

Howard Davies

Banking and the State: changing the social contract

Original citation:

Davies, Howard (2008) Banking and the State: changing the social contract. [Teaching Resource]

This version available at: <http://eprints.lse.ac.uk/21466/>

Available online: October 2008

This is a copy of a lecture given at Barclay's

© 2008 Howard Davies

LSE has developed LSE Research Online so that users may access research output of the School. Copyright © and Moral Rights for the papers on this site are retained by the individual authors and/or other copyright owners. Users may download and/or print one copy of any article(s) in LSE Research Online to facilitate their private study or for non-commercial research. You may not engage in further distribution of the material or use it for any profit-making activities or any commercial gain. You may freely distribute the URL (<http://eprints.lse.ac.uk>) of the LSE Research Online website.

Banking and the State: Changing the Social Contract – slide 1

The last year has not been a good time to be a banker. Since the first wave of the liquidity crisis crashed over us on 9 August 2007 it has been trouble all the way. Every time we think there is a light at the end of the tunnel, it turns out to be an oncoming train. Almost all the statements made by bankers about their business in 2007 or the first part of 2008 are now, as the White House used to have it, “inoperative”.

It has not been a good time to be a regulator, either. My previous employer, the FSA, has also had a difficult year. I did not experience conditions so uncertain and volatile during my period there, though we had our moments with the life insurance industry from time to time. But I know enough to understand that it must be a roller-coaster ride. You never quite know where the next disaster is going to emerge, and at times of trouble the public expectations of what regulators can achieve are often unrealistically high. That celebrated commentator Harry Hindsight, who often appears in the press at these times, has trenchantly argued that the regulators should have seen the trouble coming, and headed it off at the pass. He, of course, would certainly have done so himself, though a diligent Google search has failed to unearth any warnings he himself gave.

Nor has it been much fun in the Bank of England. The Bank has had to operate in very different ways over the last 12 months, and to do things which we know it would much rather not do. The range of collateral accepted in its day to day operations has been broadened well beyond what a central bank would normally like to accept. The term of its lending have been lengthened. And no central bank likes to be dependent on the Treasury, Northern Rock's new owners, for the return of a large loan. That is the central banker's ultimate nightmare. The Bank, like the FSA, has come in for its share of criticism, both in public and in private, whether for being too parsimonious in its support for banks in liquidity stress, or on the other side for being too liberal and contributing to moral hazard by bailing out imprudent bankers who will then do it all over again when the good times roll.

And of course banks themselves have been under attack, from their shareholders who have found the experience of the last year rather depressing (slide 2). The share prices of the major British banks have fallen in the last year or so by around 60% on average. Some of that fall has been alongside the rest of the FTSE index, but by no means all of it. The banks have been particularly out of favour in this downturn, and continue to be. (Slide 3).

Customers have not been particularly flattering either. They have complained that banks have not passed on interest rate reductions to them. Small businesses complain of a tightening of credit

conditions which they think is not always justified. There are perhaps not so many complaints from potential borrowers in the housing market, as the lack of availability of mortgage credit has probably helped keep some people out of a falling market. But those who would like to sell, and who are told by their prospective purchasers that the banks won't lend, are not happy.

Even at the best of times nobody loves the banks. There is something unappealing about people who make money out of your own money, whether as a borrower or a lender. There is a strong populist strain of anti banking sentiment in this country, as elsewhere. This tendency has some fine antecedents, of course, as Christ himself threw the money changers out of the temple. This notion of banking as a conspiracy against the people was perhaps best summed up by Bertolt Brecht. In the Threepenny Opera a character rhetorically asks "what is robbing a bank compared to founding a bank?".

But banks are especially unpopular in two particular circumstances. First, when they are very profitable and, second, when they are very unprofitable. The British banking sector has achieved the unusual feat of managing to swing from one of these extremes to the other in a very short period, so accumulating criticism of both kinds, almost simultaneously. Well done to the bankers here for achieving this unusual double.

