

**TIM GARDEN MEMORIAL LECTURE**  
**UNIVERSITY OF INDIANA**  
**INTERNATIONAL FINANCIAL SECURITY**

It is very great honour and pleasure to have been asked to give the first Tim Garden Memorial Lecture. I worked very closely with Tim in the last ten years of his life at Chatham House and in the Lords. Tim Garden's service in the Royal Air Force were to make a firm foundation for the activities in public policy, academic policy research, teaching and communication that he threw himself into with such vigour and enthusiasm in the eleven years after he left the Air Force. The higher degree in international relations at Cambridge in the early eighties followed by three years as RAF Director of Defence Studies, his two books – "Can deterrence last?" published in 1984 and "The Technology Trap, Science and the Military" in 1989, and his final post as Commandant of the Royal College of Defence Studies from 1994-96, naturally led on to his Directorship of the Royal Institute of International Affairs and his chairs both here and at King's College, London.

Tim Garden had a vocation to ensure that there was an informed debate on defence and foreign policy. He contributed to that by his web site, his formal teaching and research, his innumerable conference papers and seminar contributions. But he became most widely known through his media appearances both on television and radio as well as his own writings in the London Evening Standard and many other papers. If one was with him one would know of the constant flow of requests for interviews from media from all over the world.

In 2000 he felt that to make policy changes one should be active in party politics. The Liberal Democrats were glad to welcome his experience and enthusiasm, he became an advisor to the weekly meeting of foreign affairs and defence spokesmen of the party in both Houses of Parliament. the party's defence policy. After 9/11 and the darkening clouds that followed his advice to the party in the lead up to the Iraq War was invaluable.

In 2004, he became a member of the House of Lords his Maiden Speech was not on a defence or foreign affairs but in a debate in June 2004 on the Civil Service. As a physics graduate he discussed the importance of a scientific education for much of current public policy. For the Liberal Democrats his arrival significantly improved our contributions to questions and debates on security and defence. His authoritative and firm approach was appreciated throughout the House. The breadth of his interests meant that his contributions over a wide range of topics from geopolitics, to counter-terrorism, to procurement issues, to transparency in defence export sales, to service welfare were all listened to with very wide respect.

I have been in politics now for almost fifty years. During that time I have met some good men and women as well as my share of rascals. There are a select few for whom I retain a pride at having known them and from whom I continue to gain inspiration and strength. Tim Garden was one such.

When I was asked by Professor Albright to give this lecture before Christmas on the subject of international financial security I am not sure that I realised how large a subject I was taking on. The banking and financial crises of the last two and a half years and their implications at a national, European and global level have if anything become more complex in the period since last December. The strains placed on the

Euro as a currency by the developments in Greece have only become apparent since then. The uncertainties of the legislative process in Congress, the European Parliament and the British Parliament means that we have made very limited progress in establishing regulatory systems which will be adequate to the challenges which we now see we face. The Toronto Summit meeting of the G20 in June is therefore of critical importance.

After coming so close to meltdown in September-October 2008 with the bankruptcy of Lehman Brothers in September and the rescue by the British Government of Royal Bank of Scotland and Halifax Bank of Scotland in October, there was in 2009 an apparent return to stability in 2009 as a result of government and central bank financial engineering. It is perhaps too easy to forget that the banking crisis of the last two years resulted in governmental support for the sector around the world amounting to almost a quarter of global GDP. One of the factors contributing to the crisis was that banks had been carrying out risky activities, and had mispriced and misallocated that risk. The actions Governments took to prevent financial meltdown may have been necessary, but they also revealed the implicit subsidy to the financial services sector from states which could not afford to let their banks fail. The bail-outs have not ended the mispricing of risk, and have arguably made it worse: ratings agencies now provide a 'support rating' which takes into account the likelihood that a government would not allow a particular bank to fail.

Banking reform is needed. First, both global and national regulation must be made better and more effective. Secondly the comparatively narrow capital base upon which banks operate should be addressed. The Basel

Committee is currently working on reforms to capital and liquidity ratios which should go some way towards this. There is indeed scope for better regulation. But while better regulation and higher capital ratios could mean that crises are less severe, they cannot stop them. The challenge is to make sure that the financial system itself is not, as it has been recently, a prime cause of such instability, and to ensure that, in so far as possible, financial institutions bear the consequences of their own actions. That will require more radical action.

