SHOULD BANKS TAKE MORE RISKS?

TIM CONGDON assesses the impact of tighter regulation on banks' customers – especially small businesses – and asks if that's good for the UK economy

Everyone active in business and finance knows that banks have been more tightly regulated since the Great Recession of 2008. But surprisingly, little work has been done on the impact of tighter regulation on banks' customers, particularly on those customers who borrow or try to borrow money.

The consensus is that banks took on too much risk before the crisis of a decade ago, that too many banks went "bust", and that society benefits from an ultra-safe banking system.

But has official pressure to make banks safe cut off credit from small- and medium-sized businesses, and so undermined investment and entrepreneurship? And is society made worse-off by the resulting loss of business opportunity?

Shortly after the Lehman bankruptcy of September 2008, the leaders of the G20 group of nations met in Washington to agree that the Bank for International Settlements (based in Basel, Switzerland) and the International Monetary Fund should oversee a new set of rules for the banking industry.

While the new rules are complex and wide-ranging, their focus has been on raising the amount of capital needed to cover the risks in banks' portfolios of loans and securities.

whereas before 2008 banks could have equity capital that, as a minimum, was 4 per cent of assets, nowadays that figure has been raised to 7 per cent.

If banks have the same level of capital as before, an increase in the capital/asset ratio can occur only if assets fall. Indeed, with capital given, a move from a capital/asset ratio of 4 per cent to one of 7 per cent requires a drop in assets of over 40 per cent.

Before 2008, British banks' assets consisted almost entirely of claims on the private sector, mostly in the form of loans. For the people and companies that used loans to finance investment in homes and businesses, a contraction of bank loans of 40 per cent would have been most unwelcome and sometimes catastrophic.

An argument can be made that the shrinkage of banks' risk assets from autumn 2008 led to the destruction of money balances, as some borrowers were forced to pay back loans earlier than expected.

The crash in money growth then led to the intensification of the recession. The officially-mandated increase in capital/asset ratios therefore had the paradoxical short-run effect of worsening the problem it was intended to solve.

But defenders of the new bank capital regime, known as Basel III, might still insist that in the long run the benefits will outweigh the costs.

Much depends on how large a reduction in bank credit is eventually recorded and on the types of credit which suffer the largest retrenchment.

Happily, the British banking industry has responded to the challenge by greatly increasing its capital base. The shareholders' funds of the UK's large banks more than doubled from £143 billion at the end of 2006, some months ahead of the financial meltdown, to £288 billion at the end of 2014.

The strengthening of the capital position has prevented bank lending to the UK private sector from suffering a cataclysmic reverse. It has not had to be slashed by the 40 per cent figure implicit in the headline change in capital/asset ratios. Banks have been able to duck and weave, and protect their customers from the full blast of the regulatory cold wind. Even so, bank lending to the private sector has fallen sharply relative to national output.

In analysing the UK statistics, we need to exclude an irritating set of organisations known to statisticians as "intermediate other financial corporations" or quasi-banks, and to track the numbers for lending to the genuine non-bank private sector.

HAS OFFICIAL PRESSURE TO MAKE BANKS SAFE CUT OFF CREDIT FROM SMALL AND MEDIUM SIZED BUSINESSES?

If we do so, the data tell us that the ratio of lending to national output peaked at just above 145 per cent in the first quarter of 2009. Over the six years to mid-2015 the ratio fell to under 120 per cent and may now be stabilising at roughly this figure.

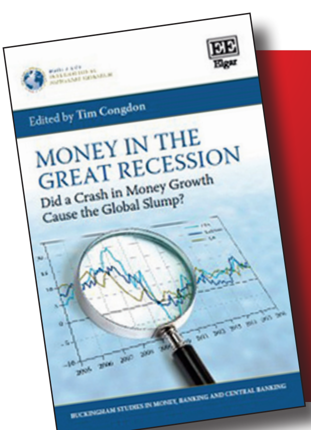
Some observers might say that the curtailment of credit is unfortunate, but far from earth-shattering. In their eyes, the new stricter capital regulations (Basel III) will confer the major long-run advantage of a more stable economy.

They would claim that the plus points from greater stability will outweigh the disadvantage of a reduction in bank credit equal to about a quarter of national output, which has been identified here.

