

# CSFI

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**Regulatory reform in the UK (2): The policy response. A round-table discussion with John McFall MP, Charles Goodhart, Mark Hoban MP, Tim Congdon, and David Green. Held on Tuesday, February 26, 2008 at Watermen's Hall, 18 St-Mary-at-Hill, London, EC3R 8EF, from 12:30-2:15pm.**

The Treasury Select Committee (TSC) report into Northern Rock is the first authoritative investigation of what went wrong and the prescription for future regulation. The first speaker outlined the main recommendations and findings. The primary cause was a reckless business strategy and failure by non-executives to hold management to account. The Financial Services Authority showed a systemic failure to regulate while liquidity regulation in general had been sidelined. There was a lack of clarity over the deposit compensation scheme while the concept of co-insurance – sharing responsibility between bank and depositor – made the run on the Rock rational. There was a failure of communication by the Bank of England (BoE) so that it seemed to be acting as lender of last resort rather than supporting a sound institution.

An Office of the Deputy Governor of the Bank of England and Head of Financial Stability should be created with a staff drawn from the FSA and BoE and responsible to the Chancellor. This should act as a bridge between the FSA and BoE - something woefully lacking during the crisis. The incumbent Sir John Gieve was in holiday in France at the time of the crisis, the speaker noted. The FSA would be the primary regulator with the BoE looking over its shoulder. The idea of "prompt corrective action" approach adopted in the US where authorities can identify problems and take steps to lessen the wider impact should be followed. Deposit insurance should be pre-funded by the banks and – most controversially – bank CEOs should be financially qualified.

The second speaker said the Rock's failure did not mean the procedure was wrong. In fact the tripartite system was inevitable as it combined the money (Government), regulator (FSA) and liquidity (BoE). There was no case for change. One issue is the mismatch in ethos and culture of financial supervisors, who are drawn from lawyers and bankers, and central bankers, drawn from economics. That was concealed in the UK as so many people from the BoE moved to the FSA. That effect is fading and being magnified by the inequality of resources between the two bodies. The idea that overlap is inefficient is wrong – in fact the UK needs more. He said the TSC should reopen the debate on the structure of supervision that had been dormant since 1997. This should include a debate over the tools needed to do the job. The BoE's financial stability function is no more than a talking shop because it lacks any tools. He suggested capital adequacy rules; caps on loan to value ratios for mortgages; and an ability to link emergency loan rates to prior lending records.

The third speaker said the tripartite had acted as three separate – rather than overlapping – circles and that there should be more overlap. The BoE should have responsibility for intervention but that requires it to build greater understanding of private banks. He said the

deposit scheme should be post-funded i.e. guaranteed by the taxpayer. One member asked what collateral the BoE should accept, drawing a contrast with Black Wednesday in 1992 and the recent crisis. The second speaker said the BoE should resist loosening collateral requirements, as that would underwrite banks, whatever their behaviour.

The fourth speaker remarked that supervision was always out of line with current market circumstances because of a lag effect. Each phase of regulation begins with a response to a major incident that leads to calls for tightening of requirements that take time to put in place. While that is happening people complain the economy is being held back, leading to a loosening of regulation. This coincides with the next market event and the cycle starts again. In this case, co-insurance and limits on deposit compensation were based on the experience of BCCI and the need for consumers to take more care.

Politicians should look at the larger picture. While the BoE used to focus on bank lending it now is solely preoccupied with monetary policy and inflation. Lax monetary policy may have contributed to excessive and reckless lending. Currently monetary policy is not allowed to think about. We may need to look at the link between monetary policy and financial stability. The second speaker said it would be wrong to try to use one tool – interest rates – to target inflation and asset prices. If the BoE were to do that, it would need more tools.

The fifth speaker said not only was Northern Rock technically “bust”, the whole UK banking system is too. That is not to say they are not solvent – they are. Even the Rock was solvent based on its first-half results. The problem arises from the fact that banks have sight deposits - credit balances on customers’ accounts – of £800bn but accessible cash of £20bn. If there was a general bank run and customers demanded 3% of their deposits, or £24bn, back they could not meet that. What would be official response be? The BoE could lend to them to ensure all deposits are repaid in cash or the Government could underwrite a guarantee on all deposits. However that would breach EU rules on state support if it lasted than six months. Given that it would take banks more than six months to wind down their assets, the outcome could be problematic.

Looking forward, the BoE’s role as lender of last resort must be made explicit. There should be clear rules on collateral and terms for loans. The BoE should be privatised with capital provided by the banks. This would make the BoE and the banks responsible for financial stability. The BoE should be free to decide the terms on which it lent. Oh, and his rating for the Treasury? BBB – blunder, bungle and bosh!

The only issue the speakers had not addressed was whether the Government would get its money back – a question the chair put to the panel. The last speaker expected it would be repaid in full, as the public sector would benefit from interest on its loans and an equity stake in the Rock. The third and fourth speakers doubted it would get all the money back because of the state of the economy. The second speaker said the Government was exposed to falls in house prices and rises in repossessions that would push the Rock into a loss. The first speaker urged all to read the full TSC report for the answers!