Mark Carney: Rebuilding trust in global banking

Remarks by Mr Mark Carney, Governor of the Bank of Canada and Chairman of the Financial Stability Board, to the 7th Annual Thomas d'Aquino Lecture on Leadership, Lawrence National Centre for Policy and Management, Richard Ivey School of Business, Western University, London, Ontario, 25 February 2013.

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Introduction

Six years ago, the collapse of the global financial system triggered the worst global recession since the Great Depression.

Losing savings, jobs, and houses has been devastating for many. Something else was lost – trust in major banking systems. This deepened the cost of the crisis and is restraining the pace of the recovery.

The real economy relies on the financial system. And the financial system depends on trust. Indeed, trust is imbedded in the language of finance. The word credit is derived from the Latin, *credere*, which means "to have trust in." Too few banks outside of Canada can claim credit today.

Bonds of trust between banks and their depositors, clients, investors and regulators have been shaken by the mismanagement of banks and, on occasion, the malfeasance of their employees.

Over the past year, the questions of competence have been supplanted by questions of conduct. Several major foreign banks and their employees have been charged with criminal activity, including the manipulation of financial benchmarks, such as LIBOR, money laundering, unlawful foreclosure and the unauthorized use of client funds. These abuses have raised fundamental doubts about the core values of financial institutions.

In my remarks today, I will discuss the breakdown of trust and what is required to rebuild it. The G-20's comprehensive financial reforms will go a long way but will not be sufficient.

Virtue cannot be regulated. Even the strongest supervision cannot guarantee good conduct. Essential will be the re-discovery of core values, and ultimately this is a question of individual responsibility. More than mastering options pricing, company valuation or accounting, living the right values will be the most important challenge for the more than one-third of Ivey students who go into finance every year.

Trust is strained at multiple levels

Between banks and their shareholders: Most major banks outside Canada are now trading well below their book value, indicating shareholder concerns about a combination of the quality of bank assets and the value of their franchises (***Chart 1***).

Between banks and their debt-holders: Bank credit ratings have been downgraded, and even the revised ratings reflect continued reliance on sovereign backstops (***Chart 2***).

Between banks and their supervisors: For too many institutions, concerns over competence, conduct and, ultimately, culture have fed supervisory concerns and built the political case for structural measures, such as ring fencing, or prohibiting certain activities, such as proprietary trading.

Between supervisors in advanced economies: Fearful that support from parent banks cannot be counted upon in times of global stress, some supervisors are moving to ensure that subsidiaries in their jurisdictions are resilient on a stand-alone basis. Measures to ring fence the capital and liquidity of local entities are being proposed. Left unchecked, these trends could substantially decrease the efficiency of the global financial system. In addition, a more balkanized system that concentrates risk within national borders would reduce systemic resilience globally.

Between emerging and advanced economies: Given that the crisis originated in the advanced economies, the incentives for emerging and developing economies to ring fence their financial systems are particularly pronounced. This has been, at times, supplemented by more active management of capital inflows, further fragmenting the global system.

Finally, and most fundamentally, there has been *a significant loss of trust by the general public in the financial system*. There is a growing suspicion of the benefits of financial deregulation and cross-border financial liberalisation, a suspicion that could ultimately undermine support for free trade and open markets more generally.[1]

The costs are potentially enormous

A global system that is nationally fragmented will lead to less efficient intermediation of savings and a deep misallocation of capital. It could reverse the process of global economic integration that has supported growth and widespread poverty reduction over the last two decades.

Within economies, the hesitancy of firms to invest reflects in part low confidence that their banks will be there to provide credit through the cycle.

Reduced trust in the financial system has increased the cost and lowered the availability of capital for non-financial firms. The massive response of central banks has provided some offset but access to credit remains strained.

Consider fractional reserve banking, which allows banks to transform savings into investments, driving growth and wealth creation. At its core, such banking relies on the trust of depositors, bonds of trust that are so vital they have been reinforced by the state through deposit insurance and supervisory oversight.

In turn, the trust between financial counterparties multiplies base money created by the central bank many times, creating an aggregate credit supply that finances our modern economy.

When trust in the system is lost, this process reverses. Depositors and investors become reluctant to provide funding to banks, banks to lend to other banks, and, in some of the most affected countries, both are sceptical of the ability of governments to backstop the system.[2]

Since the crisis, money multipliers have plummeted in the crisis economies. In the United States and European Union, the ratio of M2/M0 fell by 55 and 40 per cent, respectively, between 2006 and 2012. While some of the decline reflects the end of excess and the weakness of credit demand in a deleveraging economy, the magnitude of the decline indicates the extent to which trust has been shaken. In contrast, in Canada, where trust in the system has, if anything, increased, the ratio has risen by 22 per cent (***Chart 3***).

