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Time for a financial reformation?

By David McIlroy

Cambridge Papers
Towards a biblical mind

'What good is it for someone to gain the whole world, yet forfeit their soul?' Mark 8:36

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

Summary

The Global Financial Crisis ought to have been a wake-up call. Instead, it has largely been an opportunity missed. It is not, however, impossible to take the steps which are required to transform the financial services industry into one which lives up to its name.

This paper seeks to remind us that the shape of banks and the nature of banking are not fixed, that there is an alternative to the domination of our financial system by a few large banks focused on short-term profits. Banking was different in the past and it could be once again.

Introduction

There are moments in history when the vices which have become endemic to an institution or a network of institutions are exposed. In 1517, Martin Luther's 95 theses nailed the way in which the practice of penance had become a moneymaking exercise for the Catholic Church and had fundamentally distorted the understanding of individuals' relationship to God. In 2008, the global financial crisis showed how banks had become oversized, a club whose impenetrable dealings with one another were capable of bringing the major economies of the world to their knees.

I have spent the last 20 years explaining to students how banks are supposed to be regulated and the last eight years acting for customers who have been exploited by banks' ability to manipulate, evade or defy those rules. The current paradigm for banking (which is actually less than half a century old) has failed: it has failed taxpayers, it has failed customers, and it has failed bankers (if one measures their wellbeing in moral as well as economic terms). It is time to rethink banking and its purpose in the way that the Reformation radically rethought the Church and its mission.

Banking is, at the best of times, a perilous business. The love of money is a root of all kinds of evil (1 Timothy 6:10). Jesus warned that 'You cannot serve both God and Mammon' (Luke 16:13). He condemned our tendency to treat money as an end in itself, rather than using it to serve others. The Bible warns repeatedly about debt and lending money at interest (Romans 13:8; Job 24:9; Matthew 18:25–30; Leviticus 25:37; Deuteronomy 23:19; Ezekiel 22:12). Interest-bearing loans contain an inherent conflict of interest between borrower and lender, and create an imbalance of power which the lender can use to oppress the borrower (Proverbs 22:7, 28:8). Revelation 18 denounces the prosperous city of Babylon, a gleaming centre of world trade (v.11, v.16), because Babylon's wealth was built on exploitation (v.24). She did not only trade in goods and services but in the 'bodies and souls of men' (v.13b).

The causes of corruption

The temptations facing bankers have become besetting sins as a result of structural changes in the last century which have produced financial super-predators. There have been two major reasons for the growth of these banking behemoths: a mismatch between reward and risk, and the ability of these banks to trade with the benefit of a government guarantee. The result was that toxic behaviour became endemic.


Canary Wharf, London

A growing mismatch between risk and reward

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 temptations facing bankers have become besetting sins as a result of structural changes in the last century which have produced financial super-predators.

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

The free ride of a government guarantee

The textbooks will tell you that banks take deposits and make loans. Yet that has become a small and peripheral activity for many large banks. The 1986 'Big Bang' in the City of London led to the high street banks taking over the investment banks, and using their assets to finance trading in complex financial instruments. This trading (sometimes described as a 'casino') is undertaken by organisations which also provide essential financial services (such as current accounts, payment facilities, and savings for those who cannot afford to take risks on the markets).

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 four times global GDP and derivatives[4] about 12 times global GDP.[5] Lending to businesses has, by contrast, involved less of banks' assets over time,[6] with one recent paper suggesting that for 'large banks, business lending contributes to the rate of return on equity very little.'[7]

The trading has been financed by big banks' ability to borrow money cheaply because everyone knew that governments would be bound to bail out any large bank. Why? 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 problem is when the banks collapsed in 2008, governments ended up bailing out not just the payment system but the whole casino. Despite having to call on the government guarantee at that time, the banks remain addicted to gambling, aiming for levels of profitability which can only be achieved by winning at roulette.[8]

1 John Kay, *Other People's Money: Masters of the Universe or Servants of the People?*, London: Profile Books, 2015, p.30.
2 Andrew Haldane, 'Control rights (and wrongs), Speech, 24 October 2011, p.4. www.bis.org/review/r111026a.pdf
3 John Kay provides a detailed explanation of the effects of leverage in *Other People's Money*, pp.100–105.
4 Products which are derived from other instruments, e.g. options, futures and warrants.
5 IMF Global Financial Stability Report, table 3, p.147.
6 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.
7 Victor Ekpu and Alberto Paloni, 'Financialisation, Business Lending and Profitability in the UK', September 2015, www.gla.ac.uk/media/media_424705_en.pdf
8 Standard Chartered was targeting a return on equity of 8% by 2018 and 10% by 2020. http://citywire.co.uk/wealth-manager/news/argonaut-standard-chartered-is-a-broken-business/a855402

The need for a reformation

The Judaeo-Christian social vision goes far beyond questions of personal morality. A reformation of the banking system is possible, but just like the Reformation, it will require change at the personal, institutional, and legal levels.

