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# The New Regulatory Wisdom: good or bad?

The impact of new regulations on  
banking, credit and money

*Sir Adam Ridley*



INSTITUTE OF  
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MONETARY RESEARCH

Analysis and insight into trends in money and banking,  
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In his 1970 Institute of Economic Affairs pamphlet on *The Counter-Revolution in Monetary Theory* Milton Friedman, who was to be awarded the Nobel prize for economics six years later, wrote,

“Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output. ... A steady rate of monetary growth at a moderate level can provide a framework under which a country can have little inflation and much growth. It will not produce perfect stability; it will not produce heaven on earth; but it can make an important contribution to a stable economic society.”

# The impact of the New Regulatory Wisdom on banking, credit and money: good or bad?

*Sir Adam Ridley*

Output growth in the leading Western economies has been weaker since the Great Recession of 2008 and 2009 than at any time since the 1930s. According to the International Monetary Fund's database, advanced economies' gross domestic product was flat in 2008 and dropped by 3.4 per cent in 2009. Although 2010 enjoyed a rebound with 3.1 per cent growth, the next three years saw output advancing typically by a mere 1 ½ per cent a year. This was well beneath the pre-2008 trend. Even now (September 2016), after slightly better years in 2014 and 2015 of 2 per cent increases in advanced economy output, it is uncertain whether future growth will be sustained or vigorous. A period of several years of morose and sluggish recovery is a distinct possibility. Is such mediocrity the inevitable result of the crisis and the best for which we can hope?

By common consent, the Great Recession began with the banking disasters of 2007 and 2008. In the leading Western nations the official response to these disasters has had a number of well-known and familiar common features, although policy has been far from stable or easy to predict. The elements of this response constitute what might be termed the "New Regulatory Wisdom" (NRW). How is to be defined? What has been its impact so far? And what will be its effects if it is maintained into the future?

The next section defines the NRW in more detail, and the section after that discusses the official motives for its adoption during and after the Great Recession. The paper then reviews the impact of the NRW on the quantity, quality and pricing of new bank credit, and the ability of capital markets to take the place of the banks in the extension of new credit. The conclusion is that regulatory actions that were ostensibly wise and necessary in microeconomic terms had drastic and very unfortunate macroeconomic results. Such actions reflected the exaggerated belief of most journalists and economic commentators, soon communicated to politicians, that the key issue was potential insolvency in the financial system. The result was an obsessive focus on an actual or supposed lack of capital. No one in the top regulatory bodies, the key international agencies and the governments of leading nations stopped to ask what the cumulative and aggregated effect of the regulatory upheaval would be on bank credit, the quantity of money and macroeconomic activity. These same agencies ought now to consider how best to restore stability and predictability in the regulatory environment, and to end the

virtual “perpetual revolution” from which banking now suffers.

I

The NRW has several aspects. First, the family of controls imposed on banking and securities businesses (“banks” for short) by officialdom has become more unfriendly. Tighter requirements have been imposed on banks’ balance sheets. They must keep more capital relative to assets and limit their leverage, they must maintain a higher proportion of assets in liquid form, they must have a lower proportion of risky loans and securities in their portfolios, and they must fund their businesses more conservatively from stable sources.

Second, several policy initiatives have put pressure on market participants to transfer over-the-counter (OTC) contracts into recognised exchanges, clearing-houses and various post-trade registration businesses. In this process of “domesticating” OTC activity, these institutions – which specialize on the settlement of trades – have assumed greater significance relative to the banks. In effect, the banks are being “cut down to size” as part of the larger ambition in public policy to “deleverage balance sheets”. As a result, the financing and growth of private sector activity hereafter will be tilted more towards the capital markets than in the past.

Third, new controls are being enforced on long-term savings institutions, particularly insurance companies and pension funds. Tough policies are being introduced to ensure a closer matching of assets to the risks implicit in their liabilities, which in practice has meant a reduction in the riskiness of asset portfolios and less management discretion in asset selection.

Fourth, policy-makers have shown their concern about the structure of the banking industry, with measures to separate so-called “utility banking” from “casino banking”. Utility banking is to be understood as the provision of payments services to depositors, notably to retail depositors, combined with the matching of deposits to very safe assets, such as government securities. “Casino banking” is seen as including proprietary trading and “own account” business, traditionally undertaken in banks by the Treasury team, often with input from top management. (It needs to be emphasized here that many risk exposures in banking arise from customer business and that a key management function has always been to manage the size of such exposures relative to bank capital.) The problem of separating “utility” banking from the casinos of high finance has been particularly serious in “universal banks”. Universal banks have historically been a feature of continental European financial systems, and not of financial systems in the English-speaking world. They have combined commercial banking (that is, deposit-taking and lending) with investment banking (i.e., the trading of securities, and the underwriting of securities issued by the corporate sector).

Fifth, one of officialdom’s complaints during the period of intense crisis was that it lacked established procedures and institutions for dealing with novel challenges. So regimes have been introduced to “resolve” failing bank businesses. Of particular

concern has been to reduce the alleged “too big to fail” risk (TBTF) and to regulate better the systemically important businesses which remain.