Reform is particularly pressing for the United Kingdom. In the 1970s the UK banking sector had a balance sheet of 50% of United Kingdom GDP; it is currently 500% of GDP. During the financial crisis, governments have effectively stood behind the banking system. If international banking in the United Kingdom is to remain credible, reform must ensure that the tax payer is better protected from picking up the bill.

I should like this evening to look at the range of reforms currently under consideration, and assess them against the objectives of an orderly banking system such as protecting the consumer, protecting the taxpayer, setting an appropriate cost of doing business and providing lending to the economy. There are trade-offs between these objectives: the more consumers are protected, the more risks tax payers may have to bear; the more banks have to pay for their capital, the higher the rates they will charge their customers. Policymakers will have to decide where the trade-offs should properly be made and how this should be explained to the public who understandably want to see rapid and sustainable change.

Successful reform would transfer risk away from Government and back into the banking sector. Radical reform is necessary but it cannot be achieved immediately: if it were done too quickly the cost to banks and to

their customers would increase too quickly to be absorbed. But it has to be done. The collapse of Lehman Brothers showed that the failure of an interconnected systemically important international firm has widespread and cataclysmic implications. An indication of improvement will be a system which enables a large international institution to go bankrupt smoothly—and where prices in financial markets do not implicitly or explicitly assume a government guarantee.

The size and impact of the most recent financial crisis was so great that it is frequently treated as an unprecedented event. In fact as Carmen Reinhart and Kenneth Rogoff have shown in their impressive study “This Time is Different” this crisis has fitted into the pattern of a long line of crises. It followed a familiar pattern in which a period of substantial economic growth, low interest rates and stable inflation bred growing complacency among lenders and borrowers. In time stability bred instability. Lending standards weakened as borrowers took on larger loans to buy houses. This led to property price bubbles, not only in the US and the UK but also in Denmark, Ireland, Spain and the Netherlands among others. While the bubble burst first in the US it had particular impact because of the securitisation of sub-prime mortgages, but it could have happened in one of the other countries which had even more inflated property markets. As there were significant differences in the regulatory regimes in the countries experiencing price bubbles it is worth examining the macroeconomic factors they shared; in all of them interest rates remained low, a second factor was the massive scale of international capital flow in the ten years preceding 2007. This reflected the global macroeconomic imbalances with capital flowing from poorer to richer countries, and in the European Union from Germany and France to the Mediterranean members. Just before the crisis some 70% of global

capital flows was coming to the United States. Finally the stability of the decade leading up to 2007 resulted in an assumption of continuing stability and underestimates of risk.

These macroeconomic factors were complemented by a series of microeconomic factors linked to various forms of financial innovation and the creation of a 'shadow banking' system which was particularly opaque. It was originally thought that financial innovation, and in particular securitisation would make the banking system more secure by removing credit risk from banks' balance sheets and its dispersal to a broader range of investors. In fact very much of the securitised assets moved from one bank to another thus increasing risk in the system as a whole as banks increased their leverage by arranging more loans than their capital limits would normally have allowed. Finally the growing complexity of financial instruments meant that after Lehman's failure there was a virtual seizure of the financial system resulting from the inability of firms to locate or determine the precise scale of their own exposure to asset-backed securities, let alone that of their counterparties.

Before looking at what should be done directly to ensure our financial institutions are more secure in future there are two pieces of macroeconomic policy which should be considered. Until the crisis, Central Banks in both the US and the UK used monetary policy through interest rates to regulate general price inflation but did not use them to counter asset price inflation or the growing indebtedness of households. This as a policy should be re-examined. The policy of the European Central Bank seems to have been more successful. The second is the issue of global macroeconomic imbalances. In advance of the crisis a number of countries with low and declining savings rates, Ireland, Spain the UK and the US were running huge and widening deficits on their