Personal change: the honourable banker

Personal integrity is important. Prior to the global financial crisis there were Christians and others with high personal moral standards in positions of influence in many banks. Men such as Stephen Green (chief executive and then chairman of HSBC) *did* make a difference to the behaviour of their banks, but there is a limit to which it is possible to take a stand against seemingly profitable activity which everyone in an industry is engaging in.

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It was difficult to live with integrity in a system which taught that sales meant success. It was the traders producing the largest short-term profits who received the biggest bonuses; it was the managers who succeeded in cross-selling the most products (PPI and other insurances, interest rate swaps and other hedging products) who were promoted. The message that the short-term profit was more important than the long-term customer relationship was reinforced with every sales target, quarterly report, and appraisal.

The mismatch between reward and risk bred a system which placed profit above everything else.[9] Almost all the large banks abused the trust which their customers placed in them (Proverbs 3:29), whether by misselling PPI[10] or other unsuitable products, manipulating LIBOR, Euribor, silver, gold, or foreign exchange rates, or speculating recklessly on property lending or in complex financial instruments of little or no benefit to the real economy. 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.

The rewards seemingly within reach were so tantalising that all of Britain's large building societies (except Nationwide),[11] which historically had a clear remit and which were mutual societies accountable to their members, converted to limited liability companies. Northern Rock, Bradford & Bingley, and all the other ones which did so, had to be rescued when the global financial crisis hit.

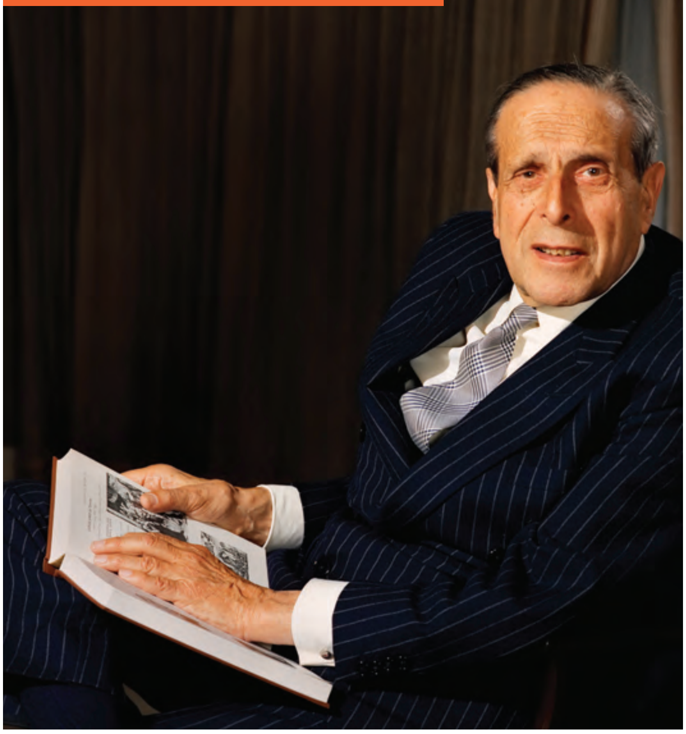
Institutional change: the ethical bank

The consequence of the mismatch between reward and risk, and the ability to trade with the benefit of a government guarantee, was a dramatic change in the culture within banks. Although it was the high street banks which took over the investment banks, the transaction culture of the investment banks came to dominate that of the high street banks as a whole.[12] Customers were no longer seen as valued clients, where the strength of a long-term relationship was key to the bank making good lending decisions and the customer's sense of obligation to repay. Instead, customers were treated as counterparties, parties to be held at arm's length, whose interests were of no concern to the banks once the 'deal' was done. Banks came to believe that they existed to make money in their own right rather than to facilitate other businesses.

