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Returning to Narrow Banking

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Bubbles and crashes have been part of financial markets for centuries. Allowing banks – which inevitably borrow short and lend long – to get deeply involved into financial markets is a recipe for disaster. The solution is to restrict banks to traditional, narrow banking with traditional oversight and guarantees while requiring financial firms involved in financial markets to more closely match the average maturities of their assets and liabilities.

There can be no doubt that a reform of the international financial system is necessary to avoid future crises. However, the G20 meeting in Washington on 15 November 2008, should also avoid an agenda that attempts to take on too many problems. The leaders need to focus on the essential problem – the international banking crisis and the factors that led to this crisis.

Banks' inherent instability

It is useful to start from the basics. Banks are in the business of borrowing short and lending long. In doing so, they provide an essential service to the rest of us, i.e. they create credit that allows the real economy to grow and expand. This credit-creation service, however, is based on an inherently fragile system. If the banks' depositors or lenders are gripped by collective distrust and everyone decides they want their money back, bank will go broke; the money is not there since the deposits were invested in illiquid assets. This is how a liquidity crisis erupts, setting in motion a devilish cycle of insolvency and new liquidity crises.

Repeal of stability regulation

We learned from the Great Depression that in order to avoid such crises we have to limit the risk-taking by bankers.

We unlearned this lesson during the 1980s and 1990s when the banking sector was progressively deregulated giving banks opportunities to seek high-risk investments. The culmination of this deregulatory movement was the repeal of the Glass-Steagall Act in 1999 under the Clinton administration. This ended the separation of the commercial and investment banking activities in the US – a separation that had been in place since the banking collapse in the 1930s. Repeal of the Glass-Steagall Act opened the gates for US banks to take on the full panoply of risky assets (securities,

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derivatives and structured products) either directly on their balance sheets or indirectly through off-balance sheet conduits.

Similar processes of deregulation occurred elsewhere, in particular in Europe, blurring the distinction between investment and commercial banks, and in the process creating ‘universal banks’. It now appears that this deregulatory process has sown the seeds of instability into the banking system.

The critical lack of a firebreak

Financial markets have, for centuries, been gripped by speculative fevers that have led to bubbles and crashes; bubbles and crashes are an endemic feature of financial markets. But financial market problems do not automatically affect banks. In the most recent crisis, bubbles and crashes would not have been a major problem had banks not been involved so deeply in financial markets. Banking sector deregulation, which started in the 1980s, is what exposed the banks so catastrophically to the speculative dynamics inherent in financial markets. Banks’ balance sheets became the mirror images of bubbles and crashes occurring in the financial markets. An explosive cocktail of credit and liquidity risks was created that was waiting to explode.

The failed Basel approach

The Basel approach to stabilise the banking system is based on an attempt to model the risks that universal banks take and to compute the required capital ratios that will minimise this risk. This approach is unworkable because the risks that matter for universal banks are ‘tail risks’, i.e. events that are extremely rare but extremely large, such as the nationalization of AIG or Lehman being allowed to go broke. The cost of such events cannot be exactly quantified because they are so rare.

The only workable approach to ensuring bank stability

This leaves only one workable approach: a return to narrow banking in which the activities banks can engage in are narrowly circumscribed. In this approach banks are excluded from investing in equities, derivatives and complex structured products. Investment in such products can only be performed by financial institutions, investment banks, which are forbidden from funding these investments by deposits (either obtained from the public or from other commercial banks).

In a nutshell, a return to narrow banking could be implemented as follows:

Financial institutions would be forced to choose between the status of a commercial bank and that of investment bank. Only the former would be allowed to attract deposits from the public and from other commercial banks and to transform these into a loan portfolio with a longer maturity (duration). Commercial banks would benefit from the lender-of-last-resort facility and deposit insurance, and would be subject to normal bank supervision and regulation.

The financial institutions that do not opt for commercial bank status would have to ensure that the duration of their liabilities is on average at least as long as the duration of their assets. This would imply, for example, that they would not be allowed to finance their illiquid assets by short-term credit lines from commercial banks.

International coordination to avoid a classic, regulatory race-to-the-bottom

A return to narrow banking can only occur if it is embedded in an international agreement. This is where the G20 comes into the picture.

When only one or a few countries return to narrow banking, the banks of these countries will face a competitive disadvantage. They will lose market shares to banks that are less tightly regulated – a result that would provoke forceful lobbying against the restrictions. In the end, the governments of these countries will yield and the whole process of deregulation will start again.

A comprehensive international agreement will be necessary to remodel the banking systems and to separate commercial banks from investment banking activities. This is what a Bretton Woods II conference should focus on.

Clearly there are other desirable reforms, such as providing better incentive structures for bank managers and rating agencies, or a better representation of emerging countries in the IMF. The focus of Bretton Woods II, however, should be to reform the banking system so that it does not get involved in bubbles and crashes that are endemic to financial markets.

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As early as April 2006, with the publication of *A world out of balance?*, CEPS provided an analysis of the forthcoming problems by diagnosing a bubble in real estate markets. See *A world out of balance?*, Special Report of the CEPS Macroeconomic Policy Group, Daniel Gros, Thomas Mayer and Angel Ubide, April 2006.