

A proposal for how to avoid the next crash

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The likelihood of a credit crunch, though not its exact form, was in fact well forecast by the regulatory community. The Bank for International Settlements had been predicting it for years and most other authorities had been warning about the underpricing of risk and the probability of a sharp reversal for some time.

The main problem is not the structure of regulatory oversight, either national or international, but the lack of counter-cyclical control mechanisms or instruments. Having foreseen the danger, the regulatory authorities did not have the instruments to do much about it. The Basel regime for capital adequacy does nothing to constrain credit booms. Its effect, if any, on the crunch will be to deepen it further.

The crash of 2007-08 has laid bare the poverty of the current regulatory philosophy. At the heart of the present approach are estimates of risk and value that use current and past market prices. This convergence of market measures of risk and regulatory capital looks sophisticated and makes life easier for banks. But it is puzzling why market measures of a bank's risk should be at the centre of financial regulation.

The reason why we have bank regulation is that every now and then markets fail and the resulting crashes have widespread and devastating effect. Yet regulators have used market prices to build their defences against market failure. Unsurprisingly, this has proved as much help as the Maginot line. If market prices were good at predicting crashes, they would not happen.

The risk sensitivity approach is upside down. Statisticians need to stand back a little and look at the broad sweep of financial history. Financial market crashes do not emerge randomly, but follow booms. What fuels the boom are market estimates that risks are low. This optimism encourages imprudent lending, which eventually leads to the next crash.

Boom-time is the best time for financial institutions to make provisions, but the incentives are for banks to respond to falling margins of a maturing boom by chasing after the marginal borrower. Current regulations do not pull them back but let them run ahead.

Market-price-based, risk-sensitive models tell banks in the up-cycle that risks have fallen and capital is sufficient for more risk-taking.

We propose that bank capital requirements should not only be contra-cyclical but also related to the rate of change of bank lending and asset prices in the relevant sectors. The capital adequacy requirement on mortgage lending could be linked to the rise in both mortgage lending and housing prices, and lending to construction and property companies to the rise in such lending and in commercial property prices.

Where there are less reliable guides to asset prices, more weight would be placed on the growth of bank lending by itself, perhaps supplemented by prices in the relevant equity market sector. The purpose of the exercise is not to end the cycle, but to build up reserves and to restrain bank lending during asset price booms, so as to release them during asset price depressions.

We do not advocate doing away completely with a floor to capital adequacy requirements. But this could be lower and simpler than today, say 3 per cent on a ratio of capital to total liabilities or assets. The bulk of the risk sensitivity requirement should be related to the growth rates of bank lending and asset prices. There are, of course, some technical problems, but once the principle is accepted, these problems are solvable. The current approach is not short of technical issues either.

We also advocate a time-varying maximum loan-to-value ratio for residential mortgages. If this approach were put in place by the Basel Committee of Banking Supervision, it would tend to mean that growth in mortgage lending would be increasingly redistributed more evenly around the world, but that is not such a bad outcome.

More generally, relating capital adequacy requirements to the rate of growth of lending would further stimulate banks' efforts to unload assets off-balance-sheet to quasi-banks. Additional steps would be needed to limit this.

It would be possible to introduce these contra-cyclical measures to the new framework of banking regulation, under the umbrella of pillar 2 of Basel II (dealing with the supervisory review process). A further potential benefit of this approach would be to reduce pressure from the financial system for central banks to adjust monetary policy in the heat of the moment.

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