12 BANK REGULATION: STARTING OVER

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The recent financial crisis led to substantial demands on taxpayers around the world to provide funds to prevent financial institutions from collapse. An understandable response has been to say that the regulations in place before that crisis were inadequate, and that they must be tightened so as to prevent these problems arising again. While understandable, framing the issue in this way has led to too narrow a question and to an answer that is both damaging and inadequate. In this chapter, we first set out why we think this to be the case, and then outline what we think should be done instead.

In our view, the general interest is to have a financial system that intermediates efficiently and helps absorb the shocks to the real economy. That is, one in which individual failures may worry but do not seriously threaten other members of the system, and in which those who bear losses are, at least in general, those who knowingly chose to risk doing so. This is important everywhere, but particularly in the UK, where not just the financial sector as a whole but the banking sector in particular is very large, both in absolute terms and relative to the economy.

We therefore pay particular attention to what has been done in the EU with regard to banking regulation, as this inevitably affects the UK. But our first step is to set out the principles by which regulations are to be judged; only then can EU actions sensibly be considered.

Minford-Shackleton.indd 229

24/02/2016 14:42:49

The next section summarises the kind of banks we are talking about, and why they matter. We then turn to the causes, in an accounting sense, of bank failures. We deal first with liquidity shortage, and then turn to failure through loss of capital. How these can be ameliorated where appropriate and contained when necessary, and how risks can be properly assigned, are then set out.

A time when the country is contemplating a new start in its relationship with the EU is a good time to think about starting again with regulating the banking sector. Is there a need for international cooperation in banking regulation, supervision and law? Do we need the set of international supervisors and bailout authorities that are promised, or do we just need coordination so as to avoid conflicts? We also touch briefly on whether the answers we provide would be different for banks in countries that are in the euro zone.

Banks and bank failures

The type of banks we are dealing with are fractional reserve banks – banks such as Barclays or the Royal Bank of Scotland. They take deposits and make loans. It seems almost otiose to point out we are dealing with this kind of bank except that, in the wake of the crisis, there have been proposals to return to 'cloakroom banking', as espoused, for example, by Henry Simons (1936). These are banks that take deposits and keep them. They are like the places one leaves one's coat at the theatre, which do not lend out the coats deposited with them, but return them to their owners when required. Cloakroom banks would differ in their operations from theatre cloakrooms only in that they would not promise to return exactly the same notes as had been deposited by the customers, but notes to the same value. Such systems raise very interesting questions, but discussion of these would not take us towards anything bearing on current proposals. Fractional

Minford-Shackleton.indd 230

24/02/2016 14:42:49

reserve banks need liquidity, and they need capital. Both needs arise from the same cause, their lending out some of the money they receive. They hold back some of the money deposited so as to meet the day-to-day demands of their customers for cash. And they need capital, their own funds, so that if some of the loans they made are not repaid, or are not repaid in full, they can still pay their depositors – for if they cannot, they have to close down.

Problems arise if they on some occasion do not have enough liquidity, or do not have enough capital.

Before going on, a further distinction is necessary – between an individual bank and the system as a whole, or in substantial part. We are of course concerned, if an individual manufacturing or retailing firm fails, to ensure that it brings down as few other firms as possible. This is why there are laws relating to bankruptcy. These laws, among other things, ensure that creditors are paid out in an orderly prescribed sequence, so that creditors can have at least some idea of what they will eventually receive, and can plan accordingly, fairly early in the insolvency process. But even in particularly hard cases, when many workers lose their jobs or many poor people lose money, the usual response is to try to mitigate the failure's consequences rather than to stop it happening. Why, then, in the recent crisis was there a rush to prevent *banks* failing? There are at least two reasons. First, the failure of one bank, even a small one, can trigger a panic run for cash from other banks, and, as they find themselves with insufficient to pay their depositors, they fail in turn. Eventually, a large part of the system may fail. Second, the bank that seems likely to fail may itself be a large part of the system. Such failures lead to destruction of bank deposits, nowadays a large part of the money stock, and thus produce the kind of sharp monetary squeeze that causes recession. They also destroy the channels of transmission of credit from lenders to borrowers, so that, as the economy starts to recover from the money stock contraction, the pace of recovery is inevitably sluggish.

