Separate retail and investment banking again

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From Prof Tim Congdon.

Sir, John Kay ("How we let down the diligent folk at the Halifax", September 24) is too well-disposed towards marriages of retail and investment banking, now celebrated in the US and elsewhere in "bank holding companies". The trouble is far worse than an incompatibility between two cultures. More serious are the numerous conflicts of interest, and the severe agency problems, that riddle bank holding companies. The conflicts have been exacerbated when these companies include fund management operations as well as banking businesses, as has recently been the fashion.

Senior management sometimes claims that investment management is wholly autonomous. But if that is so, why have these companies been so keen to have fund management subsidiaries? The truth is that when a securities issue cannot be sold in full (or at all) to outside investors, unwanted securities have been dumped on the fund management business. The boom in structured finance products during the past decade was possible only because, to a significant extent, the lower-rated slices of asset-backed securities issues were "sold" to in-house funds.

While conflicts of interest are most severe between bank holding companies' different sets of customers, the agency problems are particularly intense between their managements and shareholders. John Kay and Martin Wolf have on several occasions pointed out - correctly - the possible tension between the short-term focus on management bonuses and the long-term interests of shareholders.

But there is much more to say. For example, inside bank holding companies, senior management sometimes purchases equity interests in major corporate clients and finances these interests by loans from the in-house commercial bank. Such abuses were common in the 1920s ahead of the Great Crash in 1929 and the Great Depression of the early 1930s. Outrage about Wall Street misdemeanours was an important part of the background to the Glass-Steagall legislation of 1933, which separated investment and commercial banking.

The repeal of Glass-Steagall in 1999 made possible the foolish boom in structured finance products and led to the current imbroglio. It was a dreadful blunder. Investment banking, commercial banking and fund management are distinct businesses, and have clients with conflicting interests. They must be kept apart. An international accord on the break-up of bank holding companies would improve the efficiency and integrity of free market capitalism.

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The yawning information gap between bankers and the rest

By Gillian Tett

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A couple of years ago, an investment banker berated me for using the word "murky" to describe the world of structured finance.

"It's not opaque," he said indignantly. "You can get plenty of information if you know where to look on a Bloomberg machine."

"But what about those people who don't have a Bloomberg machine?" I asked. Or a Reuters terminal, say.

The banker seemed momentarily stumped; apparently he had never felt the need to wonder if the part of the population that is tragically Bloomberg-deprived might need to know about finance too. Then he declared that I was missing the point.

"People who need to know, know where to look for data," he said. "It is not really murky at all."

That little exchange popped into my mind as I watched US politicians vote on Monday night over the putative $700bn bail-out plan. In the aftermath of that vote, numerous theories have been proffered about why the package was unexpectedly rejected. However, I suspect that at least part of the explanation lies in the issue of a yawning information gap that my Bloomberg-addicted contact highlighted all that time ago.

More specifically, during most of this decade, bankers have assumed that it was not just acceptable but also entirely normal to have a situation where 99.9 per cent of people had absolutely no idea how money flowed around the world. Twenty-first century bankers, in other words, have been acting like a BlackBerry-toting priestly class that assumed that only people who spoke the equivalent of advanced financial Latin should be allowed to attend Mass.

Meanwhile, politicians and voters, for their part, have been shockingly lazy in trying to understand finance - or even just asking why they were suddenly finding it so easy to get access to cheap cash. Much of the media has been remiss, too: most mainstream outlets all but ignored the fact that a revolution was under way in finance during the first seven years of this decade.

Now it is payback time. As the crisis has unfolded over the past year, most regulators, politicians, investors and voters have been left in a state of utter shock. One consequence of that has been irrational panic. Another is likely to be some equally irrational regulatory overeach.

However, the most pernicious problem is that many voters and politicians remain so confused about how finance works that they have no idea whether a bail-out is a good idea or not. All they do know is that the events of the past year have shown that modern finance is rife with complex interlinkages that are poorly understood, if not downright murky. Suspicions are rife that any bail-out for the banks will inevitably end up bailing out bankers, too, through all manner of hidden channels. Hence the wave of anger, and hence the difficulty that the US government faces in

convincing voters that there is a difference between rescuing finance and helping fat cats.

Take the case of AIG. Last weekend it emerged that one party that had benefited from AIG credit protection was Goldman Sachs. Now, the US bank insists that its exposure was small and thus irrelevant to the fate of AIG.

But in a world where the US Treasury secretary also used to run Goldman Sachs, such links seem a tad embarrassing at best. Moreover, they are apt to leave voters and politicians alike suspicious and confused.

In the short term, more transparency might - possibly - help to defuse this. Joshua Rosner, a New York analyst, has made the sensible suggestion that AIG should reveal the banks that have received credit protection as a condition of receiving that $85bn loan. That, at least, might help silence some of the wildest rumours about Goldman Sachs or anyone else.

