

BSA Annual Lecture – 18 October 2007

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“Principles in practice: An antidote to regulatory prescription”

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(1) When I was asked to speak by the BSA, I was inordinately flattered. After all, I grew up in Skipton, and I genuinely believed that the two most important financial institutions in Britain were the Skipton BS and the Yorkshire Penny Bank. An opportunity to show off. We (the CSFI) had just published a Working Group report entitled “Principles in Practice: an antidote to regulatory prescription”, and it was (I thought) a chance to steal all the report’s good ideas, claim them as my own, and advance my career as a cutting edge thinker in the arcane field of financial regulation. Maybe someone would even offer me a contract at the FSA, or ECB, or BIS, or IMF, and I could end my career in a blaze of public sector glory (with a final salary pension).

The problem is that, when I came to think a bit more about it, I realized I was always a bit lukewarm about the premise of the RWG report – that principles-based regulation (as we have it in the UK) is a consummation devoutly to be wished. And recent events (notably the Northern Rock affair, which is obviously close to your own hearts) have reinforced that scepticism. I tended towards an alternative, put forward by one of the Group members (who, in the end, chose not to append her name to the report): minimum standards, with institutions encouraged to compete beyond those minima.

It is not (as I hope to make clear) that I am enamoured of narrowly-prescriptive rules-based regulation, which is usually postulated as the alternative to principles. It is just that I fear:

- that (as Sir Howard Davies has suggested), in practice, there really isn’t much difference between principles and rules-based systems; and
- that, if a regulator really takes principles seriously – and is prepared to prosecute offenders solely on the basis of them - then those individuals and institutions on the receiving end are going to complain bitterly about natural justice (or the lack thereof).

In other words, even though I commend our report to you (and I am very grateful to MW and all the group’s members), I don’t think we are really going to get genuine principles-based

regulation until the last lawyer is strangled with the guts of the last compliance officer. And, since we wouldn't really want it if we had it, we shouldn't hanker too much after it. There are other sticks with which to beat the FSA.

Plus, the principles themselves (at least the high-level ones the FSA professes) are also not much more than mom and apple pie. **(2)**

I assume you have all memorized these, and say them on your knees before you go to bed at night. According to Callum McCarthy, there are only 127 words, which is fewer than "The Charge of the Light Brigade". Of course, there are some problems with these – mostly, I would suggest, to do with adjectives. What is "due"? What is "reasonable"? What is "adequate"? "Proper"? "Clear"? "Fair"? "Open"? "Cooperative"? There isn't a consensual definition for any one of these, and lawyers would have a field day if we tried to define them.

No real wonder, therefore, that the FSA has 8,500 pages of detailed rules to back up these 11 principles. And 2,800 staff to enforce those rules.

That said, the FSA does say the right things. And, it is (I think genuinely) trying to trim its rulebook. It is using its commitment to principles as the excuse for that, but it is an initiative that doesn't need an excuse. Keeping down the number of rules is a good thing in any system. The FSA also insists that it is prepared to prosecute on the basis of breaches of principles alone – as (it says) it did in the cases of Citigroup (£14 million), Deutsche (£6.4 million), GLG and Philippe Jabre (£750k a pop). I don't know all the details of those cases, but I have to say that I am sceptical: GLG and Jabre were fined for market abuse over convertible bond deals. I bet the argument wasn't just over "proper" market conduct; I bet lawyers on both sides fought tooth and nail over whether some very specific rules were broken. And I bet that when you yourselves are subject to intrusive and process-driven supervision – Arrow visits, "close and continuous" assessment for bigger groups – your friendly FSA team doesn't just come in for a tea-and-buns chat about general principles.

Let me indulge in mock maths: **(3)**

$$\text{Principles (p) x Lawyers (l) = Rules (r)}$$

So, in practice, I suggest there isn't much difference between a principles-based system and a rules-based system. After all, FSA-supervised institutions employ lawyers, not ethicists or moral philosophers. And lawyers – even English ones – pay the school fees by reading the small print, not just the headlines.

