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# FINANCIAL NEWS



## Systemic risk control: it's up to the banks

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**After two years of effort, the US [Congress](#) last week gave [President Obama](#) a massive and very ambitious financial reform bill, the Dodd-Frank Act, to sign.**

The 2,300 page law in 15 sections affects all financial service activities in various ways but it does little to improve systemic risk control. It strengthens the hands of regulators, but relies on them entirely to identify and avert future crises, things they have not been successful in doing in the past.

Too-big-to-fail financial firms (those with more than \$50bn of assets, of which there are about 40 in the US) are largely left alone, free to be as large and complex as before.

However, if one of these financial firms faces a liquidity crisis in the future, which is likely given their aggressive business strategies, rescuing it with taxpayer funds to avoid a systemic crash will be much more difficult. Precluding bailouts when they are necessary will severely limit the government's ability to manage the next crisis.

To implement the reforms, several different regulators will have to write hundreds of new implementing rules, and allow time for them to take effect. It will therefore take at least three years to know the actual impact of the new law on firms and markets. There is room for some surprises in this, though industry lobbyists are doing their best to minimise them.

Ironically, the bill requires an 18-month study of the "effects of size and complexity of financial institutions on capital market efficiency and economic growth" to be made after the law has been enacted. Also, Congress passed the bill without hearing from its own [Financial Crisis Inquiry Commission](#), which was appointed a year ago to determine the causes of the breakdown and is still conducting hearings.

For all the law's faults, the US Government was pleased to point to it at the recent [G20](#) meeting in Toronto as an example of timely and comprehensive post-crisis regulatory reform, something the European Union has failed to accomplish.

European efforts in response to the crisis so far seem to be limited to imposing restrictions on cash

bonuses, requiring stress-tests on 91 large banks (18 months after the US Treasury did so), arguing about bank taxes, and awaiting (in two or three years) the forthcoming Basel III revised capital adequacy standards, which major banks are already lobbying fiercely to restrain.

European banks, which comprise 30 of the world's 50 largest banks by assets (there are only six from America) are generally thought to be undercapitalised relative to the risks on their balance sheets (and the accounting principles used to report them), so Basel III may bite deeply, requiring substantial new capital to be raised. Presumably this will occur after the results of the stress tests are released later this week.

So, on both sides of the Atlantic, after a lot of talk and promises, the financial system will soon reset to the status quo ante – banks will have replaced the capital they lost during the crisis, and added a bit more as a buffer, but may continue in much the same businesses as before, subject to additional regulations and costs, but otherwise leaving the control of systemic risk generally unchanged.

That sounds discouraging, but at this point, two things may happen to lessen the chances of a repeat financial crisis.

One is that governments continue to provide significant regulatory cost disincentives to the largest banks so they have an economic motivation to make themselves smaller and less risky. The implementation and compliance costs of the reforms will be considerable.

Charging a fee for implicit liability insurance through a bank tax as has been done in the UK (to be paid by all the top global players operating in London) will also help, as will tightening the Basel III standards if they are raised high enough. Such steps lower the return on equity of the major banks and increase their cost of capital, thereby encouraging them to reduce assets held under the now too-costly too-big-to-fail umbrella.

The other is that market forces reward these banks with higher stock prices for restructuring themselves into smaller, more competent and less risky firms. This would recognise two things that academic observers have known for years – that there has been no evidence that very large banks achieve any economies of scale or scope, and that conglomerated companies are often worth less than the sum of the market values of their parts.

Many bank analysts have known for some time that the merger-driven, “big balance sheet,” universal banking business model has never achieved the value for shareholders that their well-paid managers promised. With large banks' share prices now trading at or below book value, it surely is time to rethink the business model.

Most large banks should dump their principal trading (and investing) and alternative asset management businesses and, in some cases, their entire investment banking activities to revert to being large, steady high-street banks.

This strategy worked very well for [Citicorp](#) in the early 1990s after the bank had taken a pounding from overly aggressive lending and [John Reed](#), its chairman, announced that the bank would drop its wholesale business altogether to avoid repeating the mistake.

The strategy might work again for [Citigroup](#), [Bank of America](#), and [Royal Bank of Scotland](#). Others may prefer to focus on being effective lenders, underwriters, distributors and marketmakers to the global wholesale finance market after spinning off their main trading businesses to the hedge fund community where they might be worth more and would not involve conflicts with clients.

Revenues may decline, but so would balance sheets, capital requirements and the ongoing risks of trading losses, conflict-of-interest litigation, regulatory penalties and reputational damage. A bank

specialising in essential investment banking services ought to have a future as a large market-share, global player with predictable profitability and a price-to-book ratio of two or more.

There is a lot of inertia resisting such changes, but with both positive and negative incentives, some will try restructuring and maybe others will follow. If so, systemic risk could be substantially redistributed.

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