

# the credit crunch – your views

The Financial Services Network recently hosted a panel debate at the LSE entitled 'Climbing Out of the Credit Crunch'. This article summarises the flow of discussion and key points raised. Please note: all participants were speaking in a personal capacity and do not necessarily represent the views of ACCA.

A film of the debate, courtesy of SII, is available on ACCA TV at [tv.accaglobal.com](http://tv.accaglobal.com)

## the nature of the crisis

Centralisation of the financial system and banks were believed to be growing exponentially and globally – to the point where they were difficult to manage – this was key to the crisis. The crisis had shown the fundamental frailties of the financial system. Complacency, over-reliance on huge IT systems and a low-inflationary environment creating a search for yield helped to create the crisis by encouraging newer and riskier products. The role of hedge funds was also mentioned.

The losses reported by 20 banks exceeded primary defaults on sub prime by several times – so it was disingenuous to blame the crisis on sub prime borrowers.

It was pointed out that banks are basically illiquid – if everyone took their money out a bank would go bust, so it is necessary to support the banking system where risk

is systemic. There has been little control over liquidity – asset prices have increased exponentially with little control from the banks. A fundamental review of regulation is needed – as there is a fundamental problem with how the market works.

## macro-regulation

It was believed the crisis started in the US. The federal authorities required deposits in rated instruments creating an arbitrage opportunity. Institutions, effectively restricted to AAA, became desperate to outperform benchmarks so wanted anything rated with higher yield and over paid for those products. There are only two or three rating agencies, they are a regulated oligopoly. Regulation makes it very difficult to become a rating agency in the US. Banks can hold rated instruments off balance sheet which makes them very attractive – it allows higher leverage and profits; providing banks avoid the occasional very bad year which affects the markets every 20 years or so, they are 'in clover'. So effectively, the regulatory system designed to protect us actually increased our risk by concentrating it.

A key problem was that global banks needed global regulation but it was impossible to regulate the whole system internationally. The banks were now effectively too big to manage. This is why speakers and delegates argued that the only real answer was

decentralise, i.e. to have more, smaller banks which would be easier to regulate. 'Narrow banks', simpler to rate, were called for.

## micro-regulation

Again, opinions differed greatly on what was needed. They ranged from increased regulation and patching up present defects; to introducing different sorts of regulation; and removal of regulation altogether on some areas but tightening in others. A distinction in approach was needed between consumer/retail and investment banking, reflecting their radically different natures. Focused regulation should concentrate on depositor protection, money transmission services and money supply.

Micro management is not the solution. Quiet, thoughtful flexibility was needed; a good example was the rescue then privatisation of French banks, starting with Credit Lyonnais.

It was argued that regulators seemed confused between consumer protection and banking supervision on the one hand, and systemic risk and individual bank failure on the other. The Financial Services Authority's primary role was one of consumer protection – but could consumer interests possibly be protected if a bank was allowed to fail? What was unarguable was that the UK's tripartite regulatory arrangements would not work as long as no one was in charge. The failure of Northern Rock would not have caused major systemic problems but consumer confidence had to be maintained.

## bank failure

It is important to distinguish a bank in trouble due to a shock from one which took too much risk. No other industry has this protection

## Panellists

Professor Sudipto Bhattacharya –

*London School of Economics*

Alan Craft - *Consultant*

Brandon Davies - *GARP*

Professor Michael Mainelli – *Z/Yen Group*

Paul Moxey – *head of corporate governance and risk, ACCA (chairing)*



but individual depositors need protection. We should protect consumers but 'let the big people hurt each other'. We need to allow failure, especially of investment banks, but protect the few systemic (clearing) banks. Many banks have become too big to manage. If we had more but smaller banks you could allow some to fail without damage.

#### accounting, IFRS and Basel

Basel I and II were too simplistic. They allowed banks to rate themselves and created a large and untenable role for rating agencies. It was suggested that Basel II and IFRS have not worked well together. Some argued that there is a need to divorce banks and their capital requirements (exacerbated by Basel II) from fair value accounting under IFRS, which had proved workable in good times, but not suited to a downturn where there was no 'market' to mark to.

IFRS, some said, has made accounts '50% longer and 50% less understandable'. The regime had muddied the waters and had increased vulnerability and uncertainty, with accountants having increasing difficulty deciding what things are worth.

Price reflecting value is not accurate – although default rates of 16% and 80% recovery were likely, prices imply 100% default and 50% recovery and that is the figure which will flow through the accounts. This is a fundamental problem of fair value accounting. People will not sell at these prices. Accounts are now driven by non cash items i.e. various fair value adjustments. Banks had to raise more capital but when write-backs occur, as they will, banks will be over-capitalised. Mark to market, combined with low interest rates,

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plenty of liquidity and over-capitalisation, was a recipe for inflation.

#### banking

Noting a McKinsey Report on banking this year which said profits per employee in banks are 26 times higher than the average of all sectors, it was suggested that 'banking has over-paid people who do not run organisations very well'. Weaknesses in banks' systems mean they may have little clue who sold a product or where it came from. Arguably banking owes its profitability to firstly a lack of competition – there are strong barriers to entry; secondly asymmetry of information – exemplified by benchmarking practice, softing (the practice by which a broker agrees to pay for the supply of services from a third party to a fund manager in return for an agreed volume of business at an agreed commission rate), front running and restriction on investments; and lastly to externalities – such as the current central support propping up the system. The system is essentially uncompetitive and regulation has not helped.

Another speaker suggested that banks do not have a reputation for good management. Bankers no longer receive a general banking training, they are now all specialists. Institutional investors should demand more transparency and be more careful when they are offered apparently low-risk high-return products. There are too few NEDs challenging

executive management and too few who really understand what is going on. Perhaps we need a two-tier non-exec system, with expert people able to devote days per week, and below that the traditional non-expert non-executive directors to represent community interests.

#### key questions

The debate highlighted these key questions still to be answered:

- How can banking customers be confident there are no hidden risks in what they are buying, borrowing or lending?
- How can, or even should, shareholders hold banks more to account?
- How can accountants improve financial reporting to make reports more comprehensible and informative, particularly with regard to valuations and risks?
- How can regulators ensure that consumers are protected without unintended consequences?

If you'd like to comment on the above article or provide your opinions on the closing questions, please write to Astrid Lovelace at the address/email address given on the inside cover. ■

Notes by Paul Moxey – Head of Corporate Governance and Risk Management, ACCA, and Ian Welch – Head of Corporate Communications, ACCA