

## ***Text and remarks to Euro Economics Conference on the Vickers Report***

1. It's a pleasure to follow Geoffrey and Tim and perhaps I might do so by trying to put this report into context, both in terms of the political economy of our financial system and in the light of international developments.
2. The financial crisis seems a long time ago now. So it is worth reminding ourselves what Mervyn King subsequently revealed about what had happened at the depths of the crisis. He said: "two of our major banks which had difficulty in obtaining money could raise money only for one week and then only for one day then on Monday and Tuesday it was not possible even for those two banks really to be confident that they could get to the end of the day".
3. We faced a situation in which the whole financial transmission system seemed to be about breaking down. I have always thought there needs to be a judicious balance of Adam Smith and Thomas Hobbes in our political economy, but anyone who wanted an illustration of what the state of nature might look like in a country without a functioning financial system came quite close to discovering it. Government certainly re-established its place as the citizen's protector of last resort.
4. The economic consequences of bank behaviour have been dire. Let me quote Mervyn King again: "banking has not been good for the wealth of almost any nation recently. Over the past year – he was speaking in 2009 – almost six million jobs have been lost in the US, over two and a half million in the Euro area and over half a million in the UK. We shall all be paying for the impact of this crisis on the public finances for a generation".

5. Nor does the British banking scene fill one with joy over competition, customer service, or a truly lamentable record of mis-selling culminating in the PPI scandal.
6. My starting point, therefore, in the trade-off between prudence and risk, conservative or more liberal approaches, constraining bank behaviour or giving them the benefit of the doubt, we should go for prudence, conservatism and constraint. We need a larger number of smaller banks with larger reserves doing things that they and we understand. We need less herd-like behaviour, better credit and risk adjustments and less reliance on rating agencies.
7. Realistically speaking there will not be another political opportunity to tackle the problem anytime soon. We must seize the moment.
8. It is deeply concerning that it looks like implementation of Dodd Frank is going to be delayed for twelve months and with it the detailed rules on derivatives rating agencies and accounting standards. The lobbying power of American banks during that period must be a source of concern. Michel Barnier's letter is timely in seeking to maintain a level playing field.
9. I think the key point is that the Vickers measures are very closely connected to the overall global and European picture of financial services re-regulation.
10. I think I understood John correctly at a recent seminar to say that, to the degree that, for example, bank resolution regimes are in place and credible then this would allow a lower capital adequacy rate to be imposed than would otherwise be the case.
11. What do the new regulatory rules look like? We have the three European Supervisory Authorities which are beginning to carry out their work. They are able to introduce effective European rule books for

banking, insurance and securities markets through their promulgation of 'binding technical standards'. The Chairman of the European Banking Authority noted the other day, however, that some member states are already seeking exemptions or workarounds from some of these rules. Hector Sants at the FSA has been making just such noises.

12. Publication of bank stress tests has also been delayed. It is reported because banks and national supervisors submitted 'overly optimistic data'. So it looks as though the ESAs are getting off to a bumpy start.
13. Jacques de Larosière, the author of the EU package of measures, has been impressed so far with the speed at which those measures have been brought forward. It was clearly unfortunate and unsatisfactory that the hedge funds have been unfairly comprehensively regulated when they had little or no impact on the crisis. No less ironic that the rating agencies continue in full force, registered but unreformed and with the key question of whether they are a public good or an overgrown overly influential and possibly under-competed private market unsolved. In terms of the resolution regimes, Brussels is half way through an attempt to see whether a pan European system for cross border banks can be established. As the weeks go by all the signs are that the political and technical challenges of establishing such a regime are proving serious.
14. Wilson Ervin and his colleagues at Credit Suisse have not only developed a model of a coco bail-in system but have also tested it in the market with apparent success. But there seems limited enthusiasm from non-Swiss players in the banking market for these approaches and much muttering that bail-ins are just another albeit more sophisticated form of capital reservation which will cramp the style and activities of the banking sector.
15. So as we approach the final straits in the Vickers report it does not look to me as though we can rely upon either new pan European authorities,

a pan European resolution regime, or sophisticated new bail-in techniques to reduce the scale of the problem confronting John Vickers.

