What would Jesus say about banking today?

Seminar for Spurgeon's College, 6 December 2017

In 2007, we saw, for the first time in over 100 years, people queueing on the street outside a British bank. In 2008, the US government's decision not to bail out Lehman Brothers crowned a collapse of market confidence which has had devastating effects on the world economy.

In September 2017, I went to Ireland, a country of 4.75 million which has over 200,000 people who do not have a permanent home. The result of bad banking has been no significant house-building in Ireland in the last decade.

What I want to do this morning is to explore what caused the banking crisis: to reflect on the nexus of personal sin, institutional corruption and structural failings which triggered a decade of austerity and a bailout at taxpayers' expense which means that the UK's public debt will still be higher in 2060 than it was in 2007.

My hope is that you will treat what I present today as a case study, an example of theological reflection on a complex problem where understanding the times and knowing what is to be done (1 Chronicles 12:32) requires detailed analysis but also the ability to challenge the secular paradigms of the day.

The causes of corruption

<u>Structural</u>

Causes

- A mismatch between risk and reward (heads I win, tails someone else loses)

There used to be two types of bank: commercial banks (the high street banks) which took deposits and made loans to individuals and businesses, and investment banks which advised on investments and complex financial arrangements. Both types of bank were partnerships, whose partners had unlimited liability in the event that the bank failed. This gave the partners long term incentives to 'monitor each other closely and limit the risks the business incurred'.[1] Bank shareholders used to have unlimited liability for the debts of a bank. If a bank failed, its shareholders went bankrupt. In the late nineteenth century, unlimited liability was replaced by extended liability, but shareholders still had to pay up to three times the original value of their shares if a bank failed.[2] It was not until well into the twentieth century, and in the case of investment banks not until the 1980s or 1990s that banks became limited liability companies whose shareholders would lose nothing more than the value of their shares in the event that the bank failed.

- The ability to gamble on the casino of the financial markets with the backing of a government guarantee.

Governments guarantee the liabilities of large banks because banks are essential to the payment system (the various instruments and mechanisms which we use to pay our debts to one another). We have become so used to the convenience of direct debits and of payment cards, that only the eccentric keep enough cash at home to be able to pay for their weekly shopping and their monthly bills. Because we cannot live without our bank accounts, no bank must be allowed to collapse if its collapse would disrupt the payment system.

The consequences of the Big Bang in the City in 1986 were dramatic. Banks could now afford to take greater risks: if they lost, they no longer bore the full consequences. All limited liability companies have an incentive to take greater risks than they should. However, they are constrained in their risk-taking by the limits on the amounts they can borrow and the profits they can generate. Large commercial banks can borrow 10 to 20 times more than other companies because of the government guarantee they have. This ability to borrow (called leverage) created a multiplier effect favouring risk over reward.[3] Leverage meant that if banks won, they won big; limited liability meant that if banks lost, they no longer bore the full consequences of their actions. Individual traders and managers faced little sanction at all. Risk-taking became intoxicating. Oversight by regulators proved to be no substitute for the

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[1] John Kay, *Other People's Money: Masters of the Universe or Servants of the People?* (London: Profile Books, 2015), 30.

[2] Andrew Haldane, 'Control rights (and wrongs), Speech, 24 October 2011, 4. http://www.bis.org/review/r111026a.pdf

[3] John Kay provides a detailed explanation of the effects of leverage in *Other People's Money* at 100-105.

mutual self-control of bankers who knew that they would be personally ruined if their bank were to fail.

Consequences

- The bigger a bank got, the larger the rewards and the stronger the government guarantee. The aim was to be Too Big To Fail.

If a bank is so large that a government would not allow it to collapse, that bank has become too big to fail. The existence of this government guarantee creates an in-built tendency towards the creation of an oligopoly of large banks which become the primary source of finance for all other businesses.[4]

- Banking became mostly about trading on the financial markets. Lending to businesses became a peripheral activity.

There has been an explosion in trading for trading's sake. According to the IMF's Global Financial Stability Report in April 2008, the total debts, shares and assets of commercial banks amounted to 4 times global GDP and derivatives[5] about 12 times global GDP.[6] Lending to businesses has, by contrast, involved less of banks' assets over time,[7] with the result that for "large banks, business lending contributes to the rate of return on equity very little."[8]

<u>Institutional</u>

Causes

- Big name and fabulously well-paid CEOs decided to make their banks as big and as profitable as possible (Fred Goodwin (RBS), Dick Fulk (Lehman Bros), Jamie Dimon (CitiBank), Adam Applegarth and Matt Ridley (Northern Rock). This led to excessive

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[4] David McIlroy, 'Creating Fail-Safe Banks', (2010) 4 *Law and Financial Markets Review* 159-165.

[5] Products which are derived from other instruments, e.g. options, futures and warrants.

