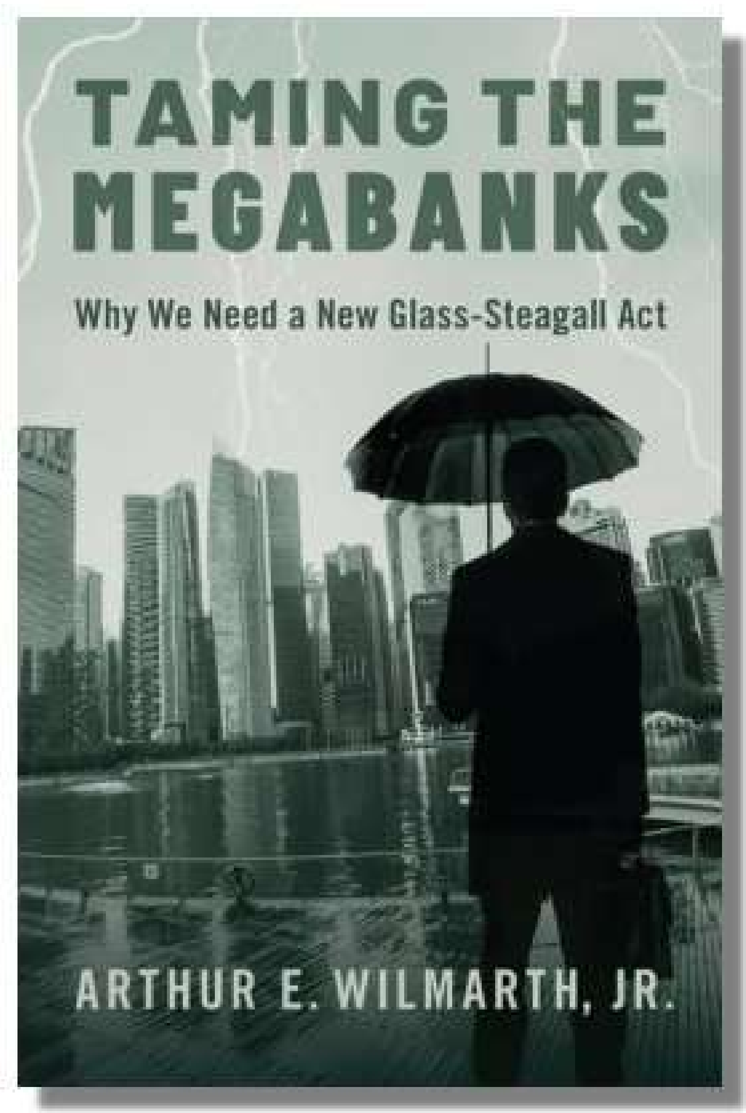

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Book Review by Andrew Cornford

The global financial crisis of 2007-2008 (GFC) was not followed by fundamental changes in the financial systems of the countries of the Group of 20 (G20), a group of developed and major emerging market economies. The weaknesses in regulation revealed by the GFC have indeed been the subject of an extensive programme of regulatory reform which has targeted increases in capital, better risk management, and better designed incentives. However, the programme has not included the major structural changes in financial institutions and markets which many regulators, policy makers and commentators believe to be necessary.

In this new book Arthur Wilmarth reviews reforms undertaken in the aftermath of the GFC primarily but not exclusively in United States. He argues that the centre-piece of the reform agenda should be the abolition of large universal banks and shadow banks to break what he calls "the doom loop" that links these institutions to governments and central banks. This could be achieved by a new Glass-Steagall Act to establish a clear structural separation between banks and the capital markets. His argument is put forward as part of an illuminating and detailed historical review of policy towards financial conglomeration in the Unites States since the First World War. The review shows that measures directed to reduce such conglomeration in the 1930s were gradually weakened or abolished during the following 60 years. The financial system which emerged from this deregulation process was ill equipped to withstand the pressures which eventually led to the GFC.

At the centre of the post-GFC G20 reform agenda are technical amendments of the existing system. Higher capital requirements for banks and rules for ensuring adequate liquidity for banks are accompanied by reforms such as procedures for the avoidance and management of institutional failures on the part of global systemically important banks (GSIBs) and other systemically important financial institutions (SIFIs), improved regulation of over-the-counter derivatives, guidelines on remuneration of key staff designed to discourage excessive risk taking, and strengthening controls over non-bank financial institutions which are potential sources of systemic risk.

