

## Conference in memory of Tommaso Padoa-Schioppa

### Presentation by Charles Goodhart

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We are all here because we have been friends of Tommaso Padoa Schioppa. I am proud and privileged to have been his friend for many years.

The latest connection I had with him was with respect to his previous role as Chairman of the Basel Committee of Banking Supervision, as indeed are also two of the other speakers in this panel. I have had the pleasant job of being historian of the Basel Committee, and in that context I corresponded with him about his time as Chairman of the BCBS.

Tommaso was an excellent Chairman. Incidentally, do not rush out and buy the book. It is far too expensive, even for you. Ask your institution to buy a copy and then stand in line to borrow it.

More generally, my main connections with Tommaso have been that we both had a considerable interest in the process of financial regulation. We provided, in the Financial Markets Group, a financial study group which was founded by Sir Mervyn King and myself just about 25 years ago, a platform where Tommaso could come and give regular presentations, which he did at fairly frequent intervals. After he had been there for his third or fourth time, I suggested that he put these papers together and collect them into a book. Which he did, in his book, Regulating Finance: Balancing Freedom and Risk. It is an excellent book; I was delighted to write a foreword for it.

I will now turn to a, not exactly a dispute, but an argument that I had with Tommaso, since it bears on what Andrea Enria has just been saying. Tommaso, like Andrea, was a keen exponent of European-wide supervision and crisis management, especially the handling of cross-border European bank resolutions. I said that this was all very well in principle, but it failed at one particular point. Which is, that if you have crisis resolution still being funded by the individual Nation State so that the guarantee, say provided by the Irish government, and the bailout via temporary public ownership is done by the Nation State, so that the Nation State bears the cost of resolution, (and there is always likely to be some cost), then that Nation State is going to want to have responsibility for being sure that the supervisory and regulatory process is as it wants. There

is a well-known phrase: He, who pays the piper, calls the tune. So long as there is still national payment for resolution, then the Nation State has a legitimate ground for saying that they have got to have the main say on the supervision of their home-based institutions, cross-border or not.

That leads me on to the view that, whereas I agree that European-wide supervision, crisis resolution and all that is highly desirable, it cannot really happen until everyone moves systemically and systematically into a proper fiscal union. And by fiscal union I do not mean the kind of reinforced stability and growth pact outlined at the October 2011 summit, but a proper fiscal union in which there are certain tax competencies and certain expenditure functions which are given to the federal center, rather than to the Nation State.

Let me now embark on a brief discussion on Tommaso's views on financial system regulation and supervision, partly illuminated by the excellent note that Alessio De Vincenzo and Andrea Generale have put out in advance on Tommaso's views. I would, in that context, like to congratulate the Banca d'Italia on their advance preparation for this conference, in many ways better than almost any other conference I have ever attended.

What they say on page 3 of their note, was that Tommaso was very concerned, as indeed he was, with the tendency for both markets and regulation to overshoot and thereby enhance procyclicality. I now hardly need to comment on the overshooting of markets; rather I want to emphasize that there is also an innate tendency for regulation to overshoot. Inevitably, if something goes wrong in the financial stability sphere, that means that in some respects regulation and supervision have been found wanting. The immediate, and inevitable, response is: "That must not happen again". And so what always happens after a crisis is that the authorities (you in this audience) push on additional regulations onto a financial system which, by the crisis itself, has been quite severely weakened, often in a context in which raising funds, either in equity or long term debt, will be difficult. So you are imposing much more regulation on a banking system which is much weaker. And then what happens all the time is that eventually one gets recovery and everything seems to be going all right and everybody notes that these regulations prevent banks doing what otherwise they would like to do, and it does not seem to be particularly disadvantageous to weaken and relax the financial constraints, as the banks naturally want, and so you do it. And so, inevitably, as time passes and nothing goes wrong, the regulations get weakened until the next crisis comes along. And then we start all over again.

Now at last I think that we have recognized that syndrome, but I am concerned that our attempt to counter that by countercyclical adjustments to the capital ratios will not be sufficient. There are a number of headwinds to the effective use of counter-cyclical measures. First, the 2,5% potential countercyclical adjustment that is allowed by Basel 3 is small compared to the cyclical swings in profit and capital. Think of the difference in the conditions of the financial and banking systems between 2006 and 2011. 2,5% compared to that, you must admit, is tiny.

Second, systemic stability management often requires a granular approach, as Mervyn King was saying, which could conflict with the desire for harmonization and uniformity. I was glad that Andrea Enria said that there was no conflict in principle and I think he is right. If you do this correctly, if you do this properly and if you do it with understanding, then there will be no conflict. The question is: will you do it in the best way?

