Andrew G Haldane: A leaf being turned

Speech by Mr Andrew G Haldane, Executive Director, Financial Stability, Bank of England, to Occupy Economics, "Socially useful banking", London, 29 October 2012.

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The theme for tonight is "Socially Useful Banking". And what better place to discuss it than tonight's venue – the main meeting hall of The Friend's House, traditionally the venue for the annual meeting of the Quakers.

The Quaker movement famously gave us two of the UK's largest banks, Lloyds and Barclays. Between them, these banks have almost 600 years of history. For most of that period, no-one questioned their social usefulness. They extended loans to businesses and helped families buy homes. Nationally and regionally, they were part of the social fabric. Today, that fabric is torn.

As the CEOs of these two institutions have both recently said, these banks need to rediscover their social usefulness. But this is not only a question for the banks. It is a key issue for wider society too, who have after all felt the financial consequences of banks' failings and failures. What do we want our banking system to ***do***? And how do we ***create*** that system?

This is where Occupy enter the picture. It is now over a year since the Occupy movement commenced its journey and entered the collective conscience of the public and policymakers. One year on, what has it achieved?

Some have suggested rather little, that Occupy's voice has been loud but vague, long on problems, short on solutions. Others have argued that the fault-lines in the global financial system, which chasmed during the crisis, are essentially unaltered, that reform has failed.

I wish to argue tonight that both are wrong – that Occupy's voice has been both loud ***and*** persuasive and that policymakers ***have*** listened and ***are*** acting in ways which will close those fault-lines. In fact, I want to argue that we are in the early stages of a reformation of finance, a reformation which Occupy has helped stir.

Let me start with the contribution of the Occupy movement itself. Occupy has been successful in its efforts to popularise the problems of the global financial system for one very simple reason: they are right.

By this I do not just mean right in a moral sense. For sure, Occupy have touched a moral nerve in pointing to growing inequities in the allocation of wealth and incomes globally. The 99% certainly agrees. But so, more interestingly, do a high and rising share of the 1%.

Yet it is the ***analytical***, every bit as much as the moral, ground that Occupy has taken. For the hard-headed facts suggest that, at the heart of the global financial crisis, were and are problems of deep and rising inequality.

We have seen, first, inequality-induced crisis and, latterly, crisis-induced inequality. The 99% have faced double-jeopardy. Let me explain why.

The up-escalator

Globalisation has conferred many benefits to the poorest in the world and narrowed global inequality. But it is well-known that income distributions ***within*** many advanced economies became increasingly skewed in the decades prior to the crisis. There was no single cause of this rise in inequality. Longer-term structural factors, such as dispersed levels of educational attainment, were clearly a key factor.

But so, too, were financial factors. James Galbraith's recent book on *Inequality and Instability* argues that the biggest single cause of rising levels of inequality in the US was the asset price boom which commenced in the early 1990s.

This rising tide of asset prices added to aggregate wealth. But it did not lift all boats. The asset rich, in particular the owner-occupying rich, became a lot richer. Meanwhile, the asset-less and indebted fell further behind. In other words, the pre-crisis asset price bubble acted like a regressive tax.

As Raghu Rajan describes in his book *Faultlines*, the response to this inequality problem, in the US but elsewhere too, was simple and, on the face of it, brilliant. It was to make asset-holders and owner-occupiers of us all. But for the majority there was one small problem: these assets had to be financed with debt.

So what followed was an era of ultra-cheap credit globally – the Heineken era, in which credit reached the parts of society it previously had not reached. Levels of debt, in particular among households, rose pretty much exactly in line with levels of inequality.

Rising credit meant expanding bank balance sheets. To maintain this expansion, banks began to manufacture new financial products, slicing and dicing loans to meet investor demand for high yield. The acronyms we have now come to know and loathe – the CDOs, the ABSs and the CDOs of ABSs – emerged to meet this demand.

Manufacturing high-tech loans was a lucrative business. Returns to banking rose to their highest levels since the roaring '20s. Those designing and selling these new financial gadgets saw their salaries sky rocket. In 1980, an investment banker was paid roughly the same as a similarly-skilled professional in any other industry. By 2007, they were earning nearly four times as much.[1]

Those salary differences were particularly pronounced at the top of the pyramid. In 1989, the CEOs of the largest US banks earned 100 times the median US household income. That is quite a gap. Yet by 2007, that multiple had risen to 500.[2] A similar gap emerged for UK and European bank CEOs.

These widening discrepancies ***within*** banks compounded the widening discrepancies ***between*** banking and other industries. Banks, especially the top of banks, became first among unequals.

