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Misunderstanding the Banking Industry

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Abstract

This essay makes the case for a fundamental reconsideration of the role of the banking industry in the West in a situation where economic growth and development is much more dependent on that industry than many of us envisaged. It looks at the growing intermingling of important public social, political, economic, and financial activities between the banking industry and Western governments and the consequences of those unplanned developments.

The approach is diagnostic, not prescriptive. I hope that readers will understand that I eschew the standard reflex reactions of the political Right and the Left as they – like the system they criticize – fail to deal with the problems they purport to confront, and crucially do not understand the nature of the banking industry today.

In analysing the banking industry as it actually operates in the West, my agenda is to begin a discussion on the real nature of that industry-if we do not understand it properly, our proposals on its restructuring, reform, and regulation will be at best misplaced.

I begin by drawing attention to the fact that the banking industry no longer belongs in the public or private sectors, but is a uniquely powerful hybrid of both, and its multi-faceted activities reach directly into core activities of government. As in all human endeavours, villains occur from time to time, but my purpose is get beyond the sterility of the "blame game" to initiate a meaningful discussion on the first steps to a New Banking Order which is robust, responsible and accountable. My belief is that this first step is a dispassionate factual examination of where that industry is today. I hope this essay will be understood as an attempt to move in that direction

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Misunderstanding the banking industry

“Banking establishments are more dangerous than standing armies.”

- Thomas Jefferson, third president of the United States of America.

A basic category error is at the core of the problems in the banking industry.

The drumbeat of scandals in the banking industry continues, and unless we properly understand the place of banking in modern life, they will continue into the foreseeable future.

A basic category error - assuming that the banking industry is part of the private sector and therefore should be viewed, treated and regulated a part of that sector - is at the core of the difficulties with this industry.

In fact banking forms a unique separate category –a hybrid of the public and private sectors, combining many of the worst features of both. Banking stands apart and operates in a fashion very different in every sense from both the public and private sectors.

To make sense of the current economic maelstrom, three sectors now need to be separately distinguished, regulated, and recognised - the public sector, the private sector, and totally different from both - the banking sector.

This outcome was not planned in any sense. It unfortunately developed, as economies developed, and as a result of a flaw inherent in Western democracy: short-term political decision-making, particularly in making resource allocation decisions.

The point of this analysis is not to ascribe blame, nor to prescribe solutions. My aim is to clear the ground for a rational and objective discussion of the place, role, and regulation of banking in liberal democratic society today.

1. The core activities of credit and cash transmission, allocation, and pricing, at the heart of much of public policy in Western economies, are carried out by banks.

When I studied economics at university many years ago, the course was named “Political Economy”. That description recognised that much of the activities being studied can neither be measured nor completely controlled, but that term soon fell out of favour. This was doubly unfortunate, in that it eventually led many to believe that mathematical models would help eliminate risk in finance, and with the growth in the importance of finance in all Western economies, in the economy generally. This misconception lies at the heart of many of our current difficulties, as does the general notion that politics and economics are inherently separate and so could be analysed and “managed” separately. In fact, as we learn daily, they are almost totally intermingled.

This intermingling of politics and economics, via the transmission belt of finance, is most striking in the banking industry.

And so you have a situation where the allocation, transmission, and pricing (interest rates etc.) of cash and increasingly credit, which have a huge direct impact on Western economies, and so on voters, and the related success or failure of political parties, is normally carried out by companies in the private sector, whose activities therefore have a direct massive impact on the public sector and particularly the political party in power.

This has led to an impossible relationship developing between the public sector in the broadest sense and the banking industry. As the banking industry has developed and increased its activities, and therefore become much more important in Western economies, this problem has worsened dramatically.

The impact of the collapse of a bank (unless it is absolutely tiny) on any individual country is such that that it is worth almost anything to the party in power and the public sector to prevent such a collapse. This gives undue power to the banking industry, *vis-a-vis* both the public sector and the political party in power. More generally this transfer of power has had an extraordinarily corrosive influence on those in leadership positions within the banking industry, as well as on politicians and bank regulators.

