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The banker blame game

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As if pension funds and other institutional shareholders did not already have enough on their plates, the calls on them to engage more with companies have been increasing in volume over the last few years.

These calls are turning into demands. From next year, Switzerland's constitution will require the country's pension funds to vote on all their domestic shareholdings and then disclose their voting records. This aims to curb excessive executive remuneration at the big Swiss multinationals – and the country's banks.

Getting involved in the European banking sector should be one of the next steps in engagement on the pension fund agenda anyway, according to the authors of the The Bankers New Clothes, Anat Admati and Martin Hellwig.

Pension funds and other shareholders can help change what the authors call the extremely bad and distortive banking system in Europe, by calling on banks to become less risky by increasing the amount of equity they hold on their balance sheets. While the banks should refrain from lobbying politicians and thereby diluting banking regulations such as Basel I to III, pension funds should lobby the regulators to get them to contain the out-of-control banking system.

Clearly a lot is wrong with the highly indebted banking system. Part of its problem is its size, which makes it too big to be allowed to fail, but also its inefficient lending and investments.

That bankers chase returns, take risks and mis-sell, leave shareholders exposed to risks without proper compensation and creditors and taxpayers to bear the downside risk, is more than a governance problem, it is a cultural problem.

And as can see be seen in the cases of Cyprus, Iceland and Ireland, banks can endanger entire economies.

The authors argue that to improve banks and reduce the risks of their distress and failure, they should be holding a large amount of equity, ideally 20-30%. This is a serious step up from the single-digit amounts that European banks currently have on their balance sheets. Bankers prefer to borrow rather than hold more equity. It does not matter that for society, excessive bank leverage is expensive.

The authors suggest that retained profits are an obvious source of equity funding. In addition, they should ban payouts to build up equity.

Addressing this is not going to be easy for pension funds. The banker blame game has just become serious.

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