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## "BEAUTY OF SMALL" WORLD IS TOO SMALL THAT IS WHY WE NEED SMALL BANKS.

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### **Abstract:**

*Objective-*To understand the interdependencies and complexities of the economic system and how in an attempt to reduce the volatility of the financial markets, central governments and banks try to control and regulate the interest rates, credit creation and supply of money, but creates havoc in the economy and to understand that big banks are not the solutions anymore because to bail out such giant banks is very difficult. In this era of technology it has become easy to communicate, distance is no problem at all. If just hundred years back someone would have said that you can talk to someone or send documents, pictures etc. sitting thousands of miles away. Well here we are all connected to each other no matter where we are in the world. Well what a boon technology is! Sure it is. But relax, sit back, think a little before you jump the gun. Remember those essays we use to write in school (SCIENCE & TECHNOLOGY: BOON OR CURSE). Conclusions of those essays invariably use to be that "It is both, a boon and a curse". From the beginning of time human beings have not been in a habit of handling information as there was barely any communication with the rest of the world. From the beginning of 20th century, we have assumed that large banks lead to economies of scale. Larger the bank, better it is for the economy as it leads to efficiency, economies of scale, increased productivity, higher GDP etc.. Big banks certainly can do this but probability is a single edged sword. An outcome may happen 9 on 10 times and most of the people get excited about it, ignoring that on one occasion when things did not turn up the way we expected, it may lead to disaster. Instead of a few large 'too big to fail' banks if there are many small banks then we can easily avoid disasters. Let's say because of reckless lending practices if a couple of small banks fail that will not lead to contagion. Only a very small number of bank's customers will be affected and these small reckless banks will lose their credibility.

*Design / Methodology/ Approach-*The present research paper is conceptualized and is based on secondary data collected from various resources like books, newspapers, management journals and internet. Many researchers and practitioners of finance are working in this direction because in the past one decade we have seen many downturns because of huge big bank world over.

**Findings-** *Effective formulation of financial and banking strategies needed for improving the global conditions emerged due to faulty financial practices..*

**Limitations-** *Present research is conceptualized and based on secondary data; research could have been more authenticated if it would have been based on primary data.*

**Practical implications-** *This paper can inspire bankers, policy makers, economists, fund managers and experts of their fields for bringing certain changes in their existing strategies for better financial future. By implementing such banking solutions, economies (emerging or developed) can be better off, because an effort to smooth out volatility generally turns things upside down.*

**Originality/Value-** *The paper includes practical examples of economies, quotes by financial experts and veterans of the financial markets, be it emerging economy or the developed world, each and every country needs a robust banking solution. “Too big to fail”; “Too big to bail” and “Too big to jail” are the consequence of faulty financial policies. This paper can at least trigger the sense of realization that small banking solutions are the key.*

**Key Words-** Financial Markets, Technology, Too big to fail, Interest Rates, Volatility, Business Fluctuations.

## **Introduction**

We live in a world of interdependencies. If connectivity has made communication fast & easy beyond our imagination, it has also increase interdependency in monstrous proportions. Rather I should say we live in a world where every variable is dependence on one or more variables. Information spreads faster than fire of the jungle and the so called information (the right word is noise not information) ends up burning even those who have nothing to do with the fire. Fire fighters (central banks all over the world and big interfering Governments) who themselves are the cause of fire are running out of there ammution. We see chaos all over the world. From developed world to emerging markets, barring a handful of countries is burning in this fire, a fire that they themselves started. Who started this fire? On the surface it seems that big interfering governments are responsible for it & yes they are. But what are the causes that lead to the crises of the past and if things are not changed dramatically could the same causes lead to the crises of the future. For a couple of months markets give us thumbs up then in no time everything turns upside down.

How did all this happen? What causes lead to the dire economic situations we live in? And the most important point, what can we do about it?

As I mentioned above we live in an interdependent world. But remember we are not far from our ancestors who roamed savannas. I mean in terms of our DNA we are much like our ancestors who existed on this planet thousands of years back. Now 'DNA', wait a minute, what on earth does DNA has to do with economics. Now that is the fun part. Look around you, everything has changed. Thanks to technology. It has made our lives convenient & that's great. But there is a catch. In the process we have unknowingly created interdependencies. Ok now you must be thinking whatever I say ultimately it comes back to interdependency. Now what to I mean by this & is this a bad thing. Let's look at an analogy to understand the point.

