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What are Banks For?

All investment carries some risk. From time to time people have lost money by putting their trust in the motto "as safe as houses", and it looks as if they may again. An investment is called speculative if it entails more risk than usual. Different people will put the boundary at different places, but the distinction is real and intelligible. The scale is one of willingness to risk losing money in the hope of gaining more. Speculation need not be disreputable. If there is an acceptable face of captialism it is the basic principle that money is used to back a business: if the business succeeds the money grows, if not, not. As investors in Venture Capital Trusts have discovered over the last ten years, serious investments in start-up companies can be very risky and, it might be said, speculative. In that case part of the speculative investment comes in the form of state subsidy by way of tax rebates.

There is a clear distinction between all forms of investment up to and including speculation on the one hand, and gambling on the other. The difference between investment and gambling is that, with the latter, money is simply or complicatedly transferred from one party to another; this applies to investment, even if all the money is lost, only in the case of fraud.

The rationality of banks, which gives them any respectability they have, is that they are the channels of simple capitalism. Depositors as well as investors provide money which the bank then uses in financing productive concerns, and so if all goes well successful products or services are actually made, and along with them money: the financed business prospers, the depositors get interest and the investors dividends and capital gains.

Contemporary banks also have "proprietary trading desks" where plainly speculative activities go on, and in some cases outright gambling. Deutsche Bank got a good press last year because (which some nonspecialists might think did not require much acumen [1]), having seen

the "sub-prime" mortgage trouble brewing, they made money by "shorting" the relevant market. [*P. S.* two years later there was a report of ". . . Deutsche Bank's full year loss, driven by lousy proprietary trading . . . ." (Lex column, *Financial Times* 15 January 2009). Gamblers naturally have ups and downs.] For anybody who doesn't know, to "go short" on any stock or commodity is to sell something which you don't own, in the hope that by the time you have to supply the goods the price will have dropped. This is done by way of borrowing other people's shares, or by put options and the like in the futures markets: agreement to sell (or with "calls" buy) something at a fixed price at a future date. So for instance if the present price is 100 you can buy a put option to sell next month at 80, for which the contract may not cost you much, and if the price drops to 60 you can collect a profit.

Notice that nothing is produced by shorting, and the speculator need have no acquaintance with the underlying assets. There is a lot of speculation in hogs' bellies. It can nevertheless have effects in "the real world": if enough gamblers go short at the same time we have not abstract academic prediction but a market force in its own right, so that the prophecy can be self-fulfilling.

Firms like IG Index and City Index turn this kind of speculation formally into betting. Clients simply bet on market movements, and since they never own anything but the betting contract are not liable to capital gains tax (and cannot claim capital losses). The firms concerned can lay off the bets in the markets to cover themselves, but essentially they are in the same position as the bookie who calculates the odds and makes a profit or loss accordingly, usually the former.

Now: gambling is not what banks are for. It is no new thing for banks to gamble. In the Ealing comedy *Kind Hearts and Coronets* (1949) one banker rebukes another for getting into trouble with unwise shorting. But from the point of view of respectable banking in any age, all shorting is unwise and should simply be avoided.

Whenever anything goes wrong with a bank, offers are made to improve “the system”. With the Northern Rock débacle the system does seem to have been at fault, or perhaps it would be truer to say that the run on the bank got going because the powers that be had a system “in place” which they thought would handle such matters. Before the “big bang” in the City, the high-ups in the Bank of England would have seen trouble ahead—which, like the sub-prime business would not have been difficult [2]—and quietly arranged a takeover. Mr King seems to have done what he could along these lines, but the “transparency” of Mr Brown’s system prevented any effective action. Mr Darling, the new Chancellor, early on in the affair, went on the radio to say, as a rebuke to the Governor, that the bad old days of private stitch-ups were over; a view repeated by the Commons select committee which reported (26 January 2008) on the ineffectiveness of the system. *Any* transparent system would guarantee the occasional run on a bank. But central banks ought to be able to make what arrangements are necessary; which in this case would have been to facilitate a takeover by Lloyds TSB. In the U.S.A., free from the British system of tripartite supervision, they have just avoided a major banking crash by helping another bank take over Bear Stearns. (A legend about one of Mr Bernanke’s predecessors: he received into his office the directors of a bank in trouble and said, “Gentlemen, I shall be happy to discuss your problems, with your successors.”)

What is needed is not a better system. The ingenious M. Jérôme Kerviel managed to lose nearly a thousand million pounds for Société Générale before anyone noticed, and then the bank lost three times as much closing his positions in a hurry. M. Kerviel was enabled to get that far by his intimate knowledge of their system. In a respectable bank he would not have been gambling at all. Gambling is just not what banks are for.

That should be the difference between a bank and a hedge-fund: hedge-funds gamble, banks invest, though there is no doubt a shared area of speculation. With a hedge-fund you at least know where you are, and that any genuine investment is coincidental.

If you wish to risk your money on gambling, join a betting syndicate, but if you want to make money out of gambling as an investment buy a casino or a bingo hall. Banks should be doing something else. That there is in fact only a difference of scale or proportion between a contemporary bank and a hedge fund is demonstrated by the euphemisms. As well as "proprietary trading" there is "investment" itself. "Can banks run investment banks?" asks the *Financial Times* (Editorial, 23 February 2008). By "investment bank" they just mean "speculative/gambling operation". So the essential distinction between investment and betting is lost.

By the way, M. Kerviel was at first reported as having committed a massive fraud. One doesn't know quite what the charges will be, but so far nobody says that he was trying to misappropriate funds for himself: if not it was not fraud, just institutionalisation of gambling. If he had *made* seven thousand million euros would anybody have complained? (But remember that if he made them somebody else lost them, and what he lost somebody else gained.)

The only guard against the Leesons and Kerviels is integrity. Integrity is not a system. A company calling itself a bank but making (or losing) its money by betting should not expect integrity from its staff.

NOTES

1 The present "credit crunch" was very predictable not because history repeats itself, but because certain fairly obvious economic conditions were met. After years during which the Western economies kept themselves going by nearly unlimited cheap credit, interest rates began going up, and it became harder for individuals and firms both to "service" loans and to renew them without paying a lot more money, which not all could afford to do. What could be less surprising than that people who were already having trouble paying the interest on a mortgage should have more trouble when it went up?

2 Northern Rock's trouble seems not to have been an unsound mortgage book—for the interested parties all assure us that the assets are good, and that is why the business can be a going concern—but the very elementary mistake of borrowing short to finance long at a time when interest rates are going up: see Note 1. That is, they went one better

than the old idea that people save their money in a building society which then lends it to others to buy houses; they increased their level of activity by borrowing money at lower rates of interest than have to be offered to depositors, enabled to do so by the Greenspan-inspired world low interest rates, and didn't notice that the age of artificially low interest rates on the money markets was coming to an end. So they needed to renew short-term loans which they were unable to do except at rates higher than they were paying depositors and then, when lenders realised something was seriously wrong, were unable to do at all. Any treasurer who ran the finances of a golf club in this way would be judged to be both of questionable morality and incompetent.

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