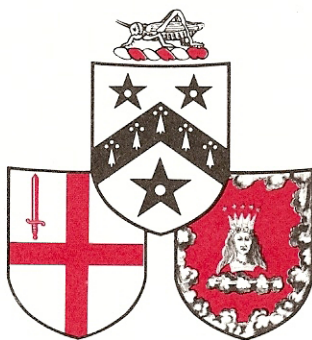


G R E S H A M
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Gresham Special Lecture

BANKING TODAY

delivered by

Sir Peter Middleton GCB
Deputy Chairman, Barclay's Bank PLC and Chairman, BZW

at Guildhall

Wednesday 1 May 1996

Gresham College, Barnard's Inn Hall, Holborn, London EC1N 2HH

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I am very grateful to Gresham College for giving me the chance to ruminate about banking. Having spent most of my life in the Treasury inhaling the wisdom of bankers about economic management, this is a wonderful opportunity to get my own back.

But I have a more serious purpose. There is a pervasive idea in the world outside banking, that banking and financial services should really be a riskless business, providing riskless products. Indeed, some of the comments which greet the ever expanding flow of new products - most recently evident in the case of derivatives - indicate that some people think that traditional commercial banking is already risk free or has been made so by regulation.

My objective tonight is to explore how in the 1900s banks reconcile the image of being a safe haven, and a safe means of transmission, with the need to make money - especially as there is nothing really safe that banks can do with money when they get it.

Lending and Risk

Deposits taken for safe keeping, are still the main means by which banks raise finance. It is now quite common to pay the customer for this service rather than charge him. The deposits are then used by the bank - together with other sorts of finance it might raise - to lend or invest as principals. Indeed, this activity comes neatly within the Board of Banking Supervision's recent definition (in the Barings Report) of proprietary trading as "the taking of risk positions for an institution's own account as distinct from client business". The banks are not agents - as the term financial intermediation might be thought to imply. They are own account traders on a grand scale and have been since the earliest times. Traditional forms of banking were, and are, amazingly risky.

The banks' ability to raise deposits stems from the fact that savers mostly wish to have a very high degree of certainty both as to the safety of their deposit and the timing of its repayment. None of this can easily be achieved by a saver lending to an individual borrower whose risk may be difficult to assess. Depositors are not normally concerned if the bank lends to the local second-hand car dealer; whereas they would recoil in horror from the prospect of doing it themselves.

The borrower, on the other hand, may wish both to borrow a different amount and for a different length of time to that preferred by the saver. A bank can solve this problem in a variety of ways. First, deposits can be aggregated and lent in differing amounts according to borrowers' needs. Second, even if all deposits are repayable on demand, the fact that only a small net percentage will actually be withdrawn from a bank which retains public confidence and pays competitive interest rates, means it can lend for longer periods.

Third, there is the all-important ability to specialise and acquire expertise in the assessment and management of risk. For traditional commercial banking, this meant two things: acquiring information to assess the credit worthiness of individual borrowers; and having a wide spread of borrowers so risks were diversified and thus reduced when taken together.

It is strange that this latter aspect of managing risk did not really develop into a formal portfolio management arrangement until the past few years. Banks got along for centuries without recognised systems to assess the risks inherent in their portfolios.

Reliance on expertise in assessing an individual loan, a vaguely diversified loan portfolio, cross-subsidy, the lack of full profit disclosure and the presumed comfort provided by official prudential supervision has meant that banks have not for most of their history had to subject their rewards and risk taking to rigorous scrutiny.

The techniques available to manage risk are not new. The average risk in a bank's portfolio can be estimated over a "typical" economic cycle. At the same time, it is not too difficult to judge the amount of capital which is needed as a cushion against extreme outcomes with low probabilities. These two pieces of information lead to basic pricing policies which in turn mean that banks should be able to charge for the risk they are taking with a particular loan, taking account of both its individual characteristics and its contribution to the total risk taken by the bank.

But in practice things are much more difficult.

We would all agree that a bank should take into account the possibility that a loan might not be repaid - or not repaid in full. That is why so much effort is made to assess the individual characteristics of particular loans to particular customers.

Most, but probably not all, would agree that this risk element should be incorporated into the price of a loan. It is much better that the price should reflect the true risk rather than the loans should either be refused altogether or granted at the wrong price. This principle is no different from that followed by insurance companies where a premium, not unlike the risk element in the price of a loan, is charged when an event is insured.

It is tempting to stop there. So far there is nothing that could not be easily understood by a bank's staff and its customers. But, there is much more to the successful pricing of risk. Any bank's loan book involves a portfolio of assets comparable to but more complex than a portfolio of investments held by, say, a pension fund.

