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King puts spotlight on banks too big to fail

Iain Dey, Dominic Rushe and David Smith

Mervyn King chooses his words carefully. So when the Bank of England governor said in his Mansion House speech last week that banks should not be allowed to become too big to fail, he knew what he was doing.

His comments on his lack of weapons to force changes in bank behaviour and his musings on whether Britain's banking sector had become too big for the economy were also well rehearsed.

He insists he was not starting a battle with the Treasury or making a crude grab for more powers. He was interested in generating a debate on the future of banking and how it is policed, and there was no better place to do this than at one of the City's great occasions.

That debate has further to run. Alistair Darling, the chancellor, while playing down differences with King, will publish the government's proposals on regulation over the next 10 days, drawing heavily on Lord Turner's recent report for the Financial Services Authority.

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However, it was King's remarks on the size of banks, and whether governments can provide guarantees against the failure of large banks that "combine high-street retail banking with risky investment banking or funding strategies" that caused most controversy.

Anyone who wants to see the full impact of what can happen when banks grow too big for their economies need only look at Iceland. When the bubble burst, Icelandic taxpayers were asked to pick up the tab. Now the country is living on loans from the International Monetary Fund, which is enforcing savage cuts to public services.

Iceland's banks were bigger than the economy by a considerable factor, but in the international context they were small.

Most banking analysts insist the credit crunch has thrown up no evidence to prove that bigger institutions are more likely to fail. If global regulators had drawn up a list of systemically important institutions, Northern Rock would not have been on that list. Yet the queues outside its branches did more to dent consumer confidence and the international perception of Britain's financial strength than the subsequent failures of HBOS and Royal Bank of Scotland (RBS).

"There has been no correlation between banks failing and their size," said one bank analyst. "Dunfermline [building society] was tiny yet it failed – and was saved. Northern Rock and Bradford & Bingley were in the middle. RBS was huge but only failed because it bought ABN Amro. Restricting the size of banks would not stop them failing. Paying more attention to what they do would be more effective."

Swiss regulators last week warned they would consider curbing the size of their two big banks, UBS and Credit Suisse. Switzerland, with a long-established role in the international financial community, will not allow itself to become the next Iceland. Nor is it likely to score an own goal by sitting back and watching while banks in other countries start making big money again, leaving Switzerland in their wake.

If banks were to be limited in size by the size of the economy in which they operated, serious international banks would simply move headquarters to America or, in time, China, India or Brazil.

"King seemed to make a quite direct attack on Barclays last week, when he spoke about the need to separate investment banking from retail banking," said one senior banker.

"What he doesn't understand is that by the time a new government or regulator is in a position to introduce any new rules, Barclays is likely to be one of the biggest investment banks in the world, run primarily from America.

"By this time, John Varley [Barclays' chief executive] will have his knighthood for keeping the bank out of state hands. Would King really want to force it out of the country?"

Banks such as Barclays and Deutsche have managed to avoid

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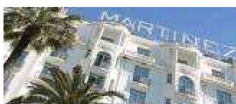

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state ownership thanks to profits generated by their investment banks, even as bad debts on traditional loans have soared.

Bank of America /Merrill Lynch, the universal bank created by the American authorities on the same weekend last September that Lehman Brothers collapsed, also disproves the logic. While losses in Merrill's investment-banking business forced it into the deal, it is now the Bank of America business that is in greater difficulty.

That is food for thought for President Barack Obama who has been trying to reshape America's system of banking regulation. He inherited the biggest financial meltdown since the Great Depression and has staked his presidency on clearing up the mess. Last week he began to outline his grand plans to sweep aside a "culture of irresponsibility" that had taken root "from Wall Street to Washington to Main Street".

Obama's plans were launched with a 13-minute presidential statement in the White House, in which he called for "a sweeping overhaul of the financial regulatory system, a transformation on a scale not seen since the reforms that followed the Great Depression".

The plan aims to give the Federal Reserve the authority to police all financial institutions – not just banks – whose failure could threaten the financial system. The lightly regulated hedge-fund industry would also be compelled to register with the Securities and Exchange Commission and a new agency would be created to safeguard consumers. The proposals mark the end of an era when self-regulation was the preferred route which, critics claim, led to the credit crisis and the disasters at AIG, Bear Stearns, Citigroup and others.

"Every financial crisis of the last generation has sparked some effort at reform. But past efforts have begun too late, after the will to act has subsided," said Tim Geithner, Obama's Treasury secretary. "We cannot let that happen this time."

Obama's critics, however, are already arguing that the reforms give too much power to the Fed. "This represents a grossly inflated view of the Fed's expertise," said Republican senator Richard Shelby.

Charles Geisst, author of Wall Street: A History, said that given the public outcry over the financial crisis he was surprised by how "toothless" the proposals seemed. He said it was too early to see how the legislation would pan out. "The thing about American financial legislation is that you really have to wait until the final vote."

Others said there was much to admire in the plan. Gus Faucher, director of macroeconomics at Moody's Economy.com, the financial data firm, said today's financial crisis was very different from the Great Depression. "Things were much worse then than they are now," he said, broadly welcoming Obama's moves.

"Regulation has been very scatter-shot and not very effective," he said. "The nonbank financial institutions have become much more important. We saw that with AIG. The problem is not that they make mistakes and they fail. The problem is that they have knock-on effects for the wider economy. I think there is a recognition that we need to look at systemic risk."

Some see the proposed changes as window dressing, warning that they would not have prevented the current crisis. "I'm not someone who says we should do nothing. I think we need to make some big changes," said Mark Calabria, director of financial regulation studies at the free-market Cato Institute in Washington. "The big question is if this package had been in place seven or eight years ago, would we be in any better position now? I think the answer is no."

He said the proposed changes set a bad example globally and that Britain and Europe were likely to follow suit and extend their safety nets. "It's a race to the bottom in terms of policy," said Calabria.

It is a race that has a long way to run, in America and Europe. Gordon Brown spent two days last week in Brussels, fighting proposals to bring financial regulation under European Union control.

The prime minister won one battle: the EU will not be able to force national regulators to rescue troubled institutions but there are plenty more to come before decisions are reached in the

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HAVE YOUR SAY

King has failed in his judgement on a number of important decisions, and his job is too big for a failure.

David, London,

It is not that smaller institutions will not fail, but when they fail, it is easier to clean up. We have all seen what failure of bigger institutions has given us.

Arun, Reading,

You have to let them go bust, split up and sold up! Or banks will not care and let the goverments prop them up and look for hand out. Let the markets decide if they are not worth investing in!

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