

# WESTMINSTER ECONOMICS FORUM

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Are policy-makers revising financial regulation correctly in the aftermath of the financial crisis?

Date: 26th October 2009  
Venue: NIESR, 2 Dean Trench Street, Smith Square, London, SW1P 3HE

Speaker: Professor Charles Goodhart, CBE, FBA  
Chair: Dr Martin Weale, CBE

A summary by Paul Wallace of The Economist

An extraordinary banking crisis has wreaked immense economic and fiscal damage. The natural response is to say "never again" and to take all necessary steps to achieve that aim. But counter-measures will work only if they go to the heart of the problem. In a provocative talk, Professor Goodhart set out his views on what went wrong and questioned some of the reforms now being proposed.



## SUMMARY

Paul Wallace of The Economist

In the wake of the gravest financial crisis in a lifetime, an eclectic array of counter-measures have been proposed to try to prevent another one. Some of these make more sense than others, suggested Charles Goodhart in a wide-ranging analysis of what went wrong, the regulatory lessons that should and should not be learnt, and the likely outcome in practice. Professor Goodhart pointed out that finance is inherently procyclical. In the upturn, asset prices rise and leverage (the ratio of total assets to capital) increases as banks extend more credit. Risk appears to decline as standard measures like volatility or the proportion of non-performing loans fall, giving further impetus to the upswing. When the cycle turns, these processes go into reverse, amplifying the downward phase.

The adoption of Basel II banking-capital requirements and the move to mark-to-market accounting intensified this procyclicality. Both had merits. Basel II improved on its predecessor by taking account of the varying riskiness of loan books and including off-balance-sheet activities, such as conduits, that had been created to avoid Basel I

stipulations. In normal times, mark-to-market valuations offer a better gauge of the health of a bank than historic accounts. But each added to the procyclicality of the financial system and, crucially, no offsetting steps were taken to neutralise that effect.

A transatlantic regulatory rift made things worse. European supervisors were prompt to adopt Basel II, whereas the American authorities delayed implementing it, partly because they had an independent tool in the form of leverage ratios. This created the opportunity for international regulatory arbitrage on a grand scale. American banks fed the subprime mortgage credit boom but dodged leverage curbs by securitising the loans and sending them across the Atlantic. The European banks were more than happy to bulk up their balance-sheets with the securitised assets since they were mostly high-rated and required relatively little capital under Basel II.

An underlying weakness was the lack of global rules on liquidity, which banks duly exploited. In Britain for example, banks had held liquid assets, such as bills as well as

cash, worth as much as 30 per cent of their balance-sheets in the late 1960s, but these had dwindled to less than 1 per cent on the eve of the crisis. Banks switched instead to managing liquidity by adjusting their funding rather than their assets. The fatal error was to assume that international wholesale money markets were so big that they would remain open at all times.

Were such misjudgments a consequence of moral hazard? Professor Goodhart described as vastly exaggerated the notion that banking bosses bet their banks because they knew governments would bail them out. They were fools rather than knaves. He also gave short shrift to the contention that misaligned remuneration incentives were to blame by encouraging bankers to behave more riskily. Recent research had shown that the greater the equity stake bank bosses had, the worse their banks fared: Dick Fuld of failed Lehman Brothers, who had much of his personal wealth tied up in the investment bank, was not an exception.

Turning to counter-measures, the speaker had some sympathy for the idea that banks too big to fail are too

Paul Wallace of The Economist

big. Concentration of the banking sector was undesirable if it suppressed competition. But although it might make crises more serious - bigger banks are more contagious - it also made them less likely. The banks that failed in the American depression of the early 1930s were small and undiversified. The crucial problem was contagion rather than sheer size.

He rejected the proposal to separate "utility" banking - limited to deposit-taking and payments - from "casino" investment banking while confining government guarantees to the narrow banks. The biggest single policy mistake in the crisis had been to let Lehman - a pure casino - fail. The reform ignored the boundary problem. Unable to make higher returns by taking on credit risk, narrow banks would offer less attractive deposit rates, prompting their customers to take their business to unprotected banks. In bad times, they would try to shift their funds back into the guaranteed sector, bringing the banks they left behind down with them.

By contrast, reforms requiring banks to hold more capital and liquid assets made a lot more

sense. Professor Goodhart favoured varying capital requirements over the cycle, so that they would rise in the upturn and fall in the downturn, thus tempering procyclicality. This approach was backed in Europe but less so in the United States where there was support for an alternative approach requiring banks to self-insure against crises by issuing debt that could be switched into equity if necessary. An international accord would not take shape until 2011 at the earliest and while it would toughen up both capital and liquidity requirements it was unclear how and to what extent it would be more counter-cyclical.

The speaker concluded by predicting the return of securitisation, albeit in simpler and more transparent guise. As banks had to hold more capital, the costs of financial intermediation would rise, shrinking traditional banking activities, notably the relationship banking common in mainland Europe. Reform would thus, ironically, favour the vilified Anglo-Saxon model of capital markets.

Philip Davis, the discussant, argued that early warning

systems could help to forestall financial crises. Credit indicators and asset prices offered important clues, as research at the Bank for International Settlements had shown as early as 2002. More recent work that he had done with Ray Barrell of NIESR had shown that bank leverage and liquidity ratios together with property prices could provide useful warnings in OECD countries.

Replying to this and other points raised in the subsequent discussion, Professor Goodhart doubted the value of early warning systems, arguing that crises by definition could not be anticipated. He backed "living wills", which were essential to deal with the cross-border snags that made it difficult to allow international banks to fail. Reforming the governance of banks was crucial but at the same time the trickiest problem of all. As for hopes that regulatory reforms would prevent future blowouts, he feared these would prove illusory once the generation of bankers burnt so badly this time round had retired.

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From here you can view or download papers and presentations from previous WEF seminars and find summaries, provided by Paul Wallace of The Economist. Details of forthcoming seminars are also listed on the site.