"THE FUTURE OF BANKING STANDARDS AND ETHICS"

Lecture by

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ARCHBISHOP OF CANTERBURY:

First of all, I am very grateful for the invitation from John McFall to speak today and to have the chance to share what I hope will not be too random (they may be slightly random) thoughts about where we have got to and where we are.

I want to go back first of all to just remind ourselves of essentially what the Banking Standards Commission did. It was set up for six months and lasted two years, which was increasingly problematic for those of us who were serving on it all kinds of other things came onto it. It had two crossbench members, one genuine crossbencher and myself, and consisted of five Peers and five Commons.

Very quickly after it began, it was asked to do the pre-legislative scrutiny for the Financial Services (Banking Reform) Bill, and it was described in much less complimentary terms but the politest way of saying it was that it was one of the most complex pieces of legislation that had ever come across the floor of the House of Lords. Those of us who were there remember slogging through that. Most of it was cross references to other Bills. We did the pre-legislative scrutiny for that and that was our first report, which made recommendations to strengthen the proposed legislation as well as suggesting further necessary measures to enhance the stability of the banking system, themes to which I am going to come back.

The second report, *Banking reform: towards the right structure* considered the Government's response to our first report and somewhat unusually it proposed amendments further to improve the Bill in a number of key areas, many of which have now been accepted. The vast majority of those amendments ended up in the Bill.

Our third and fourth reports focused on specific examples of the banking system that were especially concerning, and, again, I will refer back to those later. One of them was a report called *Proprietary Trading*, and we looked at one particular banking activity and its impact on the culture and standards in banks. Proprietary trading is that process of the banks trading entirely for their own book and not for anyone else, not for a client. It was the key thing that Volcker in the States under the Volcker Rule said should not happen in banks that were legislated for and regulated by the central banking authority and in some sense protected by the central banking authority.

We welcomed the breadth of the review into proprietary trading that the Government amendments announced, but I am not sure how much further it has gone, and when I have a look at where we are, that is one of the subjects that is on my mind.

The next report '*An accident waiting to happen': the failure of HBOS* was a real page-turner. It was in fact a real page-turner and I do recommend it as reading, and not just late at night to help you sleep, which I have to say some other bits of the reports could be very useful for. It looked at why HBOS failed and the key thing in that for me was HBOS did not fail because of casino banking but because of bad banking. It did two things that were generally reckoned as errors. It borrowed short and lent long. In other words, it took a very significant amount of its money, over 50% of its deposits came from highly volatile wholesale funds in the money markets, and it lent to commercial property and, secondly, it lent a very large sum of money to people who could not pay it back. If you do that in banking, on the whole you run into a certain amount of trouble. It was a very, very good bit of work, led exclusively by Lord Turnbull, and it got more and more complex as time went on. He started off with a folder under his arm and ended up towing a suitcase everywhere he went with him, and that was an indication of the amounts of paper it generated.

It did not make specific recommendations, but it looked at the impact and the culture of poor banking decisions and the lack of consequences that there were in the banking industry prior to 2008.

The final report - the thick one - *Changing banking for good* outlined the radical reform required to improve standards across the banking industry and presented government, the regulators and industry with a package of recommendations which, taken together, were intended to raise standards and drive positive cultural change, ultimately changing banking for good.

There have been some good developments since then. The vast majority of the legislative recommendations were taken up in one way or another, sometimes after a little bit of debate. Payday lending, which was one of the areas that came out at the time and was referred to in some of the regulatory side, has declined significantly. As you will all know, a very high proportion of payday lenders have not applied for a licence to carry on working and on the other side we see the beginning of movement in credit unions. Of course I am concerned, and this has a lot to do with the future of the City, the future of the financial services industry in this country, that if you knock payday lenders on the head before there is a viable alternative, in many parts of the country, the only place people can go is loan sharks. Those are the criminal lenders as opposed to the payday lenders about whom we may argue amongst ourselves, but I would argue are charging usurious rates of interest but are perfectly legal and overseen. They do not send people round with baseball bats. One of the worries at the moment is if payday lending declines very rapidly and credit unions do not take up the slack, where will people turn? There is a danger of a gap in the market. It is going to take ten years for credit unions to become an effective provider of low-cost funds. They have grown enormously in the last 12 to 18 months but that remains an issue to be faced.

A second development since the report has been a growing focus on shadow banking, which was alluded to in Banking Standards Commission reports but has really become much more something that people are looking at since then. The Governor of the Bank of England yesterday in an article in the *Financial Times*, which bears reading as it is certainly a very striking article, and that he writes so clearly on it, talks about a number of things to do with the shadow banking which, incidentally, were picked up very informatively and well on BBC Radio Four this morning at about 6.20 am. He talks about the need for fire breaks between shadow banking and the main commercial banking industry that shadow banking, by its nature, is an area of significant potential risk and that those firebreaks need to be in place.

