The Financial Sector and the UK Economy

The Danger of Over-Regulation

John McFall
Kent Matthews
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Edward George

Editor:
Sheila Lawlor

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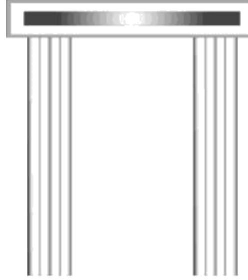

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Foreword: The Financial Crisis, the Banks and Political Momentum

Where Should the Buck Stop?

Sheila Lawlor

In the aftermath of the 2007-8 crisis when failing banks were bailed out with public funds, politicians came to focus on what they and the public held to be one of the main causes of the crisis, the banks. Never again should they be in a position to hold the taxpayer to ransom. There would be no repeat of bank failure and so no more taxpayer funded bailouts.[1]

The policy focus since then has been to intensify the regulation of the banking and financial services sector. To the measures proposed by HMG can be added those of the EU and other international regulatory bodies. In particular the aim has been to remove risk from the system by 'ring-fencing' investment operations from retail banking and by increasing the proportion of capital banks should hold; these changes are being introduced against the implied assumption that bailouts will not be necessary or take place in future.[2] The new and proposed measures also reflect the official and popular view that financial crisis and developments in its aftermath were 'caused' by the banks. This has encouraged policy makers and regulators to take the view that banks, if not the wider financial sector, bear much of the blame for what went wrong, and the entire sector must now be made proof against any repeat.

To the authors of this volume, both academic economists and others with specialist knowledge of the financial services industry, that message – and the direction of regulation to which it has led – raises a number of questions.

Regulation itself, as Lord McFall points out, does not make people behave ethically. What is needed is a change in culture from within the organisations, more emphasis on individual accountability and the right regulation. Yet the current regulatory drive – to ring fencing, higher capital ratios and the implied rule of no future bailouts – may undermine the goal of safer banks and prove the wrong solution for the problems addressed, explains Kent Matthews. It may also add to the costs of banking and the disruptions normally to be expected in working markets. Indeed, there is a real danger

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[1] I would like to thank David B. Smith for his helpful advice for this volume from the outset

[2] Apart from the EU measures mentioned in these chapters and the Basel III (2010-11) proposals for higher capital requirements, higher liquidity ratios and additional counter-cyclical capacity requirements), the recent UK approach includes: the Vickers Report (2011), proposing ring-fencing, to separate utility banking from investment banking, and higher capital reserves; the Financial Services Act (2012), setting up three regulatory bodies in place of the FSA, the Prudential Regulation Authority (PRA), for regulating banks, building societies and the insurance industry, the Financial Conduct Authority (FCA) to regulate the sections not covered by the PRA, and the Financial Policy Committee (FPC), the Bank of England's Committee for monitoring the economy; the Banking Reform Bill (2013), due to come into force 2014, for proposals for a ring fence and certain powers over banks for the PRA and HMG).

that policy is being gripped by regulative fallacy, with consequences for competition and the cost of credit and with implications for the whole economy, argues Patrick Minford. This is especially so for those groups who help economies recover – small businesses and house buyers. That impact on the wider economy of the disproportionate or untargeted regulation should be born in mind by policy makers, says David Green, who warns of the consequences for the wider or real economy. What happens in the financial sector and what happens in the rest of the economy are intertwined. Requiring higher bank capital ratios will have its impact elsewhere in the system (for example, leaving less available for investment in other parts of the economy). To such unintended consequences, others can be added by the often indiscriminate and insensitive regulation of the sector with a peppering of measures from the EU. To the cost of compliance must be added the impact on the competitiveness of businesses as different as investment banking and insurance, explain Scott Cochrane and John Hodgson.

Central to much of this economic thinking is the weighting given to the causes of the crisis and the economic recession which followed. Certainly it is clear that the present banking structure, especially the size and role of huge monolithic banks – 'too big to fail' – play a part. David B. Smith's solution is to break up the 'too big to fail' model along the lines he proposed as early as 2009, by returning to the model of a number of smaller banks and building societies. Ring-fencing will not do the job. Examples of that model failed during the recent crisis. Jamie Dannhauser's concern is with the role played by exchange rates and the part fixed exchange rates. More generally, economic crises can be the result of a change in circumstances, including non-banking shocks, rather than the result of excessive lending, says Patrick Minford. These may be no different to others except rather bigger than those which caused previous post-war recessions. Not to be overlooked, of course, is the role played by the unsustainable fiscal balances which escalated rapidly in the present century and have much to answer for. Smith explains that there is growing and incontrovertible evidence that the unsustainable fiscal balances and rising proportion of public spending to GDP played a significant part in declining growth and output loss to the tune of one per cent in GDP for every one per cent increase in the ratio of general government expenditure to GDP. [3]

If the causes of the crisis are more complex than the political debate suggests, the solutions may not lie in the current direction of regulation. Yes, there is agreement that there are serious problems with the banking sector, not least that the banks have become too big to fail. But what is needed may not be more indiscriminate regulation for the sector, but the right regulation. More to the point, the big banks must be broken up. The 'too big to fail' syndrome results from the failure of competition policy. There

[3] OECD real GDP.

is also a sense that the supervisory role of the Bank of England is paramount. The hope expressed here is that the new system will be allowed to develop once again to a point where the Bank of England discharges the role of supervisor in its traditional informal way, with a minimum of intervention and costly rules and as the body with detailed knowledge and good contacts within the banking industry.

It is fitting, therefore, that we close this volume with the essay by the late Eddie George, who was known and respected as a great Governor of the Bank of England. Politeia published this in 2008 – to mark his *Address* to our economic series, given at a time of financial turbulence. Lord George had joined the Bank of England as a young Cambridge graduate in the 1960s and he saw the evolution of a free market in the financial sector from the controlled system in place when he arrived. In this piece he reminded readers of the 'uncomfortable fact' that 'the buck stops essentially with management and shareholders'. Though that might sound 'hard hearted', he added, if the country were to 'move away from that, we will revert to the days when the authorities were directly controlling the financial system as a whole ... back to the days of direct controls which would certainly not be in our overall economic interest'.

Sheila Lawlor,
Politeia, July 2013

I
The Financial Sector and the British Economy
Principles for a Sound System
John McFall

The financial sector is central to the Britain's economy; its successes and failures have a direct impact on businesses big and small and the lives of many people. In the case of the banking sector, this has been especially clear since the financial crisis of 2007-8 where the economic effects for countries and their citizens are and will continue to be profound.

The causes of that crisis will continue to prompt discussion and debate, and the emphases given to the different factors will vary. What is not in doubt is that societies will have to live with the adverse consequences for many years to come. But there is now agreement that in so far as the banking sector goes, certain problems stand out: a culture which led to excesses; a failure of accountability by those at the top with inadequate systems of responsibility; an industry where the rewards were out sync with those in other professions, and where perverse incentives encouraged action at odds with the long term interests of both bank and customer. To such problems, highlighted by the Parliamentary Commission on Banking Standards in its recent report, can be added a central structural problem. Some banks have become 'too big to fail' and prone to maximise risk to boost profits or bonuses knowing that the taxpayer will pick up the tab when things go wrong.

At heart, these and other problems, such as the Libor scandal which prompted the fuller Banking Commission enquiry into banking standards, which have continued to unfold, can be reduced to one central failing: the customer appears to come, not first, but last. Unlike any other business, the first question asked seems to be, 'What level of short term profit can be made?' Instead of the question being 'What can we devise to serve the interests of our customers?' it too often is 'What can we sell, irrespective of suitability to customers' needs?' This means that a sales-based culture has pervaded the banks intent on selling what are often unwanted, unnecessary or flawed product – rather than treating customers fairly and properly. This and other problems have been exacerbated because there has been no individual accountability at the helm. All sorts of murky, on occasion illegal, activities such as Libor rigging could take place, but when it comes to the top echelons there often exists a 'no see, no tell' policy. In fact, when those at the top were giving evidence to the Banking Commission, they appeared content to come across as more uninformed and ignorant of events than knowledgeable and thereby avoided admitting or taking responsibility.

The banking sector is only one part of the financial sector, albeit a central one. The question we now face is how this industry, so crucial to the economic well-being of citizens and communities, can be changed for the better?

There is no magic prescription. It will take many years to change banking culture, since it requires those in the industry to *want* to change, and what is needed is *individual buy-in*. It will need those at the top to take responsibility for a 'duty of care' to customers. This is essential if a proper ethos is to permeate the organisations.

Individual accountability of Chairmen, Chief Executives and Boards is essential. The recently established Financial Conduct Authority (the FCA, which will regulate conduct in retail, as well as wholesale, financial and have responsibility for the prudential regulation of firms that do not fall under the PRA's scope) should ensure a named Board/Senior Executive is responsible for each line of activity. Never again should we hear the refrain from the regulator that when, after transgressions occurred, they tried to pinpoint responsibility 'the trail went cold'. The conclusion must be that the regulator was captured, cowed and conned by the industry they were charged with supervising. This in turn raises the related question of tackling the problem of 'regulatory capture', where agencies created to act in the public interest instead advance the commercial or other interests of the groups dominating the industry and can be seen as a failure of government.

Second, in terms of pay and rewards, there appears to be a delusional element to those who think they are special and worth it. Whereas the norm for society is remuneration and increments of hundreds and thousands, for senior bankers it has come to be in multiple of millions of pounds. Only by tackling the 'too big to fail' – and dealing with the implicit subsidy from the taxpayer – can this be brought down to more sensible levels.

In retail banking, staff need to be rewarded for the right things – delivering high levels of customer service rather than simply selling products. And this must involve removing the pressure on the front-line to sell at all costs – something that often stems from performance management schemes.

These three, relatively simple, principles in turn raise the question of where the law or regulation and the operation of the rules must change. Resorting to ever increasing regulation will not bring a magic solution. What is needed is the right framework for clear and effective law. In the case of the official agencies, the danger of 'regulatory capture' must be anticipated and, for the banks, a clear and simple regime which requires accountability by those in charge , backed up by legal requirement and the operation of the criminal justice system and a remuneration code which better aligns risks taken to rewards received.

For the sector as a whole there will be other questions, but we should remember that the UK financial sector is a diverse sector, one which has grown up over centuries, with small businesses meeting a range of needs as well as the bigger banks. The problems which have emerged more recently, and the costs with which the taxpayer

has been charged, owe much to the 'too big to fail' syndrome at least in the banking sector. That itself was partly the result of changes in policy over a number of decades as well as to the worldwide change in business models. The problems may also be due to the failure to put in place the right regulation, despite the hundreds and thousands of regulations which now swamp the financial sector. It is therefore important, for the success of the whole sector and its impact on the economy and the lives of all who live and work in this country, that reform must first come from within the organisations – and be expected to do so. The law, regulation and sanction can underpin such change, provided it does not make for damaging or perverse incentives. But unless that change comes from within those who lead and work in the sector, no law or regulation will be effective. Thousands and thousands of pages of regulation cannot make people behave ethically. What opaqueness and complexity does is provide a dangerous illusion of control. So beware. It seems to me that if opaqueness and complexity provide a dangerous illusion of control, reality demands simplicity and understanding. These twin themes are the best guiding lights for a safe and sound financial system serving the best interests of the economy and society.

II
Banking, the Law and a Free economy
Kent Matthews

The 1933 Banking Act in the USA was the first in a series of regulatory actions that brought banks firmly within the control of national authorities in the developed world. The act established protection for depositors, and created boundaries for bank activities that were to be copied by financial authorities all over the developed world. Specifically it set up a deposit insurance system, provided a scheme of government oversight over all commercial banks, separated investment banking from commercial banking (Glass-Steagall Act) and, in the USA, placed limits on deposit interest payments.[4] So, the post-Great Depression period is a good point to start tracing the development of modern bank regulation, although in fact the regulation of banks began even earlier with the imposition of limits on banks operating in the so called 'free banking' periods of nineteenth century Scotland and the USA.[5] In the UK, there was no clearly defined mechanism of control for banks until the Banking Act of 1979 that introduced deposit insurance. Before that the Banking Act of 1946 had given the Bank of England powers to compel the clearing banks to hold certain levels of reserves or to favour one industry over another in the national interest. Control worked under a system of 'moral suasion' whereby the veiled threat of Treasury backing would be used to adjust the lending portfolio of specific banks or quantitative credit controls imposed on the industry as a whole. That system prevailed until 1971 with the creation of Competition and Credit Control.

As for the banks themselves, during the 1950s the clearing banks were narrowly focused on retail activity funded almost entirely from customer deposits. The commercial banks' loan portfolio was dominated by government securities and reflecting the low risk nature of their assets, capital ratios were around 3 per cent.[6] Credit controls were applied periodically in the post-war period (consonant with the stop-go policy of the period) and the clearing banks were also subject to an 8 per cent cash ratio and a 28 per cent liquid assets ratio.[7] The cosy cartelised system of control, where interest rates and bank charges were agreed by the clearing banks, favoured the specialisation of the banking system in the UK. Unlike the rest of Europe which had moved to universal banking (offering all types of banking services), London remained

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[4] Sections of this Act were repealed by the Gramm-Leach-Bliley Act of 1999 that removed the separation of investment from commercial banking.

[5] In the USA the period 1837-1864 was one where banks were largely unregulated and issued their own banknotes. The Scottish period of free banking is generally accepted to be 1716-1845. In that period banks were unregulated up until the Bank of England Act 1844, which created conditions for Scottish note issue.

[6] Billings M., and Capie F., 'Capital in British banking, 1920-1970', *Business History* vol. 49, No.2, March 2007, pp. 139-162.

[7] Gowland D., *Monetary Policy and Credit Control*, (London: Croom Helm. 1978).

functionally distinct between commercial banking, investment banking, housing finance, and life insurance etc.

Throughout much of this period the system worked well with the regulator (the Bank of England) regarding restrictions on competition as a bulwark against excessive risk-taking and the regulated financial institutions happy to operate within self-imposed restrictive practices. The Bank exercised its influence and kept its finger on the pulse through regular meetings with various committees of the clearing banks. Similarly it had regular meetings and observers on committees of the Accepting houses and Discount houses.

Globalisation and the City of London: From Credit Controls to Competition

However, structural changes were occurring as London became the focal centre for the global financial industry with the development of the euro-dollar market and the expansion of foreign banks into the City in the 1960s. The drivers of such structural change included increased competition, domestically as well as internationally; asset price volatility and high inflation that spurred financial innovation; the creation of new financial instruments; changes to information, trading and delivery technology.[8] The consequence was a sharp increase in foreign currency assets held by both domestic and foreign banks. In 1962 sterling assets held by the banks were around 50 per cent of GDP and foreign currency assets were about 10 per cent. By 1979, sterling assets had grown to 65 per cent of GDP and foreign currency assets to nearly 90 per cent.

Meanwhile, the system of control seemed to be ineffective or damaging. The system of credit controls began to lose its effectiveness during the 1960s as the clearing banks set up trading subsidiaries to circumvent the controls that did not apply to them. But even after HP controls were extended to the subsidiaries, the cash ratio and liquid-asset rules did not apply – so giving them a profit advantage. Evidence was also mounting that competition was being blunted and dynamism hindered by the system of controls including that reported by the Monopolies Commission on proposed bank mergers or the Prices and Incomes Board reports on bank charges. Bank of England 'insiders' had long recognised the misallocation of resources that arose from quantitative controls.

The Competition and Credit Control Act of 1971 aimed therefore to promote competition within the banking sector as well as between banks and the non-bank financial sector. The cash ratio was abolished and the liquid-assets ratio reduced to 12.5 per cent. The clearing banks would be obliged to keep 1.5 per cent of deposits as

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[8] D. Llewellyn, 'Structural Change in the British Financial System', in *Surveys in Monetary Economics*, Vol 2, C. Green and D. Llewellyn (eds.), (Blackwell, Oxford: 1991).

non-interest bearing deposits with the Bank of England. Control of the money supply was exacted by the use of the Bank Minimum Lending Rate (MLR) and open market operations. This experiment with a market based mechanism did not last long. The lifting of lending restrictions saw an explosion of bank credit and rapid growth in the money supply which alarmed the authorities into reintroducing quantitative controls through the mechanism of the 'Corset' – a financial tool which constrained the growth of the commercial banks' deposits. A desirable policy on microeconomic grounds therefore seemed undesirable in macroeconomic terms because of the implication for inflation from a loss of monetary control.

During this period, except when constrained to holding low capital ratios in the 1950s, the banks decided on the amount of capital they held. Calculation of the risk-weighted ratio during the 1960s suggested that they were in the order of 13 per cent. The secondary banking crisis of the 1970s (which saw the bailout of a number of smaller banks that had lent heavily to the property market) that followed the collapse of the property boom and later the proposals of the EC First Banking Directive in 1977 provided the catalyst for the reappraisal of regulation which culminated in the Banking Act of 1979. The aim was to formalise the regulatory powers of the Bank of England and to provide protection to depositors.

The Bank of England in the New Order: De- and Re-regulation

Under the 1979 Banking Act, Bank of England oversight was extended to all deposit taking institutions, 'fit and proper' rules were instituted and a system of limited deposit insurance introduced. These rules soon followed with a period of deregulation that heavily impacted on commercial bank activities. Exchange controls were abolished in 1979, the 'Corset' in 1980 and HP controls in 1981. A number of major changes in the banking environment followed in the 1980s with banks, building societies, and insurance companies offering a range of financial products. 'Big Bang' deregulated the stock market and enabled banks to diversify into trading activity and the greater development of 'off-balance sheet' business and the shift towards 'universal banking'. The 1998 Bank of England Act was a watershed in that it gave the Bank operational independence over monetary policy but took away two important functions: a) the regulation of banks and the rest of the financial industry (given to the Financial Services Authority) and b) the agency for the sale and purchase of government debt (given to the Debt Management Office). The effect was twofold. First, it meant that the Bank would now have its finger off the pulse of the banking industry and second it had given up one of its levers to control the money supply, leaving only the rate of interest as the instrument of control.[9]

[9] It can also be argued that with the primary function being the operation of monetary policy, the Bank came under the influence of economists rather than practical bankers, causing a seismic shift in its culture.

