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# Narrow Banking and All That

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## Foreword

John Kay has been an excellent friend to the David Hume Institute during the five years for which I have been Director. We were immensely grateful when he agreed to visit us once more in February this year, to deliver the paper that is presented in this document. We were also very grateful to Scottish Enterprise for supporting the Institute and for sponsoring this excellent seminar.

John Kay is a member of the First Minister's Council of Economic Advisers and a renowned and informed expert on matters pertaining to the Scottish economy. He is also, as all fans of his column in the Financial Times will know, a highly respected commentator on matters relating to the banking sector – and one whose comments in recent months have been closely watched by key players including the Governor of the Bank of England. Indeed Dr Mervyn King referred to, nay endorsed, John Kay's thoughts on 'narrow banking' in a speech given in Edinburgh at the end of 2009.

Therefore John was the ideal person to relate banking sector issues to the Scottish context. This is a complex and potentially controversial topic, given that two of the major players in the UK banking drama in 2008 and 2009 were based in Scotland. On the evening our attention was immediately engaged by John's first words – as set out in this paper. How should a First Minister in a newly independent Scotland react to news that RBS is on the point of going bust?

After this attention-grabbing start, and the tough starter question for ten, we were treated to a set of high quality mini-seminars on the key relevant topics, before he provided his fascinating answer to the question raised at the outset. This proved the foundation for a thought-provoking question and answer session and indeed a highly charged discussion over a dinner with representatives of the Scottish banking sector that followed.

The issues that John Kay raised remain at least as pertinent now as they did in February. The new coalition government is giving serious consideration to the possibility of splitting the 'casino' banks from the utility banks, as are a wide range of other national governments and international institutions.

In a subsequent David Hume Institute seminar this spring we heard Willem Buiter argue that banks that were deemed 'too big to fail' may now have become 'too big to save'. If that is correct, then the case for seeking a solution to the enormous risks still extant in the banking sector becomes more important and even more urgent.

I commend this paper to you while noting that – as must always be the case – the Institute has no collective views on any such matters.

Jeremy A Peat
Director

# Narrow Banking and All That

## *1. The problem*

You are the recently appointed First Minister of an independent Scotland, sitting in the elegant drawing room of Bute House, enjoying a relaxing moment after a stressful day. Then you receive an urgent call from the Governor of the Central Bank of Scotland. A few minutes later, the Governor is shown in. He explains that within a few days the Royal Bank of Scotland will be unable to roll over its facilities and will run out of cash. What do you do?

If you are wise, you will ask for a few minutes to think over the problem. I want to invite you to do the same this evening. Many of you will start from the viewpoint that you would prefer not to have to answer this question, or that you would not wish to be in a position in which you did have to answer it. I am not going to allow that answer. Any of us who are in any way involved in public life in Scotland – and that includes more or less everyone in this audience, otherwise we would not be here – must acknowledge that they might either have been faced with that problem, or called on to give advice to those who might have been faced with that problem. What would we have proposed?

The question which I have proposed is a demanding examination question, which tests the candidate's knowledge and analytic skills in several areas. It requires us to think about the implications of a political and economic structure that gave greater economic autonomy, or political independence, to Scotland. The question raises general issues about the nature of regulation, both generally and in financial services. The question also invites us to review the purposes and structure of the financial services industry in Scotland and elsewhere.

But, to be fair, an examination question is normally posed at the end of the course, not at the beginning. So this evening I propose to orchestrate a series of mini-seminars on relevant topics before demanding an answer to my question at the end.

## *2. Scotland's money*

Begin with the monetary arrangements which might be in place following Scottish independence. There are three broad options. The first is for Scotland to be part of a United Kingdom monetary union. The second is for Scotland to be part of the eurozone while England remains outside the eurozone. A third possibility involves the establishment of a distinct Scottish currency. In this scenario the pound Scots would float independently of both the euro and sterling, although its value would obviously be heavily influenced by the changing levels of each.