So, frankly, the story of the last year in British banks has not been particularly edifying. It has been even less edifying in the United States, but that is no great comfort at present. More recently, there has been significant failures amongst institutions in continental Europe. Now of course the credit crisis has been far more severe than expected. There were those, and I was among them, who thought this time last year that we were headed for recession, but even the pessimists have found the bad news running ahead of them. The Government began by saying that the UK was "uniquely well placed" to weather the storm. That seemed an unwise assertion, since UK consumers are more heavily indebted even than Americans, and UK house prices have risen more in real terms than American house prices (slide 4) over the last decade and more than most other countries in Europe apart from Spain and Ireland. We also have a much larger financial services industry here, which is a benefit to us when financial services are growing rapidly as they have been for the last decade or more, but is bound to be a problem in this kind of difficult market. And we went into the downturn with a loose fiscal position, following an over generous budget in 2007, before the election that never came. The Government has now swung round 180 degrees and Alistair Darling appears to have said – though no one seems quite to know what he said – that conditions are the worst for 60 years. That seems as unwise on the downside as the previous formulation was on the upside. No doubt at some point the Government will find a central position which makes sense.

But the short point must be that conditions in financial markets have been more extreme than anyone can recall. The inter bank market was effectively closed for some time last year. It is still highly stressed, and the securitisation markets have still not re opened. These are really unusual, once in a lifetime circumstances, and it is not reasonable to expect that all financial institutions could position themselves so that they would comfortably survive conditions of this severity. Indeed if they had done, the costs in terms of unused capital in the good times would have been astonishingly high. So I part company with Harry Hindsight and do not charge all the banks with a comprehensive failure to prepare.

On the other hand, it is clear that mistakes were made. Banks were happy to fuel the consumer borrowing binge. They seem to have been somewhat surprised by the growth of credit card and other delinquencies in that market. Mortgages were too easy to get, on multiples often too high, and sometimes with weak credit standards. There was an over reliance on wholesale funding and on securitisation. (Slide 5). There was unwise investment in complex securitisations based on US sub prime mortgages, which it turns out many bankers did not well understand, placing excessive reliance on credit ratings, rather than their own due diligence. Some used consumer deposits to invest in high risky ventures, unaware that risks were correlated with those in the core business. And there was expansion, with associated balance sheet weakening, at precisely the wrong time.

Fortunately, not all of these mistakes were made by any one institution. There was great variation, for example, in the degree of reliance on wholesale funding. (Slide 6). It is not my purpose here to undertake a character assassination of British banks, one by one, unpicking their strategies for all to see. I do not think that is quite what the Barclays had in mind when they invited me, since if I went alphabetically I would begin with them, now that the banks beginning with A, Abbey and Alliance and Leicester, come under S for Santander. But I would say that strategic lessons have emerged from this experience for the banks themselves, and I am not wholly persuaded from what I have heard that those lessons have been well understood. Some of those who made the worst mistakes are still in their jobs, which is surprising. That is not the case in the US.

It is arguable that as a result of all this turmoil the cost of capital has gone up for British banks, and will remain high for some time. The arguments were set out in a very interesting paper produced recently by David Miles, Morgan Stanley's Chief UK economist. His argument is that there has effectively been a switch towards greater use of equity capital by the banks, which has increased the cost of banks' funding, and this trend is more observable in the UK than elsewhere. He argues that the rise in the cost of money to banks has been greater here than in the Euro zone and in the US, partly because of the fall in UK bank share prices which I have described. But it is also because UK banks were much more dependent on wholesale funding than others elsewhere, and by derivation had a higher loan to deposit ratio. (slide 7). The UK ratio last year was above that in

Germany, the US and France, except for the UK banks active in Asia, HSBC and Standard Chartered. The 2007 range was striking, with HBOS at the top of this particular league (Slide 8).

You can see that the banks have found their margins squeezed as the cost of retail deposits has risen quite sharply. (Slide 9). He also estimates that the cost of tier one capital has risen sharply for UK banks (Slide 10).

