Where Now For Bank Regulation?

Some Lessons From Economic History

JULIAN HODGE INSTITUTE OF APPLIED MACROECONOMICS

ANNUAL LECTURE

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at the CASS Business School, City University, London

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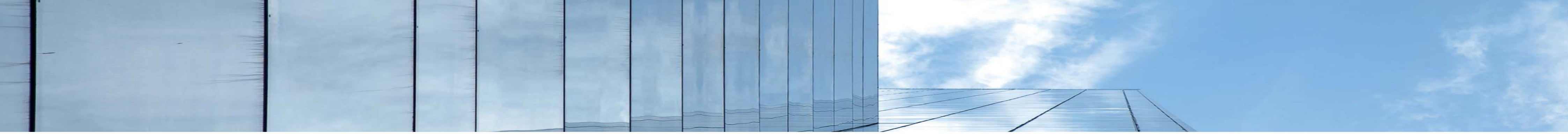
Julian Hodge Bank



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He was Head of Department of Banking and Finance at City University from 1989 to 1992; Editor of the Economic History Review from 1993 to 1999. He recently completed the commissioned history of the Bank of England (CUP, 2010). His latest book (with G E Wood) is, Money over two centuries (2012 OUP).

JULIAN HODGE INSTITUTE OF APPLIED MACROECONOMICS

In May 1999, Cardiff Business School and Julian Hodge Bank entered into a significant collaboration, resulting in the establishment of the Julian Hodge Institute of Applied Macroeconomics. The main aim of the Institute is to carry out research into the behaviour of the UK economy, and to study in particular its relationship with the other economies of Europe. The Institute's research work further extends across international trade, money and banking, international finance and econometrics, in a collaboration between around twenty academics, mostly in Cardiff, and some thirty PhD students.

The institute's director since it was founded has been Professor Patrick Minford, of Cardiff Business School, who is also the Economic Adviser to Julian Hodge Bank. Apart from its research projects the institute carries on the forecasting and modelling work which Minford began at Liverpool University and has been based mainly in Cardiff for more than a decade, producing forecasts and policy analysis of the UK and other major economies.

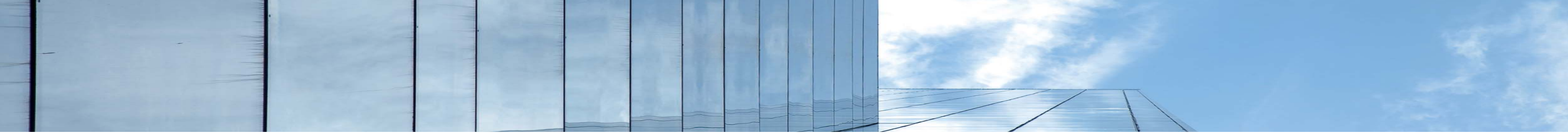
WHERE NOW FOR BANK REGULATION? SOME LESSONS FROM ECONOMIC HISTORY

Forrest Capie

The recent financial crisis prompted what has come to be expected in such crises, a call for more regulation. And more regulation has been introduced. Certainly, better regulation was required; but better regulation might well have been less regulation. The history of English banking can be instructive. In the nineteenth century after a period of dissatisfaction with the state and monopolies and regulation, moves were made to reform and deregulate the system. Once achieved, a long period of financial stability followed. But a gradual return to a regulated system resulted in disaster. Can lessons be learned?

INTRODUCTION

It is a great honour to be invited to give tonight's Julian Hodge lecture. Julian Hodge was a distinguished figure in the world of banking. He built the Hodge Group over a period and in 1972 it was one of only five that received the prestigious 'Section 127' status in the complicated system of categorisation that the Bank of England had instituted. In 1973 Standard Chartered acquired a significant stake in the Hodge Group but by the autumn of that year Sir Julian began to feel that things were not right in the sector and he sold the balance to Standard Chartered before the end of the year and before the banking crisis of the turn of that year broke. That sale has been described by the historian of the episode as 'one of the best-timed multi-million pound sales in history'. (Reid) The bank that Sir Julian founded in 1987, and is in business today, follows the kinds of principles of the banks that I shall get to speak about this evening. I am sure he would have approved of them.



