

“Risk Lessons from the Financial Crisis”

Thu 4th November

- Thank you for inviting me...

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- Any discussion of the future of financial services has to start by asking the question: why are they important? What do we need them for? Why am I interested in them, as a Parliamentarian?
- Most obviously, finance is at the very heart of our economy. The financial crisis led inevitably to an economic crisis, which we are still not quite through.
- Last month, the IMF called the financial sector the “Achilles’ heel” of the global economic recovery. European and North American banks will need to find an estimated 4 trillion US dollars over the next 24 months to refinance debts. That includes up to £800 billion pounds in the UK alone. That is a lot of money to take out of the economy at a time like this; it could have a dragging effect on the economic recovery.
- And in today’s increasingly complex world, even the smallest of businesses needs finance just to keep going and manage its cash flow. Before the election, businesses contacted me facing bankruptcy, not because their business was struggling per se, but simply because their bank had cancelled their overdraft facility.
- The banks, despite all the criticism they have got – John Varley, the outgoing Chief Executive of Barclays, famously said that the industry was in a “PR crisis” – they are the very heart of the economy.
- Last year, I established the Future of Banking Commission, sponsored by Which? and chaired by David Davis MP and with Vince Cable as a member, which produced its report this year. We aimed to create a debate which included both the banks, and ordinary people, and to ask the big questions about what banking was for and how it could be reshaped to best serve that purpose. We found a great deal of agreement from the public,

regulators and the industry itself, that banking was useful for three core purposes:

- facilitating payments between people and businesses;
 - co-ordinating savers with borrowers; and
 - managing financial risks on behalf of customers.
- UK business relies on the banking system more than most other developed countries. Adam Posen said last year, when he joined the Monetary Policy Committee, that we lack a well developed “spare tyre” for when the banking system goes wrong. If there is a thrombosis in that system, it has serious consequences for the rest of us.

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- However – today, there is an even deeper aspect to our relationship with the financial system. It is an aspect that we did not see in the last major banking crisis. It is the social aspect. Our society now relies on financial services in a way that it never has before – we have become a technology-integrated society.
- Even as recently as the 1970s, it was common for an ordinary person not to use any financial services at all – particularly a person on a low income. Perhaps not surprising, given that most bank branches closed at three in the afternoon, the ATM was still a rare, exotic thing, and there was no such thing as a direct debit. Keeping your money in a tin at home must have seemed a much easier option.
- I remember my uncle Paddy, who was a coal merchant, used to keep his money under the bed. Any talk of using a bank was met with derision.
- Not so any more. We all rely on having easy access to banking, credit, savings and insurance – they are utilities, not luxuries. Those who are excluded from the financial system – because they have a low income, or have little financial capability, or are physically isolated – they can become excluded from society. Financially excluded people can find it much more difficult, and expensive, to do basic things like getting a job or childcare or paying the bills.

- During my chairmanship of the Treasury Committee in Parliament, we pushed financial inclusion high up the Government's agenda. There has been a great deal of success over the years, from the introduction of Basic Bank Accounts, to increasing the number of free cash machines, to the establishment of the new Consumer Financial Education Body. The reluctance of the financial industry to engage on financial inclusion is changing, with their efforts in providing basic bank accounts, forming the Banking Code (later the Lending Code), and so on. Banks such as the Halifax led the way before the financial crisis, in particular by piloting the savings gateway scheme. All this highlighted the importance to our communities of having access to finance.
- Again, the banks are at the very heart of the system, and we no longer have very many "spare tyres," as Adam Posen put it, for when the banks go wrong. During the 1990s we saw a collapse in financial diversity, as large banks merged and many building societies became PLCs. Unlike the 1970s, millions now have their savings in banks, including many on modest means. When Northern Rock and HBOS were endangered, it was no longer just an economic threat: these people could have been personally affected.

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- It is important to remember the human aspect of the financial and economic crisis. In the UK, nearly two and a half million people are unemployed; 600,000 young people leave full-time education each year and face few job prospects; and 46,000 homes were repossessed in the UK in 2009, a 14-year high.

