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Retail and investment banking must be separated

In a few weeks we will celebrate the fifth anniversary of the financial crisis that has engulfed the world. Banks and financial companies were at the heart of the crisis and were exposed as institutions that pose serious danger to the public and society at large.

Over the past five years numerous laws and regulations have been enacted to better try and control the financial industry. But is the world a safer place?

The Weekly Courier[i] believes that this effort has largely been unsuccessful.

Analysis of what went wrong has been classified into five categories:

1. Excessive bonus systems
2. Focus on short term returns
3. Many banks had both investment and retail divisions
4. Light touch regulation
5. Accounting standards

Policymakers have reacted to the crisis by pushing regulation and regulating authorities. They have also come down hard on the bonus culture and demanded lower leverage of banks and financial institution,

Indications are that the Bonus culture is again on the rise as banks relentlessly push for higher wages for their employees.

Most financial institutions have reacted to regulatory scrutiny by centralizing loan decisions. More and more loans are granted on a numerical basis. Loan officers are far removed from customers and very little thought is given to qualitative aspects of loans - which often are more important than numbers to ensure repayment. Loans to small and medium enterprises which form the backbone of the economy have been severally reduced.

More regressive audit rules have been enforced that make banks financial statements more truthful and this is a good thing although there are areas such as derivatives trading that will remain grey areas for the foreseeable future.

Yet, the main problem causing all financial crises in the past thousand years has been speculation. Speculation is almost always been fuelled by lenders. The current crisis was mainly caused by investment banks by availing too much money for speculative investment. More aggressive investment banks even undertook massive speculative bets using their own balance sheets and equity.

It remains fiendishly difficult to see when a bank is assisting a client in hedging their regular activities such as forward buying of currency or taking a naked bet with its own equity.

Retail banks are essentially, on the one hand, long-term, relationship building companies, which serve as mitigators of risk within economies. Investment banks, on the other, are institutions with short-term agendas. This is typically reflected in the institutions' liabilities.

In the early stages of the crisis it looked like the two would be forcefully separated. Banks have lobbied relentlessly against this. Some of them have even demonstrated that they cannot survive without investment and fee income. Policy makers have dithered as banks still pose a systemic risk to society.

Until regulators separate retail and investment banking, banks and financial companies will continue to pose major risks to the public and society.

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[i] The Weekly Courier is a weekly newsletter published and issued privately to stakeholders of Arev and related entities.