THE RECENT FINANCIAL CRISIS

It was not long after the recent financial crisis broke before a long list of culprits was found. Everyone from politicians, the monetary authorities through academics, the rating agencies, the banks, and the regulators, has been found guilty in some respect. I am sure there is some truth in all that but I want to focus on the regulatory part and to what suggestions might be found from what looks like a big economic lesson of the nineteenth century - the response then to financial crises.

The recent financial crisis has demonstrated dramatically the modern response to identified defects in the system – legislate against them. Wherever faults are detected or shortcomings found act to stamp them out and prevent them from re-appearing or correct the shortcoming.

There may be good arguments for regulation. The traditional view has been competition where possible and regulation where necessary. Necessary means where market failure is found. And market failure has been found at every turn and corrective action taken. Little thought (amongst policy makers) has been given to regulatory failure or government failure. The contrasting approach to regulation is that associated with George Stigler and others. This work has found that regulation was either ineffective or worked to the benefit of existing firms in the industry. Regulation, ostensibly intended to benefit the consumer, is often encouraged by producers as a way of restricting competition. It was in this vein that John Kay recently concluded that detailed regulatory rules in British finance were ineffective. (Kay 2010)

Regulation in banking has changed greatly over the years since modern banking began. Initially, there were severe restrictions on banks and these lasted until the nineteenth century. No joint-stock banking was allowed. Banks were limited in size to partnerships of no more than six. The Usury laws placed a cap on interest rates. And so on. There then followed a long period when restrictions were gradually removed and then a period of relative freedom from the mid-nineteenth century to the mid-twentieth century. The banks then began to become more regulated from World War II onwards.

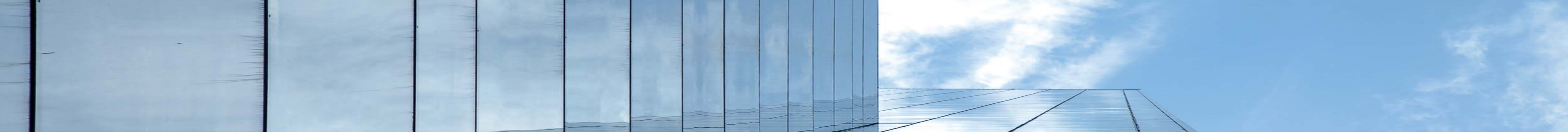
Something of a myth has developed that the late part of the twentieth century was a time of deregulation in the banking sector. Charles Calomiris has demonstrated convincingly that this is the opposite of the case in the U.S. A particular example he gives was the 2004 change in the SEC net capital rules that was hailed by some as deregulation but was in fact a regulatory failure that loaded firms down with extra data collection and reporting. As far as the rest of the world goes one only has to look at the rules contained in Basel I, II, and III to see

how extensive new regulation has become. Vast armies of compliance officers are required.

But it is a particular myth for Britain. The British financial system enjoyed the long period of relatively light regulation from the middle of the nineteenth century to the middle of the twentieth. But that began to change to a more heavily regulated system from the Second World War and it intensified from the 1970s. The growth of supervision and regulation from within the Bank of England began to gather pace in the 1970s. The first statutory regulation came with the Banking Act of 1979.

Much is often made of the Big Bang of 1986 although this did not deal directly with banking. It is true that building societies changed and property lending began to be done by the changing banks. In any case the 1986 change was more a change in regulation rather than a reduction. The changes allowed large firms to buy into activities formerly unavailable to them. That fostered increasing concentration and so reduced competition and increased complexity. At the same time, ‘a multiplicity of different bodies, multiple levels of administration and greater complexity’ led to heavier bureaucratic burdens. (Jaffer et al)

Then there was another Banking Act in 1987. Deficiencies in the Act of 1979 were said to need correcting. With the creation of the Financial Services Authority (FSA) in 1998



regulation took off in a serious way. The institution grew from 700 employees at the start to 2,750 in 2006 (before the crisis). (This happened at a time when the numbers in the Bank of England fell to around 1,700.) FSA numbers then took off and reached 4,000 in 2012.

