

Crisis Management ?

How British banks should
face the future

David B. Smith

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Preface

This study discusses the lessons to be learned from the recent banking crisis in Britain. The UK was not the only country to have suffered from the global financial turbulence that started in mid 2007 and Asian currency manipulation and misguided US monetary policies were among its main causes. However, most nations did not suffer a banking collapse as we did. Indeed, the crisis affected Britain more than any other major country, apart from the US. It is now accepted that one reason why the UK credit crunch was so severe was that the Bank of England reacted too slowly initially. This was because Labour's post-1997 arrangements had split financial supervision three ways; it was unclear who was responsible for what. However, there was a more fundamental conceptual failure underlying the flawed arrangements that were put in place a few weeks after the May 1997 general election. In particular, an over-simplified theoretical approach based on a particular economic model was entrenched in legislation - the so-called conventional theoretical macroeconomic model (CTMM). A thorough debate in 1997 might have averted the problems that became apparent a decade later on.

Now, having presided over one of the worst financial meltdowns amongst the leading economies, the British Government has unfortunately engaged in populist interventionist policies that are logically incoherent and may be incompatible with the need to re-capitalise the banking system. Serious long-term damage to the wider economy could result.

The first section of this pamphlet summarises the arrangements codified in the 1998 Bank of England Act which lie at the root of the authorities' inadequate response a decade later. A critical discussion of the CTMM, which implicitly provided the justification for the UK's post-1997 monetary arrangements, follows. The ways in which this approach introduced a form of 'tunnel vision' into the Bank's view of the monetary transmission mechanism and its forecasting model are then described. The study goes on to consider how the Bank ignored the economic 'red flags' produced by the credit boom of the mid 2000s. The international sources of the crisis and the lessons from the spate of UK bank failures are then discussed. The study concludes with a series of proposals to improve Britain's monetary arrangements and warns that present policies risk making matters worse, not better. In particular, internationally-co-ordinated regulatory changes may exacerbate these problems by causing the credit cycles in individual countries to become aligned.

I

The Problem: The 1998 Bank of England Act

Britain was not the only country to experience a banking crisis from the late summer of 2007 onwards. However, it suffered an unusually severe one, while many comparable countries encountered no serious difficulties. By contrast, not one bank in the British Empire failed in the Great Depression of the 1930s, which suggests that the official response to the recent UK banking crisis was inept. At the heart of the problem were the new monetary arrangements implemented after the May 1997 general election. These arrangements ignored the lessons of UK monetary history; and could only be justified in terms of one, highly restricted, theoretical economic model. The flawed arrangements of 1997 were then prematurely set in legislative concrete, for reasons of political expediency. There is now no urgency about passing new banking legislation because it will be several years before shell-shocked bankers engage in another credit binge. It is, however, crucial that the right decisions are made this time round. Another rushed implementation of flawed proposals must be avoided, particularly as there is likely to be a change of government before any new measures can take effect.

Historically, the Bank of England had an excellent record of maintaining a stable banking system in both peace and war from the late nineteenth century onwards. (It was founded in 1694 but only gradually came to discharge the full set of responsibilities associated with a traditional central bank). One reason was that the pre-1997 Bank of England had a wide range of responsibilities, including the management of the government bond market and financial supervision. This meant that senior bank officials were market-savvy and that the Bank was close to the commercial banks and the financial markets generally. The main failing of British monetary policy after the Bank of England was nationalised in 1946 was its inability to avert runs on sterling and to maintain low and stable inflation. One important reason was that the Bank 'really was the East End branch of the Treasury' to quote the late Lord George (George (2008)), and Bank Rate was set by politicians. The last vestiges of independence had been snuffed out when the then Governor, Lord Cromer, was forced to resign by Harold Wilson in the 1960s, a development that paved the way for the high inflation of the 1970s. Between 1946 and 1997, the Bank was only permitted to proffer advice about rates and its views were frequently ignored. The post-1946 settlement was modified after sterling's departure from the Exchange Rate Mechanism in 1992 to give the Governor more say. Inflation targeting was also

introduced in 1992. However, it is reasonable to treat 1997 as representing ‘year zero’ where Britain’s monetary arrangements are concerned.¹

At the time, most commentators were caught out by the speed with which the Bank was granted the operational independence to set interest rates five days after the May 1997 election. However, this was not the bolt from the blue it appeared at first sight. It was revealed in 2004 that the then Governor ‘Eddie’ George had discussed the issue with Tony Blair and Gordon Brown for two years before the 1997 election, with the blessing of the Conservative Chancellor, Kenneth Clarke. Surprisingly, Lord George had not been forewarned that an incoming Labour Government intended to transfer the Bank’s responsibility for the gilt-edged market to the newly formed Debt Management Office (DMO) and that for financial supervision to the Financial Services Authority (FSA). This tripartite dismemberment was implemented just three weeks after the announcement of operational independence and explains why the new arrangements went largely unquestioned at the time (see Gowland (1997) for a prescient early criticism).

The Bank had three core responsibilities under the 1998 Bank of England Act.

- Firstly, to choose and implement the interest rates necessary to meet the inflation target set by the Chancellor of the Exchequer. This included the work of the Monetary Policy Committee (MPC). In addition, it covered the Bank’s tasks in data collection and economic analysis, and the information provided by the Bank’s regional agents.
- Second, to maintain the stability of the financial system and to act as the lender of last resort in exceptional circumstances. This task was shared with HM Treasury and the FSA, with the latter being responsible for individual institutions and the Bank for the system as a whole. The clumsiness of this tripartite structure has been widely blamed for the extremely poor initial response to the UK banking crisis.
- Third, the Bank was also supposed to ensure that the UK financial system supported the rest of the economy and that the UK remained an attractive location for international financial business.

¹ A full account of the Bank of England’s role can be found on its website (www.bankofengland.co.uk)

By and large, the Bank has achieved its first responsibility, but failed significantly on the second, and abysmally on the third. Bank officials have somewhat huffily emphasised their inflation targeting success. But that is like winning the war at sea, but losing on the land and in the air. The Bank and FSA may be in psychological denial, but they have failed ignominiously by international standards. Indeed, many comparable nations have suffered from the global recession but have managed to avoid a banking crisis entirely. The British officials responsible for this mess were highly intelligent people. However, they were operating under an unduly tight mandate, which they lacked the courage to challenge. They were also misled by their reliance on the over-simplified conceptual approach of a particular economic paradigm.