In my view, there are other things to fight for.

One is to ensure that the FSA doesn't do too much. Whether we are dealing with rules or principles, I think it is crucially important to emphasise that it is not the job of regulation:

- to force everyone to match the standards of the best;
- to impose a zero failure regime;
- to control prices in a competitive market; or
- to “improve” on requirements that are imposed on us by our lords and masters in Brussels or Basel.

Again, the FSA says the right thing on these issues, but it needs to be kept to its word. At the top, for instance, the talk about not running a zero failure regime is genuine. But which line supervisor has ever seen his or her career enhanced by letting an institution fall over? The bureaucratic imperative pushes towards a No Fail regime.

Plus, whether the FSA operates a principles-based regime or not is probably less important – to you as practitioners, to me as a consumer, to the UK as a financial centre – than whether its supervisory regime:

- is risk-based;
- is proportionate; and
- is not (as many people feel it is) simply process-driven.

Those intermediate mid-level-principles are far more important in practical terms than the 11 Commandments.

By “process-driven”, what I suppose I mean is box-ticking, presumably to compensate for senior managers' lack of faith in the judgement and discretion of their juniors. “Risk-based” regulation is important – though as we shall see, just where risk lies these days is hard to judge. But regulation should be aimed at institutions that are actually likely to pose a problem.

“Proportionate” regulation is also crucial; it is silly for the FSA to take a sledgehammer to crack a banker's nuts unless there is some public good involved. And there must be room for initiative and judgement.

But let's step back a bit. In this talk, I want to postulate a couple of my own principles; you can add them to the three mid-level ones I have just noted. I don't have 11, or even 10 Commandments. But here is No 1:

- “All regulation is bad”. **(4)**

This was the message of our last two BBS surveys. As you can see **(5)**, it beat out credit risk, derivatives, corporate governance and that perennial bugbear, the hedge fund manager.

It is also something that we forget at our peril. Yes, regulation is frequently inevitable. But, in and of itself, it is a bad thing – for at least five good reasons that the FSA must recognize:

- It is not a free good. Indeed, it can be very expensive – and its cost is spread over every financial product sold in the UK. (Actually, there is huge controversy over just how expensive it is, anywhere from 1% to 37% of the total cost of doing business. But no one seriously doubts that it can be mind-bogglingly costly.) In the case of long-term products, that cost is magnified by the magic of compound interest.

It is worth emphasizing that the cost has at least three components: the cost of fees to the regulators, the cost of fines (not trivial) and, last but far from least, the cost of compliance – at least part of which, one must acknowledge, is self-imposed. I was at an APCIMS conference yesterday, at which John Hall, the chairman, claimed that the cost of compliance for his firms has risen five-fold in the last five years.

- Regulation is a barrier to entry – another row of bricks on the wall that protects incumbents from the healthy wind of competition. Since the costs of regulation can usually be passed on to consumers, don't expect incumbents to fight too hard against their regulators. In fact, they (and by that, I mean most of you) quite like regulation. The bleating of incumbents against regulation is at least 50% hypocrisy.
- Linked to this, regulation favours the big over the small, since its fixed costs can be amortized over a larger customer base. And most regulatory costs are fixed. That may not matter in boom times, but (as we shall likely see) that is going to be a big problem for smaller institutions on the downward half of the business/credit cycle – which is where I fear we now find ourselves.

- Regulation also inhibits innovation. This is not quite as straightforward as it sounds, since one can make a case that what the UK FS sector suffers from is too much innovation, not too little, and since one can argue that the customer interest would be better served by fewer products, not more. But it seems plausible that putting every new retail product through endless regulatory hoops means at least a few good ideas will be strangled at birth.
- Regulation can hurt the consumer almost as much as it can protect him/her. It does this in two ways. One is the obvious one: it cuts the returns that one can expect on products bought from regulated entities. The less obvious one is that it undermines the principle of *caveat emptor*; to paraphrase Professor Gower, it encourages the negligent to exploit protections that were aimed at the vulnerable. And it makes an already litigious industry even more so.