Summing up what had happened at Barclays, Anthony Salz reported: '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.'[13] Banks became all about making money *regardless:* without reference to the impact of their activities on their customers, on governments, or on society as a whole. Like Lord Business in *The Lego Movie* (2014), many banks lost sight of the need for their activities to have any higher purpose or to be in service of anyone else.

There was a triumph of contract, which in practice meant the banks' ability to pass risk to others by reducing their legal liability through the imposition of their standard terms and conditions, over the idea of banks as fiduciaries owing a duty to act in the interests of their customers. Banks forgot the wisdom of Sir Siegmund Warburg, founder of the investment bank SG Warburg, who said 'First you make someone your friend, then you become his banker.'

Sir Siegmund George Warburg by Bernard Schwartz



9 The Financial Conduct Authority found, in its Final Notice against Lloyds Bank and Bank of Scotland dated 28 July 2014 §2.14, that at both Lloyds Bank and Bank of Scotland there was 'a culture on the Money Market Desks of seeking to take a financial advantage wherever possible.'

10 Payment Protection Insurance was supposed to make credit repayments if the borrower became unemployed or ill. Many customers were sold PPI without knowing and many customers were not eligible to claim under the policies sold to them.

11 In 1998, Nationwide narrowly defeated a vote to demutualise brought by carpetbaggers (members seeking a windfall payout of up to £1,500) against the wishes of the directors.

12 http://newcityagenda.co.uk/wp-content/uploads/2014/11/Online-version.pdf

13 Anthony Salz, 'The Salz Review of Barclays', April 2013, §2.13. http://online.wsj.com/public/resources/documents/SalzReview04032013.pdf

The effect of this on Western economies over the last decade has been devastating. Businesses with a high level of debt have been the victim of short-term decisions by banks which have forced the business into liquidation in order to strip their assets. RBS's Global Restructuring Group (GRG) has been the most notorious exponent of such practices in the UK but similar approaches have been taken by other banks.

Technological changes, economic theory from the Chicago School of Economics,[14] and the compelling image of Gordon Gekko, the unscrupulous trader played by Michael Douglas in *Wall Street* (1987), all created a generation of financiers who revelled in anonymous or arm's length trading, divorced from economic context and personal relationships.[15]

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. A Christian seeking a career in the financial services sector should look for a firm which has a deserved reputation for high ethical standards and for serving the interests of its customers, which might be a venture capitalist or an insurer rather than a bank.

However, it is difficult for banks behaving differently to win over customers in the banking sector. Statistics show that many of us are unhappy with our bank but we do not switch. The complexity of the technical rules is weighted in favour of the big banks which makes it very difficult for a smaller bank to compete.[16] In banking, it seems, inertia and the structure of the industry prevents banks from winning customers by offering better service.

It is inevitable that banks will fail in future....Financial crises are endemic in any system which produces large banks and relies on debt finance.

Legal change: the regulator defending the public interest

Financial regulators are vulnerable to thinking just like the industry they are supposed to be regulating. This phenomenon is known as 'regulatory capture'. 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'.[17] 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.[18] 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 rulebook, replacing many of the detailed rules with clear principles which bankers are required to internalise and to live by.[19]

The instruments of change

Revoking the government guarantee

The solution to the problem of the government guarantee is to shrink and separate: shrink the size of banks and separate the payment system from their other activities.

Shrinking banks down to size

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.[20] The guarantee is, however, very costly. Reinhart and Rogoff have calculated that, on average, 'government debt rises by 86 per cent during the three years following a banking crisis'.[21]

Cambridge Papers have pointed out on several occasions the Bible's hostility to Empire.[22] There are strong reasons to object to concentrations of power in large banks.[23] In very large organisations it is very difficult for anyone, whether shareholders, directors, regulators, or customers, to know how the organisation is really operating and what is the true level of risk which is actually being taken.[24] It is, however, all too easy for those at the heart of such large organisations to abuse their power, to ignore their responsibilities to anyone other than themselves, and to cause significant harm to others.

It is inevitable that banks will fail in future. In *This Time Is Different*,[25] Reinhart and Rogoff trace 800 years of banking crises to show that financial crises are endemic in any system which produces large banks and relies on debt finance. A financial reformation must make banks safe to fail. As Ian Fraser says: 'The only viable long-term solution for such financial behemoths is to break them up into

14 Eugene Fama's efficient market hypothesis, according to which deregulated markets will produce the most efficient outcomes, regardless of the selfishness of their participants, was described by Will Hutton in 2009 as arguably 'the biggest intellectual mistake … the world has ever witnessed'.

