Regulation of Banks

There is an opportunity here to eschew heavy handed regulation.

The public are clearly incensed at the behaviour of the bankers and prop traders. The people are disappointed at the level of diligence and care that their bankers have applied in the conduct of their businesses.

The opportunity exists today for regulators to demand nothing more than disclosure that is fair, clear and not misleading, so that private individuals can decide if they want to deposit money with, invest in the equity of or trade as counterparty with, a financial institution. The public will therefore decide what is too big to fail and provide a market solution for the right size of banks.

The alternative is increased regulation, bureaucracy, inefficiency and ultimately a higher cost to the economy than is optimal.

It is sub-optimal to risk manage to the tails on an ongoing basis. As long as the system consists of a sufficient number of independent decision makers, a concept of self insurance takes force. When the number falls or the independence assumption is breached or weakened, systemic risk rises.

Another condition for a market solution to work is that agents, that’s savers, investors, counterparties, are able to make sense of the information that they are given. This is a stretch. Not many people can understand the full complexity of the modern bank. Not many people understand financial statements of any type of business let alone a bank. Education is the answer. Economic agents need to be educated in prudent household financial management in order to interpret the information and allow them to behave more rationally and predictably. Until they don’t.