vox

Research-based policy analysis and commentary from leading economists

Destabilising market forces and the structure of banks going forward

Arnoud Boot

25 October 2011

The financial sector has become increasingly complex in terms of its speed and interconnectedness. This column says that market discipline won't stabilise financial markets, and complexity makes regulating markets more difficult. It advocates substantial intervention in order to restructure the banking industry, address institutional complexity, and correct misaligned incentives.

The financial services sector has gone through unprecedented turmoil in the last few years. We see fundamental forces that have affected the stability of financial institutions. In particular, information technology has led to an enormous proliferation of financial markets, but also opened up the banks' balance sheets by enhancing the marketability of their assets. As a matter of fact, a fundamental feature of recent financial innovations – securitisation, for example – is that they are often aimed at augmenting marketability. Such marketability can augment diversification opportunities, but it also creates systemic risk via herding behaviour and interconnectedness.

More fundamentally, when markets exist for all kinds of real and financial assets of a firm, a firm can more easily change the direction of its strategy. This might be good, but could also lead to more impulsive decision making and possibly herding. The latter refers to the tendency to follow current fads. In banking, herding is particularly worrisome because it could create systemic risk – meaning, when all institutions make the same bets, risk exposures become more highly correlated and a simultaneous failure of institutions might become more likely.

We see the complexity of the financial sector (the fluid nature of the sector and difficulties in timely intervention by supervisors) and the systemic risk that has mushroomed as the two key issues that need to be addressed. Endogenous developments in the industry itself may not lead to less complex institutions. Market discipline – as we will argue next – also cannot be expected to be effective. The important question then is how to deal with this complexity. We will argue that imposing structural measures on the business models of banks might be needed to contain possibly destabilising market forces and improve the effectiveness of supervision.

Failure of market discipline adds to destabilising market forces

The increasingly fluid and complex nature of the banking industry – via speed of change, interconnectedness, and the presence of large and complex institutions – has motivated some to point to the importance of market discipline in banking as a supplement to regulatory and supervisory controls. But can we expect that markets will control the behaviour of financial institutions? We see a paradox in the notion of market discipline. The opportunistic behaviour that we pointed at is driven by banks engaging in particular financial market-driven strategies. Those strategies are heavily promoted by momentum in the financial markets that typically mushrooms in euphoric times. Financial markets more or less encourage banks to (opportunistically) exploit them.

But now the paradox. In the way we have formulated the argument, financial markets that are supposed to engage in market discipline are momentum-driven, and hence encourage banks to engage in specific activities. How then can we expect these same markets to impose market discipline? It appears to us that market discipline is not present when banks follow financial market-inspired strategies. Things are even worse because the correlation in strategies between financial institutions will then be high because all see the same opportunities and hence we see herding behaviour. Systemic risk would be enormous and not checked by market discipline.

It follows from this analysis that, from a macroprudential view (*ie* a system-wide view), market discipline is not effective. This supports Flannery's (2009) analysis that in the summer of 2007 neither share prices nor CDS spreads provided information about pending problems. We tend to conclude that market discipline might more readily work for idiosyncratic risk choices of an individual financial institution (*ie* across institutions) than for the choices of the sector as a whole. In the financial sector with the correlated strategies induced by momentum in financial markets, market discipline seems ineffective.

Complexity does not help: Forces towards scale and scope (and complexity)

With market discipline being ineffective, and complexity (speed of change and interconnectedness) complicating the effectiveness of regulation and supervision, the question is how to improve control over financial institutions. Can it be expected that the structure of banks becomes simpler? While the current statements in the industry might suggest that institutions 'go back to basics', *ie* reduce organizational complexity, focus, and simplify product offerings (KPMG 2011), we expect that size will continue to be a driver in the industry.

Whether size really offers scale or scope economies is a totally different question. Research on this remains rather inconclusive, or in the words of Richardson, Smith and Walter (2011): "Indeed, the recent studies mirror the findings [...] some 15 years earlier [...] there was no predominance of evidence either for or against economies of scale in the financial sector." But banks might benefit from the protection that size gives. That is, by going for size banks might capitalize on too-big-to-fail, or rather too-interconnected-to-fail, concerns.

