I wrote the following on 20 October 2008. Not much has changed since then (regrettably) and we're now heading for another banking crisis, so I offer it again:

Everywhere you turn at present you read or hear people saying there is a need for a fundamental reform of the banking system. The difficulty is that as yet I have not seen anyone say how to do it.

I have, of course, already offered my opinion on what I would do if I was to be appointed as a director of a major bank and I also outlined my longer term strategy, which would involve divesting those banks of their low risk assets in a fairly short period to leave a core banking operation, probably under state control. I note that seasoned observers suggest that this is the likely policy to be adopted with regard to RBS.

Neither is, however a fundamental reform of banking. They are an appropriate commercial response to the mess into which these banks have descended. Something much more radical is needed if we are to address the systemic flaws that have been found to exist in our banking system.

There are in essence four such flaws. The first, and perhaps most shocking to those in government who had not appreciated it, is that the state has absolutely no control over the payment mechanisms on which our fundamental economic order depends. We had no choice but to bail out banks because they were the only people who could actually facilitate the exchange of money in our economy. Social chaos and major economic turmoil, probably associated with a breakdown in law and order, would have occurred if the banks had not been rescued.

Second, and perhaps just as shocking to those in authority, is that it has become glaringly obvious that the government has almost no control over the money supply in the UK. About 3% of the cash in the UK economy is actually issued by the Bank of England. The rest is electronic money, and as I have explained here, this is created by the commercial banks and not by central government. The commercial banks do as a consequence take the profit from this activity. Unsurprisingly if they make cash out of thin air and then charge people for the privilege of using it they have, they do during a period of massive monetary growth maximise their profit by the creation of enormous quantities of new money through offering debt. That is exactly what we have seen.

Third, as the banks have fallen over it has become very clear that we might end up with very few banks and a wholly uncompetitive market for their services. This seems undesirable to almost everyone.

Fourth, and finally, it is very obvious that the banks have been unable to regulate themselves, whether that be with regards to capital adequacy ratios, the payment of appropriate incentives, the appraisal of lending, money laundering (to which many of their tax haven subsidiaries appear to have been oblivious) or any other issue.

These problems cannot be resolved by merging a few banks. They cannot be resolved by stripping out of the banks those assets that can be disposed of now to make payments to shareholders in compensation for those assets that must remain under state control for some period of time. They can only be resolved by a radical and fundamental reform of our banking system.

I have applied myself to this problem and without suggesting that the solution that follows is either fully developed or without potential flaw, I offer it nonetheless as a basis for discussion. It seems to me that any reform of the banking system must achieve the following objectives:

1. The basic payment system must be under the control of the state;
2. The state must have control of the creation of all money and must profit from the creation of that money
3. There must be sufficient banks in the market to both offer choice to consumers and to prevent any one bank becoming so large that its failure could represent a fundamental threat to the economy as a whole
4. The banking system must be better regulated and monitored in the future to prevent a recurrence of the problems that have created the current crisis.

I call my solution Network Banking. Think of it as a bit like Network Rail. The basic infrastructure of banking will be entirely owned by the state. The banks themselves will be franchised operations, offering different levels of services and rates to attract deposits, which at the end of each day they place on secure reserve with the Bank of England. Based upon the volume of deposits they attract when compared to their proven risk profile they will be allowed to make loans using funds that they themselves borrow from the Bank of England.

They will make their income from the difference between the loan income they can generate and payment that they make to the Bank of England for the funds that they borrow. They will make their income from depositors by charging for some services (although basic banking would be provided free, as of right), from the difference between the amount they earn by placing sums on deposit with the Bank of England and the amount they pay to depositors, and from the sale of a limited and regulated range of additional services such as credit cards, life assurance, pensions and low-risk investments.

It is possible that some banks will simply be deposit taking institutions under this arrangement. It is also possible that some will only be dedicated lenders, given access to central funds simply because of their proven ability to manage them. It is now obvious that the two skills do not need to be located in the same institution.

But which ever option is chosen the banks will in effect become franchise operations. They would raise capital to cover the risk inherent in their own lending decisions which would relate to the margin that they could lose in making loans. This loss would, however, be much less than the total loan, which would still be owed to the Bank of England at the end of the day, giving them an incentive to intervene long before a crisis situation arose, largely because the majority of any bank's capital would be supplied by the Bank of England, because the funds that they would lend would come from that source. This reflects the practical reality that we now know that the equity in banks does now really belong to the state, and is supplied by it.

