Principles of banking

Banks are almost as old as recorded history. The Babylonians practised a form of banking, as did the Romans, although the commercial institution that we recognise today originated in the Italian city-states of the 15th century. As one might expect with such a venerable art, the basic principles of banking are unchanged from the time of these first banks, because the basic *raison d'etre* of banks remains as it did in the Middle Ages.

Banks are no different to any other commercial enterprise in that their operations are based on capital, but of course they employ a comparatively small amount of their own equity as a percentage of their total business, instead using the funds raised through deposits when advancing revenue-generating loans. Banks are also notable for offering instant availability of customers' cash (unlike, say an investment manager or hedge fund). A requirement of banking then, is the need to maintain constant liquidity at all times.

This further dictates that the overarching principle of good banking practice should be that of following a sustainable business model. Cyclical behaviour is inherent in the capitalist free-market model, and while all companies will want to position themselves so that they can survive the inevitable economic downturn, with banks this is the No.1 priority because of the part they play in the wider economy. A failing bank has a knock-on impact that is considerably greater than a failing corporate, which is why a formal regulatory regime exists to monitor the business practices at all deposit taking institutions.

At the same time, most banks are private shareholder-owned enterprises. A textbook approach to shareholder value-added (SVA) dictates that banks should follow a business model that maximises shareholder return, but this requirement must necessarily be tempered by the need to structure the business model to ensure it is sustainable. Hence shareholder value must, of necessity, be at times subservient to the need to preserve liquidity at all times.

It is this demand to follow sound liquidity risk practice that defines banking, and describes what "good" looks like. Despite the current economic environment being very different from that of 50 or 100 years ago, with free and instant movement of currencies around the world, the basic principles of bank risk practice remain unchanged. This applies to a bank's internal models as well. A current "hot topic" in bank risk management is that of internal funds transfer pricing (FTP), and how this should be implemented in a bank's business lines. However the object of an FTP regime, which seeks to apply the cost of liquidity to the business and ensure correct product pricing, is simply to ensure sound liquidity risk practice. Whether the bank is a multinational operating across the world or a single branch entity, the need to embed a robust FTP regime remains.

One could say the same of capital management policy. In effect, the requirement of a bank's directors should not be so much to maintain capital levels at the level dictated by regulators, rather to hold sufficient capital that the bank remains a going concern at all times. Given that we cannot be certain of the nature and extent of the next economic downturn, this suggests a conservative risk management policy of holding capital levels of a size greater than what internal risk models might otherwise suggest. In other words, one has to allow for "unknown unknowns", to borrow an infamous phrase.

What drives returns at a bank therefore cannot solely be profit maximisation, even though for SVA purposes this is very important. Equally vital is the need to recognise the place of banks

in society and follow sustainable business practice. The current buzzwords for this are "macroprudential policy", which recognises that a bank's strategy needs to be pertinent to the vagaries of the business cycle. This requires management to be aware of the cycle itself and to adjust risk management policies so that they reflect risk-reward choices that are prudent for the time. As a practical task, this may well be akin to the central banker's monetary policy remit of driving whilst looking at the rearview mirror, but it is nevertheless a discipline that needs to be part of banks' strategic approach.

In the post-crash environment the challenge for banks is not simply to operate successfully in a stricter regulatory environment. This is a given and should be taken as necessary but not sufficient. The challenge is more to embed the lessons of 2008 into the culture of the bank operating model, and view conservative liquidity and risk principles as second nature. The business of banking is ultimately unchanged from what it was in the 15th century, that of ensuring that liquidity and a sufficient capital base are maintained at all times. If this does indeed take place, then the experience of the last crash will not have been in vain.

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