[6] IMF Global Financial Stability Report, table 3, 147.

[7] Robert DeYoung and Tara Rice, 'How do banks make money? The fallacies of fee income', Table 4, *Economic Perspectives* 4Q/2004, Oscar Jordá, Moritz Schularick and Alan M. Taylor, 'The Great Mortgaging: Housing Finance, Crises, and Business Cycles', *Federal Reserve Bank of San Francisco Working Paper Series* (September 2014).

[8] Victor Ekpu and Alberto Paloni, 'Financialisation, Business Lending and Profitability in the UK', (September 2015), http://www.gla.ac.uk/media/media_424705_en.pdf

risk-taking and over-optimism. Bankers began to believe that they could predict and control the future.

Over the last 30 years, all banks have grown in size but the big banks have grown disproportionately quickly.

- Making a short term profit regardless of customers was valued more highly than long term relationships with customers.

That there *was* a widespread problem with the culture within banks prior to the global financial crisis is perhaps as well-established a fact as anything can be in the social sciences. There was a heavy emphasis on short term profitability which led to a systemic exploitation of information asymmetries between banks and their customers.

Prior to the global financial crisis, individuals had very large incentives to achieve sales and faced little by way of downside risk if they sold their customers unnecessary or toxic products (though in some banks they faced losing their jobs if they didn't).

McCabe (2009)[9] identified how the branches of a UK high street bank had become seen internally as selling spaces rather than bases from which financial services were provided. Kerr and Robinson (2012)[10] studied the changes in Scottish banking and found that: a business culture imported from the USA had a big impact in changing Scottish banking; branches came to be seen as sales outlets and staff were transformed from professional advisors embedded in the community into salespeople with targets to meet. Knights and Tullberg (2011)[11] studied financial services in the UK and Sweden and found that: the banking crisis arose partly because of a narrative of the 'masculine autonomous self' – notion of the self-interested, self-sustaining individual; which led to "poor ethical standards stemmed from the conditioning of individuals to not recognize their social interdependence".

In his independent review of Barclays business practices, Anthony Salz lays many of the central failings of Barclays bank in the run-up to the LIBOR scandal on its internal culture:

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[9] McCabe, D. (2009). 'Enterprise contested: Betwixt and between the discourses of career and enterprise in a UK bank'. *Human Relations*, 62(10), 1551 – 1579.

[10] Kerr, R., & Robinson, S. (2012). 'From symbolic violence to economic violence: The globalizing of the Scottish banking elite'. *Organization Studies*. 33(2), 247 – 266.

[11] Knights, D., & Tullberg, M. (2012) 'Managing masculinity/mismanaging the corporation.' *Organization,* 19(4), 385 - 404

"despite some attempts to establish Group-wide values, the culture that emerged tended to favour transactions over relationships, the short term over sustainability, and financial over other business purposes."[12]

- Herd effect: other banks felt obliged to copy the behaviour of those banks which appeared to be the most profitable (e.g. Bradford & Bingley copying Northern Rock, Bank of Ireland copying Anglo-Irish Bank).

Because banks are no longer partnerships whose partners must take the long view, banks became more and more focussed on achieving short term returns for shareholders. This meant that once one bank pursued a business model which seemed to generate large profits, other banks felt obliged to follow suit.

There were real differences in the extent of their exploitative and unscrupulous behaviour but it was practically impossible, in a situation in which the boards and shareholders demanded sizeable short term profits, for a bank quoted on the stock market, to take a wholly different course.

British building societies were owned by their members, in the same way that John Lewis is owned by its staff; all the building societies that converted to companies owned by shareholders collapsed in the financial crisis. Nationwide which did not, survived.

Short termism is a bad idea in any business but it is particularly problematic in banking where the accounting rules relating to loans and to buying and selling financial products enable banks to book a large profit now on something which may turn out to have been a disaster in years to come.

In the decade ending in 2007, the banks booked extraordinary and historically unprecedented levels of profit. Like the dream of the fat cows and the thin cows which Joseph interpreted for Pharaoh (Genesis 41), the bailouts by governments have been greater than the profits which were made. The exceptional profits were an illusion. But bankers walked away with those profits and left taxpayers to pick up the losses.

Consequences

- Banks took too many risks on too many things, without realising that the combination multiplied the size of their gamble.

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[12] Antony Salz, 'The Salz Review of Barclays' (April 2013) 2.13 http://online.wsj.com/public/resources/documents/SalzReview04032013.pdf

Instead of spreading risk, banks ended up multiplying risks. A whole series of complex financial products and trades between banks all became toxic because of a good, old-fashioned drop in US property prices. What was new was not such an event; what was new was the chaos it caused because there was now a chain of transactions from the empty houses in Florida to a local authority in Norway and no-one knew which one of the links in the chain would break or who would end up suffering the loss.