With returns sky-high, there was then a great sucking sound as both people and monies were drawn into banking, in particular the high-risk/high return, sharp-suited parts such as investment banking. A generation of scientists' and mathematicians' heads were turned towards finance. Funds flowed into the bank money machine, with balance sheets rising fivefold in less than 20 years, much of it to support short-term trading activities rather than long-term investment.

Yet even while it was still inflating, this bubble was already having silent costs – costs to the economy and indeed costs to other parts of banking. Many of the best people and the best financial resources were drawn away from other sectors, including the retail banking sector. Industries outside of finance were starved of sunlight.

The costs of this great sucking sound are only now being properly understood. Recent research by the Bank for International Settlements suggests that, once bank assets exceed annual GDP in size, they begin to act as a drag on growth.[3]

1 Philippon and Reshef (2009).

2 Haldane (2011).

3 Cecchetti and Kharroubi (2012).

Why? Because human and financial resources are drained from elsewhere in the economy. The sectors hardest-hit by this financial vacuum-cleaner effect are R&D-intensive businesses (who might otherwise have attracted the scarce, skilled labour that flowed into finance) and businesses reliant on external funds (whose financial cake was instead being eaten by the banking system). These are the very businesses that today we are seeking to re-nurture.

At the same time, the ballooning of trading activities was starving basic banking of resources. In consequence, the offering to bank customers became a rather different one. The humble, regional loan officer was pensioned-off, replaced by a centralised credit risk model which neither answered back nor required a pension. Branches were closed in an effort to contain costs. Banking became a transactional business, underpinned by a sales-driven, commission-focussed culture.

The down-escalator

Nonetheless, as long as asset prices were rising, the cheap credit strategy seemed to be working like a dream. For those who had borrowed, debt was being inflated away, not by the traditional route of goods price inflation but by asset price inflation. The world was experiencing the biggest bank bubble, perhaps in its history.

In 2007, that bubble burst. Asset prices and balance sheets collapsed. The dream turned into a nightmare, as asset price ***de***flation combined with high debts to put many balance sheets underwater.

As the most leveraged institutions on the planet, banks were deepest underwater. To prevent those institutions sinking without a trace, governments were forced to ride to the rescue. This support came from both governments and central banks, in both cases underpinned by the tax-payer.

All in, this support to the financial sector amounted to perhaps as much as two-thirds of annual GDP in the UK and US, somewhat less (but still rising) in the euro-area. Those government transfers were not shared equally even across the financial sector, with a strong skew towards institutions deemed too-big-to-fail. This protected species status meant large institutions benefitted – indeed, continue to benefit from an implicit subsidy from the state.

This subsidy is big. For the global banking system, it may currently amount to as much as several hundreds of billions of dollars ***each year***. By comparison, that is multiples of the global aid budget. For UK banks, the subsidy amounts to tens of billions of pound each year. That too is multiples of the overseas development budget. These are extraordinarily large, and peculiarly-directed, government transfers to one sector.

If banks have been the winner from these transfers, then the wider economy has clearly been the loser. The damage wrought by the pre-crisis debt mountain has been huge and is still rising. The cumulative loss of output relative to trend is already fast approaching one year’s output in the UK. As context, only world wars come with a heftier price tag.

The strain is being felt by many homeowners, companies and, increasingly, governments. In the US alone, more than 4 million homeowners have so far lost their properties. Many more households and companies globally can only support their debts at near-zero interest rates. They are zombies, caught in a debt trap.

In a way, none of this should have come as a surprise. We know from past crises that debt acts as a dragging anchor on growth for a protracted period. And we know too that the costs of crises are felt disproportionately by the worst-off in society whose living standards tend to fall not just relatively but absolutely too. So it has been during this crisis.

So if the seeds of the crisis were sown by inequality, then the crisis itself has germinated these seeds. The returns to finance were privatised in the upswing and the risks then socialised in the downswing. Having lost out on the swings, the 99% have been forcibly ejected from the roundabouts.

Diagnosing the problems

So what is to be done?

Ferocious criticism has been levelled at the individuals at the helm of failing financial firms. A chunk of that is fully justified. The stewardship of many financial institutions was reckless, fuelled by a cocktail of leverage and a culture which put short-term transactions ahead of long-term relationships. Among especially the bigger banks, there was a quest for size over safety, for quantity over quality.

It is important to punish negligence and criminality and this is being done across the financial sector in the light of the slew of recent scandals and mis-selling episodes. Heads have rolled and I imagine will continue to do so. Skeletons which had accumulated in the closet for the better part of two decades are being discovered and the bodies disposed of.

