Banking Regulation and the Financial Crisis

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The current financial crisis started in the Autumn of 2008, and is only the last one of the many that have followed the banking deregulation of the mid-1980s. It has been a rolling financial crisis moving from economy to economy. Governments and bank regulators have tried to understand the role of financial markets in this process and are trying to improve financial stability. Reforms are taking place at the global and national level. Globally, the most important reforms come from the Basel Committee, so called Basel III. This aims to make banks financially stable through, among other things, holding more shareholder capital to absorb the losses banks suffer when loans are not repaid.

Beyond Basel, the UK has a number of unique reforms which are also aimed at making banks safe. The two key changes are:

1. The Bank of England taking over Prudential Control so it can monitor the behaviour of banks and the interaction between the banks and the wider economy.
2. The Independent Commission on Banking.

The ICB's Report recommend that large UK banks hold more capital than the minimum levels suggested by the Basel Committee to improve the financial stability of banks which are "Systemically Important". The Report also recommends banks be forced to build "firewalls" between the retail banking division and the "riskier" investment banking division. The idea is that retail banking arms will have their own capital, so if the investment bank fails the retail arm can be protected. Finally, they wish to see new competitors in the UK market through the sale of some Lloyds Banking Group branches.

Will it work? Maybe, but there will be pain. Birmingham is a city of business. The ICB report wants business lending to be secure and consistent. It is likely, and expected, that banks will include their lending to small and medium-sized businesses (the vast majority of British firms) within the ring-fenced retail operation. That should be good, but other elements work against business lending. Banks are being told to hold more capital versus the loans they make. However, banks are finding it hard to build up capital so instead they are lending less and that is causing shortages of funding to both consumers and businesses, especially SMEs.

In *Europe's Advantage. Banks and Small Firms in Britain, France, Germany and Italy since 1918* (Oxford University Press, 2005) we show how banks, especially strong, regional banks are crucial to the development of this sector of the economy. This is the quandary government faces. Yes, banks should be more stable, but to achieve this banks will contribute less to helping develop current economic activity. We want safety, but will we like the taste of the medicine? And if banks are not going to be the engines of growth, who will?

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