Minford-Shackleton.indd 231

24/02/2016 14:42:49

Concern then is with the system, not, in principle, with any one institution. In this paper, we address first how to prevent an individual failure spreading to the system and, second, what to do if one bank is, or soon will be, a substantial part of the system. The first part of that question was addressed in the nineteenth century, and it was addressed not in the abstract but in the face of failures triggered by loss of liquidity.

Before turning back to the nineteenth century and its possible lessons, we of course acknowledge that banking has changed since then. Banks have become much bigger relative to their economies, and in many cases relative to the banking systems in which they operate.[1] They carry out a much wider range of activities than they did then. Banks have become more international: while in the nineteenth century they carried out many activities overseas, not many banks provided a full range of banking services in every country in which they operated. There was neither bank regulation nor bank supervision: in Britain, banks were regulated by exactly the same laws as governed other firms (this remained the case until 1979), and the only supervision was by banks monitoring their counterparties and the Bank of England seeing what was going on in markets. Few banks now are unlimited liability partnerships. That last may seem a modest point compared with the others, but when we consider how the lessons of the nineteenth century may need to be modified for the twenty-first, it turns out to be of considerable importance.

Liquidity and the lender of last resort

In 1793, war was declared between France and Britain:

> That dreadful calamity is usually preceded by some indication which enables the commercial and monied men to make

1 See Capie and Rodrik-Bali (1982) for discussion of aspects of this process in the UK.

Minford-Shackleton.indd 232 24/02/2016 14:42:49

> preparation. On this occasion the short notice rendered the least degree of general preparation impossible. The foreign market was either shut, or rendered more difficult of access to the merchant. Of course he would not purchase from the manufacturers; … the manufacturers in their distress applied to the Bankers in the country for relief; but as the want of money became general, and that want increased gradually by a general alarm, the country Banks required the payment of old debts. … In this predicament the country at large could have no other resource but London; and after having exhausted the bankers, that resource finally terminated in the Bank of England. In such cases the Bank are not an intermediary body, or power; there is no resource on their refusal, for they are the *dernier resort*.

This is how Francis Baring, writing in 1797 of the dramatic events of 1793, introduced the notion of the Bank of England as the 'last resort' of the banking system. The concept was soon afterwards developed very substantially by Henry Thornton (1802). Further refinements were introduced by Walter Bagehot, most notably in *Lombard Street* (1873), but also in his writings in *The Economist* and elsewhere. Throughout the nineteenth century, the Bank of England's practice in the task gradually evolved.

A sudden lack of liquidity can, as Francis Baring set out, readily bring down a large part, or even all, of a banking system. What to do to prevent this being an almost inevitable consequence of such an event was fully explained, in the context of a Britain then on the Gold Standard, by Bagehot in 1848:

> It is a great defect of a purely metallic circulation that the quantity of it cannot be readily suited to any sudden demand; it takes time to get new supplies of gold and silver, and, in the meantime, a temporary rise in the value of bullion takes place. Now as paper money can be supplied in unlimited quantities, however sudden the demand may be, it does not appear to us that there

Minford-Shackleton.indd 233

24/02/2016 14:42:49

> is any objection on principle of sudden issues of paper money to meet sudden and large extensions of demand. It gives to a purely metallic circulation that greater constancy of purchasing power possessed by articles whose quantity can be quickly suited to demand. It will be evident from what we have said before that this power of issuing notes is one excessively liable to abuse because, as before shown, it may depreciate the currency; and on that account such a power ought only to be lodged in the hands of government … It should only be used in rare and exceptional circumstances. But when the fact of a *sudden* demand is proved, we see no objection, but decided advantage, in introducing this new element into a metallic circulation.

Or, in other words, the central bank should sharply increase the supply of money to match the sudden demand for it.

That summarises nineteenth-century theory on the subject. Because the central bank was the monopoly note issuer, it was the ultimate source of cash. If it did not, by acting as lender of last resort, supply that cash in a panic, the panic would continue, get worse and a widespread banking collapse would ensue, bringing along with it a sharp monetary contraction.

Practice of that preventative developed rapidly. Sterling returned to its pre-war gold parity in 1821. The first subsequent occasion for emergency assistance from the Bank of England was in 1825. There had been a substantial external drain of gold, and there was a shortage of currency. A panic developed, and there were runs on banks. The types of bills the Bank would normally discount soon ran out and the panic continued. If a wave of bank failures was to be prevented, the banks would have had to borrow on the security of other types of assets. On 14 December, the Bank of England suddenly deviated from its normal practice; it made advances on government securities offered to it by the banks instead of limiting itself to discounting commercial bills.