This unbalanced interlocking relationship, and the related power it gives to the banking industry is replicated in no other area of the private sector. The pharmaceutical industry, the aviation industry, and similar industrial sectors – all heavily regulated - have not ended up with such intermingled relationships and power imbalances *vis-a-vis* the public sector and the political party in power.

This inherently corrupting (using the term in the broader sense) relationship is at its worst in those countries where many of the banks are in public ownership (such as the Landesbanken in Germany and the Cajas in Spain), in countries where some banks have had a direct or indirect link with political parties in power (as had Anglo Irish Bank in Ireland through its irresponsible lending to the construction and house property sector), and in countries where the banking industry has provided many of the senior financial figures for administrations which are supposed to manage or control their activities, the US being a prime example). These countries have also been the location of some of the most serious banking crises, even if that is still not fully appreciated in the case of Germany.[i]

However it is structured, the core problem is that the allocation, transmission, and pricing of cash and particularly credit, which are utterly fundamental to the successful growth of Western economies, are in private and frequently not very transparent hands. Without anyone planning it, this gives significant power to the banking industry.

This fact is generally ignored, until everyone understands it very clearly when the process hits a spectacular speed bump, such as in the euro zone crisis and the sub-prime mortgage scandal in the US.

No other industry, in the public or private sectors, has such an unbalanced, intermingled power relationship, or the ability to economically almost destroy or seriously damage sovereign states.

2. The human reaction to this unbalanced relationship generates unique incentive structures that favour excessive risk-taking in the banking industry.

Homo sapiens seeks to optimise his/her position in any set of circumstances As soon as it becomes understood that the government will always pick up the pieces when a bank fails because of their fear of the impact on the economy, and therefore their own position, the notion that banks must behave responsibly, and in a risk-minimisation fashion, goes out the window. “My bank” collapses and someone else picks up the bill, with little if any impact on me, is a most dangerous lesson for most of us. Instead of incentivising responsible behaviour, we enter an upside down world, which maximises excessive risk-taking as a matter of course in the banking industry.

If the investment, bet, gamble or position assumed, whichever way you wish to describe it, is successful, the gain accrues either to me directly or to “my bank”, with positive consequences for me in the latter situation. The ebb and flow of business life can generate “normal” losses, and they are not a major problem in the banking industry. However massive systemic losses are another matter, and unlike every other industry in the private sector, they almost always now eventually accrue (directly or indirectly) to someone other than “my bank”, usually with only minor if any consequences to me or to the executives or board of “my bank”. Herein lies moral hazard – writ large.

What many have not appreciated is that the more often this scenario occurs, the more people in the banking industry come to understand these unique rules of the game, and therefore the more widespread the unique incentives to greater risk-taking behaviour become. Counter-intuitively the incentive for excessive risk-taking increases with each public scandal, and not the opposite as we might reasonably assume. All the formal rules and regulations in the world, corporate governance codes etc., cannot counterbalance the very human and understandable reaction to what is happening in front of our eyes in the banking industry. With the continuation and growth of this dangerous “structure”, it is not a question of whether another banking crisis will occur, but simply when.

It is clear therefore that the dividing line between the public and private sectors has been almost totally eroded in terms of major losses or massive financial exposures in the banking industry in the West today. Incentive structures that maximise risk-taking are inherent in this unique, dangerous, and unbalanced relationship between the governments of liberal democracies and the banking industry. No other industry is in this position.

3. This dangerous incentivisation of excessive risk-taking is further magnified due to the inability to successfully prosecute the banking industry for any misdemeanour, negligence, or incompetence short of absolute fraud.

A major concern arising from the endless banking scandals has been the inability of the “system” to successfully prosecute even a reasonable number of bankers despite the massive damage done to many countries and the world economy over the last five years. Scandals in other industries in the private sector have inevitably led to successful prosecutions, boardroom shakeups and significant changes to the relevant industries.

Why is the banking industry once again unique?

The first broadly applicable reason is that for a variety of reasons, much of the corporate legislation in Western economies excludes the banking industry, due to the unique position it holds. This situation, which is slowly changing at present, has provided significant room to manoeuvre to executives and boards in this sector, particularly when combined with flawed incentive structures leading to excessive risk-taking.