Since 2008 there has been an avalanche of new financial regulation. Huge numbers of compliance people populate the financial institutions. According to some figures there are now 147,000 people working in banking in the City of London. But there are 257,000 others in the City overseeing in one way or another what the bankers do. This is not simply the case in Britain. It is true too in the United States with Volcker rules and Dodd-Frank, and in Europe and of course world-wide with another Basel.

There was a time when all of this was different, when the response to crisis was not to regulate but to de-regulate and that is what I want to talk about.

PREVIOUS EXPERIENCE

The story has its beginnings in the eighteenth century and its happy outcome can be found by the middle of the nineteenth century.

Let me begin then with what is sometimes called the first great financial crisis of capitalism that occurred in 1825. In many ways it was a template for the typical crisis that followed – monetary ease and expansion followed by stock-market boom, euphoria, some doubts, monetary tightening etc. ending in panic and crash. (Aliber and Kindleberger) The background to the 1825 crisis was of industrialisation and the development of the banking system throughout the eighteenth century. In the Revolutionary/Napoleonic Wars 1793-1815 with the gold standard suspended the Bank of England could issue notes without limit and it issued extravagantly and profited from that. There was inflation across the period and a depreciation of sterling. After the end of the war deflation followed to allow for the restoration of the gold standard at the old parity as soon as could be achieved. A period of recession followed before the gold standard was eventually restored in 1821

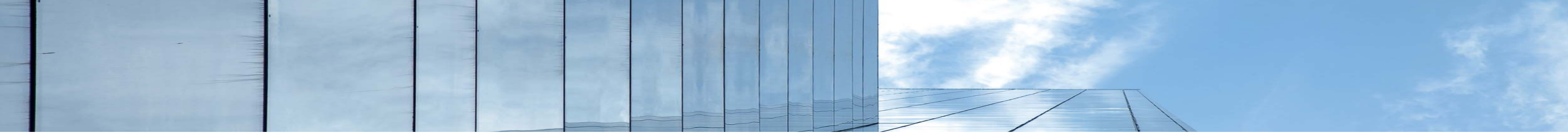
The Bank of England was at the centre of a banking system made up of hundreds of unit banks, partnerships of limited size with unlimited liability. Many had failed in the deep post-war recession of 1815-17. There was the beginning of the emergence of discount brokers who would later become the discount houses (and provided an early interbank market). But with monetary stability re-established by 1821 vigorous economic growth resumed. An investment boom followed especially in infrastructure - gas lighting, canals etc. The developing boom was reflected across domestic economic output with rapid increases in manufacturing, in cotton, wool, iron, hardware etc. In 1825 624 new joint-stock companies were formed. An export boom was well underway.

The stock market boom came partly from foreign and particularly Latin American stocks. The boom was one of the earliest stock and bond crazes. As former Spanish colonies gained independence and believed prosperity was theirs they borrowed heavily. The distinguished and cautious Bank of England official, George Wade Norman, invested heavily. Everything seemed set fair. A new paradigm perhaps? Easy money and abundant credit prevailed. Between 1819 and 1824 there was a large gold inflow and the Bank of England was flush with reserves. Bank Rate, which had been constant at 5% for the previous 50 years, was then lowered in June1822. The Bank of England accommodated all the government's fiscal demands. Country banks joined in and issued notes freely. In 1822 Parliament extended the circulation of small notes of country banks for a further ten years. In1824 country banks stamped twice as many notes as they had in 1820 and in 1825 notes were up 30 per cent on 1824. Then rising domestic prices led to a trade deficit and a gold outflow - of £7m. in 1825 (£3.6m. in August alone). Nevertheless, it was said that reserves were still sufficient for domestic needs.

Moreover, there was the conversion of government debt to lower yields: in 1823 there was the conversion of £135m of 5% to 4%; in 1824 £80m of 4% to 3.5% was converted. Together these were roughly one quarter of the total National Debt. Total debt was around £800m and GDP around £300m so there was a debt/income ratio of around 250 per cent. Recipients of lower dividends sought higher returns elsewhere and there were plenty of schemes offering.