However, in the longer term, the real lesson is that policymakers should never have permitted such a yawning information gap to emerge between bankers and everyone else. For the first seven years of this decade, that situation bred excess and abuse; now it is delivering a monumental backlash. The consequence of that will haunt us for years - with or without a Bloomberg machine.

Now is not the time to agonise over moral hazard

By Charles Goodhart

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The continued closure of wholesale financial markets has been the main cause of the financial turmoil and the reason why HBOS has had to seek the protection of a merger with a stronger bank.

Almost all banks, and some other financial institutions as well, relied on such wholesale markets to finance lending well in excess of their capital and core deposit base, in the case of Northern Rock spectacularly so. When the housing market turned down sharply, first in the US and then in the UK, concern rose about the bad debts and solvency of weaker banks at the same time as each bank worried about meeting its own future financing obligations.

So everyone started to hoard liquidity rather than lending it out. The more that banks have been perceived as exposed both to the weakening housing market and to a need to replace external maturing wholesale funding, the weaker their position has become. Moreover, their marginal funding costs then rises, relative to their peers, so that they begin to run at a loss, even without mortgage defaults. Step forward HBOS. Letting such a bank fail would just worsen the panic and downward cycle. The merger with Lloyds was necessary.

The basic problem has been that virtually no one, whether practitioner, regulator or academic, ever expected that wholesale financial markets would dry up for so long. So banks put their trust in maintaining liquidity via liability management - that is, access to such wholesale markets - and regulators/supervisors let them do so. Nowadays banks hold few traditional liquid assets, such as gilts, and instead are fully loaned up with claims of greater or lesser quality on the private sector, largely based on residential or commercial property. In so far as banks can now sell these, it just drives asset prices down further, making the whole situation worse. These asset price falls cause, with mark-to-market accounting, further declines in bank profits and larger write-offs, which are often misinterpreted in the current febrile atmosphere as evidence that the banks in question had not been fully transparent beforehand and were, perhaps, still hiding bad news.

Surely we should not have allowed the banking and financial system to get into such straits, but it is no use crying over spilt milk. The financial system must now be saved whatever past failings - as much the fault of regulators as of banks - may have been. In the current context that means that the central bank must stand ready to liquefy those assets that the commercial banks can now offer - that is, their better mortgages - but at an appropriate price. Or, as my colleague Willem Buiter would say, the Bank of England has to become the market maker of last resort.

This was, in effect, done with the introduction of the Special Liquidity Scheme earlier this year. The error then was to give it a terminal date of this October, an error which has now been repeated by giving its extension a terminal date of January 30 2009. UK housing prices will still be falling then, and default ratios rising. Given the scale of recent shocks to the system, wholesalemarkets are unlikely to be bursting into life again. The SLS should not be given a terminal date until we are out of the woods.

We have been promised a revision of the Bank of England's liquidity management arrangements. It may be that this new, revised system can do more of the heavy lifting that in the present milieu is done by the SLS. But it will be new and untested. We should stick with what works until it can be replaced with a proven better alternative.

The Bank of England is right not to accept current mortgage originations, but it should now move the base date forward to June 2009. Is this not moral hazard again? Will banks not now originate mortgages in the expectation of being able, after a few months, to off-load them on to the Bank of England? Perhaps, but at a time when mortgage approvals are running at a quarter of the previous year's rate and the housing market is moribund, this is hardly a bad thing.

The time to worry about moral hazard is in the boom. The first priority is to get out of the present hole. Worrying about moral hazard in current circumstances is rather like refusing to sell fire insurance just after the Great Fire of London for fear of adversely affecting future behaviour.

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America's chance to kick its Asian addiction

By David Pilling

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Did America hang itself with Asian rope? I put this to a Chinese official last week and, quick as a flash, he responded: "No. It drowned itself in Asian liquidity."

Asia's part in America's financial downfall has been two-fold. First, shiploads of cheap goods from China and other low-cost producers helped keep a lid on US prices. That lulled the Fed, with its tight focus on the consumer price index, into thinking it could have it both ways: high growth with low inflation.

Second, Asian bank reserves of $4,300bn (£2,400bn) combined with petrodollars to provide the US with almost endless liquidity. This poured into US Treasuries and Fannie and Freddie bonds, suppressing US interest rates, inflating the housing bubble and funding buy-now pay-later consumption.

Western banks and hedge funds used Asia, particularly Japan, as an enchanted pool of money. Through the so-called carry trade, they dipped their ladles into its ultra-low interest rate waters and splashed the proceeds around on exotic, high-yield instruments. For a while it all worked beautifully. You know the rest.