Implementation of the reform programme is the responsibility of the Financial Stability Board (FSB) which is to collaborate for this purpose with the Basel Committee on Banking Supervision (BCBS) and the International Monetary Fund. The reforms are to be implemented in an open world economy operating on market principles in a context of avoidance of overregulated financial markets and maintenance of free cross-border capital movements. Failures of GSIBs and SIFIs are to be avoided partly thanks to the regulatory reforms but also to the provision of emergency financing to ailing institutions. This last not only crimps the reform agenda but, as is argued forcefully by Wilmarth, also fails address the way in which large universal banks and large shadow banks (entities outside the regulated banking system performing some banking functions) , through their interdependent relationships, have become a major source of systemic financial risk.

What follows is a survey (drawing heavily on Wilmarth's book) of the internationally agreed reforms of financial regulation – with special attention to those directed at banks' capital and liquidity as well as other major items of the post-2007-2008 agenda adopted by major countries. This leads to a review of ways in which the reforms have been frustrated and weakened by pressures from the financial lobby and steps undertaken by the unsympathetic Trump administration in the United States. The account of shortcomings of the reform path actually taken is followed by presentation of alternatives, with special attention to the measures advocated by Wilmarth, principally those directed at reducing conglomeration in the banking sector.

Banks' balance sheets and management of credit risk

There was agreement amongst observers that major features of the GFC in the banks of the principal advanced economies (AEs) were excessive leverage and inadequate liquidity provisions, and that these contributed to the severity of the crisis.

Leverage is a measure of financial institutions' exposure to risk in relation to their protective layers of capital. The exposure reflects not only that due to straightforward instruments like loans but also to derivatives (instruments requiring little or no initial investment whose price is derived from that of another asset, rate or index) and to obligations linked to other financial services. Liquidity refers to the ability of a financial institution to meet financial obligations as they fall due. Satisfactory liquidity denotes sufficient cash for this purpose from different sources.

Excessive leverage and inadequate liquidity are closely related. Excessive leverage leaves banks vulnerable to low or zero profitability in periods of widespread defaulting and thus to endangering their own solvency. The condition of excessive leverage calls into question banks' capacity to attract deposits and other forms of commercial funding and thus the availability of the liquidity essential to their continued operation. Unsurprisingly the post-GFC agenda for financial reform accorded a central role to reduced leverage and stronger liquidity positions alongside of other reforms for regulation and financial infrastructure.

The most important standards under this heading were contained in successive versions of the Basel Capital Accord, Basel I, Basel II and Basel III, developed by the BCBS (BCBS, 2011) The current version of the framework is designed to control banking risks through regulatory requirements for capital and liquidity together with improvements in banks' internal risk controls .

Major changes introduced in Basel III included increased capital buffers based on a stricter definition of capital, the requirements for minimum required regulatory capital including common equity amounting to 7 per cent of risk-weighted assets. Capital is now to include a conservation buffer consisting of equity intended to absorb losses during periods of stress. National authorities may also impose a countercyclical capital buffer as a way of countering rapid credit growth.

For global systemically important banks (GSIBs) there is a capital surcharge in the range of 1 to 3.5 per cent. GSIBs are also subject to additional rules on absorption capacity in the form of Total Loss Absorption Capacity (TLAC) consisting of instruments meeting certain conditions as to their capacity for absorbing losses and amounting to 16-20 percent of a bank's risk-weighted assets. TLAC rules are designed to facilitate the resolution of GSIBs following insolvency and thus to minimise the resulting costs to governments and tax payers.

Rules specifying capital in relation to risk-weighted assets are supplemented by a "risk-blind" minimum leverage ratio of high-quality capital in relation to total assets and some other exposures (off-balance-sheet items), initially set at 3 per cent. The rules include the restriction for GSIBs of a minimum level of equity capital in the numerator of 50 per cent of risk-weighted items.