This period of deregulation (from the 1980s onwards) was accompanied by a period of ‘reregulation’. Internationally accepted regulations of capital adequacy in Basel 1, (1988 Basel Accord for minimum capital requirements) were enforced. Whereas previously risk-weighted capital-assets in the 1960s were well above the 8 per cent norm considered acceptable under Basel 1 regulations, now banks saw the regulations as minimum targets, which had the effect of encouraging the ‘originate to distribute’ model of securitisation because it did not attach capital requirements to the operation. How is it that banks were able to operate with such low capital ratios? Part of the answer is that banks had the expectation of rescue from the Bank of England – in other words the development of a ‘too big to fail’ culture.

The deficiencies of Basel 1 were followed with Basel 2 (2004) which took the approach of a three pillar concept – namely, capital requirements, supervisory oversight, and market discipline. Basel 2 was known for two things. First it was known for its increased sophistication in the use of internal models: the recognition of market risk and the application of ‘value-at-risk’ models to calculate both risk exposure and recommended capital requirements, the recognition of operational risk and the application of market discipline through greater disclosure. Basel 2 also allowed the use of external rating agencies to provide a risk rating on the loan portfolio of the commercial bank. In the upswing of the business cycle, loan portfolios look good and a higher rating meant less capital being held, releasing resources for even more lending. Second, and a well known feature of Basel 2, was its wide non-observance or selective observance. While target dates were set by banking authorities, few of these were met before the onset of the global banking crisis The introduction of further regulations is now proposed under Basel 3 (2010-11), the Volcker Rule in the USA and the Vickers Report of 2011 in the UK. Basel 3 proposes higher capital requirements, higher liquidity ratios and additional counter-cyclical capital requirements which mean that banks will hold more capital in the upswing of the business cycle (to counter the pro-cyclical bias of Basel 2).

The Implications of the New Way: Bad for borrowers, business and the economy

The main aim of the new regulations in banking is to make banks safer and therefore less likely to fail; or if they do, less likely to be a cost to the taxpayer. It is questionable whether the current policies will do that.

As a result of deregulation, reregulation, and globalisation, UK banks’ assets had grown from 60 per cent of GDP in the 1960s to over 500 per cent in the 2010s. The trend to universal banking is seen in the ratio of non-interest earnings to interest earnings which rose from 0.4 in 1980 to roughly 1.8 by 2010.

Through a process of merger and acquisition UK banks have become more concentrated and less competitive with emerging evidence of strategic pricing underlying switching costs. But as banks have grown during the period of deregulation

and reregulation, it can be argued that they have become 'too big to fail' or their complex interconnectedness has made them 'too important to fail'.[10] The moral hazard implications are seen in the increased level of risk taking and leverage of the banks. Retail deposits as a percentage of total liabilities fell from 88 per cent in 1969 to less than 40 per cent by 2009, indicating a greater reliance on wholesale funding.

Regarding the current state of bank regulation, the object of the Vickers proposals, (for ring-fencing the 'riskier' activities) is to strengthen financial stability and ensure a reduced taxpayer exposure to a future bank bailout. It is possible that ring-fencing retail from investment bank operations with higher capital requirements will cushion tax payers in any future bank bailout. However, it raises two potential questions relating first to the design of regulation and whether there is reason to believe it will make banking safer, and second to the timing of regulation.

First, will ring-fencing make the banking system safer? It is not obvious that the ring-fenced bank will be safer as it will not be able to diversify its risks like a universal bank and will be narrowly subject to the UK property cycle. Furthermore, while banks continue to operate on the expectation of a bailout, regulating capital adequacy will not necessarily create safer banks. Higher capital ratios will make banking expensive but not necessarily safer. Banks must be allowed to fail in an orderly fashion so as to minimize the disruption to the financial market but it is unclear whether ring-fencing will provide this.

The second issue is the timing of such regulation. Increasing capital requirements for banks at this stage of the business cycle will only serve to dampen any recovery by withdrawing credit from the Small and Medium Sized (SME) business sector. Even delaying the implementation of higher capital ratios influences expectations in the banking sector, which has to either raise more capital at a time when bank shares are depressed or reduce lending to marginally risky borrowers. Banks need effective regulation but it is questionable whether they need it now when banking is on its knees.

The current policy involves a tripartite 'solution' of ring-fencing, capital ratios and implied no-bail-out. But there is no evidence that these will solve the problems they are supposed to address. Indeed they may make things worse. Ring-fencing will not be effective in making banks safer. Higher capital ratios do not eliminate the moral hazard problem and excess risk-taking. A no-bail-out policy is simply not credible under the current arrangements.

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[10] R. Davies, P. Richardson, V. Katinaite and M. Manning , 'Evolution of the UK banking system', *Bank of England Quarterly Bulletin*, Q4, 2010, pp.321-332.

Rather, what is needed is a return to the old system that requires the Bank of England to keep its ‘finger on the pulse’ so that it can take ‘prompt corrective action’ before a bank crisis occurs. Banks decide on their own capital requirements based on the business they undertake and the understanding that if they fail because of bad business decisions the role of the Bank of England is to arrange an orderly exit. The Bank of England has to keep the function of ‘lender of last resort’ so that in case of a bank failure it can provide liquidity to the banking system to stop an individual bank failure from becoming a systemic failure.

III

The Financial Sector, the Banks and the British Economy

Markets, Money and Mistaken Regulation

Patrick Minford

The Problem: Regulative Miasma and its Impact on the UK Economy

Periodically great fallacies grip the British establishment and cause enormous harm to the economy. The last big one was the obsession with joining the European Exchange Rate Mechanism at the end of the 1980s. It led first to a resurgence of inflation in 1988 as money was loosened excessively in the attempt to prevent the pound appreciating against the Deutschemark; and it then led to the ferocious monetary squeeze of 1990-2 as John Major's government tried to stop the pound being devalued out of the ERM. Finally after this failed the government dropped all such ideas and returned to guiding monetary policy by domestic conditions with the new inflation target framework.

Now we have the regulative fallacy. The great and the good – from Mervyn King, through John Vickers and Adair Turner to George Osborne and David Cameron – are in its grip. They have identified wicked bankers and excessive debt as the cause of the crisis and resolved to prevent future crises by draconian regulation of the banks. The result has been that the cost of credit to those who rely exclusively on it, namely housebuyers with little cash and small businesses, has been prohibitive, if at all available. The price of this credit has remained entirely immune to massive printing of money via Quantitative Easing (now an octupling of the monetary base); no credit growth has resulted. A recovery, which would normally have been invigorated by these two groups, has remained astonishingly weak. The Chancellor has tried numerous initiatives to stimulate lending at almost every appearance – Funding for Lending Scheme, FLS, the latest Budget subsidies for mortgages, and now another bigger version of FLS. The penny has dropped that regulation has blocked the credit channel; but these palliatives will not unblock it. What is needed is a new settlement with the banks which restores their confidence and persuades them again that they have regained their traditional ally in the Bank of England.

There needs to be new competition, aided by a break-up in the current banking monoliths we have in government ownership. As for regulation, the emphasis should, over the long term, be on setting up procedures for bank liquidation and recapitalisation along the lines of the US Federal Deposit Insurance Corporation rather than massive externally imposed capital requirements, which raise costs hugely but particularly raise the marginal cost of lending to individually risky ventures, since these require more capital to be raised to 'cover' their extra risk. The Bank of England should supervise the banks, using its information strength; it should not make rules for them, nor should it 'direct' them.

The Background: 1998, the Bank of England and the Transfer of Powers

The mistakes in regulation started in 1998 when the Bank was made 'independent' with regulation taken away and the Tripartite System set up. Under this arrangement, the Bank published information on stability, the FSA regulated the banks, and the Treasury had 'overall responsibility'. This had several bad effects. The Bank lost its close relationship with the banks and became increasingly hostile to them; it published a regular Financial Stability Report that increasingly bemoaned the risks which the banks were running as the 2000s wore on, and was totally ignored. The FSA had insufficient information and expertise to supervise the banks and the banks were able to act with effective freedom. The Treasury was unable to influence events since of its two arms, the Bank was powerless and the FSA information-less.

The original aim for the 1998 measure was that the Bank should be independent to set monetary policy and therefore should not also have supervisory policy because each would conflict with and prejudice the other. Yet the necessity for Bank independence in monetary policy was questionable; it was designed to create 'commitment' to the inflation target. But such commitment must come from the political process; as we see today from some obiter dicta of Mr Osborne, if the politicians were to withdraw support for the inflation target, it would destroy the Bank's de facto ability to keep inflation under control. Furthermore, as is also plainly visible today, monetary policy cannot be independent of the Treasury because the taxpayer backs the currency.

Looking back on developments, had the Bank been left with its supervisory role and had monetary policy continued to be handled cooperatively under an inflation target regime by Treasury and Bank, matters would have been better handled both in the run-up to the crisis in 2007 and in the crisis itself. The Bank would have exerted pressure on the banks to limit the frothier end of their lending, in line with its Stability Reports. And, during the initial crisis, rather than the pointless lectures on Moral Hazard from the Governor, such arrangements might instead have allowed large-scale lending facilities via the discount window to be made available that could well have averted the Northern Rock bank run.

Then there would have been less pressure today to change the regulative system so drastically. The Bank would have urged caution and defended its power to keep the banks in check. The politicians would have had less power to force through damagingly large capital requirements.

Competitive Credit Markets for a Working Economy

We need to keep in mind the purpose of banks in the wider economy. This is to purvey credit to businesses and households that would not be done directly by savers who want security. By intermediating between savers and high-risk borrowers banks bring down the private rate of interest to these borrowers. If the system is working well due to high competition, it will drive the rate down to the risk-free rate plus a

competitive margin reflecting only bank costs plus non-diversifiable risk. Socially and at the level of the whole economy individual risks are cancelled out; the aggregate of investment made by competing individual firms, small and large, benefits the economy by its extra product, the only risk surrounding which is the aggregate (non-diversifiable) risk – e.g. due to the business cycle.

Traditionally the system has worked by eliminating the 'credit friction' that pushes the 'credit premium' up, with society encouraging investment and savings to rise, generating higher output and welfare. Against this it is now argued that we should put obstacles in the way of lending in order to prevent future crises. Thus recently regulation has imposed much higher capital requirements on banks, related to their risk-taking. The effect of this, as repeatedly pointed out by Per Kurowski in his indefatigable blogs[11], has been to raise the credit premium on individually risky lending substantially because in addition to the usual credit friction that arises because banks cannot diversify away this individual risk owing to the costs of possible bankruptcy, the capital requirement adds a further marginal cost, that of raising risk capital to maintain the capital ratio.

Yet how exactly will this prevent future crises? Are crises produced by banks' excessive lending or are they caused by general shifts in circumstances which in turn bring down banks? The evidence points to the latter. Work in Cardiff has shown that US and Euro-area crises are mainly caused by non-banking shocks, while banking shocks contribute a small further element.[12] This work also explains why some other studies have found a larger role for banking shocks: in particular they attribute too big an effect to financial transmission compared with what the data supports and they also abstract from the permanent shocks that have caused the sharp downward shifts in activity we have seen in this Great Recession. This is in line with conclusions in a recent Brookings study which finds that in the US the shocks causing the crisis are no different from the shocks that have caused previous post-war recessions, but are just rather bigger this time.[13]

In other words, hamstringing banks will not stop the next crisis but it will damage the economy's workings in order to make some small dent in the economy's fluctuations.

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11 See *A View from the Radical Middle*, perkurowski.blogspot.co.uk

12 Vo Phuong Mai Le, David Meenagh and Patrick Minford, 'What causes banking crises? An empirical investigation', Cardiff Economics Working Papers E2012/14, Cardiff University, Cardiff Business School, Economics Section, 2012; also CEPR DP 9057. Vo Phuong Mai Le, David Meenagh, Patrick Minford and Zhirong Ou, 'What causes banking crises? An empirical investigation for the world economy', Cardiff Economics Working Papers E2013/03, Cardiff University, Cardiff Business School, Economics Section , 2013, also CEPR DP 7648.

13 J.H. Stock and M. W. Watson, 'Disentangling the Channels of the 2007-2009 Recession', Brookings Papers on Economic Activity, 2012.

This is a poor trade-off; it would be less costly to moderate these fluctuations with an effective monetary policy.

Competition v Ringfencing – Simple rules, bank supervision, a return to Bagehot

Our knowledge of the financial market's workings is insufficient for us to intervene in them without causing potential damage. We see that from the way in which the UK recovery has been aborted by the blocking of the credit channel; well-intentioned regulation has put a spanner into the credit works. So we should be more modest in our aims and our interference.

One thing we can say is that competition drives down credit margins and is a major weapon in driving down the credit friction. It also can keep banks smaller and more conscious of the need to maintain their depositors' confidence. Rather than interfere in the internal structure of banks, as in putting in ring-fences between activities that banks naturally are involved in, our competition authorities could ensure that the structure is competitive and that free entry is maintained.

The Basel agreements, which aim to regulate risk undertaken by banks by setting requirements for capital and liquidity,[14] have become highly onerous and complex. They also raise the credit premium. The problem they are designed to address is excessive lending in boom periods, when over-confidence drives down credit margins and drives up credit volumes. A better way to address this is via monetary policy. Monetary policy sets the main risk-free interest rate and QE but disregards the credit premium. It has done so because published data suggested the credit premium did not vary much so that all interest rates moved together. However, this neglects unrecorded terms of credit such as arrangement fees and discounts, which vary sharply between period of credit boom and credit bust. Money and credit volumes should be added into the target mix to proxy these unobserved elements in the credit premium. Thus one could envisage simple rules relating interest rates and QE not merely to the inflation target and the output gap but also to money growth outside a certain range.

As part of this change in monetary policy we need to reconsider the role of the Bank as notionally the monopoly controller of policy. The first point to make is that in practice policy must involve the Treasury: the terms of engagement in areas like Quantitative Easing are backed by the taxpayer most obviously[15] and implicitly this backing applies across all monetary policy. Bank of England 'independence' (of 1998) is something of a misnomer. 'Independence' has merely applied to a narrow operating area of fixing the risk-free interest rate; however with risk-free interest rates close to

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[14] The first enacted in 1992, the second published in 2004 but superseded after the crisis by the third and latest, mandating changes by 2019.

[15] The Bank of England's balance sheet is the taxpayer's because the Bank of England is owned by the government.

the zero bound this has revealed how small an area this is as the credit premium wanders around in the stratosphere. A second point is that the Bank's monopoly has been exercised with dubious competence; clearly mistakes will always be made in policy but since the crisis struck the Bank's performance has been dire indeed, beginning with the Northern Rock episode, going on to misjudgements on the new regulative environment, an aggressive attitude to the banks leading to relational breakdown, absurd claims about the effects of QE and now the FLS, and a failure even to achieve credible inflation targeting for the past few years. This has been associated with an internal culture that has been dictatorial, even secretive, and unwilling to draw on wide advice; and a running down of a proper research function inside the Bank. It is time to broaden the base on which monetary policy draws. With the widening of the rule for setting interest rates – as suggested above – should go a widening of the composition of the MPC to include the Treasury and a new independent Chair with a good knowledge of monetary policy and research. The MPC should be taken out of the Bank and made an independent governmental committee serviced by the Bank and the Treasury. There is a precedent for this if we go back to the 'Ken and Eddie show'[17] of the mid-1990s, originally set up by the Chancellor Norman Lamont in late 1992. It permitted a more open debate with wider access to the research base. Monetary policy is a huge canvas which needs to be treated as a unity.

Then there is Bank supervision. The merits of the old pre-Tripartite system were that the supervisor, the Bank, was the body with detailed knowledge and also good contacts within the banking industry. It is plain that the industry has strong self-interest in ensuring orderly banking markets. For several centuries the Bank's role was to organise this process within a self-regulating industry; such arrangements are typical of successful free markets. Its role was discarded over the last decade and a half with bad results. Fortunately the Bank is back in this role now; it should discharge it in its old informal way, with a minimum of intervention and costly rules. With monetary policy taken to a remove by the changes I have just suggested the Bank will be able to focus more on this core role as the gatekeeper of the banking industry.

Under the current arrangements temporarily put in place by the Coalition the Bank has far too much abstract power, with too little competence to deliver.

Finally, there is the role of government as ultimate guarantor for the banking system and the financial markets generally, as originally envisaged by Bagehot. With the Bank as its agent it should arrange bank resolution, perform the lender of last resort function and ensure the survival of the banking and financial system when unforeseeable events threaten them. Some are opposed to any such role because it creates moral hazard. Yet moral hazard is created by many beneficial insurance

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[17] When the then Chancellor, Kenneth Clarke and the Governor of the Bank, Eddie George, consulted publicly over interest rate setting in the context of inflation targeting and were advised by the Panel of Independent Forecasters.

processes: fire insurance and fire engines promote moral hazard in fire safety but we still have them. There are many examples of successful government rescue and resolution operations: the US Resolution Trust of 1988 which dealt effectively with the collapse of Savings and Loan Corporations, the Swedish bank rescue of the early 1990s, and the Bank lifeboat in 1974. To those who produce the old canard about how large the offshore banking system's balance sheet is relative to UK GDP, in case the UK taxpayer is called on to help, I simply say that this is a principal way the UK has, through the City of London, earned its living for several centuries; we should not lose our nerve now but instead keep in place the old methods that made this activity successful over such a long time period – these methods are the ones I have been discussing.