But this is to overlook a crucial effect. As the Basel III recapitalisation drive has been intended to make banks safer, the new rules have been less hostile to safe lending than to risky lending.

The safest kind of lending over the decades has been lending to individuals for the purpose of home ownership. Banks do need to hold more capital relative to residential mortgage assets than before 2008, but the shift is small and manageable.

Not surprisingly, UK banks' mortgages – nowadays over half of banks' assets – have not changed much relative to national output.

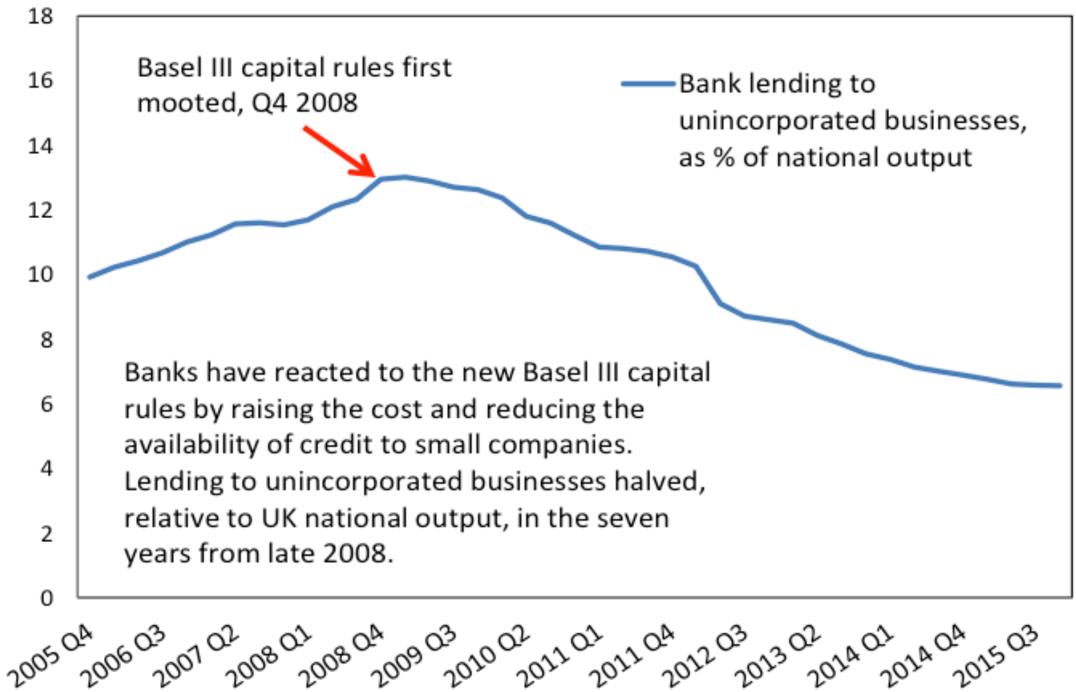


FOR MORE

Read *Money in the Great Recession*, edited by Tim Congdon and published by Edward Elgar Publishing.

Rise and fall of bank lending to unincorporated businesses in the UK

Data are quarterly, author's estimates using Bank of England and Office for National Statistics data



RELATIVE TO NATIONAL OUTPUT, BANK LENDING TO THE SMALLEST OF SMALL COMPANIES HAS FALLEN BY ABOUT A HALF SINCE THE FINANCIAL CRISIS

But if bank lending to the private sector in total has dropped by a quarter relative to national output, and if safe mortgage lending to households has not gone down at all on the same basis, what must have happened to risky lending to companies? It must have tumbled.

That is exactly what the official numbers show. The problem is at its worst for small- and medium-sized enterprises, which are often the heroes of speeches from Treasury ministers.

Unincorporated businesses are the smallest of the SMEs. A series in the Bank of England's database shows that at the end of 2008 bank lending to unincorporated businesses was just above £50 billion. But by 2015 this had dropped to little more than £31 billion.

Relative to national output, bank lending to the smallest of small companies has fallen by about a half since the financial crisis.

Is that really a positive development for the supply-side efficiency of the British economy? Can a case be made that financial regulation, and in particular Basel III's hostility to risk, has gone too far?•

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