Fading political will has let banks off the hook

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By John Plender
Published: June 26 2009 19:25 | Last updated: June 26 2009 19:25

In London, the adventure playground of the global financial system until the financial crisis struck, banks such as **Barclays** and Nomura are once again energetically **hiring** and poaching staff. As in New York, trading profits are up and bonuses are back. At government-controlled **Royal Bank of Scotland**, they are back with a vengeance. Many in Westminster feel the new £9.6m ($16m, €11m) pay package for **Stephen Hester**, chief executive since November, smacks of the pre-crisis era.

Certainly, the mood among financiers is suddenly more cheery. There is also a growing suspicion on both sides of the Atlantic that bankers, a lethal breed whose activities have pretty much throttled the global economy while causing government deficits to balloon, are going back to business as usual – a frightening prospect for taxpayers everywhere.

What is so extraordinary about this new bankerly optimism is that it comes despite the financial crisis remaining unresolved after nearly two years of grief. The lack of trust in markets is such that central banks are still having to step into private bankers' shoes to keep funds flowing.

For all the numerous initiatives by the authorities in the US and Europe, the value of much toxic paper in the system is still uncertain. Moves to soften mark-to-market accounting rules, which required assets to be written down to realistic values, have raised the risk of creating "zombie" banks that live on despite being insolvent. That was the syndrome that gave Japan its lost economic decade.

Perhaps most worrying of all, it looks as though the political will to secure a strong regulatory response to the crisis is waning. The Obama administration's reform proposals last week shuffled institutional deckchairs and gave more power to the **Federal Reserve** despite its signal failure to do its regulatory stuff during the credit bubble. There were worthy plans for this and that. Yet the result of all the bail-outs and mergers is still a higher degree of concentration in banking, which does nothing to mitigate the systemic threat from outfits that are too big or too interconnected to fail.

The likes of **JPMorgan Chase** and **Goldman Sachs** will continue to reap fat profits from opaque over-the-counter trade in credit default swaps and other derivatives. The stronger banks, while preparing to release themselves, from government guarantees, are bent on pursuing business models that are not dramatically different from those they adopted before they foundered.

In the UK, Mervyn King, governor of the Bank of England, has strongly urged that the casino element of the banking system be separated from the conventional borrowing and lending business that enjoys the benefit of deposit insurance and the Bank's support as a lender of last resort. Lord Turner, his counterpart at the Financial Services Authority, has a more nuanced position. In his recent review of the regulatory system, he said: "Serving the financial needs of today's complex globally interconnected economy ... requires the existence of large complex banking institutions providing financial risk management products which can only be delivered off the platform of extensive market-making activities, which inevitably involve at least some position-taking."

He also questions whether it is realistic to think that high-risk trading activity could exist outside the utility-type banking sector and be subject to pure market discipline in a world of interconnected markets. Bear Stearns had no utility-type business but the US authorities still recognised that it posed a systemic threat when it ran into difficulty.

Alistair Darling, the UK chancellor of the exchequer, appears to be on **Lord Turner**'s side in this argument. He is also proposing to pass some of the Bank of England's responsibility for financial stability to the FSA. The outcome is that re-regulation in the UK will fall short of radical.

In the European Union, meanwhile, the regulatory response has been lopsided, directed as much at hedge funds and private equity firms, which posed little or no systemic threat in this crisis, as at banks. This no doubt reflects the perennial Franco-German desire to knock British finance.

Why is it that the bankers suddenly appear to be off the hook? One answer is that the monetary remedies for the financial crisis create the potential for trading profits by reducing the banks' cost of funds. While this appears offensive to ordinary people, it is nonetheless desirable, because it recapitalises banks via the back door.

But the less-than-draconian regulatory response represents a triumph of lobbying power, especially in the US where investment banks have been highly persuasive in Washington and have made full use of a deeply flawed campaign funding system.

In the UK, the government is still taken with the notion that Britain has a valuable comparative advantage in finance that should not be thrown away lightly, though the advantage seems questionable in the light of the damage finance has wrought on the economy. More generally, the complexity of the financial debacle is such that it has been hard for policymakers to find a firm response other than through changed regulatory architecture and the broad brush of capital adequacy requirements for banks.

There remains the possibility that, when the global economy and the banking system pick up, more swingeing capital requirements than expected will make banking more like a utility. But for the moment we are all saddled with huge public sector debts, courtesy of the bankers, while confronting what promises to be a very anaemic recovery. Against the background of unresolved global imbalances, there must be a possibility that with bankers once again at play, the financial system will return to chaos in the not too distant future.

The writer is an FT columnist and chairman of Quintain plc