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Banking and Finance Policy

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Central Definition

Banking and finance policy encompasses public policy towards regulating the behaviour of banks (regarding lending decisions, minimum standards for holding cash, and depositor protection) and financial markets (investor protection, stock, commodity and derivative markets, trading, payments, and deposits).

The Nature and Importance of Banking and Finance Policy

Finance, which includes banking, stock markets, commodity markets, bond markets, national currencies, derivatives, fintech, and crypto-assets, is essential for economic and social development and the quality of life in general. As a good, it can be likened to electricity, while the institutions and practices that make finance work can be compared with the electrical grid. While we depend on electricity and are constantly upgrading the quality, availability, and sustainability of supply, the danger of electrical fires and blackouts lead to product and infrastructure safety standards to ensure continuity of service and prevent disasters in one location from spreading throughout the system. Similarly, public policy, law, and regulation regarding finance seeks to ensure supply and allow for innovation to achieve this, but in ways that prevent those innovations and fraudulent behaviour (Ponzi schemes) from leading to financial meltdowns that hurt individual investors and the broader financial system on which we all depend.

Distinguishing Banking and Finance Policy

Banking and finance policy is therefore a core area of competence for public policy professionals, especially those trying to channel investment for economic, social, and environmental policies. Public policy, regulations, institutions, and oversight both influence the nature of finance and are influenced by financial enterprises in ways that matter for the capacity and goals of the state. A key difference between banking and finance is that banks generally invest directly in the economy to clients they know by lending to households, companies, and government over the medium and long term, while financial markets

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invest indirectly and beyond the real economy though bonds, stocks, commodities, financial derivatives, and crypto-assets that can be sold at a moment's notice. Another difference is that states sometimes establish and operate public sector banks to supplement private activity in the pursuit of public policy goals. Either way, public policy sets out the legal framework providing opportunities and conditions for banks and financial markets to do business. In doing so, each country makes decisions about how strongly it wishes to foster bank lending, which is arguably safer (lower risk), more conservative (lower reward), and planned, or financial markets, which are more risk-acceptant and volatile (high risk, high reward). Typically, countries assign bank and insurance regulators to ensure that banks and insurance companies keep enough cash on hand to meet their daily needs and invest prudently enough to avoid disaster. They also assign financial market supervisors to ensure that companies offer transparent information to investors and treat them equally. All of these supervisors work in the context of national regulations that in turn are reflected in the standards of global standard setters, which set out principles and guidelines: the Basel Committee on Bank Supervision; the International Association of Insurance Supervisors; the International Accounting Standards Board, the International Organization of Securities Exchange Commissions, and the Financial Stability Board.

The Rise of Financial Markets and the Remaining Roles for Banking

For much of human history, states have tended to cultivate and negotiate a symbiotic relationship with banks as entities that not only provide patient capital for long-term development, but in ways that can be harnessed for industrial, social, and environmental goals. Since the 1980s, many states have also increasingly legalized and regulated financial markets specializing in short-term investments to finance riskier, more costly economic transformation and infrastructure development. This shift to financial markets went hand in hand with the rise of international capital mobility, rising interest rates, and restrictions on public borrowing after the early 1980s. It also coincided with the departure from known, predictable kinds of industry that banks felt safer financing towards a higher appetite in financial markets for channelling private wealth into high-risk, high-reward investment in new business models and unproven technology. Both the third and fourth industrial revolutions owe their development to financial markets more than banks. Nevertheless, banks are considered critical infrastructure, providing critical loan and investment services to the economy.

Changing public policy to allow this shift to rely more heavily on financial markets has not only changed the balance between banks and financial markets in the economy, it has also changed the balance between states and markets, with public policy generally much more sensitive to the views that financial markets have about a country's economic strategy, political stability, and overall socioeconomic performance.

The rest of this chapter covers the interaction in four ways: secular patterns over time that reflect political eras across countries; secular trends across countries rooted in responses to global and regional financial crises; comparative public policy across countries that reflect institutional and political differences over the relative desirability of banks and financial markets; and new strategies for leveraging banks and financial markets to finance public policy goals.