That awakens echoes of one of the problems that we were looking at on the Banking Standards Commission which is the cross-contamination of cultures. The culture of banking became contaminated in commercial banks which were the ones that ran into the most serious trouble and caused the most fear and most disruption in the markets through the impact of the culture of the investment banks. We do need to pay attention to that. When Volcker himself gave evidence to the Commission, I think John would agree, it was one of the most memorable moments of the entire thing. It was a magisterial look at 60 years of the banking industry. He was the one who spoke of cultural contamination as one of the biggest risks around. Cultural contamination is not something you deal with particularly by regulation, but the whole idea of the ring-fence, of separating investment and commercial banking, of the plain vanilla banking being protected from other influences, arose out of that evidence on cross-contamination. Mark Carney yesterday raised this issue again implicitly in his excellent article in the *Financial Times*.

He wrote secondly about the need for resilience in shadow banking. Banking, as we know, is all about confidence. No bank can pay its depositors back, that is an old fact; it relies on sufficiently few asking for their money at any one moment that nobody knows there is a problem. If confidence breaks - and a break in confidence in shadow banking would certainly be infectious across the entire financial services industry - you get back into the situation we faced in 2008 with perfectly safe organisations like money market funds seeing runs because of the general fear in the markets. Mark Carney raises this very effectively. He talks about the old demons rising from the deep - that is my phrase, not his - but of incentives, liquidity and margins that admit the need for a framework that is sufficiently flexible to monitor new forms of banking. This picks up something that was key to the Banking Standards Commission report, which is the markets will always move faster than the regulators; always, and therefore regulation has to be immensely flexible and quick on its feet. You cannot put a structure in place and say that is that; we have buttoned that down, we have sorted it out. It will not work. This new interest in shadow banking amongst regulators illustrates exactly that point and calls for a framework that can monitor emerging alternative sources of finance as much as existing established ones.

In the Financial Services Act, which set up the present regulatory system a year earlier, there were amendments brought forward particularly to deal with the regulation of direct person-to-person lending intermediated through the Web and that was a very good example of something that has grown immensely rapidly but still lacks effective oversight and regulation.

There have been a number of what I am going to rather rudely describe as - am I? I always get into trouble when I do this - challenges, I am not going to be so rude, challenges in the regulatory system and across the process. I want to pick up on three or four particularly. First of all, leverage and capital adequacy. Leverage is the very quick and dirty calculation of the amount of equity there is to the amount of debt there is in a bank. At one point in one of the major banks, RBS in early 2008, it had 2% of capital to 98% of debt. That means you make a very small mistake and you are bust; if you make a big mistake, you are very, very, very bust. Lehman was geared at 1% to 99% when it failed. The Banking Standards Commission recommended 4%. The banking industry pushed very hard and the Government settled on 3%.

Many of us on the Banking Standards Commission felt that was too low and continue to feel it is too low. Pressure from the banking industry in the European system within the Eurozone has overturned the recommendations in the Liikanen Report and again there has been a push back on the level of leverage. Banks in the UK at the moment are running at around 3.5%-4%. In the States they are talking about aiming for 5%-6%. The economic impact of that is obviously to restrict the banks' appetite for lending. They have to have more capital. They can either do it by raising more capital, which is quite difficult, or by reducing their loan book. Those are the only two ways in which you do it. Reducing your loan book, if you have a fixed amount of capital that you have to have, you may as well make the most you can from it so necessarily you lend to the high-risk/high-return clients and particularly mortgages get squeezed. It is a conundrum.

The alternative under Basel III is weighted capital adequacy ratios in which different categories of asset are ascribed different levels of capital so the very high risk get very high levels of capital and the low risk get much lower ones. Mortgage would get very little. There are two problems with that. First of all, categories do not work very well. In 2010 loans to Greece were ascribed the same risk category as loans to the UK Government or the US Government, which clearly the markets would not have entirely agreed with.

Secondly, our investigations in the Banking Standards Commission showed that there was a total mismatch between different banks weighting of how they defined into which category of capital weighting banks put their assets. The banks did it on an internal black box system. The regulators accepted the black box. There were not nearly enough regulators to audit the entire system. You would basically have had to have loan monitoring groups in each bank as big as the banks' own loan monitoring group to keep up with what was going on. The result was the weighted capital adequacy was completely inadequate as an effective objective measure of the safety of banks.

