Comment

15

We need new rules to keep bankers honest

Adair Turner

Last week the Financial Services Authority announced, following an investigation of management conduct at the Royal Bank of Scotland, that we would not bring enforcement proceedings against any individuals. This caused criticism that no "charges" could be brought and no "report" published. Neither criticism is valid.

An enforcement case needs to rest not on popular desire to find someone to blame but on whether rules were broken. Legal investigations are also rightly subject to confidentiality. The FSA has not produced, even for internal use, a comprehensive report on the events that led to the public rescue of RBS. There is, therefore, no one report which could be published.

But the criticism raises two legitimate issues. First, do we understand the causes of the crisis and RBS's role within it? And second, should executives and directors of failing banks be subject to sanctions, even if they are not guilty of reckless or unprofessional behaviour but solely of poor business judgments?

On the first, the causes of the crisis and the role of ill-designed international regulations, poor supervisory practices and bank risk-taking are well understood. In April 2008 the FSA published a report into the Northern Rock failure and set out, more openly than any other financial authority, the inadequacies of our approach. A complete reform of FSA supervisory approaches followed. Then in March 2009 we published my own Turner Review, which detailed how globally agreed capital adequacy and liquidity rules were woefully deficient pre-crisis, allowing banks to take dangerous risks. The international community is midway through radical reforms to put this right too.

It would be possible to add a report looking just at the RBS story. Such a report would be more comprehensive than the FSA's internal investigation, which focused solely on whether individuals broke FSA rules. But it would add little, if anything, to our understanding of what went wrong. It would reveal the same deficiencies of regulatory philosophy already identified, under which the FSA simply did not believe our remit included preventing the ABN Amro acquisition – which was highly risky but breached no regulation. In future we would act differently. It would also reveal that international rules on capital and liquidity allowed RBS to take risks with leverage and wholesale funding, which will not be allowed in future.

It would therefore reveal that the executives and board of RBS made

In other sectors we want bold risk-taking, which sometimes results in failure. But banking is different

risky decisions, allowed by the rules of the time and applauded by much of the market. They made judgments about the balance of risk and return, which under different circumstances might have served stakeholders' interests but which in retrospect were poor. But these were not, our investigation shows, made without consideration of relevant information. They were therefore doing what executives and boards in other sectors of the economy do: sometimes getting judgments right and sometimes wrong.

But banking is not like other sectors. The fact that many banks made decisions in the same way as other companies was itself a key driver of the crisis, a big problem, but not one that regulators had adequately identified. In some other sectors we want bold risk-taking, which might sometimes result in failure, shareholder loss or even the danger of bankruptcy. But banking is different.

Failure in banking, or even the threat of failure offset by public intervention, carries huge economic costs quite different from non-banks. In banking, higher return for higher risks is also sometimes achieved not by socially valuable product innovation, but by leveraging up and taking liquidity risks, increasing the danger that society must clean up the mess.

The question is should we reflect these fundamental differences in a more explicit recognition that the attitude of bank boards and executives towards risk-return trade-offs should be different from other sectors, and should we create incentives to adopt this different attitude? It would, for instance, be possible to set a rule that no board member or senior executive of a failing bank will be allowed to perform a similar function at a bank unless they can positively demonstrate to the regulator that they warned against and sought to reduce the risk-taking that led to failure.

Such automatic rules would recognise that while the financial crisis entailed some instances of professional incompetence, recklessness and fraud, the more general problem was that some executives and boards made risk-return trade-offs that might have been appropriate in non-banks, but were hugely harmful to society when made by banks

Investigations focused on whether individual executives breached rules have a role and the FSA has successfully brought some enforcement cases relating to breaches revealed by the banking crisis. But achieving a general shift in attitudes to risk and return may require that bank directors and executives are made subject to quite different incentives than those that are appropriate in other sectors of the economy.

The writer is chairman of the FSA

Is there the will to save the eurozone?

Martin Wolf

Will the eurozone survive in its current form? To address this question, we need to consider three more precise issues. First, how likely is a wave of sovereign defaults? Second, will the eurozone make the changes needed to prevent these? Third, could the eurozone survive them? My answers, in turn, are: quite likely; probably not; and perhaps – but not with certainty.

