What are banks for?

What sort of regulation enables banks to best fulfil their role in the economy?

Banks have been widely held responsible for the financial crisis which began in 2007. The reality is more complex, although banks – especially those in the US and UK – were certainly implicated in the crisis and may have aggravated it. However, our purpose here is not to hark back to the origins of the crisis but rather to answer questions regarding the purpose of banks and their usefulness in support of the economy.

The fundamental role of a commercial bank is to collect savings and make loans. This may be self-evident, but it is at the heart of the matter. And this can be demonstrated in developing economies, including emerging economies, where banking among the wider population is rare. In such countries a proportion of national savings, the largest proportion, does not flow within a rational and efficient allocation circuit. Most of the population invest in assets, sometimes leading to bubbles, or hoard their assets in cash. This is an inefficient system at the end of the day, as savings are not invested in support of growth, namely in individual and company projects.

The reality is somewhat different in France, of course, as the multiplication of branches since the 1960s has led to nearly 100% of the population holding a bank account. In developed countries, banks therefore play an essential role in the collection and proper allocation of savings. In particular, the ability to obtain loans from economic players in the financial markets has been severely reduced, with the exception of large companies and certain medium-sized ones. Issuing debt on these markets means you have to be known, you must make regular issues, frequently use rating agencies and therefore spend significant amounts of money to ensure the abundance of information about yourself. You have to be of a certain size to be able to absorb the costs involved, to entice investors to analyse your accounts and, accordingly, reduce what is known in economics as information asymmetry between the lender and borrower.

Yet all players in the economy have financing requirements. And this is precisely the role filled by banks thanks to their in-depth knowledge of borrowers, whether households, professionals, SMEs, medium-sized companies and even large concerns. Over time such in-depth knowledge enables banks to understand the profile of the borrower, the context of the loan and therefore to adequately take into account the credit risk. They are also helped in this by their management of their clients' payment flows.

The usefulness of banks is also clear for savers (investors). Most lack sufficient financial standing to take on a concentrated credit risk with just a few debt issuers. So it is the bank's role to borrow from savers and to take the credit risk with clients requiring financing which, in the event of a proven risk, has an impact on its own balance sheet. In other words, by investing in banking products, savers take a risk with the bank and not with the multitude of borrowers to whom the bank lends. Through its intermediation, the bank therefore plays a crucial economic and social role, both by matching up financing needs and capacities and itself taking on credit risk instead of the savers.

The second role of a bank is to take on interest-rate and liquidity risks which arise from its activities of collecting savings and granting loans. This is its activity of "transformation" (of deposit and loan maturities). In practice, households and companies alike most often favour short-term investments that are readily available. But most borrowers wish to borrow over the long-term that is over a sufficiently long duration so as to make a return on an investment in a company or gradually generate a savings capacity to pay off a property loan, for example. The markets can certainly play a role in this respect. But purchasing a seven-year bond issued by a company, for instance, not only carries a credit risk for the investor over many years, it also entails an interest-rate risk that gives rise to a risk of capital loss in the event of resale prior to the term. Purchasing bonds or any other type of debt entails a capital gain/loss risk, according to fluctuations in interest rates. These may vary wildly as has happened many times over the past thirty years. On the other hand, if a saver makes an investment through a bank, then he bears no risk of capital gain or loss, as the interest-rate risk has been transferred to the bank which has the required professional expertise to manage it, and which complies with prudential regulations in such matters. The bank records any losses associated with the occurrence of such a risk in its own books, yet without undermining the value of the investments of its saver-customers, unless the bank itself goes under.

In addition to interest-rate risk, lending over the medium term and borrowing over the short term entails a liquidity risk. Savers who have made short-term investments or deposits may wish to withdraw their money while it is frozen by the bank in medium-term loans. In the markets, the liquidity risk is offset in principle by the secondary market. A share or bond can in principle be sold on this market at a capital gain or loss (see above). But in reality liquidity is "self-referential". A market is not liquid intrinsically but because investors believe in it. Should this belief disappear and investors have fears about liquidity, they will stop buying and no sales will take place or only at prices way in excess of the "normal" value of the securities in question. This liquidity risk is borne by everyone who directly participates in the financial markets. In the case of the banks, liquidity risk is managed by the bank on a professional basis and, once again, in compliance with ad hoc prudential ratios. As a last resort, central banks may intervene and provide liquidity for the banks. This happened on an international scale in 2008, and then again in 2011 during the euro zone's specific liquidity crisis.

In summary, banks are not only indispensable for the rational allocation of savings but also, and unlike the markets, they also assume credit risk, interest-rate risk and liquidity risk in the place of their customers. And such risks are taken under regulation and supervision. Banks' specific and irreducible economic and social usefulness is based on these functions as a whole.

In this paper we will not cover investment banks, which play an advisory role and whose purpose is to participate in the financial markets as an intermediary, placing buyers and sellers in direct contact and originating securities on behalf of borrowers.

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One question needs to be addressed today: do the new banking regulations improve banks' ability to manage risk? Macro-prudential regulations are vital, as the markets can regularly become disconnected from economic fundamentals. The more markets are globalised, the more volatile they become and the greater the risk of bubbles emerging. Self-evident market errors therefore occur regularly. For example banks, like the markets, may be encouraged in more euphoric times to lend too much, causing borrowers to incur too much debt, thereby contributing to the development of credit bubbles on assets (shares, property, etc.). This then leads to turnarounds and overly sudden credit rationing and sharp falls in asset prices. Furthermore, and this is the historic basis of regulation, micro-financial regulation is required to protect savers' deposits in every bank and hence ensure the stability of the banking and financial system, which is indispensable to a smooth-running economy. But when clear and repeated market errors occur, regulatory errors can also be made.