15 David McIlroy, 'From Captain Mainwaring to Gordon Gekko: Why bankers need to be a law unto themselves', *Crucible*, January 2017.

16 The capital adequacy rules often require small banks to hold two or three times as much capital in respect of the same loans as the big banks.

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

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

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

20 David McIlroy, 'Creating Fail-Safe Banks', 2010, *Law and Financial Markets Review* Vol. 4, pp.159–165.

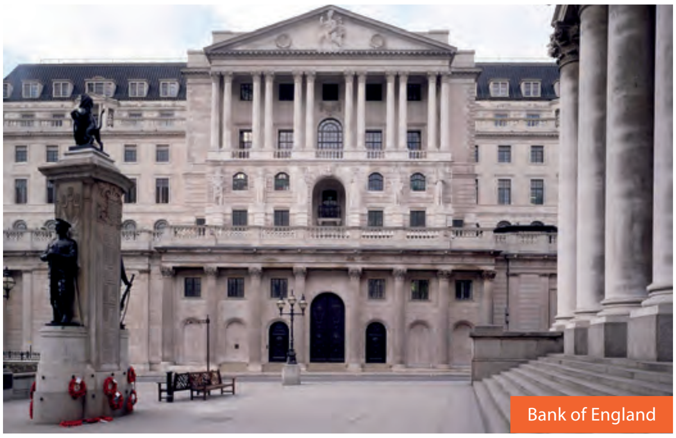
21 Carmen Reinhart and Kenneth Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*, Princeton: Princeton University Press, 2009, p.142.

22 Paul Mills, 'Globalization and the world economy – for richer for poorer, for better or worse?', www.jubilee-centre.org/globalization-and-the-world-economy-for-richer-for-poorer-for-better-or-worse-by-paul-mills/; Julian Rivers, 'The new world order?', www.jubilee-centre.org/the-new-world-order-by-julian-rivers/; Paul Mills and Michael Schluter, 'Should Christians support the euro?', www.jubilee-centre.org/should-christians-support-the-euro/

23 Simon Johnson, 'The Quiet Coup', *The Atlantic*, May 2009, www.theatlantic.com/magazine/archive/2009/05/the-quiet-coup/307364/

24 Stephen Green admitted as much when accused by Margaret Hodge MP of being either 'asleep at the wheel' or involved in the tax-dodging activities of HSBC's subsidiary.

25 Carmen Reinhart and Kenneth Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*, Princeton: Princeton University Press, 2009.


Bank of England

more manageable chunks.'[26] 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.[27]

Separating 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.

Since the global financial crisis, the UK and US have taken a lead in imposing a ring-fence and living wills on banks, which are supposed to isolate the essential services banks provide from losses sustained in the casino, and to make it possible to dismantle a bank in the event of a crisis. However, the measures are not radical enough.[28] The payment system is the utility service which everyone needs. It, and only it, should be within the ring-fence.

It is time to decide what sort of payment system we want: is it a public good[29] or should we seize the opportunity which new technology provides, of returning to more decentralised payment systems which do not depend on banks?[30]

Reforming the banking sector starts with us.... We need to recognise that it is our own ignorance or greed which has fuelled some of the abuses.

Rebalancing risk and reward
Rebalancing risk and reward requires measures which tie reward into long-term performance and reduce banks' ability to use leverage.

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 managers' 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.[31]

Facing up to the problem of interest
Banks are factories of debt. Their activities on the financial markets have been fuelled by debt. In addition to removing the government guarantee, abolishing tax relief on interest payments would reduce the level of speculation. This would rebalance the financial sector away from debt and towards investment. From a relational perspective, investment is preferable to borrowing because investors' incentives are more closely aligned with those of the business than are those of a creditor. The result is that an investor is far more likely to support a business through a difficult period of trading than to take a short-term decision to realise its capital.[32]

Reforming banking culture
Embedded commitment by banks to positive purposes
The Quaker bankers internalised key principles which guided the way they treated their customers. The G30 (an international group of financiers and academics) have called for banks 'to restore the primacy of serving customers to help them achieve their financial goals, and of serving the communities and economies in which they operate.'[33] Achieving such a reformation in the culture in banks will require a definitive commitment to 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.[34]