So, all financial regulation is bad. And it must, therefore, be justified by a greater good that comes out of it.

My second principle is one that I hope will warm the cockles of your mutually-owned hearts:

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“An institution that benefits from the umbrella of regulation must be regulatable.”

This is a tricky one, and so far there is no sign that any regulator has had the courage to tackle it. Until now, regulators have been content to play catch up – trying (more or less ineffectually) to regulate institutions that have, implicitly or explicitly, seen it as in their own interests and that of their shareholders to become:

- too big to fail; and/or
- too complex to understand.

Given that the FSA employs 2,800 people and HSBC well over 100,000, this isn't too difficult. Given what any top investment or commercial bank can pay for first-class brains, it also isn't going to be too difficult to dream up structured products that will make a regulator's eyes whiz round on sticks either. And the whole farrago is made worse by the compression of generations in the FS sector – which means that there is no such thing as corporate memory any more. This is just as true in High St. banking as it is in the go-go-world of investment banking; my guess is that is it equally true of the BSA's membership.

Jumping slightly ahead of myself to the sub-prime/Northern Rock affair, two examples of this come to mind:

- I mentioned to the *FT* journalist who has been covering the crisis my surprise that Ed Cahill, the Barcap executive responsible for the Irish conduits that got Barclays into trouble, was only 33. “Only 33”, she said. “That’s old.” Most people in his department were in their twenties – which means they were barely through puberty when Barings failed.
- Linked to this, don’t you find it astonishing how the off-balance sheet SPVs we excoriated at the time of Enron (and swore we would never let auditors tolerate) have re-emerged as “conduits”? A small door prize for anyone who can explain the difference between IBK’s conduits and Enron’s SPVs.

The result is that, all too often, regulators kowtow to the biggest and most complex banks, while beating up on the littler and simpler ones. (This is specifically reflected in Basel 2, the new capital rules, which explicitly accept the validity of those VaR models promoted by the banks that we are now learning are deeply, perhaps fatally, flawed.) Of course, big oaks can grow from little acorns – and I must acknowledge that big problems can be caused by little institutions. Unfortunately – since that does rather undercut the argument that the BSA’s membership should creep in under the regulator’s radar.

This brings me to the current crisis, and what it means for regulation – at your end of the market and for the LCFIs (who would love to make the case, as they tried a few years ago, that they are so sophisticated, so clever that they don’t really need supervising in any conventional sense).

Lets look at this crisis – and, as an economist, I genuinely think it is a crisis, because chances are at least one in three that it will tip the global economy into something very close to an old-fashioned recession and because it risks doing for the dollar what 15 years of benign neglect by the Fed have failed to achieve. A hard landing.

If you boil it down, what caused the original problem in the US was a combination of (old-fashioned) rotten lending and (new-fangled) financial engineering – which immediately globalized the problem. Everyone (and I include myself) had known for years that the sub-prime mortgage market in the US was a disaster waiting to happen – predatory lending, commission-driven sales forces, politicians urging a blind eye. But it also produced a product with so much vigorish in it that the financial engineers on Wall St. couldn’t stay away. Hence, the transmogrification of dross into gold – or sub-prime debt into investment-grade CDO

tranches that could be sold off all over the world. Especially if the buyer had a nifty little off-balance sheet conduit into which he could stuff them.

That process of securitization was the vector that spread the plague. From Countrywide in the US to IKB in Germany was an electronic blink of an eye. And one imagines that IKB was far from the only second-tier Continental institution that stuffed itself with complex CDOs and CLOs that it didn't understand, but which promised speculative returns on investment grade paper. It would be invidious to name names, but I bet I could pinpoint half-a-dozen banks – German, Dutch, Swiss – with just as dodgy portfolios, who are being kept alive on a diet of regulatory forbearance and central bank liquidity. (In that sense, I guess, our own dear regulators – who are a bit more transparent than our cousins across the water – have got a bum rap.)

But, in a way, the Continent's problems are less interesting than our own little local problem.