What are the consequences of all of this for the banks, and indeed for the economy as a whole? They are potentially quite severe. That is partly because the level of household bank debt relative to the size of the economy is greater in the UK than in the US or most of the rest of Europe (slide 11). So a reduction in the availability of that credit may have a more serious effect on the economy here than elsewhere. But in the longer run as far as banks are concerned, I think this will have some quite fundamental implications for their business models, and indeed for their growth rates. Miles thinks this is part of the reason why bank shares here have been hit so hard. I wonder whether banks' management have yet fully digested the impact of all this on their business models, and on their achievable return on equity and growth rates. If this analysis is correct, then both banks and their shareholders will have to lower their expectations of ROE in growth in the future.

However, as my title today suggests, this is not meant to be an exercise in forecasting bank share prices. My main aim is, rather, to talk about the way in which these events have altered the relationship between the banks, the regulatory authorities, the central bank and the Government. I have referred to this set of relationships using the short hand term "social contract", which some may find surprising in this context. We tend to think of social contracts as being labour market agreements, rather than regulatory frameworks. But I think it is an appropriate formulation to use, and indeed I can call on the authority of the Bank of England, no less, in the person of its distinguished Markets Director Paul Tucker, for its use.

Speaking to a Chatham House conference in April of this year Tucker described the social contract, and some of the problems which we have encountered with it recently, in an interesting way. Rather than paraphrase, I may as well quote him directly.

"For over a century – coincident with the development of central banking – there has effectively been a social contract between the banking system and the authorities. On one side of the contract, commercial banks have been permitted to profit from maturity transformation, turning liquid savings into illiquid loans. Commercial banks' ability to do this relies on their deposit liabilities being a universally acceptable means of payment, money. But maturity transformation – borrowing short to lend long – is risky; it relies on confidence. And if that confidence cracks, the costs are felt not just by the customers and shareholders of the banks concerned, but more widely

in the economy given the potential disruption to the payment system. Our monetary economy relies on stability in the banking system. (Slide 12)

The other side of the contract has, accordingly, had three elements designed to protect the economy from those risks. First, prudential regulation of banks, to contain their risk taking and so reduce the likelihood of confidence cracking. Second, deposit insurance, to make retail depositors more or less whole in the event of failure notwithstanding that regulation. And thirdly, central bank liquidity policy. Essentially, central banks have stood ready to provide unlimited amounts of liquidity against good collateral at a rate above the market rate prevailing during peace time. During the recent turmoil that last part of the contract broke down because borrowing from the central bank via premium rate facilities became stigmatised”.

Tucker went on to describe the ways in which the Bank of England's liquidity scheme had been revised in an attempt to overcome that stigmatisation problem. Since then it has been revised further, and was extended in the midst of the recent turbulence of the week before last.

But in fact I think that the events of the last twelve months have thrown all three dimensions of the social contract which Paul Tucker describes into question.

On the regulatory front, the initial reaction to the failure of Northern Rock was to question the structure of regulation in this country, and notably the tripartite agreement. (We have a national weakness for considering structural solutions to any problem, rather than facing up to the possibility that mistakes may have been made, and that mistakes will be made from time to time whatever the structure). Some argued that banking supervision should be returned to the Bank of England, or that some kind of parallel banking supervision department, under a dedicated Deputy Governor, should be set up there. The Treasury Committee have continued to advance that argument.

I am not persuaded by these ideas. My own view is that in general terms the nature of this credit crisis has strengthened the arguments for integrated regulation. Perhaps, as the founding Chairman of the FSA, I am bound to say that. To understand what is going on one needs a good view both of banks' balance sheets and indeed of the securities markets through which much wholesale funding came. In the US, the treasury have argued that their complex system needs rationalisation, moving several steps towards the UK arrangements.

As for the details of the Northern Rock crisis, the Financial Services Authority has acknowledged its supervisory failings, though whether correcting those procedural failings would have prevented the crisis of Northern Rock is a moot point. There are also questions about whether the Bank of

England should have extended its liquidity arrangements earlier, facilitated a take over of Northern Rock, or whatever. No doubt arguments of that sort will rumble on for some time. But these are hard cases, and I do not think that they create a justification for major structural change. I think and hope that the threat of further structural change has receded, though some in the Conservative party would like to shift banking supervision back to the Bank of England. It is not clear to me the banking system would welcome further upheaval of that kind, and I certainly doubt whether it is wise to move responsibilities to an institution which palpably does not wish to receive them.