Each of these three options has merits, and each raises further questions. The European link would probably have been the worst option for Scotland in the period 1999 – 2007, but also the best option in the crisis that followed. I think this is a fair interpretation of the Irish experience. Ireland's link to the euro and particularly to European interest rates contributed substantially to the inflationary boom in Ireland during the years up to 2007. But after the virtual collapse of the Irish banking system in the autumn of 2008, the resources of the European Central Bank, and the implied support of European institutions, put Ireland in a stronger position as a eurozone member than if the country had enjoyed monetary independence.

A Scottish peg to the pound sterling might be an informal arrangement. For many decades following Irish independence, that country linked its currency to the pound sterling in this way, effectively bound by UK monetary policy but playing no part in its formulation. An informal peg would, of course, leave Scotland almost as vulnerable in the event of a specifically Scottish crisis – such as the collapse of Scottish banks – as the country would have been with a freely floating currency.

An alternative possibility involves a formal monetary union with England. The specific institutional arrangements for this would no doubt have been negotiated as part of the overall discussions surrounding any independence settlement. Plainly, if there were such a monetary union, there would also need to be some kind of growth and stability pact.

It is hard to believe that an English government would have agreed to enforcement mechanisms as informal and ineffectual as those of the European Growth and Stability Pact – and it certainly should not have done so. Although a formal monetary union offers some influence – probably slight – on the monetary policies of the currency union, the price is therefore a significant loss of the fiscal autonomy which might be an aspiration of independence. Of course, the apparent loss of political freedom is only an acknowledgement of the limited economic autonomy available to a country whose principal trading partner is a much larger neighbour.

The third option, a freely floating currency, has some attractions. The experience of countries which have followed this route, such as the Scandinavian states which remain outside the eurozone, is that there is a strong *de facto* link to a European monetary policy and exchange rate policy. But the experience of Iceland illustrates the extent to which freedom of action conveys vulnerability. Iceland considerably aggravated its difficulties by failing to accept advice or practical help from other Nordic countries until its crisis was unmanageable.

It is certainly not my brief, nor my intention, to debate such monetary issues tonight. But any response to the First Minister's banking dilemma requires a view on the monetary arrangements which would have been adopted by an independent Scotland?' The banking question is contingent on an answer to the monetary question.

## *3. The economics of regulation*

My next topic is the economics of regulation. A central lesson of regulatory history is that regulation works best when it is focused on a limited number of well defined objectives. Regulation works badly when the policy seeks to impose in generalised supervision with a view to the promotion of a particular conception of good business practices. Such regulation tends to be extensive and intrusive, yet at the same time prone to regulatory capture. That capture means that despite the complexity and comprehensiveness of regulation it is largely ineffective. Today, financial services is the paradigm case of this outcome with all the effects.

The textbook example in books on the history of regulation is the US airline industry. It is obvious that we need to regulate airlines because we cannot have unsafe planes flying over cities. So we need to regulate airline safety. Such regulation has been in place since the industry began. But safe aircraft are more likely to be well maintained by well run and well financed companies. So regulators started looking at the capital structure and finances of airline businesses. Then they started looking at their business plans. Regulation of the airline industry then extended to the determination and evaluation of routes and fares. By the 1970s the scope of regulation embraced far more than these economic matters. Regulators reviewed the distance between seats. In one notorious instance they felt obliged to consider what were and were not appropriate for an airline sandwich.

The left thought that this regulatory structure had become a racket operated on behalf of large corporations. They were correct. The right thought that market forces would serve customers better than such regulation of conduct. They were In the 1970s a US Congressional coalition of left and right dismantled this structure. Correct too. The regulatory reform adopted in the US was copied with varying degrees of enthusiasm in Europe.

The result of that reform is that today we have both safer planes and a more competitive market for airline services. The services offered to consumers have been transformed, mostly for the better, in the last thirty years. Focused regulation was also a feature of the new regimes adopted in other industries like telecommunications. More recently, structures for electricity and gas were established with a similar philosophy. It is over twenty years since I first posed the question of why financial services is different. I have yet to hear a convincing answer.

## *4. Financial services regulation*

The best answer would be that experience shows that a different approach to financial services regulation has been more successful in practice. This answer is difficult to give. There are three levels of jurisdiction: the international, the European and the local.