The Northern Rock affair is, at the same time, parochial in the extreme and profound in its implications:

- parochial, because it was only the UK's fifth largest mortgage lender, with a trivial branch network and no international presence. Not even sticking an aristocrat on the top of the tree gave it much of a sparkle.
- profound because it has already provoked the first bout of regulatory soul-searching in the UK since the FSA was set up in 1997. I am not sure just what kind of a shake-up is in the works, but a lot of questions that we thought had been answered are now back on the table. And (as someone who was always a bit sceptical about the massive concentration of power in a unitary regulator) that is no bad thing.

Northern Rock is also an almost perfect example of why regulation is so damn difficult – and why even the most obvious principles can sometimes look rather silly. I alluded earlier to the importance of insisting that the FSA's regulatory regime is "risk-based" and "proportionate", and that the regulators don't just thump the little guys because they can't fight back. I believe that – as, I assume, so do you. The problem is that Northern Rock was a little guy – albeit a little guy with ideas above his station. The Northern Rock affair is an example of the damage that can be caused by even a second-tier institution. It may not have been a 10-tonne truck going berserk in Piccadilly; but even a Mini can do damage in the hands of a drunken driver.

I don't want to go into the details of what actually happened at Northern Rock – but it is worth emphasizing a few pretty obvious points about the bank that were well known a long time ago and that don't reflect well on anyone. In particular:

- its deposits-to-total loans ratio was low by industry standards, even taking account of its securitization programme;
- its dependence on wholesale money was accordingly higher than most of its peers; and
- its lending practices (though way short of, say, Countrywide in the US) were at the more aggressive end of the spectrum.

Hence – and this is, I think, important for you in making the case against an FSA backlash – there were good reasons for the regulator to have kept a special eye on Northern Rock. The fact that (despite what FSA officials told the Treasury Select Committee) it doesn't really seem to have done so may have had something to do with the fact that the responsible line supervisor was off to sunnier climes. But it may equally have been an institutional problem that needs to be corrected since Northern Rock is most unlikely to be unique.

Anyway, when things did go wrong – when the market for Northern Rock's securitized mortgages disappeared and when the money markets themselves essentially froze – Northern Rock was left high and dry, and that's where it remains. Very sad for Northern Rock shareholders – but I don't think even Richard Branson will bail them out. (I was going to make a joke about rebranding the bank as 'Northern Virgin' – if Branson could find one. But I notice that the *Evening Standard* made the same joke on Tuesday. There has to be an alternative: 'Virgin on the rocks' comes to mind.)

The key issue, though, is not the fate of Northern Rock – or even of its CEO (though I do think one lesson is that a bank with a dodgy business model should not be run by someone who shaves his head): It is the regulatory implications – which, as I say, may be profound.

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The main focus of attention at the moment is on the Tripartite Agreement, which governs relations between the Bank, the FSA and the Treasury when it comes to organising some kind of intervention. The formal memorandum that underpins this has already been rewritten once, which suggests to me that there was some dissatisfaction with it even before Northern Rock. Essentially, it sets up a committee (at deputy level) that meets once a month to discuss financial issues, together with a sub-committee structure.

Obviously (as both Governor King and Callum McCarthy have acknowledged) this committee doesn't seem to have worked very well – perhaps because the personalities don't get on as well as they did when all the participants seemed to be BofE alumni. This isn't a profound point: it was made repeatedly when the FSA was set up. These high-level committees depend on personal commitment. If one of the participants prefers to lie on a beach, the momentum dissipates.

But what's the alternative? In a situation in which responsibility is dispersed among three separate agencies, something like the Tripartite Committee is necessary given the overlapping responsibilities:

- the FSA as line supervisor;
- the Bank as guarantor of systemic stability; and
- the Treasury as the national ATM machine.

Clearly, something went wrong. Northern Rock should have stood out like a sore thumb – both because everyone was looking at the weaknesses of the UK housing sector and because of its anomalous business model. There should have been stress-testing, scenario-playing, war-gaming – call it what you will. A special sub-committee should have been set up with Northern Rock's name on the door. And any gaming should have included the possibility that Northern Rock's unusual business model (with its dependence on access to wholesale markets) would have affected its access to liquidity. I really don't think that is too much to expect, and I note that Northern Rock's share price had been under pressure all year – which also ought to have alerted its regulators.