balance of payments current accounts which were funded by capital inflow from countries particularly China and Germany that were running large current-account deficits. These massive external imbalances that built up between 1997 and 2007 were an important contributor to the problem, but at the G20 meeting in June of last year in London it was not possible reach agreement to include any reference to global imbalances and in the run-up to the G20 meeting in September in Pittsburgh there was very strong resistance to any reference by China and Germany, with Chancellor Merkel referring to global imbalances as an *ersatz* issue. In the end an implicit reference appeared with the call for “sustained and balance growth” in the world economy. Within the European Union it has been equally difficult to persuade Germany that it needs to consume more and spend less just as the deficit countries must save more and consume less. The recent exchanges between the French and German Finance ministers reflect this. While measures directly affecting the banks are of very great importance they have to be seen in the macroeconomic context.

The emergency actions taken by governments across the world during the banking crisis appear to have identified a type of financial firm, or group of financial firms, so integral to the financial system ('systemic') that the respective governments were forced to bail them out in some form, rather than let them fail as an ordinary firm would. These firms are collectively known as “too big or too important to fail”

One of the characteristics of firms that are classified as 'too important to fail' can be that they operate across borders. Such international financial institutions bring benefits both to the firm and countries in which they operate. But they can also be more difficult to resolve (i.e. close down or make bankrupt) should the firm run into difficulties. The most recent

Financial Integration Report prepared for the European Commission considers the integration of the countries of Central and Eastern Europe into the European financial system, and describes the following benefits:

“EU financial integration, through cross-border establishment, has risen sharply over the past decade and has brought with it a range of benefits to both home and host countries. Benefits range from increased income generation, improvements in technology and risk management, increased access to funds, risk diversification and deepening of financial markets.”

However, it also recognises that such integration is not without difficulties:

“The current crisis has demonstrated that there is a risk in building up major concentrated exposures. If several of these countries use a 'common funding channel', such as Austria or Sweden, this significantly increases their risk and vulnerability to fluctuations in home countries. The same conversely applies for home countries in the event of excessive concentration of the cross-border lending business of their banking sector on a few countries.”

“Swedish bank establishments in the Baltic region provide an illustration of the difficulties that may occur for both home and host countries.

For the home country, Sweden, the establishment of banks in the Baltic countries has had significant benefits for the Swedish banking sector, in particular in terms of market expansion and creation of new revenue streams. However, when the global crisis emerged, the credit expansion came to an end and credit losses started to increase in the Baltic region. Many commentators then explained the fall in the Swedish Krona and falls in market confidence as directly stemming from Sweden's high

exposure to the Baltic region. Swedish banks also experienced substantial loan losses, estimated to be in the order of SEK 30 billion (some \$4 billion) for the first six months of 2009, with 44 percent of these losses directly attributable to the Swedish banks' operations in the Baltic Member States.

For the Baltic region the rapid increase of foreign bank presence has had considerable, but different consequences. On the one hand, it contributed to the growth of financial infrastructure, facilitating economic growth.

On the other hand, the high concentration of exposures and the lack of adequate risk management and regulation contributed to the building up of major imbalances. The easy access to foreign loans, denominated in euro, also resulted in the building up of a speculative property bubble as well as substantial current account deficits in the Baltic region. When the financial crisis hit, and sources of credit dried up, assets were re-valued and credit ratings were downgraded, leaving these Member States highly exposed to foreign exchange denominated debt, falling property prices and internal revaluations.”

As the Financial Integration Report notes, integration can expose both home and host countries to risks from poorly managed and poorly regulated institutions in other countries. In the recent weeks press attention has focused on the discussions between the United Kingdom, the Netherlands and Iceland about how Iceland might repay the compensation to depositors in the Icelandic bank Landsbanki provided by the British and Dutch governments. However, other cross-border institutions have also faced dangers, such as the Swedish banks noted above. Fortis bank needed to be rescued in Belgium and the Netherlands. These examples show clearly the need to take account of the fact that

financial services are increasingly international. I will wish to return to this as the problem of the relationship of the regulatory systems in different countries is a critical one if we wish to avoid the dangers of regulatory arbitrage with banks choosing to move their operations to avoid the constraints of their home jurisdiction.

