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*Speech notes for the Berlin Conference of
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Financial and regulatory reform

My own view is that lax monetary policy and global imbalances were the main causes of the crisis. Although I have been a regulator I am aware of the limitations of regulatory powers. Regulators could not have created this mess on their own! But regulation could have done more to put speed bumps in the road.

There have been so many analyses of the regulatory failings that I will adopt shorthand here.

The main problems revealed were:

1. That global governance was wrongly structured and involved the wrong set of people.
2. That there was no discipline in the system and regulators could spend more than a decade devising rules which were “dead on arrival”.
3. That capital regulation was fundamentally flawed, pro-cyclical, too light, and ignored off balance sheet vehicles, and the parallel banking system.
4. In Europe there was a major flaw in the single market, which was revealed by the Iceland problem.
5. Supervisors were too focused on form rather than substance and the sum of individual institutional supervision was less than the sum of its parts. Systemic risks were not properly identified.

How far have the flaws been corrected by reforms agreed since the crisis erupted?

The Financial Stability Board is an improvement. I argued for it (technically a Council) in my book on global financial regulation two years ago. The membership has been broadened. Arguably there are now too many members, but that arose because reform was resisted for too long by the US and EU. (Do we need lessons on regulation from Argentina?). Should include the countries which have international financial centres or institutions with international reach.

Also the FSB has no real authority over the individual regulatory groups and has an uncomfortable relationship with the IMF. It may be imperfect but it is the best horse in the race and should be backed more strongly.

Stronger capital regulation has in principle been agreed by everybody. But everybody has a different interpretation on what is meant. Macro-prudential additions. Systemic risk charges. Leverage ratios. Tripled capital in the trading book (in Europe). Stress test related supplements (in the US). There are many competing ideas in the market place now. Discipline is needed, probably driven by the FSB, or we will enter a new phase of de-globalisation as the playing field becomes too bumpy.

In Europe we have a halfhearted solution with the European Systemic Risk Board (a good idea) and three authorities for banking, securities and insurance. They are also good ideas but they are not really authorities because it is impossible to agree treaty changes to give them firm powers. This is a halfhearted solution which ultimately will not work. Unfortunately, the UK government is the one most resistant to further central responsibilities.

The problem of how to respond to the obvious failures of supervisors in the run-up to the crisis has once again reignited the debate on regulatory structure, in a number of countries.

In a way, this is odd. It is hard to see any correlation between regulatory structure and regulatory performance in the years before the crisis.

The US had the most balkanised system of regulation, with an important role for the central bank. The UK had the most centralized system, with a modest role for the central bank. Yet both failed equally and in very similar ways.

If we look at countries which did relatively better, then Spain had a central bank with a very strong role. But Australia and Canada whose financial systems have survived more or less unscathed had no central bank involvement in institutional supervision. Indeed in Canada it has never been so involved and Australia separated out banking supervision at the same time as the UK.

Yet in spite of this evidence, countries now tend to want whatever system and regulation they did not have before the crisis. So in the UK the Conservatives want to put all supervision back into the Bank of England. Their model is closest to the Dutch – which probably failed more catastrophically than any other. Had RBS not bought ABN Amro, more or less the whole of the Dutch banking system would have gone down.

And in the US there is now a very polarised debate on what the role of the Federal Reserve in supervision should be. Similarly in Germany, the new coalition wants to strengthen the Bundesbank's role again. The Bundesbank was initially conceived without supervision responsibilities, of course, because of the potential incompatibility –as they saw it- with monetary policy.

What is my view on all this, and particularly on the role of the central bank ?

I strongly believe that the central bank needs a major focus on financial stability. Indeed I think it is a good idea to give it a statutory responsibility for financial stability, something which most central banks have not had. But I believe that as much because I think it is important for financial stability to influence monetary policy as for the central bank to influence supervision. That follows from what I have said at the start about the central role of monetary policy in the crisis.

My second point is that in order to carry out an effective financial stability role the central bank does not need to be an institutional supervisor. Indeed while it can be argued both ways, there are powerful points against. They are:

1. Contagion Risk. Things go wrong in financial markets and those responsible get blamed. Supervisors are there for that purpose. We should not want our monetary authority to be tainted. (Of course in the euro zone central banks are no longer monetary authorities, so this argument

does not have as much force). Indeed in EMU there is a case for using the central bank more in regulation, especially if you cannot reduce its staffing!

2. Central Banks as supervisors make regulatory integration harder. Only in the Netherlands, and perhaps now in the UK, has the idea of putting insurance and perhaps securities firms in the central bank gained traction. Yet we can see that some insurers can be systemic – AIG must have been or why was it rescued? (Do not answer Goldman Sachs).

3. The third point applies specifically to central banks as monetary authorities. Very different structures of accountability are required. The argument for central banking independence on monetary policy is very strong. But when it comes to supervision it is clear that the central bank has to be accountable to the government and to parliament when public money may be at risk. It is quite difficult to manage two different accountability routes in one institution. We are seeing some examples of that problem now.

I think that the ECB is now well placed in Europe. It chairs the Systemic Risk Board. It has a very good overview of financial markets across the euro zone. But it does not have direct institutional responsibility. The US should contemplate achieving something similar.