Why banking is an accident waiting to happen

By Martin Wolf

Published: November 27 2007 18:51 | Last updated: November 27 2007 18:51

Why does banking generate such turmoil, with the crisis over securitised lending the latest example? Why is the industry so profitable? Why are the people it employs so well paid? The answer to these three questions is the same: banking takes high risks. But the public sector subsidises this risk-taking. It does so because banks provide a utility. What the banks give in return, however, is gung-ho speculation.

Perhaps the most striking characteristic of the banking sector is its profitability. Between 1997 and 2006, for example, the median nominal return on equity of UK banks was 20 per cent. While high by international standards, this seems not to be exceptional. In 2006, returns on equity were about 20 per cent in Ireland, Spain and the Nordic countries. In the US they were a little over 12 per cent. Returns in Germany, France and Italy seem to have been close to US levels.

As Andrew Smithers of London-based Smithers & Co and Geoffrey Wood of the Cass Business School at the City University London note in a splendid report, from which I have taken these data, long-run real returns on equity in the US have been a little below 7 per cent.* Another study estimated the global real return on equity in the 20th century at close to 6 per cent.**

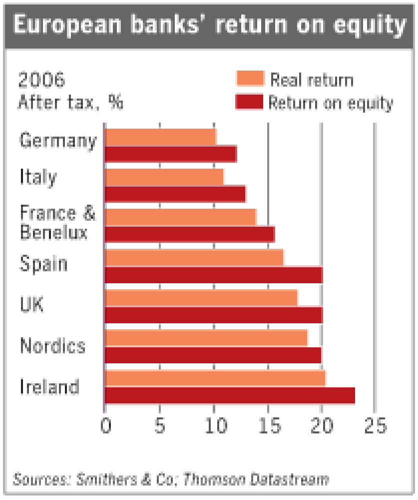
A starting assumption for a competitive economy is that returns on equity should be much the same across industries. If a particular industry earns two or three times long-run average returns for a while, one should expect an offsetting period when returns will be below that average. If the high returns are very high, as they are, the low returns are likely to be negative.

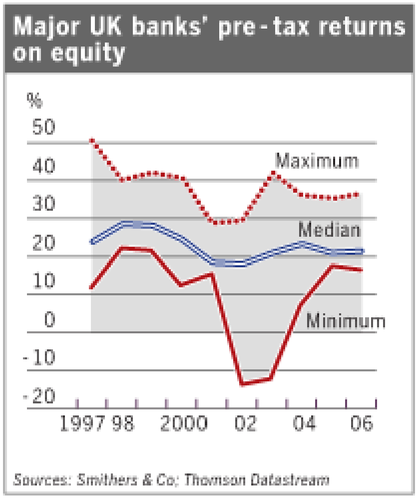
Yet banks are also thinly capitalised: the core "tier 1" capital of big UK banks is a mere 4 per cent of liabilities. If returns on equity become negative in a thinly capitalised business, many banks will become insolvent. The point can be put more tellingly: these high returns on equity suggest that banks are taking substantial risks on a slender equity base. But the slenderness of that base also means that insolvency threatens when bad times arrive.

How do banks get away with holding so little capital that they make the most debt-laden of private equity deals in other industries look well-capitalised? It can hardly be because they are intrinsically safe. The volatility of earnings, the history of failure and the strong government regulation all suggest that this is not the case. The chief answer to the question is that banks benefit from sundry explicit and implicit guarantees: lender-of-last-resort facilities from central banks; formal deposit insurance; informal deposit insurance (of the kind just extracted from the

UK Treasury by the crisis at Northern Rock); and, frequently, informal insurance of all debt liabilities and even of shareholders' funds in institutions deemed too big or too politically sensitive to fail.

Such assistance reduces the cost of the debt associated with any level of equity, since lenders know they are protected by claims on the state, as well as by the equity cushion. This, then, allows banks to take more risk. If things go well, shareholders earn exceptional returns. If they go badly, the downside cannot exceed their equity. Beyond that point, creditors and government share the losses.