However, even if structural change is not on the agenda, there are some issues to be dealt with in the regulatory area. Alistair Darling has asked Adair Turner to “review urgently what we need to do to review the system”. What issues might he identify, with Harry Hindsight’s help? I see three, in particular (Slide 13). Should the banks be obliged hold more capital in the upturn, especially when there are signs of the emergence of an asset price bubble. This is often couched as a debate about ‘macro prudential regulation’, as opposed to the micro prudential kind which looks at the position of individual institutions. The notion is that one might determine that conditions in capital markets were such that the risk of a collapse in asset values was higher, and therefore that banks should be making larger provisions. As Tucker said “we need to debate whether or not it would be feasible to design discretionary levers that the authorities could employ as credit cycle circuit breakers”. My own view is that it might be possible to do so, though some of the proposals (which have emanated from Charles Goodhart and others) for automatic increases in capital requirements related to lending growth in an individual bank would not work in practice, I suspect. Overall, though, it is clear that we need to find a way of making capital requirements less pro cyclical in their effect. And that needs to be done in such a way as to preserve competitive equality within national markets, and internationally – not an easy task. A cautionary note however. Capital requirements are very powerful instruments. Raising them sharply would increase the cost of credit to all borrowers. That in turn would have an impact on growth. We need to move carefully.

The second area in which regulation needs to be improved relates to liquidity. It is strongly arguable that the Basel committee has been far more effective in devising capital accords than it has been in regulating liquidity. Only recently, and in response to the crisis, has the committee begun to try to overhaul its rules in that area, and so far without conspicuous success. The FSA has produced some proposals with quantitative rules built in, which the banks are currently considering. This is an area where progress is urgently needed. The crisis has amply demonstrated that liquidity problems can bring down banks just as surely, and more quickly, than a shortage of capital. Banks hold a far lower proportion of their assets in the form of highly liquid instruments than they used to do. Though it will be costly to do so, banks will need to maintain longer liquidity cushions in the future.

The third issue which I consider under this regulatory heading, is what kind of responsibility for financial stability a central bank should have, and what that responsibility means. This is under serious debate in the UK and in the US, and indeed in relation to the European Central Bank which has no supervision responsibilities of its own. In the US the latest proposals from the Treasury would involve the Federal Reserve having a general oversight responsibility for financial stability across the financial system, but would remove it from detailed institutional regulation. That seems to make sense to me, and would align the British and the American systems more closely than they have been hitherto. In the UK, the Government plan to legislate to give the Bank an explicit financial stability duty.

Many people, including those who have worked at a senior level in the Bank of England in the past, have always believed that the Bank had such a duty, though it is fair to say that you cannot find it in any statute. Perhaps it will be helpful to remind the Bank of its responsibilities in that area. But the more important question is just what the practical policies the Bank could and should adopt in the cause of financial stability. Without any policy instruments or levers to pull, this will be no more than a cosmetic change. Will a financial stability duty influence the Bank's interest rate decisions? Perhaps it should, but we have heard nothing about that so far. What I think it could reasonably mean is that the Bank was more actively engaged in macro prudential supervision than it currently is, and I would regard that as generally beneficial.

All of these changes will amount to a revision of this first pillar of Tucker's social contract. So what of the second pillar, the deposit protection arrangements?

When Northern Rock ran into difficulties, the most dramatically visible consequence was the queues outside Northern Rock branches of depositors seeking to rescue their funds. Bradford and Bingley experienced something similar last week. These Northern Rock pictures were seen around the world, and were about as bad a publicity exercise for the British banking system as could be imagined. After some inexplicable delay, the Treasury announced that the retail deposits in the bank were safe, even before nationalisation, and also announced that deposit protection arrangements generally would be strengthened. General astonishment was expressed at the fact that there were circumstances in which individual retail depositors could lose money in the event of a bank failure, and everybody agreed that it would be unsatisfactory if depositors found themselves caught up in a lengthy set of bankruptcy proceedings before they received their money.