The crisis broke without any identifiable trigger. At the beginning of 1825 the Bank had begun to worry about the extent of the expansion and in March sold Exchequer bills as a means of contracting circulation. It continued to be cautious thereafter. The stock market crashed in April and that triggered commercial failures.

Commodity prices began falling and bank failures began to appear in late summer. The banking panic came in December. On 8th December the Bank of England afforded substantial financial assistance to Pole Thornton and Co. It did this secretly. Pole was connected by marriage to the Governor of the Bank of England. Nevertheless, on 13th December Pole Thornton and Co. failed. It was an important London bank and was agent for 47 country banks (It was the bank of the great banker, economist and parliamentarian Henry Thornton



who had a son who joined the bank in early 1825.) On 13 December the banking system was poised on the edge of an abyss. Bank Rate was raised to its allowed maximum of 5%. In the following week four big London banks failed together with 60 country banks. By 16th December it was all quiet. The first of the great cyclical crises of capitalism was over; all the bank failures were over by the end of January.

The Bank of England's response to the crisis had been in part constrained by the Usury laws. But it was slow to act, then reversed its policy and began to lend. Eventually, as Jeremiah Harman, a director of the Bank put it: 'We lent it by every possible means and in modes we had never adopted before; we took in stock on security, we purchased Exchequer bills, we not only discounted outright, but we made advances on the deposit of bills of exchange to an immense amount, in short, by every possible means consistent with the safety of the Bank, and we were not on some occasions over nice. Seeing the dreadful state in which the public were, we rendered every assistance in our power.' (quoted in Bagehot) (They weighed the gold coin to dish out to save time in counting it.)

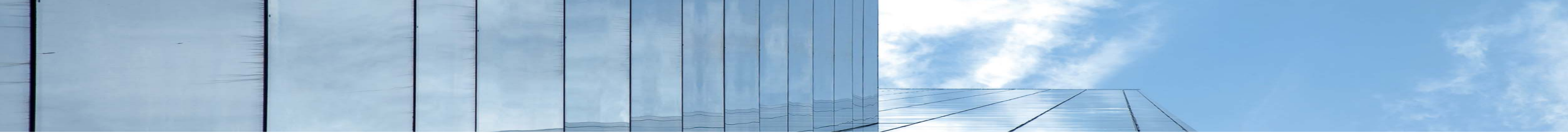
Nevertheless, the criticism remains – the Bank was slow to act, there were many failures and there was a serious recession in 1826. Unemployment soared and there was widespread rioting. The Bank was the main culprit. Its expansionary monetary policy fuelled the boom and its tight money ended it. It did not know how to act as lender of last resort or did not accept the role. The remedy had all been laid out before by Henry Thornton in 1802 and it was again by Thomas Joplin in 1825. On the evening of 13 December when the Bank was showing reluctance to lend Thomas Joplin published a letter in the newspaper, The Courier. His case was, briefly, that the Bank had precipitated a liquidity shortage by its policy of monetary tightness. That resulted in completely abnormal increase in precautionary balances outside the bank. The Bank should respond said Joplin by increasing its note issue to offset the loss of circulation. This could be done safely because the increase in the money supply affected the price level and the exchanges only after a long lag and the extra notes could be withdrawn from circulation once the crisis had passed and long before prices were affected. (O'Brien)

Thomas Joplin was from the north of England and was described as a rough man from the timber trade and the suggestions are that the City of London did not want to acknowledge his claims. The banker Vincent Stuckey was a more acceptable figure. On the morning of 14th December he wrote to the Bank (12 hours after Joplin's piece had appeared) pressing the case for a reversal of policy. He made the same point as Joplin that emergency additions to the money supply would not affect the price level. That morning the Bank opened its doors and proceeded to offer financial assistance on the hitherto undreamed of scale referred to. (Stuckey was Walter Bagehot's maternal uncle and both Bagehot's father and Bagehot himself later on worked for the bank of Stuckey and Bagehot.) Bagehot made no reference to his uncle in his famous work Lombard Street.

It may seem unfair to put all the blame on the Bank of England for this particular disaster. It was still a joint stock company and restricted by regulation that prevented it from behaving as it might. But it must accept the bulk of the blame.