In discussing the methods of ensuring the long term stability of the financial system the two broad approaches are to develop and make more effective the existing regulatory systems or to examine more radical structural changes. The Pittsburgh Summit Communiqué of last September's G20 meeting set out the proposals agreed for more effective regulation:

*"To make sure our regulatory system for banks and other financial firms reins in the excesses that led to the crisis. Where reckless behavior and a lack of responsibility led to crisis, we will not allow a return to banking as usual.*

We committed to act together to raise capital standards, to implement strong international compensation standards aimed at ending practices that lead to excessive risk-taking, to improve the over-the-counter derivatives market and to create more powerful tools to hold large global firms to account for the risks they take. Standards for large global financial firms should be commensurate with the cost of their failure. For all these reforms, we have set for ourselves strict and precise timetables.

*To reform the global architecture to meet the needs of the 21<sup>st</sup> century.* After this crisis, critical players need to be at the table and fully vested in our institutions to allow us to cooperate to lay the foundation for strong, sustainable and balanced growth.

We designated the G-20 to be the premier forum for our international economic cooperation. We established the Financial Stability Board

(FSB) to include major emerging economies and welcome its efforts to coordinate and monitor progress in strengthening financial regulation.”

Not enough attention has been given to the achievements of the international community in responding the crisis by creating the G20, expanding from a rather restrictive G7 to involve the major emerging economies of Asia, Africa and Latin America. The results will be seen in the coming months as the end of 2010 has been set in the Pittsburgh Communiqué for many of the objectives of improved regulation to be achieved.

The crisis showed all too clearly the weaknesses of the existing structure of regulation of the financial system. Financial engineering left regulated banks holding far too little capital, liquidity requirements will also need to be tightened and leverage – the ratio of debt to capital - more carefully constrained.

The present international capital requirements were set by the Basel Committee on banking supervision, a body now made up of the Central Bank Governors and the heads of the authorities responsible for the prudential supervision of the banking system, if that is not the Central Bank, from 27 countries. They do not impose requirements but make recommendations which are normally accepted by the members of the Bank for International Settlements – the Central Bank of Central Banks. The capital requirement set under the Basel I and II accords was 8% of assets. In December 2009 the Basel Committee issued a consultative document on improving the quality of capital and following its earlier book considering higher requirements for capital for credit risks arising from securitised assets and assets held on a bank’s trading book as distinct from its banking book. It would also strengthen the capital requirements for counterparty credit risk exposures arising from

derivatives, repos and securities financing activities. They also propose to introduce a global minimum liquidity standard for internationally active banks that includes a 30-day liquidity coverage ratio requirement underpinned by a longer-term structural liquidity ratio. A further important proposal is to introduce a series of measures to promote the build-up of capital buffers in good times that can be drawn upon in periods of stress. A countercyclical capital framework will contribute to a more stable banking system, which will help dampen, instead of amplify, economic and financial shocks. Spain has had a system of this sort in existence and it has received much favourable attention since the crisis. The finance ministers of the European Union agreed in July 2009 that something of this sort should be agreed at European level. Finally they proposed a leverage ratio as a supplementary measure. This would put a limit on the multiple of capital that could be borrowed. All of these proposals are work in progress document as the consultation document makes clear that banks and others who wish to comment on them can do so until Friday of this week! (Friday 16<sup>th</sup> April) It is perhaps worth noting that yesterday's Financial Times contained an article setting out how "investment bankers have begun to develop ways in which banks might be able to circumvent the most punitive of the new capital rules being drawn up by international regulators."

The Governor of the Bank of England, Mervyn King, recently explained these changes saying "The banking sector is running with a much smaller amount of capital and a tiny amount of liquid assets in comparison to the banking system of 40 years ago, and that inherently makes it more unstable, so more capital makes more sense. It is not an answer in itself because the only logical capital requirement that removes all risk is 100%." As we shall see Mervyn King like Paul Volcker believes that

structural measures are also necessary. He has warned that “tinkering with capital requirements may not be enough, [and] that structural changes will be important.”.....“One of the reasons why capital alone will not work is because banks can just take more risks to offset a higher capital requirement, getting you right back where you were before.”