Say you are a young adult but you think much like a toddler and they make you the CEO of your organization. Trouble is the only thing you can create. My point is that our ancestors lived in small groups called tribes. They barely had any contact with other tribes. That means communication with other tribes was either nonexistent or minimal, forget the rest of the world. So flow of information (in most of the cases it's just noise) was nil. From the beginning of time human beings have not been in a habit of handling information as there was barely any communication with the rest of the world. Now human beings have not changed much as far as handling of information is concerned. Financial markets world over keep proving the point with phases of fear and euphoria. As most of us now understand that markets are known for breaking there so called boundaries and go for the unimaginable extremes. Why does that happen? Well most of what we get in the name of information is noise and it is very difficult, rather impossible to separate information from noise. Noise is the reason that leads to confusions, fear, euphoria and fierce moves in the markets and distortions in the economy. Just a few hundred years back there was barely any flow of information because of lack of technological advancements. But now the moment something happens in one corner of the world, the rest of the world comes to know about it, as information travels fast or instantly. People first jump the gun and then think about the data. So the economies and financial markets come down to their knee first then data analysis

happens. Humans are physiologically and psychologically not apt to deal with large number of data that information flows nonstop.

### **True Knowledge- Banking Industry**

One of the significant problems of the modern world is that we think that knowledge and information is the same thing. Rather acquiring knowledge leads to the understanding how trivial a role does this humongous data flow plays in reaching the truth. Quality analysis needs knowledge not noise.

Karl Popper said “True ignorance is not the absence of knowledge, but the refusal to acquire it”. It seems that we are constantly refusing to acquire knowledge by refusing to look at big moves both up and down in the economies and the markets calling them aberration and pushing them under the carpet. Closing our eyes to rare events that are not so rare is just a way of fooling ourselves.

Let’s look at the banking industry world over. We have argued from the beginning of 20th century that large banks lead to economies of scale. Larger the bank, better it is for the economy as it leads to efficiency, economies of scale, increased productivity, higher GDP and what not. Well I am not tiring to argue that a few big banks cannot do that, they can. Why do we think that probability is a single edged sword? That fact of the matter is that it is not. An outcome may happen 9 on 10 times and most of the people get excited about it, ignoring that on one occasion when things did not turn up the way we expected, it may lead to disaster. Well I am being to skeptic. That never happens. No! It happens all the time. It’s just that we have learned the art of ignorance. After all ignorance is bliss. Fukushima nuclear power plant was based on the assumption that you just need to account for nature’s fury that nature was done with in the past. Humans are generally sure that Mother Nature cannot outdo them. It seems that humans are blind to the elephant in the room all the time. Or is it short sightedness of a few policy makers who cannot see the obvious. You cannot look at the outcome and celebrate without looking at the consequences. If the probability of falling is small but consequences could be big then decisions are taken based on consequences and not probability. Why do people treat high probability as a sure thing? So coming back to banks, how does it make any difference in the world if most of the times they can do all the

economy of scale, efficiency, GDP nonsense if they lose more than what they earn in good times. And how is it justified on the part of the governments to allow banks to get bigger and bigger if the cost of falling has to be borne by tax payers and ordinary citizens.

Most people think of banks as institutions which channel their savings into productive loans and investments. Loan banking is essentially that healthy and productive process in operation. If such a bank makes unsound loans and goes bankrupt, then, as in any kind of insolvency, its shareholders and creditors will suffer losses. This sort of bankruptcy is little different from any other: unwise management or poor entrepreneurship will have caused harm to owners and creditors.

Deposit banking began as a totally different institution from loan banking. Hence it was unfortunate that the same name, bank, became attached to both. If loan banking was a way of channeling savings into productive loans to earn interest, deposit banking arose to serve the convenience of the holders of gold and silver.