26 Ian Fraser, *Shredded: Inside RBS: The Bank that Broke Britain*, 2014, Introduction.
27 Guptara, 'Another View: Flaws in the Obama Oversight Plan', available online at http://dealbook.blogs.nytimes.com/2009/06/25/another-views-flaws-in-the-obama-oversight-plan, accessed 1 September 2009.
28 As John Kay observed, 'The sanguine reaction of banks and markets to the … proposal suggests that they do not believe the proposed measures will really make much difference.': 'Why banks' ringfences risk being Chinese walls', *Financial Times*, 14 June 2011.
29 Which could be funded through direct taxation or backed by Treasury bills and a taxpayer guarantee of current account deposits.
30 Bills of exchange used to circulate freely, dependent on the creditworthiness of the payor and not necessarily requiring encashment at a bank. The new possibilities here are explored by Guy Brandon in *Crumbling Foundations: a biblical critique of modern money*, Jubilee Centre: Cambridge, 2016.
31 Peter Boone and Simon Johnson, 'The Next Financial Crisis', 8 September 2009, *The New Republic*, https://newrepublic.com/article/69024/the-next-financial-crisis
32 M. Schluter, 'Beyond Capitalism: Towards a Relational Economy', jubilee-centre.org/beyond-capitalism-towards-a-relational-economy-by-michael-schluter/. See also Michael Schluter, 'Is Capitalism morally bankrupt?', *Cambridge Papers*, Vol. 18, No. 3, Sept 2009, and Andrew McNally, *Debtonator: How Debt favours the few and Equity can work for all of us*, Elliot & Thompson, 2015.
33 G30, 'Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform', July 2015, p.11, http://newsite.group30.org/publications/detail/166.
34 David McIlroy, 'Banking on Ethics: is Greed really Good?', www.theosthinktank.co.uk/comment/2016/09/30/banking-on-ethics-is-greed-really-good.

Responsible customers

Reforming the banking sector starts with us. All of us are customers of banks. We need to recognise that it is our own ignorance or greed which has fuelled some of the abuses. We enjoy the illusion that the payment system is free, but it is not. Banks provide it as a loss-leader, as we pay for it through the provision of the government guarantee and through the financial products and services which banks cross-sell to us. The misselling of PPI and excessive overdraft charges are the true cost of 'free in-credit banking', which we are forcing onto the poor and vulnerable.[35]

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 also need to recognise that the only way in which we can make our treasures on earth fully secure (see Matthew 6:19–20) is if we unjustly force others to take all the risk and bear all the losses. The only just way to use our savings is to invest them, to place our capital at risk in the hope of a long-term reward. We have been seeking to reap where we did not sow (Luke 19:22). We need to rethink fundamentally how we use our money and how our money is used on our behalf.

Conclusion

Reforming the banking sector *is* possible. In the 1930s, even the largest US banks were split in two. Both the USA and Germany have lots of local banks and many people in Ireland are members of a credit union. In 2008, Iceland chose to allow its oversized banks to fail and sent 26 corrupt bankers to jail.[36]

Reforming the banking sector *is* necessary. The enormous sums of money spent by governments on rescuing the banking sector have come at the expense of future generations of taxpayers.[37] That money has already been pledged. All the tools in the toolbox were used to fix the last banking crisis; there is nothing left to fix the next one.

A financial reformation will require radical change: a reduction in the size of banks so that governments have no need to rescue banks and large banks have no competitive advantage as a result; and a separation of payment services from other financial activities. An imposition of extended liability on those who control and profit from banks the most: a thoroughgoing commitment to embedding a culture of service through education, empathy, example and enforcement; and a change to our expectations regarding taxation of interest payments, the sources of finance for businesses, and the choices we make about where to place our money.

David McIlroy, a guest contributor to *Cambridge Papers*, is Visiting Professor in Banking Law at SOAS, University of London, and a barrister at Forum Chambers. He is especially grateful to David Corbett for his research assistance in the preparation of this paper.

35 Simon Read, 'Fairer banking for the hard-up', *Evening Standard*, 16 May 2017, p.41.

36 Ian Birrell, 'Iceland has jailed 26 bankers, why won't we?', The Independent, 15 November 2015, http://www.independent.co.uk/voices/iceland-has-jailed-26-bankers-why-wont-we-a6735411.html

37 In the case of Ireland, the explicit guarantee of all borrowings by Irish banks given by the Irish government on 30 September 2008 amounted to €97,560 per head of the Irish population, more than twice Ireland's gross domestic product!

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