So, that was a failure – and it is one that all three parties must share.

The Bank also failed in its attempt to take a tough line on pouring cut-price liquidity into the market. Intellectually, Dr. King had a strong point: there was huge moral hazard attached to what the ECB and Fed did – intervening on an utterly unprecedented scope, with cheap, almost free, money. But a bit of moral hazard is a small price to pay for averting a full-scale, Technicolor bank run.

The other astonishing failure by the BofE was the admission by Mervyn King that he would have liked to have “rescued” Northern Rock via an arranged marriage (probably with Lloyds TSB) – as used to happen not infrequently in the good old/bad old days of BofE supervision. Unfortunately, at least according to the Governor, at the last moment, he was unable to tie the knot because of a legal opinion from Freshfields:

- that the UK’s Takeover Code prohibited a non-public sale; and
- that the EU’s MAD forbade any kind of secret bail-out.

There has been a lot of controversy about this – particularly about the Governor’s interpretation of the MAD, which has been challenged by DG Markt’s David Wright. But the real issue (to me, at least) is why the Governor hadn’t got this advice – right or wrong – months (or even years) ago. When the Takeover Code was put in place and MAD transposed into UK law. Isn’t that what an in-house lawyer is for?

There is another issue: I bet BaFin and the Bundesbank didn’t read MAD the same way as Governor King. I bet they said “Bugger the markets, bugger transparency, we are not going to let half the landesbanken go under”.

And then there’s the deposit insurance issue. I know the arguments. I know that those who devised the bizarre UK system thought they were striking a jolly clever balance between *caveat emptor* and moral hazard. But, in the end, I fear, the only way to guarantee that retail depositors never take to the streets again is to offer 100% deposit insurance up to a very hefty number (in this age of house price appreciation, and smaller families, £100k may not be enough) – and to make sure that payment is immediate. I know there are a lot of issues about funding this insurance – public or private, a flat rate or risk-based? But I don’t really see an alternative; the banks might as well stop bleating and start working out the costings.

I think the government is also serious about aligning our insolvency laws regarding banks more closely with the US model, so as to permit early intervention . The intention would be, effectively, to take over a failing bank and to preserve some critical banking functions so that depositors get another layer of protection. There are real issues around this, and any bank that was “intervened” in this way would bleat; but it is probably, on balance, a good thing.

Beyond that, what’s going to happen?

Well, there are a few romantics who believe that bank supervision should never have been removed from the BofE, and who want it to go back. Peter Oppenheimer made this point in the *FT*, and I have heard it from several ex-regulators (on both sides of the Atlantic). No dice: The FSA now has almost 3,000 employees; the Bank has only 800. (In comparison, in the 50s, the Bank employed 9,000, thanks to the exchange control regime.) It would be like a mouse swallowing a cat.

But that doesn't get the Bank off the hook. Over the last few years, its financial stability wing has been steadily downgraded – possibly because the Governor himself has been more concerned with monetary policy than with financial stability. Someone is going to have to pump up what a friend of mine called “the collapsed left lung of the Bank”; the Bank is going to have to relearn what the City of London is all about. Unfortunately, since generations have also compressed in central banking, that isn't going to be easy – though bringing back Alastair Clark is a good start. A modest proposal: There are lots of senior folk in the City who are forced to retire, against their will, in their late 50s or early 60s. Give a few an expense account, let them lunch with their old mates, and have them submit a BTO memo to the Bank on City gossip. “Licensed to lunch”, I call it.

Nor does it get the FSA off the hook to accept that putting supervision back in the central bank is impractical.

