

Comments on ‘Financial stability and depositor protection: strengthening the framework’

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The proposals are (a) a general response to the credit crunch, (b) an attempt to improve specific aspects of the law and regulation which were thought to have impeded a more expeditious resolution of the Northern Rock episode, and (c) some other measures which were presumably thought to be independently desirable.

General comments

My first general comment is that it is not clear that any major tightening-up is necessary or desirable in the body of law and regulation which aims to prevent financial crises. Certainly the losses that are currently being suffered as a result of unwise provision of sub-prime mortgages and investment in certain structured products are severe. However, the losses are by and large being suffered by the people who were ultimately responsible for the decisions that led to the losses. Moreover, although economic growth in the global economy is now clearly slowing down as a result of the credit crunch, it is slowing down from a very rapid rate which had been sustained for several years, supported by financial innovation. Macro-economic forecasts do not suggest that the slowdown will be so serious that it will be impossible for macro-economic policy to be adjusted or adapted to take account of it. Legal or regulatory measures which significantly intensified regulation of financial services might reduce the risk of future accidents of the kind that has just happened (though I doubt it – see below), but at the likely cost of making the financial services industry less competitive and efficient, and therefore less able to support future economic growth. I doubt very much whether the price would be worth paying.

My second general comment is that even if all the Northern Rock-related proposals were implemented and even if they put the law of the United Kingdom into a condition which was conducive to the expeditious resolution of problems like Northern Rock, that would not be enough. The reason is that all kinds of pieces of law and regulation have potential implications for financial stability, which are easily overlooked. The law and the practice of regulation are constantly changing for all kinds of reasons, as are financial market practices, and the implications for financial stability need to be continuously monitored. That clearly did not happen in the few years before Northern Rock.

I therefore suggest that some part of the government (or, more broadly, of ‘the regulatory authorities’) should be instructed to review each piece of forthcoming legislation and each regulatory innovation, and assess the financial stability implications of what is being proposed. Specifically, the report should assess the effect of the proposed measures on both (a) the likelihood of a financial crisis occurring, and (b) the ease with which a financial crisis could be resolved, if one were to occur. Reports on proposed legislation should be presented to Parliament, which could take account of the assessment in debating the legislation. In the case of changes driven by EU legislation or regulation, it would be necessary for the reports to be presented to the responsible EU body, and in the

case of domestic regulation, the reports should be presented to the responsible regulatory body. There seems no good reason why such reports should not be published.

Specific comments

My other comments are on the substance of the proposed changes.

a. Background to the Northern Rock episode

It is clear that the market turbulence which led to Northern Rock's downfall was truly extreme. It was described as follows by Mr Hector Sants of the Financial Services Authority in evidence to the Treasury Committee of the House of Commons on 9 October 2007 (see Uncorrected Oral Evidence <http://www.publications.parliament.uk/pa/cm200607/cmselect/cmtreasy/uc999-ii/uc99902.htm>):

Mr Sants: As I said before, I think that the set of circumstances that transpired in the market were highly unusual and was not, I think, in fairness, anticipated by any regulators around the world; nor, indeed, if you look at the individual commentators. Some, of course, or a number, may have been pointing out the share price was too high; there was nobody really anticipating that set of circumstances. It is not just a question of the securitisation market being closed to them for a prolonged period, it is also a question of other mechanisms of wholesale funding, in particular the repo market being closed. As we indicated, they had high quality assets - there is no suggestion here this is an organisation taking on poor quality assets - and it really is an extraordinary set of circumstances which lead to them being unable to repo those assets for a period of six weeks or so as well as the combined closure of the securitisation. One final point, if I may, because I think it is important to understand, they did not actually have a complete closure of the wholesale funding market here. As we pointed out in our note, what happened was the duration of that funding shortage shortened to the point that they were funding over night. They were not not funding this themselves. What happened, however, was that with the duration shortening the Board very properly (and I think quite rightly, and we would agree with that) took the view that they needed the insurance of opening up a facility with the Bank of England. They would not have had to use that facility, or it may well have been that they would not have had to use that facility unless there had been a retail run. So, to focus solely on the securitisation issue and the fact that market was closed is the sole driver in the set of circumstances

that have taken Northern Rock to where it is now would be incorrect. We need to look at it as a combination of circumstances which included the retail run as a major driver of their problem. They were not using the Bank of England facility until the retail run.