It is perhaps worth pointing out that in parallel to the work in the Basel Committee the European Commission is preparing a new Capital Requirements Directive which is due to be agreed by the European Union later this year. It very much follows the proposals of the Basel Committee down to the extent that the closing date for responses to its most recent consultation paper is the same day this week as set by the Basel Committee!

While there is now general agreement that more capital should be held but there is also some concern about how much more and when the requirements should come into effect. This is important for higher capital requirements will increase the cost of borrowing and at a time when one is anxious to increase the lending activities of banks it is probably not wise to move too quickly on increasing capital requirements.

An area sometimes linked to increasing capital requirements in that it also imposes further costs on the financial, or parts of it are bank specific taxes or levies. Here there were important proposals put forward by President Obama in January this year when he proposed a Financial Crisis Responsibility Fee. The fee is designed to last for 10 years, or longer if necessary, to ensure the full pay-back of money in the Troubled Asset Relief Programme (TARP), the US measures to combat the crisis in the financial system. According to the White House press release, the fee "would be levied on the debts of financial firms with more than \$50

billion in consolidated asset, providing a deterrent against excessive leverage for the largest financial firms." Over sixty percent of the revenues, from the measure, expected to be \$117 billion over about 12 years, and \$90 billion over the next 10 years, will probably be provided by the 10 largest financial institutions. This is described as an *ex post* levy in that it comes in to collect funds from those who have survived a crisis to reimburse the state for the funds it has expended to assist the financial system. An alternative which three European countries France, Germany and Britain is for a global system of levies to be paid *ex ante* in advance of a crisis. This would be some form of an insurance policy to cover the costs of future bank rescues. The British Prime Minister is anxious that the tax should be preferably global but if not as widely applied as possible using a common base. The International Monetary Fund is expected to produce proposals and possibly reach general agreement on such a levy at its Spring Meetings in Washington next week. Although there is a wish to take this forward at the June meetings of the G20 in Toronto it is thought that this is unlikely as the Canadians whose financial system was relatively little affected by the banking crisis and therefore those advocating a global model feel it is more likely at the Seoul meeting of the G20 in November. TOBIN TAX

While a levy of either sort would have some benefits the \$10 billion a year of the Obama proposal or the \$1.5 billion of the German proposal while it might cover the direct cost to the national governments of bailing out the banks' it would go no way at all to compensating the national economies for the costs of the global contraction that has followed the banking crisis. A recent estimate for this from the Bank of England produces a figure of between \$60 and \$200 trillion. A levy to cover this is unimaginable.

It is because of this that there is a lively debate on both sides of the Atlantic about whether there should be structural changes to the banking system to deal with the risks created by the large and systemically important institutions. The Financial Security Board's Standing Committee for Supervisory and Regulatory Cooperation is tasked to produce a report on this for the G20 meeting in Seoul in November.

This problem is linked to the policy dilemma of 'moral hazard', the encouragement which is given to banks and financial institutions to take excessive gambles if they believe they will be bailed out by the state. This is the problem of those institutions who either because of their size or interconnectedness would put the banking system as a whole at risk if they were to fail. It is particularly difficult to provide a general rule about this across countries because banking structures and cultures vary widely across countries and even within a relatively homogeneous region such as the European Union. In Britain the Governor of the Bank of England and his senior colleagues and some but not all of the academic community have advocated looking at rather radical position, others including Adair Turner the Chairman of the Financial Services Authority, at present the principle regulatory authority have adopted a position not too dissimilar to that put forward by President Obama and Paul Volcker on January 19<sup>th</sup>. The Government has been more cautious. The large banks have argued that there are great advantages of scale and Barclays has recently quoted an independent study for them by Frontier Economics found that integrated global banks bring a number of benefits to the financial and economic system including:

financial efficiency benefits—reflecting the greater risk diversification, reduced financial intermediation costs and increased financial stability benefits that universal banks offer;

bank customer benefits—reflecting the ability of integrated global banks fully to meet the corporate finance needs of companies (e.g. access to capital markets);

international trade and investment benefits—reflecting the role of integrated global banks in international trade (through trade finance, foreign exchange and other trade services) and in international investment (through direct cross border investment and international capital markets);

competition and innovation benefits—reflecting the propensity of universal banks to expand and enter new product and country markets, so increasing the spread of innovation and best practice; and

UK specific benefits—reflecting the contribution of financial services to the UK economy, even after the costs of the financial crisis and the leading role of UK domiciled universal banks in the global financial system.