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- Globally, the picture is worse. The IMF has said that 50m additional people would become unemployed around the world, as a result of the crisis. The World Bank predicted that 53 million additional people across the world would fall into severe poverty, and three million additional children would die.

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- Given all this, at the centre of the financial industry must be responsibility. But the financial crises we saw in 2007 and 2008 were a story of a lack of responsibility.
- The fall of the Berlin Wall was not only a momentous event in global politics. It was equally momentous in global finance. Suddenly, in stark contrast to what we had seen before, we entered a period characterised by low interest rates – what with hindsight we might call rather loose monetary policy – yet with stable inflation. Mervyn King called it the “NICE” decade – non-inflationary, consistently expansionary. At the time, we all thought that central bankers had finally just “got it right.” Now, we think it was more to do with the globalisation of product and capital markets. Massive global imbalances have built up.
- Whatever the cause, responsibility in the financial industry fell by the wayside. Credit became extremely cheap, so retail banks lent far more to customers, and at far higher levels of risk, than was responsible. NINJA loans (for those with No Income, No Job and no Assets), self-certification mortgages and 125% loan-to-value mortgages are examples of the craziness we saw at that time.
- Businesses also loaded up with irresponsible levels of debt. The private equity industry swelled to massive proportions, as enormous buy-out deals became possible with billions of pounds of debt – such as the £12.4bn takeover of Alliance Boots.
- The banks themselves became less responsible with debt. Leverage ratios rose to over 50 to 1 in some cases in the West; and banks relied increasingly on shorter-term funding – all without considering the consequences if things were to go wrong. Importantly, capital ratios fell to dangerously low levels.

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- At the same time, what Mervyn King called the “search for yield” took place, across the financial industry but principally in the investment banking sector. With interest rates low, clever young PhDs devised new,

ever more complex ways to generate higher returns by slicing and spreading the risk as far and wide as possible, through new forms of derivative contracts.

- But with hindsight, financial innovation masked an offloading of responsibility, particularly in many of the larger banks. Whilst financial risk could now be passed around, it was building up across the whole financial system, in ways too complex to properly track.
- Worse, traders and investors were using the complexity of the new financial world as an excuse to forget about responsibility. Many types of risk were not tracked, such as counterparty risk – because they couldn't be tracked. 'Due diligence' was often not carried out on investments, because of the increasing complexity of that task, so investors often simply relied on credit ratings. The credit rating agencies, in turn, took to rating banks' products using the banks' mathematical models, because it would have been too complex to produce their own. Northern Rock's paper, for example, got the top AAA rating right up until it collapsed.
- To a simple soul like me, the burning question was, 'where is the risk?' But during our Treasury Committee sessions with bankers and regulators, we couldn't get an answer to this question. We were told that financial innovation was the 'new paradigm.' We were told the risk had been sliced and diced off the companies' books completely and wasn't their responsibility any more. But whose then was it?
- Innovation can be good, but we have to recognise it is not always good – particularly in an industry which relies so much on trust. If I get in a plane and am told that my pilot is renowned for being very innovative, I'm out of there!
- Ultimately, as we know, the result of all this was the 2007 and 2008 crisis, which impacted, and is still impacting, on the lives of millions of people.

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- The late Sir Brian Pitman told the Future of Banking Commission that banking was unique, because it could generate greater profits in the short term simply by taking on more risk. He said: "One of the great differences

between banking and other activities, is that in banking you can increase the profits simply by changing the risk profile. I was chairman of Next at one time, and we couldn't wake up in the morning at Next and say, what we're going to do is greatly expand our business, what we're going to do is increase the risk profile. But in banking, it's perfectly possible, in the short term... And if you gear up the remuneration system appropriately, you can become rich quite quickly."

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- It is worth remembering that our best minds before the crisis did not see what was happening.
- At the time, almost all of the best minds in finance agreed that financial innovation had made everyone's life better. Just before the crisis, in 2006, the IMF famously said that "the dispersion of credit risk by banks has helped make the banking system more resilient". Now they must wish they could take those words back!