- Banking changed from being a service industry to being an industry in which clever people made money out of people who were less financially sophisticated.

John Mann MP: 'I…wonder, Mr Diamond, if you could remind me of the three founding principles of the Quakers who set up Barclays?'.

Bob Diamond, who had just resigned as Chief Executive of Barclays: 'I can't, sir'

John Mann MP: 'Honesty, integrity and plain dealing'

(Treasury Select Committee, 4 July 2012)

- Copy-cat behaviour in the good times first artificially inflated prices, then meant that all banks suffered significant losses when the market turned.

Have you been following the news about Bitcoin. Bitcoin is a crypto-currency, which keeps increasing in value. But Bitcoin does not really exist. What I mean by that is that Bitcoin is not a thing. Bitcoin is an idea. So long as people believe in the idea of Bitcoin, it has value. Once people stop believing in Bitcoin, it becomes worthless.

The law of supply and demand

<u>Personal</u>

Causes

- Decision-making power was taken away from local bank managers. Lending decisions were made by computer or by committee.

Captain Mainwaring, portrayed by Arthur Lowe in the sitcom *Dad's Army*.

- Short term profits were achieved by selling customers unnecessary or unsuitable products.

The New City Agenda's top 10 of UK retail banking scandals listed: Payment Protection Insurance, Interest Rate Hedging Products, Endowment Mortgages, breaches of the

Consumer Credit Act, packaged bank accounts, investment products and advice, mortgages, pensions, unfair bank charges, and identity theft and card protection insurance. Each of those scandals cost the banks more than £400 million. Those are retail banking scandal caused by the adoption of an aggressive sales culture required to achieve demanding sales targets. Even now, nearly 10 years on from the crisis, banks continue to target levels of profitability which are only achievable if their retail arms function not as a utility but as a vehicle for cross-selling products offered by the casino.

- Those who were promoted and rewarded at banks were those who made the largest short term profits.

What gets measured, gets done.

Banks changed from sleepy, prudent institutions into money-making machines obsessed with short-term gains. The break with the past was symbolised in new corporate headquarters. The new motto was: let's make a profit at all costs and by all means. A striking feature of the defences of their actions mounted by Tom Hayes (convicted for manipulating LIBOR), Kweku Adoboli (whose fraudulent trading cost UBS £1.4 billion) and Jerome Kerviel (whose fraudulent trading lost Société Générale 4.9 billion euros) was their insistence that their bosses knew what they were doing, and tacitly approved it so long as they seemed to be making money, regardless of whether they were breaking the rules. Pay, promotion and prestige were all dependent on their performance in making money, at all costs.

Corporate raider Gordon Gekko, played by Michael Douglas in the film *Wall Street*.

Gekko was a powerful role model. A generation of highly paid, mostly white, males grew up admiring Gekko's ruthlessness, his lack of hypocrisy about his motives, and, perhaps above all, the money he made. Film-maker Oliver Stone intended Gekko to be an indictment of the traders on the financial markets who saw themselves as "the Masters of the Universe". Instead, he became the poster boy for the lifestyle and the rewards to which so many talented people became fatally attracted. In a speech on 8 October 2008, Australian Prime Minister Kevin Rudd described the bankers who caused the global financial crisis as the "the 21st century children of Gordon Gekko".[13]

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[13] http://www.theaustralian.news.com.au/story/0,25197,24450662-7583,00.html

Consequences

- Knowing your customers' businesses and building long term relationships with customers was no longer relevant.
- Acting in your customers' best interests no longer paid: failing to meet your targets could get you dismissed.
- Bank employees became demoralised as they realised there was no purpose to their business beyond profit-making.

Theological Reflections

In this context,

- a banker seeking to live righteously faced dismissal for not exploiting his customers;
- a bank seeking to act ethically faced the anger of its shareholders for not making the same level of profits as its competitors;
- the system developed over the last 30 years has created a series of incentives which render just action by a bank deeply unattractive.

The Required Reformation

- Jesus condemned our tendency to treat money as an end in itself, rather than using it to serve others.

<u>Personal</u>

- We need a theology of vocation in general (LICC)

Jesus told a story about the parable of the talents, which seems to contain an implied criticism of banking (Matthew 25:27), though Jesus' criticism was that depositing money with a banker produced a far lower return that investing it on risk.

- We need a more thought-through theology of banking and of money (Stephen Green described *Loving God, Loving Mammon* as out of print and out of date)

Finance should be understood as a service industry, one whose value lies in the services it provides to companies, individuals and public institutions. This means that the primary focus of banks ought to be on the quality of the service provided, in the interest of its customers and counterparties. It is from the provision of good quality services which are in the customers' and counterparties' best interests that the profits of the banks should flow.

This is particularly important because many of those with whom banks deal do not have access to any alternative sources of information and advice about the bank's products.

