Norman T L Chan: How can the banking industry regain the moral and ethical high ground it once enjoyed before the Global Financial Crisis

Speech by Mr Norman T L Chan, Chief Executive of the Hong Kong Monetary Authority, at the Asian Banker Summit, Hong Kong, 15 April 2015.

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Emmanuel (Daniel), Helen (Wong), Hans (Eichel), Gary (Stern), Ladies and Gentlemen,

1. It is always good to see the Asian Banker Summit return to Hong Kong. It has been four years since our city last hosted the Summit in 2011 when I talked about the Monetary Authority's supervisory philosophy on universal banking. A lot has happened since then. But of particular relevance to us here today are the significant waves of regulatory activity we have witnessed in those intervening years. Activity both in terms of rolling out new standards but also, very visibly, in enforcement action. Libor manipulation in 2012, followed by Forex rigging, sanctions breaches, money laundering and a fairly constant stream of mis-selling allegations – structured bonds, mortgages, Payment Protection Insurance.

2. Against this background, I have to say that I was pleased to see the thorny subject of ethical behaviour within the financial services industry as a key theme for this Summit, although I would like to confine my remarks today to the banking industry and not the entire financial services industry. I was really encouraged by the implicit acceptance, in putting this on the agenda of a banker's summit, that it is primarily for the industry to seek to regain the moral and ethical highground it once enjoyed. I wholeheartedly agree. This is not something which can, or should, be regarded as a "policing" or "enforcement" matter for the regulator. Getting caught out, taking the fine as a "cost of doing business" and moving on with making money, is just not acceptable as a sustainable banking business model going forward. I do not subscribe to the view that banks' primary role is to generate maximum shareholder value, leaving the regulator to worry about the safety of deposits and the interests of the banks' customers. Now, don't get me wrong I am not thinking of banks as break-even utility operations but, making a reasonable return should be a ***result*** of what banks do – to quote Jack Welch when talking to the FT a few years ago "Shareholder value is a result not a strategy".[1]

3. Having a licence or franchise to take deposits, which represent the hard earned savings of millions of people, and use these funds for private gain is a privilege conferred by society on a bank, which merits exemplary professional and ethical behaviour.

Moral and ethical highground: trust and respect

4. Returning to the theme of the Summit "regaining the moral and ethical highground" – what do we really mean here? I think, in a word, "trust". With "trust", comes "respect".

5. In the past, banking was regarded as a reputable profession and bankers were highly trusted and respected both by their customers and by members of the public more generally. This was not surprising as basically customers entrusted their life savings to their bankers and the preservation and safety of their hard-earned money was in the hands of those bankers. Although nowadays customers still place their life savings with banks, bankers no longer enjoy the same high degree of trust and respect from society, especially after the Global Financial Crisis. What has changed so dramatically to bring the reputation of bankers so low?

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1 FT.com – March 12, 2009 "Welch condemns share price focus".

Change in modality and governance structure of banking

6. Well, the modality and governance structure of banking have changed a great deal over the last century. More importantly, these changes have created an incentive system that leads to a misalignment and disconnect between the interests of the owners of banks (i.e. the shareholders), bank management and customers.

7. Not so very long ago, banking was a business conducted by individuals, families and (more latterly) private partnerships, where the owners and managers of banks had ample "skin in the game". They stood to lose not only their investments in the banks but also their entire family wealth or, in some more extreme cases, even their liberty, should their actions, or the actions of their partners, result in the failure of their bank. This naturally served to temper the degree of exuberant risk-taking. Partners or managers in a bank were in for the long haul, with their investments and family wealth tied into the firm until retirement. So it was not just their next year's bonus that was at risk. This evident "alignment of interest" between the bank owners or managers and the bank's customers and creditors clearly helped promote trust.

8. That said, although some US investment banks only moved from the partnership to public ownership model in the past 25 years, it is the case that other commercial banks have been structured as public joint stock banks with limited liability since the 19th century. So if limited liability has existed for two hundred years, in at least commercial banking, with the attendant potential "agency" risks (i.e. shareholders with limited skin in the game and managers with relatively little capital invested), what else has been at work to create the problems which so vividly surfaced in the Global Financial Crisis?

