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# The end of banks?

By Xavier Vives

Are banks doomed as a result of the current financial crisis? The securitisation of mortgages originally was seen as a triumph, because it shifted risk to financial markets, while taking deposits and making and monitoring loans - the purview of traditional banks - was regarded as narrow and old-fashioned. By contrast, modern banks would seek finance mainly in the interbank market and securitise their loan portfolios.

In theory, such banks should be immune to runs, because the interbank market is supposed to be extremely efficient, and risk would be shifted to investors willing to bear it. Deposits would be replaced by mutual funds, which, as we know, are also immune to runs, and the risk of structured investment vehicles (SIV's) would be assessed accurately by rating agencies. All this financial engineering would avoid the obsolete capital requirements that burden banks' operation.

The current crisis killed off this optimistic scenario. The interbank market has almost collapsed, because banks do not trust each other in the same way that we tend not to trust an eager seller of a second-hand car.

This is a textbook market failure. The origin of the problem is uncertainty about banks' exposure to sub-prime mortgages, the risks of which have been carelessly assessed by rating agencies due to conflicts of interest. Northern Rock in the United Kingdom has been a victim of this modern banking strategy, as has Bear Stearns in the United States. Others may follow soon.

Moreover, institutions that thought they had transferred risk to the market realised that the demise of sponsored SIV's would damage their reputations irreversibly. This implied that they had to rescue these SIV's. Alas, they failed to set aside enough capital for this unforeseen contingency, and external investors such as the sovereign wealth funds of China, Singapore and the Middle East have had to come to the rescue.

Finally, mutual funds are at risk as well, because their supposedly safe investments may sour and the insurance that backs them now appears shaky. The sub-prime contamination of money market funds would prove disastrous, with consequences far beyond what we have seen up to now. The supposed transfer of risk would turn out to have been a mirage.

Are banks, markets, or regulators to blame? The answer may indicate what future awaits banks. Some regulators were irresponsible for not anticipating the rational profit-maximising behaviour of institutions with a limited liability charter and of executives effectively protected from failure.

After all, what should banks do when, instead of keeping sub-prime mortgages on their books, monitoring their performance, and incurring capital requirements, they can securitise them advantageously (because the rating agencies have a stake in the business), avoid capital requirements, and profit from investors' inexperience with such products. Indeed, even if things turned ugly and banks' equity suffered, executives knew that their own generous bonuses and pension packages most likely would not. Given this, regulators should have thought twice before permitting off-balance sheet operations without any further provision.

The fundamental question today is who monitors opaque loans, whether of the sub-prime or any other variety. Traditionally, the answer was banks; in the securitised world, it remains a question.

So, is there an alternative to the old-fashioned monitoring of loans by banks?

Perhaps if those securitised packages had been properly rated, the originating institution would be obliged to retain a share to signal to the market that risk was being controlled. And, clearly, the idea that capital requirements were not needed for banks' off-balance sheet activities (because the banks were not bearing the risk), was simply wrong.

Appropriate regulation - including regulation of rating agencies - would most likely make traditional banks popular again. A reconsideration of banks' limited liability charter would go even further in restoring credibility.

The principle is simple: when your own money is at stake, you tend to be careful. But when you can play with others' money and expect a very high reward for success and no punishment for failure, the incentives for irresponsible risk-taking become enormous.

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