II

A Flawed Approach and its Consequences

The Bank's post-1997 arrangements implicitly relied on a narrow theoretical approach, known as the Conventional Theoretical Macro Model (CTMM). This framework had emerged out of the 'rational-expectations' revolution of the late 1970s and early 1980s. It posited that both output and inflation could be controlled by manipulating the official short-term rate of interest. To a practical City economist, the CTMM's 'Dr Spock' logic always seemed an attempt to impose an excessively neat framework onto a messy reality. Unfortunately, the 1998 Act meant that the flawed approach of the CTMM had consequences: for the institutional structure of the Bank of England; for the Bank's theoretical framework; and for the statistical model used to produce the Bank's *Inflation Report* forecasts. The deficiencies of the CTMM are a reason why the Bank did not foresee the financial meltdown that commenced in September 2007 and was timorous and tardy when the crisis erupted. The CTMM also provided the analytical framework employed by the US Federal Reserve under Chairman Greenspan. This means that its conceptual inadequacies were a major contributor to the policy errors that led to the global crisis.

What is the Conventional Theoretical Macro Model (CTMM)?

A more formal exposition of the CTMM is set out in Smith (2007), but the underlying logic is simple. The essential idea is that a central bank faced with above-target inflation can raise the real rate of interest by increasing its official interest rate; this then leads to a downturn and the emergence of spare capacity; the excess spare capacity then drives down inflation until it is back on target, at which point the economy recovers, although this only works if the populace's expectation of future inflation remains steady throughout. This explains the importance that modern central banks pay to the credibility of their policies and to the measurement of inflationary expectations.

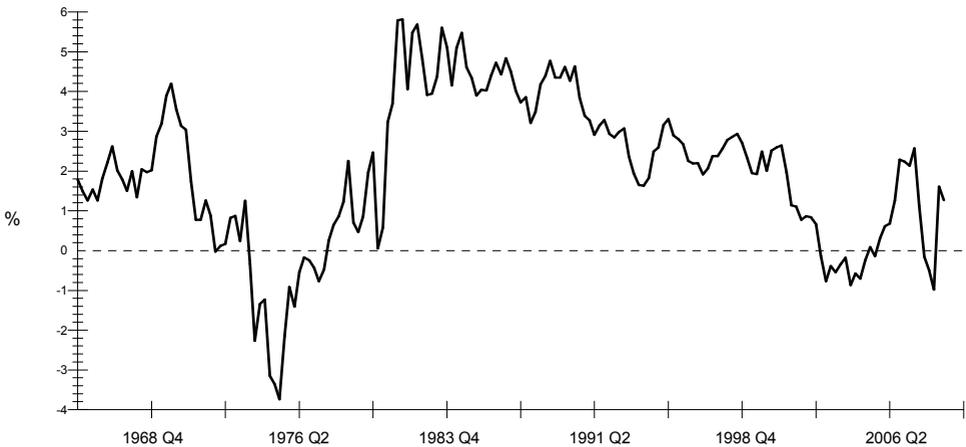
To be more precise, the CTMM is typically expressed in terms of three simple forward-looking dynamic equations.

- The first equation relates the present period's output gap to its actual value in the previous period, its expected value in the next period, and negatively to the real rate of interest, defined as the current period's interest rate less the expected inflation rate in the next period.

- The second equation relates the inflation rate to the present period's output gap, and a weighted average of inflation in the previous period and expected inflation in the next period.
- Finally, in the third equation, the nominal rate of interest is determined by its equilibrium real rate, together with expected inflation in the next period, the previous period's output gap and the deviations of the previous period's inflation rate from the official inflation target.

Two general objections to the CTMM are that it ignored broad money and credit, and was inconsistent with the historic experience of the UK and aggregated OECD area since the mid 1960s (Smith (2007)). A more specific criticism is that the CTMM involves a dangerously over-simplified view of the rate of interest for two reasons.

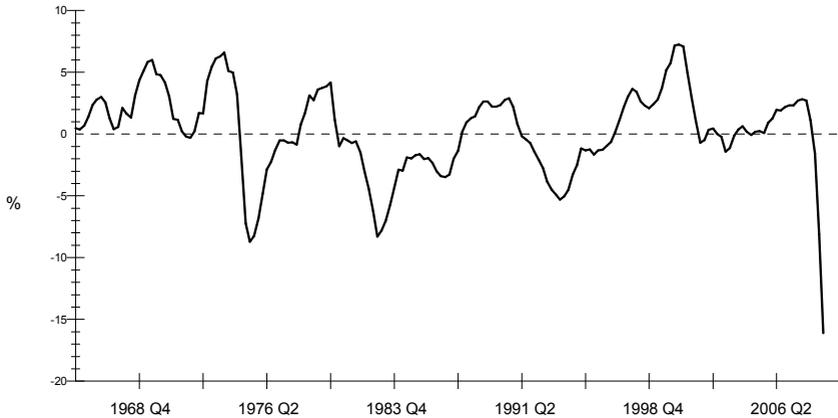
Chart 1: Real 'World' Three Month Rate of Interest 1965Q1-2009Q1



The first reason is that central banks can only set the nominal REPO rate, not the real rate that features in equation one of the CTMM. It may be easy to translate the nominal REPO rate into its equivalent real rate when anticipated inflation is low and steady, although the graphical evidence suggests that the real rate of interest can wander over a wide range in practice and seems to have been on a downward trend since the early 1980s.

Some of the movements in the real rate can be explained by changes in the level of capacity utilisation in the world as a whole (Chart 2) but it is difficult to obtain a reliable statistical relationship. A more serious issue is that the intellectual framework of the CTMM falls to bits if inflationary expectations are high and volatile. This is why central banks were probably justified in not cutting rates earlier on in 2008, when the oil price peaked at over US\$145. Once inflation expectations become unstable, the growth of real broad money becomes a better guide to future activity than nominal interest rates. This happened in the 1970s and explains why money-supply targets had become widely adopted by the end of that decade. However, broad money and interest rates are not rivals – as many economists appear to believe - but complements where activity is concerned. This is because most bank deposits pay interest so that increased real interest rates induce an upwards shift in the demand for money and *vice versa*. Such demand shifts can then either offset, or reinforce, the effects of movements in the real money supply.