What has changed: bank management

9. First, bank employees' time horizons have shifted. By this I mean that in the past employees, for a variety of reasons, tended to be much more "stable" in the sense of their ties to a given employer. An employee might join a bank, work their way steadily up through its ranks and then, on retirement after 30 or 40 years of service, receive a pension from the bank. So the employee identified their near and longer term future with that bank: another form of "skin in the game" and alignment of interest. However nowadays, not many banks offer pensions and it is much more common for employees to advance their own careers, as "freelancers", by hopping from one institution to another to secure promotion or higher pay. In these circumstances, employees naturally identify less with the employing institution as their future is not, in their mind, inextricably linked with it. They work ***at*** banks not ***for*** banks.[2]

10. Now this is of course also a two way street, in the sense that banks in their turn can on occasion nowadays be very adept at severe downsizing if market conditions turn. So loyalty works both ways and has over the years declined.

What has changed: incentives for risk-taking

11. Business profiles and activities have also changed over time. Simple deposit-taking and lending businesses have been combined with investment banking, securities and capital markets, and even proprietary-trading activities, to form large, complex organizations, raising clear issues of cultural compatibility across businesses with very different objectives, time horizons and employee profiles. In an environment where near term profits are very highly prized and rewarded, it is all too easy to see how the more aggressive of the approaches introduced into the mix (with the power of traders rising in line with trading profits in buoyant

[2] Report of the UK Parliamentary Commission on Banking Standards "Changing banking for good", Volume II paragraph 120.

markets) might prevail in shifting a culture from a client focus to one that is overly defined by financial performance.

12. It is interesting, when comparing and contrasting cultures within banking, to consider for a moment Glass-Steagall and its separation of commercial and investment banking to prevent commercial banks from trading securities with their customers' deposits.

13. Passed during the Great Depression, following a number of bank runs which destabilized the US economy, Glass-Steagall's motivation rested on: real or perceived conflicts of interest, in the form of collusion between banks and their affiliates with the affiliates borrowing from the banks to buy securities and then selling securities to repay the banks' debts and worries that banks would engage in risk-taking speculation, trading with customers' deposits rather than lending to promote economic growth. The "firewall" created by Glass-Steagall was gradually weakened over the years and, as you all know, was eventually repealed in 1999. Some argue that this repeal contributed to the Global Financial Crisis. Joseph Stiglitz, the Nobel prize winner, summed it up thus: "Commercial banks are not supposed to be high-risk ventures; they are supposed to manage other people's money very conservatively….. Investment banks, on the other hand, have traditionally managed rich people's money – people who can take bigger risks in order to get bigger returns."[3]

14. When repeal of Glass-Steagall brought investment and commercial banks together, it would appear from the events over the last decade or so that the investment bank culture came out on top. The prevailing business strategy becoming pursuit of the high returns that could be obtained only through increasing leverage and risk-taking.

What has changed: commoditisation of banking relationships

15. As well as bolting together different businesses with different cultures to achieve growth at a much faster pace than would be possible "organically", banks have over the past few decades expanded from serving more limited numbers of wealthy customers to covering the mass market. Where once the local bank manager might have expected to know a significant number of his customers personally, now customer numbers are so large as to render relationship banking (outside of specialist areas such as private banking) all but impossible. The result? Well a degree of commoditisation, and perhaps inevitably alienation. As a banker cannot possibly engage with the vast majority of his customers, personal bonds are much weaker or indeed no longer created, blocking off another avenue through which relationships built on trust might develop. At the same time, customers have increasingly regarded banking as a transactional relationship and are willing to jump from one bank to another just for the sake of a slight improvement in the interest rate received on deposits.