In all this debate one could have imagined that the deposit protection schemes had been imposed by some external power, without any involvement by the Government here or the authorities. In fact of course they were carefully considered in the past, many times, and sometimes in public.

The most recent occasion was in the early period of the establishment of the FSA, when there was extensive consultation (Slide 14). In this country we have long had a post-funded, levy based deposit protection scheme as opposed to the American pre-funded variety. And we have also for a long time had a scheme based on some element of what is known as coinsurance, in other words where the payout in the event of failure is not necessarily 100%. When the FSA was established we consulted on various options, and the consensus led to some strengthening of the scheme from a consumer protection point of view, but the retention of an element of coinsurance and a ceiling of just over £30,000. Before the FSA there was no 100% payout at all. The FSA introduced 100% essentially for transactions balances.

The reasons for coinsurance and for a level set around the EU minimum requirement was that a blanket 100% guarantee would damage competition and indeed would create a climate in which banks might imprudently seek to attract deposits by positioning themselves at the top of the interest rate tables, knowing that however risky the institution looked, from a depositor point of view the 100% protection offered by others was a powerful reassurance. Also, there is an argument relating to consumer benefit of a different sort. If bank deposits are 100% guaranteed, that is certainly likely to skew consumer saving behaviour towards the banks and away from other possible homes for their money. Is that sensible? In the long run, might one not advise a consumer with more than £30,000 to invest to consider diversification, in the first place, and to consider some exposure to equities or bonds as well, which would typically offer a higher return over time? So there are non trivial arguments in favour of coinsurance and a modest deposit protection limit.

These arguments might be said to have been superseded by the panic surrounding the failure of Northern Rock. I am a little cautious about reaching that conclusion. In the first place, there is a separable question related to the resolution mechanism for failing banks. There I am entirely clear, that our arrangements are flawed, and I very much welcome the introduction of special resolution mechanism for banks which allows retail depositors interests to be more effectively protected. In retrospect, this should have been done in the Financial Services and Markets Act but it was not. The rational fear of Northern Rock depositors was that they would be caught up in a lengthy process before they received their money. That is a far more important reform than any changes to the deposit protection arrangements, though I would accept that if politicians have a zero appetite for any losses by bank depositors, and will offer 100% guarantee in the event of a failure, then perhaps one is wasting one's time with these market based competition arguments. However, and this is an important new point to emerge, during last autumn we were all told about the superiority of the American arrangements, with 100% deposit protection up to \$100,000, and a pre funded scheme. Yet when the Californian bank Indymac failed, just as with Northern Rock there were depositors queuing up outside the branches. Nobody wants to get caught up in a bank failure,

however much they are told that their interests are protected, and one can exaggerate the practical effects of different types of deposit protection arrangements.

The third and final area, and the one which Paul Tucker himself covered effectively in his April speech, is the way in which the central bank provides liquidity to banks at times of stress. Here it is clear that the three major western central banks, the Fed, the ECB and the Bank of England have all had to change their methods of operating during this crisis. The ECB already accepted a very broad range of collateral at its discount window, largely because its list of eligible assets was a compilation of all the assets accepted by the previous national central banks. Indeed the ECB, somewhat against the trend, have recently narrowed the range of assets they were prepared to accept because they found that some banks were gaming the system and creating liabilities which would qualify for ECB acceptance, for that express purpose.

But have these arrangements resolved the stigma effect to which Tucker refers? One cannot be certain of that. Some argue that the only way that effect can be overcome is if the central bank operates a facility which all banks are using, to some degree, all the time, which somewhat muddies the waters when it comes to larger scale assistance at a time of crisis. The Bank of England is thinking hard about the arrangements it wants to have in place for the longer term, and it may be that that dimension of the social contract does need further re-engineering.

I have another concern in this area. The underlying logic of the social contract as described here is that banks undertake certain risky activities, which are absolutely essential from an economic point of view in that they transform maturities and intermediate savings, and benefit from some potential Government backing in order to allow that beneficial activity to go on. The quid pro quo of that backing is a regulatory regime which protects the public purse against the potential implications of providing liquidity which may turn into solvency. In the past one has been able clearly to distinguish this social contract from the relationship which the authorities have with other types of financial institution, where typically the lender of last resort arrangements do not apply.

