Regulators start rethinking their rules on banks

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As Northern Rock has crumbled in recent days, Adam Applegarth, chief executive of the UK mortgage lender, has made little attempt to conceal his shock. "Nobody could [fore]see the squeeze on global liquidity . . . Watching liquidity disappear has been astonishing," he declared last week, adding that "life changed on August 9" when a sudden money market intervention by the European Central Bank revealed a broad freeze in the funding system.

Such comments about the unpredictability of events are unlikely to placate investors in Northern Rock's shares, let alone the depositors who queued to get their money out. But Mr Applegarth's comments highlight a crucial point about the spreading credit squeeze: behind the scenes many other private sector bankers, central bankers and regulators are also expressing astonishment at the turn of events.

Until this summer, most financiers had assumed that it was extremely unlikely that widespread problems in the money markets - on which financial institutions depend to fund their day-to-day operations - would occur. Thus, while financial institutions of almost every hue have been pouring resources into computer models designed to assess future risks, they had spent relatively little time analysing the events that have brought Northern Rock crashing down.

At the Bank of England, for example, officials had this year started warning about liquidity risks and creating new frameworks for measuring these, ahead of almost all of the central bank's counterparts in the western world. But the Bank had not rushed to finish this framework, since it thought a systemic funding freeze was unlikely. "Nobody expected a complete money market freeze of this kind," confesses one senior continental European central banker. "Every-one was looking for idiosyncratic financial shocks or worrying about subprime or credit being mispriced - that was the focus."

Or as the treasurer of one big investment bank admits: "What we are seeing now is like a natural disaster - whole parts of the financial system which we took for granted have stopped working. But that was not something that people had really prepared for."

To a certain extent, this lack of preparation reflects the perennial tendency of experts in risk management to keep fighting the last financial war - in this case, the implosion of Long Term Capital Management, a US hedge fund, in 1998. The scenario that banks' planning meetings have focused on has been the possibility of another large-scale hedge fund collapse.

In some respects, this LTCM obsession has delivered welcome benefits. This summer, almost two dozen hedge funds ran into serious problems, including two linked to Bear Stearns, the Wall Street investment bank. These jolts have been handled relatively smoothly - in part because banks and regulators prepared so thoroughly for this scenario. "Hedge funds have not been the issue this time," says one senior international regulator, who suggests this outcome may help to defuse demands from politicians for greater regulation of hedge funds in the coming months.

But while a focus on LTCM has helped the industry survive some of this summer's troubles, it may also have distracted risk managers from considering other potential shocks. That in turn highlights a bigger problem: in recent years regulators and investors have tended to play down the risks attached to banks, because they tended to assume that the biggest threats to financial stability lay elsewhere, most notably in unregulated areas such as hedge funds.

The reason for this lopsided view is that a fundamental shift has been under way in the financial system.

Banks used to be considered the dominant pillars of the financial world, since they provided credit to companies and individuals and retained the risk that these loans would turn sour. That meant that if a company defaulted, banks were left on the hook. As a result of this vulnerability, regulators required banks to hold large reserves of spare capital and pools of liquid assets to ensure they could cope with sudden credit shocks.

However, this decade has brought a move to what bankers describe as an "originate and distribute" model - meaning that although banks still tend to make (or "originate") loans, these are increasingly sold (or "distributed") to other capital market investors rather than retained on the banks' books. Since they have been selling on these loans, regulators have assumed that the banks would be less vulnerable if loans turned bad. Thus they have been willing to let the banks hold smaller cushions of capital relative to the volume of loans they create.

This shift towards an "originate and distribute" system has been good news for investment bankers, since it has enabled them to increase the volume of business they can do. One reason why Northern Rock, for example, expanded its mortgage book so fast this decade is that when the lender started turning its home loans into securities, regulatory rules permitted it to lend three times as much per unit of capital.

Until now regulators have generally tolerated - if not actively encouraged - this "originate and distribute" trend, since there was a widespread belief that the financial system would be saferif credit risk were spread around. In particular, policymakers assumed that the fact that banks were selling risks into the capital markets was making them less vulnerable to any future financial turmoil. Thus, it was presumed that there was now far less chance that a crisis would ever erupt in, say, the interbank lending market than among the hedge funds who were buying the credit risk from banks.