Sixth, the monitoring of risks in the financial sector relies on support from two powerful associates, the accountancy profession and the ratings industry. Top accountants have pressed for new and sometimes rather complex standards. In particular, they require financial institutions’ accounts to be prepared on a “fair value” basis. (Under fair value accounting, assets are entered on balance sheets on a mark-to-market basis instead of according to their historical cost.) The consensus is that the rating agencies did an unsatisfactory job in the run-up to the crisis, by underestimating the loss probabilities in the riskier tranches of asset-backed paper. They have been criticised especially for being too soft towards dangerous underwriting practices in US housing finance between 2002 and 2006. But during and since the Great Recession they have over-compensated for such earlier failures by pre-emptive and often excessive downgrades of intrinsically strong financial businesses. That has aggravated the funding strains for such businesses, in an environment already beset by a systemic lack of confidence.

These six trends in financial industries’ organization and regulation have been disruptive in their own right. But they have been at work while the peak regulatory institutions, both domestic and international, have been reshuffling their responsibilities and powers. (The upheavals have been greatest in the USA and the UK.) In effect, the financial sectors of major economies have been subject to a disorderly process of perpetual revolution. Year after year seemingly definitive measures are modified, almost always tightened and usually rendered more complex. Politicians, acting under the auspices of the G20 Group of leading nations, feel that they must “do something”, and recommend new committees and institutions. This leads to the recruitment of an increasing number of ever more risk-averse regulators who, once they have been appointed, move into new policy areas and propose new initiatives. All too often, the initiatives emanate from a multiplicity of sources and may be inconsistent. For example, regulatory policy in EU member states reflects inputs from national, EU and global authorities, and these inputs often differ in both their priorities and substantive content.

## II

The recurring pattern of the policy response to the crisis emerged soon after its intensification in autumn 2008. The authorities’ first concern focussed on the banking industry, seen as the prime culprit for the Great Recession. The key prescription was to require more banking capital from private sources or, where that was impossible, to mandate capital injections from the state. National regulators implemented recommendations from the Basle-based Bank for International Settlements, with a new set of regulations (Basle III) updating and reinforcing the standards contained in Basle I and II that had originated in the 1980s. The European Commission advanced the EU’s

own framework, in a Capital Requirement Directive that had begun hesitantly in 2006, but post-crisis was to become more respected, central and urgent in implementation. The years after the crisis saw progressive and remorseless tightening of target ratios for capital, liquidity and leverage. This was complemented by ever more demanding analyses of varying scenarios of market stress and failure, with capital and funding tests based on them.

The larger institutions faced a particular burden. Officialdom had been perplexed during 2008 by the potentially self-reinforcing downward spiral of system-wide confidence breakdown and market disintegration that seemed to be under way. Such system-wide pathologies were judged to be due to trouble only at large banking or financial businesses. Smaller banking businesses could therefore be allowed to close, because their disappearance would have only isolated effects and these would not be of systemic significance. But large businesses were deemed “too big to fail”, because of their “systemic importance”.<sup>1</sup> Officialdom decided that in future “global systemically important banks” (G-SIBs) should have advance plans about how their “resolution” would proceed in crises of various kinds. These plans had to be agreed with official institutions in several jurisdictions, such as the Prudential Regulation Authority in the UK, and the Federal Reserve and the Securities Exchange Commission in the USA. In the EU big banks – banks with operations in several European nations – had to negotiate their resolution strategies not only with national regulatory bodies, but also with the European Banking Authority. The EBA had been set up as recently as January 2011.

In the USA a veritable encyclopaedia of measures was launched by Dodd-Frank legislation in 2010. Indeed, Dodd-Frank was perhaps the critical post-crisis regulatory innovation for US capital markets. One of its main aims was to curb the supposed excesses of OTC derivation and trading. It even went so far as to specify initial and variation margins for certain categories of securities trading, as well as directing that OTC trading had to take place on organised platforms rather than between one stand-alone finance institution and its customers. Fund management was also regarded as an appropriate subject for more regulation, even though no economic theory identifies the fund management industry as capable of causing booms and busts in the economy as a whole.

The insurance industry posed specific issues. Like the fund management industry, it is not usually seen as having any bearing on business cycles. But the turmoil at AIG in late 2008 had suggested to some that, in the extreme, the solvency of big insurers and leading investment banks could be related. The EU therefore pushed national insurance industries to accept its Solvency II Directive, with risk-sensitive asset weighting used in assessing and fixing the regulatory capital of insurers. Solvency II is now [late 2016] widely adopted across the EU. It penalises illiquid, high-yield and risky long-term assets (such as private equity, property and infrastructure), and favours liquid, low-yield and safe short-term assets with high credit ratings, notably short-dated government and public sector bonds.

