Panicked into a crisis

PROFESSOR TIM CONGDON, KEYNOTE SPEAKER AT THE ACT ANNUAL CONFERENCE IN APRIL, WAS GIVEN THE TOUGHEST OF ASSIGNMENTS. HOW HAS THE CREDIT CRISIS DUST SETTLED AND WHAT DOES IT MEAN FOR THE CORPORATE TREASURER?, THE ECONOMIST WAS ASKED. **PETER WILLIAMS** LISTENED TO HIS RESPONSE.

The ACT conference-goers were left in no doubt where Tim Congdon stood on the financial crisis. According to him, the dust should never have been stirred to such an extent in the first place. He described the handling of the crisis by what he called "officialdom" as a "lash up", although he was more complimentary about the subsequent, recently completed programme of quantitative easing. But what should not have been a crisis at all turned into a disaster.

The legacy of this self-generated problem is a set of issues around capital ratios in banking that will stay with us for some time. But while the dust has by no means settled, Congdon told the conference he was optimistic about the world economy for the next few years, with economies emerging from recession benefitting from subdued inflation and enjoying above-trend growth.

LIQUID AND SOLVENT Going back to basics, Congdon suggested that banks need two basic attributes: liquidity and solvency. Banks must be able to repay deposits with cash and they need capital to operate legally and provide protection against risk. When a bank has liquidity issues its natural course of action is to go and borrow money from the central bank. Banks and central banks are in constant communication and have a mutual understanding of when cash needs to be pulled out of the central bank and pumped into a commercial entity.

Congdon suggested that before 1997 Britain had a tremendous record on dealing with problems in the banking sector. In 1997 the incoming Labour government created the Financial Services Authority (FSA) as part of a new tripartite system of regulation. The Bank of England was given independence and the following year the FSA took over responsibility for banking supervision from the Bank. That move, said Congdon, made the understanding between the banking sector and the central bank less clear.

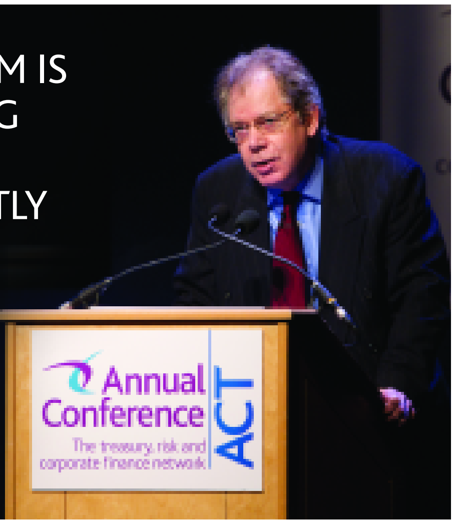
So if a bank is solvent but experiencing liquidity problems the solution is for it to go to the central bank and ask to borrow money, providing in return suitable collateral. These unlimited loans, so-called last-resort loans, are given for the required period but at a penal rate of interest and only against good collateral. If, however, a bank is insolvent, Congdon likened the scenario to moving a patient to an emergency ward. The action required may include the provision of last-resort loans but more important is the need to secure capital injection and/or a takeover by a better-capitalised organisation. This principle was expressed back in the 19th century by Walter Bagehot in his study of banking methods, Lombard Street, published in 1873.

So was the banking crisis which started in 2007 a liquidity or a solvency crisis? Congdon said it was a crisis of illiquidity that government and regulators wrongly treated as a solvency crisis, hence his description of the rescue as a lash up – in other words, an improvised and cobbled together operation.

What started in the summer of 2007 – and in certain ways continues today – was the tendency of officialdom to treat the issue as a problem of a lack of cash. But look at the figures for the banking sector and you discover that the losses in the period for individual entities were not that big. Even if some of those figures are debatable, overall the banking industry remained in the black (see Table 1 for the profits of some of the UK's banks). The total losses for all UK banks that survived were £7.6bn, a relatively insignificant figure. Congdon added that even if HBOS, Northern Rock and Bradford & Bingley (the UK banks that were rescued in one form or another) are included, it is difficult to arrive at a figure for losses that is much more than £20bn.