Rebuilding trust: the Five Cs

So what to do? A combination of institutional and individual initiatives – the "Five Cs" – is required.

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[1] See also "The Financial Crisis Inquiry Report: The Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States," Financial Crisis Inquiry Commission, January 2011.

[2] This skepticism is in part related to the fiscal and sovereign debt situations in some of the affected countries.

The G-20's comprehensive financial reforms will go a long way to rebuild trust. The good news is that there has been progress, even if it is not yet fully reflected in market valuations or public attitudes.

Capital

Many people remember the pivotal moment when Lehman Brothers collapsed, but that was only one example of a widespread failure of banking models across the advanced economies.

That same year, major banks in the United States, the United Kingdom, Germany, France, Ireland, Switzerland, the Netherlands and Belgium either failed or were rescued by the state. Gallingly, on the eve of their collapse, every bank boasted of capital levels well in excess of the standards of the time.

So it should be no surprise when building a more resilient system, the first priority was to strengthen the bank capital regime. Through higher minimums, surcharges for systemically important banks, countercyclical buffers and tougher definitions of capital, the largest banks will have to hold at least seven times as much capital as before the crisis.

As a backstop to the risk-based capital framework, a simple, but effective leverage ratio has been imported from Canada. It protects the system from risks we might think are low but in fact are not.

Since the end of 2007, major banks in the United States and Europe have increased their common equity capital by $575 billion and their common equity capital ratios by 25 per cent.

Canadian banks are setting the pace. Since withstanding the financial crisis, they have become considerably stronger. Their common equity capital has increased by 77 per cent, or $72 billion, and they already meet the new Basel III capital requirements six full years ahead of schedule.

Clarity

Greater clarity, the second "C," is critical to well-functioning capital markets.

In the run-up to the crisis, financial institutions became increasingly opaque. Their balance sheets were stuffed with mark-to-model assets, massive undisclosed contingent exposures, and debt classified as regulatory capital. Annual reports ran over 400 pages in some cases, leaving investors exhausted but no better informed.

In the past few years, there have been some improvements, including better accounting for off-balance-sheet securitisations, and enhanced disclosures of credit risk and the transfers of financial assets.

Encouraged by the G-20, U.S. and international accounting standard-setters have made progress toward a single set of high-quality reporting standards, particularly in the areas of revenue recognition and asset valuation.

But more is required. The two boards have not yet been able to agree on a common approach for asset impairment based on expected, rather than incurred, losses. The G-20 has now called on them to redouble their efforts.

One of the most important initiatives to improve clarity is the work of a private sector group, the Enhanced Disclosure Task Force (EDTF), which was formed at the encouragement of the Financial Stability Board (FSB).[3] It has made a series of recommendations to improve annual financial reporting by banks based on seven principles. Disclosures should be clear,

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[3] "Enhancing the Risk Disclosures of Banks," Report of the Enhanced Disclosure Task Force (29 October 2012).

comprehensive, relevant, consistent, comparable, and timely. Finally, annual reports should explain how risk is actually managed.

Once adopted, enhanced disclosure will contribute to effective market discipline, better access to funding, and, importantly, improved market confidence in banks.

The Bank of Canada joins the Office of the Superintendent of Financial Institutions in encouraging major Canadian banks to implement the EDTF standards as soon as is possible.

Better disclosure of a bank's current financial condition can be usefully supplemented by regular assessments of the impact of stress on it. Stress tests can expose excessive mismatches in maturities and currencies, find evidence of undue forbearance in lending and reveal excess or correlated asset concentrations. In the current environment, the FSB has emphasised particularly the value of stressing against sharp movements in yield curves.

Capitalism

Perhaps the most fatal blow to public trust has been the perception of a heads-I-win-tails-you-lose finance. Bankers made enormous sums in the run-up to the crisis and were often well compensated after it hit. In turn, taxpayers picked up the tab for their failures. Thus, at the heart of financial reform must be measures that restore capitalism to the capitalists.

To that end, the FSB is enhancing the role of the market. The measures to improve clarity will enhance market discipline.

The development of effective resolution tools will also help diminish the moral hazard associated with "too big to fail." The FSB has identified those banks that are systemically important at the global level and developed a range of measures that, once implemented, will help to ensure that any financial institution can be resolved without severe disruption to the financial system and without exposing the taxpayer to the risk of loss.