Adequate liquidity for a bank is to be assured by a Liquidity Coverage Ratio (LCR) and a Net Stable Funding Ratios (NSFR). The first targets the supply of liquidity during thirty days, and the second that for one year during conditions of market stress. The ratios are also designed to reduce the incentives of banks to rely on short-term and potentially volatile funding

The initial versions of the Basel capital framework had two principal objectives. The first *microprudential* objective was to help to ensure the strength and soundness of individual banks, and thus only indirectly those of the banking systems of which they are a part. The second objective was to help equalize cross-border competition between banks by eliminating advantages due to differences among their regimes for capital adequacy.

Since the initiation of Basel III the objectives now incorporate a *macroprudential* dimension. This reflects a more explicit acknowledgement that many of the risks targeted by regulation in crisis situations can spill over into risks affecting several institutions and thus threaten essential functions of the financial system such as payments, lending and deposit taking. Examples in the Basel framework of measures directed at the macroprudential dimension are the countercyclical buffer and the special rules for GSIBs, both of which comprise targets transcending the soundness of individual banks.

In Wilmarth's view the traditional macroprudential dimension involving the impact of linkages between financial firms should now be extended to include the almost automatic response in situations of crisis for governments and central banks to intervene in support of large financial institutions (commercial banks and shadow banks) for the purpose of preventing failures of large interdependent institutions and thus stabilizing financial markets. These linkages have been described by Wilmarth as “a doom loop” between banks and the authorities in their home countries. For a country with large debts the authorities have a strong incentive to rescue banks to avoid wholesale liquidation of their bond portfolios resulting in a collapse of the bonds’ values and a likely triggering of a sovereign debt crisis.

The BCBS announced at the end of 2017 that Basel III was now complete. However, this seemed questionable. The final capital standards for market risk had not yet been issued. There remained unsettled issues regarding the standards for the banking book. These included standards for banks’ exposures to sovereign risk (and thus to sovereign insolvency) which is still not subject to minimum risk weights. And regulators are apparently still debating whether standards for interest-rate risk should be included in the banking book.

Moreover revisions of the standards for the credit risk of securitised assets issued in July 2016 (BCBS, 2016a)) had not yet been incorporated in the text of Basel III as of December 2017, The revisions to the framework for such assets published in July 2016 were designed to eliminate shortcomings highlighted by the GFC as follows: they seek to reduce mechanistic reliance on often misleading external credit ratings; they increase risk weights for highly-rated risk exposures and reduce risk weights for low-rated senior securitisation exposures; and more generally they are designed to enhance the framework’s risk sensitivity.

The Basel Capital Accord is still the subject of much criticism On the one hand the banking lobby wants to limit the stringency of the new standards, arguing that they have an unfavourable effect on banks’ capacity to finance higher economic growth. On the other hand several experts think that the prescribed increases in capital provide insufficient protection against banking risks.

Market and some other risks

The proposals on market risk, which had already been strengthened in Basel II.5 in response to experience during the early part of the GFC, underwent in January 2016 a thorough revision to deal with still unmet weaknesses (BCBS, 2016). The deficiencies which this revision flagged included the following: the definition of the boundary between the banking and the trading book, which has long been the subject of regulatory arbitrage by banks seeking to lower their capital requirements; and the methods for risk measurement which, relying heavily on banks own models, were insufficiently robust and led to the provision of inadequate capital for banking systems as a whole.

More specifically in the reforms of Basel II.5 a key determinant of the boundary between the trading and banking book was banks’ intent to trade, which was inherently subjective. The reforms under the heading of the internal models approach to market risk were dependent on the framework of Value at Risk (VaR) which failed to take account of the substantial exposures to credit as well as market risk of trading exposures. Moreover the restriction of VaR to protection against risks beyond the 99th percentile was shown to leave banks vulnerable to “tail risks” which had led to unexpectedly large trading losses for banks during the GFC. Allowance under the internal models approach for market illiquidity was not realistic for stressed conditions. Moreover recognition of the potential for risk reduction through hedging and diversification was too generous, based as it was on correlations from data during normal conditions.

Shortcomings of the standardised approach to market risk of Basel II.5 revealed by the GFC included the following: lack of sensitivity to different risk exposures; inadequate rules for recognition of hedging and diversification; and failure to capture risks associated with more complex trading instruments. The standardised approach was not a credible threat to banks facing withdrawal of approval of their use of the internal models approach.

