

# What should the authorities have done?

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# Global issues

- Securitisation
- Rating agencies
- Disintermediation
- Competitive deregulation
- Excessive global liquidity

# UK issues

- Deposit insurance arrangements inadequate
- Tripartite arrangement failed
  - LOLR mechanism did not work well
  - Information and resources not in the same institution
- Bank of England
  - Liquidity-enhancing OMOs (repos) flawed
    - Collateral
    - Maturity
  - Discount window policy (Standing lending facility) flawed
    - Collateral
    - Maturity
    - Counterparties
  - Lack of clarity as to what the MPC does when it sets Bank Rate

# Securitisation: Issues

- Good news
  - makes non-marketable marketable; makes illiquid liquid. Greater scope for trading risk, diversification, hedging risk
- Bad news
  - destroys information (originator becomes agent instead of principal)
  - Puts information in the wrong place

# Securitisation: Solutions

- Solution: mainly market-driven.
  - Simpler structures
  - Actual 'unpicking' of securitisation
  - Originator to retain 'equity tranche' of securitised & tranced issues.

# Rating agencies: Issues

- Rating agencies as solution to information problems of securitisation
  - What do they know?
  - Conflicts of interest
    - Appraiser paid by seller rather than buyer
    - Multi-product firms (similar to auditors' problem).
    - Selling advice on how to structure securities so as to obtain the best rating to structured product designers/issuers whose products they subsequently rate
  - Reputation mitigates but does not solve this
  - Problems mainly with rating structured financial products, less with sovereign debt issues & corporations.

# Rating agencies: Solutions

- Solution partly market-driven, partly regulatory
  - Reduce role of rating agencies in Basel 2.
  - Restrict rating agencies to sell but one service: ratings
  - No more payment by issuer
    - Payment by levy on industry (investors and/or issuers)

# Disintermediation: Issues

- Much disintermediation & creation of off-balance sheet vehicles (SPVs, SIVs, conduits etc.) motivated by tax efficiency (avoidance) & regulatory avoidance considerations, instead of by economic efficiency consideration.
- Much *de jure* or *de facto* (reputation) exposure remains with sponsoring banks

# Disintermediation: Solutions

- Solutions partly market-driven, partly regulatory
  - Re-intermediation
  - Conduits, SIVs and other off-balance sheet vehicles taken back on balance sheet of banks
  - Accounting and reporting requirements for consolidation driven more by principles, with constant adaptation of rules

# Competitive deregulation: Issues

- Welcome antidote to tendency to excessive & heavy-handed regulation or race to the bottom?
  - Principles vs. rules: fundamentally phoney distinction. You need both
  - Is self-regulation no regulation?
  - Voluntary codes of conduct: the lunatics in charge of the asylum?
  - Is UK light-touch regulation just weak regulation that lets regulated parties get away with murder?

# Competitive deregulation: solutions

- Greater international cooperation
- In the EU: a single regulatory regime for banks and all other financial institutions
- Crackdown on “convenience regulatory regimes” (weird islands etc.) through non-recognition & non-enforceability of contracts & court judgements & rulings

# Excessive global liquidity: issues

- Since (at least 2003) policy rates too low in US, Japan & Eurozone
- Undervalued exchange rates & sterilized reserve accumulation by emerging markets depress long-term risk-free rates

# Excessive Global Liquidity: Solutions

- Just stop it
  - USA, Japan, Eurozone: stop getting behind the policy rate curve once tightening is required
  - China & co: revalue and/or let the exchange rate be market-driven

# UK Deposit Insurance: solutions

- Financial Services Compensation Scheme useless (100% of first £2,000; 90% of next £33,000)
- Raise limits to £50,000 per person per bank.
- Deductible good for incentives, but bad for runs, so: no deductible
- Rapid payout (at most 2 working days)
- Only retail deposits (held by natural persons).
- Administered by FSA
- In principle financed from levies on member banks
- Needs fiscal back-up from Treasury to handle deposit guarantee in case of system-wide solvency crisis
  - Could be provided through credit line or overdraft of FSA with BoE, guaranteed by Treasury

# UK Tripartite arrangement: solution

- Tripartite arrangement failed.
  - LOLR mechanism (dealing with troubled individual banks) did not work because information about individual banks (FSA) and resources required for LOLR role (BoE) not in the same institution
- Solution: put information and resources in the same institution
  - Return banking supervision & regulation to BoE; problem: independent monetary policy

*or*

  - Give LOLR responsibility to FSA & Treasury. FSA gets credit line/overdraft facility (uncapped & open-ended) with BoE, guaranteed by Treasury.

