Mega-problem

Regulators need to shrink the banks and ensure there are more of them, say **Michael Mainelli** and **Richard North**

Alistair Darling, chancellor of the Exchequer, has spent the past year bolstering Royal Bank of Scotland (RBS) and Lloyds Banking Group with new money, in the process helping them digest two botched acquisitions, those of ABN Amro and HBOS. There have been timid exchanges on bank size, including a speech in October by Mervyn King, the governor of the Bank of England, on reform of the UK banking system. Yet it fell to Neelie Kroes, the EU competition commissioner, to decree that RBS and Lloyds should shrink.

But the bigger the bail-out and the greater the impulse to regulate, the more essential it becomes to stand up for the best discipline of all: competition. We need much more competition than the current generation of regulators, politicians and bureaucrats envisages.

Banking competition has been in short supply locally and globally. Niall Ferguson, the historian, wrote in the *Daily Telegraph* in October: "By the end of 2007, 15 megabanks, with combined shareholder equity of $857bn, had total assets of $13.6 trillion and off-balance-sheet commitments of $5.8 trillion – an aggregate leverage ratio of 23 to 1. They also had underwritten derivatives with a gross notional value of $216 trillion – more than a third of the total."

So a global industry that affects every organisation was competitive with just 15 banks and four auditing firms? Today, we are left with even fewer megabanks and retail banks.

The credit crunch happened because the west allowed too much cheap money to flow too profitably through too few people, who chased deals with a herd mentality. Yet the bail-out has replicated and intensified some of these aspects.

Trillions have been spent on increasing the amount of cheap money, reducing the motivation to save and preserving the *status quo* of too few banks globally, and too few banks in countries with systemic retail failures, such as the UK.

The financial industry is still gaming the state regulatory and guarantee processes. Indeed, recent bail-outs seem to reassure financiers that their old business model of carefree risk-taking is sounder now than it was before the credit crunch. King told his Edinburgh audience that there had been "little real reform".

Both he and Lord Turner, chairman of the FSA, with their different styles and approaches, have described a safer world in which financial regulators redesign large parts of the financial system. But the more they interfere in details rather than structure, the more they court disaster. King's tilt towards controlling size resonates better with another Edinburgh missive over two centuries ago – Adam Smith calling for "free competition" in *The Wealth of Nations*. "By dividing the whole circulation into a greater number of parts," wrote Smith, "the failure of any one company, an accident which, in the course of things, must sometimes happen, becomes of less consequence to the public. This free competition, too, obliges all bankers to be more liberal in their dealings with their customers, lest their rivals should carry them away."

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Thus competition with caps on size reduces systemic risk and encourages lending.

Regulation should also be capped. It creates barriers to entry, promotes the large over the small and reduces competitive variation. Furthermore, its aims are remarkably like those that competition achieves more naturally.

We will only have a decent system when regulators become the safety device of last resort. Governments should break up firms that are too big to fail and too big to regulate. This would have the merit of being in line with the fundamental and old understanding that capitalism's biggest hazard is oligopoly.

Competition helps the vigour of greed produce the rigour of fear. It makes alpha financiers hungry to demonstrate that they have safe hands as well sharp elbows.

We are not advocating a romantic, gentlemanly capitalism but a creative tension within and between sectors. We see firms facing unprecedented scrutiny and evaluation by their own peers, savers, investors, managers, shareholders, academics, credit rating agencies, journalists and regulators – all of whom will become more anxious and more active sources of discipline in the market.

National financial regulators in Europe are bumbling in the right direction, towards smaller competitive banks, propelled by the EU competition commissioner. Large banks from RBS to Deutsche Bank are howling about the dangers of downsizing – a good sign.

How much better if financial regulators raced in the direction of truly resizing a competitive industry? Regulators need to shrink the banks, ensure there are more of them – and then shrink themselves.

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