### III

The discussion so far shows that the NRW constituted a “regime shift” for banking systems in all the advanced economies. This regime shift is still not complete and remains far from certain in its eventual scope. But it has clearly had major effects already on virtually every aspect of banks’ operations, notably

- Asset selection,
- Costs and margins on loans and other products,
- Market standing and credit ratings,
- Ability to raise new capital, and
- Capacity to lend,

Each of these may be considered in turn.

## 1. Asset selection

The NRW can be viewed as a comprehensive attempt to make banks safer. It has involved constant regulatory pressure for banks to set their risk appetite at lower levels, both in general and specific terms. Pivotal to the process of de-risking bank balance sheets have been the requirements to hold more capital relative to assets. The banking industry has therefore been anxious about the critical, but little noticed implications for the return on capital, particularly on equity, and on both simple and risk-weighted bases.

The argument has revolved around a well-known formula for deriving bank profitability. Banks’ assets (A) can be seen as split between safe and liquid assets (C), and relatively risky earning assets (or “loans”), L. The paradigmatic safe asset is of course cash and, for simplicity, the safe and liquid assets can be taken to yield nothing. The ratio of liquid assets to total assets may be assumed set by regulators at  $c$ . Total assets are  $L + C$  or  $L + c.A$ . So  $L = (1-c).A$ . Profits (P) are equal to the loan margin or profit “spread” on earning assets,  $s$ , multiplied by the quantity of earning assets, which is

$$P = s.L = s.(1-c).A,$$

while the rate of return on capital (K), is  $P/K$ , which is

$$P/K = s.(1-c).A/K.$$

It is evident that, if the loan margin ( $s$ ) is given, the rate of return on capital is inversely related to the ratio of liquid assets to total assets and the capital/assets ratio. Alternatively put, if new regulation demands a doubling of the “leverage ratio” (that is, of the ratio of capital to assets), a bank’s balance sheet must halve for any given level of capital. If the target return on capital is to be maintained, the net loan margin has

to double. The proportion of private sector borrowers which can absorb this increased cost is limited. In practice, banks have reacted to the range of new regulatory intrusions by switching credit from high-risk, exciting clients to safe and boring ones.

The need for regulatory capital can be further reduced by eliminating or cutting back capital-intensive, high-risk products and services. Since 2008 banks have had to restrict or even to abandon specialised activities, such as private equity financings, shipping and aircraft leasing, and infrastructure and unsecured long-term lending. The de-risking of balance sheets has also been accompanied by a rise in the ratio of low-risk claims on the public sector to total assets. Overall, both commercial banks (with their loan portfolios) and investment banks (with their portfolios of securities and underwriting activities) have been forced to write less business at a lower return. Not surprisingly, in all the major economies the stock market capitalisation of the banking sector has fallen heavily relative to that of other economic sectors.

## 2. Costs and margins on loans

As already explained, newly-imposed official obligations to hold more capital and liquidity relative to total assets must either reduce banks' return on capital or force them to widen loan margins.<sup>2</sup> Of course, banks have for many decades faced downward pressure on margins from competition, so that much of the mainstream loan book before 2007 was of marginal profitability. One response was to seek profits in other parts of the balance sheet, notably by currency trading, and the origination, writing and trading of derivatives, all of which served customer needs. More extreme and adventurous was outright proprietary trading, on the back of banks' capital, regardless of customer requirements.

Banks – particularly large banks with their number and diversity of customers, and their access to numerous marketplaces – are well-placed to manage risk on currency and derivative exposures. However, officialdom interpreted the late 2008 media alarm about credit default swaps and other products as justifying restrictions on banks' position-taking. More specifically, they saw it as providing a rationale for separating commercial banking from the kind of risk-taking seen in the proprietary trading of the investment banks. The “Volcker rule”, that banks must not engage in proprietary trading divorced from customer business, was part of the USA's Dodd-Frank legislation and was publicly endorsed by President Obama in January 2010. The similar reforms recommended by the 2011 Vickers Report in the UK were part of the wider international trend. The Liikanen Report of September 2012, published under the impetus of the European Commission, applied the same thinking to the EU as a whole.

But – if banks cannot make profits from trading activities, whether customer-related or not – they must either accept a lower rate of return on capital or charge a wider margin on their loans. The official attack on proprietary trading was in this sense an attack on bank profitability. Over and above this effect, extra regulation has added an assortment of additional charges, costs and expenses. The expansion of regulation and



the increased burden of compliance have been obvious sequels to the crisis, but talk of pre-funding deposit insurance schemes and a new EU-wide financial transactions tax have also been a worry for the banking industry. (In the first instance contributions to such schemes are straight deductions from banks' profits. Banks may try to recover them by charging their customers more, but then the ultimate effect of more regulation is again to widen loan margins.)