The way in which the economy and the public sphere is financed, and the policies that shape that finance vary accordingly over time in response to political imperatives. The last century has seen the rise and then the fall of public policies that support banks as the main vehicle of economic investment. During the pre-democratic Gold Standard era, banking and financial markets coexisted side by side and were largely private affairs, financing northern industrialization and imperial globalization in the absence of state responsibility for economic management. Between the late 1930s and early 1980s, banks became largely public and/or nationally controlled institutions, with widespread reliance on public ownership and

regulation of banks to prioritize economic and social development and stability where financial markets failed to do this. The World Bank was also developed as an UN-based agency to loan money to national governments, particularly those with the least access to international or domestic investment, for the same purpose.

From the mid-1980s until 2020, states legalized, fostered, and opened up national borders again to financial markets, which they increasingly relied on to pay for industrial, corporate, and even public infrastructure development. During this neoliberal period, public officials relied less on banks and sacrificed some degree of direct responsibility for social goals. By 2020, however, a combination of health, geopolitical, environmental, and social challenges had revitalized state involvement in banking, including state-sponsored development banking and finance to restore infrastructure, industrial capacity, and public services. Overall, the greater the crises facing governments, and the greater the need to produce social goods to a broad population, the greater the political imperative to favour banks over financial markets. Governments have leverage over banks, or can provide banking services themselves, in ways that are not possible with bond and stock markets.

Recurrent crises have meanwhile led to increases in regulation and oversight of banks over time, with the goal of rendering them more resilient to crises, both internal and external, and less likely to require a taxpayer-funded bailout. From the 1930s to the 1970s, bank regulation and deposit insurance was introduced in many countries but varied greatly. In 1974, the Basel Committee on Banking Supervision was established to set international banking standards after a spectacular banking collapse in Germany that threatened to collapse the international banking system. The Basel Committee's standards cover capital adequacy (how much cash a bank has available under different conditions to remain able to pay customers and in what form), market confidence (assessments by credit rating agencies about the bank's finances and corporate governance covering rules, procedures, and offices required to make sound financial decisions), and state supervision (through legal rights of bank supervisors to demand resources, information, and issue orders). Overall, Basel standards now mandate that the riskier a bank's loans and assets, the more capital it must raise and set aside, which theoretically restrains credit to the economy. This means that public officials seeking to use banks to finance local infrastructure need to produce a business plan detailing how the funds would be paid back.

In practice, however, there have been two trends since the 1990s that lead to a decline in the connection between banking and public policy goals broadly defined. The first is the commercialization of banking (the reduction in the number of banks with a public service or social mission since the 1990s), and the second is the financialization of banking (in which banks rely on financial markets to finance themselves rather than depositors). As regulations on capital adequacy have been introduced, they have also permitted banks to access financial markets for funding, rather than the deposits of their clients, and to insure themselves against losses, rather than scrutinizing their borrowers, with the blessing of the politicians and regulators they successfully lobbied to allow this. While this has allowed them to make more loans that are safe according to financial engineers, which public officials generally support, it has also made them more vulnerable to irrational exuberance in bank lending (which caused the Great Financial Crisis of 2008) and to panics in financial markets directed at banks in particular countries and regions (such as the Eurozone Crisis of 2010–2015) (Hardie et al. 2013). A result is the periodic development of new regulatory requirements that require banks to lend to safer borrowers, including government bodies.

Despite these general trends, banking and finance policy varies depending on jurisdiction, with implications for the flow of finance to the economy, and state capacity to manage banking and financial crises. Since the Big Bang deregulation of 1986, the UK is home to massive financial markets that are lightly regulated, as well as a highly commercialized and internationalized banking sector. Bank regulation is limited to high capital adequacy standards to ensure global investor confidence in the sector. Prior to Brexit,

the UK provided most of Europe's critical financial services outside of banking and insurance, so that the country's departure from the EU posed significant challenges for the bloc. In the wake of Brexit, EU bodies and national authorities have effectively forced financial services companies to migrate some of their personnel and assets from London. Brexit has led Paris in particular to emerge as the central organizing hub for financial services that have migrated from London to a variety of European cities, depending on the legal and regulatory environments to support them (Donnelly 2022).

