

Call for evidence

Please accept as my response to your call for evidence,

- a) the attached text of a speech I gave at the Korean Capital Markets Institute conference in Seoul a year ago; and
- b) chapters 22 and 58 of the abridged version of my memoirs (Memoirs of a Tory Radical), to be published by Biteback next month.

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Chancellor of the Exchequer 1983-89.

Post-crisis Financial System Architecture
Regulatory Perspective

Address by Nigel Lawson to the KCMI International Conference
Seoul, 23 September 2009

I congratulate the KCMI on both the work they do in general and on holding this important conference.

It is a very great pleasure for me to be here, for my very first visit to Seoul, albeit 21 years late.

Exactly 21 years ago, as UK Chancellor of the Exchequer, I was all set to attend the 1988 annual meeting of the International Monetary Fund here in Seoul.

Unfortunately, and to my great disappointment, pressing business obliged me to remain in London, and I sent one of my junior ministers to represent me instead.

So here I am, 21 years late.

And what remarkable progress you here in Korea have made over those past 21 years, in the economy in general and in the financial sector in particular.

I salute you for it.

Inevitably, like the rest of us, although less severely than many others, you are suffering the effects of the worst banking crisis, and the worst global recession, for three-quarters of a century.

Happily, it is clear that the world is now gradually emerging from that crisis and that recession.

There is still some way to go, and many difficulties still to overcome.

But the storm clouds have abated, and it is time to learn the lessons, so that we may hope to avoid a repetition in the future.

For the cost has been a very heavy one, and the burden of paying it will remain with us for years to come.

The first point that needs to be made is that the crisis in no way undermines the case for market capitalism.

History, notably the history of the world since the second world war, has demonstrated beyond dispute the superiority of market capitalism over all other economic systems known to mankind in satisfying the material needs and desires of the people.

And, indeed, there could be no more striking example of this than the contrast between the two halves of this divided country.

But we cannot afford to be complacent.

On what, then, should we focus our attention?

We need to be clear.

The first point to make is that, in addition to proving the superiority of market capitalism, history has also demonstrated that all free economies move in cycles.

There are rival explanations of why this should be so; but the evidence of an inescapable cyclical pattern is painfully evident.

For Keynes, who was a close observer of, and active participant in, the financial markets, and whose thinking was greatly influenced by this, the cycle was essentially a matter of collective (for mankind is at all times profoundly affected by the herd instinct) mood swings, from high optimism to deep pessimism and back again, *ad infinitum*.

This was made to sound rather more scientific by being described in the *General Theory* as fluctuations in what Keynes called the ‘marginal efficiency of capital’.

But the ‘marginal efficiency of capital’, which sounds so objective in those terms, was defined by Keynes as the expected return on new investment; and what fluctuated, he explained, was expectations.

So we are back to mood swings, an ineradicable aspect of human psychology – which means that the business cycle is itself ineradicable, and we should not waste our time vainly trying to prevent it.

Moreover, a case can be made for the proposition that what might be termed the normal business cycle confers benefits as well as incurring costs.

The superiority of market capitalism lies in particular in two areas: the freedom and encouragement it gives to innovation and risk-taking entrepreneurial activity generally, and the discipline that drives up efficiency and drives down costs.

The former is stimulated most during the cyclical upswing, and the latter is compelled most during the downswing.

It is at least arguable that if economies moved in a straight line rather than a cyclical pattern, there might, in the long run, be less of both these benefits of the capitalist market system

However, whether that is so or not is academic; for the cycle is ineradicable..

But what matters in the present context is that there is another lesson of history, which we have now seen repeated.

This is that when a banking crisis is superimposed on the normal and inescapable business cycle, the consequences are worse by an order of magnitude.

As we have once again seen, they are worse for the economy, worse for unemployment, worse for the taxpayer, and worse for the public finances.

So it is banking meltdown, and not the cycle, that we must seek to prevent.

Before leaving Keynes, it may be worth sparing a moment to consider the explanation given in some quarters, particularly the neo-Keynesians who habitually think in macroeconomic rather than microeconomic terms, for the recent crisis, and thus the remedy they propose.