Dealing with complexity

From a regulator's perspective, complexity worsens externalities that one might want to contain. Complexity may also put bank supervisors in a dependent position; *eg* how is timely intervention possible if the complexity of the institution cannot be grasped by supervisors? And a complex financial institution may have many linkages with the financial system at large that are difficult to discern. This may augment concerns about banks being too big, or rather too interconnected, to fail.

One is tempted to conclude that one way of dealing with the complexity is to disentangle activities and put them in separate legal structures ('subsidiaries'). Those subsidiaries could deal on an arms-length basis with each other, with each being adequately capitalized without recourse to each other. This would resemble the non-operating holding company structure that the OECD has promoted in some studies (Blundell-Wignall *et al* 2009). With such a structure supervisors could possibly more easily (and more quickly) target, *ie* rescue, systemically important parts of a financial institution in case of distress; other parts could be sold or dismantled.

One could also choose a more radical approach and force a bank to break up or limit its range of activities. Actually, the UK government's Independent Commission on Banking, the Vickers Committee, advocates some structural remedies, particularly 'ring-fencing' the more locally oriented retail-banking operations. In terms of actually implementing new policies, the US appears to be in the lead with the Volcker Rule (part of the Dodd-Frank Act) that seeks to prohibit the involvement of banks in proprietary trading, and limits their investments and sponsorship in hedge funds, private equity and derivative activities.

We see the safeguarding of core-commercial banking functions (like the payment system) and the improvement of possibilities for timely intervention as key public policy objectives. From a policy perspective it is then hard to defend the desirability of very complex institutions considering the difficulty of timely intervention in such institutions. And more limited commercial banking institutions without much exposure to the financial markets and primarily financed by deposits (contrary to less stable wholesale financing) might be better at safeguarding core-commercial banking functions.

What to do?

We do not believe that it is sufficient to only introduce behavioural measures like higher capital requirements. These are undoubtedly needed, including also more system- and cyclical-oriented measures focusing on externalities and interlinkages, but they do little to address the complexity of institutions and the misalignment between market forces and prudential concerns. Instructive in this regard are the counterproductive incentives that higher capital requirements might induce, *eg* banks might choose to increase their risk exposure following higher capital requirements in order to preserve a high return on equity over this broader capital base (but note, return on equity does not measure nor control for risk and is therefore not the right measure to look at[1]).

We believe that heavy-handed intervention in the structure of the banking industry – possibly building on the work of the OECD, Volcker Rule and the ring -fencing advocated by the UK Independent Committee on Banking – is an inevitable part of the restructuring of the industry. It could address complexity but also help in containing market forces that might run orthogonal to what prudential concerns would dictate – as the insights on market discipline suggest. How to precisely shape the structural measures is an open issue. All proposals currently on the table can be criticized. But safeguarding essential public infrastructure is a laudable objective, and the structure needs to be such that supervisors can have control. The proposals by the UK Independent Committee on Banking seem consistent with this and thus deserve support. This does not mean that such a solution is sufficient. The interlinkages between the ring-fenced parts and the rest, and the way the rest operate, need to be focused on as well. We do not believe that there are simple remedies, but we are convinced that we need to find new 'fixed points' in the financial system; not everything can be fluid.

References

Blundell-Wignall, A, G Wehinger, and P Slovik (2009), "The Elephant in the Room: The Need to Deal with What Banks Do", *Financial Market Trends*, 2009 (2): 1-26.

Flannery, MJ (2009), "Market Discipline in Bank Supervision", in Berger, AN, P. Molyneux, and JOS Wilson (eds),*The Oxford Handbook of Banking.* Oxford: Oxford University Press.

KPMG (2011), "UK Banks: Performance Benchmarking Report. Full Year Results 2010".

Richardson, M, RC Smith and I Walter (2011), "Large Banks and the Volcker Rule", in Acharya, VV, TF Cooley, MP Richardson, and I Walter (eds), *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance*. Hoboken NJ: Wiley.

---

[1] Obviously, corporate finance theory tells us that the cost of capital of a bank is not fixed (this is in corporate finance a risk-dependent measure). Return on equity (ROE) is a measure that is not risk-adjusted. It therefore cannot be that maximizing ROE is value-maximizing. Doing as if the cost of capital of a bank is fixed at a high level might induce banks to engage in excessive risk-taking.

Topics: Financial markets, International finance
Tags:

Comments