The revisions proposed in 2016, partly in response to the results of Quantitative Impact Studies (QIS), included additional guidance on the boundary between trading and banking books; reductions in banks' ability to arbitrage this boundary; enhanced powers for supervisors regarding instruments improperly designated; and clearer rules concerning internal transfers of trading instruments between risk classes.

A major change in the methods of risk capture under the internal-models approach was the replacement of VaR with an Expected Shortfall (ES) metric. VaR is intended to measure the maximum loss at a specified degree of probability during a given period. By contrast ES is intended to answer the question of what is the expected loss on the condition that the loss exceeds a specified probability – i.e. more informally the expected loss if things do get bad - likewise within a specified time horizon. The initial popularity of VaR in risk management was due less to its superiority as a measure than to its advantages in comprehensibility and facility (Hull,2010: 161-165). ES was to be calibrated on the basis of periods of significant market stress.

The process for supervisory approval of a bank's models was to become more granular and was to apply at the level of each of a bank's trading desks rather than, as previously, at a bank-wide level. Approval was to depend on a desk's proficiency in modelling the dependence of profit and loss on risk factors. This would include a proper classification of risk factors into those which are "modellable" and those which are "non-modellable", with the latter subject to a separate stressed capital add-on under the ES approach. Potential advantages to a bank from hedging and diversification were constrained by rules concerning the classification of risk categories and the correlations eligible for inclusion in risk mitigation through diversification. The revised standardised approach was also designed to measure the risks of securitisation exposures in the trading book.

Closer calibration between the revised standardised and internal-model approaches was to be achieved through a sensitivities-based method involving the use of standardised "bucket" risk weights reflecting stressed market conditions under an ES framework, which also incorporated varying liquidity horizons as in the internal models approach. The approach was now to reflect more fully risk sensitivities which were already an integral part of the models used for risk pricing and management by banks with an extensive involvement in trading activity.

The revised standardised approach included a standardised Default Risk Charge calibrated to reduce potential discrepancies between capital requirements for similar risk exposures in the banking and trading books. There was also a Residual Risk Add-on designed to capture risks not already covered by the sensitivities-based method or the standardised Default Risk Charge.

In 2019 there were further revisions of both the internal-models and the standardised approaches (BCBS, 2019). For the former there are further clarifications of the way in which financial instruments are assigned either to the trading or to the banking book, and of the treatment of positions in investment and other managed funds. Tail risks are no longer to be captured by VaR but by the measure of ES described above. For the standardised approach there is a refinement of the sensitives–based approach to risk measurement and of the Default Risk Charge and of the Residual Risk Add-On.

Market risk accounts for a small share – less than 5 per cent - of total capital requirements even of internationally active banks (Coen, 2018:3-4). For many critics this indicates that the post-GFC reform agenda has become increasingly detached from what should be priority issues. For the market- risk framework the question has been posed whether it adequately balances simplicity, comparability and risk sensitivity. As the Secretary General of the BCBS himself has noted, “if the risk-weighted regime is too opaque, market participants will simply stop using risk-weighted ratios to assess the health of banks” (Coen, 2018:4). The danger extends to banks’ senior management and boards for whom “undue regulatory complexity can impair their ability to ensure that the bank has adequate capital to support its risks”.

In 2016 revisions to the treatment of securitisation were also published (BCBS, 2016a). These were designed to remedy shortcomings in the revised version of Basel 2.5 and to incorporate a hierarchy of approaches to risk measurement according to the availability and usability of estimates of the capital charges for the exposures of instruments underlying the securitisations. Here too the rules were highly complex.

In his critique of the capital requirements for banks prescribed as part of the response to the GFC Wilmarth draws special attention to the risk-weighted capital requirement of zero for holdings of their sovereign debt, which he views providing an incentive to the “doom loop” described earlier, and to the arbitraging by big banking conglomerates of estimates of risk-weighted exposures through manipulatory use of their internal models.

Limits and weakening of reform

As Wilmarth emphasises, the G-20 reform agenda revealed that even after the massive losses incurred during the GFC, financial systems with structures incorporating interlocking systems of huge conglomerate banks and shadow banks still had “powerful defenders and remarkable staying power” thanks, importantly, to key figures in the Treasury and the White House during the administration of President Obama. Timothy Geithner, the Treasury Secretary, insisted that what the United States financial system required was measures designed to ensure the survival of all major financial institutions, while also ensuring their resilience and strengthening their oversight. Subject to regional and national variation the overall policy response in other major G-20 economies was framed by similar limits.

The Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), the major set of reforms adopted by the United States, contained the following major features. Title I established a super-agency, the Financial Stability Oversight Council (FSOC) to identify and control systemic risks. The Chair of the FSOC is the Secretary of the Treasury and its membership includes the Federal Reserve, the Securities and Exchange Commission (SEC), the newly established Consumer Financial Protection Bureau, and an independent representative of the Insurance industry. The FSOC can designate sufficiently large and complex non-bank financial institutions as non-bank SIFIs. The Fed is enabled to impose stricter regulations for capital and liquidity on GSIBs and non-bank SIFIs, and together with the Federal Deposit Insurance Corporation to require them to submit plans (“living wills”) for orderly resolution in the event of serious financial distress or insolvency.

Title II created Orderly Liquidation Authority to handle such insolvencies. Title VII targets greater transparency in the pricing and trading of derivatives together with stronger regulation of derivatives dealers and large end-users. Title VII also mandates capital requirements, margin rules, and stress tests for Designated Contract Markets and clearinghouses. Margin rules and other prudential standards are also prescribed for customised derivatives traded in over-the-counter (OTC) transactions with dealers.

Dodd-Frank also covers rules not directly related to market functioning and transactions. Federal regulators are to issue rules prohibiting compensation policies that encourage excessive risk-taking by executives, directors, and key insiders of banks, securities broker-dealers, and other financial institutions. Title IV also imposes registration and informational requirements on advisers to hedge funds and private equity funds. Title X of Dodd-Frank establishes the Consumer Financial Protection Bureau (CFPB), which has rulemaking, examination, and enforcement powers to protect consumers of financial services. Title X was vehemently opposed by megabanks and Wall Street, and killing the CFPB became a priority for the financial lobby.

Reforms in countries other than the United States are treated by Wilmarth in a more perfunctory way. The reforms included introduction of changes in the Basel Framework on banks' capital, risk management, and liquidity requirements. The results included rises in average LCRs and NSFRs during the period 2012-2017. But such improvements ceased thereafter. The revised rules on banks' capital for reasons discussed earlier still remained insufficient in the view of many commentators and vulnerable to manipulation and evasion by large banks.

Reforms were introduced for the resolution regimes of SIFIs in the European Union and the United Kingdom as well as the United States. These will require arrangements for support of the principal subsidiaries of a failing SIFI and for restructuring of its holding company. The reforms of resolution regimes are based on what are widely considered untried assumptions about the dynamics of SIFI failures, especially during systemic crises.

In the United States important reform initiatives were weakened during the process of introducing Dodd-Frank, and the provisions of the law were subject to additional limitations and watering down during implementation. Amongst the former initiatives was the Lincoln Amendment. This was originally designed to force banks to transfer their derivatives to non-bank affiliates. As enacted by the United States Congress the Amendment applied only to equity derivatives, commodity derivatives, and uncleared credit default swaps – and thus only to less than 10 per cent of banks' derivative holdings. In December 2014 the Amendment was effectively gutted by a provision allowing financial holding companies to conduct the great majority of their derivatives activities within their subsidiary banks.

The weakening of reform initiatives also affected the version of the Volcker Rule eventually enacted. As proposed by the former Fed Chairman banks should be barred from holding ownership interests in hedge and private equity funds and from engaging in proprietary trading in securities, commodities and derivatives. The Rule enacted as part of Dodd-Frank exempted transactions in financial instruments for the purpose of underwriting, market making, and risk-mitigating hedging. In 2018 the Rule was weakened in various ways: some trading transactions and assets valued on a mark-to-market basis but not held in a bank's trading account were removed from coverage by the Rule's restrictions; and quantitative tests for the exemption of underwriting, market making and hedging were replaced by more lenient qualitative standards which could be based on a bank's internal policies and procedures. Many large banks were removed from the enhanced regulatory authority of the Fed under Dodd-Frank, and liquidity requirements were reduced for banks with assets between USD 250 billion and USD 700 billion (a category which would have included several institutions which posed systemic threats to United States financial markets during the GFC).