In a nutshell, they believe that the root cause lies in the massive current account imbalances that characterise the world economy, and in particular the huge Chinese current account surplus.

This, it is argued, has unleashed a flood of surplus savings onto the world economy, driving down the cost of money, and encouraging both excessive borrowing in the United States and a number of other countries, and excessive risk-taking in a search for higher yield.

For these people, the overriding need is to end the so-called imbalances.

I believe this is both historically and economically mistaken.

In the first place, history shows that banking crises can occur without the existence of current account imbalances.

In the second place, in an open, globalised, economy – which it is of the first importance we preserve, and I will come back to that later – current account imbalances are both natural and indeed almost inevitable.

There is no *prima facie* reason why, in any one country in an open globalised economy, savings should precisely match investment opportunities - any more than they do within the different geographical areas of a single national economy.

In particular, in a country the size of China, with its rapid growth and in its particular stage of economic development, it is wholly unsurprising and indeed inevitable that there will be a high propensity to save and a massive growth of savings much of which will spill over into the rest of the world.

Hence the existence of imbalances.

These may have been increased to some extent as a result of policy decisions, but they would have occurred even without those policies.

Moreover, the ready availability of cheap money is no excuse for unwise borrowing or foolish lending decisions.

Nor is the desire for a higher return than is prudently available in prevailing circumstances any excuse for excessive risk-taking, least of all by bankers.

No: the popular view that the root cause of the crisis lies in the greed and folly of all too many bankers (in the broad sense of the term) is essentially correct.

Let me be quite clear.

All mankind is flawed, both morally and in other ways.

It would indeed be good news if moral standards, in all aspects of life – not just among, but including, bankers – were to rise.

But that is not within the gift of policymakers, or of anyone else, I suspect.

There are, however, a number of respects in which the greed and folly of bankers is worse than the greed and folly of the rest of us.

One is, bluntly, that bankers are exposed to greater temptation, in terms of the sums of money that greed and folly might earn them, and in recent years have earned them, than anyone else.

Another is that they have been encouraged in their folly by the spurious comfort of modern finance theory.

I refer, essentially, to the combination of the efficient market hypothesis and the rational expectations hypothesis, which has enabled mathematically inclined economists to provide them with computer models based on

mathematical equations which effectively pretend to take the uncertainty out of risk taking.

It is of course true that markets are less inefficient than any other form of economic organization, and that expectations are on the whole rational most of the time.

But to derive the mathematical equations and the computer models it is necessary to assume total efficiency and total rationality, which is absurd.

Economics, after all, is about human behaviour.

The notion that you can adequately capture human nature in a series of mathematical equations is inherently ludicrous.

Yet that is the premise of modern finance theory, on which bankers chose to rely.

Modern finance theory is both absurd and – as we have seen – highly dangerous.

But even if modern finance theory were to be jettisoned, as it should be, we would still have the problem of ineradicable greed and folly.

And the consequences of greed and folly among bankers are likely to be more serious than the consequences of equal greed and folly among the rest of us.

Moreover - and now we are getting to the heart of the problem – the success of the market economy derives from the fact that greed and folly are kept in check by the disciplines of the marketplace.

The former Chairman of the US Federal Reserve Board, Alan Greenspan, used to believe that this fact, coupled with basic self-interest, would prevent the excesses that led to the recent banking meltdown.

He has been obliged to admit publicly that he was mistaken.

To some extent, I suspect, his error was to confuse the individual with the institution.

In many, if not in all cases, greed, imprudence and folly were indeed in the self interest of many of those within the management who were enjoying huge bonuses - paid from the bubble-inflated paper profits that mark-to-market accounting allows

But they were not in the interest of the bank as a whole.

What used, in former times, to reconcile the two was a regard for personal reputation.

If an individual literally bet the bank, and the bet was lost and the bank with it, his reputation, which mattered a great deal to him, was destroyed; and this was an important inhibiting, and thus prudential, force.

