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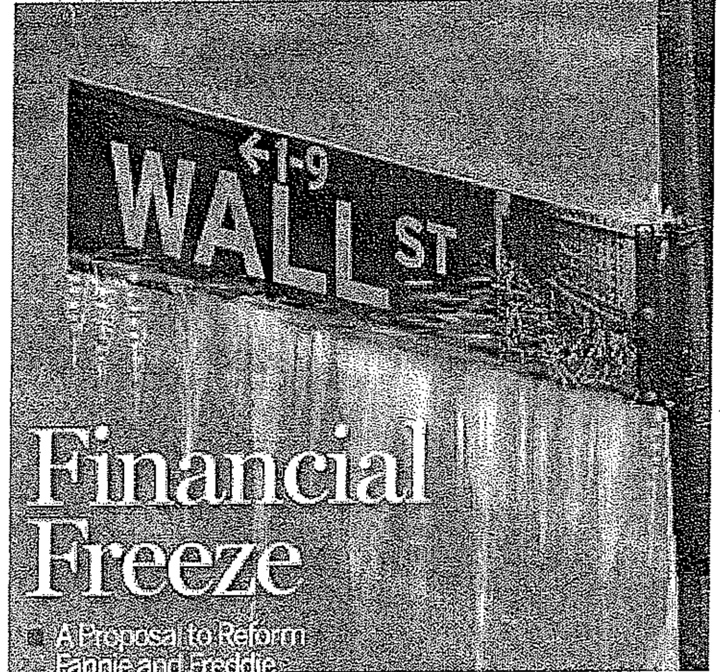

Bankers Only Listen to Laws

By William Kingston
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Some government intervention in the marketplace is necessary, but it will only work well if policymakers get the laws right. For confirmation of this, we need only look at the history of banking, where laws that granted limited liability to bank ownership underwrote risk-taking that escaped all public control.

The limited liability corporation is an extremely valuable social invention. It appeared in Britain and the United States in the 1860s, and was adopted by the rest of Europe in the following decade. By saving investors from having all their wealth at stake if a business were to fail, this type of shareholding made it possible both for higher risks to be taken in investing and for the risks to be spread over portfolios.

Initially, banks did not benefit from this legal innovation. In 1782, the Irish Parliament passed the first act permitting general limited liability partnerships. This contributed to a remarkable period of productive investment and prosperity in the country. Significantly, however, the privilege was explicitly denied to investment in businesses that dealt in any form of money. Banks were similarly excluded from the benefits of the first British acts that gave limited liability to shareholders in companies.

Because of this, the 1878 collapses of the City of Glasgow Bank and Caledonian Bank did not harm the depositors; it was the owners in both cases who suffered the losses because, as partners, their liability was unlimited. The same happened in 1890, when Barings Bank became overextended in South America. The Bank of England persuaded the other banks to help it provide enough liquidity to save Barings, but this was only on condition of great cost to the Baring family members who owned the bank in partnership.

RECKLESS TRADING When the law was changed to extend the privilege of limited liability to bank shares, Barings incorporated in 1905. The eventual result was that the second time the bank could not meet its liabilities – this time in 1995, following outrageous risk-taking in the Far East – the fortunes of its owners (other than their actual shares in the bank) were protected. Instead, it was the depositors who lost. It is highly

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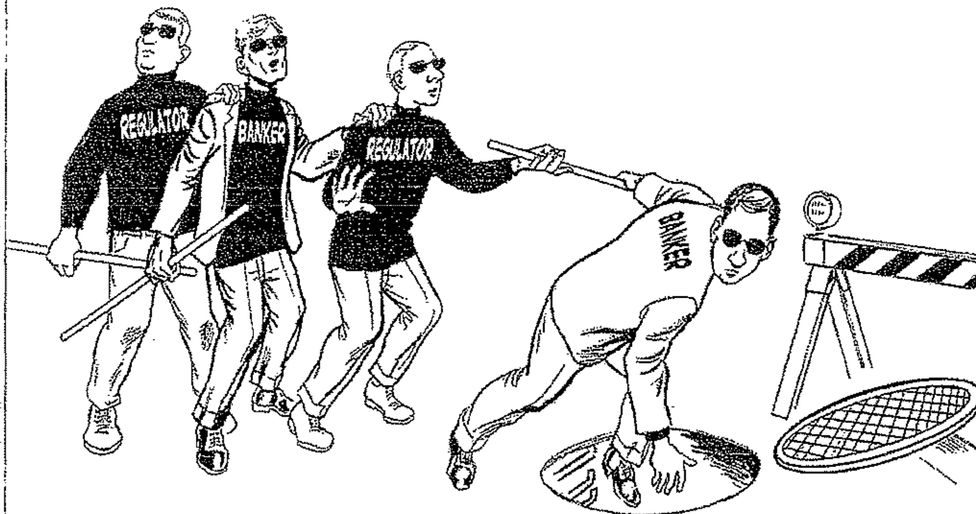
doubtful that, if the owners had still been liable for losses up to the entire limit of their wealth, they would have allowed such reckless trading with the bank's money.