Minford-Shackleton.indd 234

24/02/2016 14:42:50

The next step was taken in 1866, with the Overend and Gurney crisis.

Overend, Gurney, and Company originated with two eighteenth-century firms, the Gurney Bank (of Norwich) and the London firm of Richardson, Overend and Company. By the 1850s, the combined firm was very large; its annual turnover of bills of exchange was in value equal to about half the national debt, and its balance sheet was ten times the size of the next largest bank.[2] It was floated during the stock market boom of 1865. By early 1866, the boom had ended. A good number of firms were failing. Bank rate had been raised from 3 per cent in July 1865 to 7 per cent in January 1866. After February, bank rate started to ease, but, on 11 May, Gurney's was declared insolvent.

To quote the *Bankers' Magazine* for June 1866, 'a terror and anxiety took possession of men's minds for the remainder of that and the whole following day'. The Bank of England for a brief time made matters worse by hesitating to lend even on government debt. The Bank Charter Act (which, among other things, restricted the note issue to the extent of the gold reserve plus a small fiduciary issue) was then suspended, and the panic gradually subsided.

The failure in 1878 of the City of Glasgow Bank was much less dramatic. It had started respectably, was managed fraudulently and failed. There was fear that the Bank Charter Act would have to be suspended again, but no major problems appeared: 'There was no run, or any semblance of a run; there was no local discredit.' Other Scottish banks took up all the notes of the bank; Gregory (1929) conjectures that they acted in that way to preserve confidence in their own note issues.

In summary, in nineteenth-century Britain, ample provision, on security, of cash from the central bank to the banking system

2 It was, however, substantially smaller, relative to available estimates of British national income for that time, than Britain's large banks now are relative to national income.

Minford-Shackleton.indd 235

24/02/2016 14:42:50

ensured that one bank's running out of cash did not lead to panics causing other banks to fail as well. The system was protected in the face of occasional liquidity-driven failure. Note that individual banks were allowed to fail if they ran out of even the crisis-lowered quality of collateral that the Bank of England would accept; see the example of Overend and Gurney.

Central banks today have generally accepted their lender-of-last-resort responsibility. Indeed, central banks started doing so, following the Bank of England's lead (the Banca d'Italia explicitly stated that they were following that lead) from the late nineteenth century. The responsibility goes by a number of names: in Britain, for example, it is now being subsumed under the heading of maintaining financial stability, but it is accepted everywhere. This is not to say that practice is always perfect. For those who wish to read of difficulties in this task, there is an abundant literature on the failure in 2007 of Northern Rock. But if practice is needed to produce perfection, deviations from perfection are welcome. (The euro area, with its system of central banks, has somewhat novel arrangements, but these seem entirely workable.)

Lender of last resort, then, can deal with liquidity crises, and it has been tested, and shown to work, intermittently since the nineteenth century. It has worked every time it was used; and on the occasions it was not used (the US in 1930 and onwards, for example), individual failure spread across the system.

Loss of capital in the nineteenth century

Loss of liquidity was the subject of theorising from which policy conclusions were derived. In general, following the nineteenth-century laissez-faire view, banks that ran out of capital were allowed to fail. They were the authors of their own misfortune, through either imprudence or being excessively burdened by ill fortune.

Minford-Shackleton.indd 236

24/02/2016 14:42:50

But there was a most instructive exception in 1890 – the (first) Baring crisis. Barings was a large bank of great reputation; in 1877, when Treasury bills were introduced, Bagehot praised them as being 'as good as Barings'. It nevertheless became involved in a financial crisis in Argentina. The Argentinian government found difficulty in paying the interest on its debt in April 1890; then, the national Bank suspended interest payments on *its* debt. This precipitated a run on the Argentinian banking system, and there was revolution on 26 July. Barings had lent heavily to Argentina. On 8 November, it revealed the resulting difficulties to the Bank of England. The Bank (and the government) were horrified, fearing a run on London should Barings default. A hurried inspection of Barings suggested that the situation could be saved, but that £10 million was needed to finance current and imminent obligations. A consortium was organised, initially with £17 million of capital. By 15 November, the news had leaked, and there was some switching of bills of exchange into cash. But there was no major panic and no run on London or on sterling. The impact on financial markets was small. Barings was liquidated, and refloated as a limited company with additional capital and new management.