The contrary position can be found in a recent statement by Mervyn King the Governor of the Bank of England, "I do think that I would like to see an outcome in which the size and variety of activities contained within these big institutions, if they are going to be financed in the way they are, is a lot less. To have a small number of big institutions dominating world banking is not a healthy position to be in." and Andrew Haldane, the Executive Director of the Bank spelt it out, "the economics of banking do not suggest that bigger need be better. Indeed, if large-scale processing of loans risks economising on the collection of information, there might even be diseconomies of scale in banking. The present crisis provides a case study. The desire to make loans a tradable commodity led to a loss

of information, as transactions replaced relationships and quantity trumped quality. Within the space of a decade, banks went from monogamy to speed-dating. Evidence from a range of countries paints a revealing picture. There is not a scrap of evidence of economies of scale or scope in banking—of bigger or broader being better— beyond a low size threshold. At least during this crisis, big banks have if anything been found to be less stable than their smaller counterparts, requiring on average larger-scale support. It could be argued that big business needs big banks to supply their needs. But this is not an argument that big businesses themselves endorse, at least according to a recent survey by the Association of Corporate Treasurers”

A particular problem in Europe arises in that the European Union’s single market is based on the principle of mutual recognition. All financial firms established in the EU can open branches in another member-state, or provide services on a cross-border basis, on the basis of a single authorisation from their home country authority. In effect, the EU ‘passport’ removes the right of host countries to prevent banks established elsewhere in the EU from operating on their territory.

Events during the crisis have cast doubts on the sustainability of the arrangements. Particularly damaging has been the experience of Icelandic banks. Although Iceland is not a member of the EU, it belongs to the single market by virtue of its participation in the European Economic Area. In the run-up to the crisis, Icelandic banks attracted deposits in other EU countries by offering market-beating interest rates. However when these banks ran into difficulties it became clear they had outgrown the capacity of the Icelandic state to rescue them; and that the resources of the Icelandic deposit protection system were insufficient to compensate depositors in other EU countries. As a result depositors in

the Netherlands and the UK were not compensated by the Icelandic scheme.

There are many who following this experience feel that the 'host' country should have more opportunity to regulate banks from other EU countries, in effect turning them into subsidiaries rather than branches. This might require treaty revision which after recent experience is not a welcome prospect.

The creation of subsidiaries is a way of segmenting global banks geographically, the proposals for narrow banking is a way of segmenting banks by types of business. It is the most extreme form of structural reform and has been put forward most directly by Professor John Kay of the LSE and can be explained to an American audience most briefly by saying it is a 21<sup>st</sup> Century version of Glass-Steagall and can be seen in the United States in the position of Professor Koltikoff of Boston University and Professor Simon Johnson of MIT, a former Chief Economist of the IMF.

Narrow banking implies the creation of banking institutions focussed on the traditional functions that the financial system offers to the non-financial economy:

- payments systems (national and international), for institutions of all sizes;
- deposit taking, from individuals and small and medium-sized enterprises.

Only narrow banks specialising in these activities could describe themselves as banks. Only narrow banks could take deposits from the

general public (deposits of less than a minimum amount, say £50,000). (\$80,000) Only narrow banks could access the principal payments systems (CHAPS or BACS), or qualify for deposit protection. The rest of the financial system would be unregulated on the basis that its failure would not undermine the basic banking function which are required for normal personal and commercial transactions.