The weakening of reforms of Dodd-Frank was facilitated by provisions whose implementation depended on action by financial regulators. These included appointees of the Trump administration who were often unsympathetic to the law's programme. Inadequacies on the regulatory side were accompanied by unwillingness amongst the leaders of financial sectors as a class to assume special responsibility for controlling the huge, simultaneous losses of the major banks and other financial institutions of the GFC. Arguably the mind-set deemphasising personal responsibility was reinforced by the way in which individual cases of wrongdoing were treated by the legal system. Big banks did pay large fines and reached large financial settlements with the authorities after investigations. But leaders of large financial institutions rarely faced prosecution. Penalties were more likely to take the form of forced dismissal and fines, which frequently none the less accorded those affected substantial severance payments. In such a climate of opinion it is unsurprising that discussion of reform devoted little space to the possible restoration of unlimited liability for individual participants in banking activities.

A new Glass-Steagall Act

Wilmarth's review of recent reforms of banking and the financial markets ranges widely over both measures adopted, though often in watered-down form, and ideas which did not get beyond the stage of consideration and discussion. But clearly for him the most important targets for reform are large banking conglomerates. The vehicle for this should be renewed Glass-Steagall Act.

The version of Glass-Steagall cited in current discussions of reform was another name given to the comprehensive Banking Act of 1933 (Jackson and Symons,1999: 43-44 and 1033-1035) The Act contained four sections which required the separation of commercial and investment banking. Section 16 limited the involvement of depositary institutions in the business of dealing in securities and stock to purchases and sales and undertaken for customers and to underwriting of certain government securities. Section 21 prohibited organisations involved in underwriting securities from also engaging in the business of receiving deposits. Sections 20 and 32 extend the Act's prohibitions to certain banking affiliates and other related entities and individual officers, directors, partners and employees.

The other reforms contained in the Banking Act of 1933 were wide-ranging. Probably the most important for the purpose of ensuring financial stability was the establishment of the Federal Deposit Insurance Corporation (FDIC), through which the Federal Government insured deposits in qualified banks. Since this measure applied to small as well as large banks, deposit insurance arguably contributed also to competition in the banking sector since henceforth deposits would be just as safe in small as in large banks (Skeel, 2011: 55).

The backdrop of the 1933 Banking Act was the failure in the United States of more than 5000 banks between 1930 and 1932. The backdrop of the post-GFC reforms on the other hand was a serious financial crisis but one which was more successfully contained by the macroeconomic policy response in Advanced Economies. The threat to the banking system at an institutional level in the latter case involved the failure of Lehman Brothers and the near failure of a number of other large institutions but not generalised bank insolvency. Another difference between the two crises was the relative importance in key policy decisions of two groups with different perspectives on the direction which should be taken by banking reform.

In the United States response to the GFC the dominant was role was played by corporatists, that is to say policy makers who believe that reform of the financial sector should be channelled through selected large financial institutions (Skeel, 2011: 11-12, 55 and 77-85). The key role in the oversight of systemic risks was to be played by the FSOC, a body which brought together major regulatory agencies and was likely to be sensitive to representations of the financial sector. In the administration of Franklin Roosevelt structural reformers were more important in the policy response to the banking collapse of the early 1930s. Amongst these the most influential voice was that of Louis Brandeis, Boston lawyer, adviser of President Woodrow Wilson, Supreme Court Justice, and author of *Other People's Money*. This book popularized the 1913 findings of the Pujo subcommittee, established by the House of Representatives, which found that the so-called Money Trust of a close-knit group of Wall Street investment and commercial banks and their associates in Boston and Chicago – in Wilmarth's words – "controlled the market for financing the great interstate corporations". Brandeis highlighted "the revolutionary change in the conduct of our leading banking institutions" due to "invasion by the banks into the realm of investment banker".