Within the portfolio there are risks which reinforce each other and risks which offset each other. The portfolio can be managed in all sorts of ways in order to reduce the risk to the whole business by diversification.

This too needs to be reflected in pricing. The incorporation of this portfolio element into pricing is much more difficult for staff to handle and customers to comprehend. It may, for example, involve charging more for a particular loan; lending a smaller amount than required by the borrower, or even turning it down altogether when the bank has an excessive amount of that sort of risk in its portfolio. And this may be desirable even if the individual characteristics of the loan may seem better than similar loans already granted.

Things get even more complicated when one looks beyond the loan portfolio to the banks' total portfolio assets.

Risk and Market Making

Most banks of any size now offer a wide range of banking products and other financial services. They include elements of retail banking (taking small deposits and lending to small and medium-sized borrowers), wholesale banking (taking large deposits and dealing with large undertakings), and investment banking (bringing investors and lenders together through the financial markets).

Typically, one thinks of bank lending as a different function from that of participating in financial markets and trading in securities.

But by acting as a principal as well as an agent or broker, the market-maker is undertaking another form of own account activity which amplifies the service provided by a bank. The development of financial markets has been driven by the need to satisfy the increasing demand from both savers and investors for a better, wider and more tailored range of services. The growth of derivatives is an essential element in this process. Customers use derivative markets to hedge risk of all types - to create for the customer a degree of certainty in an uncertain world - such as the risk that interest rates will be higher in six months' time than now.

Conceptually, this is no different from the service provided in the traditional bank intermediation function. What is different is the nature of the risk. When a financial market exists, the risk is not primarily that of default. Rather, it is risk that the value of the asset will change. Indeed, the change in value is continuous as the price of currencies and securities react within seconds to every piece of new information.

As principals, the banks must measure and control these risks in much the same way as with a loan portfolio. Some losses are inevitable. Pricing (or the margin between buying and selling a security) must reflect what can be expected. And capital backing must protect against the unexpected.

Let us now ask how this activity affects the riskiness of the bank and the portfolio element in pricing its products. It is widely thought that participation in the derivatives market makes banks and banking more risky than hitherto. Yet it is not at all obvious why this should be so as the timescale of risks taken in market trading is generally much shorter. Even if we assume that trading in derivatives, and indeed market trading generally, is a higher risk/higher reward business than that of traditional banking activities, it does not follow that a financial services group that operates in these markets is more risky than one which does not.

It is not just that these markets may be used to hedge the risk inherent in traditional banking - such as a sharp fall in interest rates which would reduce profits from lending, given the continued existence of the endowment effect. But, more fundamentally, we have to consider whether the volatility of earnings from market trading offset or partially offset the profit cycle which exists in many areas of banking in line with the business cycle. To the extent that it does, the overall riskiness of the banking group is actually lowered by market trading activity. Moreover, it should not be forgotten that a high average rate of return can compensate for volatility, and thus also reduce solvency risk.

A bank's portfolio is one of its most valuable assets. If all the risks that a bank takes can be properly quantified and brought to a common basis for measurement, risk diversification can be managed more effectively. All the bank's products and all its customers gain. The economy also gains from a reduction in risk generally. Attempts to segment different types of business into watertight compartments in order to contain particular types of risk almost always result in

an increased price for taking those risks or a poorer service.

Hastened perhaps by experience in the last recession, there have been huge advances in recent years in the understanding of measurement and control of risk. Operating systems and accounting systems have greatly improved the information flow. There has been a positive explosion of intellectual effort beamed at the practical problems involved in the management of risk. This has the entirely desirable result of increasing banks' capacity to take individual risks while containing the risk at group level by building a truly diversified portfolio as well as having sufficient capital to absorb unexpected losses.

It will therefore not surprise you if I say that the banking system is more secure than it has ever been. This is particularly true in the UK where there has not been a major bank failure since the collapse of the Bank of Glasgow in 1878. There have been plenty of tremors and minor tribulations. But British banks have been sufficiently well spread and sufficiently well capitalised to maintain their business through good times and bad.

Bank Regulation

It is therefore paradoxical, to say the least, that a starkly obvious feature of the banking scene has been the crescendo of regulation. At a time when one might reasonably expect a diminution in the intensity and intrusiveness of regulation there has instead been a sharp increase. An increase which reflects neither an increase in the riskiness of banks nor sound financial principles. Indeed academic opinion seems to be moving sharply in the opposite direction.