Thus you had these two. You have the more sophisticated one which is difficult to trust because you are not quite sure what is going on and you have the less sophisticated one that drives people to make riskier loans in order to make more money. We did not square that circle, but I want to signal it and that it has not been dealt with. Underlying that as well is pressure on the ring-fence. One of the things we forecast at the time is that there would be pressure on the ring-fence with banks saying we want more activities within the ring-fence and fewer activities outside the ring-fence, not always for the good of the client necessarily. Funnily enough, when I was Group Treasurer of an oil company I never remember it being particularly difficult to call two separate banks to get different services but maybe life has got more complicated. That pressure on the ring-fence is showing itself particularly in the United States and in Europe. I am less aware of evidence here. There is evidence of it in the United States with pressure through the lobbyists in the Congress and in Europe, to which I have already referred, with pressure on the Commission.

All that links in to the elephant in the room which we have not dealt with and show no signs of dealing with which is "too big to fail". The trouble with too big to fail is that it is also too big to regulate. For me, along with Volcker, the other most memorable moment - and I do not know if John remembers it as well as I do - was a former chairman of UBS, a clearly broken man, with a deep sense of personal failure over what he had done as UBS ran into trouble, someone you could not accuse of not taking responsibility; if anything he had taken far too much. We very deliberately did not push him hard. I felt a deep sense of regret at seeing someone so talented who clearly was so shattered by the events, but I asked at one point that as we all do, and I expect everyone in this room does from time to time, when you have had a failure - and I have had many - you wake up in the night and you think, “If only I had done this; if only I had done that”, what did he think, and he said, “To keep it simple”. His memorable answer was you can have a big simple bank and run it well or a small complex bank and run it well. You cannot have a big, complex bank. For me it was one of the great openings that changed my mind about how the report should go.

Too big to fail is about that. If it is too big to manage, it is too big to regulate. If it is too big to fail, it will be too big to manage. The figures we have - and I am going back probably six months here so I have not seen anything more recent - is the estimated subsidy to the banking system in terms of the implicit guarantee by the British Government on the major banks is, by the banks’ own calculations, worth about £25 to £30 billion a year. Imagine what that would do in any other industry in this country. It has to be there because we cannot afford a bank to go under because it would take everything else with it. Failure is ultimately contagious. I think that we have still really not dealt with too big to fail. I think it is going to take a lot longer, but my hope would be that it is a problem that remains front and centre in people’s minds. You will never stop banks failing. Disasters will happen. We saw that with the Co-op. The issue is not how you stop it, because in the end you will not, it may take 20 or 30 years but when it happens, it happens, and the impact of financial failure, as we see today is a much longer time before economies return to proper progress. Confidence is much more affected than raw economic production and output. A failure of confidence subverts everything else you do and is intangible. I think that is the big issue. I am not sure we have cracked how we should do it. There are different political views on breaking up banks, all kinds of things. I am not commenting on that. We can discuss it in the Q&A. In the struggles, so not failures, not successes, but the struggles as to where I see we are now in terms of building a healthy City in the future, the culture and wealth culture continues to be a major challenge.

I was talking to the head of a major bank, not a British bank, a foreign bank 11 months ago last summer and he very kindly had given me a drink and it was in the evening and *in vino veritas* sort of stuff and he said, “Well, you know the culture has changed completely. Do you know we have scarcely got anyone in this bank paid more than £3 million a year”! I can tell you at the Church of England we have almost no vicars in ordinary parishes paid more than £22,000 a year. I do not know what he would say to that. It would be a rounding error! Few people paid over £3 million a year. That says something about the wealth culture because these are not entrepreneurs who have invented their own companies; these are managers, and it is a very different game. To build up something yourself, the Googles of this world, the Microsofts, the JCBs, that kind of thing, I think that is worth a huge amount; you have changed the world. A manager is a very important job, a manager of a bank is an incredibly responsible job, but it is not quite the same thing. All the big banks are still struggling with this, as we know, from the news over the last few months, particularly around bonuses. I want to say very deliberately they are struggling with it despite the courageous and determined efforts of their chief executives. I have spent a lot of time with some of the chief executives over the last few months and I am quite genuinely convinced of their determination to change the culture of their banks, but it is a very long-term and very, very difficult process indeed. If you have 30% of your profits coming from investment banking, it is difficult simply to say we are going to change our salary structure so it does not reward investment banking. It is very difficult to do that and it has considerable dangers for the future of your organisation.