The drive for greater clarity about banks' resolution strategies has encouraged the issuance of new types of liability, such the hybrid bail-in "contingent convertibles" (or COCOs). COCOs provide for investors to convert their bond-like claim on a bank into equity, if the unfortunate contingency occurs. This contingency is that the bank suffers losses that deplete capital beneath a regulatory capital/asset ratio minimum. As they are novel and untested, they create serious uncertainties for both the banks which issue them and the investors who buy them. The poisonous combination of risk and unfamiliarity makes COCOs an expensive form of capital, which again cuts into banks' profitability.

### **3. Market standing and credit ratings**

The impact of the post-2007 deterioration in banks' credit rating on their operations has been surprisingly little noticed and discussed. It is widely agreed that the credit rating agencies did not distinguish themselves in the period before the Great Recession, as they failed to spot the slide in credit standards in the American housing finance industry and wrongly gave triple-A ratings to securities that turned out to be unsatisfactory in the end. But their assessments of the banking industry from 2008 onwards – that it was much riskier and less credit-worthy than before – were taken very seriously. The ratings agencies have marked down severely the credit standing of the vast majority of banks and insurance companies. The downgrading has not only reduced the market values of quoted banking groups, but also added to their difficulties in financing assets. Regaining strong ratings will be hard and take time.

Arguably, the setters of accounting standards have made matters still worse by pressing for early, comprehensive and conservative treatment of bad debts. Instead of taking a pragmatic and flexible view, banks are being obliged to over-provide when in doubt about the likelihood of loans being repaid. Such write-offs reduce capital, which then undermines banks' ability to extend new credit. (The traditional bank practice of forbearance on bad or doubtful debts has been condemned by those emphasizing the moral hazard supposedly implicit in it. This condemnation overlooks the large body of historical evidence, notably from the Third World debt crisis of the 1980s, which demonstrates the scope for asset values and loan collateral to recover in cyclical upswings.)

#### **4. Ability to raise new capital**

Given all the regulatory reforms, innovations and threats, and the pervasive assumption that risk is bad and must be minimized, it is not surprising that the return on equity in most banks has fallen steeply compared with the pre-crisis period. (The return on equity is now widely seen as likely to be between 5 and 10 per cent a year for most banking groups, compared with a cost of equity commonly cited as over 10 per cent.) Logically, with the return on equity lower than its cost, the market value of quoted banks is beneath their book value. This makes it harder still to raise new equity capital and also adds to the cost of issuing such non-deposit liabilities as the COCOs that currently have regulatory blessing.

#### **5. Capacity to lend**

Commercial banks' defining characteristics are that they provide settlement and money transmission services to non-banks, and that they extend credit to the private sector and (sometimes) the state. Relative to capital markets, which enable non-bank savers to transfer funds to corporate borrowers, their credit facilities are low-cost and flexible. (Capital markets cannot grant overdrafts to small- and medium-sized companies, whereas banks can.)

The NRW has undermined banks' ability to extend credit to the private sector. Three mechanisms need to be mentioned. First, the regulatory demands for more capital and liquidity have of course reduced the scope to lend to the private sector. With the quantity of banks' capital given, it is obvious that an increase in their capital-assets ratio means a reduction in assets. Since at the start of the crisis banks' assets were overwhelmingly claims on the private sector, a reduction in assets has in practice been synonymous with a reduction in loans to the private sector. Meanwhile liquid assets (such as cash reserves at the central bank and short-dated government securities) are mostly claims on the government. If they expand when total assets are given, loans to the private sector must drop further to accommodate them.

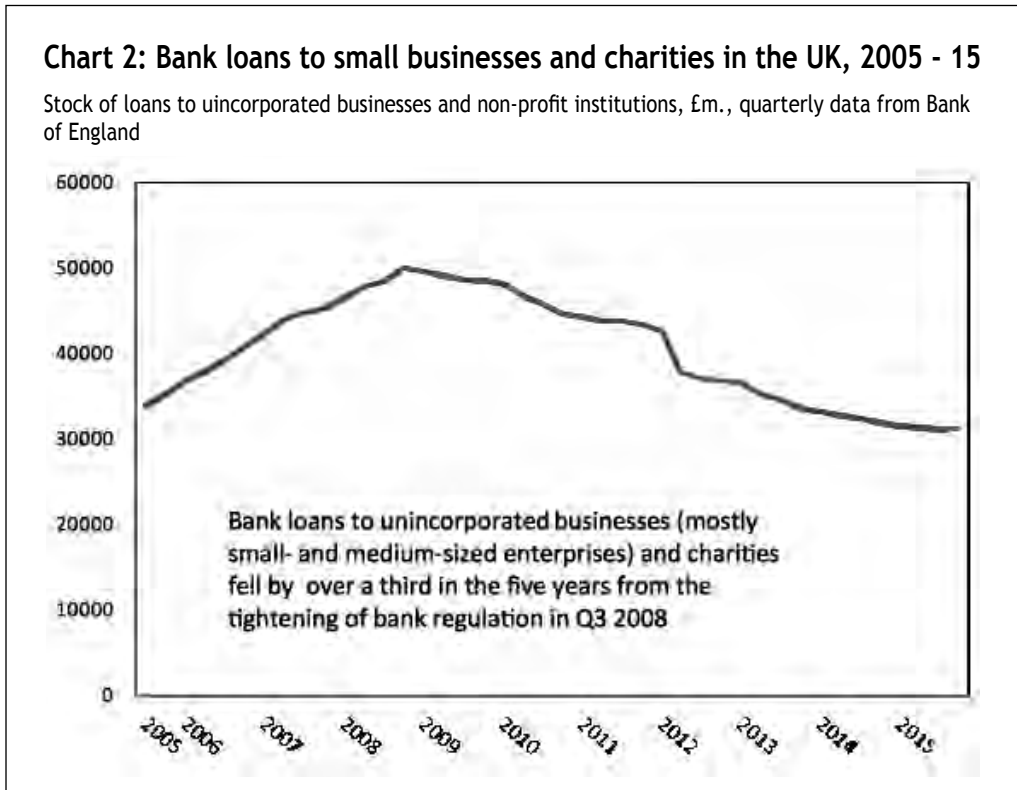
Secondly, as explained above, banks have responded to the regulatory assault by widening loan margins. That has made credit more expensive to borrowers. At the margin, some borrowers must have repaid loans or declined to seek new facilities.