As soon as the 1825 crisis was over the Treasury, keen to ensure that such an event would not recur, wrote to the Bank at the beginning of February 1826: 'The panic in the money market having subsided and the pecuniary transactions of the country having reverted to their accustomed course it becomes important to lose no time in considering whether any measures can be adopted to prevent the recurrence in future of such evils as we have recently experienced.' (1st Lord of Treasury HMT, to Governor, 3/2/26)

After 1825 the Bank did begin to learn slowly how to behave. But there were several similar financial crises of 1836/39, 1847, 1857, and 1866 in which it played a similar role in



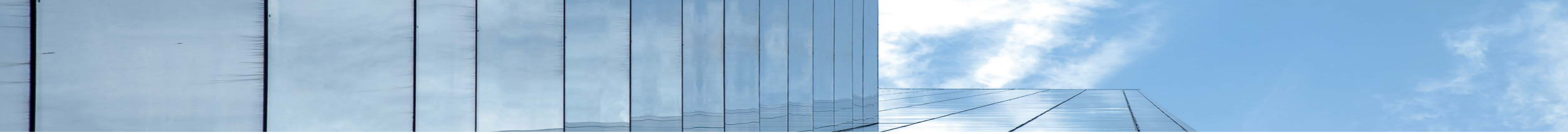
accommodating a boom and then causing panic by tightening. In the 1830s according to WTC King the Bank was responsible for the crisis as it fostered easy money which encouraged the growth of paper of doubtful quality. In the 1840s railways were the new thing and the source of investor excitement. And after the 1844 Act the Bank believed it had an obligation to discount competitively and it cut its discount rate to 2.5 %, and introduced a wider definition for acceptable collateral. The Banker's Magazine warned, 'if this line of conduct continues a monetary crisis will be inevitable'. Easy money did continue. The boom developed. The Bank then raised its discount rate and otherwise made it impossible to discount bills and the crash followed. In the 1850s feverish speculation had its origins in the gold discoveries of the decade. Market rates fell and the Bank imprudently followed them down. Then when bad news began to filter through the Bank raised its rates and panic followed. In the 1860s in the mid-Victorian boom the mighty firm Overend Gurney got involved in bad asset management and became grossly over-committed to risky enterprises. As Bagehot put it, 'Overend's losses were made in a manner so reckless and so foolish that one would think a child who had lent money in the City of London would have lent it better.' (Bagehot, p.19) Overend's failed. Bank Rate went to 10% and the crisis was soon resolved.

But in the course of these 40 years after 1825 and through these several similar crises, and from promptings from commentators such as Bagehot, the Bank of England arrived albeit somewhat reluctantly, at a position where it accepted that it was at the centre of the monetary system and the monopoly note-issuer, and as such the lender of last resort in a crisis.

RESPONSE TO PREVIOUS CRISES

The responses to the nineteenth century crises were completely different to those of the later twentieth century and early twenty-first century. How do we explain that? The prevailing political philosophy in Britain (and across most of Europe too) in the eighteenth century was mercantilism, at the core of which was the centrality of the state. A consequence was extensive corruption – 'the widespread use of pensions, sinecures, and gratuitous emoluments granted to persons whom the British government, between the earlier eighteenth century and the Age of Reform wished to bribe, reward or buy'. (Rubenstein, p 56) A substantial proportion of those who prospered in the eighteenth century were not landowners, manufacturers, or merchants but clerics, lawyers, judges, government bureaucrats and placemen.

Intimately bound up in this was the Bank of England, virtually a department of state. The



new financial aristocracy was according to one contemporary critic, 'more base in its origin, more revolting in its association, and more inimical to general freedom and enjoyment…', (Wade, p.428) The Bank took its full part 'both as a bastion of government and monopoly, and as a parasitic element itself upheld by a network of patronage and corruption' (Howe, FHR, p23)

But this position was gradually over-turned. The early nineteenth century in England provides an illustration of a desire to reverse the process of monopoly and restriction. Revulsion against the 'old corruption' of the eighteenth century led to change. For most of the nineteenth century legislation was of a liberalising kind. In the course of the nineteenth century English/British (the two effectively came together with the legislation of 1844) banking legislation followed a trend of deregulation. First the usury laws were relaxed and then removed. In the 1820s there was a cap on interest rates of 5%. The relaxation first applied to the Bank of England. In the 1830s crisis it raised its discount rate above 5%.