But we now, sadly, live in an age in which the acquisition of wealth counts for more than reputation – a cultural change which has greatly increased systemic risk.

Be that as it may, it has long been recognised, at least since the 19th century, that the particularly grave consequences of banking failure, and the consequent need for the authorities to stand ready to help failed banks, implied the need for banks to submit to a form of regulation that is neither necessary nor desirable in the case of other industries.

But the regulatory framework that we had in place, both globally in the shape of Basel 2, and in most countries nationally, clearly failed the test.

Indeed, to some extent it made matters worse.

There are a number of reasons for that.

One is that any globally-agreed solution is likely to be inadequate.

This may appear paradoxical.

Surely, it will be argued, since this is a global problem, it requires a global solution, so the overriding need must be for a global agreement.

This may indeed sound statesmanlike, but it is in fact a dangerous delusion. The overriding need is for the authorities in each country to put their own house in order.

The threat from terrorism is an instructive parallel. Terrorism is indeed a global problem, and international cooperation is clearly desirable. But that in no way diminishes the overriding duty of national governments to do what is necessary to protect their own people.

The same applies to financial regulation.

Not least because, as has been well said, while banks may live globally, they die nationally – and it is the national taxpayer who has to pay the funeral expenses and the cost of looking after the dependants.

As Basel 2 clearly showed, international agreement is slow in arriving and, when it does arrive, it is likely to prove inadequate, based on the lowest common denominator of accord.

It was also, incidentally, far too complex, setting a range of capital adequacy requirements for a whole range of different activities and different risk ratings.

The more regulations there are, the more ingenuity will be shown in getting round them, or ‘gaming’ them.

And this happened in spades, with the result that, as the system as a whole took on more and more risk, less and less capital appeared to be required to meet the regulatory requirements.

It is a sobering thought that, throughout the recent crisis, hedge funds, which were unregulated, and which had to make their own assessment of risk, in the knowledge that, unlike banks, they would be allowed to fail if they got it wrong, have had fewer casualties than the banks.

So what kind of regulatory framework do we now need to put in place?

That is the big challenge facing us today.

And it is a particularly difficult challenge in the light of the huge complexity and sophistication of modern banking and the modern financial services industry.

That there needs to be a regulatory framework is clear, for the reasons I spelled out earlier.

And at its heart we need to ensure that the banking system is adequately capitalised at all times.

But I do not believe it is either practicable or sensible to try and put in place a sophisticated regulatory system which is both flexible enough to deal with all the many complex forms of modern banking, and robust enough to provide the safeguards we need.

If we try, it will either be inadequate, or stultify the financial sector with over-regulation – if not both.

What we need is a fundamental structural reform of the banking industry.

Last March I wrote an article in the *Financial Times*, subsequently republished in their May 2009 supplement ‘The Future of Capitalism’, advocating, as one of the lessons to be learned from the current global banking crisis, that in order to make a repetition of similar severity in future less likely, a return to something along the lines of the US Glass-Steagall Act of 1933 (introduced in the wake of the world recession of the 1930s, and not repealed until the 1999).

The purpose would be to enforce a separation between narrow, commercial, deposit-taking ‘utility’ banking on the one hand and high-risk investment banking (and other forms of banking and financial activity) on the other.

It is, needless to say, anathema to those who currently run broad or ‘universal’ banks.

There are four objections frequently made, all of which need to be considered.

The first is that corporate clients require their commercial banks to offer them the full range of financial services, and that to restrict their activities in any way would drastically reduce the financing options available to business and industry..

This is palpably absurd.

While many corporates may well desire a wide range of financing options, they have no need to get them all from the same institution.

Indeed, before the age of consolidation (which did not occur for their benefit, but for that of the banks) many corporates actively preferred to be able to shop around.

The second objection is that the crisis did not occur simply because the banks engaged, partly on the back of an effectively taxpayer-guaranteed retail deposit base, and partly because they saw themselves as being too big to be allowed to fail – the ultimate moral hazard – on high-risk, high-reward principal trading (or proprietary trading).