Professor Kay's proposals also suggested that the liabilities of the narrow banks should be matched by safe assets:

The most effective way to ensure that public subsidy to failed financial institutions is not required is to insist that retail deposits qualifying for deposit protection should be 100% supported by genuinely safe liquid assets. Ideally, this means government securities, since nothing else has assured safety and liquidity

While there is a very good theoretical case for this approach and it does have some resonance in both the United States and the United Kingdom where the historic experience of the distinction which existed in the United States under Glass-Steagall or in the United Kingdom in the distinction between merchant banks and Joint Stock banks it would seem practically and politically very difficult to reintroduce. This is partly because in other advanced financial systems, for example, Germany, France, Switzerland the concept of universal banks is widespread and the concepts of major restructuring virtually impossible to consider. In addition there is the boundary problem. How would we really be able to keep the two parts of the financial system apart? Our experience is that the ingenuity of those involved together with possibility of variations in regulatory systems would mean that we would not avoid financial crises that could have very deleterious general effects.

There has been some sympathy in London among Central Bankers and senior regulators with proposals put forward on January 21<sup>st</sup> 2010 by President Obama, in the presence of Paul Volcker, and referred to by the President as the Volcker rule “Banks will no longer be allowed to own, invest, or sponsor hedge funds, private equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers.” The “Economist” described this as ‘Glass-Steagall lite’ .

Proprietary trading is therefore trading on behalf of the firm rather than on behalf of its clients. While both the Deputy Governor of the Bank of England and the Lord Turner, Chairman of the Financial Services Authority felt that in principle this was the right direction of travel they felt that in practice it would be difficult to define proprietary trading, that proprietary trading was not the only reason for the financial crisis and that the objective might be best implemented by higher capital charges on activities regulators deem risky rather than an outright ban. In any case there is considerable interest in the UK as to how the United States will be able to legislate on this and define proprietary trading,

As distinct from the Central Bankers and Regulators the British Government in its statements has rejected limits on banks’ size and complexity. In this they have been largely supported by the Conservative opposition. The Government find “little evidence to suggest that artificial restrictions on a financial institution’s size or complexity, including a distinction between commercial and investment banking activity, would automatically reduce the likelihood failure.”

While the British Government has ruled out structural reform in its changes to the regulatory structure of the financial system, the debate on banking remains very lively. As Andrew Haldane of the Bank of England

said in a speech at the end of March, “We are at the start of a great debate on the future structure of finance, not the end. Some fear that momentum for radical financial reform will be lost. But financial crises leave a scar. This time’s sovereign scar should act as a lasting reminder of the criticality of reform. Today’s crisis has stretched some states’ sinews to the limit. Both literally and metaphorically, global finance cannot afford another.” Similarly in a report on the subject published on March 21<sup>st</sup> 2010, with unanimous cross-party support, the Treasury Committee of the House of Commons concluded “Structural reforms should not be ruled out.”

The progress of Senator Dodd’s committee in working on these issues and achieving effective legislation will therefore be watched with great attention in Westminster as well as in the City of London and Wall St.

The third element of financial reform considered in London as well as elsewhere is to have better planning for the worst case outcomes so that governments are not faced with dilemmas of being forced to choose between saving institutions or risking financial stability. That is again the problem of “moral hazard” . If institutions feel they will not be allowed to fail, this leads to greater risk taking and reduces market discipline. It is therefore felt essential that there should be arrangements which would ensure that even if the largest banks were to get into difficulty they could be “resolved” that is wound down and liquidated in a way that did not put at risk the whole of the financial system. The UK has been working at developing such a “resolution authority” – the body that would facilitate this process would require and developing the legal framework, and indeed has used the framework in the case of the Dunfermline Building Society. The United States has comparable arrangements used by the

FDIC to deal with the failure of smaller banks. These arrangements seem to many far from what would be required for a large international bank to fail smoothly.

In this respect the concept has been developed that banks should have “living wills”, this implies that big banks should be required to develop detailed pre-packaged resolution procedures that would be applied when regulators judged that the bank had gone beyond the stage where prompt corrective action could save it. Particular problems occur with international banks where cross-border problems arise. It would be necessary for the “living wills” in these cases to be agreed with all the regulators and this would lead to some clarification in advance of the relevant responsibilities of regulators across jurisdictions to be agreed. One of the advantages of this could be increased transparency.

While this is desirable there are considerable complications arising in the differences in bankruptcy laws in different jurisdictions. This already occurred in the collapse of Lehman’s where an organisation which, as has been said was international in life became very distinctly national in death. There has been some progress in this and I understand that the Bank of England has recently signed a memorandum with the Federal Deposit Insurance Corporation which is designed to ensure that, were a bank that had businesses in both countries in a situation where it looked as though it were going to fail, there would be collaboration between the Central Banks and the supervisors.