16. The problem I guess shows itself in two dimensions – the Volcker rule debate or in Vickers language, the degree of ring fencing required; and the effective elaboration of capital reserve requirements on the second.
17. From the approach I have taken I think my own conclusions follow fairly logically. The persuasiveness of the John Kay analysis on casino and utility banking does require us to draw some sort of line between the two. What is the evidence on the most effective remedy? I would look to the competition world for a comparator and analogue. When the competition authorities have a problematic antitrust issue before them they usually have two sorts of remedies in their toolbox: behavioural or structural. In my twenty years in that realm I have found that on the whole behavioural remedies don't work. Inviting supermarkets to sign codes of conduct to say that they will be nicer to their suppliers or not overdo their presence in local markets tends on the whole to be for the birds.
18. Analysis of behavioural remedies, codes of conduct, undertakings and so on conducted by what is now BIS over the years have suggested that it doesn't work. Monitoring is difficult and labour- intensive. The issues all begin to see a long way away. In the real world people have moved on. Eventually you have piles of unmonitored and forgotten behavioural promises.
19. Structural remedies on the other hand are self-policing. They go with the grain of the market and with competition. The moment Gatwick Airport is in different hands from BAA, its starts behaving and competing in a completely different way. The need for the authorities to regulate is reduced and the creative and innovative powers of the market begin to show themselves.

20. My form of ring fencing would therefore be structural splits so that the utility banks and the casino banks are in future in separate ownership.
21. In elaborating capital adequacy rules, I must declare a personal puzzlement that the use of reserve requirements has not shown itself earlier in the UK and as a helpful weapon in monetary policy as well as in prudential regulation.
22. “Additional capital requirements should be considered part of the monetary authority’s tool kit”, concluded Cosimano and Hakura, the IMF authors of a useful recent study. This is after all why the Chinese authorities use them, taking the pressure off interest rate adjustments. The Chinese current requirements are of the order of 21%, I understand.
23. I remember asking Robin Leigh-Pemberton, that great former Governor, whether there were any technical reasons why we couldn’t use reserve requirements in the same way in the UK and I remember his reply being that there were not, but that the banks would never allow it.
24. I think in today’s environment the banks are going to have to allow it. Or at least significantly higher levels. The Vickers Commission is hovering around the 10% level with one member known to regard it as “at least” 10%. The ‘Swiss finish’ which adds their own requirements to the Basel rules will come in at about 19%. In my view we should go for quality and try to match the Swiss. Like ours their banks are disproportionately large compared to the rest of their economy – not that the rest of the economy in Switzerland is in any way a bad thing.
25. They had as big a fight as we did and possibly a larger one as UBS had it gone under – and it was for quite a while on a daily watch – it is difficult to see how an economy the size of Switzerland could have righted a bank of UBS’ size.

26. Cosimano and Hakura's work which uses real bank data rather than aggregates suggests Basel III will increase the loan rate by 16 basis points for the world's 100 largest banks. They note, correctly in my view, that the higher loan rate may not be a social cost since it mitigates the adverse effects of a too-big-to-fail policy as it reduces excessive lending.
27. They conclude that this will reduce loans by 1.3% for those 100 banks in the long run. If there is a declaration of 'excessive credit growth' a further 2.5% increase in the equity to asset ratio is expected in loans by 2.5%. As the IMF authors say, these charges are not substantial.
28. With apologies for going slightly broader than our theme I would recommend to John Vickers that he launches structural rather than behavioural changes; introduces higher rather than lower capital requirements; and on competition issues strikes a deal with the Competition Commission for a fast track remedies report, building on earlier work, with a timescale of one year. On one technical aspect I hope he will be a little bolder. As I understand it he does not want his report to be "overly prescriptive" but leave plenty of room for the Government to come to a view, having been informed by the principles of his report.
29. Don't do it John!! **Be** overly prescriptive. Tell them what to do and that they have got to do it quickly for all our sakes.