At the same time the restrictions on banks being limited to partnerships of no more than six was also abandoned and joint stock banks were allowed to form. Initially, they could only operate away from London—outside a radius of 65 miles. But a few years later they were also allowed to operate within London. The gold standard had been more strictly defined in the Act of 1844 but it proved too restrictive and when the crisis of 1847 developed it was clear that the Bank could not hold to the law and do what was required for financial stability. The Chancellor then wrote to the Governor and relieved him temporarily of the need to stick to the requirements of the Act and so the limitless lending (at a high rate) could take place. A criticism of the 1844 Act is that crisis management would have been preferable in a crisis to regulatory measures drawn up in anticipation of the event. (Campbell)

There was a growing discussion on the merits and demerits of limited liability in the second quarter of the nineteenth century, and after the crisis of 1857 the laws were relaxed and limited liability was available for those who chose to avail themselves. Not all did, but it was an option. (The failure of the unlimited liability City of Glasgow Bank in 1878 and the widespread misery that caused (at least in Scotland) hastened the demise of unlimited liability.)

Initially too, the denomination of bank share prices acted as a further constraint, for they had a minimum value of £100. (In rough terms that would be about £4,000 at the present time.) In time this too was relaxed.

By the 1860s the banking system was effectively deregulated and there followed a remarkable period of stability across more than 100 years when there were no financial crises and no one doubted for a moment the utter reliability of their bank.

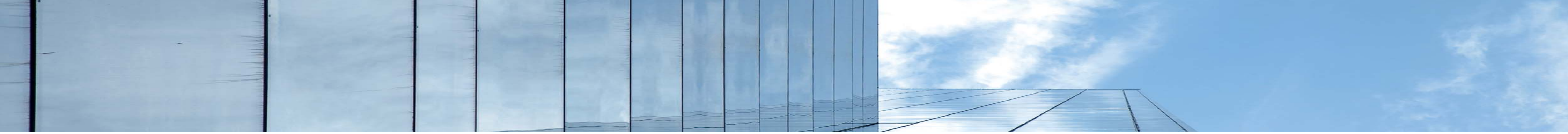
Of course, the other parties had to learn their respective roles. The commercial banks had to find their way to appropriately structured balance sheets – sufficient capital and liquidity consistent with an acceptable profitability. When these elements were in place, roughly from the late 1860s onwards, there followed over a hundred years of financial stability. There were years when a famous bank failed (e.g. Barings in 1890), or an exchange-rate crisis blew up (as in 1931), but there were no financial crises properly understood.

On the outbreak of war in the summer of 1914 a financial crisis blew up but this was not in any way a typical financial crisis. There was no preceding boom and no monetary ease or state of euphoria. The system froze and had most of the features of a typical crisis on account of a complete failure of remittance from abroad when London was the hub of an extensive international system. All parts of an already complex and inter-related system were affected. It was not a pure liquidity crisis so other measures were required. But there was a liquidity crisis and so the lender of last resort was not redundant. The crisis was resolved largely by the actions of the Treasury. (Sayers, p.85) No regulation followed.

BANK CAPITAL

Of particular note is that in the nineteenth century there was no mention of bank capital. In the aftermath of the recent crisis particular attention has focussed on bank capital. Almost immediately after the crisis broke the knee-jerk reaction was to demand increases in bank capital/asset ratios. Demands for raising the ratios from both domestic and international agencies resulted in damaging effects on monetary growth not entirely offset by the quantitative easing programme. Raising capital asset ratios of necessity reduces lending in spite of what the monetary authorities bafflingly said to the contrary.

Capital has always been important to British banks. Indeed it was considered so important that the government and the Bank of England accepted the public interest argument that allowed the concealment of true profits and capital until as recently as 1970. Banks face a tension between having too much capital and too little. Strong capital positions are designed to give depositors confidence. But the greater the capital the lower will be the return on capital and so there is a trade-off between depositor confidence and shareholder satisfaction. And of course the quality of the assets is key to any calculation.