# Proposed UK Division of labour

- Bank of England supports systemically important financial markets and financial instruments (institutions with public goods features)
- Bank of England has short-run deep, liquid pockets
- FSA supports individual financial businesses (sometimes mislabelled financial institutions)
- FSA does consumer/customer protection
- Treasury: overall responsibility & authority and long-term deep pockets

# Bank of England

- Natural liquidity provider & market maker of last resort
  - Liquidity-oriented OMOs through repos & reverse repos
    - Widen list of eligible collateral to include private, illiquid & non-marketable securities (mortgages)
    - Organise auctions if no market exists
      - Pay penalty prices and apply hefty haircuts
      - Take punitively priced illiquid assets on balance sheet to be sold off later
    - Do liquidity-oriented repos at longer maturities (overnight, 1 months, 3 months, possibly longer).

# Bank of England

- Modify discount window operations (Standing lending facility)
  - Do not reduce penalty rate (100 basis points over Bank rate for overnight lending)
  - Widen list of eligible collateral as for OMOs
  - Lengthen maturities, increasing the penalty rate with the maturity (125 basis points for 1 month, 150 basis points for 3 months etc.)
  - Extend the list of eligible counterparties to include all financial institutions that are subject to a regulatory regime approved by the Bank

Northern Rock could probably have survived with OMOs<sub>18</sub> and Standing lending facility+

# FSA & Treasury

- When bank cannot survive with OMOs+ & Discount Window+, it turns to FSA for institution-specific support
- Special credit line, approved by FSA and Treasury until
  - bank decides it no longer needs the facility