The second reason is that over time the banking industry has built up a significant expertise in excluding itself from liability for any failure in its activities, particularly by setting standard terms and conditions for customers who invest with or through it, that put most of the “due diligence” requirements on the customer (including usually the need to take independent legal, taxation, and financial advice) which most professional or business investors would not have the time, or frequently the resources, to ever complete.

In effect, almost all investors end up in a position where to access certain financial products or make certain investments, they must always accept terms and conditions from the relevant bank which are totally unbalanced in its favour.

This has had the extraordinary outcome in practice, that following the greatest decline in recent history of the wealth of most individuals over the last five years, very few successful prosecutions of banks or their boards or executives have occurred. In almost all such situations, in the absence of the ability to prove complete fraud, any form of incompetence, negligence, or failure cannot be legally held against the bank, and the related massive losses accrue to the customer.

Once again, as this becomes more broadly understood in the banking industry, this almost unique inability to be held accountable for investment failures and the related endless misdeeds (other than in the most serious provable frauds) fosters an attitude of impunity and further corrodes the culture, ethos, and business attitude of the boards and executives of Western banks. This “structure” is unique in the private sector, but similar to the lack of real accountability, and the related virtual impunity, that prevails in practice in the public sector in many Western economies.

4. Bank funding of governments, together with direct or indirect state funding of banks, has created a mutual co-dependency eliminating the leverage governments should have over the banking industry, and drawing both ever closer together.

In almost all countries in the West, banks are significant holders of government stock. Should that change, many sovereign states in the West would have significant difficulties funding themselves.

In addition significant bank funding is either provided, directly or indirectly, by, or through the good offices of, the state (usually by the central bank), or in the case of the euro zone, by the ECB. This creates a structured, mutual co-dependency, which, especially in the Eurozone area, begins to have certain parallels with the infamous mutual assured destruction (MAD) doctrine of the Cold War nuclear balance between the US and the Soviet Union. Simply put - in more and more countries the future of major banks is becoming increasingly, and very directly, identified with the future of the host sovereign state.

Many do not understand that when banks buy sovereign debt of "their own" government they are lending money to that government, and when this is done via the "carry-trade" (see below), they are getting a disguised subsidy from that government. You therefore have a unique relationship, where the banks are lenders to the government, with all the power of such lenders. In the euro zone, there are very few other sources of such government borrowing. On top of that they are getting a subsidy from that government to lend them the money. Truly a unique relationship, further empowering banks, with no parallel in the private sector.

This co-dependency is particularly highlighted in the "carry-trade", where the ECB advances funds to Eurozone banks at 1%, and those banks then " invest" these funds in sovereign bonds of their country, making a significant profit on the transaction. This "profit" ignores the predictable bad debt risk attached to any investment in euro zone sovereign debt and significant concerns on how many governments will repay those funds at the relevant date, other than a "roll-over" of the same trade to the banks again.

And so you have the Irish government, preparing to re-enter the sovereign bond market, and selling a small number of bonds on the supposed open market, nominally to prepare the market for such re-entry and to test the waters with respect to such. It then transpires that Irish banks bought a significant percentage of the bonds "successfully" sold.

This type of non-market trade is illustrative of the extent to which banks and governments are involved in a significant number of what might be best described as "non-market mutual support activities".

Whatever this type of transaction is, it has no parallel in the private sector. It raises serious questions about the extent to which the basic laws of supply and demand apply to many aspects of the banking industry, and clearly positions that industry in a unique, co-dependent relationship with the public sector in general, and the politicians in office in particular. In those circumstances who has leverage over whom, and who can genuinely regulate the other?

5. The owner-manager divide in the banking industry is the widest in the private sector, due to the absence of the normal laws of supply and demand in many sectors in that industry, and the opacity of many of its transactions.

One indirect benefit of many of the recent banking scandals is the light they have thrown on current banking practices.