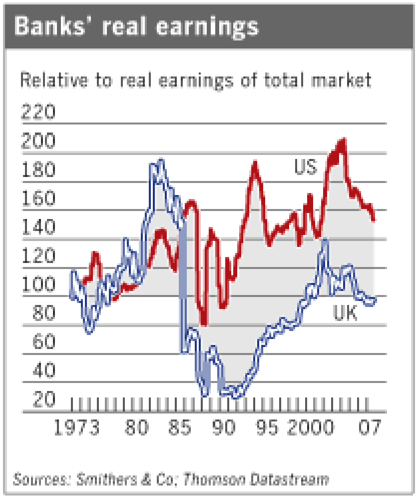


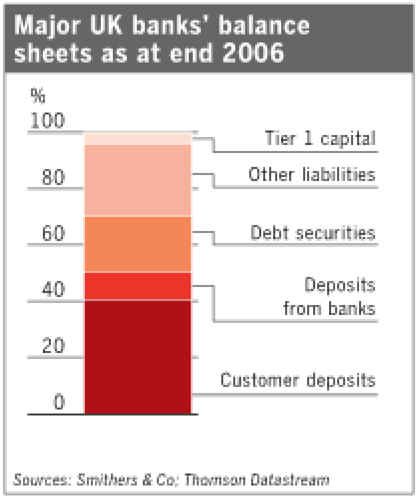
Governments are not totally stupid. They guarantee banks because the latter provide a social utility: a safe haven for money, and a payment system. But governments also realise that they are providing incentives for banks to economise on capital and take on risk. So governments impose capital-adequacy ratios, rules on risk management and (if they are sensible) liquidity requirements, as well. Unfortunately, these institutions are not only complex, but are staffed by single-minded and talented people. They go round regulations, just as water flows round an obstruction.

The result of this ingenuity includes "special purpose vehicles", hedge funds and even, in some respects, private equity funds. These are all, in varying ways, off-balance-sheet banks: ways to exploit the exceptionally profitable opportunities (and corresponding risks) created by high leverage and maturity transformation. Securitisation, to take a salient example, is a clever way to shift what would once have been bank loans on to the books of these quasi-banks, with the consequences we all now see.

Quite as important as the tussle between regulators and shareholders is that between shareholders and their employees. In an industry with long periods of high profitability, followed by massive write-offs, the ideal employment contract for the employee has high bonuses for short-term performance.

Assume, then, a run of profitable years in which shareholders receive high returns and employees are handsomely rewarded. Then comes the year of the locusts. Many employees may then lose their jobs. But since they do not receive negative pay, they are able to keep their earlier gains.





So what we have is a risk-loving industry guaranteed as a public utility. One result has been insufficient capital. That permits splendid returns in good times. But the capital may well prove inadequate in bad ones. The loss of capital could well lead to a tightening of credit in the years ahead.

If so, the structure and regulation of banking might have to be reconsidered, again. One possibility would be higher capital requirements. This would lower peak returns and so reduce the chances of subsequent negative returns. Mr Smithers and Prof Wood suggest a 40 per cent increase in capital for the UK. Other possibilities are measures to make regulation easier: narrow banking is an old favourite, although hard to make work. Henry Kaufman, a highly experienced observer of credit markets, suggests intense scrutiny of banks deemed "too big to fail".

What seems increasingly clear is that the combination of generous government guarantees with rampant profit-making in inadequately capitalised institutions is an accident waiting to happen - again and again and again. Either the banking industry should be treated as a utility, with regulated returns, or it should be viewed as a profit-seeking industry that operates in accordance with the laws of the market, including, if necessary, mass bankruptcies. Since we cannot accept the latter, I suspect we will be forced to move towards the former. Little can be done now. But when the recovery begins, we must impose higher capital requirements.

* 'Do Banks Have Adequate Capital?', Report 298, November 7 2007, www.smithers.co.uk <http://www.smithers.co.uk/> (subscribers only);
** Elroy Dimson and others, 'Triumph of the Optimists', Princeton University Press, 2002

martin.wolf@ft.com