But there was a big change to this in the United States around the St Patrick's Day weekend in March, when the Fed facilitated the rescue of Bear Stearns and its transfer to J P Morgan. At the same time, anxious about the confidence effects on other investment banks, the Fed opened its discount window to those banks, making them eligible for the kind of liquidity support which had previously been available to commercial banks. Those arrangements remain in place, though they are still technically temporary. Indeed they were extended to other types of asset, even including equities, at the time of the Lehman Brothers failure. (Slide 15).

Now, of course, the Fed has gone one step further. Even these arrangements were not seen as adequate to reassure the market about the liquidity of the two remaining standalone investment banks, which – ten days ago – transformed themselves into bank holding companies overnight in a process which normally takes years. The Fed now has a direct relationship with investment banks which it has not had in the past. It is highly likely that some regulatory consequences will flow in terms of tougher capital requirement or leverage ratios, as it is unlikely that Congress will accept the continued provision of this kind of support without any constraints on leverage. (Slide 16) So as a consequence of this episode the regulatory frontier has been pushed forward, and a new type of social contract has been set up with the investment banks. They will need to hold more capital in future, for a given size of balance sheet. That has implications for them, and for their competition. There are hedge funds and private equity firms who undertake some of the activities of investment banks, who in turn undertake some of the activities of commercial banks. This is difficult territory, and we do not have time to cover it comprehensively this evening. But it is important, especially in the United States – but though consequences will be felt equally in London – to think clearly about where we want this regulatory frontier to come to rest, and what relationships the authorities might wish to have with firms which are currently outside it. Can we imagine circumstances in which the authorities might intervene to prevent a hedge fund folding up? The Fed came close at the time of LTCM. If so, then should we think of imposing some elements of the other side of the social contract on them?

There have also been some remarkable changes in the competitive landscape. These concern me. In the UK, the competition rules were suspended to allow the merger of Lloyds TSB and HBOS, creating a new institution with almost 40% of current accounts. In the US, megabanks are being created in very short order, in spite of the widespread doubts in the past about whether huge and diversified entities can be managed effectively. There is a growing assumption that investment banks need a retail deposit base, in spite of the fact that the standalone investment banks have typically outperformed the competition in the past. Do we think we were quite wrong in the past? I wonder. New structures are being created in a crisis which may need to be rethought in the medium term.

There is one, final, and most delicate question. If the social contract has changed, and there is a new relationship between bank and the state, with stronger government underpinning of the system, what does that imply for levels of remuneration? If a bank stays in existence only at the government's pleasure, so to speak, should it not reflect that in the way it pays its senior people. The heads of public utilities typically earn rather less than CEO's in fully competitive business. The implication of this crisis is that bankers will be paid less in the future. Should the government or the regulators decree it? I would prefer that not to happen, as it could be the thin end of a very dangerous wedge. Reduced profitability ought to do some of the work but boards will have to step

up to the plate also, or they will find the political pressure becomes intolerable. People are pretty angry about what has gone on in the financial system, and will expect to see some consequences flow. If not, there will be direct political interference. My colleague at LSE, Willem Buiter has put the question very starkly 'Is the reality of the modern transactions-orientated model of financial capitalism indeed that the large private firms will make enormous profits when the going is good and get bailed out and taken into temporary public ownership when the going gets bad, with the taxpayer taking the risk and the losses? If so, why not keep these activities in permanent public ownership?' This is not where I would like to end up. To avoid it, restraint will be needed.

We do not have answers to all of these questions. Central banks and regulators have rationally been engaged, as firemen should be, in putting out fires when they are blazing, and perhaps thinking less about the reconfiguration of the fire service and its coverage which will follow when peace time returns. But we all need to recognise that the consequences of the crisis have been such that we will not return to the status quo ante. The banking world will never be the same again. There will be a new social contract in due course: we are moving crab-like towards one now, and Paul Tucker was right to open up the debate.