### Chart 1: UK bank lending to companies, before, during and after the Great Financial Crisis

Chart shows monthly values of stock of loans (August 2008 = 100, just before the tightening of bank regulation), in both nominal and real terms



Finally, officialdom's aversion to risk has affected the relative dynamism of different types of credit. As loans to small companies are risky compared with residential mortgages, it is plausible that the implementation of the NRW would raise the ratio of mortgage loans to small company loans in banks' overall loan portfolios. The pressures to lend to safe, boring and low-risk businesses, and to dispose of high-risk capital intensive services and activities, are intensifying. The quality of banking services will decline, as expertise is lost in understanding the credit requirements of sectors which are important to long-run growth and innovation. As Chart 1 shows, in the UK the stock of bank credit extended to companies fell in nominal terms, and more drastically in real terms, in the five years from autumn 2008 and remains sluggish even now (late 2016). Small- and medium-sized companies have been particular targets of the credit squeeze. (See Chart 2, which demonstrates that the trend in SME credit was even weaker than lending to corporates as a whole.)



#### IV

The “top-down” constraint of the regulatory pressures on leverage ratios, capital and liquidity in banking has had – and continues to have – a severely contractionary effect on all European economies. As Van Steenis, a top analyst of the banking sector at Morgan Stanley, observed in a 2012 research paper, for the European economy “historical data...imply [approximately] €1 trillion of net new lending to support 1% - 2% a year GDP growth to 2017”. But Morgan Stanley’s estimate was that, “banks in Europe will struggle to deliver more than €400 billion of new credit over the next five years given constraints on funding as well as leverage under [the Basel III regulatory framework]”. Bluntly, “[b]alance sheet light competitors [i.e., competitors not subject to the same capital rules as the banks] will attempt to disrupt and take share...[B]anks will be forced quickly to find a new model to deliver credit or lose relevance through disintermediation. We estimate a \$5 trillion funding gap globally, \$3 trillion of which is in Europe.”<sup>3</sup>

What of the motivation of individual banks? Is there any commercial logic in providing credit on an ample scale in the new regulatory environment? Deutsche Bank

reached sombre conclusions in another 2012 analysis for investment clients. In its view the challenges were particularly severe for European BBB-rated banks, since they had a higher funding cost than their better-rated competitors. Indeed, their high funding costs – in combination with all the new capital and liquidity rules – meant that they could not lend to any low-risk corporate counter-parties and still be profitable. Even A-rated and AAA-rated banks found it difficult to make profits sufficient to meet target returns to capital. Only if they sold bank services to corporate customers in addition to extending credit could long-standing relationships with big corporates provide returns that might match the cost of equity. The message was that some banks running corporate loan books might be doing so in a value-destructive way. Undoubtedly, the NRW can choke off or cap credit expansion. To quote the Deutsche report, “So most lending should be dis-intermediated [that is, transferred] to the bond market. We have...estimated top-down \$2 trillion of corporate loan disintermediation... We now think it could be \$3 trillion [in the coming period of bank balance-sheet retrenchment].”<sup>4</sup>

Its critics claim that the banking system is not as capital-constrained as its spokesmen sometimes assert. They argue, for example, that staff costs and employee numbers are too high, and that a clampdown on inefficiency could lead to higher profits and more capital retention. Alternatively, the critics say that banks’ balance sheets are replete with assets of little or no social value, such as loans to other financial intermediaries. In their view, public policy-makers are entitled to ask for the banks to focus on areas of most social and economic value to the economy (as these policy-makers regard the issue), and to demand a rebalancing of bank assets. Their assessment is that fewer loans to the finance sector can be accompanied by more to industry. Further, in their judgement, banks can comply with the officially-approved “deleveraging” of their balance sheets and yet serve the wider economy successfully.