But, as disappointing as this might sound to some of you, in building a new financial system I think there are limits to what can be achieved through a "heads on sticks" strategy. For me at least, the financial crisis was in the main not a story of ***individual*** fallibility, greed or hubris.

There are 400,000 people employed in banking in the UK. The vast majority of those, perhaps even 99%, were not driven by individual greed and were not professionally negligent. Nor, even in the go-go years, were they trousering skyscraper salaries. It is unfair, as well as inaccurate, to heap the blame on them.

For me, the crisis was instead the story of a ***system*** with in-built incentives for self-harm: in its structure, its leverage, its governance, the level and form of its remuneration, its (lack of) competition. Avoiding those self-destructive tendencies means changing the incentives and culture of finance, root and branch. This requires a systematic approach, a structural approach, a financial reformation.

A financial reformation

I want to argue that we are in the early throes of such a financial reformation. And that this will help to deliver a more socially useful banking system. Let me mention some of the more important of these reform strands. These fall into five categories – the five "c"s: culture; capital; compensation; credit; and competition. It is easier to will the ends on these issues than it is to divine the means. How exactly ***do*** we change banking culture?

So I want to give you some concrete, practical proposals for change. And I want to tell you not only that these ***should*** be delivered but that they ***will*** be delivered. Individually, none of these reforms may sound like a game-changer. A number lack the pizzazz of a "tar and feathers" strategy. But taken together, I think they amount to the most radical agenda of financial reform for 80 years. Importantly, I also think they will work.

First, and perhaps foremost, ***culture***. We are about to undertake structural reform of the global banking system, perhaps the largest since the 1930s. In the US, this is the Volcker rule. In the UK, it is the Vickers proposals. Most recently in Europe, we have had the Liikanen plans.

Though different in name, these structural reform proposals contain a common thread. They will seek a separation – or at least a ring-fencing of retail and investment banking activities, legally, financially and operationally.

Part of their motivation is to stop some of the riskier parts of investment banking, such as proprietary trading, infecting the indispensible parts, such as deposit-taking and loan-making. The crisis has provided ample evidence of the costs of such cross-contamination, with losses on risky trading portfolios imperilling bank depositors and borrowers.

But at least as important is what such a separation might do ***ahead*** of crisis. Ahead of this time's crisis, financial and human resources were diverted away from retail banking services and non-bank activities towards investment banking. At the same time, the culture and practices of investment banking infiltrated retail banking – a sales culture which culminated in harmful cross-selling and unlawful mis-selling.

If they are successful, these structural reform efforts will reverse this pattern. They will seek a separation, not just legally, financially and operationally, but culturally too between the very distinctive sub-cultures of transactional investment banking and relationship retail banking. That cultural separation ought to be the acid test of the success of these structural reform proposals.

There are those who doubt whether a ring-fence is sufficient to achieve that cultural separation in banking – can two separate sub-cultures really operate underneath a single roof? Time will tell. If it is not possible, then full separation would be the logical next step. Alternatively, banks themselves might of course voluntarily choose to divest and separate, as some are already doing.

Second, ***capital***. Much greater levels of protection are being put in place for banks generally and for big banks in particular. New regulatory standards will mean that shareholders' funds will be 7 times higher than before the crisis. For the world's biggest banks, they will be 10 times higher. And for the first-time ever, banks will have to hold sufficient liquid assets to pay out depositors in a timely fashion.

Regulation of this type might sound rather arid and technical. Welcome to my world. But it is also important. Higher financial buffers are not about protecting the banks – just like other firms, they can and should fail. They are there to protect the customers of banks, reducing the chances of them suffering panic or loss. And they are there to protect taxpayers too, reducing the chances of them footing the bill.

Does this new regulatory protection go far enough? Banks will go from being 99% debt-financed to being 95% debt-financed – in other words, still high. Many academics have made the case for tighter regulatory standards. Their analysis is compelling and, frankly, I have seen no analytically-coherent counter arguments. But once again, time will tell. If more capital is needed, regulators will simply ask for more.

Third, ***compensation***. There is a deeply-rooted problem of short-termism in modern capital markets, with too great a focus on near-term versus longer-term, on spending over saving, on twisting rather than sticking. John Kay's recent review for the UK government made some useful suggestions for tackling this problem.

This short-termism problem is especially acute in the financial sector, where job tenures and performance targets have tended to be short, especially for CEOs. Pre-crisis, this encouraged unhealthy rent-seeking and risk-taking, gambling on one more big bonus. This gave rise to all the wrong incentives if the aim was to generate long-run value for customers and investors.