The principal cause, it is argued, was that the banks engaged in old-fashioned imprudent lending, largely against house purchase, as with the sub-prime market in the United States.

The truth of the matter is that both activities made major contributions to the meltdown.

But whereas the second can be addressed by straightforward capital-adequacy-based regulation, the former cannot.

The third alleged objection to a new Glass-Steagall is that even if such a separation were made, the collapse of a 'pure' investment bank can still be a systemic threat: look at Lehman, they say.

But the case for compulsory separation is that it very substantially reduces the threat of systemic risk, in a way that nothing else can, and the fact that systemic threats may still occur does not undermine this point.

Moreover, had the core commercial banking system been thoroughly sound, it is likely that the collapse of Lehman, although a shock, would not have posed a systemic threat.

In any event, I am not proposing that investment banking should be wholly free of prudential regulation, although such regulation would need to be 'light touch', both for practical reasons and to allow the sector's creativity to flourish adequately (something that is unlikely to happen in the current climate without a new Glass-Steagall).

There is only one serious objection that has been raised to this reform.

That is that, in the complex modern financial world, it is impossible to draw a line between those activities a narrow bank is permitted to undertake and those which it is not.

In particular, it is said, prohibiting narrow banks from engaging in principal trading (or proprietary trading) would be unenforceable, because such

trading is indistinguishable from a bank's normal treasury operations, when it is merely acting as an agent - notably hedging its risks.

But however difficult it may be to draw the line, I have no doubt that, given the will and the need, it is not impossible.

As for where the line should be drawn between financial activities a narrow bank may undertake on behalf of its clients and those it may not, there may inevitably be an element of judgment or even arbitrariness about this: that is usually the case when lines are drawn in law; but that (quite rightly) does not mean they are not drawn.

And in this case that judgment clearly needs to have a conservative, that is to say prudent, bias.

Moreover, it is generally agreed that a new and improved system of prudential supervision/regulation will need to insist on different capital adequacy and other requirements to reflect different degrees of risk in different activities; so lines are going to have to be drawn, anyway.

An important question is whether the desired separation needs to be complete institutional separation or whether it can be achieved by the less brutal means of a ring fence or firewall within a single institution, with retail depositors being given absolute priority in the event of a failure.

While the latter may appear a judicious compromise, it is in fact wholly inadequate.

There are a number of reasons for this.

The characteristic of such ring fences is that they are not watertight under extreme pressure: moreover, they cannot exist at all levels, since the group chief executive will need to know what is going on throughout the group.

There is the fact that the 'ring fence' option still rests much more weight than is prudent on the predication of sophisticated and effective supervision/regulation (in practice, it is likely that either the regulators will be outsmarted by the hugely better paid and motivated practitioners, or else that they will be excessively heavy-handed to try and prevent this: maybe both).

There will be huge shareholder and other pressures, in a broad bank, to boost the profitability (real or apparent) of the investment bank, inevitably at the expense of the soundness of the core commercial bank.

And if the investment banking activities come unstuck, this will inevitably weaken and possibly bankrupt the group as a whole, even if retail depositors are fully protected.

After all, throughout the present debacle, government deposit protection schemes have ensured in most countries that no retail depositors have lost any money.

That has not prevented fundamental systemic damage with huge economic consequences.

Moreover, we only need to look at the United States to see the practical reality.

Citibank, for example, has always been a wholly separate and thus theoretically ring-fenced corporate entity within Citigroup.

That did not save it.

It is, of course, true that, even with complete separation, narrow commercial banks will have normal banking exposures to investment banks and other financial companies.

But, first, normal banking prudence is much more likely to limit the scale and nature of such exposures than is the case with the conflict of interest that arises when the institution and its shareholders have a substantial equity interest in investment banking.

And, second, this will be closely monitored by the supervisory authority.

What is important is that the instincts and perceived interests of management and supervisors are, for the most part, aligned; which (sadly) has not been the case hitherto, and is unlikely to be the case without complete institutional separation.