This smacks of dangerous optimism. Deleveraging is not a simple mechanical process which can be implemented swiftly and without cost to the bank, its clients or the wider market. When banks extend loans, they enter into legal contractual commitments to their borrowers. If they ask borrowers for early loan repayment in order to meet the supposed imperative of deleveraging, they may breach the terms of contracts and leave themselves open to challenge in the courts. They cannot discriminate against certain types of customer, merely because official policy (which is itself highly volatile) is in favour of rebalancing between different sectors of the economy.

It must again be emphasized that, certainly for the larger banks, the biggest challenge in capital raising today is the “permanent revolution” which the NRW embodies. Since 2008 the regulatory regime has tightened significantly and without interruption, year after year, to an unpredictable degree and in unforeseen ways. Senior bank executives have to expect that the regulatory assault is to continue into the medium term. If so, why should a rational fund manager invest in any banking institution? Thus, in November 2015, a full seven years after the initial moves to a more rigorous regulatory regime, the Financial Stability Board issued new guidelines for G-SIBs’ capital position. In this environment the notion that large amounts of new bank equity can be raised

from market sources is unrealistic.

If banks are indeed so hemmed in by new regulation that they cannot expand their loan portfolios, is there any prospect that credit business can be transferred to capital market? One view is that novel forms of financial business can develop rapidly and bypass the old-fashioned mainstream banks. In a 2013 article in *The Spectator* Andrew Haldane, the chief economist at the Bank of England, pointed out how many of banks' customers can now meet each other in cyberspace. To quote,

New peer-to-peer entrants into most aspects of banking services – consumer financing, foreign exchange, IPO underwriting, invoice financing, small business lending and equity venture capital financing (so-called crowd-funding)... [These entrants are]...small and few but growing rapidly in size and multiplying in number.

Haldane's fundamental proposition was that, thanks to the information technology revolution, the new services would fill the so-called "Macmillan gap". Innovation on these lines is undeniable and welcome. But past experience suggests that the impact over the next few years will be patchy. Peer-to-peer lending cannot grow fast enough to take on the role of the banks. Another issue is how the regulatory authorities will view the risks involved in these new and still rather informal credit channels. Will there be the usual miserable early scandals and failures?<sup>5</sup> Will this new financial Wild West attract the outlaws or the responsible entrepreneurs for whom this should be a great opportunity? Will there be heavy-handed clampdown at any point?

Sure enough, some financial business will be diverted from the banking system to capital markets. Nowadays large British companies have access to the international bond market, where the best names can issue paper in any currency and convert the proceeds back into sterling. No doubt some "securitisation" of bank finance will occur. Optimists might take comfort from the American example. In the USA about 70 per cent of corporate funding comes from the capital markets and only 30 per cent is provided by the banks. If the USA can do it, surely the UK and Europe can copy? A realistic reply to this question is that the gigantic upheaval envisaged might take place over a decade or two, but not in the course of a single business cycle (of five or seven years). An institutional and cultural revolution would be needed for a more rapid shift to capital market finance. In any case, the capital markets cannot readily deal with the financing needs of small- and medium-sized businesses. For SMEs bank finance is critical, and will remain so.

It must also be pointed out that big players in the capital market have also to cope with the regulatory distrust of risk-taking. Not only have underwriters and brokers to redirect business towards clearing houses, but they have also to allow for heavier capital loading than pre-2008 for assets held during the securitization process. This extra loading on securitization activity is over and above the more general move towards higher capital/asset ratios in the banking industry. Moreover, because commercial banks have bowed to official pressure and cut their credit lines to the securities industry, investment banks have smaller books of securities than before. In bond markets they

cannot deal with counter-parties in the same size and with the same narrow dealing spreads as in 2006 or early 2007. A common complaint at present (late 2016) is that the secondary market in bonds is less liquid than pre-crisis. On this basis, the ability of the primary market to accommodate vastly increased bond issuance must be in doubt.

The markets through which so many of these processes must operate will also be under the same familiar pressures. The reforms imposed by officialdom require private sector profit-motivated businesses to operate with a larger capital burden. As already noted, banks are always competing with the capital markets as sources of funds for corporates. But they are less able to help corporates with their own financing needs, and both they and their customers must lodge extra collateral to conduct derivatives business. Morgan Stanley calculated that the USA's Dodd-Frank legislation led to an "industry-wide incremental initial margin requirement associated with the new regulations at \$1.7 trillion".<sup>6</sup>

## V

Where does the discussion lead us? As far as the past is concerned, it is plain that the NRW has acted not just to check the growth of banks' risk assets, but to cause large outright contractions in many banks' holdings of such assets. The further consequence has been to cause reductions, or at best stagnation, in banks' overall balance sheet size. At the aggregate level, this was most obvious in 2009 and 2010. The evidence strongly suggests that the NRW was one of the main reasons why the potentially manageable banking crisis of 2007 and 2008 turned into the disastrous Great Recession. Ostensibly microeconomic steps to reduce risk in the banking system had drastic macroeconomic results. They constituted, in reality even if not in intention, a ferociously contractionary monetary policy.