Regulation of banks as institutions has historically been based on the principle of systemic risk. This is the fear that the collapse of one bank might provoke a run on others - which might put perfectly sound banks in difficulty.

Because it is known that banks' assets are generally less liquid than their deposits, depositors might wish to withdraw their demand deposits (change notes for gold in the past) because they fear that other depositors might get there first. There might thus be a failure in the banking system and a potential contraction in the money supply and the flow of credit - with severe effects on the economy.

It is the potential to affect the money supply which distinguishes bank failures from those in other parts of the economy which may equally have contagious effects on similar businesses. And it is this unique possibility which had caused the state to intervene to prevent systemic problems in the financial world.

Yet it is not at all necessary to resort to detailed supervision to mitigate or remove this risk. The Bank of England came to develop a perfectly satisfactory technique for protecting the system from systemic failure in the second half of the 19th century. The Bank put arrangements in place to ensure that the system had enough liquidity by itself providing enough gold coin to meet withdrawals. It became prepared to supply gold by discounting good quality commercial paper at Bank rate. The aim was to protect the system not individual banks. If a bank became insolvent it could go to the wall leaving the system intact.

Moreover, systemic risk today is not quite what it was in the 19th century. With the development of wholesale markets, banks now obtain their liquidity by borrowing in international inter-bank markets. So systemic risk has become more a question of inter-bank settlement than withdrawals by retail customers. As notes and coins have been substantially replaced by bank deposits as the medium of exchange, the likelihood is that a run - if it occurred

at all - would be on the part of corporate deposit holders rather than individuals.

This development also means that it is much less likely that a bank run could threaten the money supply. Today a loss of confidence in one bank would mainly result in the transfer of deposits to other banks and the central bank. They would re-invest excess liquid balances. So the problem, though still unpleasant, is much less serious than the classic horror story of a contagious collapse of sound banks. The traumatic 1987 Stock Market collapse provides a relatively recent example of central banks providing liquidity to ensure that the financial system was not jeopardised.

It is therefore quite difficult to produce an intellectual justification for the increased emphasis on regulation. The thought process appears to be that it is insufficient to maintain the system intact; banks must be prevented from getting into difficulty in the first place. This inevitably leads to detailed and intrusive inspections as the supervisors direct their efforts towards the solvency of individual banks. Yet there have been some very obvious examples of the dangers which this approach to supervision brings.

First among these is moral hazard. If banks know they will be rescued in a crisis they will be more inclined to take the sort of risks which will bring one about. And the bank's customers will seek the most beneficial returns in the expectation that all risks are equal and underwritten by the authorities.

The most recent dramatic example was the 3,000 failures of Savings and Loans in the USA. This involved the government in a \$150 bn rescue package - a clear case of over protection causing systemic risk rather than reducing it. And it took place despite an army of bank examiners.

Second is the risk to the standing and integrity of the regulators themselves. Though we say in the UK that the object of supervision is not to rescue banks but to safeguard the system, it is increasingly difficult to carry conviction when the process is moving in the opposite direction. Every failure, however small, is laid at the regulators' door. This in turn is bound to make the regulators excessively risk averse and naturally to breed a defensive attitude.

Looking back over what I have said about this in the past - always a good discipline - I see that I have normally taken the line that supervision is inevitable but bad supervision is not. The inevitability derives from the state of public opinion and Governments increasing inability to let significant numbers of depositors suffer.

We have only had two pieces of banking legislation in the UK - the 1979 and 1987 Banking Acts. Both were aimed at protecting depositors. Yet very few depositors have any idea of the level of formal protection available to them. They think that whatever happens their deposits will be alright on the night. So it is that regardless of the merits, it is exceedingly unlikely that the depositors in any major British bank would be likely to lose despite what the regulators and indeed governments say to the contrary.

Yet even with such a massive problem as this in terms of public expectation and political reality, I wonder whether the answer is more, different, supervisors and more of the business driven by their requirements rather than the demands of the market.

For there is another route.

If it is true, as I have argued earlier, that diversification is the key to solvency, it follows that this rather than the present panoply of detailed controls could be the focus of regulation. It would make possible a return to a more liberal philosophy of maximum freedom for the banks to run their business coupled with maximum disclosure of loan and diversification risks. The markets would then be able to judge a bank's solvency for themselves. Banks with poorly diversified exposures would find themselves paying more for wholesale deposits - a much more effective constraint than can be provided by a bank examination.