In these extreme circumstances, it is understandable that the Bank of England's decision not to offer prompt generalized liquidity support to the mortgage market by offering to lend against the collateral of high-quality mortgages has been questioned. The Bank of England's metamorphosis in the 19th century from a privileged commercial bank to a central bank was marked above all by its willingness to relieve periodic liquidity crises, and Walter Bagehot set out the guiding principles in his book 'Lombard Street: A Description of the Money Market': lend freely as to amount, against high-quality collateral, and at a high interest rate. And there have been more recent episodes in which the government financial authorities have provided liquidity support to troubled financial markets – eg after the stock market crash in 1987, when the underwritten offer of BP shares owned by the government was outstanding, the Bank of England offered to buy the shares back at a price below the underwriting price¹.

Returning to the Northern Rock episode, it is true that the Bank did offer generalized liquidity support of this kind to the mortgage market, but not until 19th September, which was clearly too late. No one can tell whether an offer of generalized liquidity support immediately after the crisis had begun would have saved Northern Rock, but it seems entirely possible that it would have done. One argument made against providing support was based on the fear of creating moral hazard and thereby making future crises more likely. Moral hazard is indeed a serious issue, but it could have been addressed by charging a penalty interest rate. Another was that the scale of support required would have been too large, but the Bank of England could have absorbed any surplus liquidity that it had created by lending against mortgages either by selling other assets or by issuing its own debt instruments.

I do not want to suggest that the directors of Northern Rock bear no responsibility for what happened. Just as mountaineers have a responsibility not to require the services of the mountain rescue service, so the directors of Northern Rock had a responsibility not to require emergency liquidity support. However, in the light of history and previous practice, I think it would have been reasonable to expect the Bank of England to provide liquidity support to the mortgage market at a much earlier stage in the crisis.

b. Stability and resilience of the financial system (chapter 2).

The proposals in this chapter fall into two groups – 'more regulation' and 'more transparency'.

¹ In the event, the Bank of England bought none of the shares. See N. Lawson, The View from No. 11, Bantam Press, 1992, pages 757 – 782.

‘More regulation’ encompasses the proposals on stress testing by banks (questions 2.1 and 2.2) and on liquidity regulation (question 2.3). ‘More transparency’ encompasses the proposals on valuation and disclosure by banks (questions 2.4 and 2.5). The proposals on credit rating agencies (questions 2.6, 2.7 and 2.8) relate to both regulation and transparency.

Before making specific comments, I think it is worth noting that the ‘originate and distribute’ model of banking described in Box 1, which is thought to have contributed to the recent problems of the banking industry, is itself largely a product of regulation (Basel 1). As the box correctly points out, the ‘originate and distribute’ model has the key attraction that it enables banks to earn interest income without tying up significant amounts of regulatory capital. This is a good example of a well-intentioned piece of regulation having important and quite unforeseen consequences. The example should serve as a warning not to react to a crisis like the present one in financial markets by intensifying regulation.

It may be argued that Basel 1 is becoming obsolete and that Basel 2 will not share its drawbacks. This is the position taken by Mr Charles Freeland in his letter to the Financial Times published on 7 February. He admits that Basel 1 created perverse incentives², but the truth is that any centrally-imposed structure of capital or liquidity requirements, including Basel 2, is bound to create perverse incentives of some kind or other. Such perverse incentives create distortions in financial markets which typically have gradually increasing effects, unless and until the regulatory structure is changed. Of course, even if there were no official bank regulation at all, the managements of individual banks would have to impose internal regulatory structures in order to try to align the incentives of their employees with those of the shareholders. The alignment would inescapably be incomplete and each bank’s internal regulatory structure would create perverse incentives, but at least there would be diversity among structures within the banking industry as a whole. One of the unfortunate effects of official regulation is to ensure that all banks face the same perverse incentives.