Observe, however, that there are major differences between this bailout and those that took place at the start of the twenty-first century. The management of Barings lost their jobs, and most of their capital in the bank. Fresh capital was provided not by the taxpayer but by other banks in the British banking system, who had identified a common interest in preserving the reputation of that system. These other banks had the capital to lend. Unlike Barings, they had not lost money in Argentina, nor indeed life-threatening amounts elsewhere. It might appear, then, that this example of a capital injection is of little assistance in guiding us in present-day banking. But that is not the case, for these very significant differences help us see much more desirable reforms than those currently being considered.

Minford-Shackleton.indd 237

24/02/2016 14:42:50

Banking in the twenty-first century

The nineteenth-century approaches to liquidity and capital crises that we have described did, broadly speaking, achieve what we consider to be in the general interest: a financial system that intermediates efficiently and helps absorb the shocks to the real economy; in which individual failures may worry but do not seriously threaten other members of the system; and in which those who bear losses are, at least in general, those who knowingly took on the risk of doing so.

In what ways do these earlier approaches need to be modified so as to achieve the same result in the twenty-first century? We first summarise the relevant changes to the banking system that we touched on earlier, and then consider what needs to be done to achieve our desired outcome.

Banks have become much bigger relative to their economies. They carry out a much wider range of activities than they did then, both domestically and overseas. Banks have become international: in the nineteenth century, they carried out many activities abroad, but not many banks provided a full range of banking services in every country in which they operated. Furthermore, there was neither bank regulation nor formal bank supervision in Britain. This last seems to us to have implications for current proposals, which involve international cooperation in banking regulation, supervision and law, along with international supervisors and bailout authorities. Perhaps we actually just need coordination so as to avoid conflicts.

As is clear from our earlier remarks, in our view the key to the successful operation of the banking sector is to be able to cope with failures in a way that does not destabilise the financial and economic system. That ability needs not merely to exist but to be viewed as credible by those running banks, those who own them, those who lend to them and, of course, to depositors and borrowers. Above all, it must appear credible to governments, as

Minford-Shackleton.indd 238

24/02/2016 14:42:50

they are the ones who step in and use taxpayers' funds if they fear for the stability of the financial system.

It has long been clear that ordinary bankruptcy does not offer the ability to cope with failures of any but small banks. It brings transactions to a halt, depositors cannot get access to their funds (even after accounting for any losses) for a substantial period of time, and the problems will be transmitted immediately to counterparties who may, in turn, fail. Because the outcome is uncertain, there will be a general loss of confidence. However, it took the global financial crisis for most authorities to realise this. The aspects of the new legislation in the US (Dodd–Frank Act), the EU (Bank Recovery and Resolution Directive) and elsewhere that have introduced a *lex specialis* to enable a resolution of bank failures virtually overnight are therefore welcome. Such schemes apply the same principles as bankruptcy law, including the maintenance of a hierarchy of creditors, but compress the whole process of establishing claims, valuing the assets and realising that value through sale and liquidation, into a few hours rather than many years (without requiring a fire sale of assets at the prevailing distressed prices).

However, that on its own does not appear sufficient to ensure a purely private sector solution to the problem. The first reason is simply that liquidity beyond what could be achieved through lender of last resort is likely to be needed to effect the immediate resolution. In the US, this is achieved through the Federal Deposit Insurance Corporation's (FDIC's) assets, and in future with the help of the Orderly Liquidation Authority (OLA) enabling temporary funding from the taxpayer. The EU hopes it has achieved the same result by setting up resolution funds in each member state, but these funds are small in comparison with those of the US, even after appropriate adjustment for size of economies. Second, it has usually been necessary in recent crises for the authorities to issue some sort of guarantee against further loss in order to restore confidence in the system and get new lending

Minford-Shackleton.indd 239

24/02/2016 14:42:50

restarted in order to enable the recovery of the real economy. The need for this action implies that the credible ability to handle the resolution of each individual bank may not be sufficient for confidence in the system. That is an example of systemic risk. There is more to financial stability than the case-by-case treatment of individual members of the financial system.