The knowledge that this could happen should enhance market discipline of private creditors who previously enjoyed a free ride at the expense of taxpayers.

While solid progress has been made it is not yet mission accomplished. In the coming months, jurisdictions need to articulate comprehensive plans to resolve each systemic institution. These should include effective cross-border agreements for handling a failure and, a minimum amount of bail-inable liabilities and the publication of a presumptive path for resolution.

To take stock, the FSB will report to the G-20 leaders at the St. Petersburg Summit on the extent to which "too big to fail" has been ended and, if not, what further steps are required.

Connecting with clients

Financial capitalism is not an end in itself, but a means to promote investment, innovation, growth and prosperity. Banking is fundamentally about intermediation – connecting borrowers and savers in the real economy. Yet, too many in finance saw it as the apex of economic activity.

In the run-up to the crisis, banking became more about banks connecting with other banks. Clients were replaced by counterparties, and banking was increasingly transactional rather than relational.

These attitudes developed over years as new markets and instruments were created. The initial motivation was to meet the credit and hedging needs of clients in support of their business activities. However, over time, many of these innovations morphed into ways to amplify bets on financial outcomes.

An important example of a useful, but eventually misused, innovation is securitisation, which initially provided funding diversification for banks while spreading risk among investors with different load-bearing capacities.

However, in the run-up to the crisis, highly complex chains developed, linking low-risk money market funds with high-risk subprime mortgages via off-balance-sheet structured investment vehicles (SIVs). Banks sold mortgages into the SIVs and many of the SIVs in turn wrote credit insurance contracts, often to the very banks that sponsored them, to “insure” the bank’s proprietary credit positions.

These links with banks were simultaneously too weak and too strong. The shift of credit exposure from originating bank to the SIV eroded underwriting and monitoring standards.

In addition, the transfer of risk itself was frequently incomplete, with banks retaining large quantities of supposedly risk-free senior tranches of structured products. Moreover, the insurance provided by the SIV was only as good as the quality of the mortgages bought by the bank. These dynamics were at the heart of the Canadian non-bank asset-backed commercial paper fiasco.

Similarly, the rapid expansion of banks into over-the-counter derivatives was initially motivated by the desire to provide hedges to their clients as end-users. These transactions eventually morphed into a mountain of intra-financial system claims, largely divorced from end-users, with banks and other financial entities trading among themselves.

The magnitude of these developments was remarkable. In the final years of the boom, the scale of shadow-banking activity exploded. The value of structured investment vehicles, for example, almost tripled in the three years to 2007. Credit default swaps grew sixfold over the same period.

As intra-financial sector claims grew, banks became increasingly detached from their ultimate clients in the real economy. In most professions, people see the ‘real’ impact of their work: teachers witness the growth of their students, farmers that of their crops. When bankers become disconnected from their ultimate clients in the real economy, they have no direct view of the impact of their work. The LIBOR-setter sees only the numbers on the screen as a game to be won, ignoring the consequences of his or her actions on mortgage-holders or corporate borrowers.

Fortunately, there are some signs that global banks are returning to their roots. Complex securitisation chains have dissolved. Mechanistic reliance on credit ratings is declining. With higher capital requirements on trading activities (and the prospect of structural restrictions), traditional lending is looking more attractive. These shifts will promote diverse private sector judgments, reduce cliff effects and build resilience, and possibly over time, a measure of trust.

But there arguably has not yet been a full recognition of the need for banks to return to what Ed Clark calls “old fashioned banking – activities that help grow their country and communities.”[4] To do this, some banks may need to reconsider their values.

Core values

The fifth “C” – core values – is the responsibility of the financial sector and its leaders. Their behaviour during the crisis demonstrated that many were not being guided by sound core values.

Many in the wake of the crisis looked first to how compensation affects behaviour. Indeed, an important lesson was that compensation schemes that delivered large bonuses for short-

[4] E. Clark, “Building a Better Banking System for America” (speech to Chief Executives’ Club of Boston, Boston College, Boston, MA, 26 April 2012).

term returns encouraged individuals to take on too much long-term and tail risk. In short, the present was overvalued and the future heavily discounted.

To better align incentives with long-term interests of the firm and, more broadly, society, the FSB developed *Principles and Standards for Sound Compensation Practices*. Core elements include deferred variable performance payments, paying bonuses in stock rather than cash, and introducing bonus clawbacks.

