Rewards of risk

THE CREDIT CRUNCH AND SOME HIGH-PROFILE CASUALTIES IN THE BANKING SECTOR HAVE BROUGHT RENEWED CALLS FOR 'SAFER' BANKING. BUT ONE RESPECTED FIGURE IS ARGUING STRONGLY THAT RISKY BANKING BENEFITS US ALL. **GRAHAM BUCK** REPORTS

Executive summary

- **The Bank of England's agreement earlier this year to provide UK banks with £50bn in liquidity has been described as peanuts in comparison with the size of the market. The way forward is to establish good central banking practice that manages to reconcile low-ratio banking with safety.**

The credit crunch is already a year old and looks increasingly likely to endure for some time yet. It has provoked plenty of analysis on the factors that led to it. Following such high-profile casualties as Bear Stearns and Northern Rock, much attention has been devoted to measures to make banking 'safer', including renewed calls for a return to 100% reserve banking. Also dubbed narrow banking, 100% reserve banking represents the ultimate in completely safe banking and periodically elicits fresh interest, although Tim Congdon, founder of Lombard Street Research, robustly dismisses it as "rubbish".

MORE RISK, MORE BENEFIT From 1992 to 1997 Congdon served on the HM Treasury panel of independent forecasters – the so-called wise men who advised the Chancellors of the Exchequer of the period, Norman Lamont and Ken Clarke, on economic policy. He firmly believes that the more risk assumed by the banks, the greater the benefit to the general public. He expanded on this view in a presentation at the annual conference of the Institute of Economic Affairs and Marketforce in early June.

"Banking began with 100% (or even 110% or 120%) cash reserve backing for deposits," he said. "But it is competition – the free play of market forces – that causes banks to reduce the ratio of cash to assets." The subsequent decline in the ratio of capital to assets helped bring about a reduction in the cost of banking services.

DECLINING RATIOS Cash ratio deposit schemes that require high-street banks to place some of their funds with the central bank have also taken a steadily falling percentage of banks' cash. During the 1930s, a cash ratio deposit of around 10% was typical for UK banks, and that percentage more or less endured until the early 1960s. But by 2005, the figure had declined to under 1%, and by the end of that year had fallen as low as 0.3% in some cases.

Over the same period, fashions in the regulation of bank balance sheets have changed, with the original emphasis on liquidity shifting to one of solvency.

"The truth is they both matter," said Congdon.

Low-margin banking had proved highly beneficial, and banks with fee-motivated managements can drive down their margin on loans to extremely low levels. This "massive achievement" in securing much more competitive banking is now under threat.

"Provided that banks are solvent, the assumption has been that they can borrow more or less freely from the central bank," said

Congdon. "However, this assumption was challenged last summer by Mervyn King, and all at once liquidity did matter again."

Set against this development has been the steady merger of commercial and investment banking over the past 10 to 15 years, which has triggered a host of new questions. Institutions had become "far too complex and caused all sorts of problems", said Congdon, who added that he agreed with the strict separation of the two activities, as required by the Glass-Steagall Act of 1933 until its repeal at the end of the 1990s.

CATASTROPHIC RESULTS The shift in emphasis towards solvency has been comparatively recent. For up to 40 years of the post-World War II period, the focus was on cash and liquidity; both were used as benchmarks when a slowdown in economic growth was required.

However, despite the opposition of Eddie George, its Governor at the time, the Bank of England was relieved of responsibility for bank balance sheet oversight, and the UK's tripartite regulatory structure came about largely in response to pressure from the (mostly US) investment banks for a single regulator.

The subsequent period has seen the clearing banks acquire a number of building societies and trustee savings banks, which, as a rule, are better at taking in deposits than making payments. Others, principally Northern Rock, Bradford & Bingley and Alliance & Leicester, have relied on wholesale funding, with catastrophic results in the case of Northern Rock.

Congdon said that banks with comprehensive branch networks had a "huge advantage" over the others. "Although the clearing banks' mortgage approvals are down, it's not that sharply, while there has been a collapse in that of the specialist lenders. The wholesale markets have broken down, possibly because central banks weren't helpful enough."

His conclusion is that while safe banking is a good thing, so is the competition created by the very low cash/deposit and capital/asset ratios of risky banking.

"As long as a bank's assets are good, then low ratios are a good thing for the consumer," he said. "But the structures need to be improved. The complexities of running a complicated business such as Citigroup – and the series of problems that it has experienced along with other mega-groups – suggest they should be split up into more manageable entities."

INCREDIBLY COMPLICATED The key challenge now is to reconcile low-ratio banking with safety. Congdon is fully behind HM Treasury in the current squabble over the Bank's future and advocates a "private and powerful Bank that is owned by the banks".

Also participating in the session was Sir Brian Pitman, former Chief Executive of Lloyds TSB and currently a senior adviser to Morgan Stanley. He agreed the shift from a world of plain-vanilla financial products to many that have become "incredibly complicated" had created a danger of increased regulation that would kill off innovation and prove detrimental for the consumer.

Sir Brian said that politicians were only belatedly waking up to the size and significance of the global markets. He called the Bank of England's agreement in April to provide UK banks with £50bn in liquidity "peanuts" in comparison with the market's size and said even the US Fed's $200bn programme was relatively small.

"The possibility of a backlash worries me," Sir Brian admitted. "The power of the markets has diminished the power of the politicians to the point where there's very little they can do."

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