The trouble began when the deposit banker has suddenly become a loan banker. The difference is that he is not taking his own savings or borrowing in order to lend to consumers or investors. Instead he is taking someone else's money and lending it out at the same time that the depositor thinks his money is still available for him to redeem. This is what we call as fractional reserve banking. It started in the name of increasing efficiency etc. argument. Thus, fractional reserve banking, like government fiat paper is inflationary, and aids some at the expense of others. But there are more problems here, because unlike government paper the bank credit is subject to contraction as well as expansion. In the case of bank credit, what comes up, can later come down, and generally does. The expansion of bank credit makes the banks shaky and leaves them open, in various ways, to a contraction of their credit.

Fractional reserve banking clubbed with the concept of a few large banks is certainly a combination that leads to the birth of 'too big to fail banks'. Once you create monsters of such proportions it becomes difficult to feed then in crises situation but governments feel compelled to protect them because their failure could lead to a complete disaster. When the cost of failing is so significant, how it makes any difference for how long can these monster banks propel the economy because when they will come down and they do come down as we

have seen in the past, they create havoc. When it comes to matters of money and banking, all practical political issues ultimately depend on one central question. Can one improve or deteriorate the state of an economy by increasing or decreasing the quantity of money? Aristotle said that money was not a part of the wealth of a nation because it was simply a medium of exchange

### **Smoothing of the business fluctuations!... Not Possible**

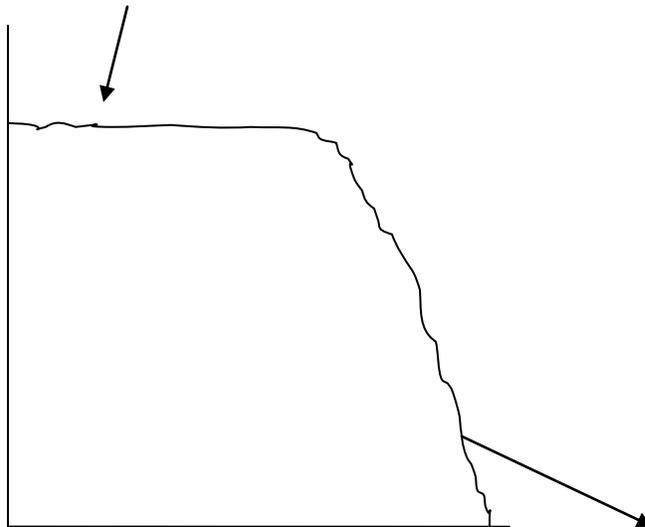
It seems that our central bankers want to smooth out even the last possible business fluctuation in the world. How beautiful, how predictable this world will be once we get rid of all possible business fluctuations. But so far we have only succeeded in creating havocs in the economies world over in the process of smoothing the business fluctuations. It is important, first, to distinguish between business cycles and ordinary business fluctuations. We live necessarily in a society of continual and unending change, change that can never be precisely charted in advance. People try to forecast and anticipate changes as best they can, but such forecasting can never be reduced to an exact science. Entrepreneurs are in the business of forecasting changes on the market, both for conditions of demand and of supply. The more successful ones make profits with their accuracy of judgment, while the unsuccessful forecasters fall by the wayside. As a result, the successful entrepreneurs on the free market will be the ones most adept at anticipating future business conditions. Yet, the forecasting can never be perfect, and entrepreneurs will continue to differ in the success of their judgments. If this were not so, no profits or losses would ever be made in business.

Changes, then, take place continually in all spheres of the economy. Consumer tastes shift; time preferences and consequent proportions of investment and consumption change; the labor force changes in quantity, quality, and location; natural resources are discovered and others are used up; technological changes alter production possibilities; vagaries of climate alter crops, etc. All these changes are typical features of any economic system.

In order to kill all possible volatility these central banks end up creating extreme volatility. Certain systems live because of volatility. Such mediocre volatility is the driving forces of economies the world over. An attempt to strangle this volatility leads to stable economies for some time but not for ever and when the next bout of volatility happens it's like a tsunami.

The chart below shows how attempts to smooth out volatility leads to extreme volatility

Y attempt to smooth out economic fluctuations



X attempt fails and extreme

move happens

### **Imperfect understanding is the human condition**

George Soros said “Once we realize that imperfect understanding is the human condition there is no shame in being wrong, only in failing to correct our mistakes”.