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- Incidentally – we have heard from many that no-one predicted the crisis. But it was predicted! Someone wrote: *"Owners of capital will stimulate the working class to buy more and more expensive goods, houses and technology, pushing them to take more and more expensive credits, until debt becomes unbearable. The unpaid debt will lead to the bankruptcy of banks, which will have to be nationalized..."*
- Any clue who this was?

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- Here's a clue. The end of the quote is: *"...and the State will have to take the road which will eventually lead to Communism."*
- It was of course...

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- ...Karl Marx in 1867.

- That's why one of the richest private-equity players in the world said to me at a dinner, 'the centre of capitalism is now Beijing – and the centre of non-capitalism is Washington.' I took that in my stride.

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- So, the crisis in the financial industry was brought about by the banks and other financial institutions, and their management. But there were those who had a responsibility to oversee those managers – and they also failed in that responsibility.
- Of course, corporate governance goes far wider than just the financial sector. But it was the financial sector that brought it into the limelight – first, when the private equity industry came under scrutiny in 2006 and 2007; and then, following the financial crisis, when people began to question bankers' remuneration and bonuses.
- But the most important question for bank directors is not about bonuses – but about how they let allowed the managers of their banks to lose sight of risk and responsibility, in such a spectacular way. They failed in their duty to analyse what was going on in the banks, and hold the executives to account on behalf of shareholders.
- There has understandably been some considerable focus on regulation, and how it can be improved to make the next crisis both less damaging and less likely to happen. A new level of intrusive supervision has now come into force, with regulators overseeing decisions about how banks are run. I will come to that in a moment. But proper corporate governance should come before supervision. A financial institution has a responsibility to set its own house in order – to avoid damage not only to the company itself, but to the wider economy and society. No regulator in the world foresaw or acted on the looming crisis – institutions themselves must have a role in doing this.
- Banks' boards and chairmen have accepted responsibility for the crisis after the fact – as chairman of the Treasury Committee, I heard a great deal of bankers' apologies – without them necessarily accepting that they could or should have acted differently. They apologised for the failure of the system but not the part they played in it. Yet they approved the

business strategies and products which were instrumental in causing the crisis.

- However, there is clearly a second level of corporate governance, and that is with the owners of the companies themselves.
- The phrase “ownerless corporations” came to prominence with Treasury Committee’s report on corporate governance and the financial crisis, published last year. The Committee, like many people, asked why shareholders had not had more to say about the way their banks were being run. Governance was given a low priority by most major institutional investors. Essentially, as long as investors got their returns, the banks’ executives seemed to have free reign.
- Corporate Governance was one of the key areas we looked at on the Future of Banking Commission. We made a number of recommendations on this – for example:
 - the Companies Act could be amended, to give directors a duty to consider the impact of their strategy on wider financial stability;
 - directors could make better use of their power to appoint their own staff and independent experts, and commission their own research, to give them a better ability to challenge their executives;
 - board members could each be given responsibility for their own particular area of governance, ideally one where they have particular skills and experience, to focus the activities of the board;
 - the law could be clarified on the responsibilities of trustees and institutional investors in corporate governance; and
 - the Stewardship Code for Institutional Investors could be made mandatory for those investors holding bank shares.
- One idea that I like is the idea of Sir Dennis Weatherstone, former CEO and Chairman of J P Morgan – you’ve got 15 minutes to explain it to me, and if you can’t explain it in that time, it’s off the agenda...