Wilmarth leaves no doubt as to where his sympathies lie. He notes that John Reed and Sandy Weill, major figures in the creation of the massive Citigroup, as part of the merger movement associated with the repeal of the original Glass-Steagall Act in 1999, have changed their positions. They now see a new Glass-Steagall as likely to improve the internal functioning of financial institutions by ending the culture clash within universal banks between investment and commercial bankers and the conflict of interest preventing universal banks from acting effectively as both objective lenders and impartial investment advisers. In their view a new Glass-Steagall would also reinforce the resilience of the financial system through the creation of strong structural buffers between banks and other financial institutions. Perhaps most interestingly two major bankers stress the importance for the great majority of the population not actively involved in the management of commercial and investment banking of the way in which a new Glass-Steagall would prevent, or at least greatly reduce, the exercise by financial conglomerates of dominance over political and regulatory policies. Wilmarth agrees with the positions of Reid and Weill, and his treatment extends them with special emphasis on the way in which a new Glass-Steagall can enhance financial stability.

Wilmarth is unconvinced by the argument of the corporatists that open-ended support for large banks and shadow banks is the only guarantee that a future financial crisis will not lead to a new Great Depression. On the contrary such an option in his view would increase the stress on already stretched financial and fiscal systems, eventually – although he does not explicitly say so – leading to some kind of breaking point. Avoidance of this danger requires recourse to structural reforms in an appropriately modernised version of Glass-Steagall.

Central to this new version of Glass-Steagall would be a delimiting of which activities constitute commercial banking. This is not simple owing to the extension of banks' activities into such fields as insurance, securities underwriting, and real estate investment. Wilmarth's approach to this question involves both the liabilities and assets of commercial banks.

On the liability side banks' deposits would henceforth include all short-term financial instruments which are payable in practice at par (100 per cent of amount invested) either on demand or within 90 days of issuance. Non-banking institutions would be prohibited from issuing short-term financial instruments which function as cash equivalents or deposit substitutes. This would imply, for example, that Money Market Mutual Funds (MMMFs) and other deposit substitutes would be issued by banks and not by non-banking institutions. Such funds would be thus be subject to the more rigorous regulatory regime applying to banks. Funds issued by non-banking institutions would be subject to stronger market discipline, and thus such holdings of them would be less likely to contribute to financial instability.

Creation by banks and affiliates of derivatives designed to serve as "synthetic" substitutes for certain items on their balance sheets would be subject to greater restrictions. Derivatives would be permitted for banks only if they qualified for hedge-accounting treatment under the standards of the Financial Accounting Standards Board.

On the asset side the main prohibition of a revised Glass-Steagall would concern involvement of banks in securities business other than underwriting and investing in government bonds, a restriction similar to that in the 1933 Glass-Steagall. This would imply no participation in securitization, trading on the bank's own account, and other investment banking services.

Wilmarth views his proposals as conducive to an improved alignment of financial risks and risk management in the financial sector. Non-bank financial institutions would face more rigorous regulatory rules. Shadow banks, the entities outside the regulated banking system which perform several banking functions and which have become increasingly important since 1975, could well largely disappear in a regime in which issuance of short-term claims on nonbanks was no longer permitted. Wilmarth's proposals would also end current anomalies where large banks are able, sometimes through capital-market affiliates or regulatory redefinition of themselves as commercial banks, to exploit safety-net subsidies such as deposit insurance, access to favourable terms on loans from the Fed, and even implicit guarantees for banks considered Too Big to Fail. Institutional anomalies here have merely been a highly visible manifestation of a pervasive intertwining of banking conglomerates and securities firms which created on- and off-balance sheet exposures whose dangers Treasury and Fed leaders such as Ben Bernanke and Timothy Geithner on their own admission had failed to grasp before the GFC. This failure had partly conceptual origins: the models used for forecasting failed to include what proved to be crucial details of the functioning of the financial system and its potential impact on the macroeconomy.

In presenting his proposals for better controlled interdependence of different categories of financial institution - similar to the structural buffers of John Reid and Sandy Weill – Wilmarth gives special emphasis to the way in which it would enhance financial stability through methods which avoid the reliance on large-scale support from government institutions of the corporatist approach that has characterised much of the post- GFC reform programme. Features of these methods, characterised by Wilmarth as "the global doom loop", are the following: Too Big To Fail guarantees to universal and large shadow banks which, supported by easy monetary policies, finance rapidly rising levels of private and public sector debt; and the assumption of outsized financial risks by investors and creditors in the expectation that governments and central banks will take the actions necessary to stabilize financial markets and prevent failures of large financial institutions.

Supportive policies towards universal and shadow banks have in fact been accompanied by a more severe regime for smaller banks. Over 2000 new community banks opened between 1993 and 2008 but fewer than 20 between 2010 and 2018. Wilmarth attributes much of this decline to severe chartering requirements for such banks which have been an impediment to establishing new banks in smaller cities or rural areas. Regulatory stringency for small banks has been accompanied by leniency in the adoption of antitrust standards elsewhere, which permitted consolidation of the banking industry through mergers and acquisitions. Longer-term in this area trends included a fall in the number of community banks between 1984 and 2015 from more than 14,000 to less than 6,000 and a decline in such banks' share of the total assets of the banking industry from 38 per cent to 14 per cent. Such trends were associated with a sharp decline in the number of business start-ups (and it is safe to assume in the creation of new employment).

Wilmarth is sceptical that the decline in classical small-scale banking can be replaced by on-line nonbank financial (fintech) services. He is more optimistic concerning the likely effects of a new Glass-Steagall, which he thinks would encourage substantial inflows of deposits and capital into community banks as universal banks break up and nonbanks are barred from issuing short-term financial claims. He draws attention here to a recent comparative study of local regions in Austria, France, Germany, Italy and Spain which indicated that regions with a more substantial presence for smaller banks had higher levels of income and wealth and lower unemployment rates.

Wilmarth emphasises that the new Glass-Steagall which he is proposing will permit banks and their affiliates to engage in several financial activities other than deposit taking and lending. He cites here the earning of agency-based fees for investment advice and securities brokerage services, and acting as agents in selling insurance products. Acceptable under the new Glass-Steagall would also be greater flexibility for the definition by the Fed under the Bank Holding Company Act of 1956 “of activities closely related to banking” (i.e. the activities of deposit-taking, lending, payment and settlement services, and wealth management) which it could permit to bank holding companies.

In his view such services can be provided without creating the dangerous conflicts of interest and risks currently generated when universal banks underwrite or create the financial products which they sell. The task of regulation will be to ensure that banks do not assume legal duties or exposures as principals as part of their participation in such activities.

Wilmarth confronts some of the common arguments favouring large universal banks. The first cites the advantages of their economies of scale and scope. Another argument is that the ability of United Sates financial institutions to compete with those of other major countries depends on their size and the diversification of their activities. Closely related to this argument is that only big universal banks can satisfy the requirements of large, multinational firms. On the basis of conceptual and historical considerations Wilmarth argues that all such points are questionable.

Firstly, there no consensus that the performance of large universal banks is generally superior once one has taken account of determinants other than scale and scope. On the contrary according to many studies increases in scale and in geographic and activity diversification have been associated with higher volatility of earnings and higher insolvency risk, and thus lower market valuations even during periods preceding the GFC. Moreover many critics of excessive reliance on large universal banks would argue that the superior competitive performance of United Sates financial firms in the 1980s and 1990s was driven to a significant extent by conditions in the country’s home markets, conditions which included roles for vigorous competition and the decentralisation of activities and markets that were more important than size and activity diversification .As for the unique capacity of universal banks to satisfy the needs of multinational firms Wilmarth points out that this does not receive support from postwar history between the 1940s and 1990s. Transborder financing during this period relied heavily on syndication - in bank lending and in offerings of debt and equity securities. More competitive transborder banking on the contrary could end a regime characterised by regulatory complacency towards big universal banks as well as the astronomical remuneration of their senior officers.

Conclusion

Wilmarth’s book covers interestingly territory other than the key regulatory issues which are the principal focus of this review. He provides a detailed treatment of the evolution of principally United Sates banking practices and regulation since the beginning of the 20th century. Of interest in itself this also provides important muscle for his case against acceptance of financial conglomeration and of the institutions and supportive legal and regulatory framework with which this has been associated.

However, impressively though Wilmarth makes his case, reversing conglomeration amongst large banks will be difficult. Financial lobbies will mostly oppose such a reversal, and they will have support not only from within the industry but also from significant parts of intellectual and regulatory élites. Moreover consolidation and associated mergers are prioritized in several countries for the purpose of reorganisation and reinforcement of banking sectors. Accompanying structural reforms by contrast are often limited and halting. Nevertheless, regardless of unsupportive climates, Wilmarth’s wide-ranging commentary on underlying issues merits close attention in debates on the future of banking regulation.

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