I have already noted that in the first half of the nineteenth century there were several hundred banks in England. And that before 1826 these were all unlimited liability partnerships of no more than six. After 1826 joint-stock banking was permitted and banks gradually adopted that form. In the periodic financial crises that appeared many banks failed or suspended payment for a time or merged or were taken over.

There were no regulations as to what proportion of the balance sheet their capital or any other liability or asset might be. The banks had to find their own way to the appropriate balance sheet shape. Following the repeated financial crises in the 1820s, 1830s, 1840s, 1850s, and 1860s the banks began to move from cautiously high capital/asset ratios and similarly high liquid assets ratios. These gradually came down as trust and understanding developed. And additionally, when after the 1870s it also became clear that the Bank of England had assumed the role of lender of last resort there was an added reason for well-behaved banks to let their capital/asset and other ratios fall slightly further.

The maintenance of 'inner' or 'hidden' reserves allowed banks to smooth their reported profits, reassuring depositors and shareholders by presenting a picture of financial soundness and prudent behaviour thereby contributing to financial stability. The practice of maintaining hidden reserves had been prevalent from the mid-nineteenth century - -the Midland Bank had, for example, first established a hidden reserve in 1866.

By the beginning of the last quarter of the nineteenth century the published capital ratios of the banks had settled at around 15 per cent with only a little variation across banks, and by the end of the century that figure had slipped to around 10-12 per cent. (Discount Houses operated with much lower levels for good reasons.)

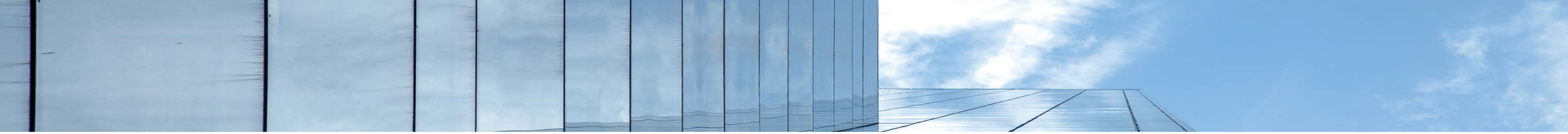
In the inflationary conditions of the First World War the ratios fell further. In the years between the two world wars there continued to be remarkable stability in the banking sector and the ratios slipped slightly lower. In the 1920s and 1930s they had settled at around 7 per cent. The point that needs stressing is that English banks were remarkably strong through these years and no doubt contributed to the monetary and macro-stability in the economy and the avoidance of a great depression.

In the Second World War the banks' capital ratios fell sharply. They were around 3 per cent. Their balance sheets expanded with government debt while private lending fell away. But as the ratios fell so too did the risk since the bulk of the balance sheet was made up of gilts. This continued to be the case in the long

period of adjustment following the war. In fact the ratios reached their all-time lows in the 1950s when they were down to between 2 and 3 per cent.

But then regulation began to appear. Raising capital after the war was not easy with the restrictions placed by the Capital Issues Committee. This particular restriction on the banks began to tell and bank chairmen spent a lot of time in the 1950s lobbying the Bank of England for support in allowing them to raise new capital. A note for the Chief Cashier at the Bank of England made the problem clear, '… it will be seen that the capital structure of the Clearing Banks is far from sound … At present it is clear that in times of trouble they must either put footnotes in their balance sheets – which we deplore – or lean on us for financial aid which would be disastrous … The banks, [if] freed from restriction, should pursue energetically the implementation of a programme which, for good reasons, is long overdue.' (Quoted in Billings and Capie p.145.)

As normality was restored and private lending came back after the war to the position it had formerly occupied and gilt holdings were correspondingly reduced the capital/asset ratios slowly came back to around 4 or 5 per cent in the 1960s (though the banks would have preferred them to be higher). There were still no



regulations of any kind on what capital asset ratios should be.

