

**Response to Treasury 'Financial stability and depositor protection:
strengthening the framework', January 2008**

There seemed to be no hint of irony in the opening statement: "All modern economies benefit from efficient, stable and fair financial markets". The fact is that they do not so 'would' that it were true. In fact all modern economies suffer from inefficiencies in their financial systems, and the UK is no exception. The UK financial sectors, and particularly the big banks, have been under almost continuous (and ongoing) investigations by the competition authorities and the FSA for monopolistic and punitive pricing and mis-selling products etc. Also, the big banks have achieved cost cutting by closing branches, and abrogating from any social or public duties they used to be expected to perform. Finally, they now stand accused of irresponsible (and perhaps even predatory) lending and are reluctantly agreeing sharper Banking Codes.

Regulation and supervision should be based on fundamental principles. The starting point is that (non-mutual) retail deposit taking banks are profit seeking institutions that use depositors' money (90% of the balance sheet) to generate profits for shareholders (10% of the balance sheet) and that 'big banks' are simply too big to be allowed to fail (and thus enjoy implicit and free taxpayer support). The big banks thus have a fiduciary duty to depositors as well as to shareholders and a public duty to taxpayers (financial stability is a public good).

Financial innovation (FI) is itself driven by processes, not just a driver in itself. To the extent that the recent instability is caused by FI, it is important to understand the process of FI. In recent years new capital market FIs have been associated with underpricing of risk (junk bonds in the 90s, subprime in the 00s). One reason is that rapid widespread adoption is required for success (network externality effects). To some extent underpricing is used as a loss-leader prior to establishing a market and thus financial innovation (as with other innovations) involves underpricing at the outset.

What drives FI? Some of it is genuinely seeking new market opportunities and should reduce transactions costs and increase efficiencies. But much of it has been aimed at circumventing regulations (off balance sheet/capital saving vehicles). A third driver has been financial liberalisation allowing financial globalisation, but also including 'deregulation' or regulatory reform e.g. replacement of the Glass-Steagall

Act in the US. One question is why the re-regulation has occurred and, has it gone too far and if so, did it contribute to the current crisis and should it be reversed (at least in part)? Clearly if it is to be partially reversed, international action is required so that the UK does not put itself at a competitive disadvantage.

James Tobin, among others, expressed the view that not all financial activity is efficient and proposed a revenue collecting tax (the 'Tobin tax'). But who would collect the revenue and how would its revenue be used? There is a clear risk of uneven implementation of regulations/supervision across countries as individual countries seek competitive advantage.

Instead, what seems to be required are automatic (financial) stabilisers (Crockett (2000),¹ Mullineux (2000)² and the work of Borio and his colleagues at the Bank for International Settlements). This is especially true in light of recent experience and the expectation that Basel II will be even more pro-cyclical (i.e. cycle amplifying) than Basel I due to the introduction of time varying risk weights and as a result of increasingly rigorous 'marking to market'. In other words we need 'taxes' that discourage excessive risk taking and mispricing and 'throw sand in the wheels' of the financial machine to avoid overlending in booms and credit crunches (underlending in recessions).

The literature suggests a number of options:

1. Risk-related and funded deposit insurance. Co-insurance (with the small retail depositors getting less than 100% DI) clearly does not prevent runs and is misconceived since, due to 'opacity', it is not possible for depositors to identify the safest bank (they expect the supervisor to assure safety as a public good) and co-insurance in the end encourages a graduation of deposits to the biggest (and safest) banks (as they will not be allowed to fail). The minimum size of funds covered should be on the large side (old ladies often have sizeable deposits and often can't use the phone or the internet to move funds, let alone visit branches at short notice

¹ Crockett, A. (2000), "Managing the micro and macroprudential dimensions of Financial Stability, *BIS Speeches*, 21 September.

² Mullineux, A.W. (2000), "Lessons from the financial crisis in Pacific and South East Asia, Chapter 11, pp 206-219, in *Finance, Governance and Economic Performance in Pacific and South East Asia*", edited by D.G. Dickinson, J.L. Ford, M.J. Fry, A.W. Mullineux and S. Sen, Edward Elgar, Cheltenham

during a run on their bank!). If banks compete on interest rates, 100% DI encourages adverse selection since the banks offering the highest rates tend to more risks to make adequate returns. They often grow faster as they must lend the deposits they collect (Credit Lyonnais). Thus 100% DI requires risk related DI (Merton, 1977).³

As in the US, DI must also be funded otherwise there is no tax on risk taking (only a deferred tax). If it is not funded, when the hat is passed round, the banks will say 'can't pay and won't pay' if there is a general liquidity crisis, as at present.

