Lessons from the Crisis for Financial Regulation: What we need and what we do not need

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In its broad outlines the current financial crisis was foreseen, though not in its specific detail. Virtually all of the major central banks and international financial institutions had been warning about the underpricing of risk and excessive leveraging by 2006/7. the BIS had been warning about it for years. Admittedly few outside the banks themselves knew about the growth and extent of the grey, or shadow, banking system in the guise of conduits, SIVs, etc., and, since a main rationale for this shadowy sub-system was regulatory arbitrage, the banks were not loudly advertising such activities.

So I very much doubt whether insufficient information was a major problem in this crisis. And even if the central banks had had more information, what could they have done with it? There are those who believe that public warnings, based on better information, would help. But I remember Robin Leigh-Pemberton warning the British banks in 1988/89 against making more property loans. And did it make a blind bit of difference? Even if Mother Teresa, the Archbishop of Canterbury and the Pope were to warn against a certain line of bank activities, it would do no good; indeed probably the reverse because immoral actions are usually short-term fun and profitable.

The problem is <u>not</u> information, but the lack of instruments that can be used to counter the bubbles in asset prices and bank lending that precede and create the subsequent bust (and also the will to use such few prudential instruments as may be available to temper an asset price bubble). When I served Eddie George as an adviser on prudential matters, the Bank of England had a financial stability committee, meant in some ways to be the counterpart of the Monetary Policy Committee. But it was not, of course. The MPC sets the interest rate; it has a role and a function. The FSC set nothing; it had nothing it could set; it was just a talking shop, rehearsing potential fragilities and dangers in the financial system, to be later revealed to a public, awaiting with anxious trepidation, in the Bank's <u>Financial Stability Review</u>.

Now this is better than nothing, but not much. The Bank's FSC, the BIS and the IMF can warn till they are blue in the face, with the benefit of more and more information, but it will not do much good. What we need are counter-cyclical instruments.

Can we use the one counter-cyclical instrument that Central Banks now have, the interest rate, to counter asset price bubbles? Most economists say, 'no'; interest rates should be predicated to achieving price stability. Broadly I agree, but I would make two points. First, should not a proper definition of price stability include housing prices; currently excluded from the European CPI; and second even if interest rates were to lean a little against asset price bubbles, (and those in bank lending), for example via Otmar Issing's second pillar, it probably would not be enough to flatten a strong bubble and bust in asset markets by much.

What else have Central Banks got to counter asset price, and bank lending fluctuations? Most regulation is currently pro-cyclical. The combination of Basel II and mark-to-market accounting further drives the procyclical spiral. Most official, and unofficial, studies of the financial turmoil have been silent on the responsibility of the regulatory system for our present troubles.

At least when the bust does finally come, central banks can help pick up the pieces with liquidity support. But here there are problems too. First there is the stigma issue. Because of this many of the supposed first-round defences, for example lending at the discount-window, or upper band, became largely unusable. Second, when push came to shove, Central Banks were effectively forced to lend to all systemic parts of the financial system on the basis of whatever the latter had available. Is there not a moral hazard in that? Why should commercial banks hold low-yielding safe assets in good times, if central banks will lend on anything that banks can rustle up in bad times?

Central banks did nothing during the asset price and leveraged credit bubble prior to 2007, because there was almost nothing that they could do. And now there are suggestions that central banks should be made statutorily responsible, at least in the USA and UK, for systemic financial stability. You may have heard the phrase, normally attributed to newspaper magnates, that ‘power without responsibility is the prerogative of the harlot’. Well, ‘responsibility without power is the prerogative of a eunuch’. Not only are our Central Banks currently eunuchs in this case, but the life of a harlot probably involves more fun and better earnings than the life of a eunuch.

So, what needs to be done to give our central bank some balls? In broad terms capital and liquidity requirements have, somehow, to be made counter-cyclical, and I would add maximum, time-varying, loan-to-value ratios reintroduced. There are four generic counter-arguments against doing all that:-

First, it raises the cost of borrowing in good times, and hurts in particular the first-time buyer in the housing chain then;

Second, if introduced separately in an individual country, it will just drive the business off-shore;

Third, it may greatly increase the informational burden on banks; and

Fourth, by imposing greater costs on commercial banks during expansionary phases, it will even further enhance the incentive to off-load assets onto associated off-balance sheet entities.

These arguments <u>will</u> be deployed; and central banks need to respond robustly. Moreover the penalties for failure to disclose <u>all</u> associated off-balance sheet business entities need to be reinforced.

Perhaps the most problematical issue is liquidity, because a central bank, as we have now graphically seen, will lend against almost anything when a real crisis hits. My view is that a central bank cannot possibly commit to stand aside in such a case. But it may be able to commit to vary the <u>rate</u> at which it lends depending on the prior history of liquidity maintenance by each bank. If you add to that a Special Resolution Regime such that banks that find higher priced emergency lending driving them towards insolvency can be taken over quickly enough by the authorities, then maybe we can devise enough carrots and sticks to devise a time-varying liquidity scheme. I have already tried my hand at one such proposal in my paper on 'Liquidity and Money Market Operations: A Proposal', available on the Financial Markets Group website at LSE. No doubt that can be much improved. Please do so.

Similarly a time-varying LTV needs to be supported by legal restrictions on second mortgages and home equity loans. Germany, I believe, does this. Should anyone, ever, be able to borrow more than, say, 97% of the current value of a property? If not 97%, what would be your preferred figure? 125% as Northern Rock did? And should appraisers of housing values somehow be made legally responsible, or at the very least independent of mortgage lenders and other interested parties in the deal?

As you mostly know, Avinash Persaud and I have proposed time-vary CARs based on growth rates of asset prices and bank lending, and we have further work to do on that, to fill in many of the important details.

So let me conclude. What does a Financial Stability Committee need to give it potency? What I believe that it must have is the power to revise liquidity arrangements, capital requirements and LTVs on a time-varying counter-cyclical basis. One of the war-time slogans in the UK was 'Give us the tools and we will finish the job'. Currently there are no such proper tools; let us construct them.