Of course, no compensation package can fully align the incentives of a bank's shareholders and its risk-takers. Even if such a package could be devised it would not internalise the impact of individual actions on systemic risks, including on trust in the banking system.

More fundamentally, to think that compensation arrangements can ensure virtue is to miss the point entirely. Integrity cannot be legislated, and it certainly cannot be bought. It must come from within.

Purely financial compensation ignores the non-pecuniary rewards to employment, such as the satisfaction received from helping a client or colleague succeed. When bankers become detached from end-users, their only reward is money, which is generally insufficient to guide socially useful behaviour.[5]

Few regulators and virtually no bankers saw these limitations. Beliefs in efficient, self-equilibrating markets fed a reliance on market incentives that entered the realm of faith.[6] As Michael Sandel has observed, we moved from a market economy towards a market society.[7]

This reductionist view of the human condition is a poor foundation for ethical financial institutions needed to support long-term prosperity.

To help rebuild that foundation, bankers, like all of us, need to avoid compartmentalisation or what the former Chair of HSBC, Stephen Green, calls "the besetting sin of human beings."[8] When we compartmentalise, we divide our life into different realms, each with its own set of rules. Home is distinct from work; ethics from law.

In the extreme, as Ed Clark observed, "Bank leaders created cultures around a simple principle: if it's legal and others are doing it, we should do it too if it makes money. It didn't matter if it was the right thing to do for the customer, community or country."[9]

To restore trust in banks and in the broader financial system, global financial institutions need to rediscover their values. This was the conclusion of research conducted here at Western.[10]

For companies, this responsibility begins with their boards and senior management. They need to define clearly the purpose of their organisations and promote a culture of ethical business throughout them.

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5 R. Rajan, "When Money Is the Measure of All Worth," in *Fault Lines: How Hidden Fractures Still Threaten the World Economy* (Princeton,N.J.: Princeton University Press, 2010).

6 T. Padoa-Schioppa, "Markets and Government Before, During, and After the 2007-20XX Crisis," (Per Jacobsson Lecture, 27 June 2010, Basel, Switzerland).

7 Michael J. Sandel, *What Money Can't Buy: The Moral Limits of Markets* (New York: Farrar, Straus and Giroux, 2012).

8 S. Green, *Good Value: Reflections on Money, Morality and an Uncertain World* (London: Allen Lane 2009).

9 E. Clark (remarks delivered at the Bank of Canada Annual Economic Conference, "Financial Intermediation and Vulnerabilities," Ottawa, 2 October 2012).

10 J. Gandz, M. Crossan, G. Seijts, and C. Stephenson, "Leadership on Trial: A Manifesto for Leadership Development," Richard Ivey School of Business, 2010.

But a top-down approach is insufficient. Employees need a sense of broader purpose, grounded in strong connections to their clients and their communities. To move to a world that once again values the future, bankers need to see themselves as custodians of their institutions, improving them before passing them along to their successors.

Conclusion

It has been said that, "trust arrives on foot, but leaves in a Ferrari."[11] After the Ferrari screeched out of the parking lot in 2008, what steps have been taken to rebuild trust?

There has been progress. As the new Basel capital rules are implemented, and the reliance on ratings agencies diminishes, market infrastructure improves; and as banks – and, crucially, their investors – develop a better appreciation of their prospects for risk and return, business models are beginning to change.

Already, a couple of banks have fallen off the list of globally systemic banks because they have simplified, downsized and de-risked their business models. Other institutions are de-emphasizing high-profile but risky capital markets businesses that benefited employees more than shareholders and society.

Global banks have made significant progress in reforming their compensation practices so that rewards more closely match risk profiles. In addition, boards of directors and risk committees are taking more responsibility to ensure that remuneration packages and employee behaviour are aligned with updated institutional cultures.[12]

Unfortunately, a spate of conduct scandals ranging from rigging LIBOR to money laundering has overshadowed these steady and material improvements.

This underscores that it remains the collective responsibility of banks, regulators and other stakeholders to rebuild trust in banking. Banks need to participate actively in reform, not fight it. Until recently, too few bankers acknowledged their industry's role in the fiasco. The time for remorse is far from over.

At the same time, the public sector needs to be more vocal and appreciative when the industry makes major contributions. This has been the case with the EDTF and in work on bail-in debt, a key element of ending "too big to fail." In addition, the best global organisations are now recognising the need to address their corporate ethics. All of these efforts should be publicly encouraged and reinforced.