In one sense, this is a story of Asian prudence versus US recklessness. By accumulating vast savings - China and Japan alone boast 40 per cent of global central bank reserves - Asians have lived below their means so that Americans could live beyond theirs. Asia bankrolled US budget and trade deficits and provided the cash for banks and individuals to go on a spending spree and for Washington to fight wars in Afghanistan and Iraq.

"Arguably, the US overextended itself in international relations and in the management of its domestic situation. It spent way beyond its means," says Fang Xinghai, director general of Shanghai's Financial Services Office.

While it lasted, China and others were able to grow at supercharged rates by lending to Americans so that they could import its products. Now that wheeze is over, Asia will suffer too. But even if China, which grew at 12 per cent last year, loses 4 percentage points of growth, it will still be clipping along at 8 per cent. If the US or Europe loses the same amount, it will be deep in recession.

Wall Street's 9/11 could thus turn out to be an important milestone on the road to Asia's century. US presidential candidates invoked that possibility last week in their debate. Barack Obama referred to China's recent space walk as a sign that it was catching up while America floundered. John McCain, attacking waste in Washington, said: "We owe China $500bn." Mr Obama went one better, saying (more accurately) China "now holds $1,000bn of our national debt". Linking finance with power, he added: "There has never been a country on earth that saw its economy decline and yet maintained its military superiority."

There has been a cautious reappraisal in parts of Asia too. "More people understand that America is not as great as it was 10 years ago," says Shen Dingli of Fudan university in Shanghai. "This is not a time for China to be on a par with America. But the relative shift of the centre of gravity does bring China more confidence."

For the moment, though, the fates of Asia and the US remain more aligned than opposed. Chinese, Singaporean and other Asian investors have lost billions on their stakes in failing western institutions. Asian governments have insisted on the need for a US bail-out to protect their sovereign investments.

US woes bounce back in other ways, too. In August, Japan recorded its first seasonally adjusted monthly trade deficit in a quarter of a century after shipments to the US slid 22 per cent. Net exports are not expected to contribute anything to Chinese growth this year.

More fundamentally, the pattern of flows from Asia to the US and other deficit countries could change. If the US can wean itself off what has been an unhealthy addiction, the shock could yet turn out to be to its long-term advantage. It has already started increasing exports and importing less.

In another sign of change, the big gap between returns that drove Japanese capital to the US has narrowed sharply for bonds and disappeared altogether for equity, says Peter Tasker of Kleinwort Dresdner. "This could be the crumbling of the configuration that has seen capital surplus countries funding US consumption," he says.

For that to happen Asians would have to start spending more at home. That could be brought about by a deep recession, which would oblige them to run down savings. Alternatively, Asian governments could encourage their citizens to break savings habits and go on a US-style binge.

Chinese citizens, whose consumption accounts for a measly third of national output - against 70 per cent in the US - could certainly spend more. But Beijing, which has already taken steps to prick the housing bubble, appears in no hurry to encourage reckless spending.

Says Mr Fang: "I'm not sure you should encourage people to borrow in order to spend. That is what bankrupted the US."

The writer is Asia Editor of the FT

Brown must stay strong as sweetheart deal sours

Nils Pratley, Guardian. 1 October 2008.

Today we will discover whether the markets listen to Gordon Brown, who last night made clear that he expects Lloyds TSB's takeover of HBOS to proceed without a hitch. If HBOS's shares don't jump closer to Lloyds TSB's bid price after that, the government has a problem.

Yesterday's share prices were an embarrassment. HBOS closed at 122p, a discount of 35% to the value of Lloyds' all-share offer. In an ordinary takeover - in other words, one not stitched together by the government - the stench of death around the deal would be unmistakable. The market is saying that Lloyds should either walk away from an expensive takeover or negotiate a lower price.

Many Lloyds shareholders would like it to do the latter, but the management simply cannot. Chairman Victor Blank signed up to a sweetheart deal with the government, which obligingly ripped up the competition rulebook. Blank is in debt to Brown and cannot be seen to try to unpick the terms. If Lloyds walked away, HBOS would be handed on a plate to a rival at a lower price.

But the market can exert enormous pressure. The discount of 35% has become an invitation to Lloyds shareholders to threaten to vote against the deal. Worse, there is an incentive for hedge funds to buy Lloyds shares with the intention of doing the same - they would be betting that the price would rise if better terms can be secured.

We are a couple of months away from the vote, but that is not necessarily good news for Brown. There is time for this plot to develop. If the discount stays at 30%-plus, the pressure on the government to cave in to the market's demands will be intense. At what point would it decide that a deal at any price is better than no deal?

At the moment, Brown's strong-arm defence is the right tactic. He has hailed the takeover as an act of decisive intervention to ensure financial stability. He cannot show weakness now. He could also get lucky - financial markets could recover their poise and the discount could narrow. But he'll want to see HBOS's bounce today - 10% at least.

Data from Martin Wolf article in FT, 1 October 2008: