From Prof. C. Goodhart

Answers to Chapter 2

2.1 There is an undue tendency throughout this White Paper to regard some form of improved stress testing as a silver bullet to prevent future crises. This emphasis is misplaced and misguided.

On the one hand, for the next decade or so, there will be no need for specific stress tests to warn banks against the evident dangers of over-reliance on wholesale markets. Experience is the best tutor.

On the other hand, and more important, stress tests are categorically insufficient. They ask a bank whether it could survive a given scenario. But that ignores all second, and subsequent, round effects. Banks generally claim that they can survive the first round effect of almost any adverse shift of events, primarily by becoming more conservative and reducing the size of their books, by limiting new loans and selling off existing assets. But the 'safety measures' taken by each bank individually worsens market and macro-economic conditions for all other banks.

It is such second, and higher, order interactions between banks, markets and the macro-economy that lies at the heart of contagious crises, often termed 'endogenous risk'. It is, in practice, virtually impossible to get a handle on endogenous risk via stress tests. A stress test on the US sub-prime market would have revealed zilch.

Stress tests, by themselves, are strictly limited. What is needed in addition is more professional work to model the interactions between banks, markets and the economy. This is being done both in Central Banks and by academics, (such as in a series of papers by D. Tsomocos and myself). Much more

centralised modelling of such inter-actions needs to be done. That is at least as, and very likely more important than, simple stress-testing.
[I could expand at length on this point, if requested.]

2.2 Not entirely. The emphasis on liquidity and funding risk is now self-evident, a splendid example of closing stable doors after the horse has bolted.

A much more generic problem is that banks oil the wheels both of the economy and of capital markets by making contingent commitments, e.g. unused overdraft facilities and various kinds of back-up commitments to capital markets. The correlation between these commitments being triggered will be a function of (financial) conditions. While this is particularly the case for bank-related vehicles (originate and <u>pretend</u> to distribute), it still relates to contingent commitments made at arms-length. Crises are likely, at any rate initially, to cause some reintermediation onto banks. How should regulators and supervisors deal with that?

2.3 I have commented separately on the FSA's discussion paper.

As a generality quantitative liquidity requirements are self-defeating; an asset that <u>has</u> to be held cannot be used flexibly to meet a liquidity drain!

The FSA plans, though broadly sensible, do not deal with the stigma issues.

I attach in Appendix A, an early, incomplete draft, my own plan to reform money market operations and to provide incentives for banks to hold adequate liquid assets.

2.4 How do you reconcile your support for full disclosure in this respect with your proposals to limit and reduce disclosure in Chapter 3? Is protection of the public interest really sufficient justification for having one law for the private sector and another (reverse) for the public sector?

2.5 Not really. The emphasis on 'mark-to-market' ignores the serious possibility that market values can be, temporarily but significantly, affected by distress sales in a thin, or almost non-existent, secondary market. Is it really sensible to use prices in such thin markets to value a much larger total of (fairly-firmly-held) similar assets? This is mentioned in 2.47, but the resolution of this crucial issue is not, yet, clear.

2.6 Yes.

2.7 Yes, but one should not under-estimate the problems of estimating (default) probabilities in a non-stationary, constantly changing system, with fat tails and endogenous risk. There is no good evidence yet that the credit agencies could, ex ante, have done better, or that a better system is achievable.

2.8 Yes.

2.9 Mostly, but not entirely. The practice of 'Originate but pretend to distribute' was clearly largely driven by regulatory aribitrage and needs to be reformed.

However, even where the distribution, and the capital markets, are truly at arms length, such markets still rely on banks' contingent commitments (see answer to 2.1). There is bound to be some enforced re-intermediation onto banking balance sheets during adverse financial conditions. The issue of contingent commitments, and how to address the resultant risks, goes far wider than just to bank-related off-balance-sheet subsidiaries.

<u>Answers to Chapter 3</u>

3.1 The powers are not likely to be effective in the case of fraud. As shown in Barings and Soc Gen, this is most likely to occur when someone with compliance/back office experience also, or subsequently, works as a trader in the front office. FSA needs powers to prevent this happening.

The FSA needs to be aware that a bank in the top percentiles of growth/profitability is probably taking on more risk, and as likely to fail as those in the lowest percentiles.

The risk preferences of management will be a function of the incentives inherent in their bonus schemes. The government should, at least, consider Martin Wolf's suggestion that these be subject to approval, or rejection, by the FSA.

3.2 No suggestions to offer. OK, as far as I know.

3.3 Not in a position to answer, but 12 hours in Section 3.20 sounds extreme to me. 36 hours would probably be preferable.

3.4 Do not expect too much from this. No one can predict the continuing course of a crisis.

3.5 I had thought that such national information sharing between FSA, HMT and BoE was already in place. If not, it should be implemented now.

Perhaps the more important issue, not touched upon here, is cross-border information sharing. Of course, that cannot be resolved by national legislation, but it remains a crucial issue, worth mentioning.

3.6 / 3.7

Support, but again note the increasing importance of international payment systems, e.g. TARGET 11, Swift. Again international issues are worth mentioning.

3.8 / 3.9 / 3.10 / 3.11

These sections are likely to be amongst the most controversial of the whole paper. Dealing with the stigma effect by secrecy and obscurantism is retrogressive, and entirely inconsistent with your own support for transparency and mark-to-market in Chapter 2.

It is far from clear that the only, or best, way of handling the stigma effect is by a retreat to secrecy. Note that this same problem has been recognized in other monetary areas, notably in the USA, and is, I believe, under study in the BIS Committee on the Global Financial System (CGFS). Moreover, following recent experiences, with any luck the same problem may not recur for years. You can play for time.

What you need is words such as, "The stigma effect of banks' being perceived as applying for ELA has been recognized as a serious problem by the monetary authorities in most major regions. How to respond to, and offset, such reputational risk is currently under intense study in several international fora. The UK is playing a full role in these discussions. If the government, however, should come to the view that the international response is insufficient and/or too delayed, it would then propose separate measures to deal with this problem."

Do not rush into this. It would not be a good precedent. Hiding public sector usage of funds, even if only temporarily, from general oversight is not, in principle, desirable.

N.B. My own proposal in Appendix A tries to deal with the stigma effect in a less heavy-handed fashion.

3.12 Not clear what the case for such immunity, asserted in 3.51, actually is. There may, indeed, be such a case but it is asserted here, not explained nor argued. So how can one be expected to agree?

3.13 Yes.

3.14 See answer to Sections 3.8 to 3.11.

3.15 I agree changes proposed in Sections 3.59 to 3.62. I cannot see any immediate risks.

Answers to Chapter 4

4.1 Strongly support

4.2 Strongly support

4.3 Yes, but note that there may well need to be several alternative triggers, plural.

4.4 Yes, subject to a qualification noted below.

4.5 It would be helpful if it was made expressly clear that in those cases when the authorities had to take over temporarily ownership of part (Section 4.14, indent 2) or all (Section 4.15) of a bank that the intention would be to re-sell that (part of the) bank back to private ownership within five years, or less. Then the rights of share-holders, debt-holders could be met out of the receipts from any such auction (sale). The authorities should be required, once an SRR is in place, to try to maximise its subsequent sale value, subject however to the important proviso about fair competition and not mis-using the government's effective guarantee.

4.6 Subject to the above qualification, Section 4.18 is good.

4.7 Strongly support. It is a corollary of deposit insurance and Central Bank safety net. Note that, without the above, in 19th century bank shareholders had unlimited, or double, liability. Use history as a defence against those who cry 'expropriation'!

4.8 Yes

4.9 No useful opinion

4.10 Strongly support

4.11 Strongly support

4.12 Yes

4.13 See answer to 4.9

4.14 Strongly support

4.15 I would have thought that this would be covered under Section 4.26 above. The good parts of a failing bank would be transferred to a bridge bank under an SRR under public ownership; the bad parts would be liquidated. You cannot allow the existing managers any role in making this division, or in running the continuing bridge bank.

4.16 The aim should be maximisation of present value. That might need to be achieved by delaying asset sales until markets recover. Do not put a time limit, or demand for speed, on the liquidator. The FSCS should have access to funding outside of immediate proceeds from the failing (part of the) bank.

4.17 Of course. Public money will be at risk.

4.18 I am not expert, but would say ‘yes’.

4.19 No valid opinion

4.20 No. It would further complicate cross-border default problems.

4.21 14 days seems <u>far too long</u> in a crisis situation. More than enough time for a bank to be stripped dry by a run. Have you thought what might happen if such notice became public knowledge? Could it be kept secret? Note that short-sellers would benefit from claiming that such a notice had been issued. What has been the experience in other countries? At a minimum there should be a clause that, once such a notice has been issued, the existence of rumours of that affecting market values should allow the authorities to make such closure immediate.

4.22 – 4.24

Seems OK, but I am not a legal expert.

4.25 Yes. I would see this as the normal procedure. This is what happens elsewhere, in the USA, Scandinavia, IMF rescues in Indonesia, etc. Have you sent your White Paper to Sven Ingves, Governor of the Riksbank? He is the world authority on all this.

4.26 – 4.29

Yes

4.30 No expertise

4.31 Strongly oppose. The costs of an SRR rise if it is carried out too late. Because an SRR will damage the reputation of FSA, the danger is delay and forbearance. If the private sector bears the cost, the FSA would be encouraged to delay even longer. The costs will be a positive function of FSA failure/inaction; the private sector should not have to pay for public sector failure!

4.32 It would be appropriate if the costs were to fall on FSA budgetary allocation (and hence on the taxpayer). A good incentive for FSA to act fast.

4.33 / 4.34

No expertise

4.35 OK

4.36 No

Answers to Chapter 5

5.1 Not much. People with over 35,000 pounds in a deposit, except when buying, or selling, a house should be in a position to look after themselves.

5.2 Not much, but beneficially.

5.3 Since other financial products do not have the advantage of a Deposit Insurance scheme, it would help, in terms of competition equality, to keep the limit at pounds 35 K.

5.4 I would choose the option outlined in Section 5.14c.

5.5 Balances held temporarily, and at low interest rates. Any balance, over 35 K, which was clearly an investment, for example a large CD or with an initial maturity of 6 months, or more, should not be covered, (beyond the 35 K limit). Again this would be out of concern for competitive equality amongst savings media.

5.6 No expertise on this.

5.7 The key issue is the speed of the <u>interim</u> payment. If my bank shuts, seven days would be a long time to wait for spending money. So long as a reasonable interim payment could be made quickly, preferably within a couple of days, then complete, final payment, dealing with all the multitudinous detailed problems involved could perfectly easily be delayed for weeks or months.

You should distinguish even more than you do in Section 5.22 between the urgent, essential interim payment, and the full final reconciliation.

5.8 – 5.9

No expertise, but I cannot see why banks should not be and (and keen) to do this, e.g. on the basis of a recent bank statement from the failing bank.

5.10 If the interim payment could be, say, equal to the latest bank statement, up to 300 pounds, and, say 50% of the statement beyond that sum, it should cover most urgent needs.

5.11 – 5.13

I do not know. No expertise.

5.14 A note on the regular bank statements.

5.15 I am not properly aware of the present detailed eligibility criteria for the FSCS, but what should be the status of:

- Deposits with UK banks in <u>branches</u> outside the UK, e.g. in the Channel Islands, Isle of Man or elsewhere?
- Deposits with UK banks in <u>subsidiaries</u> outside the UK, e.g. in the Channel Islands, Isle of Man or elsewhere?
- Deposits held in UK sited <u>branches</u> of foreign banks?
- Deposits held in UK sited UK registered <u>subsidiaries</u> of foreign banks?

These points <u>must</u> be clarified in the final legislation. Also note that the proposed Deposit Insurance scheme for the UK may be more generous than those abroad. How would a Chancellor feel if large amounts of deposits were shifted, shortly before failure, from abroad, by a bank in difficulties to take advantage of the UK scheme? What if a foreign bank should advertise that deposits with it would be placed in the UK to obtain 100% insurance (up to 35 K)? Taking such a legislative step, as this, in advance of a general euro-zone agreement could leave this country at some risk from regulatory arbitrage. Have you thought of that?

5.16 – 5.19

Generally agree with thrust of proposals.

5.20 Strongly support this proposal. Ordinary depositors would often be bemused/suspicious of claim forms, or unwilling to complete them. The FSCS should take the initiative to send out interim payments. The interim payments could be accompanied by a form, to be completed for achievement of full repayment.

As to risks, what is the experience of other countries?

5.21 In favour of pre-funding, it possible linked to measurable criteria of default risk. I would be opposed to pay-as-you-go funding from the private sector.

5.22 No expertise on this.

5.23 Strongly support

5.24 – 5.27

These are matters for British banks and the BBA to address.

5.28 – 5.29

Why not make this information an addendum to all bank statements?

5.30 No expertise on this.

5.31 Agree

5.32 No expertise on this.

5.33 Trying to set risk-based levies is a good idea in principle, but it often turns out to be too complex and/or contentious in practice. If attempted here, duplication could be avoided by having the FSA provide the FSCS with the FSA's estimated scale of relative riskiness.

<u>Answers to Chapter 6</u>

6.1 / 6.2

I do not see the point of this at all. The main problem for the Bank's role in financial stability is that it has no <u>instruments</u> to wield (analogous to the interest rate of the MPC). The Bank can, and does, use money market operations, and ELA (LoLR), but it has been able to use these for centuries without formal, statutory authority. You need to think more about function and less about administrative procedures.

Giving the <u>full</u> Court any responsibility for financial stability is not sensible. The, present and past, members of the Court are senior, eminent people often with much knowledge of particular sectors of the economy. They provide overall wisdom; they are a sounding board; they can offer managerial oversight. But with few exceptions, they have no particular expertise on financial regulation, financial markets or financial stability.

In previous years the Bank did have an advisory Board of Bank Supervision, made up of senior experts in this role, to help with its, then larger supervisory and regulatory, responsibilities. I do not have the experience, or knowledge, to know how much help BoBS actually was. Brian Quinn would know. BoBS worked independently of the Court.

The present proposal strikes me as an attempt to abolish the present Court, and to replace it with a reconstituted BoBS, which would also take over some of the roles of the present Court. Is that really a good idea?

Key issues relating to Financial Stability are also often extremely market sensitive. Such BoBS members could hardly then be employed in commercial activity; that would limit members to the retired, the voluntary sector, or academics. And just what would they do in their Financial Stability remit?

The basic problem is that no one has really worked out yet what is the appropriate function, if any, for a Central Bank charged with responsibility for overall financial stability, but bereft of any supervisory responsibility.

I tried to provide such a function in my own proposal, added here as Appendix A.

Until the question of what are the appropriate functions, and instruments, for a Central Bank to carry out in pursuit of financial stability, the question of adjusting the legal and administrative procedures seems premature.

The 1997 measures, and 1998 Bank of England Act, were exactly right because the relative functions of the Chancellor and the MPC had been properly and fully worked out in advance. This is not so now in the case of Financial Stability.

Answers to Chapter 7

7.1 The existence of the Bank of England's Financial Stability Board (mentioned in Section 7.12) has not been previously reported. Its membership, role and functions have not been made clear. What would be the relationship between this Board, and the suggested, new smaller Court, outlined in Chapter 6?

7.2 Not much. As I repeat, ad nauseam, the need is not for rearranged administrative responsibilities nor for additional 'early warning systems', but for specific instruments, control mechanisms, to deal, contra-cyclically, with fluctuations in liquidity and risk aversion.

7.3 Not much. A relatively harmless proposal but entirely ignores the real problems.

7.4 The great relief in 2007/8 has been the absence of significant cross-border defaults, so far. It will be urgent to have some agreed principles/mechanisms in place before such a cross-border default does eventually happen.

Answers to Impact Assessment

A.1 No

A.2 No

A.3 Yes