Modest Means, Effective Markets – Best for Banks, Best for their Customers

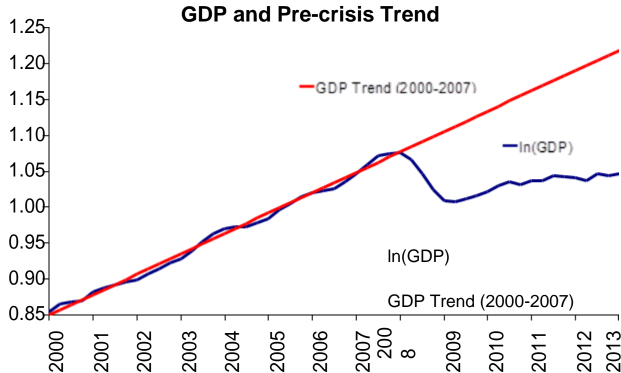
The crisis ushered in a massive escalation in regulation of banks and this has proved costly to the economy because it has blocked the credit channel. A costly lesson has, as a result, been learned about the dangers of heavy regulation and intervention in the banking industry. It is time to reflect on that lesson and pull back from this approach to one that may indeed be more modest, that recognises capitalism will encounter crises from time to time – one in which the banking system plays a minor aggravating role, though usually more sinned against than sinning – but is likely to prove more effective and productive.

Such a modest approach respects the limited knowledge which in general exists; it respects the industry's own knowledge; it also respects that of the industry's leader, the Bank of England. Monetary policy can be expanded to take account of the unobserved elements in the credit premium by additionally targeting the money supply; this would perform better the intended control of excessive credit booms. The knowledge base on which it draws should be augmented by the MPC involving the Treasury and being taken out of the Bank to become a free-standing government committee, serviced by both the Treasury and the Bank.

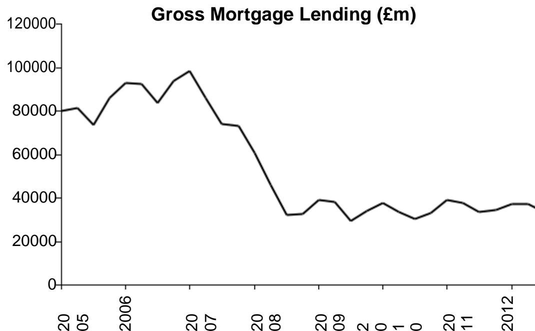
Competition should be the main aim of official intervention through the competition authorities. The Bank should supervise a self-regulating industry. The government must stand ready to underpin and restore the whole system when it is rocked by unforeseeable events. We must once again allow markets to work in our banking and financial system.

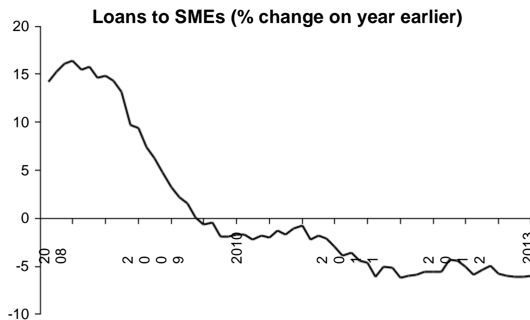
Annex of key data:
This annex carries charts of the key facts of recent years.

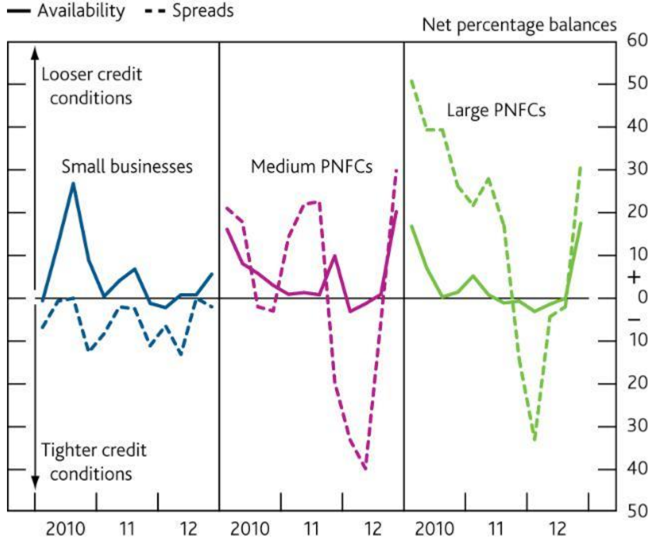
a) GDP developments: we can see how the crisis shock drove GDP down below its previous trend, apparently permanently and how weak growth has been since the drop.



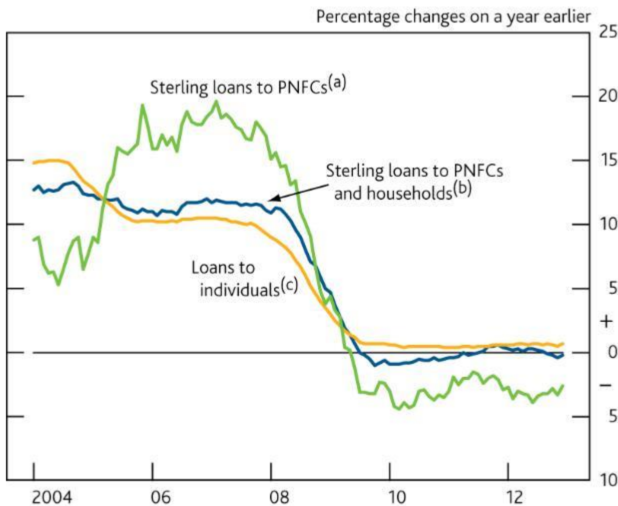
b) Credit growth: we see how virtually all categories of credit for PFNCs (private non-financial corporations) and households have declined, but especially credit for housing (mortgage advances) and for SMEs.







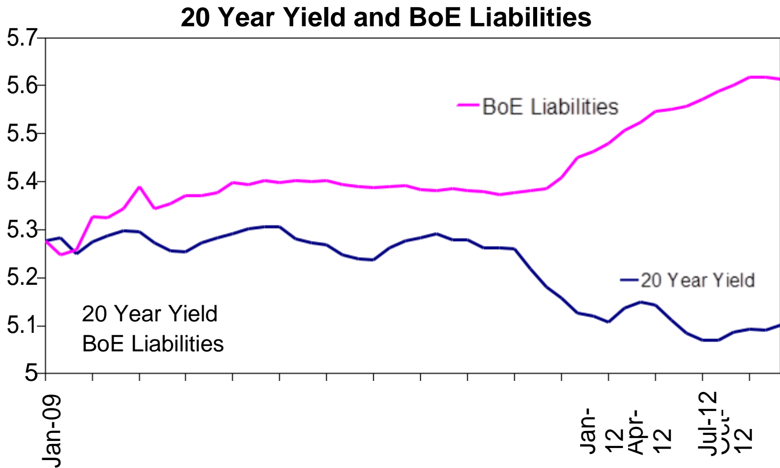
Credit Conditions Survey (Chart Source: Bank of England)

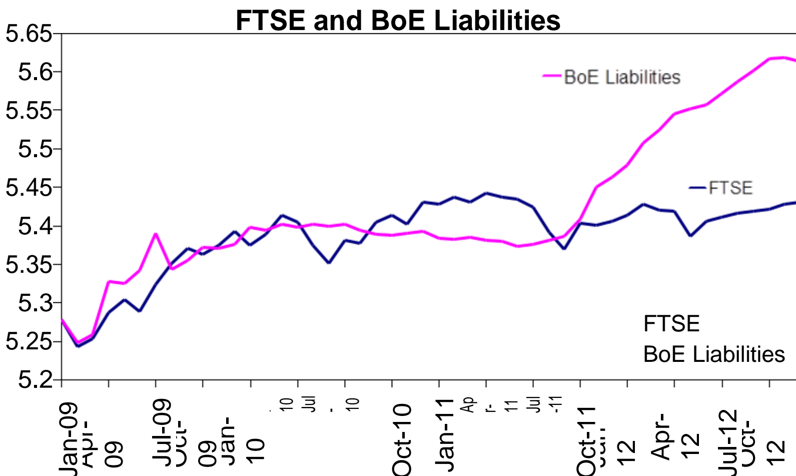


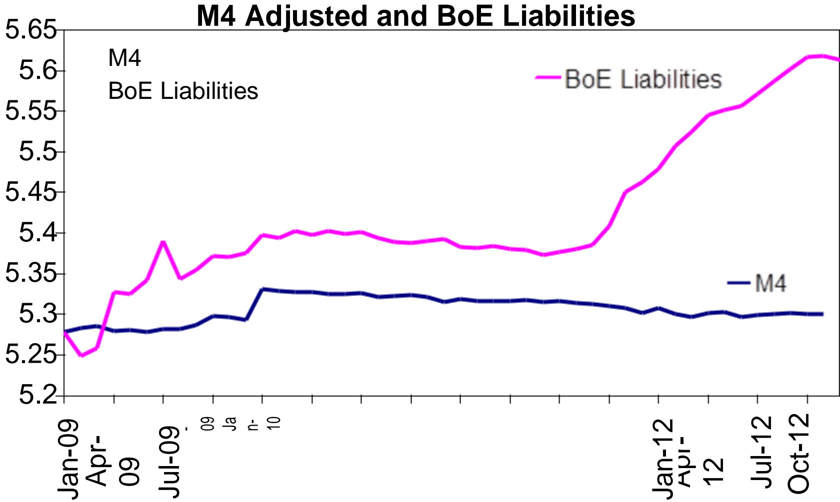
(a) M4 loans excluding the effects of securitisations and loan transfers.
(b) Sterling loans by UK-resident monetary financial institutions (MFIs) and related specialist mortgage lenders excluding the effects of securitisations and loan transfers. Funding for Lending Scheme measure. Non seasonally adjusted.
(c) Sterling loans by UK-resident MFIs and other lenders. Excludes student loans.

Loans to PNFCs and households (Source: Bank of England Inflation Report)

c) We see how QE and other Bank programmes of asset purchase (measured here by the Bank's balance sheet size) have been associated with rises in asset prices (government bonds, measured here by their yields – price varies inversely to yield; and equity prices) but not with falls in credit rates by banks to SMEs or with any significant rise in the broad money supply (adjusted by the Bank to exclude 'other intermediaries') – all variables are measured in logs from an initial value. In other words QE has failed in its key objective, to stimulate credit and money – though money has risen a little this basically just reflects the money printed and the 'money multiplier' which measures the rise in money relative to the 'QE injection' has collapsed.






M4 Adjusted and BoE Liabilities
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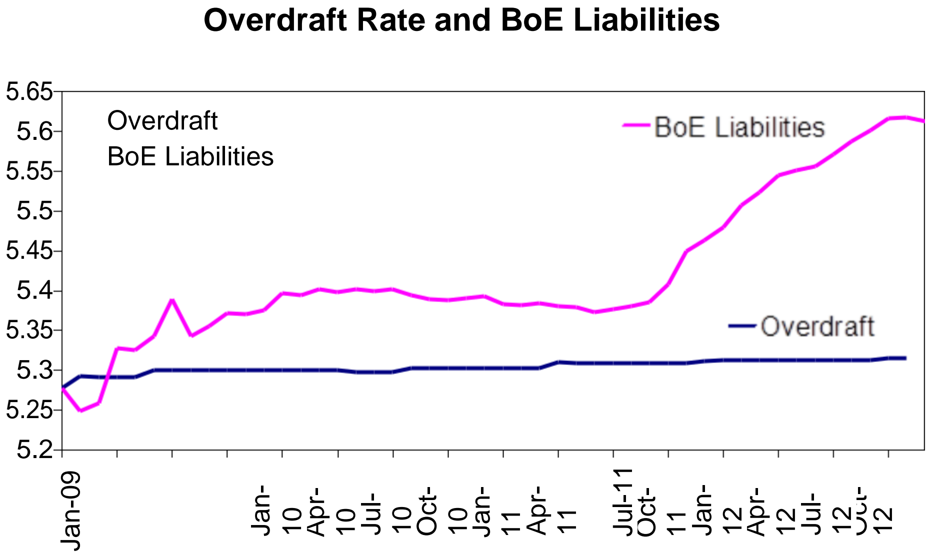
Overdraft Rate and BoE Liabilities
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IV
The Crisis, its Aftermath and Financial Supervision
Straight Thinking on Trade-Offs
David Green

The very abrupt end brought by the current financial crisis to the period of the "Great Stability" in the economy of the preceding decades has resulted in the equally abrupt adoption of new financial regulatory policies. This was in response to the unwelcome discovery that, far from being a very successful industry, finance, and banking in particular, was in fact extraordinarily badly managed. The fact that bankers succeeded in extracting rent on a massive scale from the rest of the economy has driven a powerful political urge to deliver change, retribution even, whatever the cost, and to make sure that tax payers would never again have to inject capital or liquidity into banks to keep them solvent. So new requirements are being placed on the capital and liquidity of banks, on their structure and on the ways that bankers behave.

This chapter argues that many of the policies being adopted with the aim of achieving these ends have, however, been chosen with inadequate or only partial analysis of whether they are in fact the best solution to the problems identified. There may be unintended or undesirable consequences to ill-considered remedies. One person's asset is someone else's liability; if you regulate to affect one you affect the other, which may not be what you intend or want. The chapter urges that when financial legislation is being contemplated strict attention be paid to making sure that the full consequences of such changes are examined to ensure they are accurately targeted and do not bring fresh damage for the real economy in their train. There are always trade-offs. They need to be chosen with care.

Finance and the Real Economy – Indivisibly One

One of the mistakes made in the build up to the crisis was excessive concentration by policy makers on what happens in the real economy whilst failing to keep track of the corresponding developments in the financial system. It was forgotten that they are the mirror image of each other. There is now a risk of overshoot in the opposite direction with focus solely on the financial system without regard for the consequences for the rest of the economy. Part of this is simply a consequence of concentrated political focus on the banks because of what happened and what it cost. But a large part is due to a continuing lack of understanding that what happens in the financial system and what happens in the economy are intimately and inextricably intertwined. Every economic action is reflected in the financial system or influenced by what happens in it. And every asset is someone else's liability. There remains, therefore, a risk that the solutions being promoted may bring fresh unintended and unwelcome consequences of their own.

Unintended consequences In some of the more obvious areas of policy action there is already evidence of a rethink. For instance, in Europe the proposal for a Financial Transactions Tax, a tax on securities and derivative transactions between financial institutions, initially gathered very widespread political support because it seemed to hit multiple targets, with its apparent punishment of allegedly speculative trading of sometimes overly complex products, its ability to raise money to reimburse voters for bank bailouts and its presumed impact on the bonuses earned by bankers based on such transactions. However, it is now beginning to be analysed afresh in the light of the increasing realisation of consequences that were not at all intended and the sheer impracticalities of implementation. More mature reflection suggested that the ultimate payers of the tax might not be banks or bankers after all, but players in the rest of the economy, and that its impact on the structure of the finance industry might affect employment in ways that had not been foreseen or desired. At the time of writing the jury is out on whether, and just how, the tax would be implemented, but much time and energy has been spent as a result of not thinking through what the consequences might be.

What to Do about Debt

One of the areas in which it has been difficult to get clear thinking is in the whole area of the excessive indebtedness which was a key feature in the build up of the crisis, and in particular how to manage the deleveraging which consensus suggests needs to follow. In many countries there has been a build up in debt to levels the markets judge unsustainable, often in several sectors at the same time, resulting in some cases in unsustainable overall external indebtedness. These levels of indebtedness undoubtedly need to be run down to levels which are sustainable in each sector, whether government, personal, corporate, domestic financial, or external. But what is sustainable for the debtor may have consequences for the creditor.

Debt – a zero sum game These adjustments inevitably must have a counterpart. A reduction in net debt by one party or sector involves an increase in the net debtor/reduction in the net creditor position of another. There also have to be counterparts to any changes in the composition of assets and liabilities. This means that, *ex-post*, the results are a zero sum game in terms of net positions. This zero sum game may involve counterparts within the national jurisdiction, but equally they may be outside.

This means that there are unavoidable trade-offs for policy makers. On the one hand banks had lent too much. On the other, economic activity needs finance, at least for creditworthy borrowers. Thus, if financial regulators, or the markets, conclude that banks need more capital, whether equity or debt, this has to come from somewhere and will likely reduce the availability of capital to other sectors or, at the least, increase its price, which may in turn affect the creditworthiness and/or levels of activity of the non-banking sectors of the economy.

Government deficit reduction and the rest of the economy In the wider context of the need for deleveraging there has been a general move to seek to reduce government deficits in many countries. To the extent that these are successful, the financial position of other domestic sectors will have to deteriorate as a result of increased taxation or reduced government expenditure. This will likely affect the creditworthiness of both the corporate and personal sectors and the quality of the balance sheets of the banks. It may be necessary to adjust the fiscal policy mix to minimize the likely negative effects of deficit reduction on the creditworthiness of the non-financial sector.

Bank Capital and the Economy: How Much Capital and When

There is at least the possibility that current demands for additional regulatory capital for banks may be sufficiently great that they will have a material effect on the financing of the economy, though possibly in part in other jurisdictions. If so, thought needs to be given to reconsidering the levels of required bank capital, to the extent that markets permit room for manoeuvre. What is the right trade-off between the desire to increase the capital of the banks and the impact of this on others who also need capital?

Bank capital requirements should normally allow for capital ratios to be run down when the losses for which the capital has been accumulated arise. This is the purpose of capital. The planned capital regime assumes that capital should indeed rise and fall in relation to the cycle. But this requires consensus as to where we might be in the cycle in each jurisdiction. This is far from straightforward at the best of times, but it seems to be that counter-cyclical buffers are being required to be built up even in times of near recession. Is this the right trade-off? What would need to happen for regulators or legislators to feel comfortable to allow banks to reduce their bidding for scarce capital against other users?