For the last two decades, international regulation of banks has been based on the Basel agreements. These rules are principally focused on capital requirements, imposing a risk ratio of equity and near equity to risk weighted assets.. Reserve requirements have been less demanding for banks whose internal risk management processes were considered appropriate. In practice the assessment of risk management capabilities meant encouragement to use a variety of models based around concept of value at risk.

Regulations of capital and of models proved worse than useless. Capital requirements were actively damaging through the stimulus given to regulatory arbitrage. The prescription of reserve ratios encouraged the creation of securities whose effect - and in most cases primary purpose - was to reduce the need for regulatory capital. The rules also stimulated the use of off balance sheet vehicles such as SIVS and conduits.

More broadly, the Basel regulations undermined management responsibility for risk management. I have heard several times in the last two years senior executives of banks say, with every appearance of sincerity, that regulators were at fault for not having imposed more demanding capital requirements. It should hardly need saying that determining the capital requirements of a business is a management responsibility, not a regulatory obligation.

The Basel agreements encouraged – indeed virtually required – the use of value at risk modelling. These models proved to be inadequate in precisely the situations of extreme stress for which risk modelling is, or ought to be, designed. Historic correlations, essential to the covariance matrices which are central to these models, become unstable in unstable times. Distributions of variables in financial markets are characterised by ‘fat tails’; extreme observations are far more common in reality than in the fitted theoretical distributions.

Present reform proposals involve the development of a more complex, and more demanding, structure of capital requirements. Faith in the effectiveness of ‘Basel 3’ or similar regulations represents the triumph of hope over extended experience.

The financial services rules of the European Union allow firms to trade across member states through a 'passport' system. These rules manifestly failed to work at their first substantial test, the collapse of the Icelandic banks. Kaupthing operated in the UK through a subsidiary, which was therefore under the supervision of the UK Financial Services Authority; Landsbanki operated in the UK through a branch, and therefore the primary responsibility for regulation remained in Iceland.

Finding it difficult to raise finance on acceptable terms in wholesale money markets after early 2008 both banks embarked on a programme of aggressive pursuit of retail deposits in the UK (and some other EU member states). As the recent report into the Icelandic banking crisis makes clear, the financial position of both parent banks was already irretrievable. However neither the UK nor Icelandic authorities took action. In October 2008 both institutions collapsed, and so did the Icelandic compensation scheme. The UK government immediately extended protection for retail deposits well beyond the level provided in the UK's Financial Services Compensation Scheme. The UK government continues its attempt to recover part of this cost from the Iceland taxpayers.

In the last decade regulation within the UK was described as light touch regulation. To listen to what is said today, one might get the impression that such light touch regulation was the creation of a lazy neglectful FSA: the agency ignored the demands of an industry which sought tougher regulation and a government which expected more effective regulation. The truth is that light touch regulation was a deliberate policy actively promoted by both government and the industry as a means of attracting business, of both high and low quality, to the City of London in the face of international competition.

The widespread attempts to blame regulators and regulatory agencies misses that central point. If the Board and staff of the FSA had wished to pursue a very different stance in the years before 2007 – and there is no reason to think they did – then they would have been unable to do so in the teeth of political and industry opposition.

If the FSA had sought to intervene in some of the predictable failures which occurred such as the over rapid expansion of Northern Rock; if the FSA had involved itself more intimately in some of the events which occurred in the course of the crisis, as with the RBS takeover of ABN Amro; if the FSA had acted – as it plainly should have – to block the expansion in the UK of Icelandic banks; then there would have been high level political pressure to stop action in every case. The political power of the financial services industry is at the heart of this debate.

## *5. Regulation in Scotland*

Criticism of UK financial services regulation, however, does raise the question of whether an autonomous Scotland might have managed these activities rather better. There are two conflicting considerations here.

Small countries are more vulnerable to what is often called crony capitalism. The business and political elite consists of a limited number of people, who know each other well. There is a perception of common interest. In many respects this community of interest is valuable – homogeneity of outlook and informality of process can be a competitive advantage in business, and small European states have derived economic benefit from it. But in both Iceland and Ireland the links between politics and finance were certainly inappropriate if not actually corrupt. Crony capitalism contributed centrally to the financial crisis in both countries.

