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Regulatory reform in the UK: The role of the tripartite arrangement. A round-table discussion with Michael Foot (Promontory Financial Group), Sir Malcolm Williamson (National Australia Group Europe), John Kay (*Financial Times*) and David Lascelles (CSFI) on Tuesday, February 19, 2008 at Watermen's Hall, 18 St-Mary-at-Hill, London, EC3R 8EF, from 12:30-2:15pm.

The tripartite arrangement over financial stability between the Treasury, the Bank of England and the Financial Services Authority has come under serious scrutiny in the wake of the Northern Rock fiasco. The first speaker took the round-table back to 1997 when it was set up following the creation of the FSA and reallocation of responsibility for prudential regulation from the Bank. He recalled it took 18 drafts and lot of bitter negotiating between the three sides. By 2004 it was seen as a well-working body that had survived the Y2K scare and 9/11 without any upset. In 2006 the arrangement was recast to give overall responsibility to the Chancellor.

The speaker made three points. Firstly since 1946 the Government has had the power to instruct the Bank to take a particular action but has ever used. Thus concern over that change in the 2006 agreement was probably misguided. Secondly it was clear that resolving crises needs rapid execution yet bizarrely it took almost three days for details of the Government's bank deposit guarantee announced in the Commons to be published. There is a case to answer there, he said. Finally it criticism of the process of the tripartite agreement is a mask for criticism of the substance of the decisions. While it is a good idea to review the agreement, we should stick with it and decide how it can be improved.

The second speaker said the phrase "if it ain't broke, don't fix it" applied. This crisis was no different from prior ones. They all began with banks competing over marketing, then over price, then product innovation and finally over risk and covenants until some arcane economic event triggers a bust and the process starts again. The latest crisis that began with subprime housing investment and was exacerbated by off-balance vehicles is no different from previous ones.

That doesn't mean there are not lessons to be learned. First the FSA must ask why it was facing the wrong way when a train hit the Rock. The bank had run an "excessive" business model was allowed to run unchecked through the good times. The price is now being paid by well-run banks thanks to tighter credit conditions. The Bank did not make liquidity available soon enough despite having warned for years of a credit event. The Government should have nationalised the Rock on day one, instead of raising expectations of a rescue to stupid levels. However some members said this crisis was different, being a crisis of liquidity and the first one since the introduction of mark-to-market rules.

The third speaker used the recent crash-landing of a BA plane at Heathrow as an analogy of why its financial equivalent had failed. While the pilot was skillful in landing the plane,

real credit should go to the system that ensured all pilots were well trained for all contingencies. The fault with the tripartite agreement was that the parties had not outlined specific actions to be taken and equipped people with the tools. Instead there has been a blame game and a rush to rearrange the institutional geometry.

The two tools needed are a proper deposit protection scheme which 100%, immediate and up to £35,000; the second is a special administration procedure similar to one operating for water utilities. The speaker said any redesign should have less regulation rather than more. It is pointless to look at what the FSA might have done. It could have warned the Rock its business model was unsafe but if it had not responded, would the FSA shut it down? If the FSA is to be that deeply involved, we should simply nationalise all banks. Sadly the speaker feared the authorities would “blunder on” rather than making those simple reforms. One member asked whether the systemic risk posed by the credit crunch demanded tougher action. The third speaker said it was not a systemic problem. The systemic risk was of a run on all UK bank deposits. The reason the Government had to give a blanket guarantee was that it did not have the robust deposit guarantee scheme the speaker recommended. He said the European Central Bank and Federal Reserve had been wrong to send a message that however foolish people were, the government would bail them out.

The fourth speaker said if there was a fault with the tripartite scheme it was with the Bank. The agreement was structured in a way to save the Bank's face following the removal of financial regulation responsibility. It was given an excessively large role and too much independence. The most damaging aspect was when Mervyn King went public with a philosophically different view to the Treasury on bailouts. Had the Bank acted “mechanically” to save the Rock, the situation could have been resolved more quickly. It was shocking that it took this crisis to reveal that there doubts over the legality of an intervention. Any reform should give the Bank the task of intervening once the Government has made the decision. One member doubted the Bank would be prepared to accept that role. The speaker admitted it would be a “humiliation”.

So has the City been hurt by this? The panel was in agreement on this issue. The fourth speaker said the City has suffered public embarrassment but he doubted it would have a long-term impact. “Memories are short,” he said. The second agreed, but warned there was a risk of over-reaction that would harm the City. The third speaker said the City had the potential to benefit if it led to a reform on the lines he had outlined. This was a test case with a small crisis; the right reforms put in place now would help tackle the larger crisis that may come sooner rather than later. The first speaker agreed saying that next crisis might be large enough to make the Rock look like a pimple on the Prime Minister's behind!