John Kay ed. by Robert Tann (2018) *A Level playing field in Technologically Transformed Finance* – Discussion by Domenico Siniscalco*

THE PAPER By Kay and Tann (henceforth KT) is an interesting and thought-provoking work on the reform of banking regulation. It draws lessons from the crisis of 2007-8 and advocates an innovative and fundamental reform of the financial industry and its regulation. There is no need to summarize the paper in this context. I will simply recall the main arguments which are relevant for my discussion.

According to the authors, after the crisis of 2007-8 little changed in the structure of the financial industry. As a consequence, they propose a fundamental re-regulation of the financial industry, which should aim at the *Robustness* of the system, rather than the *Stability* of the individual intermediaries.

A Robust system is structured so that any failure is contained and the cost of failure of a financial institution to the non-financial economy is minimized. According to KT this is the main principle of the regulation in many interconnected utilities, such as water or electricity or (I add) the internet, where disruptions are rare despite the high level of interdependence.

The implications of the regulation model proposed by KT are many and far reaching. i) barriers to entry should be reduced dramatically; ii) innovation must play its disruptive role without impediments; iii) higher and higher capital requirements (à la Basel) for bigger and bigger banks are unnecessary and even counterproductive; iv) "Too big to fail" and the associated bail out policy may be distortionary and give rise to moral hazard; v) banks should be broken up by establishing firewalls (a' la Glass-Steagall) vi) prudential supervision (being based on best practices) is not effective and may induce moral hazard again, bureaucracy and (I add) rent seeking.

On the contrary, a level playing field with no (or low) barriers to entry and open to new technologies leads to a more competitive and consumer oriented financial industry, where services to customers are preserved not necessarily by protecting the existing entities. Innovation, KT argue, should start from retail banks.

The resulting structure, after the adjustments, will be "Narrow Banking" (see also Kay, 2009) i.e. a system of smaller entities, less concentrated, more innovative, with a market or product oriented regulation. As in other industries, regulators will not be concerned with whether the business is well run i.e. stable: the purpose of regulation is to test the quality of products.

Within this framework taxpayers will no longer pay huge sums for preserving the very existence of banks that go bust, as they did after the collapse of Lehman brothers. In the proposed regulation, well run businesses will thrive. Badly run businesses "go to the wall" without systemic consequences.

SOME SPECIFIC REMARKS

As I said at the beginning of my note, this is an innovative and though-provoking paper. The issue it addresses is important and the solution KT propose is innovative. That said, I am not sure I agree with all the facts of KT analysis, on which I have a few remarks.

My first observation is that the industry described by KT is banking (and probably retail banking as a payment system) rather than the whole financial industry, which is a very complex ecosystem of different, complementary and interconnected market participants.

Even in banking *stricto sensu* , moreover, there is much more than a payment system. Investments banks, for example, originate, raise and allocate capital, be it equity or debt. Other banks, manage savings like asset managers.

In some segments of the industry innovation will play a big role and reduce dramatically the level of concentration (think of the PtoP lenders). In others segments however it may not be true. In other segments, innovation will not reduce concentration but may even create further barriers to entry (think of the electronic payments' system). In a nutshell I do not believe the industry will necessarily converge to Narrow Banking.

Secondly, the argument in favor of Systemic Robustness vs. Stability of the individual institutions needs to be discussed and depends, I believe, on the nature of the spillovers. Robustness of the system does not require stability of the individual institutions, and is compatible with a Darwinian selection, if the interconnectedness is similar to water, electricity and the internet, i.e. if the spillovers are transmitted by flows. My intuition, which I submit, is that the interconnectedness (not only among banks but more generally among financial institutions) is qualitatively deeper and different because it goes through stocks (assets and liabilities) rather than flows.

In the financial world, one institution's assets are another institution's liability. In this framework, ring-fencing a certain institution in the name of Robustness may prove to be very difficult, unless the taxpayer provides huge insurance schemes. And even if banks are relatively small failures may trigger domino effects.

If the two previous remarks are true, then, designing a Robust system as proposed by KT might be impossible to achieve. Suppose we achieve narrow banking. Is this competitive structure ideal in the presence of big asset managers, wealth managers, investment banks, etc.? If not, how should we regulate the other market participants? Until now, the whole financial system (e.g. investment funds and hedge funds) has been regulated by regulating banks (e.g. as prime brokers). Is this feasible in the new "narrow banking" structure?