It is hard to believe that Scotland would have entirely avoided similar dangers. The palpable – and justified – pride which was taken in Scotland over the international expansion of the Royal Bank would almost inevitably have encouraged an identity of interest between the Scottish Government and Scotland's largest business. Nor would such an involvement have been wholly a bad thing. But it would almost certainly have been a bad thing when regulatory action to constrain excessive risk taking or to discourage unduly ambitious acquisitions was required. That was true of both major Scottish banks in the years before 2007.

There is, however, a consideration which goes in the opposite direction. Some countries were more effective than others in anticipating and restraining excess in the financial services industry. Many of the states who achieved this are small, and Australia and Canada are conspicuous among them. The more restrictive and conservative stance of financial services regulators in these countries was one differentiating factor. There is certainly some truth in this observation.

But the issue is more complex than it appears at first sight. The regulatory stance is not exogenous. As I have described, regulatory capture is endemic in financial services. If Britain and the United States got the regulation the City and Wall Street wanted, Canada and Australia got the regulation Toronto and Sydney wanted. Regulation in these countries bolstered what was already a more conservative banking culture. The influence of retail bankers on conglomerate banks in Canada and Australia was much greater than in the UK where American investment banks, and other banks which had adopted their culture, have been the dominant force. It is certainly possible that Scotland might have been more like Canada and Australia, that a relationship between regulators and bankers might have sustained the traditionally more conservative Scottish financial services culture in the face of international and market pressures in the years up to the crisis. We do not know. We do know that distinguished boards of RBS and HBOS failed adequately to restrain excessive ambitions and risk taking on the part of senior executives drawn from a Scottish banking tradition. It is in the nature of counterfactual history that there can be no firm conclusions.

## *6. The development of the financial services industry*

The traditional role of the bank was to take deposits, largely from individuals, and to make loans, mostly to businesses. Deposits were repayable on short notice but loans could not in practice be called in immediately. Even a well run bank was therefore potentially vulnerable if many depositors demanded their money back simultaneously. Banks maintained extensive liquid assets and the Bank of England, in common with other central banks, offered 'lender of last resort' facilities.

The guaranteed willingness of the central bank to provide funds against good quality assets means that a solvent bank need not fear failure.

In the modern era, financial innovation allowed banks to trade both credit risk and interest rate risk. These developments were at first called disintermediation and subsequently securitisation. In consequence credit and interest rate exposures which traditionally had been contained within banks, and made banks inherently risky, could be reduced or eliminated through markets.

There was quick recognition that such disintermediation also undermined the traditional conception, and role, of a bank. Some thoughtful commentators believed that the financial institutions of the future would be narrow specialists. An important book published in 1988 by a young McKinsey partner, Lowell Bryan (now director of the company's global financial services practice) defined that firm's view at the time under the title *Breaking up the Bank*.

Bryan was half right, half wrong. All of the individual functions of established banks (with the possible exception of SME lending) are now also performed by specialist institutions. In many cases these functions are best performed by specialist institutions. Monoline credit card companies are among the most competitive and innovative consumer lenders. Specialist mortgage banks, based on wholesale funding, have offered market leading products. Supermarkets have diversified into simple financial services, such as deposit accounts. Private equity houses (venture capital firms) have transformed the provision of finance for start-up businesses. Successful proprietary traders set up their own businesses, attracting institutional money to hedge funds.

But, seemingly paradoxically, the trend to specialisation was accompanied by a trend to diversification. Traditional banks became financial conglomerates. They not only sold a wider range of retail products but also expanded their wholesale market and investment banking activities.

The bizarre consequence was that while the deposit taking and lending operations of banks could – and did – use new markets to limit their risks, speculative trading in the same markets by other divisions of the same banks would increase the overall risk exposure of the bank by far more.

