Organizational Form as a Source of Systemic Risk:

Review for Economics E-Journal, Feb 15th 2013

This paper provides an historical and institutional perspective on systemic risk, with a focus on the experience of Northern Rock, which exemplified many of the trends in UK and US banking in an especially pronounced fashion, notably its reliance on wholesale and securitised funding and the reduction in net interest margin (NIM), and correspondingly large reliance on fee income, during its period of expansion before the crisis. In particular it argues (page 9) that " the crucial legal shift from mutual cooperatives to limited liability corporations as the key commercial enterprises responsible for writing residential mortgages may have been an important factor in structurally propagating systemic risk across the British banking system in recent years."

The paper makes two contributions, which together make a concrete and publishable contribution.

First, the thumbnail sketch of the institutional changes in UK banking, from the 1950s to the 1990s. This is very well done; mostly familiar to me but nevertheless a useful and succinct review, especially on the impact of changes in both deposit market and corporate financing markets in the 1970s and the consequent squeeze of bank profitability and, related changes in the business models of both building societies and banks.

Second, and this is the principal point, a clear demonstration of how the operation and goals of Northern Rock, shifted post demutualisation. The "embrace of the ethos embodied in the virtuous circle [of low costs based on high volumes, aggressive pricing, and balance sheet expansion] caused the company to adopt a range of strategic [quantitative] targets by which to measure its performance…". This shift, together with similar if less marked shift amongst all other UK banks towards mechanical targets based on fulfilling metrics of shareholder value such as return on equity, created a fundamental systemic financial risk arising in their view out of organisational form.

This argument is well made. My main suggestion is that in the context of the special issue, a few more sentences could be added to the conclusion, in two regards (a) to strengthen the point that this shift to quantitative metrics was an industry wide problem creating systemic risk (Milne (2009) chapter 8 points to the role of similar metrics in the failure of both UBS and of Merrill Lynch); reference could also be made to the various misspelling scandals in the UK (b) to consider a wider range of possible reponses. Yes "organisational diversity", but also a shift in management culture within banks that operate as public companies, with greater emphasis on long term returns and meeting customer needs. Ring fencing will be helpful if it achieves such a cultural shift.

Some minor comments

Statement on page 14 "in part to reattract retail deposits.19". I don't recognise this description, my interpretation is that the development of London money markets and the associated relaxation of capital controls, provided banks with access to effectively unlimited wholesale financing and this in turn allowed them to compete sometimes aggressively in UK mortgage lending. i.e. competing for retail mortgages reduced not increased their dependence on retail deposits.

Pages 15-16, very long paragraph on the legal duties of the officers and director's of building socities. This is long and complex paragraph and I simply lost track of the point being made. Do I understand correctly, the point is that officers of building societies have legal and contractual obligations to the membership that do not apply to companies? Hence demutualisation removed important constraints on behaviour. Any how, whatever is intended, I suggest breaking up this paragraph, an perhaps providing a preceding summary of the key point.

Somewhat surprised to see Berle and means (1991) referred to as "seminal" on the separation of ownership and control, in the financial literature this distinction is emphasised for much longer e.g. by Jensen and Meckling (1976) in their discussion of the agency costs of equity, although clearly their analysis (which they subsequently used to justify the use of stock options as an incentive device) is far from the last word and pays insufficient attention to legal and institutional arrangements.