The big banks will naturally oppose such proposals, arguing that they are designed to bail out small banks (but because they enjoy automatic taxpayer funded insurance, they have a public duty to contribute).

The deposit insurance premium risk weights could focus on liquidity risks and there is a case for the BoE managing this part of the supervisory operation as it is clearly complementary to the monetary (interest rate setting) policy (as strongly argued by the Federal Reserve in the US).

2. Forward looking loan loss provisioning. Banks normally underprovision, arguing in the boom that there will never be another recession or financial crisis. When one eventually does occur they are 'behind the curve' and tend to under-report losses (Japan post bubble in the 1990s and the current 'subprime' crises). The *ex post* provisioning then exacerbates the credit crunch and enhances procyclicality. As a 'tax' on risk taking, the banks should be required to build up a buffer stock of general provisions (in addition to any specific provisioning). The Bank of Spain is experimenting with this and the success of its pro-active provisioning policy should be carefully monitored now that the Spanish property boom is over.
3. Basel II already needs to be reviewed and strengthened with respect of off balance sheet activity (and the US needs to adapt it more quickly), so work on Basel III should start immediately in

³ Merton, R (1977) 'An analytical derivation of the cost of deposit insurance and loan guarantees: An application of Modern option pricing theory', Journal of Banking and Finance, 1:3-11.

light of the Financial Stability Forum's forthcoming 'final report'. A core question is whether the 'average' capital requirements need to be increased (adding to the 'buffer stock') and whether capital ratio should be allowed to fall below average during a recession or financial crisis (see the Charles Goodhart and Avenish Persaud proposals, FT, 31/05/08, P9, European Edition). This is an alternative (capital) buffer stock approach and might naturally be combined with forward looking provisioning.

2) and 3) could be targeted on solvency threatening risks and weights set accordingly and, in the UK, would naturally be overseen by FSA.

1) and 3) reduce the ability of banks to expand lending in upswings and reduce the severity of credit crunches in downswings, reducing procyclicality. They also address the moral hazard issues that have arisen in the recent liquidity crisis. If banks are less able to overlend and overtrade, then they are less likely to need to be bailed out when market conditions change (and the taxpayer will be better protected, but banks will be less profitable as a result of taking less risk).

Alternatively, the UK needs to aggressively stimulate 'basic banking' provided by mutuals and could restrict DI to such bank accounts (and thus subsidisation of big banks), which are better at providing 'access to (retail) finance' and reducing social exclusion. I fear that it is too late for such a dramatic intervention.

Further, and linked to the Goodhart and Persaud proposals, the issue of whether asset price inflation should play a more prominent role in interest rate settings needs to be addressed. Links between asset and retail (CPI) price inflation need to be better understood, but one possibility is for the BoE take a view of the impact of asset price inflation on financial stability (in light of its proposed clearer responsibility of the Bank in that sphere) when setting interest rates. A change in its formal objectives, broadening from a simple symmetrical CPI target, may thus be required.

It should be noted that the Bank was essentially forced to broaden the range of eligible assets. It should narrow them again and should in future require larger holdings of such assets by big banks (as a further control on liquidity risks and overlending and to reduce the moral hazards implicit in taking mispriced assets as collateral). Again, internationally

co-ordinated actions are required here so as not to put British banks at a competitive disadvantage.

At the micro-prudential level, banks must be induced to establish adequate internal (risk management) controls. There is a strong case for Sarbanes-Oxley Act section 404 type legislation (adopted in each country) requiring the audit of bank internal controls and the senior management to sign off these audits and the final accounts under the threat of fines and/or imprisonment. The internal controls should cover operational risks (including 'rogue trading') and should consider employees' incentives to take risks or miss-sell products in pursuit of bonuses. Dangerous dogs should be kept on a lead!

Finally, the Tripartite Agreement is needed because of the links between liquidity and solvency risks. Banks are necessarily opaque (due to uncertainty and to asymmetric information). In a liquidity crisis, uncertainty about the (possibility deteriorating) quality of assets matters and it is by no means obvious that banks are adequately capitalised (other than in the sense of meeting Basel I or II requirements). Visible buffer stocks would help. It should be noted that full disclosure is impossible to achieve and counterproductive. Full disclosures by big banks allow small banks to 'free ride' in constructing their own asset portfolios. Unless banks can make profits from the proprietary information they collect, they have little incentive to collect it and to undertake costly data processing screening and monitoring. Risk management and pricing would thus regress.