Chart 2: Deviations of OECD Industrial Production about its Trend 1965Q1-2009Q1



The second reason is that even ‘the’ nominal rate of interest is not clearly defined in the CTMM. One must presume that it is an overnight official rate, such as Britain’s Bank Rate or the US Fed Funds. However, practical bankers have always known that there is not one unique rate of interest - but three, at least - that matter for monetary policy. In addition to the rate on overnight money, there is the three-month interest rate, which influences base borrowing costs, and the government bond yield, which is important for capital investment and asset prices. There has also been a substantial ‘pass-through’ problem caused by the limited extent to which changes in official rates have influenced the rates charged by commercial lenders, including mortgage rates. Populist politicians often claim that the failure of low official rates to be passed

through results from a cartel, or just ‘greedy bankers’. But it could also reflect high levels of bad and doubtful debts leading to credit rationing, in which only the most secure borrowers are given access to credit. This phenomenon has been crucial since August 2007. However, credit rationing has never had any place in the CTMM or any of the applied macroeconomic forecasting models, leaving the authorities with no intellectual framework in which to comprehend its effects.

More recently, the policy of official debt repurchases – or quantitative easing (QE) as it is now known - has come to be regarded as an antidote to the real interest rate trap caused by deflation. This trap has arisen because the large output gap indicated by Chart 2 would normally warrant substantially negative real interest rates. However, these are unobtainable when inflation is negative or close to zero, given that nominal rates always have to be positive. Unfortunately, central banks do not seem to be considering whether there is a general case for resurrecting open-market operations as an additional monetary tool to limit future booms as well as providing emergency relief in the slump. The ‘old-school’ forecasting models that prevailed before the CTMM - including those at one time run by the Bank of England - not only incorporated a multiplicity of interest rates, but also modelled how the various types of expenditures reacted to different rates of interest. Such detail would be invaluable under current circumstances when the different rates of interest have diverged so markedly.

The Implications for Britain’s Monetary Arrangements of the CTMM

It is now time to discuss the pernicious consequences of CTMM for the institutional structure of the Bank of England, for its theoretical framework, and for the forecasting model used to produce the Bank of England’s *Inflation Report* forecasts. Each will be considered in turn.

The Bank’s institutional framework

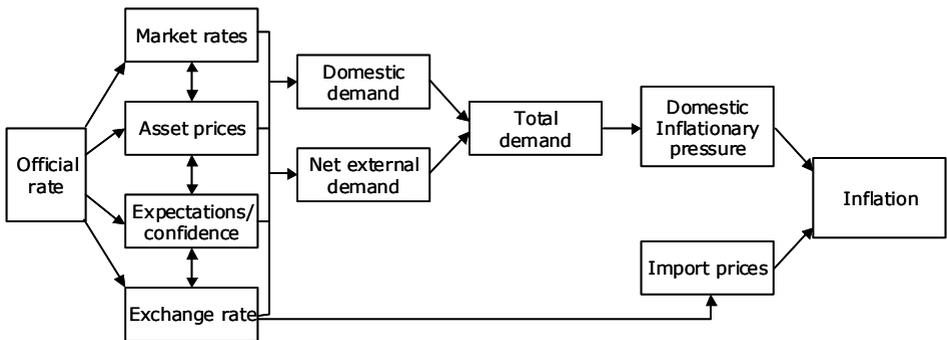
The logic of the CTMM clearly underlay the institutional arrangements for the Bank of England set out in the 1998 Act, which emphasised its REPO rate setting function at the expense of all other traditional monetary concerns. The removal of the Bank’s debt management responsibilities to the DMO, in particular, marked a clear break with three centuries of tradition. This was because the Bank had been established in 1694 to manage the national debt incurred as a result of William III’s war with Louis XIV. More generally, all traditional economics textbooks from the 1920s onwards had emphasised the role of open market operations – i.e. the sale and re-purchase of government debt from the private sector – as a major monetary policy tool. The expansionary aspect of this policy has now been revived under the name of quantitative easing (QE). However, the separation of the debt management

responsibility between the DMO and the Bank means that there is a high likelihood that the two end up working at cross purposes. There is also an argument that the Bank should have used funding policy, in conjunction with reserve asset ratio requirements, to better control the earlier excessive growth of money and credit well before the banking crises blew up.

The Bank's conceptual approach

In addition to its impact on the 1998 Bank of England Act, the members of the Monetary Policy Committee often seem to have the CTMM framework in mind when giving interviews about monetary policy. One example is that MPC members have claimed that the sharp fall in sterling in 2008 would not be inflationary as long as there was a negative output gap. This contrasts with 'Scandinavian' models of inflation where one would expect the drop in sterling to be fully reflected in British prices in the long run, unless this was offset by deflation overseas. The CTMM is also reflected in the Bank's account of the monetary transmission mechanism from which Diagram A (below) has been taken (Bank of England (1999-I)). Note the absence of a banking sector, money and credit, or any suggestion of a pass-through problem from official to market rates of interest. No serious student of monetary history, or experienced financier, would have assumed that the world was so simple or so easily controlled by modest adjustments to the official overnight rate of interest.

Diagram A: The Transmission Mechanism of Monetary Policy as Seen by the Bank of England



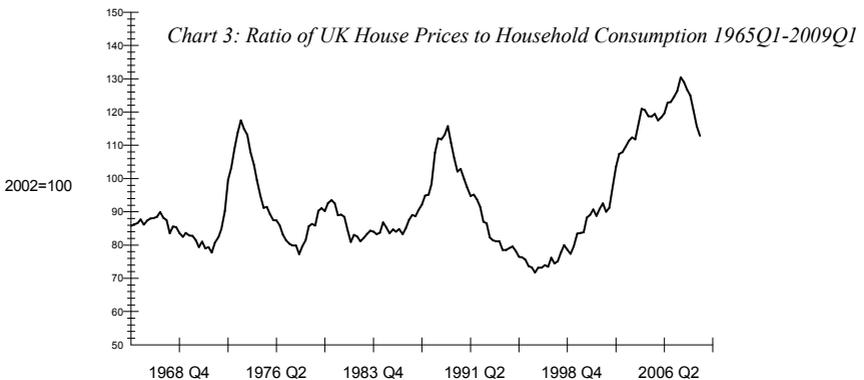
The Bank's forecasting framework

The CTMM appears to have been a strong influence on the Bank of England Quarterly Model (BEQM) and also the similar Dynamic Stochastic General Equilibrium (DGSE) models run by other central banks (see: Tovar (2008) for a fuller discussion).