Given the requirement to comply with minimum solvency ratios, regulation obliges banks to hold sufficient capital in light of the risks they assume (market and credit risks). Regulation also makes it possible to reduce liquidity risk since Basel III. Yet some regulations at times have undesired effects. For example, certain conditions were pro-cyclical under Basel II. They actually exaggerated both euphoric and depressive effects. By enabling banks to reduce their capital or increase their commitments in the event of an upturn in the economy and financial markets, they encouraged greater risk-taking, leading to speculative bubbles (credit, market and other). Conversely, in the event of a downturn, banks had to increase their capital or reduce their commitments without delay, while making provisions on loans and adopting negative positions in the financial markets, thereby accentuating the depressed economy. Basel III has at least partially corrected these pro-cyclical effects by requiring contra-cyclical capital buffers. Sometimes a regulator over-corrects past crises and fails to anticipate future crises.

One problem is always encountered with each new phase of prudential regulation: how to strike a balance between too little regulation, which would pose a risk to financial stability, and too much regulation, which poses a no less tangible risk to growth and, potentially, to financial stability itself. Cutting too sharply the interest-rate, credit and liquidity risks taken on by banks within the context of their commercial activities would in turn hamper economic activity or transfer such risks to other participants in the economy, namely businesses, the general public or professionals. For example, to avoid taking interest-rate risks, UK and Spanish banks developed variable-rate mortgages. As rates rise, borrowers find themselves under pressure, even trapped. Unlike the banks, non-bank players in the economy are only rarely able to manage such risks, which are inherent to economic activity and to a discrepancy between the wishes of economic players with financing capacity and those who require financing. Accordingly, each time banks are asked to take too few risks resulting from their economic activity as lender and collector of savings[1], this risk is transferred to players who are neither regulated, supervised nor professional. Too much regulation excessively reducing the ability of commercial banks to take on the risk inherent to their economic role would in practice lead to a reduction in their business activities, transferring risks to non-regulated players – either directly to economic participants who are ill-suited to manage such risks or to the "shadow banking" sector, leading to a build-up of uncontrolled risk. This is what has once again been happening over the past three years on a very large scale, as the IMF, very recently pointed out by sounding the alarm over the potential danger of systemic risk.

Furthermore, if in order to reduce the volume of risks taken by banks we encourage them to further securitise their loans, they once again transfer their interest-rate, credit and liquidity risks to investors which are little or not at all regulated. To which it should be added that securitisation increases the

[1] Thoughts in Basel are currently turning to implementing stricter regulations for the interest-rate risks taken on by commercial banks by modifying agreements for flows of sight deposits, considering – contrary at least to the French experience – that deposits are less stable; this therefore further constrains the ability of banks to convert short-term savings into long-term loans. This would then prompt banks either to increase securitisation or transfer their interest-rate and liquidity risk to non-banking economic players.

volatility of banks' earnings. Normally, a variation in commercial banks' earnings is a slow process as they live off the margins between the interest rate on their stocks of loans and that on their borrowings and deposits, and off the commissions on the services and products they market. But if banks were tomorrow required to securitise their loans much more, instead of being calculated on their stocks of loans, their earnings would be dependent on the volume of loans produced in a year, on throughput, making their earnings unsteady – hardly conducive to overall financial stability. Though a source of instability in many ways (inconsistent earnings by banks and transfer of risks from regulated banks to other, unregulated players), securitisation can nevertheless be positive, provided it takes place on a marginal basis and under the right conditions. The sub-prime example is proof enough that banks are capable of the very worst in this area. To avoid such excesses, banks must remain responsible for the loans they provide (retaining a minimal percentage of risk on securitisation as provided for in Basel III, in order to avoid the "moral hazard" effect), and they must retain most of their loans on the balance sheet. Securitisation can only be a supplementary – and regulated – solution if financial stability is to be maintained.

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Following the financial crisis a new objective emerged, one that is understandable, but dangerous if becomes obsessional, namely that of never again bailing out the banks from the public purse, that is, the taxpayers. Hence all the new regulations and those being worked on to avoid government bail-outs or to force bail-ins via the banks' shareholders and creditors, following the idea of a "Phoenix" bank rising from the flames. The objective is laudable, but it must be well targeted. Remember that in France banks have paid back all the money lent by the state during the crisis. But above all, the wish not to have to bail out the banks via the taxpayer, though it must legitimately lead to more effective prudential rules, must not excessively trim the risks naturally taken by banks in the course of their commercial activities. Banks are simply the risk depositaries, notably interest-rate, credit and liquidity risk, as stated above. Let us repeat it once again, the banks themselves take on the risks. And this enables other economic players to take significantly fewer risks or avoid them altogether. They do this in a professional and regulated manner, under supervision which must be unfailing. If the risks taken by banks are overly reduced, this will not lead to taxpayers spending less. If the banks themselves no longer adequately concentrated all the risks, the economy would be strangled or, without actually reducing risk and even increasing it for the reasons stated above, it would be transferred upstream to other economic players, namely the taxpayers. This would increase precariousness in times of tension or crisis; risk would be scattered and its traceability lost. With time, general financial instability would be increased.

Of course, here we are interested in the risks inherent to banks' commercial activities and not to their proprietary market activities. So these different situations must be clearly separated out in order to establish fair regulation. The indispensable and irreducible role of banks in the economy must be properly understood to avoid harming the economy and possibly causing an outcome that is the opposite of the one being sought. And finally, as is so often the case, effective and durable solutions require judgement and moderation.

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