ARE WE IN ANOTHER BUBBLE?

The interbank system should still be on ‘red alert’. The £175 billion of monetary expansion through the Quantitative Easing programme hasn’t done what it was supposed to do in oiling the wheels of commerce – companies are still facing a credit squeeze.

The monetary expansion may account though for some of the astonishing performance of the FTSE 100 and the S&P500 since the financial crisis - both stock markets rose by more than 20% during 2009. Is this the next bubble?

Regulators and Government only two years ago failed to think the unthinkable in not contemplating the possibility of a complete seizure of the interbank lending market. But now everyone is relaxing again – plenty of anger; talk of stopping big bonuses; talk of better protection for depositors; even talk of increasing capital requirements and breaking up the banks to split out the proprietary trading activities.

And after all the big speeches from the bankers at Davos, there is also much talk of why the banks should be left to carry on regardless. But the fundamental problem is that many banks are simply still “Too big to fail”. That’s where the problem lies – and it’s not about the different activities of proprietary trading versus bank deposits. It was Lehman’s failure that was the straw that broke the back of the financial markets – Lehmans was not a deposit taker and yet it was, most certainly, ‘too big to fail’. No reasonable capital requirement would have saved Lehmans. No split between proprietary trading and deposit taking would have saved them. No cap on bonuses would have saved them.

Taxpayers cannot afford another bailout of the banks – it would cause economic meltdown. Breakup of the ‘too big to fail’ financial institutions has to be the way forward.

There are three enormous risks to financial stability right now. All three point to higher interest rates and difficult times ahead for companies, which will hurt our prospects for economic recovery.

First, the Monetary Expansion via the Quantitative Easing (QE) programme. A great idea to stimulate the economy by effectively printing money and it does appear to have at least eased the pain in the short term. But there are huge risks with it:

QE was favoured by the Governor of the Bank of England as a means to achieve fiscal stimulus and pump liquidity into the banking system. His proposal was taken up by the Treasury and adopted as a solution to our economic problems. Under a Statutory Instrument the Bank of England Asset Purchase Fund Facility Ltd (BEAPFF) was set up to carry out the policy of Quantative Easing with 2 employees of the Bank of England as directors, run from a brass plate office in the City. It has two key problems:

i) First, it has no accountability to Parliament – there is no select committee overseeing it and therefore politicians are out of the loop. There has been no scrutiny of how the system is operating, what the risks are, and whether it should continue.

ii) This matters because the BEAPFF is effectively buying gilts from the market. QE has so far suppressed the yield curve, holding down interest rates due to the increased

money supply. However, when QE ends, the BEAPFF will be sitting on billions of pounds worth of gilts and interest rates may have to rise in order to attract investors. The taxpayer could suffer a massive loss on this huge gilt portfolio, as well as enduring the pain of rising interest rates and its impact on employment.

Second, the markets are now anticipating inflation – rising commodity prices and stock markets, together with the effect of QE itself make inflation more likely. Gold prices are at an all time high sparking some commentators to suggest there might be a gold ‘crash’ soon. Likewise, oil prices are back over $ a barrel. Our own latest CPI indicator showed inflation at %, well above expectations.

Third, Britain’s credit rating. The UK’s sovereign debt is rated by the major independent ratings agencies – Standard and Poor’s, Moody’s and Fitch. These agencies are remunerated by the very company, bank or country that they are rating......therefore there is clearly a huge conflict of interest ie the borrower wants the highest possible rating, in order to borrow more cheaply from the markets; the ratings agency wants to win as much business as possible in order to survive in a competitive market place.

It doesn’t take a PHD to see how there is room for great error and great corruption. In fact, it is bizarre that so many securitised loans, now worthless, were given the highest ratings by those credit ratings agencies. How could a package of mixed (some good, some bad) mortgages be rated as highly as UK or US sovereign debt?

There is a great deal of change needed in the ratings system. Nevertheless, international investors rely heavily on ratings and the UK’s huge and growing debt problem leaves us with a genuine risk of a rating downgrade. Again, if that happens, the cost of borrowing will increase and there will be huge losses on the Gilts being held for the taxpayer by the BEAPFF.

The position we are in right now is serious. But massive change in the financial sector is needed urgently to prevent us sleepwalking into an even more disastrous nightmare.

What are the options for the banking sector?

1. More or tighter regulation. But regulation helped cause the crisis by e.g. in US, attempting to administer social policy through the banks in forcing them to lend to unsuitable candidates and in general by increasing capital requirements while ignoring the real evil – massive leverage.

2. Ever higher capital ratios. But there is no regulation of assets matched against liabilities. Loopholes allow asset securitization in the balance sheet without assessing the risk. The colossal losses in 2008/9 were so great that no amount of capital would protect a bank.

3. Reintroduce Glass Steagall – separate investment banking from retail – is not the answer: it’s impossible to define the boundary between the two. If retail literally is reduced to building society type activities then we are limiting free enterprise and I don’t believe this will be sustainable in the medium term.

My proposal:

There must be free entry and exit into the financial sector on true free market principles.

The FSA will become a wholly owned subsidiary of the Bank of England and its brief will change. It will continue to have the role of ensuring good practice in the markets, but its key function will be look at each financial institution case by case and determine whether its size and/or diversity meet with the principles of free entry and exit.

i) Is it too big to fail?
ii) Is it a monopoly or an oligopoly?
iii) Does its size benefit the consumer or just its board?
iv) Is it overly dominant in a particular region?
v) If it fails, will the market be able to continue to function?

The Bank of England will take back its historic position as unchallenged head of the financial community with the FSA as a wholly owned subsidiary. (Mention my experience during the Barings collapse in mid-90's, when Eddie George was in charge). The Bank of England will be responsible for :

i) individual supervision of each financial institution (taking this role back from the FSA)
ii) systemic risk
iii) being lender of last resort
iv) manager of the National Debt Office.

There will therefore be a 2 tier regulatory structure with The Bank of England auditing and overseeing the 'anti trust' role of the FSA.

The independence of the Monetary Policy Committee will finally be achieved once the Bank of England becomes accountable once again for the financial health of the system. The role of the Chancellor and the Treasury will be the appointments to key posts in the B of E, parliamentary scrutiny over key programmes such as QE and paying down our national debt.