Even though the EU's Capital Markets Union project supports these developments, and even tries to direct financial markets into supporting sustainable development by promoting environmental, social, and governance (ESG) investments (companies with strong ESG credentials), the strong presence of banking remains distinctive in Europe to this day in contrast to the USA or the UK. France, Germany, Spain, and Italy are countries with large commercial banking entities alongside alternative banks with non-profit missions to support local economic and social development, as well as green economic investment. While successive financial crises have caused distress in the banking sector through non-performing loans that sap banks' financial strength, significant steps have been taken in the form of Banking Union to harmonize and raise safety standards and oversight for the banking sector, stabilizing the eurozone (Howarth and Quaglia 2016).

Throughout much of the world's emerging market countries, state-owned development banks are a common tool for channelling strategic investment into industrial, infrastructure, and social public policy goals. In some cases, national finance ministries have also directed private banks to direct credit into strategic sectors enjoying political support. Both have been vehicles for state development strategies in countries like Japan, South Korea, Taiwan, and China to propel their economies from the periphery of the global economy to the upper echelons (Wade 2004). The same is true for sovereign wealth funds. Both have mandates and often representatives from the government sector. Generally, the more professionalized, resourced, and development-focused these entities are, the greater the impact on overall economic advancement.

In contrast, the USA is well known for both the world's deepest financial markets and a hub of international banking, alongside small, regional bank entities that are required to reinvest a portion of their profits into local communities. Regulations on large banks and their involvement in financial markets were introduced in the 1930s, then repealed in the 1990s, and then reintroduced after the 2008 Financial Crisis to enhance financial stability and prevent economic and social disruption. While the intent is primarily to ensure domestic investor confidence and depositor protection, international confidence in the safety of US investments is also an outcome that policymakers seek to ensure. The USA remains the centre of the international financial system, attracting investment from around the world and providing a safe haven during time of crisis and instability.

Resilience in Banking and Finance Under Pressure

As well, the USA plays a unique role internationally for a key function that all financial systems require, whether bank- or financial market based: public backstops, known also as the lender of last resort function. While the failure of individual financial institutions can often be managed by deposit insurance and bankruptcy proceedings, some crises threaten to spread throughout the financial system, and can only be stopped through government intervention. This intervention takes the form of cash injections into the economy, typically through the banks that are in jeopardy. While these can be grants provided by government, or payments from a deposit insurance system from a failed bank, they are more typically loans to banks that are still fundamentally sound but short of cash in a moment of financial crisis, and most typically loans against collateral from the central bank to help banks access enough cash to weather the storm. While each national central bank bears responsibility for its own banks, the

US Federal Reserve has periodically provided other central banks with similar services to keep the global network of financial services intact. In addition to the emergency interventions of the Fed, national governments can also call on the International Monetary Fund for loans when they can no longer access credit by selling government bonds directly to investors. IMF loans are negotiated in exchange for policy concessions that set the terms for repayment over several decades.

These actions serve the same functions as a combination of breaker circuit and a backup generator system in the electrical grid that allow it to weather calamities. Deposit insurance stops individual meltdowns from spreading to the rest of the system, and are now combined with resolution systems, which aim to transfer bank clients to new banks and close the bank while containing contagion to the rest of the financial system, while lender of last resort interventions keep the rest of the system supplied with the energy they need as part of the system falls away.

The Corona pandemic and Europe's urgent need for an energy transition in the wake of conflict with Russia have returned attention once again to using and supporting banks, including alternative and public banks as providers of credit. The most visible use was providing public loans and loan guarantees for companies to keep them and their employees paid during the pandemic. Accelerated investments in housing, health, alternative energy, energy conservation, and physical infrastructure require targeting that financial markets are unable to accomplish and have led public officials to leverage banks for these purposes alongside direct public investments. In Europe, this can be seen in the NextGenerationEU programme, which grants money to invest and guarantee loans in digital, health, and environmental improvement.

Cross-References

▶ Economic Policy
▶ Monetary Policy
▶ Regulation in Public Policy

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