Squaring the circle of financial intermediation

Czech National Bank vice-governor Mojmir Hampl, who is also a member of the European Union’s economic and financial committee, is concerned by the perfectionists who are out in force on the regulation front.

If the ancient geometers were watching the current debate about appropriate future regulation of the financial sector, they would probably see a strong analogy with the age-old, logically impossible task of squaring the circle.

Many participants in the financial regulation debate now have the ambition to create a future financial sector that will be perfectly efficient, perfectly safe for savers or investors and will never require life support from taxpayers as a result of moral hazard behavior.

In this ideal world, financial institutions are innovators, providing their clients with cheap services and smooth, growth-enhancing maturity transformation, while nobody ever has to worry about their investments and deposits and taxpayers never have to pick up the bill.

There is no doubt that we would all love to have a financial sector that fully meets all these criteria.

Alas, in reality we can hardly achieve all these objectives at the same time. We can have an efficient financial sector which fuels economic growth and in which savers and investors need not worry much about their funds – but then the sector will inevitably exhibit moral hazard, resulting sometimes in a necessity for the public to pick up the tab. Or the financial sector can be efficient and never require any public action – but then savers and other investors in this not-perfectly-safe sector will simply lose a lot of money now and again. Finally, we can tame the sector into a creature that is safer for both savers and taxpayers. But this creature will be little more than a cash-vault, far from competitive, efficient, and growth-enhancing.

Of course, in reality we must always find an equilibrium between all of these principals.

But does the current debate give a promise of finding a better equilibrium for the future? Not necessarily, I am afraid.

Politicians fail to grasp that financial intermediation has been and always will be inherently fraught with problems of asymmetric information and risk. In front of their audiences they pretend that it is possible to eliminate the problem of risk once and for all. They claim that while there have been many crises and many attempted solutions before, “this time it is different” and they really have a solution that will please all the main stakeholders for good.

Therefore, instead of waiting for a detailed, careful, and quantified analysis of what exactly went wrong, where, when and why, commentators, journalists, academics, politicians, bureaucrats, and others have rushed to offer numerous measures, often without thinking through all the details and combined consequences. For instance, some say “let’s focus on systemically important banks” without saying how to define systemically important institutions ex ante in a dynamic world.

Others say “let’s ban overly big banks” as if the supervision of a herd of small banks is easier than the supervision of a few big ones, or as if in times of systemic crisis saving dozens of small banks is easier than saving a couple of big ones, and so on.

The list of suggestions is much longer: altering the accounting rules, requiring banks to have more capital and bigger liquidity cushions, dynamic provisioning, charging banks a new tax or levy, micromanaging remuneration in financial institutions (by the way, were the remuneration rules contained in the EU’s updated Capital Requirements Directive to be applied to central banks, it would definitely be seen as an attack on their independence), forbidding them to do certain operations, tightening the screws even on institutions – such as private equity and hedge funds – which have played only a minor role in the crisis, and so on and so forth.

Many of the suggested measures go clearly in the direction of the public sector having more say – as if the government having more say is a guarantee of more appropriate management.

A quick look around the globe shows, however, that the government often fails to do its primary job of managing public finances well and also supervising the financial universe well.

The two most often debated problems have been the pro-cyclicality of the Basel II capital requirements regulation and the tendency of financial markets to form bubbles. However, the very regulatory debate seems to be subject to pro-cyclicality and bubbly behavior: in good times it is slow and relaxed, while in bad times it goes much too far much too quickly. The same applies to supervisory initiatives.

Three new pan-European agencies, so-called ESAs, are to be established in addition to the European Systemic Risk Board, based on the principles articulated in the de Larosière report; the powers of colleges of supervisors are to be increased; the working group led by the Swedish central banker Lars Nyberg has suggested the compulsory establishment of Cross-Border Stability Groups in the EU and so on. It almost looks like national-level authorities will participate in an intricate web of EU-level regulatory and supervisory committees, boards, and agencies, while having less and less time to do their real job, that is, supervising their respective financial sectors.

In short, there is a risk that the world will end up implementing an uncoordinated and poorly thought out sum of many measures, leading to clear regulatory overkill.

The bundle of reforms gravitates toward a financial sector that will resemble a classical public-goods-providing “utility,” a sector attracting little capital and thus shrinking and becoming uncompetitive, while having less and less time to do their real job.

We seem to be heading for less banking and less financial intermediation and thus less efficiency in the economy as a whole.

Do we want to pay such a high price for the crisis and subsequent regulatory madness when we know for sure that we can never have a perfect financial sector anyway?