Of the four large British banks, only Lloyds retained a UK retail focus. Building societies took advantage of deregulation to convert into public limited companies and diversify from their specialism in residential mortgage finance. Germany had always had universal banks, but they had been conservative in style; Deutsche Bank reinvented itself on essentially Anglo-Saxon lines. Crédit Lyonnais's rapid growth in the 1990s led to the first major failure of a modern conglomerate bank. Its French competitors also diversified and expanded internationally, albeit less disastrously.

In 2007-8, the process by which retail banks became financial conglomerates ended in tears. Almost all the businesses concerned experienced share price collapses, rounds of emergency capital raising, and became reliant on explicit or implicit government support to continue operations. Within every diversified retail bank, there was evidence of the fundamental tension between the cultures of trading and deal-making – buccaneering, entrepreneurial, grasping – and the conservative bureaucratic approach appropriate for retail banking. It was a conflict in which the investment bankers and traders generally came out on top.

The attractions of financial conglomerates are more evident to the people who run them than to their customers, employees, shareholders – or the taxpayers who have been faced with bills of startling magnitude by their failure. The opportunity to gain access to the retail deposit base has been and remains irresistible to ambitious deal makers. That deposit base, which carries an explicit or implicit government guarantee and can be used to leverage a range of other, more exciting, financial activities.

RBS and HBOS, like other financial institutions, had received massive government support because the organisations are viewed as 'too big to fail'.

But neither a democratic society nor a market economy can contemplate private sector organisations that are ‘too big to fail’. Such a company represents a concentration of unaccountable private power, answerable neither to an electorate nor to a market place.

And ‘too big to fail’ destroys the dynamism that is the central achievement of the market economy. Any form of selective government support distorts competition. To win such subsidy today, the firms concerned must be both large and unsuccessful. It is difficult to imagine a policy more damaging to innovation and progress.

## *8. The options*

Let’s now go back to our evening in Bute House. The options available to Scotland’s First Minister fall into three broad categories

- *the support option.* The First Minister calls the chief executives of RBS and HBOS. He tells them that the resources of the Scottish government stand behind Scotland’s banks.
- *the internationalist option.* The First Ministers tells the Governor of the Central Bank of Scotland that he must try to put together an international support package for the Scottish banks.
- *the resolution option.* The First Minister calls his Permanent Secretary and the Presiding Officer of the Scottish Parliament and tells them they must work round the clock. Their task is to prepare and secure approval for legislation which would enable the Scottish Government to take control of the principal operating activities within Scotland of the failing banks, and to appoint an administrator to take charge of the remainder.

While there are variants on each of these options, and choices which involve postponement of which option to choose, I believe this list describes the principal courses of action open to the Scottish government. The majority of the activities of both banks were outside Scotland and, although the head offices of both banks were in Edinburgh, both employed more people in England than in Scotland. About one in six of the more than 200,000 employees of HBOS and RBS worked in Scotland.

The problem we describe is one for any government faced with the collapse of banks whose head offices were located within its territory but whose activities were mostly located outside it.

Any First Minister would be tempted by the support option- what small boy has not wanted to be the leader of the cavalry as it rides to the rescue. The Irish Taoiseach adopted it. But it is not a decision which could responsibly have been made in Scotland. The liabilities of the two major Scottish banks amounted to about 30 times Scottish GDP, or almost three-quarters of a million pounds per inhabitant of Scotland. Both these figures are substantially higher than the corresponding figures for Iceland, far less Ireland. Not only do most inhabitants of Scotland not have three quarters of a million pounds, but they do not expect to earn three-quarters of a million pounds in the course of their lifetime.

The likelihood is that once the scale of the problems faced by the Scottish banks become evident the Scottish government's guarantee would simple not have been credible. Markets would have asked whether Scottish taxpayers would be willing or able to meet the potential liabilities and would not have been readily convinced that the answer was yes. At that point the Scottish government would have had to seek international assistance, or abandon its pledges.

Of course, there are assets on the other side of the balance sheet, and assets of better quality than those on the balance sheets of the Icelandic banks. But not only could the First Minister not have known, even approximately, what their assets were worth, but it is now evident that no-one else knew, even approximately, what they were worth. The executives of HBOS and RBS continued to give Panglossian accounts of their situation – evidently in good faith – until they were removed from office: the quality of Lloyds' due diligence in HBOS appears to have been execrable although Lloyds has greater capacity to undertake such diligence than the Scottish government or the Scottish central bank, and considerable incentive.

