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Speech by Sir Martin Jacomb

In creating a framework for a banking and financial system that is efficient, safe and economical, we do not start with a blank sheet of paper. There are political imperatives which stand in the way and, even if this were not the case, the impact of global capital flows on the size and international scope of major banks creates problems which are difficult for individual nation states to deal with. Yet, despite a great deal of international collaboration, we still have to try and solve our own problems for it is our taxpayers who are at risk.

The first political imperative is to keep the financial system from total collapse, because of the damage this would do to the economy as a whole. A much more recent consideration is the need to keep retail depositors safe from loss (after all, they have votes!).

Banking is an inherently risky business – this is a basic truth. A banker accepts deposits in order to lend it out to borrowers. The margin on the loan pays for overheads, services the capital invested in the business – and yields the profit. Lending money runs the risk that some loans will go bad. There is no totally safe lending, except lending against the government's credit; but if a bank restricted itself to that there would be no profit unless it paid nothing, or very little, for its deposits. The Trustee Savings Banks were a version of this activity and while they suited depositors who wanted total safety, the rates of interest were unrewarding and the service was limited.

Even a prudent banker is bound to make some loans which go bad; but if prudence rules and the banker's judgment is good, the losses will be covered by the profit. If losses outstrip profit, then they must be made good out of capital. If the capital is insufficient, bankruptcy follows and depositors risk not getting their money back. Banks thus have to have capital both to reassure their customers and engender confidence that depositors will get their money back. Over and above this, governments want to ensure that banks are safe and that there will be no collapse of the system nor depositors, particularly retail depositors, lose money. Therefore, they introduce capital requirements to make sure there will be enough to repay depositors (even of less well-run banks) in the event of disaster.

Banks also need to keep enough liquidity: but I will mention that later.

The need for capital is straightforward, but holding capital is expensive and it has to be serviced. If you require banks to hold more than they would judge to be necessary, then they will be tempted to cut lending rather than raise more. In any event, they will have to make more profit from their assets in order to service the extra capital. The problem is that you have to take more risk to make more profit. Thus heavy capital requirements will inevitably increase the risk within the system. Those managing the banks are thus being nudged towards extra risk. They will know that others are doing the same and thus there is a collective migration away from basic standards of prudence.

The system as a whole is inherently risky. Banks deal with each other. As they balance their books at the end of each day, some will have surplus funds, some not enough, so the former lend overnight to the latter. The scale of banks' dealings with each other is enormous. So it is unavoidable that the failure of one large bank may jeopardise the health of others. If the system is to remain secure, governments must be ready to step in and discharge the liabilities of a failed bank, or else other bank creditors may themselves collapse. This need for governments to step in with taxpayers' money to prevent or compensate for total collapse has always been there. Just by the Rialto bridge, you can still see the site of the Banco del Giro, founded and backed by the Venetian government, after a collapse of the banking system in the early 17th century.

Given the enormous size of banks since the globalisation of trade and capital flows, the task of keeping the system safe is not easy. Many banks have become too big or too interconnected with others to be allowed to fail. This leads directly to moral hazard, because those running banks know that, in the event of failure, the government will step in.

When governments step in, they use taxpayers' money. So they are tempted, or see themselves inevitably required, to increase capital requirements in order to reduce this risk. But as we have already seen, this in fact increases the propensity to risk due to the need to service the increased capital. Bank managements know that their counterparts in other banks are doing the same and the whole system becomes riskier. Prudent management is somewhat suppressed. When regulation rather than prudent commercial judgment becomes the governing principle, standards drop and everyone behaves up to the limit of regulation instead of relying on their own commercial judgment – after all, their competitors are doing the same.

There is another problem here. Regulation is very often defective. The pre-2007 Basel capital requirements were so framed that they led directly to the enormous losses caused in the securitised mortgage debt market. This was a major cause of the whole trouble, the consequences of which we are now having to deal with. The full story is told vividly in Gillian Tett's book *Fool's Gold*. It is an example of bad regulation having utterly tragic consequences. History tells you that regulation is almost always defective. A much more authoritative and coherent critique of the proposed extension of regulation is to be found in the views of those running banks like HSBC: they really know the subject first hand and better than any regulator.

Many people think that moral hazard afflicts bank managements because of the prospect of enormous bonuses. There may be a bit of truth in this. The prospect of a huge bonus if you earn your employer a big profit is alluring. Yet there is another much more important factor at work. Banks are no longer owned by bankers. They are owned by shareholders who are, in general, not the actual beneficial owners themselves but are simply agents for the beneficial owners: they are fund managers, managing other people's money. These 'owners' are often interested in capital gains as much as the long term health of the business and promotes a focus on short term capital gains. This is most assuredly unhealthy, because it encourages those managing banks to run a riskier, higher margin lending and asset portfolio than a prudent bank would. But if it is what shareholders want, managements are likely to respond.

You can see a picture emerging of a problem with no satisfactory answer. The answer is certainly not to be found in a reversion to Glass Steagall Act, i.e. splitting commercial and retail banking from the securities business.

Ordinary commercial customers want banks to provide services which can only come efficiently from investment banking operations: these services include, for example, covering long term forex risks or interest rate risks, and the substitution of bond finance in place of bank lending. In any event, the evil that Glass Steagall was designed to counter in the 1920s no longer exists, at least in that form. Nowadays, with modern information technology, securities can be widely distributed with full transparency and information, and often rated by independent rating agencies. Furthermore, Northern Rock, Bradford & Bingley and HBOS, which caused the trouble, were not universal banks.

The result of all this trouble has been a wave of heavier and more intrusive regulation, which leaves less and less room for prudent management in the true sense. If the past standard of regulation is anything to go by, far from making the system safer it is a recipe for increased cost and inefficiency. And worse than this, it actually increases risk. The reason for this is that if you impose such expensive regulation, which involves the cost of a great deal more capital and, incidentally liquidity, plus a huge wage cost of internal regulatory work, as well as the direct cost of regulation which has to be borne by the sector, you drive managers to seek high returns from riskier business and to find ways of overcoming the barriers imposed by regulation.

Today, there are cooperatives of lenders being matched with borrowers outside the established banking system and outside regulation. This might just be acceptable if limited to totally professional parties; but there are internet sites where those seeking finance are matched with retail lenders seeking higher returns than those obtained from regulated banks. The intermediary takes no risk and the activity is not regulated. There is no process by which the lender can rely on the judgment of someone who understands lending risk and who underwrites that judgment with his own capital. The end of all this will assuredly involve scandals and losses.

My contention is that you should stop imagining banks can be made completely safe; and accept that the best route to safety is through prudent management. Therefore it is a priority to look for ways of encouraging and incentivising prudence. Today's bank owners look for greater shorter-term profit than comes from long term prudence. So the only way to do this is to make depositors and other bank creditors take some risk, then they will prefer to deal with prudently-run banks. The cost of deposits will go down if you run your bank prudently and gain a reputation for doing so. This incentive has to come from action by depositors and other counterparties, because unfortunately it will not come from shareholders. Shareholders will not reward prudence unless and until prudence earns a decent return.

I suggest that depositors of all kinds should be at risk of losing, say, 10 per cent of their deposits. Unfortunately I see little chance of political leaders having the wisdom and long term vision to adopt this idea. Instead they will embrace an ever heavier, more cumbersome, complicated and inefficient system which will do no one any good. Certainly not those who need bank finance.