The specific proposals on strengthening risk management by banks are:

- Introduction of Basel 2 and the Capital Requirements Directive. I am very sceptical that Basel 2, and Pillar 1 in particular, will have a positive effect on the quality of risk management in large banks in the long run. The reasons are that it imposes on banks a mandatory single framework for risk management, which will inevitably be slow to adapt to changing conditions and circumstances; and that it largely eliminates the possibility of healthy diversity among banks in risk management frameworks³. Moreover, Basel 2 and its accompanying regulatory apparatus constitute a massive barrier to entry into the banking industry and seriously inhibit competition.

² See also P. R. Fisher, ‘Whatever Happened to Risk Dispersion?’, Banque de France Financial Stability Review, February 2008, especially page 37.

³For a fuller account, see W.A. Allen and G.E. Wood, ‘Defining and Achieving Financial Stability’, Journal of Financial Stability, 2 (2006), pages 152 – 172.

- More stringent stress testing. I doubt whether any substantial financial institutions need any official encouragement to undertake more stringent stress testing. However, there is one important issue that the financial stability authorities should acknowledge and act on. It is logically impossible for financial institutions to undertake stress testing for liquidity risk if they do not know in what way the central bank is likely to react in a liquidity crisis. Clearly there was a serious misunderstanding on this issue in August 2007, when the Bank of England did not behave in the way that many market participants expected. In September, however, it changed its stance and offered the facilities that had been widely expected in August. It seems to me that an essential input to liquidity stress testing is a statement by the Bank of England about how it would be likely to react to a future liquidity crisis⁴.

‘More transparency’ would clearly be highly desirable in present circumstances. As chapter 2 notes, a new accounting standard for financial instruments has become mandatory for 2007 accounts. Implementing it is surely creating immense problems for auditors, and there may well be problems of consistency. However, it is not clear that the UK financial stability authorities will be able to do much to help resolve those problems.

The final set of questions in chapter 2 relates to credit rating agencies. I think that these are matters for the market to resolve, and I doubt that the official sector can add much value to the process. As far as I am aware, the only legal issue is the recognition of certain specific agencies in United States federal law.

c. Reducing the impact of a failing bank (chapter 4).

The main proposals are for the introduction of a special resolution regime for banks and accompanying curtailment of the rights of bank shareholders. I think that there is a case for such a regime.

I have two main comments:

- Paragraph 4.9 says that the FSA would take the decision (on using the special resolution regime in a particular case) after consultation with the Bank of England and H. M. Treasury. Decisions are usually of higher quality if the responsibility for them is clear. The FSA would probably want to consult other official bodies before making such a momentous decision in any case (and the proposed information-sharing measures should make it possible for them to do so), but I suggest that it would be better if the legislation did not *oblige* the FSA to consult. It should be clear that the responsibility lies with the FSA and not any other body.
- There is a lot of material in chapter 4 about appeal mechanisms, but the reality is that the application of the special resolution regime to any bank would probably greatly and irreversibly reduce its market value. Any appeal would be too late to

⁴ Based on the evidence of August 2007, any prudent U.K. bank would be well-advised to maintain a branch or affiliate in the euro area or the United States, where the central banks were more accommodating than the Bank of England.

make any difference unless the FSA were to be obliged to compensate shareholders for the damage done by decisions that were later found to have been mistaken. Such an obligation would be inconsistent with the statutory immunity currently enjoyed by the FSA.

d. Strengthening the Bank of England (chapter 6).

It may well be desirable to clarify the Bank of England's role in financial stability, but it would not be possible to articulate the Bank of England's objective anything like as precisely as the Bank of England Act of 1998 does in relation to monetary policy.

One reason is that there is a qualitative difference between monetary policy and financial stability. The objective of monetary policy (ie price stability) is generally thought not to involve any trade-offs with other objectives of government policy. Indeed, price stability is thought to be supportive of the government's other objectives. For this reason, it has been possible and highly desirable to delegate the implementation of monetary policy to an independent Bank of England.

The same cannot be said of financial stability. For example, there may well be a trade-off between the objectives of financial stability (which are promoted by prudence and caution) and of economic growth (which requires enterprise and risk-taking). Deciding on legislation and regulatory measures which involve such a trade-off cannot properly be left to an autonomous government agency. The Bank of England therefore cannot be independent in financial stability. Therefore its objective in financial stability must be to co-operate with other organs of government in pursuit of financial stability.