The Bank employs several models but BEQM plays the central role in the MPC's forecasting process. An account of BEQM was published in January 2005 (see: Harrison et al (2005)) and only the most relevant aspects will be touched on here. Point one is that BEQM is built in two distinct parts: firstly, a theoretical 'core' with imposed calibrated coefficients; and, second, a set of statistically-estimated 'non-core' equations that include additional variables and dynamics not incorporated in the model core. The stabiliser terms in BEQM are then defined as the difference between the lagged dependent variable and the prediction from the 'core model'. This means that the validity of the core model has not been tested empirically and that the whole model is arguably too stable because it snaps back rapidly onto its imposed core. There is no evidence that BEQM was capable of delivering advance warning of the recent contraction in national output, for example. Furthermore, its published simulations suggest that BEQM is remarkably insensitive to Bank Rate. This explains why the Bank decided to cut Bank Rate to an unprecedented low of ½ per cent on 5th March and has held it there subsequently. If you do not get much 'bang per buck' you need a lot of bucks and also a different kind of ammunition – hence the resort to QE.

Another grave deficiency of BEQM is the absence of any measure of broad money or credit, let alone credit rationing (Gieve (2009)), even if the latter may be impossible to measure in practice. In addition, there is only the one rate of interest incorporated in BEQM, precluding any consideration of the pass-through problems that have been so important since August 2007. That this may not be just an intellectual weakness, however, but also a matter of the faulty mandate delivered to the MPC can be seen from the following quotation from Harrison et al (2005):

The Bank of England is mandated by the Chancellor of the Exchequer to aim for an inflation target - at the time of writing, a 2% annual inflation rate of the Consumer Price Index (CPI) - and uses a very short-term nominal interest rate as its instrument to pursue this target.



Triple Consolidation of the CTMM into UK Monetary Framework

The conclusion at this point is that the CTMM has been trebly consolidated in Britain's monetary arrangements: once, in the institutional structure of the Bank of England; again, in its conceptual framework; and, finally, in its forecasting model. The tunnel vision that resulted from the CTMM's over simplified approach is one reason why the UK authorities did not foresee the financial meltdown that commenced in mid-2007, despite the many 'red flags' being generated by the preceding domestic credit boom. These warning signs suggested that the mistakes of the Heath-Barber and Lawson credit booms - both of which were followed by credit busts and serious recessions - were being repeated (Charts 3 to 5). The resemblance to Slovenia's Mount Triglav - the three-headed giant - is remarkable. However, another reason was that this was partly an international crisis. Britain has a small open economy and was partly swept along by global events over which it had no control. The next section turns to the international roots of the crisis.

Chart 4: Deviations of UK Real Household Consumption about its trend 1965Q1 to 2009Q1

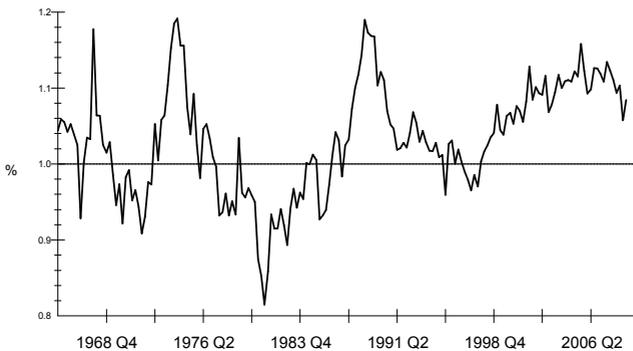
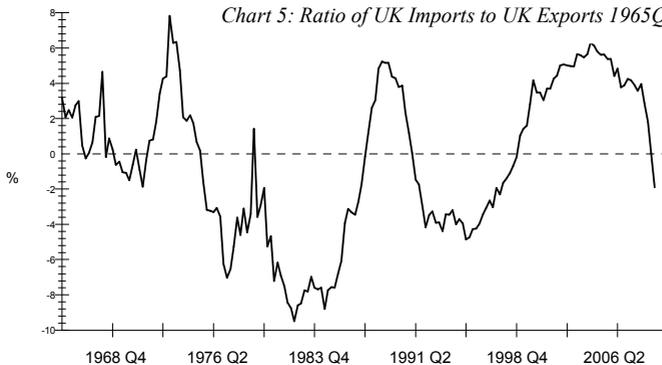


Chart 5: Ratio of UK Imports to UK Exports 1965Q1 to 2009Q1



III

Distinct Features of the Present Crisis

Britain's post-1997 monetary arrangements contained grave structural flaws which exacerbated Britain's banking crisis. By contrast, the better designed banking systems of countries such as Canada continued to function unscathed. The turbulent international background is an important part of the story. But that does not absolve the failure of the UK regulatory authorities to do as well as many of their counterparts overseas.

International Roots

British households are often regarded as over-borrowed. What has been less recognised is how far the British government and the nation as a whole have enjoyed an unsustainable spending spree. This was funded by the availability of the abnormally cheap international credit that resulted from: first, Alan Greenspan's misguided policies in the US and second, the attempts of South East Asian and Middle-Eastern oil-producing countries to peg their currencies. The latter generated capital inflows that supported sterling, reduced inflation, enabled the MPC to keep interest rates lower than might otherwise have been the case, and allowed the UK government to fund its budget deficits artificially cheaply.