Size and structure

In the early literature on bank failure (that is to say, literature from the mid-twentieth century on, since in the nineteenth century individual bank failure was a source of concern only insofar as it threatened the banking system), it was thought that it was simply the size and complexity of the largest banks that made it impossible for their problems to be resolved without a taxpayer bailout. This belief still seems to be held. The response of the authorities since the financial crisis has, however, been less than transparent in this regard. Banks are being required to put together confidential recovery and resolution plans that spell out how they can be resolved immediately in the face of any plausible failure. Initial experience in the US, at any rate, has not been promising where the first draft from every such large bank has been rejected by the Federal Reserve and the FDIC as implausible.

There is a second side to this concern, in that not all activities undertaken by banks, and particularly by more diversified financial groups, need be subject to immediate resolution. They can be handled by ordinary insolvency. The question, therefore, is whether it is sensible to separate out these activities from the essential banking functions, or at least to protect the banking functions from problems in the rest of a group's activity. Doing so would help to simplify the group's structure for the immediate resolution, which has to be possible for part of the group. Here, there has been little agreement internationally about what should be done, and the proposed legislation in the EU is

Minford-Shackleton.indd 240 24/02/2016 14:42:50

currently stalled. But, in any case, it is clear that with more institutions performing bank-like functions, and more thus being vital to the continuing operation of the financial system, the *lex specialis* approach will have to be extended somewhat.

One problem in implementing these principles is simply that splitting up the large financial groups would be expensive for them, and with strong lobbying power they have been able to avoid change. Perhaps this issue will be resolved through the resolution plans, but it is beginning to look as if the largest institutions are still not resolvable in a useful sense (expeditiously and without threatening contagion) in a crisis. This would not only fail to remove the risk of the taxpayer being called upon but would distort competition in the rest of the industry.

Incentives

When reviewing incentives, attention has focussed on incentives *within* the institution. These are important, of course, but as the example of both Barings and the City of Glasgow Bank's failures showed, incentives within the *industry* are also important. In both cases, there was seen to be a collective interest: in the Barings case in the reputation of London as a financial centre, and in the Glasgow case in the reputation of the notes of every individual bank in the area. This collective interest is not only useful in the case of outright failure. It can also be useful in helping to prevent failure, if not of a troubled institution then certainly the failure of institutions in the same system. For if one firm were seen as at risk through either folly or deliberate excessive risk taking of one sort or another, then other firms would reduce or eliminate their exposures to it. An example of this being useful is provided by the experience in London of the now-defunct Bank of Credit and Commerce International (BCCI). Because the London discount houses (specialist interbank market makers) could not get sufficient information on the BCCI, and did not like what

little they could get, they collectively did not deal with it. Thus, when the BCCI was suddenly closed, there were, to the pleasure and surprise of the Bank of England, no adverse knock-on effects within the banking system.

Questions do arise, however, as to whether, in a setting where so many banks are international and engaged in extensive cross-border business, such a common interest would be felt; and, of course, it is of little relevance if the whole, or greater part, of a banking system is in danger.

Cross-border

We have deliberately avoided discussing the problems of banks whose activities run across borders in order to keep the analysis simple; but if organising a resolution in a single jurisdiction is proving too difficult, as it currently seems, it will be much harder where separate proceedings have to be started for resolution in each jurisdiction, even if they are to be linked. Cooperation is essential, yet cannot normally be compelled, as these are arrangements between sovereigns.

While effective cooperation may well be the optimal solution (although so far there is only assertion to support this), we have to ask what should be done if it cannot be achieved. The UK and the US have come to the conclusion that the likely workable solution is that the home country solves the problem for the banking group as a whole. In the US, this is particularly straightforward, as the usual structure of such a group is through a holding company with the component banks as affiliates (generally wholly owned). As long as the creditors of the holding company can be written down far enough, then just one authority can implement a resolution of the entire group, largely irrespective of the concerns of the others, as the activities in their jurisdiction will be saved. While there is some fear that some groups may run out of creditors to bear the losses, such an approach is usually likely to succeed.

