

FINANCIAL TIMES

September 17, 2013 10:55 pm

It is a mistake to put a bridle on bank innovation

From Mr Daniel J Aronoff.

Sir, Most recommendations to reform banking aim to reduce the risk of systemic meltdown, yet there is a divide between an approach that sets bounds on financial structure to protect against insolvency and illiquidity, such as minimum leverage ratios and liquidity levels, and proposals to regulate the business practices inside banks, such as employee compensation, lending guidelines and portfolio composition. This distinction is not often recognised, and the “five bitter pills” featured in your Analysis article of September 13 contain elements of both approaches. But there is a crucial difference between them: under the former approach, banks remain free to pursue innovation and to risk failure, while the latter approach aims to make banks behave like public utilities.

I think it is a mistake to try to make banks adopt “safer” practices, and it is not necessary to do so in order to make the financial system less prone to collapse. The system can be made safer by reducing leverage and concentration – breaking up the big banks into smaller units – while allowing experimentation to flourish. There is nothing wrong with creative destruction, so long as it does not blow up the entire economy.

Even if it were possible to devise a regulatory system that would compel banks to engage in less risky activities – and there is considerable reason to doubt that it is possible, not only because of regulatory arbitrage, but because risk is often recognised only after the outcome has been revealed, and regulators are no more prescient than managers in recognising risk *ex ante* – it would spell the end of the financial sector’s contribution to economic growth. We glorify the risk-taking culture of Silicon Valley entrepreneurs and we recognise their activities and their moneymaking culture as an important engine of economic growth. We are right to do so, but we ought to extol our banking innovators as well. The contributions of financial innovation – ranging from derivatives and asset-backed securities that enable more of us to own homes and cars, from ATMs, insurance and mutual funds, to online banking, interest-bearing checking and many other things – have arguably contributed as much to our economic wellbeing as have the technology innovators.

Oh, and one more thing. Financial innovation – venture capital and small-cap initial public offerings, for example – made Silicon Valley possible.

Daniel J Aronoff, President, The Landon Companies, Royal Oak, MI, US

You may be interested in

Everyone does not deserve a medal

Ignore the doom-mongers - Europe is being fixed

Printed from: <http://www.ft.com/cms/s/0/0b5d5040-1aee-11e3-87da-00144feab7de.html>

Print a single copy of this article for personal use. Contact us if you wish to print more to distribute to others.

© **THE FINANCIAL TIMES LTD 2013** FT and 'Financial Times' are trademarks of The Financial Times Ltd.