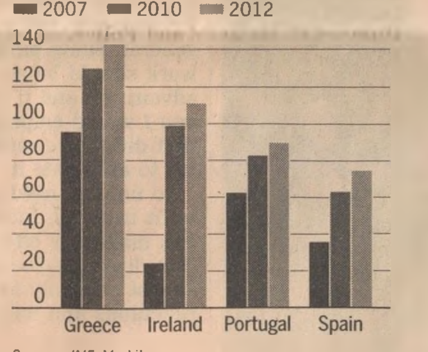
What has been happening is familiar to experts on emerging countries: this is a "sudden stop". Before 2007, credit was available on easy terms to fund asset price bubbles, construction and consumption, private and public. Then, suddenly, markets shifted towards sobriety: funding dried up, house prices collapsed, construction crashed, governments guaranteed the debts of raddled financial systems, economies slumped and fiscal deficits exploded.

As Carmen Reinhart, of the University of Maryland, and Harvard's Kenneth Rogoff noted in a paper released early this year, "in a crisis, government debt burdens often come pouring out of the woodwork, exposing solvency issues about which the public seemed blissfully unaware". So it has been in the eurozone periphery. Greece hid its true fiscal position. In Ireland and Spain (as in the US and UK), the boom covered up vast contingent fiscal liabilities. Also striking has been how closely the riskiness of banks correlates with that of sovereigns. The latter are in trouble partly because some banks are too big to fail and too big to save.

The question is whether these countries can avoid sovereign debt restructuring. On this, Prof Rogoff, a former chief economist of the International Monetary Fund, is gloomy. In a recent note, he argued that "ultimately, a significant restructuring of private and/or public debt is likely to be needed in all of the debt-distressed eurozone countries . . . Already facing sluggish growth before fiscal austerity set in, [Portugal, Ireland, Greece and Spain] face the prospect of a 'lost decade', much as Latin America experienced in the 1980s. Latin America's rebirth and modern growth-dynamic really only began to unfold after the 1987 'Brady Plan' orchestrated massive debt write-downs across the region. Surely, a similar restructuring is the most plausible scenario in Europe."

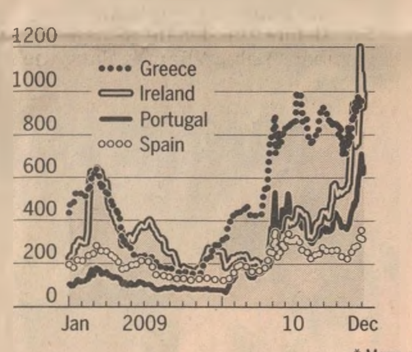
Why might one be this pessimistic?

Gross government debt
% of GDP

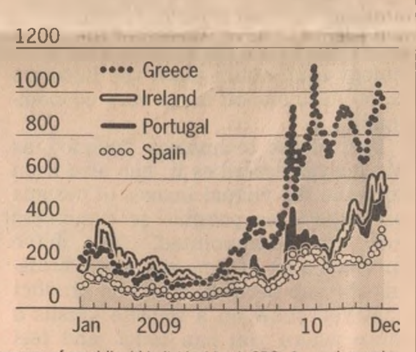


Government budget deficits
% of GDP, 2010

Banking sector default risk
CDS* of 5-year bank debt (basis points)



Sovereign default risk
CDS of 5-year government debt (basis points)



Sources: IMF; Markit

* Mean average of most liquid individual bank CDSs for each country

The salient characteristic of lending to sovereigns is the absence of collateral. Thus, the safety of the creditors depends on their ability to sell debt to others at reasonable prices. If this confidence disappears, liquidity dries up and sovereigns are driven into default. What, then, determines confidence? The short answer is: sustainability. That itself depends on the relationship between prospective economic growth and the real rate of interest. The lower the growth and the higher the interest rate, the bigger the primary fiscal surplus (before interest payments) needs to be – and so the greater the political costs of achieving it. The bigger these costs, the less confident will investors be and the higher the interest rates will become. This, then, creates a vicious spiral.

Vulnerable peripheral eurozone member countries now suffer from troubled financial systems, high fiscal deficits, rapidly rising ratios of debt to gross domestic product, elevated interest rates, poor prospective growth and the absence of a central bank that is sure to make the debt market liquid. Poor growth prospects, in turn, are partly due to loss of competitiveness. If these indicators were applied to normal emerging countries, a default would seem inevitable.

