Indebtedness is both a consumer and a financial industry problem. Regulatory bodies think more banking regulations will fix the problem. INSEAD Professor of Banking and Finance Jean Dermine is not so sure.

The world is still reeling from the financial meltdown that began in 2007, and the banking system is the whipping boy. “Too big to fail” has become the war cry of an outraged citizenry, and governments are scrambling to devise strategies to prevent another crisis of this magnitude. Many of the proposed solutions involve enforcing tougher banking regulations such as increased liquidity and higher capital requirements. In the US there are calls for the separation of investment and commercial banking... harking back to the 1933 Banking Act following the Great Depression, better known as Glass Steagall.

INSEAD Professor of Banking and Finance Jean Dermine cautions some of the proposed regulations are going too far. In a new white paper entitled “Banking regulations after the global financial crisis, good intentions and unintended evil”, he says these regulations may safeguard banks from future meltdowns but the economy could suffer because the supply of loans would be severely curtailed. In other words, the new banking regulations threaten to keep too much money in the vaults and not enough in the economy. “This is an overreaction,” Dermine told INSEAD Knowledge, “because we should not forget that banks are extremely useful in the real economy, to finance lending to consumers and small and medium-sized companies. If you come with stringent regulations, the cost of lending is going to go up tremendously. The cost of bank loans to small firms will increase.”

Devastating results

In countries that are suffering from recession, these measures could be devastating because they could restrict investment. Dermine believes that some level of risk is necessary to allow banks to function successfully in the economy. “Yes, it creates a risk of a run on the bank - depositors can take their money away - but this is why around the world we have created central banks to act as lenders of last resort,” he argues, pointing out that Central Banks do have the ability to step in when banks are in trouble. Enforcing overly strict liquidity regulations will make it very expensive for banks to lend money. This severely restricts the role of banks, which he believes is the wrong course of action.

A decrease in lending would only hurt the global economy which is already in a tailspin by making it harder to borrow to finance investment or consumption. “I don’t think the timing is appropriate to come up with this very strict regulation,” he opines. “Small and medium-sized companies would be very much affected as would consumer lending.”
Dermine also believes that tougher regulations won’t keep other financial institutions from engaging in some high-return high-risk lending and trading activity – hedge funds, for example; instead this activity will be off the books of banks and out of sight of the regulators. A failure in these sorts of investments can still tank the financial world. “That was already happening before the crisis. Banks were using all kinds of vehicles -- vehicles outside the banking industry that were not regulated,” he says. “Therefore, we could go back to where we started in the crisis.”

No more ‘too big to fail’

So what is Dermine suggesting as an alternative? In short, he would like banks to realise that they are not ‘too big to fail’. He believes that banks behave in a risky manner because they know that they will be bailed out by governments should their fortunes go awry. Instead, Dermine would like the bank’s creditors to realise that they can lose their money if the bank goes under. In other words, the bond holders’ right to repayment should not be sacrosanct, and an orderly means of default should be put in place. He says that some countries are starting to work on what is called a ‘special resolution regime’ which means that, before the bankruptcy stage, we want a legal system that allows to recapitalise the bank swiftly, with such instruments as contingent convertible bonds or haircuts (losses) imposed on all the bank’s creditors (with the exception of small insured deposits). This would put pressure on the bank to take less risk. “I’d much prefer to leave things to the market, but make it clear that large banks can default,” Dermine adds.

Cultivating prudence in the banking world

The ‘less-regulation’ strategy does not necessarily put the economy at risk. “On the interbank markets, bank creditors have the power to put pressure on other banks to take fewer risks. They have the incentive to do so if there is a very real possibility that their money will disappear if the bank goes bankrupt,” Dermine says. He calls this kind of self-regulation “the only solution to creating incentives in the financial world to care much more about the risk taken by banks.”

The global economic crisis has taught the world a hard lesson about “contagion” within the international financial system. However, Dermine thinks that this interconnectedness can also be part of the solution. By forcing banks to assume each other’s risk, there will be strong incentives throughout the banking community to be responsible in their risk taking, with strict limits on counterparty exposure. “I want all the bank’s creditors – holders of subordinated debt, holders of bonds, or bank counterparties – to be put at risk to raise the level of accountability in the financial system. For too long, creditors of large banks knew that they had nothing to fear because the ‘too-big-to-fail’ banks would be bailed out by governments. An end must be put to the ‘too-big-to-fail’ doctrine, responsible for many banking crises around the world.

Jean Dermine is Professor of Banking and Finance at INSEAD. He is the Programme Director for two Executive Education programmes: Risk Management in Banking and Strategic Management in Banking.