THE PROBLEM WITH BANKS

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To our students,

and to those who work to make our world – including the banks -

better.

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Preface

The Occupy Wall Street demonstrations which began in New York in September 2011 using the slogan, "We are the 99%" kicked off a wider US and global protest movement against corporate greed and the dominance of financial services in business and politics. By early November 2011 protests inspired by the New York movement had occurred in around 900 cities worldwide. Although we offer this book as a thoughtful contribution to the debate about banks, we understand the frustrations the global financial system and corporate capitalism generate. We think a better world is possible, and we hope this book can make a contribution to building that world.

We argue in this book that banks are very troublesome institutions. They borrow short in the form of demand deposits and lend long. Their profitable lending opportunities are being taken away from them by the capital markets, forcing them to innovate and engage in sophisticated financial engineering. We suggest that there is a lack of appreciation of how government shapes the motivations of banks, and how banks evolve as institutions alongside states. Unlike most other books about banks, which assume banks are given or natural, we argue that government has a major role in creating and shaping bank behaviour. Government does not just regulate banks, but actually creates or constitutes what banks are and what banks do. However, few who make public policy recognise this deeper, constitutive role of government in making banks.

Increasingly, banks are focused on the short-term or synchronic outlook, and neglect diachronic issues such as investment in the productive assets that will create prosperity and jobs in the future. Banks have ceased to be strategic institutions that make key decisions about how our society will evolve, even as they retain a systemic position in our global economy. If banks do not act in the public interest when they are so important to public welfare, and have to be bailed out when they fail, the case for their reform is more vital than ever. Our argument is developed as follows.

Chapter 1 considers how banking crises have led to more regulation, and how this has systematically influenced the evolution of banks. It will pay particular attention to the key argument we propose, namely that governments have played a pivotal role in shaping how banks have evolved over the centuries and that this has to be taken into account when it comes to creating space for any meaningful discussion of banking reform.

What exactly are banks? *Chapter 2* takes a closer look at the nature of banks. Banks lend long term and borrow short term. This makes them vulnerable to any loss of confidence in their ability to cover demands on their funds. This perennial issue is at the heart of most crises, including the latest. However, in recent years, the so-called maturity mismatch of bank lending has been exacerbated by the fact that banks also lent more than they borrowed from depositors. In so doing, they put extra pressure on the system. This chapter suggests that we have to think of banks as players in a metaphorical confidence game. However, ultimately confidence in banks does not derive so much from their proficiency in the game as opposed to their successful moves to free-ride on the efforts of other players, namely states. In so doing, the participation of states in the game alters the rules of the game itself. Bank free-riding is not solely restricted to bailouts, which have figured so prominently in recent media discourse, but includes issues such as the role of states as enforcers of the rules of the game (e.g. property and creditor rights as well as financial regulation broadly conceived) and as controllers of who is allowed to play the game (e.g. market access and concentration). The chapter identifies two drivers for the recent transformation of banks from market authorities to market players, progressive financial disintermediation and increased reliance on self-regulation.

The two subsequent chapters scrutinise the evolution and transformation of banks in recent decades. They suggest that banks have undergone a shift from market authorities to market players. *Chapter 3* looks at the impact of financial disintermediation on banking. Banks have increasingly had to compete as lenders with more efficient and lower cost capital markets. This competition has transformed banks from market authorities to participants, and motivated them to search for yield through financial innovation such as asset-backed securities. To protect interest income in a world where corporations tend to raise funds in capital markets, banks increasingly targeted loans at households. However, this change in banks' activities was underpinned by the perception of policymakers that diversifying funding sources by creating liquid capital markets was for the public good, as was widening access to credit. As a consequence, states acted as important facilitators of financial disintermediation and the increasingly synchronic market logic focused on profit maximization, rather than on diachronic concerns about growth through the development of productive capacities.

Chapter 4 scrutinises the interplay between increased self-regulation and the behaviour of banks. Governments changed their approach to banking regulation between the end of the Bretton Woods system in the 1970s and the onset of the global financial crisis in 2007. Regulatory authorities lost confidence in their ability to regulate banks. Instead, they sought to push responsibility for prudent behaviour onto the institutions themselves. Underlying this shift towards self-regulation was the notion that banks are simply too complex, acting in a rapidly evolving environment, for regulators to keep up. This changed not only the way that banks conducted their operations, but the nature of banks themselves. The chapter examines moves towards bank self-regulation on a global level (e.g. the impact of the Basel Accords) and at local levels in America, East Asia and Europe. A result of the drive towards self-regulation was that banks tended to get bigger. This was based on the notion that size reflects success in business and as a logical consequence bigger banks are more sophisticated and thus better able to regulate themselves, never mind economies of scale and scope. Little attention was paid to the idea that it was actually regulatory arbitrage, and not necessarily business acumen, which drove the growth of the big banks in the run up to the global financial crisis. Again, this chapter supports the notion that public policy has been fundamental in shaping banks. Moreover, it did so in a constitutive sense as opposed to in a merely reactionary regulative manner.

In *chapter 5*, we assess the proposals that have been made to reform banking regulation and say why we think these reforms will not solve the problem with banks. More specifically, we will look at three issue areas in more detail: macroprudential policies (including some of the new Basel III specifications), a ban on proprietary trading (the so-called Volcker rule) and proposals about breaking up the banks to achieve a more competitive market structure. We argue that all these proposals ignore the constitutive role played by government when it comes to shaping the nature of banks, and the need for a diachronic approach to understanding these institutions. Thus, in our opinion just implementing the Volcker rule, breaking up the banks, or creating the mechanisms for improved macroprudential regulation are not sufficient to rid us of the problem with banks. Indeed, it is questionable whether the problem with banks can ever be fully solved and if this is the case, then a more fundamental rethinking of public policy and its relation to banks is necessary.

This is not to say that we should despair. In concluding we explore alternative ways of regulating and shaping banks. Thus, *chapter 6* sets out our own reform agenda, suggesting that a more incisive view of change is needed, which relates to the very purpose of banking institutions. First of all, a broad societal consensus is required. Also, when it comes to the more intricate details of reform proposals, more creative solutions are necessary. This could mean, for example, entrusting separate organisations with the safekeeping of deposits and the generation of funds for investment, whose risk is more clearly spelled out. This implies that depositors in the future would either have to be satisfied with no return on their savings or accept the very real possibility of investment losses. The question is, is it the function of banks to generate public and individual wealth themselves (with a similar potential to destroy it), or should banks be no more than market authorities rather than market players.

A number of people helped us develop our thoughts along the way, including the anonymous reviewers of the proposal and the manuscript, a conference audience at the University of Warwick in September 2011 and Ken Barlow, our enthusiastic editor at Zed Books, whose close attention to the manuscript was greatly appreciated.

This volume has been motivated by our shared sense that banks are very troublesome but need not be such problematic institutions if we first recognize that society makes banks what they are. We have dedicated this book to our students and to all those who are still optimistic enough not to be taken in by the frequently heard notion that there is no alternative. History and our lives are about making change.

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