In the last few years many governments have pursued textbook programmes of fiscal austerity. The Greek default and related trauma argue that fiscal austerity has been necessary and wise. However, the authorities ought to have offset the adverse effect of government cutbacks on demand and employment. The combination of fiscal and monetary stringency in Eurozone periphery countries has had devastating impacts on output and jobs. The authorities should have followed a monetary and regulatory policy which supported economic activity rather than curbing it. In the run up to the crisis, commentators might reasonably have claimed that governments had learned how to achieve non-inflationary growth, but the private sector had not understood how to manage risk. Today the focus is so much on controlling risks that we can no longer bring about growth.

Economic history offers instructive precedents. In October 1987 the Black Monday stock exchange crash threatened to provoke a serious downturn. This was, indeed, forecast shortly after by a distinguished group of 33 top economists at a Washington meeting held under the auspices of the Institute for International Economics. However, in sharp contrast with officialdom's reaction to financial stress in the year to autumn

2008, in October 1987 they adopted a conscious policy of sustaining credit, easing liquidity and supporting asset prices. The adroit handling of the 1987 crash followed international success in mitigating the effects of the Third World debt crisis (from mid-1982) on economic activity, and the UK's (and especially the Bank of England's) exemplary management of the secondary banking crisis in the mid-1970s.

A case can be made that the malign effects of the NRW on the banking industry are the dominant reason that the macroeconomic sequel to the financial difficulties of 2007 and 2008 has been so much worse than the setbacks suffered after comparable difficulties in the 1970s and 1980s. At the most fundamental level, questions must be asked about the rationale and scale of the capital demands and the regulatory crackdown. As far as the UK is concerned, only two banks – RBS and Lloyd's – had significant losses in the crisis period, with those at Lloyd's arising from its officially-blessed acquisition of HBOS. As Table 5.1 shows, cumulative losses in the loss-making banks in the six years from 2008 (almost £35 billion) were only a fraction of the main groups' combined shareholder funds (about £175 billion) at end-2007, while the losses at RBS and Lloyd's were outweighed almost threefold by the profits earned by their more successful rivals.<sup>7</sup>

Some might argue that there is an obvious disparity between the loss figure (to repeat, £35 billion) and the requirement for extra capital. As Table 1 brings out, shareholders' funds at the UK's big banks rose by about £140 billion between end-2006 and end-2011, a figure that was four times the losses of RBS and Lloyd's over the entire crisis period. The dissimilarity between the severity of officialdom's response to the Great Recession and the leniency of its reaction to earlier shocks could hardly be more marked. One has to ask, "has society as a whole has benefited from the changed attitude of governments, central banks and regulators?"

Looking to the future, at least two lessons suggest themselves. First, as a minimum, the authorities – central banks, finance ministries and regulatory bodies – must recognise that apparently microeconomic steps to curb risk can have "systemic importance". Regulatory upheaval must not be so drastic and abrupt as to cause macroeconomic instability. The growth rates of bank credit and the quantity of money must be such as to ensure satisfactory expansion of nominal demand and output. A slower pace of regulatory reform may be more prudent. Policy-makers must never forget that they have a responsibility to keep aggregate economic activity advancing steadily at a trend rate.

Second, the international and national authorities need to take a step back and work out a sound long-term collective strategy. New institutions and initiatives have proliferated in the last few years to such a degree that many practitioners in the financial sector cannot cope with the upheaval. The authorities must consider how best to restore stability and predictability in the regulatory environment. Sadly, those in the eye of the storm, whether regulators or regulated, are too preoccupied to be able to resist the perpetual revolution going on around them. They often seem not even to have asked themselves whether all the turmoil is necessary and sensible.



**Table 1: UK banks' profits and capital before, during and after the Great Recession**

The table relates to the four/five largest UK-owned quoted banks, excluding Standard & Chartered. Like Standard & Chartered, the bulk (about 75% - 80%) of HSBC's profits are from international operations. HBOS was a separate bank (i.e., the fifth bank) until 2008, when it was acquired by Lloyd's.

	Pre-tax profits of all four/five banks, £m.	Share-holders' funds of all four/five banks, £m.	Total losses of banks with losses, £m.	Total earlier year share-holder funds of banks with losses, £m.	Pre-tax profits as % of shareholder funds for all banks, %	Losses as % of previous year shareholder funds for banks with losses, %	Losses (of all loss-making banks) as % of shareholder funds for all banks, %
2005	34,259	134,046	0	Not relevant	25.6	Not relevant	Not relevant
2006	36,151	143,304	0	Not relevant	25.2	Not relevant	Not relevant
2007	36,171	174,153	0	Not relevant	20.8	Not relevant	Not relevant
2008	5,896	169,073	-8,534	53,038	3.5	16.1	5.0
2009	-5,114	247,640	-12,939	31,242	-2.1	41.4	5.2
2010	19,284	266,365	0	Not relevant	7.2	Not relevant	Not relevant
2011	28,342	279,009	-2,802	121,193	10.2	2.3	1.0
2012	6,861	268,997	-3,621	75,367	2.6	4.8	1.3
2013	9,588	263,408	-6,501	68,678	3.6	9.5	2.5
2014	20,862	287,862	0	Not relevant	7.2	Not relevant	Not relevant
Totals in six years from 2008	64,857		-34,397				

Source: Company reports and accounts, as collated by REFS. REFS is a company analysis service prepared for institutional investors and now published by JD Financial Publishing Ltd. in London.