Congdon's conclusion was that the crisis was misinterpreted as one of insolvency rather than illiquidity, and that the official response – to insist on huge recapitalisations of solvent organisations – was wrong. And while he admitted that room for debate about solvency existed in the circumstances

A SAFE BANKING SYSTEM IS AN EXPENSIVE BANKING SYSTEM AND SUCH AN APPROACH WILL DIRECTLY REDUCE THE INTENSE COMPETITION THAT EXISTED BETWEEN BANKS IN 2006 AND 2007.



of 2008 and 2009, he condemned as incompetent the official reaction of a steep and immediate increase in capital/asset ratios, which caused banks to slash their credit lines – an issue with which corporate treasurers are all too familiar. The problems of the early 21st century in banking were not as serious as the secondary banking crisis of 1974; rather, it was the actions of government and regulators which turned it into such a big deal.

The real problem in the British banking system was a shortage of liquidity caused by the wholesale money market closure, an event no-one had foreseen. The eventual result of the action taken, predicted Congdon, would be a net benefit for the British taxpayer, with the government set to make a profit on its interventions. The loans will be repaid, the guarantees given will not be called on, the guarantee fees have been paid and it is likely that the stakes will ultimately be sold at a profit.

Table 1: Banks earning pretax profits (£ million)

	2005	2006	2007	2008	2009	2010*	2011*
Barclays	5280	7136	7076	6077	4585	6238	8995
HSBC	10975	11559	12674	5025	6958	10968	15261
Lloyds	3820	4248	4000	807	1042	-1110	5170
RBS	7936	9186	9900	-3118	-2595	-1031	5240
Standard Chartered	1403	1664	2112	2592	3093	3435	4181
Total	29414	33793	35762	11383	13083	18500	38847
growth	-	4379	1969	-24379	1700	5417	20347
growth (% year on year)	-	14.9	5.8	-68.2	14.9	41.4	110.0

all numbers reported except Standard Chartered
* estimate
Source: Thomson Datastream

ALL NOT WELL Congdon made clear that his analysis did not imply that the whole of the international banking system was sound. For instance, it was clear, he said, that the US investment banking sector had lost tens of billions of dollars and the Irish banking system was bust, partly in the latter case because real estate valuations had reached preposterous levels. He added: "Some banks did silly things, but then bankers tend to do silly things in booms."

In his classic 1921 publication Bank Credit, CA Phillips wrote: "The essence of banking consists in the practice of extending loans far in excess of either the capital or the cash holding of the bank in question." So banking is about solvency and liquidity. Bankers worry about the ratios of cash and liquid assets to deposits, and the ratio of capital to assets.

The capital raising exercise in the autumn of 2008, along with the raising in a hurry of the capital/asset ratios, was accompanied by government warnings of a deep recession. The result was precipitate action by both businesses and bankers. Business slashed investment plans and tried to contain costs, and bankers slashed the available credit. In particular, bankers took the opportunity to cut lines of credit to customers they weren't keen on doing business with. By the autumn of 2008 credit had fallen by 10% in six months, which equated to an annual rate of 20%. As Congdon pointed out this happened after the banks had been recapitalised, an operation that had been supposed to lead the way to greater bank lending. Congdon concluded that much of this could have been avoided if the central banks had been allowed to play their traditional role of lender of last resort.

Since the crisis broke, politicians and regulators have suggested that they want the banks to be safer, more reliable and more trustworthy. This stance reverses the process of the previous decades of lowering cash and capital asset ratios. A safe banking system is an expensive banking system and such an approach will directly reduce the intense competition that existed between banks in 2006 and 2007. US president Barack Obama has gone on record as saying he wants to shrink the banking system. He is getting his wish with the shrinkage of banks – an event which, Congdon concluded, was a traumatic and ongoing experience for all corporate treasurers.

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