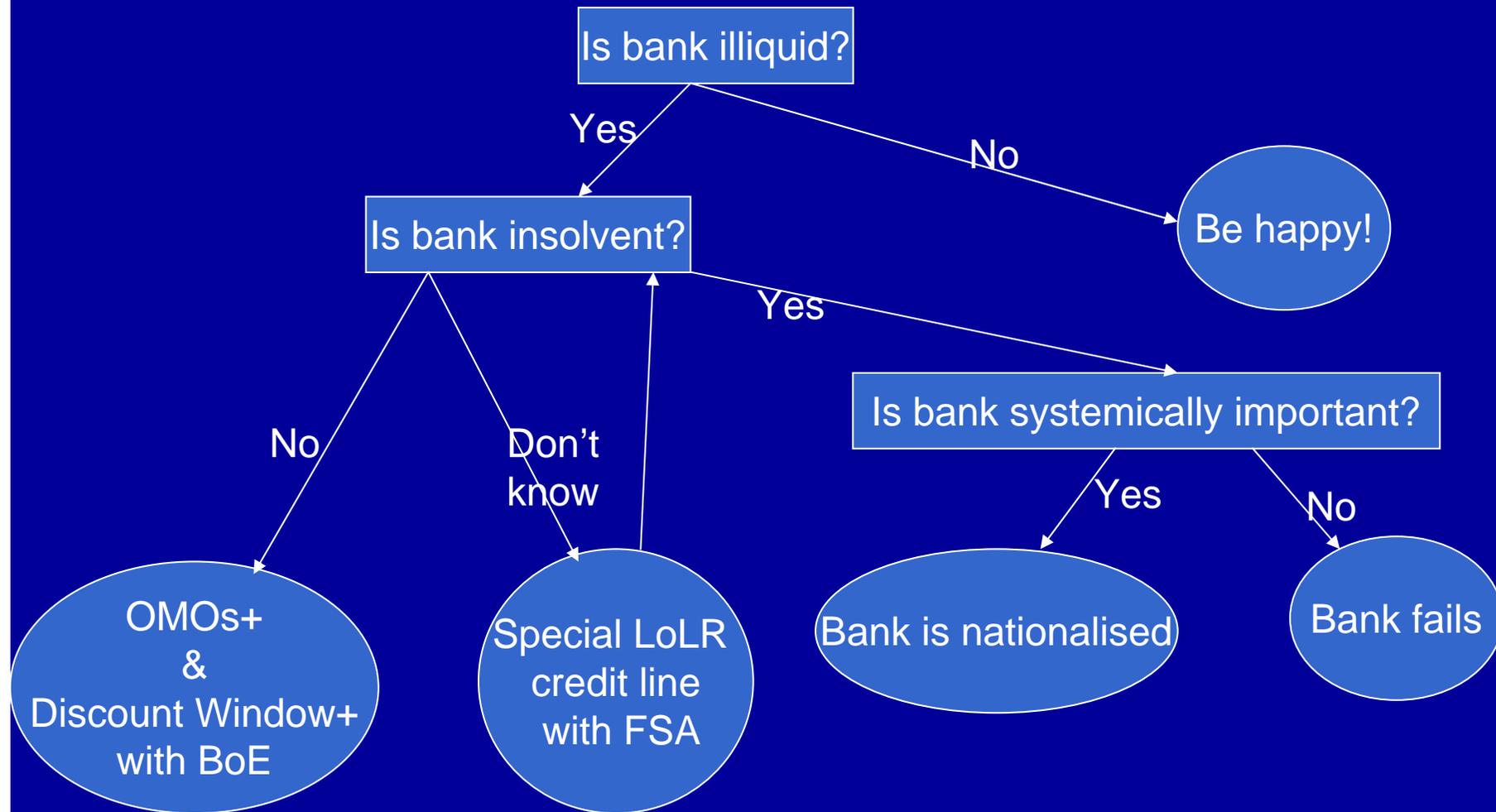
or

- FSA & Treasury resolve whether solvent or insolvent
  - If deemed solvent: retain on credit line until FSA & Treasury decide it's time for sink or swim (Northern Rock could have ended up here)
  - If deemed insolvent
    - Fail if deemed not systemically important
    - Take into public ownership if deemed systemically important
      - » Continue operations
      - » Privatise/liquidate/break up later
      - » Note: potential advisory role of BoE on systemic importance question

# Schematic of LOLR process

<b>Where do Illiquid Banks Go?</b>			
		<b>Systemically Important</b>	
		<b>Yes</b>	<b>No</b>
<b>Solvent</b>	<b>Yes</b>	<b>OMOs + Discount Window + (BoE)</b>	<b>OMOs + Discount Window + (BoE)</b>
	<b>Don't know</b>	<b>LOLR</b> (FSA & Treasury)	<b>LOLR</b> (FSA & Treasury)
	<b>No</b>	<b>Nationalise</b> (FSA & Treasury)	<b>Fail</b> (FSA)