While I am on this subject, a word about capital requirements might not come amiss. It has now become commonplace for central banks to impose minimum capital requirements - a process enshrined in the capital adequacy directives developed under the Basle agreement of 1987. These ratios are as much about level playing fields as anything, and like any crude average they do not take into account any of the specific circumstances of different banks in different countries. Most importantly, no allowance is made for the correlation between different classes of assets or the risk arising from the term and interest rate characteristics of assets and liabilities which are unique to individual banks.

It goes without saying that though Banks need to be adequately capitalised such an edifice of prescribed minima is neither necessary nor sufficient to ensure a sound structure. If a bank is well diversified and capitalised in relation to its own risk profile, minimum ratios are unnecessary. If it has an undue concentration of risks, the minimum will be insufficient.

It is very important that the crude way of adjusting a bank's capital for risk used by the regulators should not be taken as a measure of risk in an individual bank. It is inappropriate either as a denominator for pricing or for measuring risk adjusted returns. A bank has to work out its own capital requirements based on its own portfolio and allocate this capital to different activities.

It should of course then be possible to place the results before the regulators and secure their agreement so that individual banks, either taken as a whole or as a sum of parts, are neither taxed nor fined by regulatory requirements related to external requirements. Alas, we are some way from being able to do this.

Retail Regulation

I should emphasise that I have not been talking about a quite different area of financial regulation; that of protecting relatively uninformed retail customers. This is often seen as a self-evident requirement. And it is true that individuals cannot be expected to assess risk in a sophisticated way, especially for products which are complex and bought infrequently. But, even here, it is important that people should not be led to believe that they no longer have to exercise care if they buy a regulated product or buy a product from a regulated institution. Individuals need to be aware that higher returns go with higher risk - and those who take lower risk and make lower returns should not have to pay to protect those who decide to take more risk.

As with bank regulation, consumer protection only really works if there is transparency and clarity about the risks and returns on particular investment. Without that, an authorisation label carries the danger that the investor feels he is more protected than he is, and pressure to underwrite any losses is enormous. We really must resist this tendency, otherwise we face a future of increasing regulation coupled with de facto guarantees either by the financial system or the state. That raises both the costs and the risks in the system, and acts as a formidable barrier to entry.

Conclusion

In this lecture I have tried to concentrate on some vital issues of modern banking. In reality they are not so different from ancient banking. The sheer diversity of possibilities in the modern world offers both a challenge and a source of comfort. The comfort is that diversity, if properly understood, is the ultimate source of safety together with adequate capital backing.

Regulation can do very little to increase this safely and has the potential to reduce it. Even though Governments have gone along with the popular misconception that detailed regulation can increase personal safety in dealing with banks, there is really no excuse for bad regulation. And it is certainly bad regulation to add to the costs and complexity of regulation when the value for money it produces is so slight. It is very similar to the arguments against adding to the complexity of the tax system without examining the effect on the system as a whole and the costs of compliance.

I need hardly add for this audience that there is an important specific objective at stake for London. London's development as a financial centre has been based on an understanding regime both as regards the reality and regulation of banking. There is no advantage for us in following the US model where compliance represents about 60% of net income - excluding things like the cost of deposit interest figures on compulsory reserve requirements - and where there is barely a day free from some sort of inspection.

The Bank of England is almost alone in claiming that it is not in the business of rescuing individual banks. The attitude to regulation which flows from this has been an important source of competitive advantage. We should all strive to make this wise approach to regulation closer to reality than what we sense is happening.

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Gresham College was established in 1597 under the Will of the Elizabethan financier Sir Thomas Gresham, who nominated the Corporation of the City of London and the Worshipful Company of Mercers to be his Trustees. They manage the Estate through the Joint Grand Gresham Committee. The College has been maintained in various forms since the foundation. The one continuing activity (excepting the period 1939-1945) has been the annual appointment of seven distinguished academics 'sufficiently learned to reade the lectures of divyntyte, astronomy, musicke, and geometry' (appointed by the Corporation), 'meete to reade the lectures of lawe, phissicke, and rhetoricke', (appointed by the Mercers' Company). From the 16th century the Gresham Professors have given free public lectures in the City. A Mercers' School Memorial Chair of Commerce has been added to the seven 'ancient' Chairs.

The College was formally reconstituted as an independent foundation in 1984. The Governing Body, with nominations from the City Corporation, the Mercers' Company, the Gresham Professors and the City University, reports to the Joint Grand Gresham Committee. Its objectives are to sponsor innovative research and to supplement and complement existing facilities in higher education. It does not award degrees and diplomas, rather it is an active collaborator with institutions of higher education, learned societies and professional bodies.

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