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European banks

Battle to regulate banks has just begun

The question is not whether banks are successful but whether their resources are most usefully employed, write Anat Admati and Martin Hellwig

JUNE 2, 2011 by: Anat Admati and Martin Hellwig

Bankers on both sides of the Atlantic are lobbying furiously against stronger regulation. Authorities in different countries are reluctant to strengthen regulation as if the crisis never happened. The European Commission even hesitates to fully implement Basel III. In this debate, many argue that global competition requires a "level playing field". Following this argument, and concerned about the City's competitiveness, the Interim Report of the UK's Independent Commission on Banking avoids proposing tougher regulation for investment banks.

These "level playing field" arguments are invalid. If banks impose costs and risks on a country's economy, the country is better off with rules that limit the risks and costs even if others are not doing the same. The global economy is not a sporting event where a country's athletes are expected to win as many medals as possible, but a system for the exchange of goods and services. In this system, the competitive successes of banks and the competitive failures of firms in other industries are two sides of the same coin. A country exports financial services and imports other products according to its comparative advantage.

In the UK, the rise of the financial sector over the past three decades was accompanied by a decline in manufacturing. This is not a coincidence. Banks are not just in competition in financial services markets. They are also in competition in markets for scarce talent. The highly talented people that they have drawn into the financial sector have not been available to other industries.

For the economy as a whole, the question is not whether banks are successful but whether their resources are most usefully employed. Perhaps, for example, those sharp minds in investment banking might have been even more productive in innovative biotechnology?

The best uses for scarce resources are found through an undistorted market system. Without distortions, a firm's success in the competition for inputs is prima facie evidence that its use of these resources is economically desirable.

However, external factors such as the costs of government subsidies and the fallout from the financial crisis distort the functioning of the market. It is important to correct such distortions by suitable regulation. The elimination of distortions favouring banks will improve the function of the market system and enhance overall economic welfare.

The severity of the crisis was at least partly due to the fact that major financial institutions operated with only 1-3 per cent equity relative to total assets. With such high leverage, solvency concerns arose quickly and impaired refinancing. Had banks been funded with much more equity, the crisis would have been much less severe.

Basel III allows the equity of banks to be as low as 3 per cent of their total, non-risk-weighted assets, which is dangerously low. Banks funded with significantly more equity are not only less fragile but healthier, with fewer incentives for excessive risk taking and a lower likelihood of causing a credit crunch due to their overhanging debt. Such banks can better generate economically appropriate value and profits by making and monitoring loans, and by providing liquidity, while subjecting the economy to fewer unnecessary risks and costs. Arguments against requiring banks to have much-reduced leverage are either fallacious irrelevant or weak, as are dire predictions for national competitiveness, lending and growth.

Some argue stricter regulation would drive banking into the unregulated shadows. By the same argument, we might give up on taxation because we are afraid of the use of tax loopholes. Enforcing regulation is a challenge but it can be met. In the crisis, the most problematic shadow banking activities had been sponsored by regulated banks and would have been within regulatory reach. If supervisors were willing to use their enforcement powers over activities in their territory, the threat from shadow banking anywhere would be much reduced. This requires political will and determination.

The writers are a professor at Stanford University, and a director at the Max Planck Institute in Bonn

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