# How to handle illiquid banks when there is effective deposit insurance



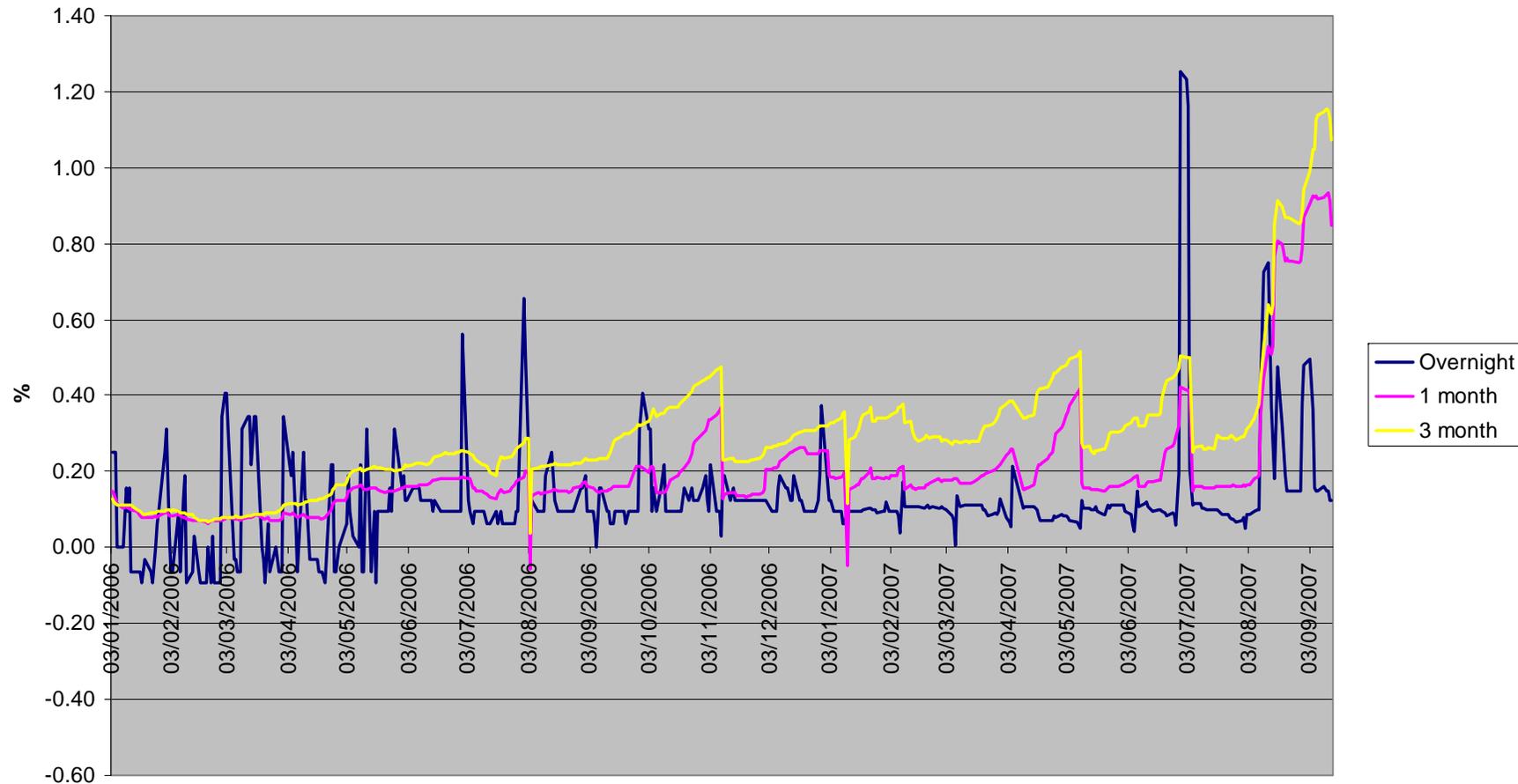
# What does the MPC set when it sets Bank Rate?

- In principle: target for overnight sterling interbank (money market) rate.

*“The Bank’s objective is for overnight market interest rates to be in line with the official Bank Rate so that there is a flat money market yield curve , consistent with the official Bank Rate, out to the next MPC decision date, with very limited volatility in market interest rates out to that horizon. But the Bank is not seeking to control credit risk premia or the cost of collateral in the market. Unsecured overnight market interest rates may, therefore, be somewhat higher than the official Bank Rate. Similarly, secured market rates may differ from the official Bank Rate as they are based on bundles of collateral different from the population of securities eligible in the Bank’s OMOs and standing lending facility.” (BoE Redbook (2007))*