In some countries the political decision has been taken that bank capital should be kept so high as to eliminate any risk that there will ever be a call on the taxpayer, even if this means that capital is required up front against even remote risks in the future. This will likely reduce the capacity of the banking system to fund economic growth in the near term. However, there has been little debate about whether the economic cost of providing this very high degree of insurance against the risk of banks' requiring tax payer expenditure at any point in the future delivers the right trade-off.

More liquidity for some means less for others There has rightly been a tightening in bank liquidity requirements following the widespread need for public funding to replace deposits lost in runs. However, this means that other sectors must become less liquid. Shortening the maturity of one person's assets means shortening the maturity of someone else's liabilities. This may not matter so much if the counterpart is reduced liquidity for governments or central banks or other financial firms with excess

liquidity. However, if the increased bank liquidity has as its counterpart reduced availability of liquidity for the non-financial sector, this will likely affect the creditworthiness of enterprises and hence their own activity levels, as well as the quality of the balance sheets of those who lend to them. There is, therefore, some risk that levels of liquidity required by supervisors in excess of those required by the markets may have unnecessary effects on the productive sector, either in the same jurisdiction or, again, elsewhere.

Alternatives to Banks: the Solution not the Problem

Notwithstanding the considerations above, there is general consensus that many banking sectors need to deleverage significantly. This can only happen without detriment to other sectors if the financing needs of those economic sectors are met by alternative sources of finance. This means the substitution of traditional bank financing by other, less capital- and liquidity-constrained financial institutions or markets. Rational ways of approaching this have been contaminated by the fear that this will lead to the rise of so-called shadow banks who, it is assumed, will repeat the damage already wrought by regulated banks.

Such channels of finance may, of course, be fully regulated as financial institutions, such as pension funds or insurance companies or various kinds of investment funds. There will also be intermediation outside financial institutions altogether such as finance provided directly by corporations to each other or their clients or by funds outside the financial sector such as sovereign wealth funds. If the banks are impeded in providing finance to the economy then it is important that there should be no unnecessary regulatory obstacles to the ability of other intermediaries, or capital markets, to substitute for bank intermediation. The same risk of being driven by desire to prevent all possibility of failure as has been behind the reregulation of the banks may also lead to increased regulation of other intermediaries which in turn fails to weigh adequately the trade-offs between minimising regulatory risk and allowing adequate financing of the economy.

Banking Structures and Incentives

Other areas where there is risk of political overreaction to what has gone wrong lie in the structural field and with the range of proposals for ring-fencing different aspects of banking business in an effort to prevent spill over in the form of a perceived need to avoid "moral hazard" or any taxpayer support for banks. It is clear that the various forms of ring-fencing that have been proposed – Volcker, Liikanen, Vickers etc – have a cost in economic terms and may not in practice deliver the result which is sought. Even wholesale banks may prove sufficiently interconnected at the end of the day to have to be publicly supported and, as has been widely noted, narrow retail banks can fail just as easily as complex universal ones. It is difficult to be confident that the solutions match the risks they are intended to mitigate.

Some of the other measures which are proposed, such as the bail in of depositors, even uninsured, when banks fail, with the motive of incentivising depositors as well as providers of risk capital to exercise market discipline over the management of the bank, may also have unintended effects, not least in undermining confidence in banks which may be perfectly sound. It is also worth noting that, at the time of writing, the one case where uninsured depositor bail in has been attempted, namely Cyprus, is not yet proven to have provided the outcome intended since the bank in question has yet to reopen free of capital controls.

The attempt to deal with exaggerated remuneration by limiting bonuses is another example of ill-considered legislation. There were two quite separate problems with remuneration; one related to perverse risk incentives caused by particular bonus structures and the other to the ability of a small number of employees to extract personal rent from access to a bank franchise provided by the shareholders. Simply limiting the relationship between bonuses and remuneration and not addressing the underlying issues may again be a case of flawed analysis leading to an ineffective and potentially costly solution.

The Wider Economy, Regulation and the Policy Trade-Offs

To sum up, there is some significant risk that the strength of political reaction to the undoubted shortcomings of the banks may produce perverse economic consequences which a more considered analysis of the overall position could help avert.

This means that where better regulation disciplines exist in principle, as in the UK Principles of Better Regulation (1997, Better Regulation Task Force), they should be deployed in practice and where they do not, notably in the procedures of the international financial regulation standard setters, they should be introduced. The ultimate decision makers on financial regulation, whether at the political or supervisory level, need to bear them in mind when trying to disentangle the arguments deployed by the various heavily-interested parties. The key better regulation principles for present purposes are the principle of **Targeting –** regulation should be focused on the problem and minimise side effects, and **Proportionality –** regulators should intervene only when necessary, and remedies should be appropriate to the risk posed, and costs identified and minimised.

Much more effort needs to be put into understanding the interdependency of financial and real activity and the fact that forcing changes on one is bound to force changes on the other. This includes understanding that all elements of financial intermediation, and not just banks, have their own role to play.

More effort needs to go into understanding policy trade-offs. There was a good reason why central banks historically stood ready to act as lenders of last resort to banks and why governments sometimes chose to recapitalise banks out of collective funds. It was

understood that if banks had to have so much liquidity and so much capital that they could withstand every conceivable risk the rest of the economy would have much less liquidity and much less capital. What the right trade-off should be is always difficult to judge, but not to be aware of the importance of the trade-off is bound to lead to poorer outcomes.

V
The Financial Sector and the Global Monetary System
Different Problems, Different Solutions
Jamie Dannhauser

The Problem of Debt

The extreme build-up of private sector and bank leverage before the financial crisis had several distinct causes, but lax regulation of financial institutions played a significant role in nurturing the credit boom. The regulatory framework was badly designed, difficult to implement and easy to circumvent. Regulators themselves were at times captured by those they were regulating, often giving too much latitude to financial institutions, particularly the largest cross-border banks, to interpret the rules as they and their auditors saw fit.

Policymakers are now devoting considerable energy towards repairing the banking sector. This is understandable – tighter regulation of financial institutions aligns the interests of politicians, who want to tap into popular discontent, with those of the wider electorate, which blames the banking sector for the economic downturn. However, aiming to fix one group of entities within the international financial system, even if it is the most important group, is not the same thing as aiming to fix the system itself.

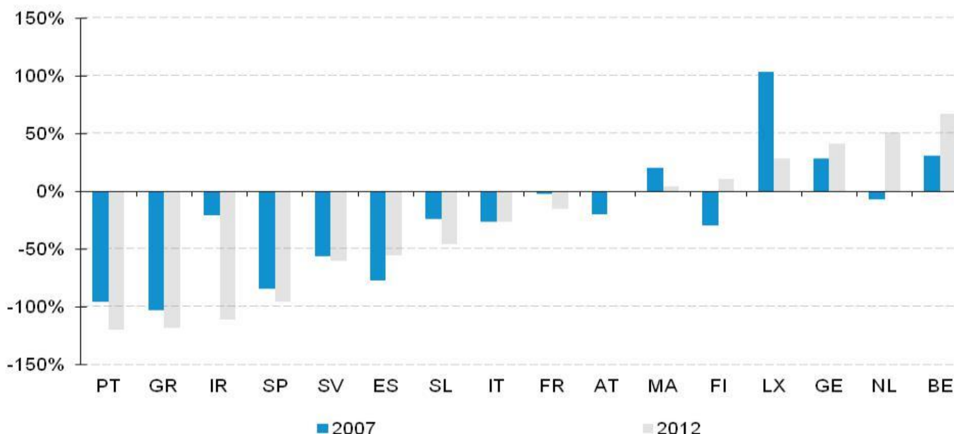
By focusing largely on traditional commercial and investment banks, current reforms may drive risk-taking into the more opaque recesses of the financial system, populated by largely unregulated 'shadow banks' themselves partly a response to past efforts to make large banks 'safer' under Basel II. The secondary banks, as the UK learned in the 1960s, emerged in response to excessive regulations which made primary institutions uncompetitive. There is also a danger that regulators take their eye off the rapidly expanding and increasingly critical payments systems and central clearing counterparties – the plumbing of the international financial system. Most importantly, though, making banks safer does little to address the extreme financial imbalances between economies.

There is too much debt in the world. Excessive risk-taking by financial institutions and lax regulation together contributed to an unsustainable easing in the supply of credit. Asset prices became inflated. Households, businesses and banks took on debt that could not be serviced by future incomes, driving global demand above the sustainable level of world output. A necessary, unavoidable and growth-inhibiting process of deleveraging now has to take place.

Excessive debt, however, is as much a cause of the crisis as it is a consequence of a deeper malaise. The global credit boom coincided with a historically *high* rate of global savings, which pushed long-term real interest rates to historically *low* levels. At

the same time, there was a dramatic expansion of external financial imbalances between countries, evident in net capital *flows*, i.e. current account balances, and *stocks* of cross-border lending and borrowing, i.e. net external asset positions. Puzzlingly, the pre-crisis era saw large (net) flows of capital from several developing countries, with considerable catch-up potential, to developed nations with rapidly ageing populations. Inside the eurozone, capital flowed in the conventional direction, from the high-income 'core' to the middle-income 'periphery'; but the size of those flows was such that exceptional external imbalances emerged between Euro Area members. Despite all the talk of Euro Area adjustment, the net external debts (assets) of the 'debtors' ('creditors') have increased markedly since 2007 (see chart below).

Eurozone countries net external assets as % of GDP.



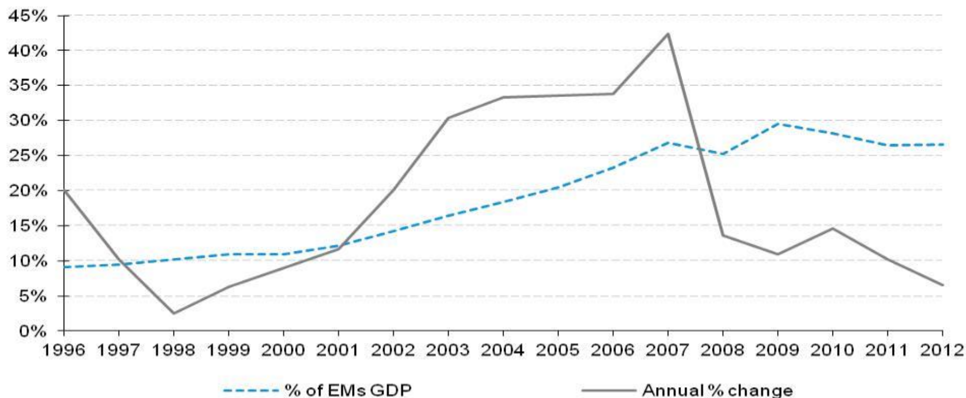
Source: Eurostat; Lombard Street Research calculations

Partly, global imbalances were cyclical, the result of cheap credit and too much spending in 'debtor' economies. But it is because they were largely structural that they are now proving so hard to resolve. They reflect different underlying trends in different economies; but the key point is that the desire to save too much in some countries, most obviously China, Japan, developing Asia, the OPEC countries and Germany, proved to be more powerful than the desire to borrow in others, e.g. the US and the UK. There was a global glut of savings, which played a critical role in depressing interest rates and stimulating the demand to borrow in 'debtor' economies.

Demographic, cultural and institutional factors all played a role in fostering structurally excessive savings in 'creditor' economies. Lax financial sector regulation added fuel to the fire in 'debtor' countries. But something critical is missing from this story – exchange rates. At least in theory, these should adjust to reflect cross-country differences in underlying inflation and growth rates. Fast-growing, catch-up economies should expect their currencies to appreciate vis-à-vis those of sluggish

advanced world nations. In practice, however, exchange rates were prevented from acting as necessary pressure valves for the global economy. In emerging markets large-scale foreign currency intervention significantly restrained upward pressure on their currencies. Meanwhile in Europe, monetary union removed exchange rate realignment as a stabilisation tool altogether.

Foreign exchange reserves of emerging market economies.



Source: IMF; Lombard Street Research calculations

European Markets, Cheap Currencies and the Impact on Debt

The build-up of emerging market (EM) foreign currency reserves was a key factor in bending the international monetary system out of shape. By 2007, EM central banks were sitting on over $4trn of Foreign Exchange reserves, representing 27 per cent of EM GDP. Their growth over the previous decade was explosive, rising from only $600bn or 10 per cent of EM GDP in 1997 (see chart above). This created an entirely artificial flow of funds out of EM currencies. US financial markets were the natural destination for this capital, as EM governments sought to keep their currencies cheap against the US dollar. This prevented desirable shifts in exchange rates i.e. an appreciation of the Chinese renminbi against the US dollar, and helped sustain, potentially even increased, the current account imbalances that had emerged.

But it had another more pernicious effect. Reserve managers did not invest on the basis of risk-adjusted returns, but instead allocated their funds passively towards low-yielding, relatively short-term US dollar debt. This depressed US government bond yields markedly. Traditional fixed-income investors were forced to 'search-for-yield' in other markets, particularly US dollar and euro credit markets. Demand for securitised debt boomed and banks found it increasingly easy to fund their balance sheet expansion via wholesale debt, rather than retail deposits.

Emerging markets' foreign exchange manipulation, therefore, did not just prevent desirable currency moves; it also directly held down advanced world (risk-free)

interest rates and indirectly eased the funding and capital constraints faced by the banking sector, allowing lenders to offer more credit on better terms than they otherwise would have been able to do. Curious as it may sound, excessive saving and a mercantilist desire for current account surpluses and cheap currencies spawned unsustainable borrowing in the 'debtor' economies.

Financial Imbalances and Exchange Rates

Fixing the international financial system is therefore as much about resolving the accumulated imbalances between nations, as it is about placing the banking system on a sounder footing. To date, policymakers have been almost exclusively focused on the latter. But ultimately, a robust and sustained global recovery is the best way for banks' balance sheet strains to be resolved. For that to be achieved, a major adjustment in the pattern of global demand and output is necessary. 'Creditors' need to spend (and import) more and produce (and export) less. The opposite is true for the 'debtors'.

This is not the first time the world has had to tackle major financial imbalances between countries. In fact, this problem has always been in the background. At no point over the last 150 years have policymakers found a reliable way to prevent the emergence of financial imbalances or create a framework for reducing them in an orderly fashion, once they have emerged.

The classical gold standard operated in the second half of the 19th and early 20th centuries; a fixed exchange rate system in which currencies were convertible to gold at a fixed rate. The system had pressure valves – in unusual circumstances, such as war, countries were temporarily allowed to suspend their commitment to gold convertibility and devalue. Even so, this flexibility did not prevent four severe global financial crises between 1870 and the start of the First World War – in 1873, 1883, 1893 and 1907.

The restoration of the gold standard in the interwar years – a bi-polar system increasingly dominated by the US – did little to bring economic and financial stability. It imparted a deflationary bias upon the world economy and ultimately prevented economic adjustments that should have taken place after the First World War. Over time, the economic cost of membership became too much for politicians to stomach and countries came off gold in the 1930s.

Post-1945, there was a desire to resurrect a global fixed exchange rate system, albeit one with enhanced flexibility. The Bretton Woods system was created, tying currencies to the dollar and indirectly to gold. The newly-created IMF was to police the system and decide whether individual countries faced a 'fundamental [balance of payments] disequilibrium' that justified a re-pegging of their currency. Having worked relatively well for twenty years, the Bretton Woods system came under increasing

pressure in the late 1960s. The 'Nixon shock' in 1971, when dollar-gold convertibility was suspended, sounded the death knell of the system. By 1976, all major currencies were floating freely against each other.

A system of floating exchange rates did not last long, however. Europe's currencies were increasingly tied together and are now irrevocably fixed as part of EMU. Although advanced economies outside continental Europe (e.g. UK, Australia, New Zealand) generally allowed their currencies to float freely, the same cannot be said of rapidly growing emerging economies including most of South East Asia. Dubbed by some 'Bretton Woods II', fixed exchange rates once again came to dominate the international monetary system before the latest crisis. But unlike previous periods of currency management, macroeconomic co-ordination and co-operation between countries was close to non-existent.

New Times, Old Mistakes

We are now in danger of repeating the policy mistakes of the past. In the Bretton Woods negotiations, the UK's position, represented by Keynes, favoured a monetary system that had robust *ex-ante* defences to prevent the emergence of imbalances between nations and equally strong *ex-post* mechanisms for ensuring *symmetric* adjustment of 'debtors' and 'creditors'. However the Bretton Woods system that evolved had all the limitations of the international monetary system that operates today.

There was little surveillance of growing imbalances, few tools for slowing their expansion and even fewer for resolving them. The pressure of adjustment was laid squarely on the 'debtor' economies – as is the case today, there was no mechanism for compelling 'creditor' economies to accept stronger currencies and borrow-and-spend more in order to smooth the global adjustment process.

Adjustment between nations after the 2008 financial shock has been highly asymmetric. This is problematic for two reasons: first, asymmetric adjustment would impose a deflationary bias upon the *world* economy, not just the 'debtors' – all countries would be worse off; second, that asymmetric adjustment would impose intolerable economic pain on the 'debtors', most obviously in the form of higher unemployment.

The global economy and international monetary system are grossly distorted. A *de facto* managed exchange rate system has once again played a malign role in fostering significant external imbalances between nations. There is too much debt in the world, and the financial system – the banks, the non-banks and the financial plumbing – does need to be put on a sounder footing. Deleveraging in indebted economies cannot be avoided.

Neither, however, can a resolution of financial imbalances between countries. Little has so far been achieved. The adjustment that is evident largely reflects cyclical weakness in 'debtor' economies; it has in some Eurozone countries gone hand in hand with exceptionally high levels of unemployment and growing political unrest in the 'debtors'. In Europe, this has called into question the future of the Eurozone itself.