The British banking industry remained profitable as a whole in the Great Recession, although two banks – RBS and Lloyd's – had significant losses. In the case of Lloyd's the losses arose from its acquisition of HBOS, which had official blessing. The losses at RBS and Lloyd's were less than their initial, pre-Great Recession capital and much less than the initial, pre-Great Recession of the whole banking system. The equity capital of UK banks rose strongly – by over £100b. - in the seven years from end – 2007 and by much more (by a factor of eight times) the losses of loss-making banks in the worst year, 2009, of £13b.

## References

- <sup>1</sup> The phrase “too big to fail” is sometimes thought to have originated in the Great Financial Crisis of 2008 and 2009. In fact, the notion has its origins in early capitalism. See Charles G. Leathers and J. Patrick Raines ‘Some historical perspectives on “too big to fail” policies’, pp. 3 – 27, in Benton Gup (ed.) *TooBig to Fail* (Westport, Connecticut, and London: Praeger, 2004).
- <sup>2</sup> The Bank of England’s *Financial Stability Report* (London: Bank of England) for June 2015 confirmed these points. Table B.1 on p. 35 noted that UK banks’ Basle III risk-weighted capital ratio had increased by 4.1 percentage points since end-2011, and ascribed 2.9 percentage points of the change to the “reduction in risk-weighted assets”. The document published an Appendix 2, with ‘Core indicators’. Spreads on new corporate lending in the UK were said to have averaged 107 basis points between 1987 and 2006, and to have been 100 basis points in 2006, just before the crisis. The latest value (for December 2014) was 237 basis points. An even larger increase had occurred in new lending to households. In 2006 the spread was 352 basis points, but in March 2015 it was 658 basis points. (See p. 55 of June 2015 *Financial Stability Report*.)
- <sup>3</sup> Morgan Stanley and Oliver Wyman *Wholesale & Investment Banking Outlook* (Blue Paper, 23 March 2012), pp. 18 – 19.
- <sup>4</sup> Deutsche Bank Markets Research European Banks Strategy: *Corporate lending structurally unprofitable, consequences for banks* (London: Deutsche Bank), 20 June 2012 note, p. 1.
- <sup>5</sup> The original version of this paper was written in early 2014. In February 2016 newspapers began to report numerous bankruptcies of companies financed by crowd-funding platforms. According to a report in the *Financial Times* (‘Fall of Rebus sparks calls for protection’, 6 February 2016), “Research by AltFI Data and the law firm Nabarro recently found that one in five companies that raised money on crowd-funding platforms between 2011 and 2013 had gone bankrupt.”
- <sup>6</sup> Morgan Stanley *US Interest Rate Strategist: the Impact of Dodd-Frank* (New York: Morgan Stanley Research), 26 October 2012.
- <sup>7</sup> The data in the table have been compiled from the REFS handbook of company analyst reports now compiled by London-based JD Financial Publishing, using a methodology developed by Jim Slater. The company analyst reports themselves come largely from company reports and accounts. Official data on the UK banking industry’s equity and bond capital, and its profitability, are available, but are opaque. Series are published for the UK banking system’s profits and losses, available for both UK- and foreign-owned organizations, are not easily related to the banks’ equity capital. The Bank of England’s *Bankstats* database has a Table B3.2 on ‘Monetary financial institutions’ annual profit and loss’, with a column under the mnemonic B5RL for ‘Pre-tax profits’. The numbers are different from those in Table 5.1, with the loss numbers in 2008 and 2009 being £20,942m. and £10,559m. However, over the whole five years to 2013 the loss totals in B5RL (£31.5 billion) and Table 7.1 (£34.3 billion) are similar. There is no question that the UK banking system’s losses in this turbulent period were much less than its equity capital before the trouble began, and that the increase in capital mandated by the authorities was a multiple of the losses incurred.

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Changes in the price level – through either inflation or deflation – have diverging effects on different people and companies. They can result in arbitrary shifts in income and wealth distribution, and cause social upheaval. As the great economist, John Maynard Keynes, said in his famous 1923 *Tract on Monetary Reform*

‘...a change in the value of money...is important to society only in so far as its incidence is unequal. Such changes have produced in the past, and are producing now, the vastest social consequences, because, when the value of money changes, it does not change equally for all persons or for all purposes...Each process, inflation and deflation alike, has inflicted great injuries.’

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