



## Can Lord Turner's proposals for bank capital work?

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Lord Turner, the Chairman of the Financial Services Authority, recently delivered a very thoughtful lecture (see [The financial crisis and the future of financial regulation](#) - The Economist's Inaugural City Lecture, 21 January 2009).

In it he analysed the causes of the financial crisis or *credit crunch* as the media have termed it. Nicely, he likens the crisis to irrational booms and busts of the past, "*in equities, in property, in South Sea project participations, in tulips*" with this being the first in relation to securitised credit instruments. When it turns to the implications of all this it contains the astonishing statement, however, that:

*"we failed to piece together the jigsaw puzzle of a large UK current account deficit, rapid credit extension and house price rises, the purchase of UK mortgage-backed securities by institutions in the US performing a new form of maturity transformation, and the potential for irrational exuberance in the market price of credit."*

A good many non-economists might have thought much of this obvious. Overall, he concludes that there was "*a failure to realise that there was an increase in total system risk*", requiring a regulatory response.

What is Lord Turner's response to this increase in risk? Central to his strategy is the need for new approaches to capital adequacy, liquidity and regulation by economic substance, the latter shorthand for bank off balance sheet vehicles. I find much to favour in the latter two approaches and hope

to write a more detailed analysis in due course. However, I do want to take issue with the principle of imposing capital adequacy requirements on banks. In my view this approach is fundamentally flawed and it is interesting that Lord Turner too criticises the *"intense regulatory focus and international debates on capital adequacy, but less focus on liquidity."*

Let us first identify what Lord Turner means by capital adequacy. Significantly, he observes that: *"we need to go beyond the avoidance of unnecessary procyclicality and to create a system which introduces significant counter cyclicity, requiring banks to build up substantial capital buffers in good economic times ... so that they can run them down in bad."*

To achieve such a buffer requires not only a one-off requirement as to capital contribution but an on-going regime of capital maintenance in practice to work. If this is the case, it begins to sound awfully like the idea of a 'creditor's buffer' a concept familiar to generations of law students, still retaining many adherents in continental Europe - but widely regarded as fundamentally flawed.

The idea of minimum capital is not new. It was extensively discussed in Parliament as long ago as 1855 when the concept of allowing companies to limit their liability by registration was being debated. We must not forget that the context of those Parliamentary debates was also a rash of significant bank failures, including the collapses of the Newcastle bank, the Monmouth and Glamorganshire Bank and the Australian Banking Company, though banking and insurance companies were to be initially excluded from the resulting legislation. Limited liability was allowed but concessions had to be made on minimum capital to get the measure through. Those who supported this clearly believed, as did Lord Grey (Hansard HL vol. 139, col. 2048 9th August 1855) that *"all Joint-Stock Companies should have a fixed property beyond their fixed capital, upon which their creditors could come"*. Those who opposed this pointed out, for example, that minimum capital would not ensure there were assets when a crisis affected a company (Cairns, Hansard HC, vol. 139, col. 354 29th June 1855) and would be easily evaded (Malins, Hansard HC, vol. 139, col. 2128 11th August 1855). I consider these arguments further in Copp, S.F. (ed.) [\*\*The Legal Foundations of Free Markets\*\*](#) (London: Institute of Economic Affairs, 2008), Chapter 8.

The arguments against capital maintenance have been thoughtfully and one might add devastatingly considered in a practitioner article that appears

neglected in academic debate "*The Myth of Capital Maintenance*" by R. Mathias (Accountancy December 1995, p. 92). He argues that in reality the rule should be renamed; its "*real effect is not to maintain capital but to discipline the company to ensure that as far as possible the capital is only available for the company and its creditors.*" In particular, he observes that "to say a company must always maintain its capital suggests that a company must never suffer losses." As the recent banking crisis has shown catastrophic losses can arise from just one transaction, such as the acquisition by Royal Bank of Scotland of Dutch bank ABN Amro.

The problem of the concept of using capital adequacy rules as some kind of 'buffer' for a rainy day as Lord Turner advocates is that such rules can never protect fully against the kinds of unforeseen risks that we have seen banks immersed in. Worse still, they are dangerous because they give depositors and investors a false sense of security that may undermine steps they might otherwise take themselves. There is a regulatory risk here too. If banks themselves cannot foresee the kinds of risks to which they might be exposed and the level of capital necessary to protect against this, how can a regulator do this in broad brush terms across a variety of companies with very different risk profiles? The danger is that the taxpayer will once again be forced to cough up compensation for investors claiming to be let down by regulators.

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