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- After the banks' own governance, next level of oversight was regulation.
- There were a number of well-documented problems at the Financial Services Authority in the years running up to the crisis.
- One major gap in Western financial regulation was the lack of macroprudential oversight. Risk was building up at a systemic level, but none of our regulatory authorities appeared to have responsibility for overseeing this – it fell down the gaps between the institutions. We will wait to see if the new responsibility for the Bank of England is successful in overseeing this.
- Of course, in addition to new oversight, there are also new, more stringent capital requirements in the form of Basel III and the Capital Requirements Directive. There is certainly a need to keep an eye on the cost of new regulations and requirements as they add up, and there will be a cost to these new requirements. Nevertheless, there is some consensus on the need for better capital. Lack of capital was an important factor in the financial crisis of 2007 – so Basel III, whilst it will not be enough all on its own, is an important step in ensuring that the next financial crisis is less damaging to the wider economy and society.
- The reforms announced by the Government – including splitting the FSA into two new authorities – are unlikely to have a substantial effect on the effectiveness of financial regulation. The Treasury Committee supported the previous Government's tripartite model, but we concluded in 2009 that it was far more important to ensure a change in the mindset of the regulators.
- The fundamental issue was that the FSA, like many in the financial industry, believed that markets were essentially self-correcting. Hector Sants acknowledged last year, that the public thought the FSA was regulating the business models and overseeing the running of financial companies. It was not.
- So, financial regulation is likely, in the future, to be more intrusive, with the FSA regulating a wider range of practices, more stringently: it will look

at companies' business practices, as well as appointments of directors, and remuneration packages will be assessed for the risks they pose to the business. Rather than "regulation," we will have fully-fledged "supervision."

- A change of approach is certainly needed, and I recognise the fact that the FSA has effectively abandoned the self-correcting markets theory. However, there is a debate to be had about whether this intensive supervision is the right approach – or rather, whether it will be enough on its own.

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- The Future of Banking Commission called earlier this year for a new model for the financial system – in particular for banking – where participants are not simply supervised and punished for breaking the rules – but are positively motivated to act in the right way.
- There are many other professions, other than banking, where a lack of responsibility could have disastrous consequences for people. Doctors, engineers and pilots are the obvious examples. They all carry out jobs where people's lives are at some risk, and that risk has to be managed carefully.
- But generally, we trust our doctors, engineers and pilots with that risk. They are all part of a profession with a strong culture of professional ethics, or values. For this reason, they are expected to act with integrity and follow the rules of their profession. They are regulated, but they are not "supervised" in the same way we now closely supervise the running of our financial institutions.
- The Future of Banking Commission heard that informal professional systems like these might have existed before the Big Bang deregulation in 1986, when there were better defined, discrete professions in financial markets. Whilst I would not advocate a return to that system, I would like to ask whether there a way we can restore professional ethics in the modern financial system.

- That word ‘ethics’ doesn’t mean the ten commandments. Culture is about people’s behaviour; ethics provides a framework for resolving conflicts of interest where they arise.
- The Commission proposed a Good Financial Practice Code for the financial industry, particularly for banking, reinforced by a professional standards body along the lines of the General Medical Council or the Legal Services Board. This was supported by members of the public who contributed to our inquiry.
- In retail banking, we also looked at the issue of customer relationships. One of the factors that reinforces responsibility and trust in the medical profession, is the close relationship with the patient. This close relationship has been lost in many retail banks, with an emphasis on automated banking via the internet, or on computerised procedures rather than branch managers assessing their own customers’ needs. We need to look at ways of restoring this relationship in modern retail banks.
- Certain kinds of financial institution have managed to keep this culture of ethics and values more than others. Financial mutuals have generally weathered the financial crisis better than commercial banks, and have maintained their focus on their relationships with their customers – who are, after all, also their owners. Mutuals are also prevented by law from taking more than 50% of their funding from the wholesale markets.
- So restoring diversity in the UK financial sector – with a greater number of financial mutuals – is one way we could spread values-based practice throughout the industry.

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- One challenge which we risk ignoring is the problem of banks which are *“too big to fail.”*
- This is the idea that certain financial institutions believe they will always be bailed out by the Government, whatever happens, because their failure could have massive consequences for ordinary people.
- In fact, “too big to fail” is something of a misnomer – we should rightly say, “too important to fail.” The issue is not necessarily the size of the

bank, but the fact that it combines consumer-facing retail activities – which the Government rightly wants to stand behind – with other complex and highly risky activities, such as investment banking – which the Government does not want to protect.