The large decline in the value of the US dollar since the crisis started suggests at least one of the necessary currency moves has occurred; but deeper structural adjustments, especially in the 'creditor' economies of Germany, China and Japan, have barely started. It is time policymakers started to wake up to the dangers of leaving these problems unaddressed. In the short-term, policymakers in 'creditor' countries must strive to boost domestic spending, and where applicable, *reverse* mercantilist policies supporting undervalued (real) exchange rates. All governments ought to push for deep reforms to labour and product markets, to boost productivity and the future incomes needed to pay down today's excessive levels of debt. In the longer-term, politicians must strive for a new international monetary system based on floating exchange rates, open capital accounts and transparent surveillance of economic and financial imbalances between countries. Otherwise, the world economy will stumble along for several more years, or worse. That will make fixing the banks even harder.[18]

[18] Jamie Dannhauser is author of 'The Euro – The Story of a Sub-Optimal Currency Area', in *The Euro – The Beginning, The Middle...and The End*, (IEA, 2013).

VI

The European Union and the Financial Sector

(i) The UK Insurance Industry and the EU

John Hodgson

Since the financial crisis of 2007-8 and the failure of Northern Rock, the focus of policy has been on regulating the banks both here in the UK and the EU. Although banking plays one central role in the financial sector, insurance plays another. The UK insurance industry is the largest in Europe and third largest in the world. It manages investments amounting to 26 per cent of annual GDP and accounts for £10.4 bn in tax revenue, employing 290,000 people in the UK alone. As an exporter, almost 30 per cent of its net written premium comes from overseas.[19] The industry also offers essential services to business, households and individuals and plays a significant part in tackling the unexpected in the lives of people and businesses

If the sector is both to flourish in a global market, and play its part in the recovery of the UK economy, the role of regulation is pivotal. However, as matters stand, the trend is no longer to manage consumer risk, something successfully done in the past, but to attempt to remove *all* risk. The consequence will be serious, as the diversity, flexibility and imagination needed for a competitive and dynamic industry will suffer. Costs will rise, returns diminish and the scale and value of the industry to the UK economy will decline.

The UK – The Industry, Regulation and the Direction of Change.

The basic premise of insurance regulation has long been that the asymmetry of knowledge between customer and insurer should not work to the harm of customers. Recently, trade bodies including the Association of British Insurers (ABI), and the regulators, the FSA (now superseded by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) have emphasized three simple premises: clarity, so consumers understand what they are buying, where the focus is on clearer documents and stylistic simplicity; fairness, so consumers are treated fairly by insurers and bad *behaviour* is prevented or punished; solvency, so that the insured are both contractually entitled to their money, and will receive it.

One example of how the system worked effectively and sensibly and ensured consumers were retrospectively compensated is the example of the mortgage endowment policy schemes, sold during the 1980s on the basis that returns on investments, particularly equities, would continue as previously. Such policies offereda major path to low cost home ownership for millions because the combined cost of interest payment and an endowment premium was lower than the cost of a repayment mortgage. In fact the policy was not guaranteed to pay off the mortgage as

[19] Association of British Insurers, *UK Insurance – Key Facts 2012*.

the sum guaranteed was less than the mortgage and the buyer was gambling on the equity market. That that was not made clear was an indefensible omission. So too was the encouragement by the system of commission hungry banks, the aggressive intermediaries selling policies (often part of the lending bank or building society), as well as arms length insurers who ran the policy but devolved the transaction to no sale, no fee companies. The upshot was an average shortfall for customers when the policy matured of around £7,000 between projections and return, with the insurance industry considered at fault and pressure for compensation winning government support. Although that might not have happened had the deal been seen as having three parts (a loan to buy the house, an investment to pay back the loan and a house) and the buyer had been offered the option of a straightforward repayment mortgage with the risks and merits of each made clear,[20] the solution reflected a central principle of UK regulation, that the customers should not be put at a disadvantage.

The problem of insolvency has also been tackled, thanks to the industry's own interventions. For example the Motor Insurers' Bureau mutualizes the costs of uninsured driving, while the financial services compensation scheme mutualizes the cost of defaults across the industry.

Other problems, however, have emerged, where attempts to improve standards of advice may have the unintended consequence of mis-buying undermining the incentive to save. To eliminate the possible conflict between advice and commission, advisors in the UK must now be qualified, a measure judged by the regulators, including Martin Wheatley, Chief Executive of the FCA, to be a success.[21] But because such advice must be paid for by the customer directly, rather than paid as commission by the producer, access will tend in practice to be limited to those with a minimum of £50,000 to invest, whereas the average pension saving is £30,000. In addition, the incentive to sell savings has declined, or been eliminated, at a time when private and household savings are recovering after years of decline, while individuals intent on saving may seek advice from unqualified sources. So the risk of some misselling has been exchanged for the twin certainties of mis-buying or avoiding/failing to start saving.

All in all, however, the industry has managed its risk and relatively few failures with success. Despite the failure of Independent Insurance and Equitable Life, where eachfailed as a consequence of management, there has been no systemic failure of insurance companies.

[20] Or if the 25 per cent shortfall was judged against the average house price increase of five fold.

[21] Martin Wheatley, Chief Executive of the FCA, in congratulating the regulatory authorities, noted that predictions of a collapse in the number of people giving advice had been ill founded, with '93 per cent of advisors remaining in business'. 'The FSA's new rules are working', *Prospect,* 24 April 2013.

EU Regulation and the UK Insurance Industry – Complex, Expensive and Insufficiently Sensitive?

Since 2006/7, policy on insurance regulation has moved to Brussels under the aegis of the European Insurance and Occupational Pensions Authority. As a result of this change, a superstructure of regulation is developing on top of the UK's relatively simple and largely effective foundation, with some potentially undesirable consequences. The problem is compounded by the popular tendency to lump banking and insurance together, yet despite apparent similarities, the difference is fundamental: banks profit by mismatching assets and liabilities – borrowing short to lend long. By contrast insurance companies work by matching their assets and liabilities and profit by the pricing of risk. Whereas in other areas of the financial sector, the tendency is for regulation to remove possible risk, it is not evident that such an aim should be paramount for insurance. While for some industries, e.g. aviation, risk aversion policies have always been the norm, (e.g. a new passenger jet continues to have a magnetic compass and a set of working instruments of the sort used in the 1930s), such risk aversion policies probably accurately reflect public anxiety about a specific industry. However, the application to the insurance industry of principles suitable for other industries, like aviation, may be misplaced.

Insurance companies are now both treated as a single group, and subject to increasingly complex legislation on grounds that the industry covers a wide range of business. But this trend means that specific regulatory measures fail to take account of the full circumstances of a problem or anticipate likely consequences. The upshot is that while some problems have been tackled others have emerged. There is an additional problem of divided responsibilities.

The EU and the UK. Divided Responsibilities: solvency, long-term assets and risk

Greater emphasis has recently been laid on mitigating the risk of insolvency and reducing its consequences, both by EU and UK regulation. The capital to be held against risk has been raised across the industry often as a result of discussion between company and regulator; but the regulator can impose a higher capital requirement than an insurer might wish. Although the then existing system worked well through the 2008 crash, the combination of market and regulatory pressure has since led to some bizarre outcomes. With the fall in asset prices, insurers were forced to liquidate risk assets in falling markets, which both made the falls worse and damaged future returns, as insurance companies rushed to bolster their solvency. The solvency margins required against a rainy day had to be maintained. The upshot is that insurance companies, traditionally long-term trans-generational investors, are obliged to behave like hedge fund managers in line with each passing market fad in the name of solvency. The need to maintain levels of solvency on essentially a daily basis means insurance companies' balance sheets will become much more volatile because the companies will be forced to hedge risks as they emerge on a very rapid basis.

Different views about what constituted safe long term assets have traditionally meant that insurance company balance sheets were made up differently across the sector.

One insurer might favour government bonds, while another liked commercial mortgages. Thus the mix of assets held by insurers varied, with some companies appearing riskier than others. However, the market worked effectively with relatively little failure (see above). Nonetheless, the recent trend from the EU aims to eliminate such risk with the European Insurance and Occupational Pensions Authority's proposals for Solvency II in 2009 – a system which involves a new and prescriptive modelling of risk, new classifications of assets and new ways of calculating required capital. Introducing the new rules has already led to huge costs and unintended consequences; for example it will also make it expensive for European insurers to own US businesses. Many have disposed of these at low prices – because the respective regulators take a different view of risk. The UK regulator is uncertain that the new regulation will ever be implemented.

In effect, the regulator now essentially determines insurance companies' appetites for risk by determining how risky each class of asset is. But whereas a company board may take one view of relative risk, that will be largely irrelevant. There will now be large capital penalties if the regulator's position is not followed and so the capacity to pay dividend will be reduced. Companies' balance sheets will become increasingly similar over time, stuffed with government bonds (which are essentially issued by the regulators' employers) and high quality bonds with ever less risk taken. Solvency II, as Andrew Bailey, the Head of the Prudential Regulatory authority, explained, is 'lost in detail and vastly expensive'. The lack of diversity in insurers' ability to manage risk also reduces customer choice and removes important sources of long term finance from the economy, exposing the entire system to greater risk if either fundamental misjudgments are made, or a novel source of risk, not anticipated in the regulatory imagination, emerges**.**

Others, including academic specialists, reiterate the message, including Philip Booth who adds that 'Solvency II should be scrapped… [that] we should think again about [the UK] regulatory system …. [that] perhaps it is time to wind back the clock – not to 2000 when the Equitable failed, but further back to an era when a regulatory system known as 'freedom with publicity' went hand-in-hand with security for policyholders'.[22]

Regulating for the Future

Although regulation in the UK had succeeded in rebalancing power between insurer and customer[23], more recent developments in regulation, both in the UK and EU, will have grave implications for the success, if not survival, of the industry.

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[22] Philip Booth, 'Scrap 'Misconceived' Solvency II Regulations', *Public Service Europe,* 1 May, 2013. www.publicserviceeurope.com/article/3419/scrap-misconceived-solvency-ii-regulations

[23] Already regulation in the UK had succeeded in rebalancing power between insurer and customer, with guidelines such as 'Treating Customers Fairly' (2006), subsequently translated into regulation, having redressed many of the abuses**.**

First, the attempt to remove commission led misselling has prompted a different problem, that of people receiving the wrong, unqualified advice or indeed being less likely to save at all. Because all advice must be paid for, smaller savers are less likely to pay for it and may, take unconsidered, or indeed the wrong, decisions.

Second, and more serious, is the threat posed to the industry's ability to succeed due to the dominant role of the regulator. Under proposed rules, the regulator, not the company, decides in practice on the balance of assets**.** This drives out the higher yield, higher risk assets in favour of low yield, 'safer' assets; a constraint not imposed on Asian and US competitors.

Not only will companies be the poorer, and many may go out of business as global competitors less fettered by their regulators will offer higher returns. But many savers and annuitants will suffer from the reduced choice of investment, including the higher yield riskier investments, permitted by the regulators.

There are strong grounds at the company and industry level for reversing the trend where the regulator takes risk decisions not just for the insurer, but for the customer too. While there is an understandable desire to "protect the taxpayer" on grounds that no government could allow an insurer to fail, the simplistic approach damages the industry's ability to take risk and compete. Until 1970 there were no specific rules for an insurance company, although there were rules about the organisation and separation of funds, clear requirements on publicity and a special resolution mechanism to wind up insurers. Much greater emphasis was put on the customer loss.

The UK, and indeed European, insurance industry is, as a result of recent regulatory trends, therefore at a disadvantage in competing against US and emerging market competitors, with consequences for employment, growth and export earnings.

Greater Freedom and the Price of Progress

The solvency system, which removes choice from customers, should be reconsidered, allowing for greater consumer choice. The regulator must accept that the cost of progress is occasional failure, and should concentrate on ensuring that individuals are risk aware, and only buy those products they feel comfortable with.

Greater discretion should be left to insurers and those running the fund. The dangers of removing diversity from the asset mixes of insurers should be taken into account and with this extra freedom should come greater responsibility – the price of failure should be explicit for those concerned.

VI

The European Union and the Financial Sector

(ii) The EU, the UK and the Financial Sector – Renegotiating the Future

Scott Cochrane

In the Western Europe of the Middle Ages, when fledgling states were more concerned with asserting their own individuality than with coming together in any political *grand projet*, William of Ockham, a Franciscan who ended his days as a political propagandist, asserted, following Aristotle, that “simpler explanations are, other things being equal, generally better than more complex ones”. Ockham's Razor was born.

The UK's relationship with the EU has once again become central to political discourse, and for many businesses the increasing and often damaging impact of EU law has become a greater focus of concern. This is particularly true of the financial services sector, where businesses, big and small, continue to struggle to respond to the complex, expensive, potentially damaging legislation which often poses unnecessary obstacles to success. The level and volume of regulation, often of questionable value, is expensive and complex to administer and raises the cost of products and services to consumers.

If, as the Prime Minister suggests, Britain concludes that a continued involvement in the EU is in the national interest, how might the process of making European law and regulation be reconsidered? How can the present levels of cumbersome, often conflicting or overlapping legislation, potentially damaging to business, be scaled back to sensible levels consistent with aims held in common by the UK and other states? How can essential regulation for the financial sector benefit from greater clarity and greater simplicity?

The Problem – Multiple Bodies, Multiple Measures, Multiple Costs

In the 40 years since the UK signed up to the European project under the Treaty of Rome[24] the scale and nature of the regulation flowing from Brussels has increased exponentially.

The *dramatis personae* involved in these legislative developments may include: the EU Commission, the executive arm of the EU responsible for driving new legislation; the EU Council of Ministers, comprising the elected representatives of the member states; the EU Parliament (which, together with the Council, comprise the two

[24] The Treaty of Rome established the European Economic Community in 1957. The United Kingdom became a member of the European Economic Community (later renamed the European Union) by acceding to the Treaty in 1973.

legislative limbs of the EU); and numerous advisory bodies tasked with advising on the implementation of legislation. On top of this EU level, implementation of legislation in the UK will involve HM Treasury and the new, dual financial services regulators, the Prudential Regulatory Authority and the Financial Conduct Authority. For specific pieces of legislation you can also anticipate the involvement of a plethora of industry bodies who are looking to push the agenda of their own membership. Multiplying the respective contributions of each of these bodies to the various legislative developments has produced a torrent of paper and often leads to conflict and overlapping or contrary views being expressed or reflected in legislation as it is being developed.

In the past five years, following the global financial crisis, European regulators have increased their focus on the financial markets, with hundreds of thousands of pages of legislation, regulation, consultation and guidance covering banking, insurance and asset management. The FCA has indicated that it is currently working on over 20 separate pieces of new EU driven legislation in the context of a financial services sector which in the last 4 years has been subject in the UK alone to 3 principal pieces of legislation, 63 Statutory Instruments and 267 new regulatory instruments, not to mention thousands of pages of guidance, enforcement actions, reviews, speeches, consultation, press-releases, warnings, Tribunal and other judicial decisions, Financial Ombudsman cases … and so it goes on. These have had an impact across the spectrum of financial services from banking and insurance through trading and settlement to asset management and the retail financial sector.

The cost to the UK financial services industry of compliance with this multiplicity of EU regulation is impossible to quantify. Take just one example, the Alternative Investment Fund Managers Directive (AIFMD), which aims to regulate the European asset management industry. The directive requires managers of all alternative asset vehicles in the EU to comply with extensive new regulatory requirements ranging from additional investor disclosures and an extensive additional reporting regime to additional rules on depositaries. However, the alternative asset management industry is a far from homogeneous sector. While in some other jurisdictions, the banks play a major role as providers of alternative asset management services, in the UK the industry comprises a wide diversity of organisations and entities, from small hedge funds to large international fund management groups. For UK authorised managers, little if any of the additional requirements are obviously necessary from the perspective of protecting investors or ensuring a properly operating asset management industry. In the UK at least, the domestic legislation is already well developed and comprehensive, which begs a wider question of whether or not it is appropriate to try to regulate at an EU level an industry which is organised in radically different ways in different member states. Industry sources put the incremental one-off costs of compliance at up to £1.6 million per firm with annual compliance costs increasing by up to £2.3 million per firm. The total cost across the EU of complying will therefore

run into hundreds of millions over the next few years (with a significant proportion being borne by UK based firms).

The Consequences for the UK Economy and The Obstacles to Reform

Any increase in the volume, complexity and compliance cost of EU law matters for two principal reasons in the UK:

The financial services sector, and the City of London in particular, play a very significant role in the UK economy. It includes a variety of different businesses – banks, insurance companies, and asset managers – each of which plays a wider part in providing the necessary capital to fuel growth in the wider economy and are essential for the financial well-being of ordinary people. The sector accounts for 9.6 per cent of Britain's annual earnings (GDP) and is both a significant contributor to the total tax raised by HM Treasury (11.6 per cent) and a significant employer.[25] Not only does EU regulation reduce the profitability of the sector but, worse, it may act to drive elements of the sector to move their businesses outside of the UK and contribute to a net reduction in national earnings, employment and tax receipts. Whilst it makes good tabloid fodder constantly to bash the financial services sector, the reality is that much of the wider government spending on health, education and social welfare depends upon the revenues raised from the financial services sector and the City of London in particular.

A significant proportion of the costs levied upon financial services businesses will ultimately be passed on to consumers through higher costs for the financial products that we buy or lower returns on our deposits, savings (including pensions savings) and investments. This will affect most households in some way as well as business, e.g. the costs of an insurance premium may rise or the value of a retirement pension decrease. Given the long-term savings time-bomb we now face in the UK, any measure that increases costs for investors or results in lower long term rates of return will exacerbate an already significant problem.

So what are the obstacles to good regulation?