Four 'E's: education both in banks and elsewhere about the virtues required of bankers, empathy so that bankers understand that they are providing services to customers, example so that those who exhibit the virtues and do serve their customers well are rewarded and promoted, and enforcement so that those who fail to live up to the standards required are held accountable.[14]

- We need bankers who trade on being trustworthy (e.g. ResPublica's bankers' oath)

Sir Siegmund Warburg, founder of the investment bank SB Warburg, said "First you make someone your friend, then you become his banker."

There is a place for a return to something like the Banking Code, a short statement of fundamental rules of fair dealing, agreed by the banks themselves, applied in the first instance by the industry, but then subject to an appeal to a body representing the public interest.

But in the end, bankers need to be people who do the right thing even when no-one else is looking.[15] The ethical person is a law unto themselves, they act justly not because they are following a rule for fear of a sanction but because they have internalised the fact that acting justly is the right thing to do.

Institutional

- We need to vote with our feet

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[14] David McIlroy, 'Banking on Ethics: is Greed really Good?', http://www.theosthinktank.co.uk/comment/2016/09/30/banking-on-ethics-is-greed-really-good.

[15] Res Publica, *Virtuous Banking*.

Statistics show that many of us are unhappy with our bank but we do not switch. We are more likely to get divorced than to switch banks. If we are unhappy with the way in which our current bank makes its profits, we should move to another bank. There are new banks, building societies and credit unions which offer genuine alternatives. We can start the reformation by switching current accounts.

- We need to support institutions which prioritise the interests of their customers (e.g. building societies)
- We need to support institutions whose corporate values are embedded into their culture (e.g. Handelsbanken, Triodos, Rabobank, Civilised Bank)

Following the global financial crisis, banks such as Handelsbanken, Triodos and Civilised Bank have sought to differentiate themselves by saying that they treat their customers differently. Not all financial institutions are the same.

<u>Structural</u>

- We need to scrap the complex rules whose net effect has been to replace with ethics with compliance

We all need to remember that the banking market is not natural, it is constructed, and it could be constructed differently.

Since the 1970s, banking has been regulated by a vast edifice of ever-more complicated, technical rules. The way in which banking transactions are carried out has become controlled by detailed prescriptive rules, but this approach "has undermined rather than enhanced ethical standards, by substituting compliance for values."[16] People in the financial services sector no longer needed to ask themselves whether what they were doing was right, all that mattered was whether what they were doing was within the rules.[17] The attempt to control people's behaviour through external laws rather than instilling in them personal morality was, as the Old Testament should have taught us, doomed to failure. Regulators need to rip up the

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16 John Kay, *Other People's Money: Masters of the Universe or Servants of the People?* (London: Profile Books, 2015), 273.

17 Alistair Alcock, 'Are UK Financial Services Over-regulated?', public lecture at the IALS on 31st October 2002.

rulebook, replacing many of the detailed rules with clear principles which bankers are required to internalise and to live by.[18]

Jeffrey Sachs wrote in the *Financial Times* on 18 January 2012, a column entitled "Self-interest, without morals, leads to capitalism's self-destruction".

- We need to shrink banks down to size

Ian Fraser says: "The only viable long-term solution for such financial behemoths is to break them up into more manageable chunks."[19] A simple way of achieving this objective is to tax banks above a certain size at a punitive rate for the benefit of the government guarantee that they enjoy. Those who own banks would then have an incentive to break them up into smaller units. Another alternative is simply to legislate so that no bank can grow larger than a certain percentage of its home country's GDP.

- We need to separate the payment system from the casino

It is possible to restrict what banks do. After the Wall Street Crash of 1933, US legislation forced banks to separate their investment banking operations from the commercial bank. The last of those controls were dismantled in 1999. Within a decade the system had failed again.

- We need to rebalance risk and reward

Addressing the issue of incentives

One way of reining in excessive risk-taking by banks would be to rebalance reward and risk by reintroducing extended liability. The behaviour of large corporations responds to the demands of shareholders for a return on equity but is driven by the senior management who have, in recent years, creamed off for themselves increasing rewards. Those senior managers could be required to receive part of their remuneration in the form of non-transferable shares bearing extended liability. There needs to be a link between the long-term performance of the bank and their personal fortunes in order to break a cycle of behaviour in which one person takes the profits and leaves everyone else to bear the loss.[20]

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[18] One suggestion by ResPublica is a bankers' oath: http://www.respublica.org.uk/disraeli-room-post/2014/08/07/bankers-oath-honesty-integrity-ethics/

[19] Ian Fraser, *Shredded: Inside RBS: The Bank that Broke Britain* (2014), Introduction.

[20] Peter Boone and Simon Johnson, 'The Next Financial Crisis', 8 September 2009, *The New Republic*, https://newrepublic.com/article/69024/the-next-financial-crisis