To comprehend this phenomenon, one must understand what happened when nations, such as China, attempted to hold their currencies below their 'natural' market-clearing rate. One consequence was that their trading partners enjoyed a supply of artificially cheap goods, which held down inflation and interest rates, and raised the living standards of ordinary people, leading to strong household consumption and buoyant tax receipts. Another consequence was that the central banks of the currency manipulators saw a rise in their foreign exchange reserves. When this happened their first response was to buy US treasury bills and then US government bonds. Having sated their demand for US\$ based assets, however, the (Asian etc.) officials concerned then diversified their portfolios by putting an increased proportion of their reserve inflows into other currencies.

As far as Britain was concerned, these overseas policies had consequences that exacerbated its indigenous credit cycle. One was that Asia's cheap money policies encouraged the development of the 'carry trade'. This caused private capital to flow into the British financial markets, and amplified the direct effects of overseas central

banks' purchases of British government debt. The build up of overseas sterling deposits provided the finance for British banks to extend credit to domestic households, businesses, and 'other' financial corporations. At the same time, overseas purchases of British government securities led to artificially low bond yields. The latter then boosted the value of long-lived assets such as equities and property but made it difficult to control broad money, allowing the bubble to become self-feeding. When these overseas inflows tapered off, these processes went into reverse and confidence collapsed in the inter-bank market.

The conclusion is that the credit crunch was an international phenomenon and Britain would have suffered disproportionately badly from it under any circumstances because of its unusually large financial sector. However, Britain's experience compares badly with that of many other countries including Canada and Australia, whose financial institutions were originally based on British precedents. This international comparison indicates that the regulation and supervision of the UK financial sector has been inadequate. The MPC were also remiss in allowing a large domestic credit bubble to emerge and should have requested additional policy instruments - such as reserve asset ratio requirements - before the credit boom got out of hand.

IV

Lessons from the UK Banking Crisis

What main conclusions should be drawn from the abnormal severity of the UK banking crisis, compared to most leading countries other than the US? This chapter will first consider these, then address possible improvements.

First, the abrupt manner in which the tripartite dismemberment of the Bank of England was implemented in 1997 led to serious structural flaws being cemented into the 1998 Bank of England Act. Senior Bank officials and MPC members should have queried these arrangements. However, rather than raising serious questions they took a narrowly legalistic view of their mandate. In the same way, the Bank's initial reaction to the crisis at Northern Rock was tardy and timorous. Whereas those in the front line must take bold often snap decisions on the basis of partial and conflicting information, the Bank seemed to suffer from 'analysis/paralysis'. The UK banking crisis might not have escalated if the Bank had been bolder at the very start. However, as it takes decades to produce a well rounded central banker, such a specialised form of human capital was unlikely to be produced by an institution with the restricted range of responsibilities of the post-1997 Bank of England. Britain's post-1997 monetary establishment illustrates the dangers of imposing a simplistic theoretical model - in this case, the CTMM - on reality. A naive faith in the efficient-markets hypothesis, and the assumption that all probability distributions are normal and stable over time, provide examples of the same damaging over-simplification in the private sector (see: Haldane (2009 - I)).

Second, the tendency of financial regulators to prefer a neat and simple world is highly dangerous. This preference has led regulators in many jurisdictions to prefer a system with a few large institutions, rather than many small ones, and internationally co-ordinated regulatory frameworks. Both are damaging. The preference for a few large institutions leads to cartelisation and the 'too-big-to-fail' syndrome while the global business cycle becomes dangerously amplified if national credit cycles are in phase as a result of internationally implemented regulatory shocks. The credit crunch would have been less damaging if there had been many small financial institutions and a boom in one country had been offset by a recession elsewhere (Haldane (2009 - II)). The collapse of Equitable Life in December 2000 should have resonated with those responsible for banking supervision. The report of the Parliamentary and Health Service Ombudsman (2008) found that investors were entitled to 'a justifiable sense of outrage on the part of all those who complained to me at the failings of those

operating the regulatory system'. The recent banking crisis would have been better handled if officials had learned lessons from the Equitable Life fiasco. They had no interest in doing so because politicians and officials are protected by their own over-generous and publicly funded pension schemes.

Third, the failures and perverse incentives produced by a slackly run and ill-considered regulatory system do not excuse the behaviour of senior managements, whose fecklessness, empire building, and negligence was highly irresponsible. However, where a handful of people at the top behaved badly, ordinary employees often behaved in an exemplary manner. The counter staff at Northern Rock, for example, coped remarkably well with a bank run, when their jobs were endangered, their pension fund risked default, their own Northern Rock shares had been trashed, and they did not know whether they would be paid at the end of the month.

Fourth, foreclosure, which prudent bankers should always have at the front of their minds, was lost sight of in the rush to package mortgages into securitised investment vehicles. The lending bank has an unambiguous and unique claim on the collateral in traditional banking arrangements and can always be judged entitled to it after due legal process. With securitised mortgages, however, each individual lender owns only a tiny share of each individual property. Coping with one default requires numerous financial institutions, operating in different national jurisdictions, to co-operate if they are going to get their money back. The prospect of tens of thousands of defaults gives rise to huge legal and administrative complications. There is clearly a case for a Brady-bonds style solution in which all the institutions concerned pool their claims, eliminating the bulk of the potential legal and administrative costs. The announcement of such a programme would probably lead to a rise in the value of the assets concerned.

Fifth, UK Financial Investments Limited (UKFI) was established to manage the British government's shareholding in the banks subscribing to its recapitalisation fund in November 2008. UKFI currently owns 68 per cent of the Royal Bank of Scotland Group and 43½ per cent of the combined Lloyds/HBOS, in addition to Northern Rock and Bradford and Bingley. Its powerful presence means that UKFI has a unique opportunity to tackle the 'too-big-to-fail' issue by bringing the institutions where it is the dominant shareholder to market piece-meal, as well as in a series of tranches. The Royal Bank of Scotland Group, for example, could be brought to market as two separate institutions, i.e. the old Royal Bank and the old National Westminster. It might even make sense to break the Royal into its two 1960s Scottish forbearers and the Nat West into its three constituent banks – the National Provincial, Westminster, and District banks – that had existed until the late 1960s. Small businesses and private

customers would be better served by a system of small competing banks with local regional head offices. The concern expressed by the EU Competition Commissioner, Neelie Kroes, about the excessive cartelisation of UK banking is entirely justified.