Conflicting national self-interest and aims The drafting or negotiation of legislation by member states may give rise to attempts to protect a given state's – or industry's – interests, rather than seeking to achieve the best outcome. It is often acknowledged that rules which might be 'bad' for London might be 'good' for Paris or Frankfurt, if they drive decisions by firms over where to locate. The temptation for member states with a limited financial services industry and limited interest in the legislation to trade their vote on financial services policy in exchange for support in an area more

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[25] *Key Facts about UK Financial and Professional Services*, report by TheCityUK, January 2013.

important to them, for example the Common Agricultural Policy, is often too great an opportunity to resist.

Partisan interests, national rivalries and the use of legislation Some political groupings of elected representatives within the EU Parliament use new proposals and the scrutiny of legislation to score points against old foes. The development of the alternative fund management regulations is a case in point, where it is widely acknowledged that hedge funds and private equity funds in particular were singled out for treatment for historical reasons. In the case of private equity funds, it seems clear that certain elements within the EU felt that private equity funds represented 'naked capitalism' which needed to be reined in. In the case of hedge funds, it was alleged that the industry had introduced systemic risk to the financial markets and this was used as a justification for greater regulation. Although the evidence now shows that any alleged ‘systemic’ impact had been at most marginal, much of the proposed new legislation was nevertheless passed and the ‘need’ to monitor the ‘systemic risk' posed by such businesses remains central to EU preoccupations. The upshot has been a significantly increased regulatory burden on hedge funds, notwithstanding that the initial justification for such regulatory oversight has now been discredited.

Free markets in Financial Services? From London to Paris, Berlin or Rome, ideological coherence is lacking amongst the institutions which decide the direction of the EU project – the Commission, the Council of Ministers, the Parliament and the regulatory bodies. There appears to be little agreement that the aim is a properly regulated free market in financial services. Instead, fundamental ideological differences in a number of areas which affect financial services continue between member states. For example, the current French regime under President Hollande has a materially different politico-economic world view from that of the UK government.

Lack of information: Who advises, who decides? Financial services businesses are complex and wide ranging and cover a range of activities, sectors and countries. A significant proportion has operations both within the EU and globally. Very few practitioners in one part of the sector will have detailed knowledge of the workings of another, although they may be specialists with considerable experience in one or more fields. Nor do they claim such expansive expertise. Legislators, by contrast, without deep knowledge of the mechanics of the industry or experience of day to day practice, cannot have the knowledge and understanding to equip them to legislate at the detailed level which is becoming characteristic of EU financial services legislation. Despite the hope that this will be countered by consultation with industry participants, the process can be ineffective or ultimately ignored when the EU Parliament or the Commission do not like the outcomes reached through consultation.

Such problems in designing EU financial services regulation often lead to unduly complex legislation, unclear in stated aim, parochial, or so difficult to understand that

industry participants spend millions of pounds on paying professional advisors to guide them through the legislative thicket. Not only that, but the law of unintended consequences can kick in (as in the case of the recent limits put on bankers' bonuses which prompted a predictable increase in base salaries).

Changing Direction. Clear Aims, Principles and National Responsibility

When it comes to reshaping relations with the EU we should have regard to Ockham's Razor and seek the simplest effective approach achievable. This principle, however, has been missing from much of recent EU legislation, which has often been prompted more by the politics of the moment than by the aims of the future.

Indeed, legislators, elected and unelected, may have a political or bureaucratic interest in increasing the scope of legislation. New legislation may follow politicians' (or regulators') reaction to a particular event, where the need to 'do something' to deal with a particular crisis is felt. Though that can lead to *volumes* of regulation, one might question whether that produces *good* regulation.

Re-negotiation of the UK's relationship with the EU should have as its aim a fundamental review of existing and planned legislation, focusing on identifying only those key areas where EU level legislation can make a clear positive difference and limiting the EU's legislative reach to those areas alone. The overriding principle should be directed towards limiting the application of EU law. Where it cannot be demonstrated that EU law is necessary or where it is clear that a 'one size fits all' approach is not appropriate, legislative power should remain with member states.

The aim of any renegotiation should be to change the assumption on which legislation is proposed. The assumption should be negative: no new measure should be considered unless there is agreement that it is 'absolutely necessary' to meet an essential aim not covered already by other rules. Only if such a condition is met, should it go further.

To begin with, the simple question should be put: *"What is this regulation for?"* Unless agreement exists on (1) the aim and (2) how the proposed measure would or indeed could meet that aim, there should be no further action. There would be no place for the often poorly written, confused and confusing reams of 'Eurospeak' to which we have become accustomed.

The best legal drafting should guide any future legislation and aim to reduce the complex to an understandable and simple set of maxims, based on clear principles, rather than ill thought-out, unfocused pages of text. For financial services, effective regulation must be drafted by able legal minds, rather than emerging from an attempt inelegantly to meld together the outpourings of various committees and advisory groups.

Instead of assuming that all existing EU legislation and regulation is good, the starting point for any re-negotiation should be to identify the key problems which need to be addressed at the EU level and how best the aim can be achieved with as little legislation as possible. Whether current regulations meet these needs and result in better outcomes would at that stage be reviewed.

Identifying the problem at the outset and articulating the outcome sought would therefore replace the production of 'shopping lists' which now appear to emerge, without rhyme or reason, from the offices of EU politicians and civil servants.

No legislator can, nor should any try, to legislate for every possible development. The more that the legislative draftsmen seek to cover each imagined eventuality, the more cumbersome the legislation will be, and with more unintended consequences. A new system should therefore aim to establish agreed principles rather than attempt to legislate for every conceivable eventuality or factual situation. Such clear principles, once adopted, can be applied more flexibly by local regulators to the particular issues encountered.

In such areas of technically complex legislation politicians and civil servants would therefore focus their energies on drafting a clear exposition of the problem to be addressed and the principles governing the solution being proposed.

It should then be the responsibility of those closer to the matters in question, the financial services participants, to meet the principal objective in an appropriate way. Where the principles can be enforced by home state regulators, rather than by regulatory drafting which seeks to encapsulate every conceivable situation, they should be.

Politicians like to fix things and tend to believe in their abilities to make the world a better place. They prod away at the financial markets, operating here and applying a bandage there. Perhaps in addition to wielding Ockham's Razor, they should also keep in mind another maxim: *"Above all else, do no harm."*

VII

Financial Regulation and the Wider Economy

Unintended Consequences

David B. Smith

The financial sector directly creates wealth and employment but it is not normally the main driving engine of national output. However, banks and other financial intermediaries also perform a vital lubricating function for the non-financial private sector, without which the efficient allocation of resources, economic growth and job creation would be impaired. Regulations that limit the activities of financial intermediaries such as banks should not be undertaken without due regard to their consequences for the wider economy. Otherwise, any gains from improved financial regulation may be more than offset by the collateral damage elsewhere.

One of the central problems for the financial sector, however, is that politicians and public officials tend to treat the issues arising from financial regulation separately in a series of discrete and disconnected boxes. As a result, ill-considered regulatory initiatives have sometimes damaged the economy because the wider context and the potential indirect impacts have been ignored. In particular, regulatory policy was too lax ahead of the financial crash of 2007 and 2008 – because the Bank of England was solely concerned with its inflation target; while recent official demands to increase capital and liquidity reserves have caused banks to reduce their balance sheets, leading to sluggish monetary growth and a reduced credit supply to the private sector. This regulatory-induced restriction of money and credit is one reason why the UK recovery has been so anaemic, although Mr Osborne's misguided tax increases have been an independent adverse factor. It also helps explain why small and medium-sized companies (SMEs) have found it almost impossible to access credit on reasonable terms. Before the financial crash, there was a strong case for the British authorities to treat monetary policy as a 'seamless garment, with Bank Rate, funding policy and financial regulation all being co-ordinated to produce a coherent policy approach.[26] This remains a key theme of the present text.

The misguided 1998 Bank of England Act codified the tri-partite dismemberment of the 'old' Bank of England, which was announced originally three weeks after the May 1997 election. That dismemberment contributed to the serious failure by the British monetary authorities during the financial crisis. However, the economy as a whole is a seamless garment, not just monetary policy. Fiscal policy affects bond yields, the demand for money and the money supply; monetary policy influences debt-servicing costs and impinges on tax receipts and welfare costs. In addition, changes to the

26 This is explained more fully in David B. Smith, *Cracks in the Foundations? A Review of the Role and Function of the Bank of England After Ten Years of Operational Independence*, Economic Research Council, Research Paper No. 23, May 2007, www.ercouncil.org.

regulatory regime[27] can independently shift aggregate supply, alter structural unemployment and change the output/inflation trade-off facing policy makers.

The new structure of the Bank of England introduced by the 2009 Banking Act represents a clear improvement on the unfortunate 1998 arrangements. Nonetheless, the new system may contain other flaws.

The Aims of Financial Regulation

In addition to protecting savers from malfeasance, financial regulation should have two wider aims: to avoid cyclical shocks in the short term – i.e. so-called ‘boom and bust’ – and to maximise in the long term the efficient use of production factors and the potential level and growth of national output. The first aim is best achieved by using regulatory policies, Bank Rate, and central bank sales and purchases of government bonds to produce a slow and steady increase in the broad money supply and the credit extended to the non-bank private sector. However, a tension exists between the need to avoid short-term cyclical instability, which may be best achieved through a highly-regulated and cartelised banking system (such as Britain operated in the 1930s and Canada more recently) and maximising potential growth in the long run, for which a competitive banking system brim full with ‘animal spirits’ and a willingness to back risky new enterprises is needed.

Such an emphasis on the macroeconomic and supply-side consequences of financial regulation may seem strange in the light of the recent UK policy debate, where politicians and regulators have aimed to avoid politically embarrassing bank failures and punish commercial bankers for perceived sins. However, the risk of failure is an inevitable part of the discipline of capitalism; an economy organised to minimise the risk of failure can only be a static feudal-style one, without any risk-taking, innovation and ‘creative destruction’. Bankruptcy does not destroy real assets but transfers ownership to other, potentially more competent, hands. The social costs of business failure are therefore less than the private one. The socially-optimal rate of business failure is, arguably, that which maximises the growth of real GDP per head. It is certainly nowhere near zero.

The three main problems with the bank failures of the later 2000s were of a different order. The Bank of England failed to heed the warning signs that the credit boom was getting out of hand; the senior officials of failed banks were free to walk away with huge payments; and many individual banks had been allowed to grow so much that they could not fail without causing serious collateral damage to the wider economy.

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[27] All forms of regulation have wider economic consequences, not just financial regulation. Labour market regulation can be particularly damaging but other forms, such as those introduced on environmental grounds, can also lead to serious mal-investment and a damaging waste of resources.

The latter was a failure of competition policy, rather than financial regulation *per se*, though the other problems may have been picked up earlier had the Bank of England not been dismembered in the late 1990s.

These issues were discussed more fully in an earlier Politeia pamphlet published in 2009[28] when the evidence at that time – and indeed since – suggested a three-fold approach was needed, one which differed significantly from that actually implemented. First, deposit insurance should be limited to, say, 85 or 90 per cent of the deposits both to encourage prudence by people making deposits and prevent innocent savers from being wiped out. Second, to help align the risk structure faced by senior bankers with that faced by society, the senior management of commercial banks (e.g. those with reward packages of over £1million per annum) should have unlimited personal financial liability if their institutions needed state bailout; such liability should remain on a diminishing scale for some years after retirement. Finally, the large state controlled banking groups should be broken up and auctioned off as a series of competing small institutions, with regional head offices in some cases, with the aim of ameliorating the 'too big to fail' problem and introducing more competition into banking services. Indeed the most effective 'quick and dirty' approach would be to unwind the bank mergers of the past four decades and spin off the building societies, insurance companies and old historic banks which had been absorbed into larger groups. In the late 1960s, for example, the number of clearing banks had been reduced from eleven to five with official connivance.[29] One proposal that has gained considerable support subsequently has been to introduce a British equivalent of the US 1933 Glass-Steagall Act in order to ring-fence and separate the so-called 'utility' from the 'casino' element of banking. Unfortunately, there is no evidence that this will make, or would have made, any difference to the likelihood of bank failure. Every type of financial institution failed in the crash, from pure retail banks, to pure securities houses. In addition, many types of ownership structure were involved, ranging from quoted companies, to mutual institutions, to banks owned by local governments such as the Spanish Cajas. The only general rule is that small financial institutions with limited capital and reserves and little ability to tap the taxpayer if things went wrong – run by executives with personal financial liability (as is common with hedge funds) – are naturally cautious in their operations and do not require intrusive and costly micro-regulation. Indeed, many of the small regional banks in the USA sailed through the financial crisis with almost no increase in default at a time the 'Big-City' banks were falling like ninepins.

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[28] David B. Smith, *Crisis Management? How British Banks Should Face the Future,* (Politeia, 2009), politeia.co.uk/sites/default/files/files/p110e%281%29.pdf

[29] It is interesting in this context that the Royal Bank of Scotland Group has considered reviving the Williams and Glyn's brand to sell off branches to comply with European Union Competition Policy, while Lloyds/HBOS has considered reviving the Trustee Savings Bank for the same purpose. The risk is that they only try to sell off the uncompetitive 'lame ducklings' if left to their own devices. That is why auctioning the branches etc. of the historic banks in their entirety seems preferable.

The International Background

Britain has a small, open, trade-dependent economy. It is like a small cork bouncing around on the turbulent seas of global developments. For that reason it is impossible for the domestic authorities, fiscal, monetary and regulatory, to fine tune the course of the UK economy. Britain's economic openness means that Keynesian demand management, as taught at Cambridge in the 1960s and now again increasingly advocated, is impossible. Even if the authorities knew the correct theoretical approach, had timely statistical data, possessed an accurate forecasting model and had a range of fiscal, monetary and regulatory tools available to them, the open nature of the economy makes it impossible.

At best, government can try to improve Britain's long-term growth performance relative to the rest of the world by maintaining fiscal discipline; by keeping a public spending ratio of no more than 40 per cent of GDP and a near-balanced budget[30]; and by refraining from ill-considered interventions in the markets, for labour, products and finance. Even so, the global business cycle dominates UK activity in the short run. This can be seen from a comparison of the annual growth rate in the UK with that in the Organisation for Economic Co-operation and Development (OECD) area in recent decades (Chart 1).

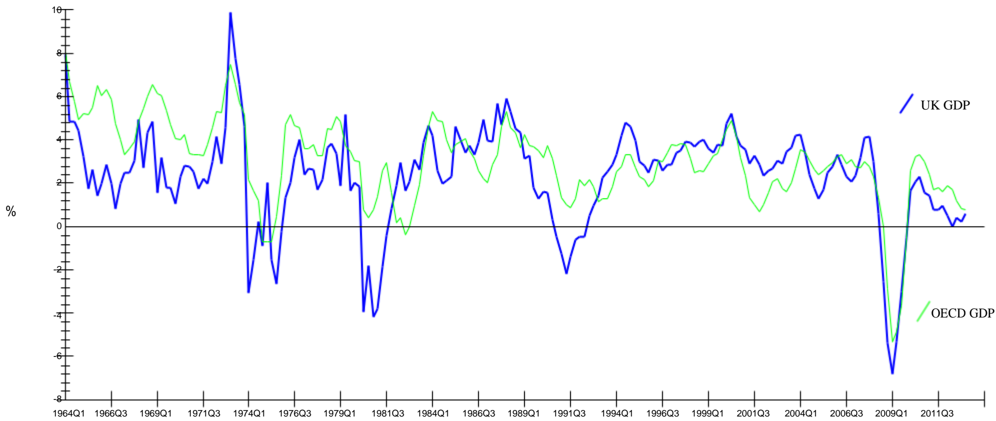

Chart 1: Annual % Changes in UK and OECD Real GDP 1964 Q1 - 2013 Q1

[30] The growth maximising share of general government expenditure in national output seems to be around 20 to 25 per cent and the welfare-maximising share 30 to 35 per cent, so the 40 per cent mark represents the upper limit of what can be sustained without resorting to endemic deficit finance, not what might be considered desirable on social welfare grounds.

Enough time has now elapsed to enable a preliminary statistical estimate of the impact of the Global Financial Crash (GFC) on activity in the developed economies to be made. A statistical equation for the volume of aggregate GDP in the OECD area as a whole, estimated using quarterly data from 1971 Q1 to 2012 Q3, suggests that there has been a permanent output loss of 11.1 per cent since the Lehman's crash but that there is also a proportionate decline of 1 per cent in OECD real GDP for every one per cent increase in the ratio of general government expenditure to GDP. [32] These numbers suggest that the Global Financial Crash was responsible for only some two thirds of the fall in OECD activity, while the rise in the OECD government spending ratio between 2000 and its peak in 2010 probably led to a further 5.8 per cent reduction in the sustainable level of OECD real GDP.[33]

A similar statistical relationship for the volume of UK private domestic expenditure on the basis of quarterly data from 1964 Q2 to 2011 Q3, found a negative effect of 11.7 per cent for the impact of the British financial crash, which was less than the long-term negative effect of the increased government spending ratio between 2000 and 2010 of 13.5 per cent.[34] This result suggests that too much blame has wrongly been placed on the financial sector where the UK is concerned. Politicians have used the financial sector as a convenient scapegoat to mask the adverse effects of their own feckless spending policies which contributed to the fall in GDP.