- The banking rescues of 2008 showed that, when one of these large “universal” banks fails, even if the cause of the failure is the investment banking part, the Government feels compelled to bail it out using taxpayer money because it holds the savings and bank accounts of millions of ordinary people.
- This creates *moral hazard* and it was instrumental in allowing large amounts of risk to build up in the system – because it encouraged bankers to act less responsibly than they should have, knowing that they had a ‘back-up’ in case of failure.
- If we are to return to responsible management of risk in the banking system, this moral hazard must be removed.
- Many people, including John Kay, Mervyn King and myself, have called for this to be done by *separating the banks* into, broadly, retail parts and investment banking parts. The retail banks would be closely supervised and protected by the taxpayer; the investment banks would be allowed to fail.
- It is important to reiterate that, in the recent crisis, even retail banks failed. Northern Rock and HBOS were largely retail banks (though they had got into certain risky non-retail activities). And if there is a situation where ordinary people’s livelihoods are put at risk, then the Government will always want to intervene to ensure they are protected as much as possible. But this protection must not extend to the risky “casino” banking operations which are of no benefit to the consumer. These parts of the bank should be allowed to fail without Government support.
- The aim of this would be to remove the moral hazard which currently affects the behaviour of bankers in the investment banking sector – enabling them to take irresponsible risks.

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- The Government has established an independent commission to look at this issue and others, which will report back next year.
- I sincerely hope that it will look at some of these issues.
- We have made much progress already on financial regulation, with new capital requirements and a change of strategy from the FSA, as well as much closer supervision. However, despite continued support from people such as Mervyn King, the structural change agenda has not been advanced. Some way of taking away moral hazard from the banking system has to be found – this cannot be ignored.
- Secondly, we have not pushed hard enough in the area of corporate governance. A few small rule changes and a voluntary code will not be enough to bring about a sea change in the way financial companies are overseen by their directors and their owners. We will need to find a way of bringing this about. I know that the Government's independent commission is looking at this. The recommendations put forward by the Future of Banking Commission will be a good start.
- Scotland in particular saw a massive failure in corporate governance, with RBS and HBOS directors failing to address those companies' excessive attitude to risk. This was particularly true of RBS and the ill-fated deal with ABN AMRO.
- Thirdly, the matter of professional standards and ethics must not be ignored. The alternative to this is, unfortunately, ever more stringent legislation and supervision, to regulate the behaviour of bankers. I do not believe this is the most effective solution. I would like to see policymakers and bankers come together to discuss ways that a professional ethical culture can be established in the financial industry.
- There is also a risk that all of this will be swept under the carpet and we will lose the momentum for change. I would like to keep the focus on this debate so that we can bring about some real change – *before*, not after, the next financial crisis.

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- One more area where we need to do some work is in measuring risk. If we are going to have good macroprudential oversight, we will need this!
- Charlie Bean, deputy Governor at the Bank of England, also said last week that the recession couldn't have been predicted with any precision. However, this does not mean we should give up trying. Bean said that even if crises are difficult to predict, we should aim to “be more alert to the vulnerabilities” building up to a crisis – if it is being monitored closely, we can still say something about the likelihood of a crisis occurring.
- Professor John Kay said to the Treasury Committee earlier this year that he had said that he “no longer believed the theories of risk and risk measurement and management that I have been teaching for 20 years of my life.”

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- Professor Charles Goodhart said in the same session: “I think it is very sensible for Basel to adopt a leverage, ratio as well, because a leverage ratio effectively says we cannot measure risk very well...”
- He was then asked by one of the Committee members, “It is like saying, we accept that we cannot manage the risk, so we just ramp up the insurance?”
- To which he replied, “Yes, absolutely”!

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- This is why I welcome the establishment of this Risk Academy. The daunting challenges facing it were well described by these Treasury Committee exchanges!
- Thank you...