But the central point is that the calculation that measures the liabilities of banks whose head offices are in Scotland as liabilities of the population of Scotland cannot be an appropriate one.

I can think of no argument at all that I could present to a Glasgow bus driver, a Skye crofter or an Edinburgh doctor as to why they should pay off foreign institutions which made subordinated loans to ABN-Amro... The size of the liabilities of the Scottish banks makes the absurdity of such an argument particularly clear: but it does not matter whether the denominator of the calculation is the population of Scotland, the population of the UK, the population of Edinburgh. These liabilities are not liabilities of the Scottish people, either morally or legally. The support option would have been extremely risky, was probably not sustainable, and could not in any event have been justified to Scotland's taxpayers.

The second option is the international one. RBS had large retail operations in England and the United States, and London was the central location of its wholesale trading. The central bank governor might reasonably have been asked to explore a support operation in which the US and English governments took the principal role.

In the circumstances of October 2008, it must be likely that willingness to provide such support would have been forthcoming. That is not, of course, the same as saying that it would have proved possible to reach an agreement. In the most analogous case – the collapse of Fortis, the equally unhappy partner of RBS in the ABN-Amro takeover – an agreement between the governments of Belgium, the Netherlands and Luxembourg to provide support was made: but the agreement fell apart when the scale of the failure became apparent. The Dutch and Belgians took unilateral (and acrimonious) action to take over operations in their own countries. (The failure of Fortis led to the fall of the Belgian government – not, it should be acknowledged, an infrequent occurrence). The funds provided to Fortis by the national governments and the proceeds of sales of divested units were, however, sufficient to enable the holding company to remain solvent. The liabilities of the wholesale creditors of the bank – which were not remotely on the scale of those of RBS – were therefore discharged and insolvency avoided.

The remaining option is that the Scottish Government takes control of the retail activities of the bank while the company as a whole goes into administration.

The presumption would be that the English and US governments would do the same in respect of commercial banking operations in their own countries. The English government would have the option of acquiring investment banking and trading operations, by legislation, purchase from the administrators, or an offer from the holding company. The Scottish government would have a similar option; though it would be absurd to exercise it (it would also be absurd for the English government to exercise that option, though perhaps more likely that it would).

Since it is neither possible nor defensible for Scottish taxpayers to protect wholesale market creditors of Scottish financial institutions from losses, the resolution option is not only the default option. In this scenario, the First Minister's response to the Governor is 'What you describe is very sad, but my overriding responsibility is to the people of Scotland, not to any particular corporate entity or to the global financial community'. That is, in my view, the response the UK government should have delivered when confronted with the same crisis.

## *9. Conclusions*

The conclusion some have drawn is the cost, or strictly speaking the exposure, which the UK government incurred in bailing out the Scottish banks would have been beyond the resources of the Scottish government, and that Scottish independence, even if desirable, is therefore an impracticable dream. This is an argument which has been widely canvassed since the events in October 2008, and it has substantially damaged the cause of Scottish independence among thoughtful people in Scotland and outside it.

Although the premise of this argument – that Scotland could not have handled the bailouts as the UK government did - may well be correct, I believe the conclusion from it – that this demonstrates the impossibility of independence - is wrong. The Scottish government probably would not, and certainly should not, have done what the UK government did. But although the UK government was able to do what it did, the UK government should not have done it and should certainly not do it again.

It is preposterous to suggest that since modern diversified conglomerate banks are too big to fail, it is necessary to create governments whose resources are many times larger than those of diversified conglomerate banks. The 'too big to fail' problem must be tackled in other ways than adapting our political system to the aspirations and needs of megalomaniac financiers, and it can be tackled in other ways. (In referring to the megalomaniac ambitions of recent financial titans, I do not exclusively or even primarily have Scottish megalomaniacs in mind).