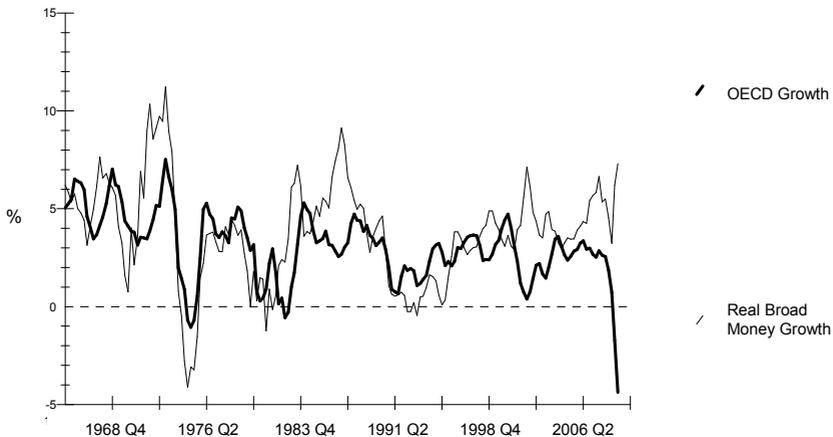
Sixth, the likelihood that the UK banking crisis was a Cromer-style watershed event and that UK monetary policy risks being effectively re-politicised must cause concern. Theoretical economists claim that once Bank Rate falls close to zero, monetary policy becomes funding policy, and fiscal and monetary policies are as one. It may still be premature to write the obituary of the operationally-independent Bank of England and there have certainly been some improvements since the new UK Banking Act became law in February 2009. The 2009 Act clarifies the legal uncertainties under UK and European Law (Congdon (2008)) that inhibited the Bank of England when Northern Rock got into difficulties. However, Bank officials could have been bolder and structural reform cannot compensate for a lack of fighting spirit on the part of the bureaucrats concerned. The Bank will now have statutory immunity when acting as a lender of last resort, and the bill establishes a Special Resolution Unit at the Bank to deal with failing financial institutions.

V Some Regulatory Dangers

Both the Government and the Opposition have advanced proposals to improve financial regulation. Certain lessons apply to all such proposals, especially the adverse consequences which the wrong measures can have. Public choice theory suggests that politicians and bureaucrats act in their own interests which may not coincide with those of society as a whole.

The Impact of Bad Legislation

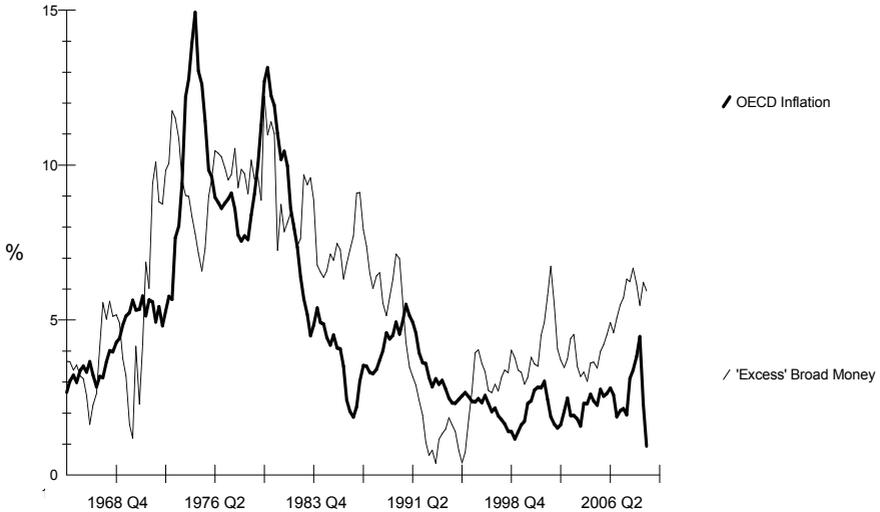
Chart 6: Annual % Changes in OECD GDP and Real OECD Broad Money 1965Q1-2009Q1



There is a long and unfortunate history of ill-considered banking legislation inducing credit crunches and economic recessions. President Roosevelt's decision in 1936 to double US banks' reserve requirements stopped recovery from the Great Depression. More recently, the 1988 Basle agreement caused the world's commercial banks to re-balance the assets side of their balance sheets away from lending to the private sector - where the capital requirements were higher - in favour of government bonds. The result was a global credit crunch, a collapse in the value of collateral, a marked deceleration in OECD monetary growth, and the global recession of the early 1990s (Chart 6 - the present global recession does not appear to have a similar monetary cause). The long period of subdued broad money growth that followed did, however,

bring down OECD inflation and paved the way for the ‘great moderation’ that followed (Chart 7).

Chart 7: Annual % Changes in OECD Consumer Prices and OECD Broad Money Divided by Trend Output 1965Q1-2009Q1



There are other worries about legislative intervention. The first is that it can lead to the monetary authorities suffering ‘regulatory capture’ (see: Tanzi (2008)) with the result that rates are set with the needs of speculators in mind, rather than the population at large, leading to an inflationary bias. It is also possible that ‘property-flipping’ politicians and the fiscal authorities welcome financial bubbles, because of the scope that they offer for personal enrichment and the buoyant tax receipts that they induce (Jaeger and Schuknecht (2004)), even if the central bank does not.

A second concern is that regulations can induce banks to ‘game’ the system and push lending off their balance sheets through opaque devices such as securitisation. This was a problem with Basle I from 1988 onwards but it got worse after 2004 with the build-up to Basle II (Blundell-Wignal *et al.* (2008)). The malign feature that most distinguishes the present credit crunch from earlier cycles - the impossibility of market participants knowing the true value of the assets concerned - was a side effect of the perverse incentives generated by the regulatory regime. It was not the inevitable outcome of market forces.

More generally, the imposition of common capital adequacy rules by international agreement, may have led to serious problems for the entire global banking system by encouraging an undue homogeneity in investment strategy, leading to a high concentration of risk across countries as well as institutions. It dangerously increases the amplitude of global credit cycles if every country is in phase, compared with situations where there may be offsetting, out of phase, credit booms and busts in individual countries. International regulations have added to systemic risk by increasing the likelihood that a crisis will affect the entire global financial system, and not be contained within individual countries and firms.