All these figures that I have quoted this far are what were presented to the public in the banks' balance sheets. When the true positions are calculated all of the figures given above can be raised by at least one percentage point so that the lowest point of the 1950s would be closer to 4 per cent. When risk weightings of the Basel type are applied the figures would be dramatically higher reflecting the quality of the assets the banks held across most of this period. Thus the figures for the 1920s would show ratios of around 14 per cent rather than 7 per cent. Those of the Second World War would turn out to be the highest of all time being even higher than 14 per cent rather than 3 per cent. And in the 1960s the ratios were of the order of 13 per cent rather than the 4 or 5 per cent shown.

But as the Chairman of Lloyds' Bank commented in the 1950s: 'there is no rule of thumb method of deciding the size of the capital funds which a bank needs in order to carry on its business. The guiding principles are that the resources as a whole must be sufficient to provide absolute security for our depositors and the reserves sufficient to meet fluctuation in our trading from year to year … provision must … be made against the difficulties associated with the fluctuations in the market price of gilt-edged securities.' (Quoted in Billings and Capie)

Only one official report of the period considered capital explicitly and that was the Prices and Incomes report of 1967. It concluded, 'There do not appear to be any concerted views among the banks about the appropriate level at which these [reserves] should be maintained. The banks do however, tend to consider their reserve requirements … in relation to total deposit obligations.' They believed that they had restored their desired capital position at the time of the report.

However, as inflation then took hold the banks were then looking to raise their capital base further. But that unfortunately coincided with the biggest stock market fall of all time to date in Britain from 1972 to 1974 – from an index number of 533 in May 1972 to 160 in January 1974. Bank shares fared worse than most and some fell by as much as 70 per cent. It then became extremely difficult to raise new capital.

There was no particular threat to the main retail bank sector but there was a crisis in the secondary banking sector in the mid-1970s and that led to legislation (in 1979). The Banking Act passed that year placed limits on individual exposures to ensure appropriate diversification. Exposures exceeding 25 per cent of capital required prior approval of the Bank of England. That marked the beginning of direct interference in bank operations. And soon after that, in the 1980s, the rules of Basel took over.

But the main point to make on bank capital is that the banks were left alone to decide how much they needed and they did that successfully across more than 100 years of stability. The actual numbers may look low at some points but they must be related to the quality of their assets. Only the banks themselves could assess competently what the quality was.

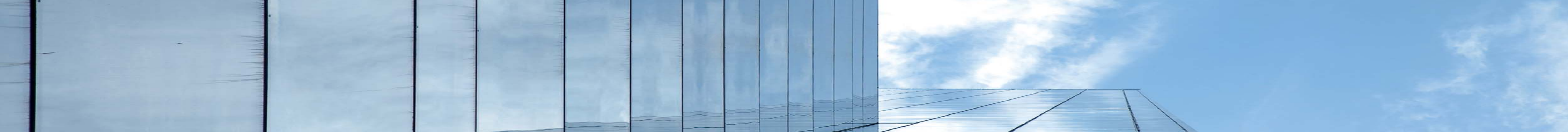
CONCLUDING REMARKS

In summary, following the recent financial crisis an opportunity has been missed. Ignorance of history has not helped. In spite of many examples of regulation being seen to be the problem rather than the solution the authorities embarked on another regulatory spree instead of a serious re-assessment of the whole regulatory framework with a view to drastic simplification and reduction.

When the crisis broke and the full folly of many was revealed there was huge public outrage over the behaviour of those identified as guilty and the fact that the public were paying while the culprits seemed to be walking away. Surely that was the point at which to say this would not happen again – as the Treasury had sought to do in 1826. And a series of credible goals could have been announced and the first moves taken toward achieving these goals. It will be argued that action is being taken but the regulatory burden is growing.

The large implicit subsidy to the sector must be abolished. It must become clear that banks are able to fail, and that those responsible will be fully accountable. Credible resolution regimes must be designed and implemented. Perhaps it is time for the bankruptcy laws to be tightened. There might be case for the introduction of limited liability.

There may be a case for the payments system to be ring-fenced from the rest of the sector. If some dramatic steps are not taken and trust not restored in the system the pessimists may be right. Another crisis will arrive and when it does the, 'frustrated public is likely to turn, not just on politicians who have been negligently lavish with public funds, or on bankers, but on the market system. What is at stake now may not just be the future of finance, but the future of capitalism'. (John Kay, 2009)



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