How to lean against these incentives? Altering the time horizon for pay would be a good starting point. For example, some banks now use a remuneration model based on "deferral until retirement". It would be fantastic if that caught on. It would align the time horizon of bank employees with that of their customers, reducing the incentives to put short-term sales ahead of long-term relationships.

Fourth, ***credit***. The rising tide of inequality either side of the crisis was given impetus by first the boom and then the bust in credit and asset prices. We must in future do a much better job of moderating those credit booms and busts, to prevent them acting like a regressive tax on the poorest in society.

That collateral damage is all too evident today in the chronically low levels of credit being extended on the high street – to first-time buyers wanting to put their foot on the first rung of the housing ladder, to business start-ups seeking to invest in assets, human and physical. Lending to UK households and companies has been contracting for 4 years and counting.

In preventing a repetition, a first step is to recognise that taming the booms and busts in credit is a key public policy responsibility. Step two is charging someone with this task. And step three is getting on and doing just that.

In the UK, we are already three steps along this road, with the introduction of a Financial Policy Committee (or FPC) housed at the Bank of England from last year. Its remit is to keep the system safe and sound while supporting lending and growth. Right now, the FPC is playing its part in trying to cushion the effects of the credit squeeze I mentioned, by freeing up banks' capital and liquidity reserves to enable loans to be made to companies and households.

If these sound like small steps for mankind, then they are giant ones for regulators. This is the first time in the Bank's 318-year history that it has attempted such "macro-prudential" regulation. Of course, it is impossible for the FPC or anyone else to eliminate mini-booms and mini-busts in credit. But the FPC can legitimately aim to head-off the maxi-booms, such as the pre-crisis one, and the maxi-busts, the like of which we are currently experiencing.

That should be good for medium-term growth, by preventing a build-up of excessive leverage. And because financial booms and busts are inherently inequitable, it ought also to be good for the distribution of this growth across society.

Fifth, we really must do a much better job of promoting ***competition*** in financial services. The most shocking statistic is that, up until 2010, no new bank had been set up in this country for a century. We need to raise our levels of ambition when breaking down barriers to entry into banking, to ensure bank customers get a fair and efficient deal.

Although there is no silver bullet solution to the competition problem, I am attracted to recent proposals which would place some core banking services in the hands of a shared utility, storing customer account details. At present, this information is private which acts as a barrier to entry by new banks. It also acts as an impediment to consumers switching and searching between banks and their products.

With customer information held in a network utility, like the electricity grid or railway network, banks could plug and play when offering deposits and loans to customers. The costs of entering the banking market would be lowered for new banks. And so too would the costs of searching and switching for customers, between banks and between products, rather as you might between gas or mobile phone suppliers.

There is already some encouraging evidence of new entrants to the banking market. In weak moments, I think that we might even be on the cusp of a technological revolution in banking. Certainly, some new firms are bringing new technologies to banking – for example, through mobile payments. Others are mobilising pools of non-bank funds to finance lending directly – peer-to-peer lending, crowd-funding, invoice-financing. Others still are demonstrating that a clear focus on retail banking services, delivered locally by forging long term relationships, can be a winning strategy.

For example, take Handelsbanken. How many of you have heard of them? They are not yet a high street name, by comparison with say a Barclays or a Lloyds. But that is changing. They may be the fastest expanding bank in the UK at the moment. On average, they open a new branch – not a cost centre, a branch every two weeks.

Their business model is fascinating, Quaker-even, in its orientation. They offer only basic banking services, mortgages and small business loans, to people in a tight, locally-defined catchment area.

All credit decisions are taken locally by people, not centrally by a computer. No bonuses are paid and no one has a sales-target. When the whole firm out-performs, a contribution is made to a pooled fund which is invested on employees' behalf. The fruits of success are distributed equally and gratification is deferred.

For banking, this is back to the future. If that sounds attractive, then it is down to us – not regulators, not politicians, you and I – to deliver it. If as bank customers we want to change the culture of banking, then we should start by supporting those banks who are delivering that change. Putting your money where your mouth is would deliver far greater and more durable change than any amount of banker-bashing.

Already there are some encouraging signs of the winds of change blowing through the system, not just from the new entrants but among the UK's oldest banks too. The new heads of the UK's biggest banks have committed to restoring trust in their institutions and improving their social usefulness. And those words are beginning to turn into actions. Barclays and today Lloyds are seeking to change their sales-oriented culture, returning to their Quaker roots. There is the quiet, but unmistakable, sound of a leaf being turned.

If I am right and a new leaf is being turned, then Occupy will have played a key role in this fledgling financial reformation. You have put the arguments. You have helped win the debate. And policymakers, like me, will need your continuing support in delivering that radical change.

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