# New banking rules: tread carefully

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Even at the best of times, nobody loves banks. There is a strong populist strain of anti-banking sentiment in the US (**vividly demonstrated in Congress this week**) and in the UK. Banks are especially unpopular in two circumstances: first, when they are very profitable; and second, when they are very unprofitable.

The British and American banking sectors (and in parts of continental Europe too) have achieved the unusual feat of swinging from one extreme to the other in very short order, so incurring criticism of both kinds almost simultaneously. That is quite an achievement.

Some people saw it all coming, of course. The celebrated commentator Harry Hindsight, who often features in the Financial Times, has trenchantly argued that any fool could have seen that the credit expansion would end in tears, that regulators should have seen the trouble coming and headed it off at the pass. He would certainly have done so himself – though a diligent Google search has failed to unearth any warnings he personally gave.

I part company with Harry, and do not charge all the banks and their regulators with a comprehensive failure to prepare. These are highly unusual, once-in-a-lifetime circumstances, and it is not reasonable to expect that all financial institutions could have positioned themselves to survive market conditions of this severity. But some massive, life-threatening mistakes have been made, and governments across the western world have been obliged to intervene in wholly unexpected and undesirable ways.

Central banks have provided liquidity on liberal terms. The Bank of England finds itself dependent on the Treasury for the repayment of its loan to **Northern Rock** – the ultimate central banker's nightmare. Treasuries own banks, or large pieces of them, and have bought or guaranteed assets about which they know little. They have underwritten retail deposits without limit. The consequence is that the "social contract" between the banks and the government has been torn up and must be rewritten.

"Social contract" may seem an odd phrase to apply to banking regulation, redolent as it is of labour markets and co-determination *à la française*. But Paul Tucker of the Bank of England, not a militant trade unionist to my knowledge, has used it to describe the deal between the banks and the authorities that underpins our markets.

Banks engage in maturity transformation, turning sight deposits [which can be immediately withdrawn without penalty] into long-term loans. This confidence trick depends on just that – confidence. Depositors must believe their money is safe, even if they are dimly aware that if they all wanted to take it out the cash would not be there.

They may rationally sustain that confidence because of the three underpinnings the authorities provide. First, there is deposit protection up to a certain level, either a legally underpinned co-operative model as in the UK, or a pre-funded system as run by the Federal Deposit Insurance Corporation. Similar reactions of nervous depositors in Northern Rock, on the one hand, and Indymac, on the other, suggest there is not as big a difference between the two as is sometimes argued.

The second underpinning is prudential regulation, which is the other side of the coin of deposit protection. Regulators try to constrain the riskiness and leverage of banks' loan portfolios, to reduce the likelihood of a failure of confidence that leads to a call on deposit protection arrangements.

And, third, there is the provision of lender-of-last-resort liquidity support, whereby, as Mr Tucker puts it, “central banks have stood ready to provide unlimited amounts of liquidity against good collateral at a rate above the market rate prevailing during peacetime”.

All three dimensions of the contract have been thrown into question. The political agonies on both sides of the Atlantic may be seen as the first signs of a renegotiation of its terms.

That renegotiation, which is inevitable, must be handled with great care. We can certainly strengthen deposit protection, but if we offer unlimited guarantees we may distort savings behaviour in a way that favours bank deposits, against more rewarding investments in the long term. Would that be positive for consumers’ financial welfare?

We can provide more generous liquidity support. In the short term that is absolutely necessary to prevent systemic collapse, but where would we like the equilibrium between central banks and the interbank market to settle? How can we wean the markets off life-support in due course?

We can also strengthen capital requirements and make banks hold more capital. But to do so would impose higher borrowing costs on bank customers. Those who argue for higher capital requirements tend to talk of imposing costs on the banks themselves. That would happen, and bank chief executives’ pay might fall, but most of the costs would be felt by customers. Higher borrowing costs would limit spending and investment.

The social contract that existed until this year was not self-evidently foolish. Over a long period it delivered a robust banking sector and diverse financial services to the banks’ customers. In this crisis it has been found wanting. But it would be hazardous to change one element of the deal hastily, in the middle of a crisis, without considering the interactions between them, and the knock-on consequences of change. Untune one string, as the playwright said, and hark what discord follows.

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