ECONOMISTS' FORUM

Read and comment on online articles by contributors to Martin Wolf's Economists' Forum at: **www.ft.com/econforum**

This leads us to the second question: will the eurozone make the changes needed to prevent defaults? The answer is: probably not. One reason is that the creditors want them. True, Germany has suggested this should apply only to future debt. But, in capital markets, the future is always now. Moreover, the funds now on offer are not enough to finance all weak countries for long enough to avoid defaults, particularly since the latter will need to deflate and restructure their way back to growth. As Desmond Lachman of the American Enterprise Institute argued in a recent paper for the London-based Legatum Institute, prospective growth is of the essence. But, in the absence of exchange rate flexibility and in the presence of high interest rates, cutting fiscal deficits on its own may well exacerbate slumps.

This leads to my final question: could the eurozone survive a wave of debt restructurings? Here the immediate point is that the crisis could be huge, since one restructuring seems sure to trigger others. In addition, the banking system would be deeply affected: at the end of 2009, for example, consolidated claims of French and German banks on the four most vulnerable members were 16 per cent and 15 per cent of their GDP, respectively. For European banks, as a group, the claims were 14 per cent of GDP. Thus, any serious likelihood of sovereign restructuring would risk creating runs by creditors and, at worst, another leg of the global financial crisis. Further injections of official capital into banks would also be needed. This is why the Irish have been "persuaded" to rescue the senior creditors of their banks, at the expense of the national taxpayer.

Yet even such a crisis would not entail dissolution of the monetary union. On the contrary, it is perfectly possible for monetary unions to survive financial crises and public sector defaults. The question is one of political will. What lies ahead is a mixture of fiscal transfers from the creditworthy with austerity among the uncreditworthy. The bigger are the former, the smaller will be the latter. This tension might be manageable if a swift return to normality were plausible. It is not. There is a good chance that this situation will become long-lasting.

Still worse, once a country has been forced to restructure its public debt and seen a substantial part of its financial system disappear as well, the additional costs of re-establishing its currency must seem rather smaller. This, too, must be clear to investors. Again, such fears increase the chances of runs from liabilities of weaker countries.

For sceptics the question has always been how robust a currency union among diverse economies with less than unlimited mutual solidarity can be. Only a crisis could answer that question. Unfortunately, the crisis we have is the biggest for 80 years. Will what the eurozone is able to agree to do be enough to keep it together? I do not know. We all will, however, in the fairly near future.

martin.wolf@ft.com

Bunga bunga in the Medici court of Silvio

Beppe Severgnini

Bunga bunga is supposed to be the Silvio Berlusconi crowd's name for risqué after-dinner antics but it could equally be the sound of Italians banging their heads against a wall in frustration when abroad. How is it, we are asked, that our prime minister was elected (1994), topped the polls again (2001) and was voted back into office (2008) in spite of a wobbling economy, failure to introduce overdue reforms on tax and justice and a string of scandalous revelations?

So can't Italians see his shortcomings – and see through his methods? Well, we can and do. This is why he has dominated public life for so long.

The Medici factor

The attitude of many modern Italians towards Mr B is reminiscent of how their Renaissance forebears viewed their Signore: "We know he's thinking about his own glory, family and interests but we hope he'll spare a thought for us, too."

The human factor

Most Italians think: "He's one of us." (Those who do not, are afraid he might be.) He adores his kids, knows his football, makes money, loves new homes, hates rules, tells jokes, swears, likes to party and is convivial to a fault. He's unconventional yet knows the importance of conforming. He extols the Church in the morning, the family in the afternoon and brings girlfriends home at night – and not just one at a time. As for the Vatican it is content with Catholicism-friendly legislation, and does not appear to worry about the example being set.

The Truman factor

How many newspapers are sold in Italy every day? Five million. How many Italians regularly go into bookshops? Five million. How many browse news websites? Five million. You get the feeling they are the same people. Mr B's control of public television (Rai), and his ownership of most private television (Mediaset) and domination of advertising (Publitalia), is more important. Living in Italy can be like Peter Weir's *The Truman Show*: someone helps us think.

Lots of Italians who prefer self-indulgence to self-discipline admit that Berlusconi does what they only dream of doing

The Hoover factor

Hoover's door-to-door salesmen were traditionally skilful psychologists, ruthless in their pursuit of a sale. Mr B has brought a flair for commercial seduction with him from his careers in construction, television and advertising. He knows the message has to be digestible, appealing and reassuring. "I work hard and in the evening I need to unwind," he has said, owning up to his escapades.

The Zelig factor

A need for approval has taught Mr B chameleon skills of which Woody Allen's Zelig would be proud. He is a ladies' man with the ladies; youthful with the young; wise with the old; a night owl with the night set; entrepreneurial with the business community; a football fan at the stadium; a Lombard with the people of Lombardy; a southerner with southerners. If he ever went to a basketball game, he would walk out taller.