But we have consistently shown our inability from our mistakes. The only thing we have learned from the past is to ignore past mistakes. Rather we keep applying makeup on the past and think of it as future. The most significant thing we need to learn from the past is that we are terrible at predicting the future. So many times in the past most of the economists failed extreme moves both in the financial markets and in the economy. But no one seems to realize that we are terrible at predicting. If we realize that we cannot predict, then the next logical step will be to concentrate on what we do not know. Our respect for the unknown will increase phenomenally.

Instead of a few large ‘too big to fail’ banks if there are many small banks then we can easily avoid disasters. Let’s say because of reckless lending practices if a couple of small banks fail that will not lead to contagion. Only a very small number of bank customers will be affected and these small reckless banks will lose their credibility. But the overall banking industry will not be affected. Though government bailout is not something I favor but even if governments decide to protect customers in a certain way they will not have to shell out a huge amount of money from their coffers. But mind you such bail out packages in the first place helps reckless banks to indulge in to ridicule lending practices. If no bail out happens in will push the banking sector to conduct their business just like any other business as they will not get any kind of special treatment. Few customers may have to suffer in case a couple of small banks go down, but it will have no impact on the economy at all. In such a case customers will also choose the banks carefully just the way they chose many other things in the open market economy. Why should banking sector get any special treatment? Are they really such big stimulants for the economy? There is no doubt about it that banks borrowing & lending practices help stimulate economy but we cannot ignore the downside risks of having a few big banks in the name of increasing economies of scale, if there failure can have cascading effects. And no one is suggesting eliminating banking industry. We are just trying to say that small is beautiful. Many small banks will not lead to contagion if few banks go bust. Yes one may argue that with big banks gone, the smoothing out of volatility from the economic system will be gone but when you look at what happens to the economy (crash and cascading effects) this seems like a small price to pay. Any smart business man will easily get the point. You never make an investment, no matter how lucrative the returns are and how high is the probability of success if the price of failure is ruin. It does not matter how low the probability of failure is but if the cost of failing is ruin then you do not make that bet. But some people think that probability is not about chance of occurrence. They treat high probability of a particular event as a sure thing and that is a ludicrous thing to do. To make my point clear that this world is too complex and interdependent, let’s look at the weather predictions. The conclusion, for the weather and for many other aspects of the world, is that the weather cannot be predicted successfully, no matter how much data is accumulated for our computers.

What I am talking about is not a mere lip service. The history of finance is glittered with the occurrence of low probability events that did not just occur but lead to disasters. And these calamities were never restricted to their area of origin (thanks to our modern era of interconnectivity and instant communication of information).

But is this a difficult point that our economists and governments world over do not want to pay attention to it. Is the idea irrelevant or flawed or is this a question of vested interests. Well I think there are many aspects to it. One of the important aspects is that we humans cannot be trusted with information. Cognitive psychology is proving that human's confidence level increases faster than the information at hand. Which means that more information leads to over confidence and over confident decisions are not trusts worthy decisions. In Jonathan Miller's words, "Human beings owe a surprisingly large proportion of their cognitive and behavioral capacities to the existence of an 'automatic self' of which they have no conscious knowledge and over which they have little voluntary control."

### **Impossible to control the overreaction and greed as well**

In this era of gushing uncontrollable information it becomes impossible to control the overreaction of the masses. It is easy to prove how much the individual forming part of a crowd differs from the isolated individual, but it is less easy to discover the causes of this difference. To understand this phenomenon in the first place we need to understand that unconscious phenomena play an altogether overwhelming part in more or less all aspects of our lives but it plays a very important role in the operations of the intelligence. The conscious life of the mind is of small importance in comparison with its unconscious life.

### **Warren Buffet said:**

“When they make these offerings, investment bankers display their humorous side: They dispense income and balance sheet projections extending five or more years into the future for companies they barely had heard of a few months earlier. If you are shown such schedules, I suggest that you join in the fun: Ask the investment banker for the one-year budgets that his own firm prepared as the last few years began and then compare these with what actually happened.”