Minford-Shackleton.indd 242 24/02/2016 14:42:51

The obvious alternative is to insist on splitting up the group along jurisdictional lines for each vital activity – and to ensure that each divided part is resolvable, which entails both that it is adequately capitalised and that it has the capability of independent operation after resolution. This is what New Zealand has insisted on with its 'Open Bank Resolution'. All main retail operations must be locally incorporated, separately capitalised and capable of operating on their own overnight. Achieving such separability implies substantial preparation, not just in terms of organisation but in computer systems so that the resolution can be performed in the few hours available.

However, the EU is in danger of being in a halfway house, where cooperation among jurisdictions is required but these arrangements are not regarded as being fully credible. Wherever such credibility does not exist, the foundation for an adequate regulatory regime is not present. And such credibility cannot be achieved without better disclosure, which itself would do much of the job by encouraging good behaviour by institutions. In any event, we discuss the special case of the EU in a little more detail just before concluding.

Capital

The principal regulatory response internationally has been to demand that banks hold more capital against risks – particularly equity capital, followed by other securities that can be 'bailed in'. Indeed, the whole resolution scheme in the EU is predicated on there being enough capital. While having enough risk-weighted capital is the requirement for registration, the requirement for resolvability is a *total capital* requirement (composed of both external and internal elements). Thus, to an extent, the risk-weighted and leverage ratios at the heart of the Basel system are becoming non-binding. Indeed, this idea was taken up in the Financial Stability Board recommendations presented to

Minford-Shackleton.indd 243

24/02/2016 14:42:51

the Group of Twenty (G20) in Brisbane in November 2014. Each bank, particularly those judged as systemically important, has to be able to have adequate total loss-absorbing capacity (TLAC) so that it can withstand the plausible range of failures without having to call on secured creditors or the taxpayer. This is simply an extension of the previous bankruptcy arrangements, where the shareholders bear the first loss, followed by the subordinated debtholders, other junior creditors and then senior unsecured creditors.

Prior to the new insolvency laws mentioned above, a firm would enter into a disorderly failure once shareholder capital was exhausted. Now, because these other creditors can be 'bailed in' and required to bear the losses, there is no need for the firm to stop trading. All short-term liabilities, those involving derivative markets and those involving other financial institutions, will be kept whole, so that the failure of the one institution does not feed on to the failure of others – providing confidence is maintained and depositors do not run.

Thus, in many respects, the requirements to hold greater risk-weighted assets under Basel III have been overtaken by the requirement to hold adequate 'bailinable' capacity (TLAC). But the overtaking is not complete, for bailing-in might in turn threaten the solvency of other institutions; bailinable debt is not suitable for all to hold. This is why it is particularly important that it be made clear that, although capital requirements do have a role in absorbing shocks and, hence, reducing the risk of failure, their primary role is not to prevent failure, but to allow orderly resolution after failure.

Depositors

The system has become complicated in recent years by the increasing importance of depositor protection. Deposits are unsecured loans to banks, yet they are made in the main by

Minford-Shackleton.indd 244

24/02/2016 14:42:51

people who are not well informed, who are unable to monitor the bank's performance and, moreover, who are likely to be seriously affected by failure, as the bank deposit is their main financial asset. Before the financial crisis, the common international position was that the deposits of 'ordinary people' ought to be fully protected. This implied limited coverage, usually to some level between one and two times GDP per head – not that this was ever the explicit explanation of the chosen limit. Since the crisis, protection levels have become much higher and now fully cover almost all depositors, going far beyond what the ordinary person needs. This restricts the amount of funds available for bailing in.

Since derivatives, covered securities, short-term financing and other preferred creditors are excluded from being bailed in, the pressure on the remaining securities could become substantial, especially if, unlike in New Zealand, depositors are part of the preferred group. Depositor preference is now becoming the norm, with (in the EU) the deposit insurer/guarantor becoming super-preferred, should it have to pay out on behalf of the depositors despite the preference.

Ironically, this solves by the back door the problem of the increased moral hazard from having high deposit insurance coverage levels for large banks. With preference, depositors are unlikely to be caught up in insolvency. Except to the extent that their funds have to provide liquidity support until the bank is fully resolved, such insurance will not be called on, and it is the senior unsecured creditors, most of whom are capable of monitoring the performance and risk-taking of the bank, who are the group that is exposed to the risk of bank failure at the margin. Deposit insurance will then in practice only remain for the smaller banks, which can be closed without the need to keep their primary banking operations running. (However, it is our expectation that bailing-in will be applied even to relatively small banks, as it may often be easier to keep them running than organise rapid sales to other providers.)