Limits on the size of banks are urged by some, but it is more important to limit their scope than to limit their scale. Financial conglomerates are riven by clashes of culture and conflicts of interests: contagion within institutions has meant that failures in relatively small parts of their operations have jeopardised the survival of the entire company. The government guaranteed retail deposit base has been used as collateral for speculative trading in wholesale financial markets.

Far from making financial conglomerates necessary, financial innovation has reduced the necessary size and scope of banks by establishing active markets in risk and maturity transformation. These developments mean that diversification need no longer be managed within a single institution. Financial innovations are capable of reducing substantially the risks associated with retail banking, but have been used inappropriately to bring about precisely the opposite result.

Insistence that action to change the structure of the financial services industry can be taken only if there is international agreement is, as those who present this argument know well, a recipe for no meaningful action at all. These issues can and, if necessary, should be addressed unilaterally by the Scottish and UK governments. It is, of course, necessary to consider the implications of any policy for competitive position of Scottish financial institutions; although this issue should always be subordinate to the wider interests of the Scottish economy. But the history of financial services in Scotland since the eighteenth century has been one in which a reputation for prudence has been no obstacle to ambition.

The events of recent years, in which ambition ran ahead of prudence, proved in the long run to damage rather than to enhance competitive advantage. The best future model for Scottish financial institutions is one in which the utility is separate from the casino. Retail banking returns to a conservative model and risk-taking activities are undertaken by people who not only have skin in the game but who derive capital, both debt and equity, from external investors who have a direct commercial relationship with the risk takers.

I do not believe that the banking crisis either strengthens or weakens the case for greater autonomy or independence for Scotland – on which, I hasten to add, I am expressing no view tonight. Nevertheless, any discussion of the banking crisis exposes the limits of the economic independence or autonomy which Scotland – or any small country – can enjoy while it participates in a global trading environment and capital market. Scotland will inevitably either be part of an explicit currency union, or at least have its currency formally or informally linked to the currency of larger states. That linkage has implications not only for monetary policy, but also for policy towards the financial sector and inevitably involves restrictions on fiscal policy as well.

The political and economic issues are much less closely linked than many suppose. The economic debate is only loosely related to issues of sovereignty – whatever, exactly, sovereignty means in the modern economic world. Scotland plainly could have substantially more autonomy in economic matters than it does today, but the largely symbolic trappings of independence – embassies, armies, anthems – are neither necessary nor sufficient to achieve that autonomy.

There is, justifiably, criticism of the role of regulation in the events leading to the collapse of the Scottish banks. But the central point is not that there was not enough regulation – there was a lot of regulation, by the standards of any other industry – but that the regulation that existed was of little use. I find it hard to understand why there is such wide agreement that what is now needed is more regulation of a similar kind.

I find it even harder to understand why there is a demand to extend the existing failed model to a wider range of institutions. We should instead learn the lessons of the more successful regulation of other activities.

Regulation should be targeted, and should stress structure rather than behaviour. Regulation should be designed to encourage market forces to accomplish public policy objectives rather than to resist or replace these market forces.

I am not optimistic that this outcome, or any good outcome, will be achieved. Very little real reform is in prospect. For the financial services industry, an increase in the bureaucratic burden of regulation, which can largely be dealt with by compliance departments, is a small price to pay for the freedom to resume business more or less as usual. Rebuilding and enhancement of capital is something that would have happened anyway. The reduction in market competition which is a direct consequence of rebuilding capital has helped enhance bank profitability to the substantial detriment of customers. If capital requirements become burdensome, they will no doubt be evaded almost as easily, and opaquely, as they were in the past.

We have experienced three financial crises since the mid 1990s – the Asia and emerging market debt crisis, the New Economy boom and bust, the credit expansion and credit crunch. Although the specifics of each of these has been very different, the basic mechanism of each has been the same. Competitive herd behaviour by financial institutions, stimulated by the large rewards paid to individuals engaged in it, leads to severe asset mispricing. When this mispricing is corrected, substantial collateral losses are imposed on bystanders.

Tonight, I have mostly looked back. Looking forward, the key issue is how Scotland's financial services industry can best be positioned for the next inevitable crisis and how the Scottish economy can best be protected from the consequences. The issues of tonight are ones to which we will certainly return in the years to come.

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