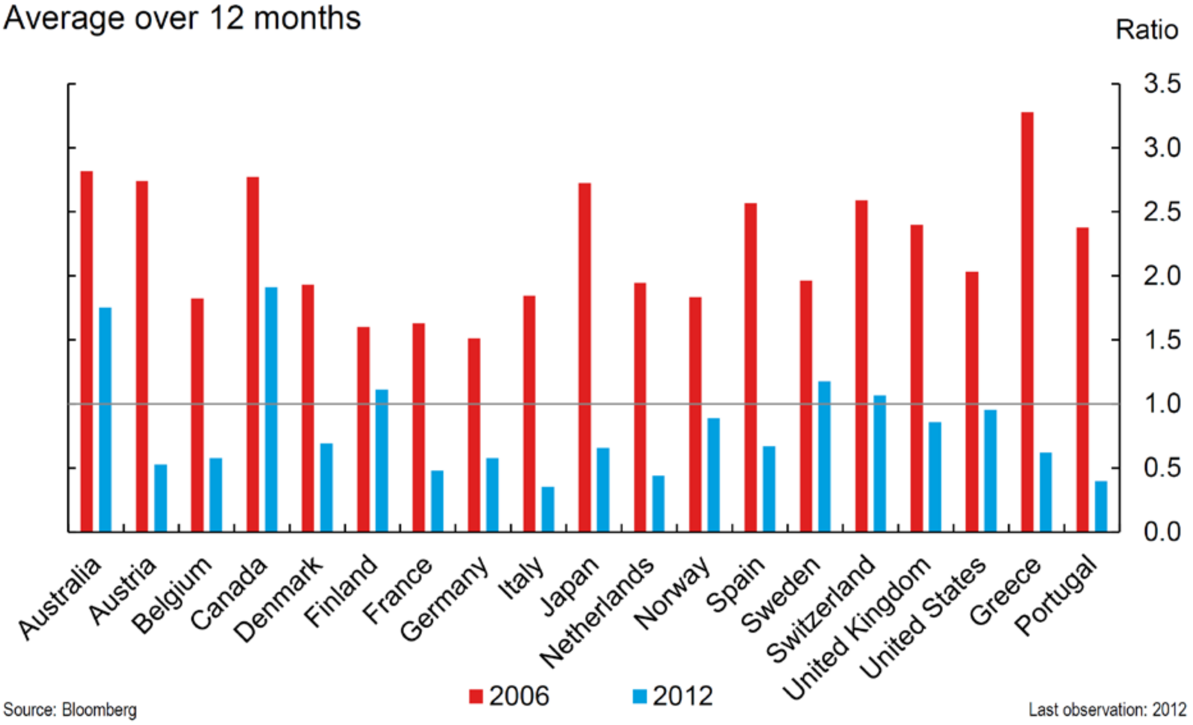
Ultimately, it will be down to individual bankers, including the Ivey grads who will go into finance. Which tradition will you uphold? Will your professional values be distinct from your personal ones? What will you leave those who come after you?

[11] R. Sermon, "Investing in Integrity" (speech to the Trust and Integrity in the Global Economy Conference, Caux, Switzerland, 19 July 2012).

[12] See a summary of a recent FSB workshop with the financial industry on compensation practices, and the most recent FSB peer review of compensation practices.