However, it is debatable whether the GFC itself was an exogenous act of God (or the sole responsibility of 'greedy' bankers) rather than part of the mechanism through which the large increases in the government spending burden between 2000 and 2010 in countries such as Britain (*plus* 14.2 percentage points) and the US (*plus* 8.9 percentage points) crowded out private-sector supply.[35] Numerous international studies indicate that adding 1 percentage point to the ratio of government consumption

[32] The equation concerned was a statistical 'Error Correction Model' estimated using quarterly data for the volume of aggregate OECD real GDP. The equation had the long-run equilibrium properties that the logarithmic level of OECD real GDP normally grows by 2.53 per cent per annum, but that output falls by 1 per cent for each 1 percentage point increase in the ratio of general government expenditure to GDP. There also appears to have been a permanent 11.1 per cent loss of output since the Lehman's crash. In the short run, changes in the real OECD broad money supply, the real 'world' short-term rate of interest and the real price of oil, also affected the international growth rate, after lags of a few quarters and with the expected signs. The explanatory power was reasonable, with an R-bar-squared of 67.3 per cent where the quarter-on-quarter changes in the logarithm of OECD real GDP are concerned and a standard error of 0.36 per cent.

[33] The estimate that the GFC permanently reduced OECD real GDP by some 11 per cent is broadly consistent with the typical output loss from a financial crash estimated by Carmen M Reinhart and Kenneth S Rogoff in their well-known book *This Time is Different: Eight Centuries of Financial Folly,* (Princeton University Press, 2009).

[34] *The Single Income Tax: Final Report of the 2020 Tax Commission*, TaxPayers' Alliance, (London, May 2012), p.180.

[35] See Ludger Schuknecht, *Booms, Busts and Fiscal Policy: Public Finances in the Future*, (Politeia, 2009), politeia.co.uk/sites/default/files/files/Ludger%20Schuknecht%20Banks,%20Booms%20and%20Busts%281%29.pdf

to national output reduces the growth of real output per head by some 0.1 to 0.2 percentage points.[36] Such research suggests that Britain's sustainable growth rate may have fallen from 2¾ per cent to 1½ per cent after 2000 on account of the adverse effects of the huge levels of public-spending under the then Labour government on aggregate supply, rather than on account of Keynesian demand-side reasons. Since the values of equities and property are derived from the future income streams expected to be generated, which should move in line with GDP for assets in aggregate, such a slowdown should have reduced the price-deflated values of shares and property by some 45 per cent, *ceteris paribus.*[37]

The UK government is currently spending some 5 to 6 per cent more of GDP than the peak costs of fighting the 1914-18 War; President Obama is consuming a higher share of US GDP than the peak cost of World War II in the USA. It is not, therefore, surprising that many western economies are suffering from the strains traditionally associated with wartime finance. Governments have also adopted many of the same devices, such as running large deficits, forced funding and 'resorting to the printing press' under Quantitative Easing (QE). Unfortunately, it is difficult to distinguish between the two incompatible views that: firstly, government are using QE and financial regulation in the wider social interest to protect society from the damaging effects of financial instability arising in the private sector; and, second, the political class is misusing financial regulation to fund its deficit by compelling banks and insurance companies to hold more government debt than they would freely chose to do. However, the branch of economics known as 'public choice' theory suggests that the latter process, which is usually referred to as financial repression, is the more likely.

Return of Tudor Taxation

The Tudor monarch Henry VII, his Lord Chancellor Archbishop John Morton and their henchmen Edmund Dudley[38] and Sir Richard Empson became infamous during Henry's reign (1485-1509) for expropriating peoples' wealth through arbitrary fines and other imposts. The bounds of legality were stretched and most subsequent generations have regarded their impositions as arbitrary devices with no place in a free society under the rule of law. Today, the manner in which the regulatory authorities fine financial institutions also ignores natural justice and reflects Tudor methods of arbitrary confiscation. In the case of the fine levied on Standard Chartered Bank by the

[36] For a review of the evidence, see *The Single Income Tax*, 2012.

[37] To be more precise, the value of equities and property represent the net present value of future income streams deflated by the risk-free long-term rate of interest. The latter is usually considered to be the long-term government bond yield. One role of QE has been to artificially reduce the real bond yield, offsetting the effects of reduced expectations of future growth on the price of fixed assets.

[38] Edmund Dudley specialised in extorting money from merchants in the City of London. Both Dudley and Empson were executed early in the reign of Henry VIII because of the intense unpopularity of their revenue raising methods.

US in August 2012 (US$340m), the bank faced : 1) multiple jeopardy, because several US regulators each with their own agendas were threatening prosecutions; 2) the New York Department of Financial Services which brought the case had a direct financial interest in the outcome because they kept half the fine, and 3) the bank was not in a position to mount a defence in court, as it seems originally to have intended, because the US officials leaked details of the case into the financial markets causing the share price to free fall.

Whatever the case alleged against Standard Chartered, $340m was expropriated from the bank's shareholders without a fair trial or any realistic prospect of one. That was inconsistent with the rule of law and private property rights and posed a threat to civil liberties. In addition there are wider and serious, consequences for the economy. Because the loss of bank capital and reserves associated with a regulatory penalty forces the bank to contract its balance sheet by a significant multiple of the fine itself – e.g. by a multiple of ten with a capital ratio of 10 per cent – such regulatory fines can lead to perverse macroeconomic effects, particularly at present when money and credit are growing too slowly to sustain recovery. Moreover, the prospect of such unpredictable windfall losses makes it harder for financial institutions to raise capital in the stock market, even if the additional capital is required to satisfy the regulators. International investors have long been aware of the concept of political risk. However, they now face an additional regulatory risk, particularly in a highly balkanised system such as that of the US where regulatory fines also seem to be taking on protectionist aspects, designed to weaken foreign competitors to politically-influential indigenous businesses.

Too Many Regulators Spoil the Economy

The 'who is really in charge of financial regulation' question becomes even more complex given the range of international bodies seeking to impose their own, often inconsistent, standards on financial institutions. All the more so, given that a number of jurisdictions make extra-territorial claims and fine banks for activities perpetrated outside their borders. Public choice theory suggests that the intrusive and damaging over-regulation of a highly cartelised financial structure will be preferred by self-interested officials, to a more socially efficient free market system that can simply be left to its own devices.[39] Added to the prospect of well-paid jobs, an over-regulated, if moribund, system is likely to generate fewer politically embarrassing surprises.

Today, the international organisations jockeying to control financial regulation are numerous. They include the Basel Committee on Banking Supervision, the Committee of European Banking Supervision; the European Union's Competition Commission – by and large a benign pro-market influence – and the European Parliament. The latter

[39] See Smith, *Crisis Management*, 2009.

is characterised by ignorance of financial matters, the presence of '*soixante-huitard'* anti-market biases, and a desire to punish Britain for being '*non-communautaire'*. Neither the British government nor its officials appear to have taken much active interest in resisting damaging EU legislation, despite the exceptional importance of the financial sector to the British economy and tax receipts and indeed the work of Dr Syed Kamall, an academic and Conservative MEP for London.

Two specific risks from internationally-co-ordinated financial regulation should be of particular concern. The first such risk is that internationally coordinated regulatory shocks bring every leading economy's business and credit cycles into phase, increasing the amplitude of the overall global business cycle, and exacerbating the instability of the world economy Much of the sluggishness of OECD output since 2008 may have resulted from financial regulation which blocked off global supplies of broad money and credit to the private sector and prevented the strong rebound which normally follows a deep recession. The modest acceleration in both British and OECD monetary growth has taken place more recently, so matters may improve in the absence of further regulatory shocks (Chart 2).

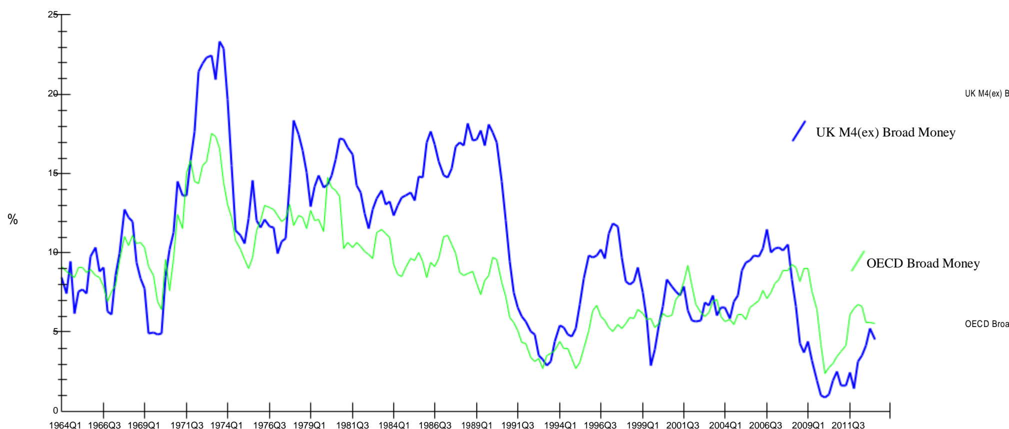

Chart 2: Annual % Changes in OECD Broad Money and UK M4^{ex} 1964 Q1 - 2013 Q1

Second, the ignorance about the potential ramifications of their decisions, which characterises so many financial regulators, is the result of their inevitable limited knowledge about the finer details of any particular financial organisation. Bad decisions by such regulators can have serious consequences, including otherwise sound financial institutions going bankrupt. In the case of the Dutch bank ING, which opened an internet deposit taking subsidiary in the US, American regulators insisted that the deposit inflow had to be matched by mortgage lending. Because ING's new US subsidiary had not yet recruited the staff required to make its own loans, it ended up buying large tranches of securitised mortgages whose price subsequently collapsed.

The scale of the consequent capital losses in the US effectively bankrupted the entire ING group, which then had to be bailed out at the expense of the Dutch taxpayer.

Indeed, another particular current problem results from banks being forced to hold more government debt on their balance sheets – because it is an allegedly risk free asset. However, this can bring down the entire banking system in the event of a sovereign default. There could also quite easily be a bank run if holders of bank deposits merely suspect that a sovereign default is conceivable. The effective default rate on Greek government bonds was around 75 per cent, for example, and it was only the implicit pledge of unlimited German support that saved the Greek banking system from collapse. In the case of Britain, there would be a 47 per cent capital loss on gilt-edged securities if the Financial Times Stock Exchange / Actuaries all-stocks gilts index reverted to its post-war nadir in 1974 Q4 from its current level.

Britain's New Monetary Arrangements

The current constitution and responsibilities of the Bank of England were established by the 2009 Banking Act which introduced changes to the responsibilities, powers and role of the Central Bank. These covered the governance of the Bank, included a new statutory financial stability objective, created a new 'Special Resolution Regime' to deal with distressed banks and building societies and gave the Bank a statutory oversight role on inter-bank payment systems. The Bank was also granted immunity in its capacity as a monetary authority and allowed to disclose financial stability-related information to certain bodies. The new system of UK financial regulation now has the following main features:

- A new Financial Policy Committee at the Bank of England with responsibility for 'macro-prudential' regulation.

- The 'micro-prudential' (i.e., firm-specific) regulation of 'risky' large firms to be carried out by an operationally independent subsidiary of the Bank of England, the Prudential Regulation Authority.

- The responsibility for business regulation has been transferred to a new specialist regulator – the Financial Conduct Authority, which deals with conduct across all financial services.

Comments on the New UK Regulatory Structure

The new regulatory structure has been well debated: only a few quick points are needed here. First, the institutional winner has been the Bank of England, with expanded resources and enhanced powers. Most of the Balls/Brown dismemberment of the Bank – which was responsible for the officialdom's poor response to the financial crisis – has been undone. Second, however, the official debt management function has not come back to the Bank. This needlessly complicates Open Market Operations such as QE.

However any regulatory system can only be as good as the people operating it, the danger is that the officials understand neither financial markets nor bankers[40], and the new system will impose a huge burden on the new Governor, Dr Mark Carney.

One further problem must be tackled, though it is one over which Parliament has little control – the European Union (EU). Since the financial crisis, the EU has set out to impose a highly interventionist top-down system of financial regulation across the entire community; this is partly because the Eurozone may not prove viable without it. The 2009 Banking Act may be affected and therefore not serve as the binding constraint intended. The risk now is that EU regulation could do to the UK financial services industry what the Common Agricultural Policy did to the fishing industry – i.e. virtually destroy it. As financial regulatory powers are decided by majority vote, Britain has no right of veto. Simultaneously, the Basel III process is rumbling away in the background. Though it may prove less destructive of credit creation than initially seemed likely, and banks will have a reasonable time to re-arrange their balance sheets, the proposals may still have a negative result on global money and credit, economic activity and employment.

Conclusions

First, all forms of regulation have potential unintended, and frequently damaging, second-round consequences for the wider economy. Regulation should not be treated as an isolated 'tool' introduced in a vacuum without causing wider economic effects.[41] The evidence is that the increased financial regulation of recent years has led to a slower expansion of bank balance sheets; a slower expansion of broad money and credit than is desirable on counter-cyclical grounds and bears much responsibility for the weak recovery in Britain and other countries.

Second, a central aim of financial regulation, along with Bank Rate and funding policy, should be to maintain a slow but steady growth of broad money and credit at a pace consistent with the maintenance of low inflation. Regulatory constraints should be tightened when the economy threatens to overheat (this should have been done in the early and middle 2000s) but loosened when the economy is in recession. This, correct approach, was taught in traditional banking and finance courses and remains valid today. Unfortunately, this course has not been followed in Britain during the 21st

[40] The 2008 report of the Parliamentary Ombudsman into the Equitable Life fiasco, *Equitable Life: A Decade of Regulatory Failure* (HC815-V, Stationary Office, London), makes chilling reading in this respect because the regulatory failures made in this earlier fiasco were repeated in the run up to the banking crisis of 2007 and 2008. More generally, the credit boom of the early 2000s was so similar in its manifestations to the Heath-Barber boom of the early 1970s and the Lawson boom of the late 1980s that it is amazing that alarm bells were not ringing in the Bank of England.

[41] Vito Tanzi, *Regulating for the New Economic Order: The Good, the Bad and the Damaging*, (Politeia, 2008).

Century. Regulatory policy has been pro-cyclical as well as inept. That has made things worse.

Third, it has long been accepted that money is a 'veil' in the ultra-long run. In other words, the money supply ultimately affects only the price level but not the level or composition of economic output. Many of the problems of slow growth facing Britain and other western economies stem from the unprecedented increase in the peacetime government spending ratio since 2000. The problems traditionally associated with wartime finance have reappeared and governments employ the same dubious methods to tackle them. The 'financial repression' – of forcing institutions to hold more public debt than they would freely chose – abuses the regulatory system and crowds out private sector borrowers such as SMEs.

Fourth, the Bank of England failed to achieve any of the three responsibilities set out in the 1998 Bank of England Act: to meet the inflation target; to maintain the stability of the financial system; and to boost the UK financial services industry. Given this underachievement, there are legitimate doubts whether the Bank's employees are capable of performing their new expanded roles. Certainly, the new Governor, Dr Mark Carney, has a major task of institutional re-building on his hands in addition to the 'super-human' qualities needed to run the new set up.

Fifth, when expressed as a ratio to household consumption – which can be treated as a proxy for the concept of permanent income – British house prices remain one standard deviation (or 16.2 per cent) above their long term average over the period 1964 to 2012 (Chart 3). One way of regarding the ultra-cheap real interest rate policy that has been pursued by the Bank of England since 2008 is that it represents an attempt to hold property values above their long-term market clearing level in order to avert the loss of collateral and default of financial institutions that would result otherwise. This policy may be justifiable on macroeconomic grounds – although Austrian-school economists would argue strongly to the contrary – but it is also hard on the younger generation of first time buyers.

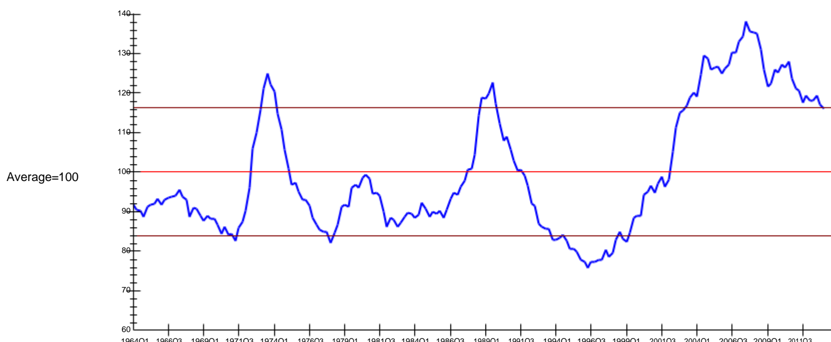

Chart 3: Ratio of UK House Prices (ONS Measure) to Household Consumption (Permanent Income Proxy) 1964 Q1 to 2013 Q1: Long-Run Average =100 57

Sixth, most economists who have looked at retail banking have argued that it would be more efficient if banks charged full marginal costs for transactions services but also paid explicit market interest rates on all deposits, including current accounts. The main reason why this more rational system has not emerged is that deposit interest attracts tax but 'free' banking services do not. The original justification for mortgage interest relief – and interest relief generally, mortgage relief was simply the last survivor – was to avoid the double taxation of interest income. With mortgage interest relief gone and deposit interest rates at rock bottom, a bold and radical Chancellor might now consider abolishing income tax on deposit income as part of a move towards a more rational marginal-cost pricing strategy by the banks. Doing something meaningful for small savers, who have suffered disproportionately from low interest rates might also prove to be an election winner on the scale of Margaret Thatcher's council house sales programme.

Finally, the nation now faces a clear choice where the future structure of the British banking system is concerned. The current approach can probably be best described as a bureaucratic-socialist one, where regulation has unintended adverse consequences that are then fire-fought with yet more regulation until the whole financial sector is effectively socialised and credit is allocated by political and bureaucratic fiat rather than by a normal market judgement. Such systems easily degenerate into the worst sort of crony capitalism, with politicians often benefitting from unduly cheap loans and other corrupt incentives. This politicisation was a major cause of the problems now confronting the German Landesbanken and Spanish Cajas both of which which were heavily influenced by regional politicians. The alternative market-liberal approach is to eliminate the two main sources of moral hazard from the present system – i.e., 100 per cent deposit insurance and the absence of direct personal financial liability on the part of senior bank executives – and then to introduce some serious competition by breaking up the Royal Bank of Scotland and, possibly, Lloyds Banking Groups into their original constituent parts. There could then be an interesting debate as to whether normal anti-monopoly legislation should be used to break up the major banking groups that are not currently wards of the state.