The harem factor

His predilection for women other than his wife has long been known in business and political circles. In the past two years it has been an open secret. At first, he denied everything, before owning up ("Am I faithful? Frequently") and flaunting ("I'm no saint"). The revelations left him unscathed. He lost his wife but not his electoral base. Lots of Italians who prefer self-indulgence to self-discipline admit that Mr B does what they can only dream of doing.

The Tina factor

There Is No Alternative, as Margaret Thatcher used to say. The Italian centre-left has proved unappetising: strife-torn coalitions, woolly proposals and hypocritical posturing. Italians are realists. Some of Mr B's initiatives have been well received (measures against illegal immigration, the campaign against organised crime).

Mr Berlusconi boasted recently he was "still the most popular head of government in Europe". Yet this week he talked about possibly being replaced by a young leader – of his choice, it goes without saying. So is this the end of the road? If so it will be a bumpy one and, if he has his way, *bunga bunga* will continue a while yet – both at home and abroad.

The writer is a columnist for Corriere della Sera and author of Berlusconi Explained to Posterity and Friends Abroad

Learn to love the candid bearer of bad news

John Kay

In Sophocles' play *Antigone*, a sentry reports the burial of Polyneices to King Creon. The sentry acknowledges that no one loves the bringer of bad news, but is unprepared for the strength of Creon's reaction. "What you say is intolerable," the king expostulates. He threatens the sentry with hanging.

Now, 2,500 years later we still attack those who tell us things we find intolerable. Dick Fuld, the former Lehman's chief, fulminates against short sellers, who – he claims – destroyed his company. But most of the copious material that has appeared since Lehman's demise suggests the finger should be pointed, not at short sellers, but at Mr Fuld. At Enron, Jeff Skilling called a hedge fund manager who queried the balance sheet an "asshole". He famously drank a glass of champagne to celebrate the news that his company could adopt mark to market accounting. It enabled Enron to take immediate credit for profits it hoped to make in years to come. Recently, Europe's banks and some of the politicians who speak for them have taken a different view, treating the accountants who insist on marking values to market as Creon treated the watchman. Both the kings of old and the potentates of today prefer to create their own reality than to face the truth.

Conspiracies of short sellers can weaken sound businesses. But there are few proven examples, and more cases where sellers brought the bad news of lies and misrepresentations.

The threat to the independence of rating agencies gives urgency to more appropriate reform

David Einhorn, who led the attack on Lehman, wrote a book about his battle to expose malpractice at Allied Capital – a battle that led the Securities and Exchange Commission to investigate, not Allied, but Mr Einhorn's own business. Events proved Mr Einhorn right. And when regulatory authorities attempted to ban short selling of financial stocks in the autumn of 2008, their objective was not to establish a better informed marketplace but to keep gloomy messengers away from the citadel until the panic had subsided.

Most recently, it is rating agencies that have been the bearers of intolerable truth. With the prescience that has distinguished these businesses throughout the crisis, Moody's has just concluded that the junior debt of Anglo Irish Bank is junk. But you need not even be the person who brings the bad news: you can be vilified for repeating what has been in the headlines for weeks. That Gordon Brown's premiership was a disaster, that Afghan president Hamid Karzai is weak, that Russia is corrupt is hardly new: the criticism of WikiLeaks is not even that it says these things – but that it says they have been said.

German chancellor Angela Merkel argues the case for new rating agencies with "an understanding of basic economic mechanisms different from the existing agencies". The European Commission has added the suggestion that agencies might be required to give governments advance notice of plans to alter ratings of sovereign debt, which would give these governments an opportunity to "correct errors".

But every journalist and columnist has encountered people who would like an opportunity to "correct errors" before they appear in print, and no one has any illusions about what is meant. The threat to the rating agencies' independence gives urgency to more appropriate reform.

The role of ratings in regulation should be progressively eliminated. The scandal was not that they told people what they did not want to hear, but that they told them what they did want to hear. If official sponsorship of agencies ended, we could expect a competitive market to emerge with ratings judged for the value of the information they provide to users rather than to the issuers who fund the rating process.

Ms Merkel was brought up in a country notorious for telling its public the news its leaders wanted to tell – and for the contempt with which the public treated such news. She should be the last European leader to threaten to hang the honest messenger. The East German state, it is said, would even doctor the weather reports to make the population feel better. On reflection, perhaps that is not such a bad idea.

johnkay@johnkay.com