Now, my next worry is that countercyclical measures only bite during booms because it is the market which is going to constrain the financial system and the banking system during the busts. And booms are very widely popular and their sustainability is by definition uncertain, because if everybody realized that a boom was unsustainable, it would go away instantaneously. The only reason that an asset price boom can continue is because many people think it is going to go on further. I remember a lecture by the then President of the Royal Economic Society to the British Academy in I think it was 2006, saying that there was absolutely nothing wrong with British housing prices, because the relatively low level of British long term real interest rates meant that asset prices should be high relative to incomes. If the President of the Royal Economic Society can say that there is nothing wrong with British housing prices, who are the rest of us to say that it is a bubble?

So you can never be sure what is an 'unsustainable bubble' ex ante; that means that you have to rely in a difficult way on a number of complex presumptive indicators, to which we did not pay enough attention, such as credit ratios, leverage ratios and so on. We need a number of, what I call, presumptive indicators to reinforce action. Without some support from some such indicators, you have to be a very brave central banker, like Paul Volcker, to get up and say "Enough is enough, I'm going to cut a lot of people out of the housing market". Such Central Bankers are not going to be politically popular. Let me note that the best person working in this field is another Italian, Claudio Borio, who has done better work at the BIS than anyone else in this field. While it may be Bill

White and Nouriel Roubini who get praise for having warned about what was going wrong, it was Claudio Borio who has been doing the underlying hard empirical work in this field.

Next, assuming that we can and do use countercyclical capital ratio requirements, raising them during the boom, can we lower them during the crisis and panic? The answer is obvious: No. Because during the crisis and the panic, the banks are all looking weak and therefore dangerous; they are looking risky. Can you lower a required ratio when all your banks are looking as if they may be in danger? The answer is: You cannot. It just does not seem to make any kind of sense.

So, how do we get out of this problem, where a countercyclical adjustment can only be ratcheted up; you can never let it down during the crisis. One of the underlying problems is that we have never really thought through the question of what these capital ratios are actually supposed to be for. One of the key moments in my book on the BCBS is where Peter Cooke, the Chairman at the time, mused about the question of what are these capital ratios supposed to be. Are they supposed to be minima? Are they supposed to be targets? Are they supposed to be standards? What the heck are these ratios supposed to be? Martin Hellwig, one of the greatest experts in this field, said that the problem is we just pragmatically apply capital ratios, without realizing that they fulfill differing functions. Martin notes that they are used to provide owners 'skin in the game'; they are used as a buffer for a going concern against loss; they are used as a buffer for other creditors when it is a gone concern; and they are used as a trigger for intervention.

The capital ratios that we have got are fairly good, not very good, but fairly good as a buffer for other creditors when the bank is a gone concern, and some work well as a trigger for intervention. But they are not very good as a margin for absorbing loss over the required minimum, because it is a minimum. I think that the way we have been operating capital ratios is wrong. Instead of having one number, we ought to have two. We ought to have a lower number as a trigger for intervention and maybe taking it over into temporary public ownership, because the bank is too weak to be allowed to continue; such a ratio should relate much more to market equity valuations than to accounting valuations, for the obvious reasons of lags and the ability to manipulate accounting ratios.

The second, upper ratio should be at the point where the marginal gain in having additional equity capital matches the marginal cost, whatever such additional cost may be, perhaps somewhere of the order of 20-25 percent. So then you would have two admittedly rather dodgy numbers.

What you then really need, rather than worrying too much about these exact numbers, since nobody knows what these numbers should actually be, is then to have an increasing ladder of sanctions between the two, upper and lower, ratios. That ladder could be in terms of constraints on bonuses and dividends, it could be a pecuniary charge, becoming tougher as the bank's position goes down towards the lower ratio.

So what you would then do to apply countercyclical measures, is to toughen the ladder extensions during the boom, and ease the ladder extensions during the downturn, so that banks could move further away from the 20-25 percent fully desirable level without running into severe sanctions.

Let me just finish with an anecdote. When I went up as an undergraduate to Trinity College, Cambridge in 1958, there was someone from America who came over to Trinity and wanted to find an English gentleman. After about a month he said "I have found two examples of an English gentleman, but one of them is a communist – who was actually Maurice Dobb, who was my supervisor at the time – and the other was an Italian, Piero Sraffa. I would like to end by saying that Tommaso represented the ideal that we all would like to think of as an English gentleman. He had all the virtues and all the qualities that we like to think an English gentleman has. It has been a privilege to have known him and a privilege to have worked with him.

Thank you.