Banking on Stability
A Framework for Economic Success (2008)
Edward George

Sheila Lawlor writes
Edward George was Governor of the Bank of England between 1993 and 2003 and became a life peer in 2004. When I first met him in 2008 to discuss his *Address* for Politeia, he was en route to chair a meeting of school governors at Dulwich from Cornwall, where he lived in retirement. With an unassuming and friendly directness, he opened by discussing the importance of education. He wanted 'to put something back' by helping the school and society, having himself benefited from a scholarship to the school after which he read economics at Cambridge.

He went on to outline the parameters of the theme he would develop for his *Address*, with a dispassionate command of the complexity of developments which had been unfolding rapidly since Northern Rock, with lucidity, patience and dispassion, mindful in what he said of the obligations of responsibility, restraint and discretion in the interests of what was best for the country.

Eddie George saw the transformation during his working life of the financial sector, from a controlled to a free system under the rule of law. His command of the whole sector in all its detail, his belief in stability, in a free system under law and his own dedicated service to that ideal, went with a public self-effacement, which by 2008 was unusual in public life.

We are reprinting Lord George's essay as a tribute to him.

Banking on Stability
A Framework for Economic Success (2008)

Introduction
Over the course of my career at the Bank of England, spanning forty years or so, a number of fundamental changes to our whole approach to macroeconomic management occurred in this country, and from different starting points and in varying degrees around much of the rest of the world. Against such a background, this address will discuss the recent turbulence in global financial markets and will consider some of the implications for financial regulation in the future.

Beginning with the change in approach to macroeconomic management, it will consider first the change in approach to the supply side of the economy. This is particularly important, because our supply side capacity essentially determines the rate

of growth that we can hope to sustain over time of output, of employment and of incomes.

A Changing Approach to Economic Management

I joined the Bank of England straight from university in the early 1960s. Shortly afterwards, in 1964, I was sent to Moscow for the best part of a year to study the Soviet economic and financial system. It proved to be a seminal experience. It very quickly became apparent that the centrally planned and controlled Soviet system was not working well. There was a disjunction between what the central planners decided should be produced and what consumers wanted to buy.

There was a story doing the rounds in Moscow then, about a nail-producing factory. As the year-end approached the factory was behind its production target. So, in order to catch up it produced a single, massive and totally useless 10-ton nail. And they were even paid for producing the nail by Gosbank, the Soviet Central Bank, which at that time was more of an accounting organisation than a financial institution. The story was probably apocryphal. But a visit to GUM, the retail store alongside Red Square, showed that things were not working well: row upon row of empty shelves alongside row upon row of shelves packed with goods overflowing into the aisles that no one wanted to buy. Though Nikita Khrushchev, who was then in power, sought to introduce a form of the profit motive to improve things, he was removed from office in October 1964. On returning to the UK, my Soviet experience made its full impact upon me. For the first time, I realised just how centrally managed and controlled we too were in this country. Having grown up in that environment, I had, until then, taken it for granted.

The role of the Bank of England at that time was very largely to administer all kinds of direct controls over the financial system on behalf of the Government. It really was the East End branch of the Treasury. There were foreign exchange controls. There were credit controls – telling the banks how much they could each lend, for which purposes they could lend, and even the form in which they could lend. There was also rationed access to the capital market through the equity queue, and so on.

But it didn't stop at the financial system. In the wider economy there were prices and incomes policies. There was also state ownership of vast swathes of industry, with very powerful trade unions secure in the knowledge that their employers could not go bust. And there were marginal rates of income tax which at one point reached an unbelievable 98 per cent on investment income.

Virtually all of this has now, happily, gone. Over the next 30-odd years we moved, very gradually – at times imperceptibly – to a much more market-based system. Yes, of course, there are still rules and regulations, as there must be in some degree for economic reasons. Markets must be reasonably fair as well as free if they are to

perform their function effectively. But rules and regulations are needed also for social reasons. Regulation can, and no doubt does in some respects, go over the top: it is often not obvious, as a matter of degree, where the balance can be most effectively struck. But the difference is that for the most part, the rules and regulations of today, at least in relation to the economic and financial system, do not dictate what can and cannot be done. Rather they tell us what criteria must be met, and what standards must be observed, in pursuing whatever course is chosen. That leaves much more room for competition between producers nationally and to a considerable extent globally, and allows far greater freedom of choice on the part of consumers. And that in turn engages the ideas and imagination, the energies and enthusiasms, of people at large within our society, rather than leaving everything to be determined at the centre.

All of that has had a positive effect on the supply side of our economy which is fundamentally important in terms of our productive potential. But there have been equally fundamental changes, gradually over time, in our approach to management of the demand side of the economy. For years, fiscal and monetary policies were operated largely in tandem, often together with direct controls. The broad objective was to manage what was seen to be a trade-off between growth and employment on the one hand, and inflation and the balance of payments on the other. If growth slowed and unemployment started to rise, both the fiscal and monetary policy levers were pushed forward to ‘go’, together, until inflation and the balance of payments threatened to get out of hand. At that point the levers were brought back to ‘stop’. This go-stop approach to demand management tended to aggravate the boom-bust economic cycle. And worse still things threatened to become explosive, with inflation progressively higher from peak to peak and unemployment higher from trough to trough.

We gradually learned from that experience that there really is no trade-off between growth and inflation, except possibly in the short term, but not necessarily even then, given the short termism in economic decision-making that it engendered in the population at large. We learned, too, that fiscal policy is in fact a cumbersome instrument for demand management, given the time it takes to put it into effect; and we began to focus increasingly on the ratio of government debt to GDP over the medium-to-longer term as a fiscal policy constraint.

This was to leave a more specific role for monetary policy – essentially, by now, the management of short-term interest rates, in the approach to overall demand management. The objective was not that of managing the earlier, perceived short run trade-off between growth and inflation. Rather it was to keep overall, aggregate demand growing consistently over time broadly in line with the underlying supply-side capacity to meet that demand. We came to terms in fact with the near-universal central bankers’ mantra that ‘stability is a necessary condition for sustainable growth’.

That objective was eventually reflected in a low and stable, symmetrical inflation target, not simply as an end in itself but as a measure or barometer of stability in the wider sense of the balance between aggregate demand and the underlying supply-side capacity of the economy to meet that demand. That eventually led to operational independence for the Bank of England in the field of monetary policy — and the creation of the Monetary Policy Committee over a decade ago.

2007 – An Economic and Financial Turning-Point?

The important point is that all of these fundamental changes in approach on both the supply and demand side of the economy, came about as a result of an emerging consensus across a broad part of the political spectrum. It was like a complicated jigsaw puzzle gradually coming together. It has worked well for us in the UK over the past 10 – 15 years, with consistent quarter by quarter growth at an average annual rate of around 2 ¾ per cent; a consistent rise in employment to an all-time high and a fall in unemployment to a 30-year low; and with inflation consistently low and relatively stable. That has happened despite the Asia crisis in the nineties and the mild recession in most other industrial countries following the dot.com bubble in the early ‘noughties’.

Only a year or so ago, the global economy as a whole was looking in pretty good shape. GDP growth led by the US and also by emerging markets, notably China and India, had recovered to around 5 per cent a year, the highest for three decades. Inflation was still reasonably low though it had begun to pick up on the back of rising energy, commodity and food prices. Although there were some dark clouds on the horizon, notably global and domestic imbalances, they did not seem to be immediately threatening. But then the sudden storm hit global financial markets last summer, a stark reminder that economic and financial stability go hand in hand. There cannot be one without the other.

With the benefit of hindsight we all should have seen the storm coming. In the face of the economic slowdown in the industrial world in the early years of the decade, when inflation was generally under control, official interest rates generally were reduced to abnormally low levels. Nominal rates were around zero for much of the time in Japan; and they troughed at 1 per cent in the US, 2 per cent in the Eurozone, and 3 ½ per cent in the UK. That had already given rise to potential social, as well as economic, concerns relating in particular to a rapid rise in household debt and rapidly escalating house prices in many countries. We were very conscious of this internal imbalance in the UK and tried hard not to do more than had to be done to keep the economy moving forward even though inflation was somewhat below our symmetrical inflation target for some of the time. But what, perhaps, was not anticipated were the wider financial market consequences of what came to be called the ‘search for yield’.

There were two sides to this equation. Those with money to invest – insurance companies, pension funds, hedge funds, sovereign wealth funds and so on – showed an increasing appetite for marketable debt assets yielding higher returns. That provided an incentive for other financial intermediaries, notably banks, to increase their earnings through fees on the origination of loans which might initially be held on their balance sheets funded by borrowing in the wholesale money markets, but which could then be sold down into the market-place. And the banks were not at all slow to respond to that incentive.

Over the past five years, the intense competition and technical innovation in loan origination and distribution, through marketable debt instruments, has resulted in an entirely new and predominantly acronymic language. I was aware of 'sub-prime' lending (though not the potential scale of it) before I left the Bank and familiar with expressions like 'cov-lite'. I understood the principle of 'securitisation', but CDOs, CLOs, ABSs and ABCPs not to mention CDSs and monoline insurance were all pretty much still in their infancy. Nor do I really understand the highly sophisticated slicing of debt into different tranches of risk or how they are related, particularly when they include market trigger points in addition to the default risk on the underlying asset. I don't understand how they are related or even rated.

Among the consequences of all this was a dramatic increase in leverage on financial transactions generally. At the same time there was a sharp and progressive narrowing of spreads between higher- and lower-risk debt instruments until last summer in what can clearly now be seen as a widespread mispricing of risk.

That is not to suggest that the financial world went completely mad. The new instruments and techniques will no doubt have contributed to economic activity, at least in the short term. And in principle the spreading of risk across the financial system, nationally and internationally, ought to mean that while individual financial institutions can still fail, and that is inherent in a market-based system, there is actually less risk of a systemic crises than before. But that is not what has been seen since last summer.

An important part of the explanation is that, as things have turned out, the scale of debt origination and of selling the debt down across the global financial services industry has reduced the transparency of the overall extent of debt within the system as a whole. It has also obscured awareness of where the risk has ended up.

Many markets commentators, regulators and central banks, including the FSA and the Bank of England in this country, had expressed unease about the 'search for yield' for some considerable time before last summer. But no one, anywhere, to my knowledge, ever anticipated the dramatic events that we saw last summer.

As it was, the surprising revelation of substantial US sub-prime losses in two relatively small German banks prompted a frantic re-examination across the financial system everywhere of the possible scale of outstanding debt and where it might be located. The almost instant reaction was a wholly unprecedented freezing up of the markets in securitised debt instruments and in the wholesale money markets. Banks that in fact had adequate liquidity were reluctant to lend, certainly for more than a few days, because they did not know the extent of the exposures of borrowers in the money markets, or how much of the debt (that they themselves had originated very often) they would have to retain or take back on to their books. Many faced massive write-downs as the price of their holdings fell. Not only did this affect US sub-prime debt; but marketable debt instruments more generally declined, if indeed a market price could be identified.

Happily the major central banks have succeeded in calming things down in the wholesale money markets. They have made very large amounts of liquidity available, for longer periods, against a wider range of collateral, and at less penal rates of interest. It's too soon to say that the systemic liquidity crisis is over. There will no doubt be further alarums and excursions through the year. But, as I see it, the central banks are very much on the job and have things under reasonable control.

Many banks and other institutions have had to make massive provisions reflected in their share price, and raised large amounts of additional equity. Some senior executives have lost their jobs. It's been a very tough time. But the only real catastrophe here in the UK has been the sad case of Northern Rock, which was an extreme case of reliance for liquidity on the wholesale debt and money markets.
The debate about Northern Rock will no doubt continue to rumble on. It is ironic that the queues of depositors outside the bank's branches wanting their money back, started only after the Bank of England had announced massive liquidity support which made the depositors' money safer than it had been for weeks.

The FSA, some say, should have seen the problem coming, and the FSA itself has accepted that its supervision might have been better than it was. But frankly I don't know of anyone who saw the problem coming in the way that it did, and I don't see how one can expect the regulator to foresee what happened when management didn't. Regulators set minimum standards that reduce the risk of banks getting into trouble, but they cannot guarantee that banks will never fail. They do not actually run the banks, and there is a real danger that the financial system would be throttled if that was what was expected of them.

Others say that the problem could have been avoided if the Bank of England had acted more promptly and more discreetly than it did. But, given the scale of the support that Northern Rock needed, that seems wholly unrealistic to me. And if the suggestion is that the Bank or the Treasury should have acted to save Northern Rock as an

independent entity, rather than to limit the damage caused by Northern Rock's predicament to the financial system as a whole, that, to my mind, would have set a highly dangerous precedent, in terms of moral hazard.

The 'uncomfortable fact', or what Al Gore might call 'the inconvenient truth', is that the buck stops essentially with management and shareholders. That may sound hard-hearted. But, if we move away from that, we will revert to the days when the authorities were directly controlling the financial system as a whole. It will be back to the days of direct controls which would certainly not be in our overall economic interest.

The Future

There are, certainly, important lessons to be learned from all of this. As far as the authorities nationally and across the wider international financial community are concerned, the need is for greater transparency in our increasingly sophisticated and integrated financial system. That may well involve greater co-ordination between regulators of different parts of the financial services industry in some countries, and greater cross-border co-ordination between them. The approach to liquidity risk management in particular also needs to be reconsidered.

Regulators already set minimum liquidity standards, typically requiring banks to hold sufficient liquidity to meet potential liabilities for a period ahead. But, in measuring that liquidity, so-called 'marketable assets' are regarded as immediately available cash (the assumption being that cash would always be available to banks wishing to borrow against them or to sell them). The depositor protection regime also needs to be reviewed. There may well be a case on social as well as financial stability grounds for increasing the size of the deposit protected and perhaps for accelerating the compensation process. But there would be a point at which depositors would simply place their deposits with whoever paid the highest rate of interest, with more prudent depositors effectively being left to pick up the tab in the event of a failure elsewhere.

The debate on all of these issues, and others thrown up by the crisis, is already under way, both at the national level and within the relevant international organisations. Here in the UK, for example, there have been documents from both the FSA and the Treasury inviting comments from the markets. I hope that we don't rush to over-hasty conclusions on all of this, because there is no doubt that the financial world will itself be changing.

The very different, but also very sad, case of Barings, brought down by a rogue trader in Singapore, always comes to mind with its lessons. I recall in particular that for months afterwards senior bankers from all around the world said to me: 'Eddie, there but for the grace of God, go I!' They then sent off auditors and inspectors to their branches and subsidiaries to ensure that they had effective controls in place, and that

those controls were being observed, so that they could rely upon the figures reported to them, whether profits or losses. It did more good in terms of the financial system as a whole than anything the authorities could themselves have done. And, ugly and painful as events since last summer have been and will probably continue to be for a while, the market itself will be looking very closely at the lessons to be learned for their own businesses.

The big question now is what impact will the financial turbulence have upon the future evolution of the macroeconomy? What will be the knock-on effects? I don't pretend to know the answer to that question with any great confidence. I sometimes wonder whether anyone who does claim to know the answer really understands the question.

There's no doubt that the financial developments discussed here, which are producing a pronounced and necessary re-pricing of risk with a tightening of credit (notably to the household sector but also more generally in terms of leverage), will contribute to a slowdown in the rate of growth of demand. Up to a point that is not necessarily a bad thing in that it should contribute to reducing the external and domestic imbalances that we've lived with for some time. The question is essentially one of degree. Will it mean an absolute decline in demand and negative growth, at least for a while in some countries, or will the slowdown be more modest?

There is reason to be hopeful that the central banks are now more on top of the liquidity problem and the financial storm will gradually blow itself out. The re-pricing of risk is now under way; and many of the banks most severely affected by substantial losses and write-downs have moved aggressively (and very successfully in many cases) to raise new equity. But it may take time before markets generally accept that this is happening.

In the meantime the major industrial countries face a considerable macroeconomic policy dilemma. The slowdown in demand growth associated with financial turbulence is currently being compounded by the increase in inflation stemming from the rise in world oil and energy, food and commodity prices. As demand growth slows so too should these inflationary pressures but that too will take time. In the meantime inflation is likely to remain above target in the UK and the Eurozone, and higher in the US, than I am sure they would ideally like to see. That carries the risk that inflationary expectations, which have generally been subdued in recent years, may escalate, affecting economic behaviour.

Maintaining stability in the broad sense of balance between overall demand and supply-side capacity to meet that demand, will not be easy over the next year or two. But I'm reasonably optimistic, which is strong language for a central banker, even a retired central banker, that it will be achieved looking further ahead. That is because

I'm convinced that the broad political consensus on the overall approach to macroeconomic management, described at the outset, remains very much intact. But it won't be an easy ride.

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Since the financial crisis broke, politicians have turned the spotlight on the banks and the financial sector. The political parties take the same approach and promise increased regulation. They believe that this is the way to ensure that never again will the taxpayer have to fund bank bailouts. There have been different detailed proposals, but there are three recurring themes. Retail operations should be ring-fenced from investments; capital requirements should be raised; and in future, the assumption should be that there will not be further bailouts.

To the authors of this volume, who include some of the country's most distinguished economists and others with specialist knowledge of the financial services industry, these policies, and the assumptions on which they rest, raise concerns. Regulation, they warn, is itself no panacea for the problems it seeks to address. Rather, the wrong regulation may damage the wider economy in which the banking sector and financial services play a central and vital role. What is needed are smaller banks and a competitive market which keeps the cost of banking and credit down; a different culture from within the industry; and effective self-regulation overseen by the Bank of England.

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