That said, the starting point by authors is right: first, there is no doubt than the existing banking regulation failed, and changed little even after 2008. Second, I add, regulation addressed the problems of the financial system one by one but did not address the issue in a holistic way. In this context, the banking sector extracted macroeconomic subsidies and guarantees from the taxpayer without fundamental changes in regulation. As a consequence there are many reasons to continue our reflection on a deeper reform of regulation of the financial industry.

And this is not enough. Imagine, for the sake of the argument, that we find an optimal solution for a "perfect" regulatory system, no matter if traditional (based on *Stability*) or innovative (based on *Robustness*). In order to discuss the feasibility of such a system, we need to debate whether the proposed solution is viable from the political-distributional viewpoint, given the stakes and the incentives. Hence the need of some political economy.

POLITICAL ECONOMY VS. NORMATIVE RECOMMENDATIONS

At the end of their paper, TK recall the current populist wave as a consequence of the crisis. They fear the populist wave may jeopardize the very notion of the market economy and (I add) liberal democracy.

As many commentators and scholars now recognize, the main consequence of the crisis has been social and political, and what happened in global capital markets in 2008 was in fact a dramatic caesura of global political significance. In the US and in Europe it forced a major rearrangement of global and national politics. (cfr. Tooze, 2018). As we all know today, the response of voters in developed countries has been populism, from the Brexit referendum, to Trump, to the protest vote in Greece, Spain, Italy, Sweden, Netherland, France, Germany and Eastern Europe. In some countries the protest vote was institutionalized in Parliaments and Government. In other countries, due to electoral laws, the protest was pushed in the streets.

As a consequence we are probably heading towards a world of less globalization and trade, smaller migration flows, less fiscal austerity and higher volatility and public deficits. Many analysts claim that global liberalism is dead (Harari 2018) and a few economists (e.g. Dani Rodrick, 2007) even predicted this trend well in advance of the crisis.

In the new world, which is a new paradigm, most likely banking and finance, which are among the big villains, will be over-regulated. I believe that in spite of many policy recommendations, the regulatory landscape will be dominated by the political economy, much more than by the search of optimality.

That said, it is crucial that such re-regulation does not kill the industry but combines efficiency and value added. A level playing field as proposed by KT may be one way. National banks and asset managers may emerge again as a new equilibrium. A greater specialization of intermediaries and market participants is equally likely taking into account the complexity of the system.

In any case, as KT argue, the new system will require a new social legitimacy among the general public if the financial industry needs and wants to survive. This, in turn, will require a rational approach, as well as an ethical compass, as the one we discuss in our conference.

In that respect, the papers by Booth, Morissey, and Hays provide very important material for reflection.

Let me add a final point. So far, from my viewpoint, ethical and religious principles have been treated as broadly independent from the financial world. At most, we have seen an effort to make them compatible with each other. Speaking as a social scientist, while the financial world has been successful in "universalizing" its own interest (what is good for finance is good for all) religious world played asymmetrically a little bit "defence".

In the aftermath of the crisis, I believe the financial world now needs ethics to legitimize its own existence. In this perspective, the themes of the Vatican 2018 letter can acquire a proactive role. For many years, as economists and social scientists, we forgot that The Wealth of Nations and The Theory of Moral Sentiments by Adam Smith should be read together. Time to go back to the classics.

REFERENCES

Harari, Y. N. (2018), *21 Questions for the 21st Century*, Jonatahan cape, London

Kay, J. (2009), Narrow Banking: The Reform of Banking Regulation, Centre For the Study of Financial Innovation, London

Rodrik, D (2007), The Inescapable Trilemma of the World economy, Dani Rodrik Weblog

Smith, A (1759), *The Theory of Moral Sentiments*, Andrew Millar, London

Smith, A. (1776), *An Inquiry into the Nature and Causes of the Wealth of Nations*, first published by Strahan and Cadell, London

Tooze, A. (2018), *Crashed*. *How a decade of Financial Crises Changed the World,* Viking, New York

*) Preliminary draft. Please do no quote without the author's permission. The views and opinions expressed by the author do not necessarily reflect the view of the Institution he belongs to. The usual caveats apply.