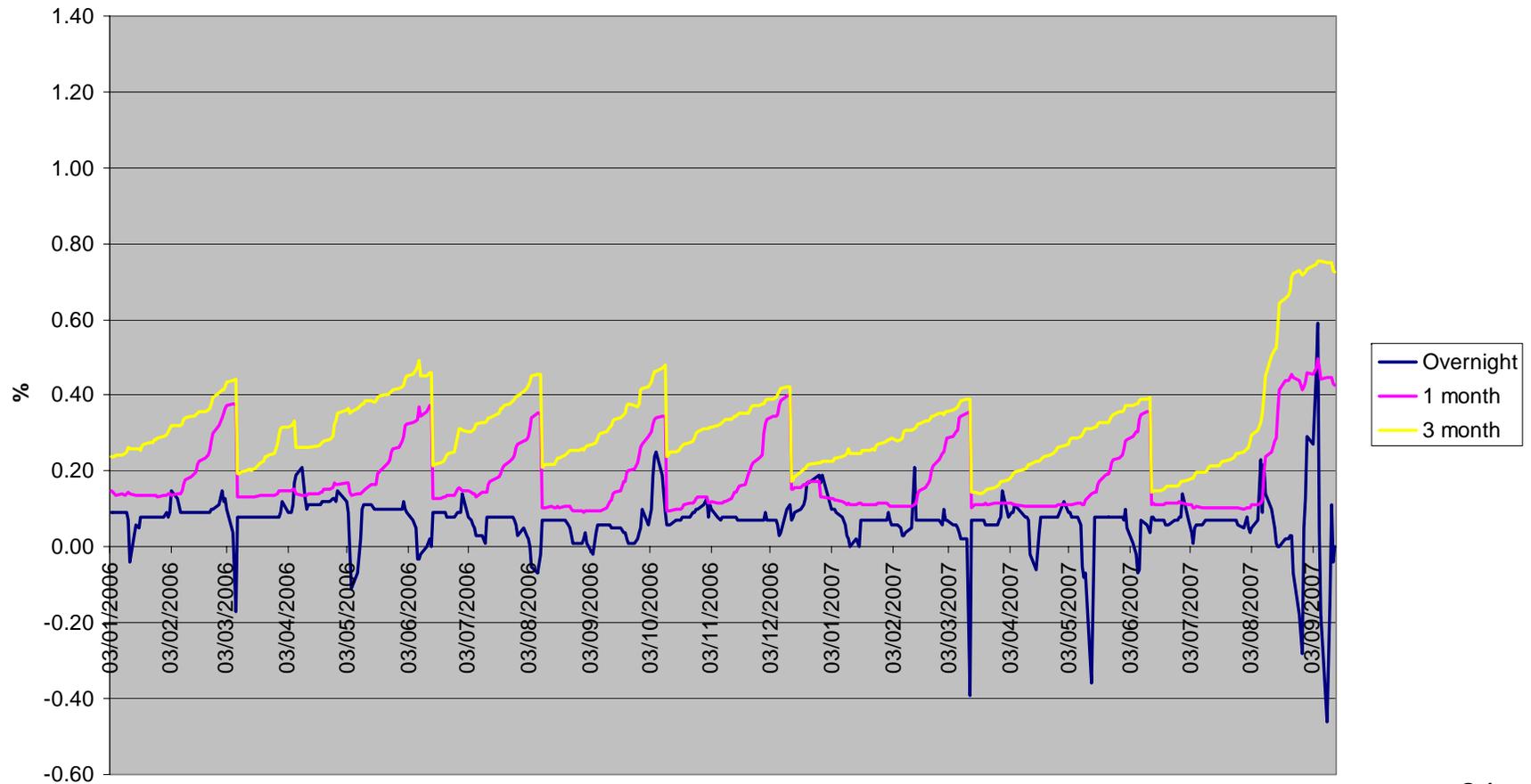
# How well did they do?