From the Libor rate-fixing scandal we now know that the relevant data were produced by what was in essence a club, a small group of powerful banks, while the underlying pricing was both lacking in transparency and utterly capricious, based on private reported quotes, not real deals.

In other words the Libor market was effectively rigged. How many other markets in the broad financial industry are still being similarly rigged?

Markets requiring close scrutiny are those with a lack of price competition, such as new issues and other capital market transactions where price protection seems to be in place; the method of establishing prices in over-the-counter markets and “dark pools” where transparency is extraordinarily low and margins are extraordinarily high; the swaps sector in many countries; and parts of the debt and derivatives markets which have a fundamental lack of transparency, and are frequently “managed” by a small number of entities.

To assess the real implications of such practices, we need to reconsider first principles. When Adam Smith (1723-1790) set down his principles for a free market his most basic assumptions were that the interests of owners and managers would be aligned, that there would be full price visibility, and that there would be free participation in all relevant markets. None of these apply fully in the banking industry in the West today.

While it is clear that there is a significant divide between the interests of owners and managers in much of the private sector, that divide in the banking industry is a chasm because of the lack of price visibility in many areas of the industry, the complexity of many of its transactions, and the absence of free participation in many of its sub-markets.

Once again the banking industry turns out to be unique, with the normal laws of supply and demand applying less to it than to any other industry in the private sector, and the consequent significant empowerment of managers and disempowerment of owners.

In many respects, the situation of senior executives in the banking industry, in this area, is akin to the position of senior managers in the public sector, who in many countries are in essence answerable to no one, and subject only to a certain level of embarrassment, and little else, when things go badly wrong.

6. Uniquely for the private sector, the banking industry is at the core of critical political and social activities of Western governments. In reality this means that banking is now an unelected and non-appointed arm of government.

In addition to the varied economic and financial relationships set out above, the banking industry is also at the heart of many of the key economically/financially driven social and political activities of government in Western economies.

Many now appreciate that at the heart of the current Great Recession in the West was an expansion of credit unparallelled in modern history. This occurred for a whole variety of reasons, some of which many do not wish to acknowledge.

Richard Duncan, an economist with a career in finance who has examined this credit increase in detail, predicted in 2002 that the post-Bretton Woods financial system would lead to huge global imbalances, and a credit bubble that would eventually collapse. Although he thought the factor that would push the world over the edge eventually was the dollar, his detailed analysis of this critical growth in credit, in his latest book, is helpful in understanding the banking industry's role in certain recent events. [ii]

Duncan analyses the role of Western governments in the modern economy, showing a significant level of detailed involvement, not just through the usual tax and spend policies, but also through monetary policy in the widest sense. With the consequent increase in credit at all levels, the resultant "system" he suggests, is not capitalism but "creditism", a system which is now broken. Unless you understand that "creditism" system you will never be able to properly modify it, regulate it, or fix it.

In the broadest sense then Western governments have been using monetary policy for a whole variety of political and social ends, with banks playing a crucial supportive/facilitating role in that effort.

In the US, and in some European countries, governments set out to make housing more available to more citizens. One policy measure was to ensure that housing finance was readily available, and that the cost of that finance was minimal. And so eventually you had the sub-prime mortgage scandal.

In the EU, "creditism" enabled various countries to finance persistent current account deficits, France being a prime example, to continue financing a welfare state that could not be paid for from current tax receipts and in a situation where looming and predictable demographic developments inevitably would require drastic action. This deficit spending generated destabilising flows of cross-border capital and an enormous increase in credit. These developments, usually routed through the banking industry, eventually led to massive increases in asset prices, especially house property. We know how that ended.

To achieve success in these critical socio-/political activities, Western governments have therefore been reliant on the full cooperation of the banking industry, with all that entails. Looked at in the widest sense, this effectively makes the banking industry an unelected and non-appointed arm of government. The outcome is massive power and no electoral or other real accountability. This is the ultimate nightmare for democratic societies.

7. The unique power of the banking industry and the growing "financialisation" of the modern world, has created a "caste" at the top of the industry which has the unique characteristics of almost full job security (akin to that in the public sector), combined with the ability to earn enormous sums of money normally only available to senior executives in the top companies in the private sector, and to certain governing elites in developing countries.

