Banking Regulation versus Growth

Credit is a necessary ingredient of economic growth. Employment growth is especially driven by small to medium sized enterprises. Start up businesses and entrepreneurship are an important part of innovation and long term economic growth. While larger, more established businesses have access to capital markets, smaller businesses without a track record do not. They rely on venture capital, private equity and banks for capital.

Since 2008 the ability of VC and PE funds to raise capital has been greatly reduced as investors shy away from risk and illiquid assets. At the same time, banks for a host of reasons either do not have sufficient capital or are asked to hold more and more capital against a given quantum of risky assets (loans.)

The intention of Basel 3 and ad hoc domestic regulation is to shore up the financial strength of banks to withstand the risks we have come to know in the past few years. In doing so, however, they are reducing the amount of leverage and the availability of credit that might fund economic growth. This seems incompatible with countries' need to grow their economies at a sufficient pace to pay down the existing stock of debt.

Since 2008, banks have come to be regulated as utilities. In one sense they provide a public good, payments, transactions enablement, custody of assets et al. On the other they are in the business of taking risks and turning a trading profit.

The fractional reserve model of banking allows banks to lend out more than they possess in equity. They lend out money held on behalf depositors. Inherent in the model at all times is a duration mismatch between short term liabilities and long term assets. For this reason, a solvent bank can easily go out of business if there is a lack of confidence in its ability to satisfy its short term liabilities.

The Glass Steagall act and the Vickers report are attempts at addressing the separate needs and challenges faced by retail banking and investment banking.

Unfortunately there is no magic solution. A perfect duration matched business will represent a massive opportunity cost. Ignoring duration mismatches lead to disaster whenever there is a crisis of confidence and liquidity. Somewhere in the middle has always been the compromise answer.

Since 2008 regulators have tended towards safety rather than efficiency. This has increased the opportunity cost to the economy in terms of availability of credit and has been a serious impediment to a rapid recovery.

Ironically one of the most ingenious of solutions to providing liquidity and efficiency was the securitization technology so maligned in the crisis of 2008. Long term assets are financed by long term liabilities which are securitized and traded. Not all these liabilities traded in liquid fashion, however, prior to the securitization market, such liabilities hardly traded at all.

The world needs to turn once again to securitization technology. Regulators need to get involved to establish standards and protocols for the establishment, issue and trading of these securities. The simplest example of such a security is a single tranche cash CLO, basically a simple pass through.

Asset based finance can also be securitized. New fund structures which raise capital the old fashioned but are later securitized and traded can offer both duration matching and liquidity. What is required is innovative structuring and fund raising techniques as well as cooperative and enlightened regulation.

The idea this time is not to feed irrational yield hungry, ratings dogmatic investors with risky and brittle product but to provide businesses with reasonably priced growth capital on the one hand and investors with an attractive return within a robust structure.