Chart 1  
Spreads of Libor over official policy rate, UK  
03/01/06 - 14/09/07



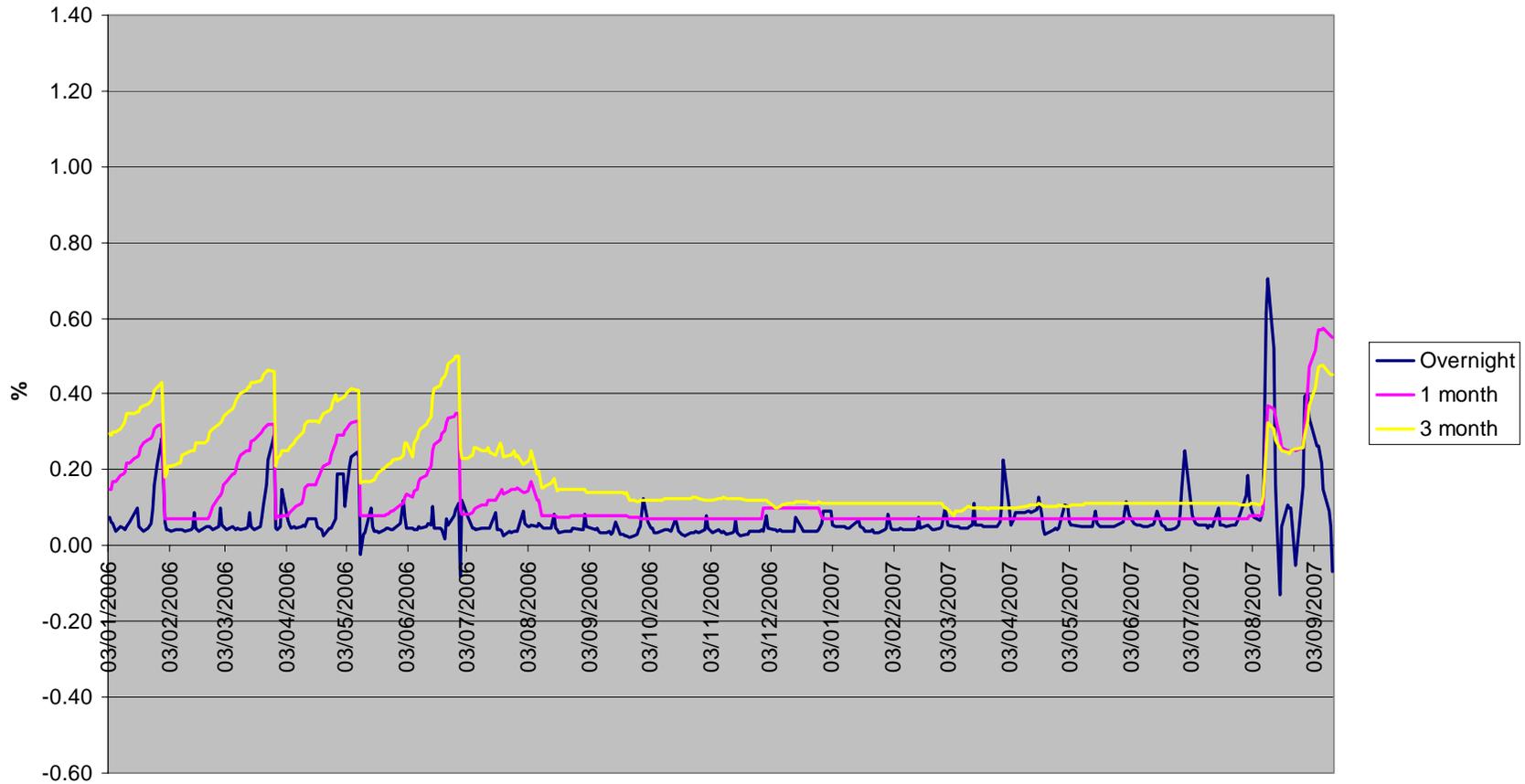
# How well did they do?

Chart 2  
Spreads between Euribor and official policy rate, Euro Area  
03/01/07 - 14/09/07



# How well did they do?

**Chart 3**  
**Spreads of Libor over official policy rate, USA**  
03/01/06 - 12/09/07



# Targeting the overnight rate

- Stop trying to set both price and quantity
- Stand ready to repo or reverse repo any amount at any time during the maintenance period, at an interest rate given by Bank Rate (for repos against collateral that is free of default risk or for repos against collateral whose cost reflects the associated default risk)



That's all folks!