

TULLETT PREBON STRATEGY INSIGHTS: 003

BUBBLE TROUBLE...WHAT NEEDS TO BE DONE NOW TO AVOID ANOTHER ECONOMIC DISASTER

- Over-indebted governments would be unable to handle another financial “bubble”
- Lending to property-buyers needs to be more tightly controlled – following best practice in France and Germany
- Government balance sheets at continued risk without splitting of banks

London, New York, 16 March 2010: **Retail and investment banking should be separated and caps imposed upon mortgage lending to arrest the development of sequential economic bubbles, says Dr Tim Morgan, Global Head of Research at leading inter-dealer broker Tullett Prebon.**

Unless firm regulatory action is taken to de-couple property price bubbles from contamination of the banking system, the world risks an accelerating series of financial crises, he argues.

And with mounting concerns over the surge in sovereign debt arising from the Great Recession, the world economy is in no shape to cope with another bubble that is likely to arise in the absence of effective regulatory reform.

In the latest edition of Tullett Prebon Strategy Insights – *Forever Blowing Bubbles: can we make it different?* – Tim makes an urgent call for two fundamental reforms to avoid a rerun of the Great Recession. In his previous note - *Brave New World? Issues in the New Decade*, Tim looked at the issues that will shape the world economy in the coming decade and offers pointers for investors seeking a new road-map for a fast-changing world.

Calling for the return of Glass-Steagall

The first is a return to a clear separation between banks that engage in investment banking, and commercial and retail banks that lend to companies and consumers.

This is needed, says Tim, because its absence provides “a potentially-lethal transmission mechanism whereby private risk flows from the borrower, via the banks, to government balance sheets”.

America’s Glass-Steagall Act, implemented in 1933 to help prevent a recurrence of the Great Depression, provided exactly this form of separation. But it was abandoned in 1999, allowing some universal banks to lend irresponsibly and then securitise the mortgages, contaminating financial markets. When borrowers were unable to repay, governments were obliged to bail them out, imperilling their own balance sheets.

“We believe that some form of modernised Glass-Steagall is the inevitable destination of the post-2008 process,” he says.

However, says Tim, “we do not believe that the reintroduction of separation along Glass-Steagall lines is enough”.

And a better regulated mortgage market

To end the problem of leverage that allows bubbles to form, lending to property-buyers needs to be more tightly controlled, he argues. Far more prescriptive regulation of mortgage markets is needed in economies prone to house-price bubbles, such as those of the US and UK, along the lines of regulations that exist in Germany and France.

“For governments, property price inflation has had at least two nasty stings in the tail. One is distortion of the economy, which has created illusory economic booms fuelled by debt-driven consumer spending and by temporary expansion in housing-related business sectors. The second is the process of toxic asset transference (to governments).”

One possibility, says Tim, is to outlaw the securitisation of mortgages, obliging banks to be more careful who they lend to. But it would be better to impose limits on mortgage finance.

“Historical evidence suggests the need to cap mortgage lending at 5½ times after-tax income.” Secondly, he argues, “mortgages should be limited to perhaps 85% of the value of the property, to be independently established.”

Is another bubble looming, and can we handle it?

Despite the strong case for such measures, Tim worries that governments are likely to rely on the ‘one-trick pony’ of tighter capital requirements to prevent recurrence of financial bubbles – a policy which he believes is doomed to failure. Indeed, he says, “Another bubble may now be building” which over-indebted governments may not be able to handle.

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For further information please contact:

Charlotte Kirkham / James Wallis
M:Communications
+44 (0)20 7920 2331 / +44 (0)20 7920 2329
kirkham@mcomgroup.com / wallis@mcomgroup.com

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