The Political Economy of Financial Regulation

It is conventional when discussing financial regulators to assume that they are perfectly informed Platonic guardians acting in the interests of society as a whole. This used to be believed about politicians and bureaucrats in general, before the development of public choice theory. However, it is now realised that this was naive. Politicians and bureaucrats are now regarded as acting as much in their own selfish interests as capitalist entrepreneurs. The main difference between the two groups is that the time horizon of politicians tends to zero as an election approaches while businessmen often deal with the same counterparties for years, incentivising them to be honest in their dealings. The old-fashioned style of relationship banking (and employment practices) that existed in Britain until the mid-1980s was of this type. Its displacement by the post 'Big-Bang' style of transactions banking (and hire-and-fire employment) could be regarded as one of the roots of the present crisis. Employees will inevitably try to grab what they can, while they can, when their employers operate a hire-and-fire policy.

The responsibility for UK financial regulation is now seriously overcrowded with the Prime Minister, the Chancellor of the Exchequer, Bank of England, FSA, HM Treasury officials - and, lest we forget, the Basle Committee on Banking Supervision (BCBS), the Committee of European Banking Supervision (CEBS) and the EU Competition Commissioner - all advancing their own agendas and endeavouring to protect their own distinct interests. The consequence has been that official initiatives have been logically incoherent. Ostensibly, the need is to restore bank profitability so that impaired assets can be written off and normal lending restored. Logically, this has to involve a widening of the spread between the rates charged to borrowers and the rates paid on deposits. When the merger between Lloyds TSB and Halifax/Bank of Scotland was approved by the Prime Minister (possibly in breach of due process and the rule of law) the government appeared to have been sponsoring a cartelised banking system in order to generate the monopoly profits needed for re-capitalisation. The 12

per cent rate of interest charged on the commercial bank's re-capitalisation loans also seemed to indicate that the authorities expected the banks to increase their rate spreads. If banks needed to borrow an extra 5 per cent of their liabilities at 12 per cent to meet the official capitalisation target, the implication is that the spread between lending and deposit rates has to widen by 0.6 percentage points to pay off the government, for example.

Reports have also suggested that commercial bankers were informed the day after they had agreed the 12 per cent rate that they had to increase their capital further to protect against a worst case scenario. The decision from a macro-prudential viewpoint was perverse and would have seemed sharp practice in a commercial deal. To add to this confusion, the Prime Minister has attacked the banks for not cutting their lending rates and increasing their lending to the private sector at the same time as the state-owned Northern Rock was generating bonuses for its employees by cutting its loan book aggressively and the FSA had asked banks to hold an increased share of their assets in government debt.

It is also hard to reconcile the fact that a root cause of the UK banking crisis was the banks' over-dependence on volatile wholesale deposits with the decline of the saver. The UK banking sector can only be permanently stabilised if it increases the share of domestic retail deposits in its liability mix. This requires savers to be given realistic post-tax rates of return on their deposits. One explanation for this policy incoherence is that economic rationality has been driven out by populist grandstanding in a pre-election period. However, there also appear to have been differences amongst the bureaucracies involved, particularly between the Bank of England and the FSA. This is much as one would expect from the political economy analysis. Similar bureaucratic turf fighting has also arisen in the US (Gapper (2009)).

VI

The Way Forward

The scale of the UK banking crisis and the fact that it hit at the core of the clearing bank system raises a number of issues against a background where questions of moral hazard are all important. These include deposit insurance, liquid asset ratio requirements, and where to draw the boundaries between the responsibilities of the various regulatory bodies involved. These will now be addressed and a series of recommendations made.

Arbitrary winners and losers are created by any intervention to prop up a banking system and questions of moral hazard must be addressed. Here, the responsibilities of: 1) depositors; 2) shareholders; and 3) the management of deposit taking institutions must be distinguished. In practice, small savers cannot know enough about the financial position of long established and apparently reputable deposit taking institutions to act as a check on their management. In this case, moral hazard does not arise if such savers are protected, as their behaviour is unlikely to change in response. The collapse in the shares of the banks that have been bailed out by the government has also largely eliminated the moral hazard aspects of bail outs where bank shareholders are concerned because future shareholders will not risk such massive capital losses again. Rather, the concern now is that sound banks will find it prohibitively expensive to raise capital because investors will demand an excessive risk premium for some time, leading to a semi-permanent state of credit rationing.

The predominant principal / agent problem is how the managements of failed institutions – who have been largely beyond the control of shareholders - can be made to share the pain, if by their recklessness they endanger the organisation. Arguably, the management contracts establishing redundancy terms, pension rights and the contractual bonuses of institutions that have to be bailed out should be declared void. This is possible because statute law takes priority over civil law. Senior managers should receive zero compensation for loss of office. Britain's regulators should also be more aggressive in the pursuit of wrong doers. The perceived threat of legal proceedings deters improper behaviour even if gaining a conviction is problematic in cases of financial fraud.

Four further points on bank management should be considered. First, in many of the cases where UK financial institutions have failed the background of senior

management has been in retailing or marketing, not traditional banking. A ‘pile-it-high-sell-it-cheap’ philosophy may work with baked beans but it is a perilous strategy when it comes to placing loans. Second, while the asymmetry of risk that arises from the financial sector’s bonus culture has been widely considered, the extent to which the combination of a bonus system determined by management fiat and a hire-and-fire culture act as Stalinist instruments of social control has not had as much attention. This means that honest employees may be terrified of the personal consequences if they do not ignore abuse by senior management. Third, international financial groups often appear to have been unduly lax in their imposition of management and financial controls on their overseas subsidiaries because they rarely looked beyond their profit and loss accounts to the deeper institutional realities. Finally, never underestimate the importance of the ‘little people’ in the back office, especially settlement clerks. Neglected settlement problems can destroy an entire firm (Philippou (2007)). However, sloppy settlement procedures can also act as a smokescreen to mask financial abuse by senior managers.

Recommendations

Deposit Insurance

To avoid problems of moral hazard, deposit insurance should not be 100 per cent and the proportion of deposits covered should be lower for people putting money in tertiary or offshore institutions.