The nature of such co-operation is likely to change through time as circumstances change. Therefore, if the Bank of England Act is to be amended to say more about financial stability, the new version will have to state the Bank's objectives in fairly general terms.

The proposals on governance of the Bank of England seem very curious, in that they are related entirely to the oversight function performed by the Court, and have nothing whatever to say about executive decision-making. This is particularly strange bearing in mind that that one of the successful innovations of the 1998 Act was to establish the Monetary Policy Committee as the Bank's executive decision-making body in monetary policy. The Court meets only once a month; its members have other jobs which are their main occupations; and they generally lack the technical expertise needed in an executive body.

While the Bank of England's responsibilities in financial stability may defy precise specification, there are some financial stability decisions that clearly are the responsibility of the Bank. The decision in August 2007 not to offer generalized liquidity support to the mortgage market by offering to lend against the collateral of high-quality mortgages was one such decision. I think there is an extremely powerful case for such decisions being taken by a committee rather than by an individual, as is the case with monetary policy

decisions. Bank of England staff members have produced evidence that committees make better monetary policy decisions than individuals⁵. There is every reason to believe that the same would be true of financial stability decisions.

Setting up a decision-making Financial Stability Committee in parallel to the Monetary Policy Committee would have the drawback that the Financial Stability Committee would have to make decisions only rarely in normal circumstances, and it would be hard to recruit and motivate members other than from the staff of the Bank of England, the Treasury and the FSA. Therefore, it would be preferable to establish an executive board of the Bank of England, which would make important decisions by majority voting and would take on both the functions of the MPC and the responsibility for those financial stability decisions that the Bank has to take alone. This is the model that has been adopted by the Swedish central bank. Many of the people who serve on the MPC would be well-equipped to participate in financial stability decisions, but it would be desirable to recruit some people to the committee purely for their expertise in financial stability.

e. Effective coordination (chapter 7).

The paper effectively proposes no change in relation to the provision of ‘general liquidity’ by the Bank of England, except that the Treasury and the FSA will be able to ‘make representations’ to the Bank about it. Thus if the proposals were fully implemented, and the circumstances of August 2007 were to recur, the Bank would be able to make the same decision not to offer generalized liquidity support to the mortgage market by offering to lend against the collateral of high-quality mortgages. It is understandable and proper that the government does not want to undermine the independence of the Bank of England, but as noted above, I think that it would be preferable if an executive board of the Bank of England were responsible for taking such decisions by majority vote.

As regards the provision of financial support to individual institutions, the proposal is not clear. The Chancellor is to authorize any ELA operations, but would the Chancellor be able to insist on provision of ELA if the Bank of England or the FSA opposed it?

Summary of comments

1. It is not clear that any major tightening-up is necessary or desirable in the body of law and regulation which aims to prevent financial crises.
2. Some part of the government should be instructed to review each piece of forthcoming legislation and regulatory, and assess the financial stability implications of what is being proposed.
3. I am very sceptical that Basel 2, and Pillar 1 in particular, will have a positive effect on the quality of risk management in large banks in the long run, since it

⁵ See C. Lombardelli, J. Proudman and J. Talbot, ‘Committees versus Individuals: An Experimental Analysis of Monetary Policy Decision-Making’, *International Journal of Central Banking*, May 2005, pages 181 - 205.

- will be slow to adapt to changing conditions and it will maintain the officially-imposed uniformity of risk management models.
4. An essential input to liquidity stress testing is a statement by the Bank of England about how it would be likely to react to a future liquidity crisis.
 5. I think that there is a case for a special resolution regime for banks. I think that the FSA should be responsible for deciding whether to apply it in specific cases, and that it would be better if the legislation did not *oblige* the FSA to consult the Treasury or the Bank of England (though the FSA would be free to consult them if it wished to). The appeal process is largely irrelevant.
 6. If the Bank of England Act is to be amended to say more about financial stability, the new version will have to state the Bank's objectives in fairly general terms. The Bank of England cannot be independent in financial stability as it is in monetary policy.
 7. The revised Bank of England Act should establish an executive board of the Bank of England, which would make decisions by majority voting and would take on both the functions of the MPC and the responsibility for those financial stability decisions that the Bank has to take alone.