But, as time goes by, and we are now 2014, it is six years since the crisis, and in many dealing rooms, fewer than half of the dealers will have been in post the last time there was a major run on the bank, and that has a massive effect on culture. As time goes by the impetus for cultural change diminishes. Over the last couple of years an enormous amount of parliamentary time has been spent deliberating the legislative response to the financial crisis, the worst in living memory and one we are still living with, our economy has recovered to where it was in 2007 and thank heavens is going well and that is a wonderful bit of news, in terms of total GDP, but it has taken far longer to get back there than it did after 1929. The reason for that is that 1929 was an economic crisis and this is a financial crisis.

I come back to my point about confidence, and confidence comes back to culture, and although we have made significant progress on the structural and regulatory aspects of banking reform, with the exceptions of the ones I have referred to, at the time of the report, one of the things that a number of us were saying was that if we think that by changing the law we have solved the problems we are profoundly mistaken. Moses tried it and it did not work then and it has not worked well since. Indeed, more often than not, and I am aware I am saying this to a bunch of legislators, the most difficult things to legislate for are the most important, if we want to see radical transformation. It is for that reason that I want to conclude by going back to the process of values-based vision.

I am sure that hearing a clergyman suggesting that business decisions should be led by values is not a huge surprise - at least I hope it is not - but I want to suggest that the values we are talking about are not those of the *Vicar of Dibley* or *Postman Pat* vicar, Reverend Green I think it was. The "wouldn't it be nice if we were nicer" kind of approach. I am not talking about values in that sense. I am talking about the kind of values that have to be intrinsic in the way a society and an economy works, based on substantial and substantive research and on philosophical - and you would expect me to say this - and theological interrogation about the kind of social system we want, which for me comes back to what I would call Christian social teaching.

Having seen first-hand what happens when a country develops a monocrop economy during my many visits to the oil regions in Nigeria and very strong knowledge of Nigeria, I know and we all know that one industry, even financial services, cannot carry an economy on its own, but we remain in an economy where the veins and arteries are somewhat clogged. The money is not flowing as it should, savings have not risen as they could and particularly the most productive area of many European economies, particularly in Germany, the small and middle-sized companies is still struggling to raise long-term and secure capital. That is a failure of our financial markets, and what is more important is it has a deep impact on the way in which our society works because it makes us far too reliant on far too narrow a base.

For that reason I am very supportive, as has been said before, of the work being done by Sir Richard Lambert on trying to create a new culture. I am going to finish in one minute with a final suggestion just to make myself look suitably stupid: what is needed? A third approach other than raw markets or the utopianism into which we often decline.

A quote from a book written by a friend of mine called Paul Dembinski and another Italian economist, both of them Catholic, called Simona Beretta, says this:

"Between the idealistic ideas of 'spontaneous markets' and the 'spontaneous strive for the Common Good' [ie raw markets and utopianism], a third, intermediary position appears as a realistic avenue. The crisis has shown that mitigation of systemic risk requires both elements: the external discipline of markets and law, and a high moral stance and self-restraint of actors. In the years preceding the financial crisis, both elements were largely missing."

Writing in 1948, François Perroux, an overtly Christian French economist, identified that capitalism in the sense of the free market economy is not self-sufficient and needs to be supported by a moral framework which it will, paradoxically, tend to destroy. That is the key point. Perroux warned about this paradox which he saw as a congenital weakness of capitalism.

All parts of the City still accept a values-based agenda on the idea of the general interest rather than the common good. General interest is the aggregation of all individual self-centred interest, but of those who are participants in the economy, and it is part of classic economic theory, that means it excludes the 50% who are not part of what is crudely called the contributing part of the economy. Acceptance that there is enough, acceptance of an economy that there is such a thing as enough, a high enough profit, and above that is the duty of gratuity is one of the things argued for both by the previous Pope and the present one. It is the basis for trust and trust is the basis for safe contract and effective reciprocity in the markets.

I was hearing this morning from someone who quoted at me Rockefeller. When asked how he had become the richest man (allowing for inflation) in human history and what he saw as "enough" he said "always a little bit more". I countered that with NM Rothschild who was asked how he had made all his money and why he was so successful and he said "I always left something on the table". Which is most likely to lead to a moral society, a society in which you can trust contract?

St John Chrysostom said this in Constantinople in the Fourth Century:

"Not to share one's wealth with the poor is to steal from them and take away their livelihood. It is not our own goods which we hold, but theirs."

And finally Pope Francis in *Evangelii Gaudium*, paragraph 58:

"A financial reform open to such ethical considerations would require a vigorous change of approach on the part of political leaders. I urge them to face this challenge with determination and an eye to the future, while not ignoring, of course, the specifics of each case. Money must serve, not rule!"

Thank you.

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