Commentary on Professor Emeritus Arthur Wilmarth's Talk
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By Dr Virag Blazsek

Thank you very much for this introduction, Steve, and thank you, Art, for your presentation, which I greatly enjoyed.

In my commentary in the next few minutes, I will reflect on what we have just heard from Art about universal banks and also about the applicability of the book's arguments to the current pandemic-related crisis. The title of today's talk is the "Lessons from the two most recent financial crises and the great depression."

Art's starting point is that we can distil lessons from previous financial crises and put regulatory measures in place to prevent or lessen future financial crises. -- As history shows, and there is no debate about this among scholars, cyclic financial crises are unavoidable. In 2011, Reinhart and Rogoff, two Harvard Professors, published an over 500 pages book about the history of financial crises of the past eight centuries. The book is titled, This Time Is Different: Eight Centuries of Financial Folly. (Rogoff also served as a Chief Economist of the International Monetary Fund, the only globally available bailout fund.)

So, we know that cyclic financial crisis are unavoidable -- and this is demonstrated by 800 years of history. What is relatively new is that in the 20th and 21st centuries, we have had two really big waves of financial regulation: first, after the 1929 financial crisis, and second, following the 2008 global financial crisis. Those regulatory measures created our current financial regulatory frameworks. So, the building blocks of financial regulation were put in place as a consequence of past financial crises. Those building blocks -- such as central banks, the existence of deposit insurance and investor compensation schemes, capital and liquidity requirements for banks, prudential regulation, financial consumer protection -- all serve the purpose of preventing or mitigating upcoming financial crises, in other words, to sustain the stability of the financial system.

As a consequence of the invention of electricity, the computer, and the internet, our world is being reshaped by technological developments exponentially. This also affects the financial sector, so keeping up with the changes is more difficult now then ever. So, the first point I want to make is that due to circumstances partly external to financial regulation, financial regulators are facing bigger challenges today than ever.

Second, in this book, Art fleshes out the legal issues and consequences of letting deposit-accepting banks to engage in issuing securities, in other words, mixing deposit-accepting functions with investment banking functions, in particular, with the power of issuing securities, which is a financing activity. Given Art's over four-decade experience and depth of knowledge, the book is an invaluable contribution to the banking law literature. The primary solution Art offers in the book is to separate those two types of activities, deposit-acceptance and investment banking, by statutory provisions. The secondary solution he offers is that if such separation wouldn't be put in place by the legislator, then the size (and systemic risk) of banks should be reduced by using the toolkit of Antitrust Law. He argues that this would increase financial stability and it would decrease the number and size of future bank bailouts.

This approach is basically the application of a fundamental risk management technique to financial regulation. From a risk management perspective, within a bank or a banking group, it is helpful to separate functionally or structurally/institutionally the different functions. The reason for that is that when something goes wrong with one specific activity, the risk team does not need to search for the location of the problem (so, there is a time-component here), and in case of institutional separation, the risk is also isolated institutionally, preventing an immediate financial contamination within the banking group.

The Glass-Steagall, as Art pointed out in his talk, separated the three financial sectors; banking, investment, and insurance. But there was a further advantage to that system, and this was also mentioned in Art's talk. Structural separation is not only a risk-management tool but it also prevents conflicts of interest and distorted business decisions. Many jurisdictions respond to that issue through mandatory information barriers within the banking organization, but it is questionable how efficiently that can work in practice.

Let me give you an example to illustrate this issue. In Hungary, like in many other universal banking jurisdictions, only so-called mortgage banks can issue mortgage-backed securities (mortgage bonds). So, if a bank wants to issue mortgage bonds, the purpose of which is to create financing for the mortgage loans the bank provides, the bank itself cannot do it. The bank needs to set up a strictly regulatied separate entity, a mortgage bank, which can issue and sell the mortgage bonds. The mortgage bank is not allowed to engage in any other activities. So, the bank, the deposit-accepting financial institution is prohibited from issuing mortgage bonds and the mortgage bank is prohibited from accepting deposits. So, even though universal banks operate in Hungary, this is an example for how the regulator can still separate deposit-accepting activities and securities-related activities in a universal banking regime. However, this is a partial separation because the two banking entities still operate in close cooperation. This is the second point I wanted to make.

Thirdly, I would like to talk about why do governments rescue financially distressed banks at all? And the answer to that question is that because those banks manage the money of their clients, including retail clients, like all of us, and also corporate clients, like the shops we purchase our goods in, manufacturers, industrial companies, agricultural companies, and all kinds of service-providers. This is why we call banks financial intermediaries. This is why banking bailouts and bailouts in other sectors of the economy are so different. So, when we talk about financial stability, we talk about the smooth operation of the economy, and that includes issues of job-security and whether the money we are using will keep or lose its value.

The final point I want to make is that future bank bailouts, in my view, are just as unavoidable as future cyclic financial crises. But this does not mean that we shouldn’t do everything we can to have less banking bailout cases and to spend less taxpayer money on those banking bailouts. The high importance of this issue and the effects on public finances were well illustrated by the charts Art has just shared with us. In that respect, I would like to mention that the pandemic-related crisis is not a financial crisis in my view, and a large part of the money spent by governments was directly spent on the real economy, on economic stimulus packages, and not on banking bailouts. All this gives you an idea of the far-reaching importance of the issues Art discusses in this book. This was the last point I wanted to make.

In sum, in this book, Art explains and supports with strong historic, economic and legal arguments why the Glass-Steagall Act’s logic is one of the provenly good tools to regulate banks. Finally, it is a great value of the book that it compares a variety of jurisdictions, such as the US, the UK and the EU. So, the Reader gets a very accurate idea of the current state of financial regulation globally.

So, this is what I wanted to say in these 10 minutes, and now I give back the floor to my colleague, Steve.