The current financial crisis is the same thing on a global scale. Limited liability was a necessary condition of the development of professional management in every industry. But in the financial sector, without any effective control from a multiplicity of shareholders, it left managers free to develop a range of instruments for the expansion of credit. In the process, they earned vast profits for their firms and correspondingly inflated bonuses for themselves, until the burst of the bubble for which they were responsible. Firms like Lehman Brothers, Bear Stearns, and Morgan Stanley survived the Great Depression of the 1930s as partnerships, but collapsed as public companies during 2008.



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The banking collapse was both inevitable and foreseen. In 1987, Paul Volcker argued prophetically that even a partial relaxation of banking disciplinary law "would recklessly lower loan standards and allow bad loans to be marketed to the public" – exactly what caused the subprime debacle.

EX POST REGULATION The traditional political and bureaucratic response to bad results of laws is to leave unchanged the laws that caused the problems, and to set up regulatory bodies to try to repair the damage. However, this is to ignore evidence that markets can only be effectively regulated *ex ante*, through the way we shape the laws of property on which they depend, and not by *ex post* interventions. There has never been greater proof of this than the catastrophic worldwide failure of regulation of financial institutions.

The phenomenon of "regulatory capture," whereby regulators fall under the power of those they are meant to be supervising, has been well-known to economists since George Stigler. No matter what the gamekeepers are paid, the poachers can always afford to hold out the prospects of jobs at multiples of their salaries to influence them. Because the poachers are the innovators, the gamekeepers can never get ahead of them, but in fact struggle to keep up.

Further, the imbalance in motivational terms between the two parties is overwhelming. Regulators, even if people of personal integrity, are public employees, and there is no reason why they should be passionately motivated to study and understand the subject-matter of their task. Nor can outcomes have much effect on their personal situation, one way or the other. Consequently, they can never be a match for those they are supposed to regulate, the Masters of the Universe who eat, sleep, and dream their project in hand. There is no point in shooting the regulators, because, even if they do their best, they can never win. They have been given a task they simply cannot perform. And as long as the regulatory "light touch" is apparently bringing about growth and jobs, a regulator who wanted to try to do his job properly would look in vain for support from politicians.

GETTING IT RIGHT Since *ex post* regulation is intrinsically incapable of working, we have to go back to trying to get the laws right. No matter how unacceptable it may be to the conventional wisdom and to special interests, one element of this would be to remove the shelter of limited liability progressively from financial institutions. The investment banks and similar funds should be the first to be forced to return to being partnerships, since it was they who devised the instruments of credit expansion that seduced the clearing banks and building societies. Such a move would restore responsibility at the top, because the owners would then be engaging their own wealth in its totality in whatever decisions they might take. There would be no more one-way bets for managers faced only with multiple and supine owners.

It is no argument against this that the financing of modern large-scale industries could not be carried on by the smaller banking units. The extraordinary economic expansion over much of the 19th century was financed by such units in the form of banking partnerships. Some of these were even able to handle flotations that would be large by today's standards. And how much ground has the collectivist cause now made through governments having to bail out banks too big to be allowed to fail?

Clearly, more than a century of going in the wrong direction cannot be reversed overnight. But the principle of getting the laws right, instead of strengthening regulation that cannot work, should nevertheless dominate the upcoming attempts to reform the international financial system. R