I know that Hector Sants has insisted publicly that Northern Rock will in no way undermine the FSA's commitment to principles-based regulation (whatever that means) or (more significantly) to its campaign to slim down the rule book. It will, he says, remain focussed on “outcomes” (again, whatever that means). But we are still stuck with the fact that the FSA is an unresponsive behemoth, increasingly driven by a box-ticking mentality. It is too big. It is too distant from what it regulates. It has tried, boy has it tried: it has split itself into wholesale and retail divisions; there are special provisions for large group supervision – and so on. May I just suggest that we think again about the basic structure of the FSA. Maybe The Netherlands and Australia can teach us something. Maybe what we really need is to revisit the idea of a “twin peaks” structure – in which conduct of business regulation is split off from prudential regulation.

This is an idea that we at the CSFI promoted (without success) when the FSA was gestating. It is also an idea that LSE's Charles Goodhart has promoted; it is certainly worth another look.

There is also a cross-border dimension.

For years, the UK has prided itself on being the best (or at least the least badly) regulated financial centre outside the US – but it now turns out that it couldn't even handle the collapse of a second-tier player from Newcastle. What would have happened if Northern Rock had had operations throughout the EU? (Actually, though it isn't really relevant to the argument, Northern Rock would have been better off, since a Continental presence would have permitted it to borrow cut-price liquidity from the ECB – as at least one or two UK High St. banks did.) More importantly, if the Tripartite Arrangement broke down at the first sign of stress, what chance of any memoranda of understanding involving French or German

supervisors, the ECB, or even the Fed? If the FSA and BofE never thought to game the chance that a likely suspect like Northern Rock would find itself shut out of the markets, what chance that international regulators have done the same for West LB or ABN Amro or some Swiss cantonalbank?

We used to be confident that regulators were on top of the challenges facing the FS industry, but the evidence of the Bank and the FSA's testimony to the Treasury Select Committee is that even the best regulators are surprisingly underprepared.

I guess that the Northern Rock debacle will reignite enthusiasm for a single European regulator. As I am sure you all know, the so-called Lamfalussy process (which saddled us with a pan-European regulatory network, but not a single regulator) is currently under review – and even the good Baron himself has, in the past, expressed scepticism about the Anglo-Saxon preference for national-level regulation. Our pretty dire performance over Northern Rock is bound to reawaken those Continental yearnings for a pan-EU regulator in Frankfurt or Paris. Not in London.

Looking further ahead, I think we are also going to see a major shift in the way regulators (national and international) look at bank ratios – and I note that this was flagged yesterday in a speech by the Economic Secretary, Kitty Ussher.

Traditionally, the focus has been on capital – and this is enshrined in both Basel 1 and the dreaded Basel 2 (which some of you may have to cope with). But Northern Rock's problems had nothing to do with capital; as Dr. King said, Northern Rock's capital ratios were A-OK. What it faced was a liquidity problem – something that, as US regulators have pointed out, would have been picked up by their cruder measures. I look for European regulators to opt for something similar. Every decade or so, regulators refocus their attention on liquidity – usually to retire defeated.

In this case, they should try harder. Globalization and securitization mean that the kind of problem that hit Northern Rock is going to be much more of a threat than it was in the past. In the past, banks failed almost exclusively because of bad credit decisions: to paraphrase the old EF Hutton ad in the US, "We lose money the old-fashioned way; we lend it." I am sure that will happen in the future as well. But that wasn't the reason Northern Rock went down: it went down because the market shut on it – and because Mr. Applegarth apparently hadn't wanted to spend his bonus money tying up MAC-proof contingent credit lines. (I hope all of you have taken that lesson to heart.)

The implication for regulators is that they should look a lot more at liquidity, and (regardless of Basel) less at capital. I know of at least one institution that has to operate on a “3-month no credit” basis; that wouldn’t be a bad rule to start with.

What does all this mean for you, the BSA membership? Well, I suppose the message is the same as it has been for a while. In a world of turmoil, simplicity ought to be a relatively easy sell, and what the building societies are selling is a relatively simple, straightforward product. Meat-and-potatoes banking makes a nice change after Gordon Ramsey has gone mad in the kitchen. As they say, *carpe diem* – seize the day.

Thank you.

October 18, 2007