However, this summer's events have shattered some of these comforting assumptions. What has become clear in recent weeks is that banks' offloading of risks into the capital markets has not eliminated their vulnerability to a shock; on the contrary, although banks have shoved risk out through the "front door" (as evidenced in their published accounts), they have been re-acquiring it in other, indirect - or backdoor - ways.

One issue creating problems is that banks have been acquiring loans from each other, repackaged as new instruments via the capital markets. Thus as the value of subprime securities has fallen, for example, it has hurt not only the hedge funds and other non-bank institutions but the investment portfolios of banks too.

Another problem is that banks have been selling their credit risk to investment vehicles or conduits. Until recently, it was widely assumed that these were separated from the banks, because they raised finance in the capital markets. But the current crisis has forced banks to prop up these vehicles, by unexpectedly extending liquidity lines - meaning that risky assets are in effect moving back on to the banks' balance sheets again.

Worse still, as the market shock has spread, investors have started to lose confidence in techniques that have underpinned the "originate and distribute" model, such as securitisation (or the practice of taking loans and using these to issue bonds).

That, in turn, has made it impossible for banks to sell assets into the capital markets - such as loans to risky borrowers. "Markets for a wide range of securities have de facto disappeared," says Marco Annunziata, chief analyst at Unicredit.

The net result of this is that, to cope with an influx of assets, banks are scrambling to plump up the cash cushions they had let grow thin in recent years. In place of the "originate and distribute" model, in other words, a new pattern of "re-intermediation" is emerging, in which banks are again on the hook for risk. "Re-intermediation by banks is a likely consequence of the current situation," note analysts at Dresdner Kleinwort Benson, who warn that this trend will "stretch capitalisation and reduce returns on assets" for most banks.

Some think this could herald a sea-change in 21st-century finance that would see banks returning to a much simpler business model instead of endlessly slicing and dicing risk. Others insist that the current pattern is simply a short-term response to a specific financial crisis that will quickly abate.

"For financial innovation, there is no reverse gear," argues Moody's, the credit rating agency (and an institution that has greatly benefited from the securitisation trend in recent years). "The old days of the bank-based intermediation system are gone. It is improbable that a dramatic reversal, a scaling backof securitisation and creditrisk transfer will take place."

But even if this second view is correct and the "originate and distribute" model is here to stay, the recent shocks are already forcing policymakers to rethink some of their approaches. This is likely to trigger some specific, micro-level reforms in the coming months: in the UK, for example, policymakers are scrambling to improve the system for protecting bank depositors from financial turmoil. While officials have been aware for several years that this system contained potential flaws - and had been mulling changes - efforts to reform it had not had much urgency before, precisely because a bank run was considered a low-risk event.

The events of recent weeks may also trigger a broader review, well beyond the UK, of the way regulators treat banks. Central bankers are already considering taking steps to force banks to prepare more effectively for liquidity shocks in their trading operations, for example, when a new set of rules about capital adequacy comes into force next year, known as Basel II.

Some policymakers also think pressure could grow for banks to hold more capital on their books against loans - even if they have sold on the credit risk. "One of the things we will have to look at is whether we should require banks to hold more capital against stuff they have distributed off their books, but where there is a risk

they may need to take this back on to their books for legal or reputational reasons," says David Dodge, governor of the Bank of Canada.

A rethink is also looming about the treatment of off-balance-sheet vehicles. "This is an area where there will definitely need to be a debate," admits one senior European financial official. Meanwhile, policy-makers of almost every hue are now united in calling for far greater transparency of complex finance. Or as Moody's notes: "Looking forward, there will be . . . a higher demand for capital and liquidity buffers throughout the financial system, which will marginally increase the cost of capital."

Such measures will be disliked by bankers, who know that a tougher regulatory regime could make finance far less lucrative. But the longer the current market turmoil continues, the more the recriminations will grow - and, with them, the pressures for reform.

One thing is already clear: just as risk managers have spent the last decade discussing LTCM, the next 10 years will now be shaped by an equally intense debate about the lessons to be learnt from Northern Rock and the shock being felt by Mr Applegarth and others.

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