Minford-Shackleton.indd 245 24/02/2016 14:42:51

The EU response

The EU has responded to the lessons of the financial crisis largely by implementing what it calls 'banking union'. This comprises enhanced capital and supervisory regulation,[3] with the creation of a Single Supervisory Mechanism (SSM) run by the European Central Bank (ECB),[4] a Bank Recovery and Regulation Directive requiring all member states to have the tools for speedy resolutions, where losses are assigned to shareholders and creditors in the manner we describe.[5] In addition, a new Single Resolution Board (SRB) has been appointed to oversee such resolutions, with funds contributed by levies on the banks to facilitate this.[6]

3 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013L0036&from=EN (accessed 2 September 2015), and Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012, available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575&from=EN (accessed 2 September 2015). See also Castaneda et al. (2015).

4 Regulation (EU) No. 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No. 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the ECB pursuant to Council Regulation (EU) No. 024/2013, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:287:0005:0014:EN:PDF (accessed 2 September 2015).

5 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC; Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU; and Regulations (EU) No. 1093/2010 and (EU) No. 648/2012, of the European Parliament and of the Council, available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN (accessed 2 September 2015).

6 Regulation (EU) No. 806/2014 of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund, and amending Regulation (EU) No. 1093/2010, available at

Minford-Shackleton.indd 246 24/02/2016 14:42:51

The EU also made a proposal in January 2014 for the restructuring of banking groups, but this is stalled at the time of writing.[7] Facilities for the lender of last resort function already exist and have been extensively used.

In the context of the difficulty of getting agreement from 28 countries, this is a major achievement, but it is convoluted: a consequence of having to get round the difficulty. Whether it will work in practice and restore confidence that orderly failures can be achieved remains to be seen. What the EU has done is not a move towards the kind of desirable regulatory framework that we developed earlier in the paper. Our view, therefore, is that when the crisis is eventually over, and the problems with banks are no longer entwined with the sovereign debt problems of the most affected countries, the EU should start again.

The new structure needs three main things.

- *A resolution entity that can handle resolutions of any bank, however complex and cross-border, in a manner that does not threaten financial stability.* The present SRB only applies to the euro area and other states that choose to join. This conflation of a monetary area with international banking is mistaken and based on the need to avoid renegotiating the EU treaties, not on the logic of the problem. Any system that does not include the UK, the member of the EU that has

http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0806&from=EN (accessed 2 September 2015), and Council Implementing Regulation (EU) 2015/81 of 19 December 2014 specifying uniform conditions of application of Regulation (EU) No. 806/2014 of the European Parliament and of the Council with regard to ex ante contributions to the Single Resolution Fund, available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0081&from=EN (accessed 2 September 2015).

7 European Commission (2014). Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions, available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52014PC0043 (accessed 30 October 2014).

Minford-Shackleton.indd 247

24/02/2016 14:42:52

some of the most significant banks and the most important financial market, is seriously flawed.

- *Access to adequate funds to effect resolutions and convey the confidence that further problems can be handled*. This can only be handled with access to temporary financing from the state, along the lines of the OLA in the US – which state does, of course, raise difficulties in the case of the EU.
- *A single legal framework where the activities of these large institutions can be handled in one jurisdiction*. The single point of entry approach, where the home country can handle the entire problem, would work, but the only alternative is to require banks to register as European companies governed by a single European regulatory regime.

There are four other aspects to be sorted out.

- *A genuine single supervisory mechanism that covers the whole of the EU is required*. How centralised this should be is a matter of opinion, but it should not be part of the ECB, as this creates a convoluted decision-making structure, as not all parties are represented on the Governing Council of the ECB. More importantly, it creates a conflict of interest between the role as lender of last resort and that of supervisor. When the opportunity arises, the EU should create an independent institution, perhaps based on the European Banking Authority (EBA), and unrelated to the euro area.
- *The issue of the appropriate constraints on banking group structure and banking activities needs to be addressed head-on*. It should not, as at present, be left to the hope that the supervisory and regulatory authorities will be able to come up with a scheme for each bank that will make them resolvable.

