

Chained but untamed

The world's banking industry faces massive upheaval as post-crisis reforms start to bite. They may make it only a little safer but much less profitable

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The near-collapse of the world's banking system two-and-a-half years ago has prompted a fundamental reassessment of the industry. Perhaps the biggest casualty of the crisis has been the idea that financial markets are inherently self-correcting and best left to their own devices. After decades of deregulation in most rich countries, finance is entering a new age of reregulation. This special report will focus on these regulatory changes, which will be the main determinant of the banks' profitability over the next few years.

Start with the additional capital that banks around the world will have to hold. Bigger capital cushions will make the system somewhat safer, but they may also reduce banks' profitability by as much as a third. In addition, they may push up borrowing costs and slow economic growth. Worse, higher capital requirements for banks may drive risk into the darker corners of financial markets where it may cause even greater harm.

Supervisors and regulators almost everywhere are still trying to find ways to deal with banks that have become too big or too interconnected to be allowed to fail. If anything, the crisis has exacerbated this problem. Some of those banks have become even bigger or more interconnected. And governments made good on the implicit guarantees offered to banks, encouraging them to take even bigger risks.

In America the rules to implement the Dodd-Frank act are beginning to take shape. Passed last year, the law runs to 2,319 pages, but it is little more than a statement of intent. Before it can take effect, 11 different agencies have to write the detailed regulations. These will redefine much of the industry in America and around the world, reversing decades of deregulation in finance in the world's biggest economy.

One key provision is the separation of investment banking from commercial banking, known as the Volcker rule. It will restore some elements of the Depression-era regulatory regime that was meant to ensure that com-

mercial banks did not "speculate" with protected deposits by forbidding them from trading securities. Other regulations in America will set the fees that some of the world's biggest retail banks can charge when one of their customers swipes a debit card. These make no pretence to making banking safer, but reflect politicians' anger at banks and suspicions of those who run them.

Britain, for long the most enthusiastic champion of financial deregulation, is going further still, pondering whether banks' retail arms should be so tightly regulated that they become little more than public utilities. Mervyn King, the governor of the Bank of England, in a recent speech in New York wondered aloud whether the use of deposits to fund loans should be outlawed. In essence, he was questioning a basic building block of modern banking. In April a government-appointed commission said that Britain's banks should wall off their retail arms so they could be salvaged if the rest of the business were to collapse. It is also trying to devise resolution regimes and living wills to reduce the harm done when banks collapse, and it wants more competition in retail banking.

Britain is not alone in reacting strongly. Switzerland, which grew rich as its buccaneering international banks sailed the tides of capital flowing around the world, is now downsizing its global banking ambitions. It plans to impose such strict capital standards on its biggest banks that their investment-banking arms will be forced to shrink or leave the country.

The wave of new regulation comes as many banks are still struggling to regain their footing after the crisis. Across much of Europe, bad debts held by banks are impairing the balance-sheets of their governments. Ireland and Spain are trying to convince bondholders that they can and will repay their national debts, despite the losses incurred by their bankers. Doubts about those two countries' creditworthiness, as well as that of Greece and Portugal, are spreading across the continent's banks, raising borrowing costs and



unsettling markets everywhere.

In America big banks are healthier, having largely rebuilt their balance sheets. Yet not all have recovered. The country's smaller regional and com-

munity banks include some 800 troubled institutions at risk of being seized by regulators if their capital ratios fall. In both America and Britain households are deeply indebted. For banks,

growth in these markets, as across much of the rest of the rich world, is likely to be slow. In Japan banks are well into their second decade of a slow motion crisis, while in China officials fret that banks are growing too quickly.

There is much that regulators around the world are doing well, yet many of their actions have been piecemeal. As a result, they tend to shuffle risk around from one country to the next instead of reducing it across the global financial system. In some ways they have exacerbated the dangers. Dodd-Frank, in its zeal to prevent any more taxpayer-funded bank bail-outs, has curbed the Federal Reserve's ability to provide cash to banks that are fundamentally sound but suffering a shortage of liquidity. That has made it harder for the central bank to act as a lender of last resort, a principle of central banking established almost 140 years ago by Walter Bagehot, a former editor of this newspaper.