The unique and growing "financialisation" of the modern world, now broadly acknowledged, has, when combined with the unique power of the banking industry, produced a series of undesirable developments, now becoming increasingly obvious.

In a review essay in the July-August 2012 edition of *Foreign Affairs*, Gillian Tett, US managing editor of the *Financial Times* reviews three books addressing various aspects of these issues, and identifies many issues relevant to my argument. [iii]

One author, James K Galbraith[iv], drawing on meticulous academic research, argues that the main source of the increasing inequality across the world has been due to the "financialisation" of the world, and not industrial change, education reform or geopolitical shift. As Tett explains: "the dramatic growth of the financial sector in recent decades, amid a supply of excess credit from central banks and other sources, has allowed a tiny elite to become far wealthier than everyone else, particularly in the US. In part, the rich have got richer because excess credit pumps up the value of tradable securities, thus raising the paper value of their wealth. But the growing clout of finance has also strengthened their position by enabling banks to skim off more profits from the economy -"rents" - in economic jargon".

Tett notes that one thread that links all three book together, is what another author, Robert J Shiller[v],terms "caste." All three authors acknowledge that as the financial industry has grown in importance, it has created an elite that "not only wields wealth and power but also passes that privilege on to the next generation, thanks to educational stratification and social exclusion".

The third author, Charles Ferguson[vi], concludes that the US has become a country that "allows predatory, value-destroying behaviour to become systematically more profitable than honest, productive work" and that "the worst people rise to the top... behave appallingly, and ... wreck havoc." Tett notes that while this language might seem extreme on occasions, "the fundamental arguments are correct and should be heeded - and Ferguson is right to argue that the key policy question today is how governments will respond."

After making related policy recommendations, she notes: "Without such market discipline, it is impossible to have a proper market at all. But above all else, policy-makers must prevent powerful cliques of bankers and banks from dominating the system for their own ends, skimming off outsize margins because nobody else can work out what they are doing or because the barriers to entry are too high for anybody else to compete".

The power of this "caste" is always very evident when they are eventually, and very rarely, forced to resign. A respected British weekly magazine put it this way: "Resigning can be a retirement plan". [vii] The anonymous "Buttonwood" column noted that when bankers leave in awkward circumstances they "make out like lottery winners". This is because the bank may wish to avoid a lawsuit, or avoid unfavourable publicity, and because frequently the relevant government is "implicated" in the affair and does not want its own dirty laundry and the way things really work in the relationship between governments and the banking industry, exposed to public view.

The caste at the top of the banking industry therefore has the unique benefits of the job security of the public sector together with the bonanza-style payoffs of the worst excesses of the private sector, on the rare occasions they resign.

Conclusion

In conclusion when one fully appreciates the unique power held by the banking industry in the West today, the enormous leverage it has over Western governments due to the varied roles it carries out for them in core economic, political, financial and social activities, its risk maximisation incentive structures, its hybrid relationship of intermingled mutual co-dependency with many governments, and the existence of an ultra-powerful caste at the top of the industry, the conclusion must be that the Western banking industry should not be thought of as part of the private sector, but a unique sector all on its own, utterly separate from the public and private sectors.

It has achieved this unique status because it has been treated, thought of, and regulated as though it were a normal part of the private sector, whereas it is in fact is a hybrid, encompassing the worst characteristics and excesses of both, while increasingly being at the heart of many core economic, political, financial and social activities in the West. It is clearly truly unique, not at all a “normal” part of the public sector-private divide, but standing alone with supra-national powers and responsibilities that liberal democracies have yet to come to terms with, and which give it unique power in these circumstances.

Until this point is fully appreciated, and all the implications carefully considered, plans to restructure, reform, and regulate the banking industry in the West are likely to be seriously misdirected, if not quite dangerous. One can, however, arrive at one tentative conclusion in that regard at this point. It may be impossible to regulate the Western banking industry in any meaningful fashion until significant restructuring of its relationship with Western governments has been completed. That will not happen any time soon, I fear.

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