Minford-Shackleton.indd 248 24/02/2016 14:42:52

- *The EU has ducked the issue of a common deposit guarantee scheme. This needs to be brought back onto the agenda.* Insurance companies are quite capable of running several different schemes, so a single entity does not need to imply a single approach to guarantees. Of course, we could simply follow the US example and have the deposit insurer as the resolution authority.
- *Lastly, the EU is caught in the same trap as all of the other main countries in perpetuating a system of capital buffers based on risk weighting.* Failures occur through errors in risk management and crisis through common errors across much of the banking system. The opportunity exists with the leverage ratio, the emphasis on equity and the concept of TLAC to make the whole of this system much simpler and more robust.

Taken together, these measures would provide a simple, coherent structure, where each party has a clear role, and banks are resolvable and, hence, have a clear incentive to run themselves more prudently – and, even if that fails, to seek a private sector solution before the resolution authority steps in. But whether such changes to the existing plans are possible in the EU is far from clear. They require the EU to 'start again'. That has not often happened; but the present context of British negotiations over future EU status is just such an opportunity. The EU has the opportunity to do the job properly rather than restrict itself to the present arrangements, which were largely determined by political constraints.

Concluding remarks

In our view, the effective regulation of banks to provide a stable and efficient banking system in which the public can have confidence, and where there is little fear of a call on the taxpayer

except in the short run, entails quite a simple system with four main ingredients – all of which have been highlighted in the global financial crisis.

1. All banks need to be readily resolvable overnight in such a manner that functions felt vital to the stability of the financial system can be kept operating without a break. This must not only be practicable at the time but must appear credible to all those involved with the banks (owners, managers, depositors, counterparties, regulators, government and taxpayers) all the time.
2. Such resolvability requires that all banks must hold adequate loss-absorbing capacity in the sense that all losses can be assigned to shareholders and then unsecured creditors in increasing order of seniority, without including those parts of the financial sector that would merely increase the chance of further institutions failing.
3. Such resolvability also requires that banks should be simple enough to ensure that such a rapid resolution is possible. While there is a plausible argument that this can be achieved if resolutions are applied with a single point of entry at the group level, or by having a bank divided upon national lines, the success of intermediate arrangements is yet to be plausibly demonstrated.
4. Lastly, it is essential that the failure of one institution, especially a large one, should not result in instability in the rest of the system through a lack of liquidity and confidence. We therefore see an enhanced role for the lender of last resort function developed in the nineteenth century, where the central bank advances unlimited credit against adequate collateral to institutions that are believed solvent. Enhanced, because we see that extra funds will be required, both to execute these resolutions

Minford-Shackleton.indd 250

24/02/2016 14:42:52

> in the short run with the required rapidity, and to provide the confidence that, should other banks get into difficulty, they can also be handled in the same manner. Only the state can do that by being able to draw on the 'unlimited' funding that could be provided by the taxpayer. Here, there is clearly a problem for those countries that are already so severely indebted that the idea of raising further funding is implausible.

What cannot be done for any banking system that is to remain efficient is removing the risk of future failures and crises. But the simple framework we suggest, building on what is already being created following the financial crisis, would tend to reduce the risk of such failures, because there is a stronger incentive for bank owners and management to run their institutions more prudently, with reinforcing pressure from those who fear they might be bailed in in the event of failure. This would not take us fully back to incentives of the strength implied by the partnership model, but it would move us in that direction.

There would also be a clear incentive affecting regulators to produce lower-cost failures, in the sense of losses to shareholders and creditors, through rapid action and avoidance of the costs of bankruptcy.

However, the failure of any large institution will always represent a shock to the economy as a whole. Being able to bail in rather than bail out a bank will not mean that somehow losses can be absorbed costlessly. The term loss-absorbing capacity can give the impression that somehow it could mop up the problem like a sponge, wring it out down the drain and rebound to normal afterwards. The real impact will depend on where the losses fall. If they can be absorbed by hedge funds and pension funds, then this will limit the short-run impact on the general population. But if they were to lead to the failure of pension funds, this would simply transfer the problem from

Minford-Shackleton.indd 251

24/02/2016 14:42:52

one part of the financial economy to another and require that matching special provisions were in place to resolve pension funds in a manner that minimised the impact on the real economy and the taxpayer.

But simplicity and clarity will do much. If incentives are clear, they are usually responded to.

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Minford-Shackleton.indd 252

24/02/2016 14:42:52