The essential point is this.

The existence of broad or universal banking, for a number of reasons, greatly increases systemic vulnerability, and there is thus a strong public interest in prohibiting it.

The essence of an enforced separation between narrow, utility, commercial banks on the one hand and investment banks and the like on the other would be as follows.

Only narrow banks would have access to the payments system, on whose health the economy is so dependent.

Only narrow banks would be permitted to accept retail deposits, and they would have to raise a specified minimum proportion of their borrowing in this way.

Moreover, it is only these deposits that would be protected by an official guarantee scheme.

While narrow banks would be permitted to securitise a proportion of their lending, they would be obliged to keep a specified minimum proportion of each loan on their own books.

And, finally, narrow banks would be prohibited from engaging in principal or proprietary trading – or, in plain language, speculation.

Only a structural reform of this kind, I believe, can make financial regulation effective and realistic, while allowing investment banks the freedom to pursue their own often high risk creativity and innovation without endangering the entire financial system and indeed the economy as a whole.

Only structural reform of this kind can greatly reduce the risk of a future banking meltdown, with all the consequences we have seen this time.

There are some, I know, who argue that what went wrong was that the authorities concentrated on the regulation of individual banks, and neglected systemic risk.

This is wholly untrue.

The prudential supervision of individual banks was woefully inadequate, indeed barely perceptible, leading to a particularly malign form of Gresham's law, with imprudent banking driving out prudent banking, as prudent banks feared a loss of market share to the imprudent.

While there is such a thing as systemic risk, which needs always to be borne in mind, if every core commercial bank is obliged to remain sound (which was not the case) the risk of a systemic collapse is in practice minimal.

Protection of the economy – and indeed of the taxpayer, who has had to bear an unacceptably heavy burden in bailing out the financial sector over the past year – can be secured by ensuring, by regulatory requirements and

oversight, that the commercial or utility banking sector is always thoroughly healthy.

The discipline of the high risk investment banking sector, which would be forbidden to take retail deposits, would thus be left largely to market forces, thus avoiding the highly damaging increase in moral hazard that the current ‘too big to fail’ doctrine has introduced, with only relatively light, simple, and thus realistic regulation.

The essential point is that broad or universal banking, for a number of reasons, greatly increases systemic vulnerability, and that there is thus a strong public interest in prohibiting it.

One last point, on a different subject, but one of such importance that I cannot refrain from making it on an occasion as important as this is.

I mentioned early on in my remarks that the context of the current banking crisis is the unparalleled extent of globalization, which has made economic life much more complicated.

But globalisation has also been the greatest boon to the world economy as a whole and to the developing countries in particular.

There is a real danger today that the pressures of the current crisis will, as they did so disastrously in the admittedly far worse crisis of the 1930s, lead to a resurgence of protectionism.

That danger does not come only from the United States, but inevitably what America does is of particular significance.

And President Obama's surprise decision last week to impose a prohibitive (and probably illegal) tariff on imported Chinese tyres is an ominous straw in the wind.

This is particularly so following the 'Buy American' provisions in the President's fiscal rescue package.

The impulse to resort to protection when economic hardship suddenly strikes is, of course, always present

But there is today a dangerous new factor which magnifies the threat.

The 'cap and trade' Bill currently before Congress, designed to limit US carbon emissions in the cause of combating global warming contains a provision enabling the President to impose special tariffs on imports from countries (like China, for example) which are understandably unwilling to bear the heavy costs of an obligation to curb their carbon emissions at the present time.

There is considerable support in Europe, notably within the European Commission and in France, for a similar approach.

It is essential, both in the United States and in Europe, that this is resolutely rejected.

The first and most important requirement for the future of capitalism is the preservation of globalization, and the massive benefits it confers on mankind, in particular in the developing world.

There are, inevitably, costs of globalization; but they are hugely outweighed by the benefits.

So resistance to protection, whatever arguments may be used in its favour, must be rigorously maintained.

Nor is this an exclusively economic argument.

It is a moral imperative, as well.

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Thank you.

