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What is wrong with banking and what to do about it?

Prof. Dr. M. Shamsul Haque

Finance is considered as the life blood in modern economies where most transactions are monetized. Banks and the banking system provide the infrastructure on which the financial system, comprising flow of funds taking place in a country. And due to globalization of trade, investment and cross-border movement of people (labour, students, tourists and emigrants) the financial system has become integrated globally. That is why financial crisis happening in one country or region move to other countries through what is called a contagion effects. Such a financial crisis started in 2008 in USA following the sub-prime ending by banks to the housing sector.

In the preface to the book titled �The Bankers� new clothes: What is wrong with Banking and to do about it?� the authors Anat Adamati & Matin Hellwing wrote �In the Fall of 2008, it seemed obvious that radical reform would be needed. For more than a year, banks and financial markets had been in a state of crisis. Then in September, the entire financial system was about to collapse. One institution after another was failing or about to fail.� While the government and the central bank stopped the panic by massive bail funds, the economy �went into a decline of a magnitude unseen since the Great Depression� of 1930s.

Investigations by commissions in USA and UK were conducted. However, as the author pointed out while banks were at the core of the problem, debates did not go in the right direction on both sides of the Atlantic. The authors took up the challenge to expose the heart of the crisis by refuting the claims by banks & lobbyists� pressure that the status quo was ok and major reforms would be counter productive for economic growth.

The issue in the core of the debate and reform was related to the amount of equity capital should a bank hold to provide safety against risk of defaults on loans. Banks so far since the beginning of banking had created an impression that banks were different kind of business and unlike other businesses they should be allowed to operate with minimum of equity capital, not exceeding 10% and borrow the rest from depositors and other lenders. Technically known as leverage, the ratio of borrowed money over total assets. Leverage is estimated by the rules prescribed by the Basle Agreement II by the International Association of Bankers. At 10% of risks adjusted assets, then leverage would be 10. In fact when a 200 years old bank (Pehman Brothers) failed in 2009, its leverage was 40 times. That is, it had only 25% of equity capital and the 97.5% borrowed money. It collapsed and the government arranged for its take over by another bank after the government paid for the losses (fall in the value of the assets) out of tax payers money.

In the economic literature it is called as moral hazard as the action by governments to bail out reduce the rate of interest paid by banks to its lenders. �The interest that the company has to pay on its debt will not reflect its true default risk, because that is partly borne by the tax payer. From the perspective of the banks, therefore, borrowing is cheap� wrote the authors. Who benefits from this subsidy is not the borrowers of the banks, its clients those who use the money in productive investments. Actual gains are derived by the high flying executives (drawing compensation exceeding $ 1.0 million a year) and their employers the shareholders getting higher ROE much above risk adjusted rates. On page 120, the section titled: the More Equity and Lower ROE� is not what bankers want.

The authors claim that a simple rule of raising the share of equity capital to 20-30% can be effective as a tool for changing the reckless behavior of bankers to be sufficient to avoid too much risk taking with OPM. That will reduce the most difficult task of bank regulations unlike Dold-Frank Rule Book of 30,000 pages. In Europe there was a consensus to fix of ROE of 15% as it is set for some utility companies. The Basle III proposes to bring down Tier 1 Capital to 6% for risk adjusted assets. The CEO of Deutche Bank said he would like to get ROE of 25% before tax and the CEO of Barclays Bank announced in April 2011 that he was targeting a 13% ROE by 2013.

Whatever happens with bank regulation finally, it must be mentioned banks are primarily owned and managed by rich people and they have Political Cloud. They will continue to avoid policies that will reduce their high ROEs. It was noted by Paul Krugman, the Noble Prize winning economist that sheer greed from bankers and their owners have caused havoc to the economies in USA and UK, and other places.

Alternative forms of banking is emerging from Islamic Finance seems to offer a more workable solution, if it can be properly applied. A recent conference on Islamic Finance was held in London for the first time outside the Muslim Countries, a Sharia compliant Islamic Bond is being launched in UK is likely to be major source to finance some infrastructure projects. At the micro level the movement started with the Grameen Bank of Bangladesh is also spreading rapidly all over the world. Its founder Professor Dr. Yunus and the bank was awarded Nobel Prize for peace in 2006. Dr. Yunus now is upscaling from micro-credit to larger investments. A concept called as Social Business to solve targeted social problems in Bangladesh and other countries of the world.

Recently a book by a French economist Thomas Piketty has captured headlines all over the world. Named as Capitalism in the Twenty-First Century(2014) the book traced the sources of growing inequity in income and wealth in the western world over the last three centuries. The main thesis in the book is a simple equation r>g where r is the rate of return on capital and g is the growth rate in national income. Started with landed aristocracy in the 17-18th century the inherited wealth has been growing at 2-3% higher rate than growth in an economy. That process slowed down up to the first three quarters of 20th century. There after it has been growing due to financial globalization and changes in asset holdings. One can easily see that the structure of the banking industry has contributed to the growing inequality in income and wealth.

All these indicate that the traditional model of banking needs to be changed to be more inclusive and less as rich men�s club as it started long time ago. The sooner it happens, the better it is for humanity.

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