Unnatural selection

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Wall Street and the City of London survived thanks to state support. Now they need to be weaned off it

"WE HAVE a long track record of pulling together when times are tough…We're on the right track." Thus spoke the boss of Lehman Brothers on September 10th 2008. Within five days Lehman had gone bust and it quickly became clear that the world's financial system had problems far beyond a single badly run investment bank and temporarily frozen credit markets. After two decades of expansion and deregulation, and the greatest bull market finance has ever known, many of the world's banks were dangerously undercapitalised. Governments were forced to step in, providing capital, loans and guarantees to banks. In America, the euro zone and Britain the sums involved so far amount to about one sixth of GDP.

A year on from Lehman that still looks like the right call. After the crash in 1929 America's economy shrank by a quarter and the unemployment rate hit 25%. This time round, with the banks wrapped in cotton wool, extremely low interest rates and big public-spending packages, the economic distress has been massively smaller. Yet the recession has still been extremely painful, prompting a sense of outrage at the financial industry and in particular the big wholesale banks that execute transactions for clients and trade on their own account. This reflects not just their past sins, but also the perception that nothing has really changed.

In a league of its own

That is not entirely true. Many bankers have lost their jobs. Some skyscrapers in Manhattan and London's Canary Wharf have new signs on them. Famous firms like Merrill Lynch have been swallowed up; the reputations of others such as UBS and Citigroup have been mauled. Plenty of hedge funds have folded. There have been relative winners, too. Many commercial banks have done well (particularly in Spain, Canada and Australia) and JPMorgan Chase, Bank of America and Barclays have expanded their investment banks (see article).

But the dramatic changes in the pecking order mask a lack of more profound change in the system of finance itself. Lehman aside, no big firms have been allowed to fail (as they would have done, unaided). Thanks to state aid, the law for big firms today is what Gordon Gekko, the red-blooded villain of the film "Wall Street", dubbed "survival of the unfittest".

Indeed, taken together, financial firms have not even really got smaller. Exclude "useful" loans to the real economy, and over the past year the remaining underlying risk-adjusted assets of the nine biggest investment banks worldwide have been broadly flat. Statistical measures of the maximum trading losses these firms could face on those positions suggest that, in aggregate, they are taking more risk. Their combined balance-sheet is 40% bigger today than in mid-2005. And all this has been amplified into public outrage by the foolish decision to pay out bumper bonuses again.

The fury at "business as usual" in the Temples of Mammon is understandable, but it is a rotten basis for trying to regulate finance. For one thing, the recent return of profits and bonuses has occurred in unusual circumstances: it is easier for healthier banks to make profits when their weaker rivals are cowed. Once competitors are back on their feet and tighter regulations introduced, things will look very different. Far from being the return of the big bonuses, this could be their last hurrah.

And bonuses are, for the most part, the symptom not the disease. They certainly have done damage, persuading traders to load the system with toxic securities and sucking away capital: in the year before its demise, Lehman paid out at least $5.1 billion in cash compensation, equivalent to a third of the core capital left just before it failed. More recently Morgan Stanley promised so much pay in its latest quarter that it almost made an underlying loss. In any other business that would be a risk for shareholders. But finance's risks are everyone's because banks rely both directly and indirectly on taxpayers' support.

The scale of that help is huge. Loans from central banks and debt guarantees alone amount to $2.7 trillion. As with any private industry in receipt of almost unlimited cheap public funds, finance now has every incentive to be as big as possible—beyond the point of usefulness. Change the assumptions behind this weird system, and everything else, including pay and the heads-I-win, tails-you-lose culture, will move too.

Removing the explicit side of the state's commitment is relatively simple. Some guarantees are still plainly needed now, but a firm deadline of, say, five years for the final expiry of the governments' various crisis-induced pledges should be set globally. With the world economy in better shape, this looks more realistic than it did six months ago. But even then the implicit assumption will linger that banks will always be bailed out. This is the core problem. There are two possible responses to it: regulate banks to try to make them safer, and attempt to limit the implicit guarantee. Both approaches are now needed.

Taming the beast

On regulation there have been some wacky ideas. Britain's top financial policeman has endorsed a tax on transactions to cut the industry down to size, an idea that is Utopian and misguided. Similarly, the idea that regulators know the optimal size of the financial sector, or are good at running banks, is a fantasy. Trying to prevent blow-ups in the first place is more sensible with economy-wide "macro-prudential" regulators working to counter bubbles such as the recent housing mania.

Booms and bust will not disappear; hence the crucial importance of bolstering capital, the buffer that banks depend on to absorb losses. At the top of the last cycle, capital levels would have needed to be about double the current permitted floor for America's banks to have got through the crisis without raising more funds. The Basel club of regulators is working to raise the level and improve the quality of banks' capital. It may also be possible to vary capital charges to prod banks to shrink, improve liquidity and, yes, curb pay. But capital, a fairly blunt tool, could be asked to do too much.

The same is true of regulators themselves. Last time round they were meant to stop banks from self-harm and make sure they had enough capital. Just because they are trying harder now does not mean they will succeed. Focus only on more rules and the medium-term risk is of a colossal, semi-socialised banking system crawling with outgunned, possibly captive regulators. Hence the importance of the second response: a concerted effort to reduce the implicit state guarantees.

That is easier said than done, especially since the recent bail-outs have reaffirmed the state as a backstop. There are, however, other options. "Living wills" can force banks to plan for their own collapse, which should make it easier to protect depositors while forcing creditors, not taxpayers, to bear the pain. There is also a case for forcing banks to finance themselves with a slice of junior "hybrid" debt (which has never been state-guaranteed). Its cost, and thus banks' profits, may at least for a while be more sensitive to the risks being taken.

No one should pretend that banking is an industry where pure natural selection takes place. But as guarantees, both explicit and implicit, are withdrawn, the hope is that self-discipline will be imposed on banks, not just swathes of new regulation. There are signs that riskier banks are already paying more to finance themselves. This differentiation must be promoted, so the weak and reckless are gradually forced to shrink and live within their means—and not off taxpayers' largesse.