What each franchise operation would do would be to add particular skill in certain areas. Some might become specialist business lenders. Others will be mortgage type operations. The interest rates that they offer might reflect the risk profile that they in turn assume regard to their lending. So, for example, those who want to lend a business might have to offer higher interest rates to attract money and may well be allowed to have relatively low loan ratios in proportion to that money, but with their income being earned by charging relatively higher loan fees to their customers, but with a significant expected added value element resulting from the supply of business advice.

In every case however the depositor will know that a reasonable proportion (but not all, in the case of very high-value depositors) of their funds will be subject to guarantee, and all of those funds will be placed on deposit with the Bank of England each night to back that up.

The result will be that in reality banks are unlikely to compete very much on interest rates (and as we've seen, by and large those that have done so have failed so this is no problem) but they will be competing quite heavily on the quality of service supplied. We are likely to see the development of niche markets for banks that will have a special understanding of customer need as a result. This is a genuine market activity for bankers.

These niche banks might be quite small. This particular arrangement will allow that. Some of the things that the state owned Network Banking operation will supply to each bank will be:

1. The basic trading platform for the bank, which means that it will not be necessary for each to develop its own IT to do this independently, so removing the massive inherent problem of economies of scale which have caused concentration in the banking market to date for this reason;
2. The rule book by which they will operate. Again, to date this has been a massive

problem leading to a concentration of supply from a small number of banks. But there is no reason why each bank should have a separately approved rulebook. They should be required to work to one common high standard.

3. A regulated structure within which it will know it can work. In other words, it will know what options it has available to it if it chooses to lend to certain markets. It will know the constraints upon its activity if it fails to attract depositors to finance that operation. The rules of the game within which it will have to work will be clear.

4. An oversight regime. Each bank will have to submit returns regularly of their ratios of deposits to loans, with profiles of each to ensure that they are working within agreed capital adequacy ratios. But, if one proves it cannot fulfil the ratio requirements then that bank will not fail: the franchise will be redirected to somebody else who can do so. This is, after all, what happens with rail franchises. The service does not stop. The operator changes.

Of course, none of these banks would undertake high-risk trading on their own account. These are banks: they are not investment operations. Companies that want to trade in derivatives, financial products of other forms, foreign currency for speculative purposes, and so on will be allowed to do so. But they will be entirely separately regulated, will have to use their own capital for this activity, but will not be banks, and I suggest it should not be possible for a bank to own them. The stock market should supply their capital, not depositors who do not know the risk that they face by doing so.

This will leave one apparent gap in the market, which is the supply of business finance for small and medium-size entities. The simple fact is that banks have been very poor at doing this anyway. Much has been provided by way of leasing, specific asset finance such as factoring, and very little indeed has been genuine capital to fund enterprise. If that is what we need then another source is required: in effect the Bank of England will have to allow specialist banks to operate as venture capitalists to small enterprises and that might require us to take a stake in those companies as is common in the German model banking. This would be good news, but it is a radical reform that may not be part of the banking system at all, and we should be aware of that. We cannot ask a reformed bank to do what existing banks have not.

What this revised scheme does, however, do is the following:

1) It puts money under the control of the Bank of England;
2) It recognises where the real equity risk is, which is with the state;
3) It provides the necessary investor protection;
4) It brings the basic transaction systems upon which our society depends under state control, where they should be;
5) It brings control of the money supply under the control of the state, where it should be, and from which it should benefit;
6) It ensures that no bank will be too big to fail: if a franchisee collapses and another can be put in its place but neither the depositors or borrowers will be prejudiced;
7) It encourages competition both with regard to rates and with regard to the level of service that the bank will supply and banking expertise will be rewarded, which is an essential development which has been lost in the current system.
8 ) One standard rulebook will be in place. There will be no argument about what standards should be in operation;
9) All banks will have their lending subject to regular monitoring. The risk of overexposure which brought about the current situation will be eliminated, subject to

competence within the central banking authority, of course.

Better still, much of the infrastructure to do this already exists. For example, the banking platform of one of the banks now under state control could be developed for universal application. No doubt the financial services authority has a standard rulebook which it expects people to comply with, and which could now be put in force. When banks are already under state control they have effectively lost their equity base and so a change to a franchise arrangement will be easy to do. The banks are already not lending to each other, but are instead placing their funds on deposit with the Bank of England each night. They are, therefore, already halfway to this structure. And so on.

We have no option but change banking. We cannot go back to where we were. I am sure that the above idea will need significant development. But I offer it as a platform for discussion as the basis for a radical new approach to banking in the UK which could reduce risk, enhance state control, and yet provide substantial consumer choice which is lacking in the current market. That’s a bold claim, but I think it is justified.