The unwelcome consequences of some of the other new rules now being introduced may be greater yet. For example, the European Commission's decision to regulate bankers' bonuses in a bid to limit risk-taking may have the perverse effect of driving up banks' costs and making their earnings more volatile.

The bright spots

Banks in emerging markets face different and far more exciting challenges. They need to grow quickly enough to keep pace with economies racing ahead at breakneck speed and to reach the legions of potential customers in villages and slums who are hungry for banking. Rapid growth and the spread of computing and communications technologies have turned these markets into huge laboratories of innovation. This special report will argue that banks in countries such as India and Kenya have much to teach those in the rich world. These lessons could come in handy, for the torrent of reregulation in developed countries will soon be raising banks' costs, trimming their profits and forcing some of their customers to look for cheaper banking services.

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Drip, drip from the euro debt crisis

REUTERS, London

The euro zone debt crisis is a story that just will not go away, a drip-drip water torture that investors and financial markets cannot ignore.

So while investors may want to focus in the coming week on issues as diverse as UK interest rates, highly volatile global commodity prices and US capital flows, they are likely instead to find Europe's debt conundrum forcibly distracting them.

The week brings with it a series of meetings that will be dominated by the question of Greek bond restructuring and the overall problem of out-of-control debt in euro zone economies including Ireland and Portugal.

Euro zone finance ministers meet on Monday before a gathering of the full European Union contingent on Tuesday.

These are followed a day later by an economic forum attended by a gaggle of the debt saga's key players -- including European Commission President Jose Manuel Barroso, International Monetary Fund Managing Director Dominique Strauss-Kahn and German Finance Minister Wolfgang Schaeuble.

Perhaps most intriguing, European Council President Herman van Rompuy will be on a four-day visit to China, whose support in buying Spanish and Portuguese bonds has been crucial in shoring up debt markets.

It has even prompted a public thank you.

"The EU gratefully acknowledges continued Chinese involvement in European sovereign bond markets during the recent and quite turbulent period," EU foreign policy chief Catherine Ashton told the English-language China Daily.

Continued Chinese diversification of its huge foreign exchange reserves from the dollar into euros (and other currencies) will not only affect the euro zone bond market, but stands to create a new pricing regime for many assets.

MAROONED

It is an odds-on bet that the crisis -- which essentially comes down to near-bankrupt countries sharing a currency with exporting giants like Germany -- will not be solved at any of these meetings.

It is in the nature of water torture,

after all, that the drip-drip continues.

But the whole process of trying to bring Greek, Irish, Portuguese and other debt under control is a slow one, involving long-term austerity programmes, guarantees that need tweaking from time to time and the agreement of 17 euro members, all 27 EU members and some outsiders like the IMF.

Nowhere is this clearer than in the current debate over whether Greece should restructure its debt -- either through extending maturities, lower-

ing promised interest rates on bonds, or just reneging on the repayment of the full amount borrowed.

A Reuters poll in the past week showed the vast majority of fund managers and economists believe Greece will restructure, although very few expect it soon.

European politicians, in the meantime, often seem to be saying one thing publicly and briefing something else privately.

The result is that markets are

haunted by what rattles them most -- uncertainty.

"It almost seems as if it needs a disaster before the policy makers take a decision," said Sanjay Joshi, portfolio manager at London & Capital. "It makes it extremely difficult for the market to get a clean slate and move forwards."

OBSCURED BY CLOUDS

Market reaction to the crisis so far has been relatively contained to the debt of a few weak economies on the euro zone's periphery and the odd euro wobble.

This is possibly because the core euro zone economies have been doing so well -- Friday's data showed roaring performances by Germany and France in the first quarter.

But investors argue that the uncertainty does add to the strength of other brakes on investor sentiment.

The latter include concerns about central banks shifting from plentiful-money policies towards higher interest rates.

Minutes from the Bank of England's last meeting should give some notion in the coming week of how close Britain is to following the European Central Bank in tightening.

US TIC data for March -- figures for capital in- and outflows -- will also be released, giving a new snapshot of the demand from China and other for US Treasuries and other paper.

With the Federal Reserve set to end its own quantitative easing (QE) bond buying in late June, the data may be even more pertinent that usual for what it says about demand after QE disappears.

Investors will also be keeping an eye on commodity prices, following recent bursts of volatility, at least partly brought on by efforts in China to cool its economy.



A man rides his bicycle in front of the parliament in Athens.

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