Chart 1: Banks' price-to-book ratios

Average over 12 months

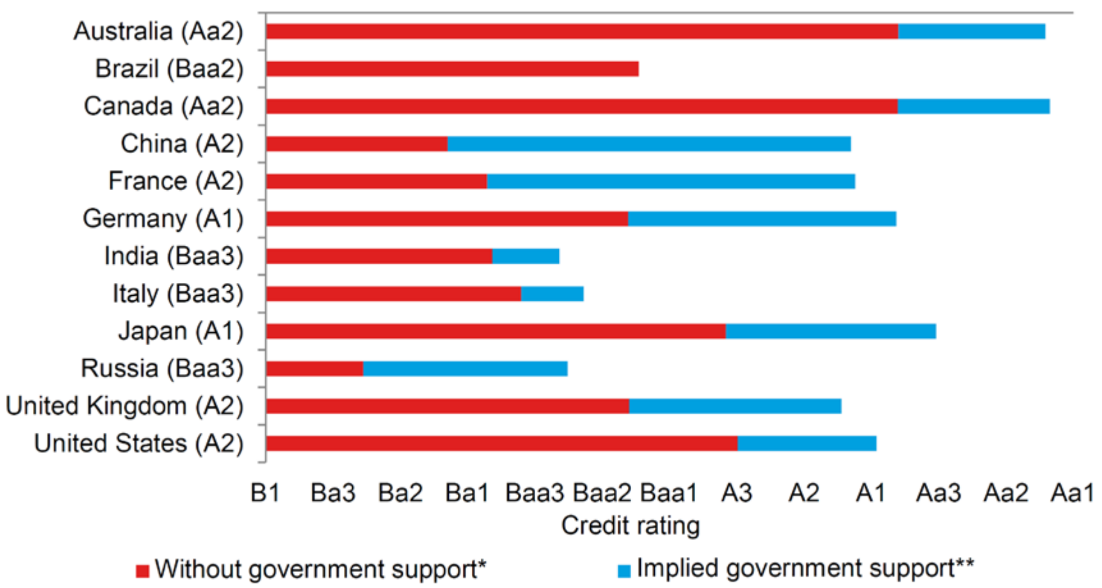


Source: Bloomberg

Last observation: 2012

Chart 2: Level of implied government support

Difference between baseline credit assessment and final rating, including likelihood of sovereign support

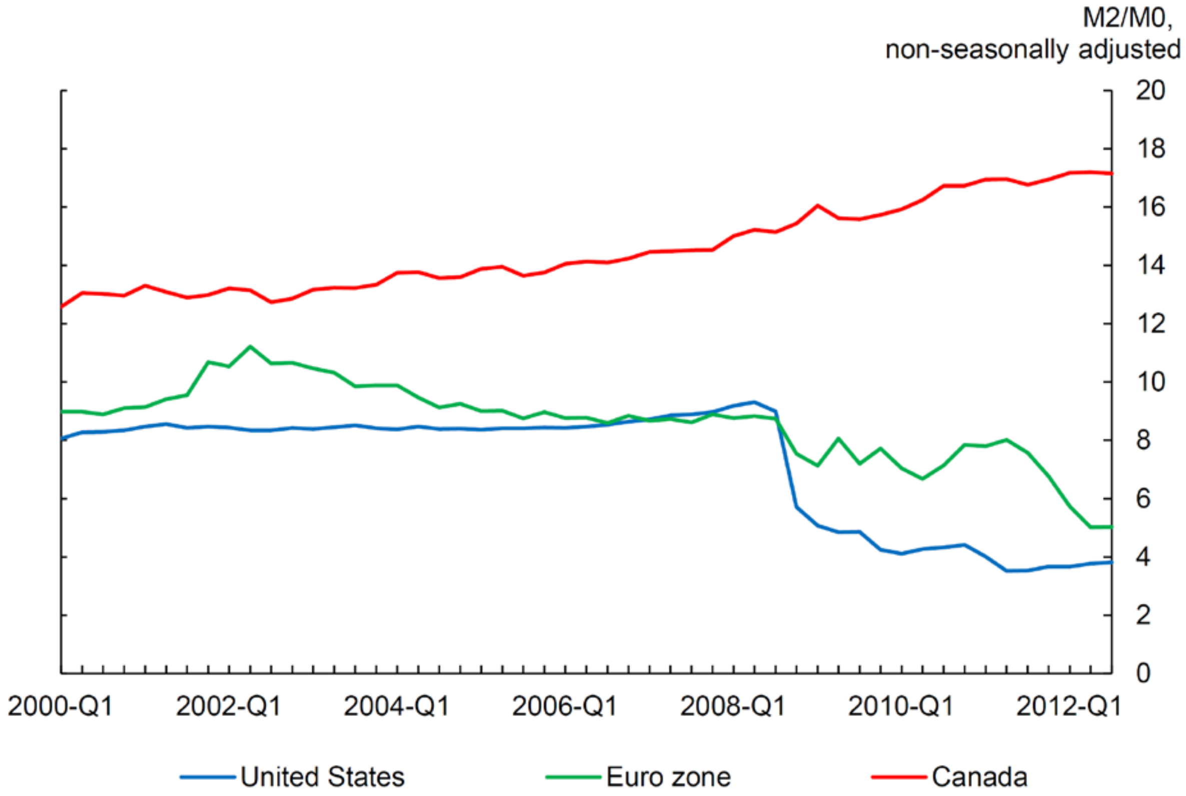


Note: *baseline credit assesment, ** weighted average parental, COOP and regional government support

Source: Moody's

Last observation: 5 February 2013

Chart 3: Money multiplier



Source: Haver Analytics

Last observation: 2012Q3