But this is not just it; greed of a few to corner as much as they can at the cost of many is also one of the factors responsible for the governments to look the other way. Economists are always busy making things complex. But why would they do that? Why do economists try to talk like physicists? Is it necessary to make things complex before you look it to them? Well the answer to all these questions is very simple. Once economists admit that all these so called economic models are based on their fanciful assumptions it will become evident that these models will lose their sanctity. There claims that these models are a reflection of reality will fall flat on the face and they will lose their sheen. Now if you simply accept that reality is far more complex and there economic models are just a caricature of their imagination and not reality (rather far from it), they will lose their face. Economics as a profession will lose the status that it enjoys. But let me warn you on this economics are not physics, it never was and it will never be. All one needs to look at to understand how flawed have been the predictions of these economists one just needs to look at their past track record. But it looks like we humans are not in a habit to learn from the past. It reminds me of the saying “history repeats itself”. Well why would history not repeat itself if we would never bother to learn from it. Following the bankruptcy of the American investment bank, Lehman Brothers, in late 2008, credit markets all over the world seized up. It is just another example of the interconnectivity of the global economy.

Almost all the developed economies in the recent economic crisis had one thing in common. Nearly all of them issued short-term liabilities in order to invest in long-term assets. Thus, they had to continuously roll over (renew) their short-term liabilities until their long-term assets matured. If an event arose whereby banks failed to find new borrowers to continue rolling their liabilities over, they would face a liquidity crisis and the financial system would collapse. Considering recent events that have exposed the riskiness of this strategy, the question that immediately comes to mind is, why did the banks world over engage so heavily in this risky practice in the first place? One reason is that such practice can turn out to be a very profitable business involving a basic interest arbitrage. Normally, long-term interest rates are higher than the corresponding short-term rates. A bank that sells short-term rates (borrows money short-term), while buying long-term rates (investing money long-term) may

profit from the difference (the “spread”) between short- and long-term rates. Yet while this can turn out to be profitable, it is also very risky, because the short-term debts require continual reinvestment (that is, there must be a continual “rollover”). For most of banking’s history, banking abided by a “golden rule” that is still talked about till date but rarely followed. The rule says that the duration to maturity of a bank’s assets should correspond to that of its liabilities. Any inconsistency opens the bank to risk in the event of liquidity shocks. It reminds me what economist Walter Williams said: “passionate issues require dispassionate analysis.”

We must not forget that no matter how lucrative an opportunity is and how high the probability of success is, if failure could lead to ruin then we should abstain from indulging in the activity.

We must not forget that the greed of the few could sometimes lead to lose of many. What we call as governments is nothing but a set of individuals. I am not trying to suggest that all governments work with a mala fide intention, certainly not. But as history has shown us there have been instances when governments (rather a set of individuals) were serving thugs more than tax payers and ordinary citizens. Max Weber puts it clearly, “These collectivities must be treated as solely the resultants and modes of organization of the particular acts of individual persons, since these alone can be treated as agents in a course of subjectively understandable action. For sociological purposes there is no such thing as a collective personality which “acts.” When reference is made in a sociological context to collectivities, what is meant is only a certain kind of development of actual or possible social actions of the individual persons.”

Central banks have always been fiddling with interest rates claiming that they have the required capability of controlling inflation and encouraging growth. Since the arrival of central banks we have learned that their desire to control has caused more worries than fix the concerns. In a market economy, prices tell us the needs of society and the best ways to meet those needs and interest rate is nothing but the price of borrowing and lending. Central-bank credit expansion sends incorrect pricing signals to entrepreneurs by artificially lowering the rate of interest. This leads entrepreneurs to make unwarranted investments, mainly in the capital sectors, errors which later become evident when the central bank stops expanding