Going beyond this Paul Tucker, the Deputy Governor of the Bank of England, who is also chair of the Financial Stability Board’s working group on the resolution of cross-border firms, said in October 2009:  
“ Basically for the top roughly 25 banks and dealers, the authorities will

work with them over the next 6-9 months to produce recovery and resolution plans. The effort will build on the existing supervisory colleges, but typically at a more senior level, and involving resolution authorities and central banks as well as line supervisors. After official level exchanges, there will be engagement with those firms, also at a senior level (say group Chief Finance Officer). The desired outputs will cover two things, first recovery plans for ‘derisking’ a group where it can and should be maintained as a going concern. Second a resolution plan when a firm needs to be wound down and put to rest, but with essential economic functions maintained somehow.” I have quoted at length because if this challenging task can be achieved I feel it will be of great importance in increasing international financial security. I should perhaps add that Paul Tucker went on “No one should think that this will be easy; or that anyone in the official sector is naïve about that. It will, in fact, be formidably difficult. The process is, for that very reason, designed to flush out the issues, so that they can be properly debated and reviewed”. What is encouraging is that at an international level it is being attempted. We should look forward to the day when we can be told that this has been achieved for all the systemically important institutions. It can be argued that the process of establishing resolution schemes or living wills will have the additional beneficial effect of obliging the banks to unwind some of the most complex features of their organisational structures, and that living wills if fully applied will lead to a partial structural reform of the banks.

While at a global level it is probably unrealistic to think of an international authority able to take the lead in the resolution of cross-border financial institutions even if in theory that might make winding up simpler and smoother the European Commission has been exploring a

European crisis management system which would extend to resolution and liquidation of cross border financial entities. Such an approach including the creation of a European Resolution Authority has recently been backed by Dominique Strauss-Kahn the Managing Director of the IMF. On the other hand the British authorities Treasury, Central Bank and Regulator have poured cold water on the proposal arguing the problems arising from different insolvency regimes across Europe and the fact that the ultimate fiscal responsibility should remain national. This one will certainly take some time to introduce.

I realise that in a lecture on this topic I should also have treated the questions of Sovereign debt which are now becoming more central, but this would have meant that the lecture would risk becoming a running commentary on Greece and the Euro, a subject on which I shall of course be glad to comment on in discussion.

When I arrived in Bloomington last week I discovered that the flyer for tonight indicated that I was also going to answer the question, “How will today’s financial crisis impact global security?” As a post note to my lecture I should try and address it. It is interesting that in one of the European Union papers on the resolution and liquidation of cross-border entities I referred to a moment or two ago the words “crisis management” were used, these are very reminiscent of hard security discussions. Equally I remember during the weekend when Lehman’s was trembling on the brink of collapse in September 2008 recalling that the last time I had been as worried about the future was in October 1962 during the Cuban Missile Crisis. We have seen the potentially devastating effects of unregulated financial systems.

There is no doubt that financial crises both over banking and sovereign debt have put strains on political relations between countries. I have referred to the clashes between Iceland and the UK and Netherlands, but equally during the last two months comment and particular media comment on relations between Greece and Germany have been rather sharp. Today's *New York Times* contains a powerful article by Steven Erlanger writing from Paris on serious strains between France and Germany, the traditional motors of the European Union, over the ways to resolve the Greek debt crisis. In the discussions in recent months over European Union measures to control hedge funds – most of which are managed in London or New York- there have been rather tense exchanges not only between Secretary Geithner and Commissioner Barnier, the member of the Commission responsible for the regulation of financial system with accusations from Washington of looming protectionism, but also across the channel with all UK political parties opposing the existing proposals.

More seriously there is a risk that the economic recession following the financial crisis can influence public and political opinion against globalism and lead to introverted policies. The positive side to this is that the last two years have as I have argued shown the creation of new global or quasi global institution – the G20, the Financial Stability Board which are looking for global solutions to these problems and thereby contribute to global security.