The need to avoid future panics justifies the decision to raise the cover provided by the British system of deposit insurance from £35,000 to £50,000. There are economies of scale in managing money and it is inefficient to have depositors breaking their savings up into penny packets to ensure that they are insured. However, the Government has drifted into a situation where it is under-writing all deposits, regardless of the quality of the institution concerned. This *de facto* provision of unlimited 100 per cent deposit insurance creates huge moral hazard and almost invites crooked Ponzi schemes.

It would be more sensible to offer 100 per cent cover for deposits of up to £5,000, then 90 per cent up to £100,000, and perhaps zero beyond that point. The prospect of a 10 per cent loss would concentrate depositors’ minds on the risks involved, while safeguarding innocent savers from the risk of financial wipe out. There also seems to be little justice in giving 100 per cent bail outs to aggressive investors placing their money with offshore or tertiary institutions. In such circumstances, compensation should be limited to a much smaller proportion – such as 50 per cent, for example.

Mandatory Liquid Assets Ratio Requirements

Liquid asset ratio requirements should be restored, they have been a vital weapon in the arsenal of central banks and they should never have been abandoned.

The second recommendation concerns liquidity requirements. The 1988 Basle agreement specified the capital requirements of the world's banks and was designed to ensure that deposit taking institutions had enough capital and reserves to avoid a solvency crisis. However, earlier generations were well aware of the risk of bank runs. This means that there is a long tradition of central banks imposing liquid asset ratio requirements in return for the provision of lender-of-last resort facilities (see: Deutsche Bundesbank (1990)). Such requirements normally specify that a minimum proportion of bank assets should be held in the form of short-term government debt, such as Treasury bills, and balances with the central bank. Such requirements should not be too onerous, because that would encourage the growth of Spivey secondary banks. However, there are potentially high social costs to a situation where commercial banks can easily expand their balance sheets while relying on the central bank to supply liquidity on tap. Free market forces do not operate in the banking sector, if depositors are protected by the state and bank directors do not have unlimited personal liability.

Before 1971, for example, British clearing banks were meant to maintain an 8 per cent cash ratio, and keep another 20 per cent of their assets in short-term gilts. It was not until the 1980s that all such restrictions were abolished, following several reductions in the liquidity ratio. The FSA is now considering the re-imposition of liquidity requirements of the order of 6 per cent to 10 per cent of eligible liabilities (Financial Services Authority (2008)). An advantage of this proposal is that the Bank of England would know with certainty the value of the first tranche of assets that was being pledged as collateral when it was a lender of last resort. However, one danger that must be avoided is imposing such a large or abrupt increase in reserve requirements that it induces a collapse in money and credit, prolonging the crisis.

There is a case for leaving the financial sector to recuperate without further regulatory shocks until there are signs of another credit boom getting under way, probably in several years' time. That is the point at which reserve asset ratio requirements and other balance sheet restrictions should be introduced, not now.

Bank of England or Financial Services Authority

The Bank should be given responsibility for banks and building societies, but only for these institutions.

Liquidity ratios may well be implemented by a Bank for International Settlements (BIS) co-ordinated agreement as well as through domestic action. In the case of Britain, the re-imposition of liquidity requirements should be accompanied by a decision to make the Bank of England responsible for supervising the deposit takers whose liabilities are included in M4 broad money, but not other institutions. This would involve around 156 banks and 58 Building Societies. Secondary institutions outside the M4 sector should not have their deposits insured by the state – or only to a far more limited extent - and people should be informed that placing money with them carried a default risk. This would also introduce a firebreak in the spectrum of liquid assets, allow broad money to be more clearly defined, and mitigate the ‘boundary problem’ (Goodhart (2008)). Another advantage of returning supervisory responsibility for M4 deposit takers to the Bank of England is that the Bank would have better intelligence on the institutions that it might have to bail out, while leaving the chore of supervising smaller institutions and non-banks to the FSA. These proposals appear to be closer to those of the Conservatives (Conservative Party (2009)) than the Chancellor’s recent suggestion of enhanced power for the FSA and a strengthened tripartite supervisory board (HM Treasury (2009)). However, the author’s view is that the Bank’s regulatory duties should be strictly confined to M4 deposit takers and not extended to the wider range of institutions advocated by the Conservatives. Even so, there is no reason why this should be a matter of party politics. Cynics might also argue that the Bank and the FSA failed so spectacularly in the financial crisis that it is arbitrary which failed institution should be given most power. Neither institution currently has the human capital required to do the job properly and it is also improbable that bureaucrats can see further ahead than the professional management of a financial institution, however inept the latter may be.

Macro-Prudential Regulation and Money Supply Targets

Macro-prudential regulation (i.e. controlling bank credit by varying banks’ capital requirements) would be better achieved through liquidity requirements than capital ones.

Recent years have witnessed a growing interest in ‘macro-prudential’ regulation (Borio and Shim (2007)) because of concern that the Basle capital requirements have perversely amplified boom/bust credit cycles. This is because commercial banks find

it easy to build up their capital and reserves and create credit during the boom, but ration credit too stringently in the downturn when they are short of capital. It is now proposed that the banks' capital ratios should be varied with the phase of the credit cycle, being raised in the run up to the boom and reduced ahead of the slump. Proponents of macro-prudential regulation believe that this function has to be carried out by central banks because they are already engaged in forecasting – although this rather begs the question of how accurate central bank forecasts have been in practice. There seems to be an unacknowledged equivalence between the desire to have the assets side of commercial banks' balance sheets growing steadily over time, to reduce the amplitude of credit cycles, and the late 1970s vogue for money supply targets, which were an attempt to control the rate of increase in the liabilities side of the balance sheet. A personal view is that a macro-prudential approach to financial regulation is done better through liquidity requirements than capital ones, which have perversely exacerbated the present crisis (Sinclair, Petrova and Smith (2008)).

Finally, rebuilding hollowed-out institutions, such as the Bank of England, inevitably involves perseverance over time. Unfortunately, such perseverance does not appeal to politicians of all parties, who generally prefer newsworthy institutional revolutions to steady incremental improvement. However, this preference partly explains why a flawed regulatory system was introduced in 1997. Today there is no immediate problem of credit excess. What matters now is that the right measures are adopted, even if this takes time for open debate and mature reflection.

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