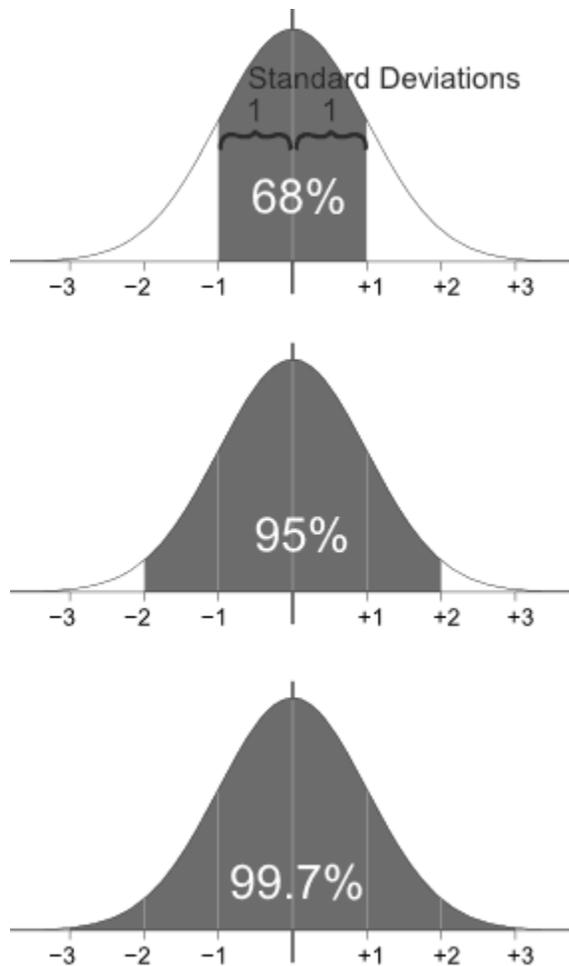
credit. The mal- investments created by distorted interest rates corrects and the economy enters a downturn.

### **Simplicity or Complexity- Statistical Analyses**

In a government agency, there are no private owners. There are no market prices for its goods or services. The data that these government agencies keep collecting for the purpose of analysis, how useful is it? What do they do with it? Of course they use statistics to analyze data. But Statistics, of course, is far more than the mere collection of data. Statistical inference is the conclusions one can draw from that data. Since we never know all the data, our conclusions must rest on very small samples drawn from the population. After taking our sample we have to find a way to make statements about the population as a whole. In the science of statistics, the way we move from our known samples to the unknown population is to make one crucial assumption: that the samples will, in all cases, whether we are dealing with height or unemployment or who is going to vote for this or that candidate, be distributed around the population figure according to the so-called "normal curve." The normal curve is a symmetrical, bell-shaped curve. 68% of the area of a normal distribution is within one standard deviation of the mean. Approximately 95% of the area of a normal distribution is within two standard deviations of the mean. Because all samples are assumed to fall around the population figure according to this curve, the statistician feels justified in claiming from his limited samples, that the height of the population, or the unemployment rate, or whatever, is definitely within a confidence level of 90 or 95%.

But do we live in a world so smooth, so predictable? In a complex environment full of interdependencies such samples are meaningless. This information is too sterile to be effective. For models to be reflections of reality we need to understand the crux of the simplicity or complexity of the environment. In complex systems such samples do not succeed in showing even a small dimension of reality.

### **NORMAL DISTRIBUTION CURVE**



Normal distribution curves work when there is no complexity. Normal distribution curves belong to the world of no surprises. It means that no single data can completely tilt the direction of the conclusion on one side. The biggest single data entry cannot influence the conclusion. For example height and weight belong to this world. But the complex world of economic variables cannot belong to the cozy family of normal distribution bell curve.

### **Conclusion**

In the world of complex systems with interdependencies extremes in the data rule, completely making the average data points trivial to the extent of there being meaningless. Astrologers and crystal-ball gazers are laughed at while professional economists are applauded for their scientific achievements. Yet the economists are no less mystical in trying to predict the direction of interest rates, economic growth, and the stock market. Despite the abysmal record, most economists remain die-hard advocates of forecasting. Most have spent

years in their profession learning the tools of their trade, and can't bring themselves to admit their own errors. The forecasters claim that it's only a matter of time before they master the techniques. Though that day will never arrive, economic forecasting remains an integral part of the economics mainstream. Economics, unlike the natural sciences, deals with human actions, plans, motivations, preferences, and so on, none of which can be quantified. Even if it were possible to quantify these things, changing tastes would make the data almost instantaneously useless to the forecaster. And then there are the millions of unimaginable things which constantly crop up, influencing people in unpredictable ways. Big governments have always led to the control and manipulation of the banking sector. I am not trying to suggest that there should be no regulation of the banking sector. But over regulation is certainly not the solution. Many small banks in existence are the need of the hour. In this way we will distribute risks associated with the sector which is so vital for the economy. By doing this we will save not only our economy from severe downturns, we will also save our taxpayers from getting robbed in the name of bailouts to save the economy.

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