What has changed: short termism of shareholders

16. And if banks' customers and creditors have changed – what about their shareholders? Well, returning for a moment to our earlier discussion. The owners, now in the form of hundreds of thousands of shareholders, have only limited "skin in the game". Their personal or family wealth, outside of their bank shares, is not at stake if the bank fails and they can now in most cases exit from their shareholdings swiftly through trading on a stock exchange. So their perspectives can now be much shorter-term and, as they alone benefit from increases in a firm's "value", they may actually favour greater risk-taking to maximise share price valuation in that shorter-term. This "short-termism" mindset is more pronounced amongst some asset managers and hedge funds, which in recent years would appear to have accumulated increasing amounts of bank shares and become more proactive in

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[3] Capitalist Fools. Joseph E Stiglitz January 2009 (The Great Hangover: 21 Tales of the New Recession from the Pages of Vanity Fair).

exerting pressure on bank management. As these asset managers are themselves rewarded on the basis of the annual valuation of their funds' holdings, including the bank shares, they have every incentive to push the banks to achieve higher profitability. So board directors and senior management were, and still are, under constant pressure to pursue higher RoEs. It is not difficult to see why capital raising, which improves the resilience of banks, is often rejected or delayed as it is negative for share prices in the short term. The result? Banks have no choice but to leverage up and take bigger risk in order to meet the targets that the shareholders demand.

Modern banking at crossroads

17. So where do we go from here? As I mentioned earlier, while bank regulators clearly play an important role in influencing banking operations, it is really up to the industry to decide what it can and should do to regain the trust and respect that banks once enjoyed. We should bear in mind bank regulators are a consequence of the emergence of modern banking. However, as discussed earlier, the modality and incentive system for banking were very different in the old model of banking : there was a high degree of alignment of interest between bank owners, bank management and bank customers, which has over the years been significantly eroded.

18. Again, don't get me wrong. I am not advocating that we should go back to old-fashioned banking. It is far too difficult, if not impossible, to turn the clock back this far and to do so might mean the loss of some beneficial innovations over the years. However, there is considerable public interest in ensuring that banking, which remains the predominant channel of intermediation between savers and borrowers in our society, functions efficiently and effectively, with a high degree of professionalism and strong ethical standards.

19. It is against this backdrop that the international community, through G20, Financial Stability Board (FSB), Basel Committee on Banking Supervision (BCBS) etc. has sought to overhaul the banking regulatory framework and banking standards in the aftermath of the Global Financial Crisis. Some of the reform measures have been designed to address the problems arising from the misalignment of interest amongst the key stakeholders in banking. While some bankers may think, rightly or wrongly, that these reform measures represent a degree of overkill, the public sector firmly believes that the current regime of "heads you win, tails I lose" must not be allowed to continue. What I mean here is the regime in which bankers pocket huge bonuses in good times (or even in bad times as in the case of AIGFP and Merrill Lynch) and when the banks run into trouble the public sector, for fear of a systemic failure, comes to the rescue with a bailout using public funds. This is clearly unacceptable. So the choice is obvious. New regulations dealing with capital buffers, liquidity management, leverage, bankers' compensation, ringfencing of deposit-taking business from riskier operations etc. have been introduced. Also notable are the measures specifically designed to mitigate the moral hazard arising from "too-big" or "too complex" to fail situations. Separately, there is a trend of regulators seeking to beef up their efforts to ensure that banks do not constantly place their own commercial interests ahead of those of their customers. Protection of consumers and investors is nothing new but it has recently attracted considerable public support that more is needed.

20. For sure, regulators will continue to pursue further changes in banking. This is ongoing and there is still some way to go. In the process, there will be arguments, frustrations and inevitably pushback. No doubt the new standards and regulations will lead to some changes in the behaviour and business models of banks. However, I do not for one moment believe that regulators and regulatory measures alone can possibly redress all of the problems stemming from the misalignment of interest amongst the various stakeholders in banking. Regulators can set standards and provide some external checks and balances. But there is no substitute for internal governance and controls that are designed to achieve the desired behavioural change across the entire firm. In this context, it is crucial that we have buy-in from the owners, directors and management of the banks.

21. Only when the public sector and the owners, directors and managers of banks share the same goals and objectives can we induce the desired outcomes on a sustainable basis. Only when shareholders cease to put unreasonable pressures on bank management to keep on improving RoEs can regulators feel comfortable that the bank is not incentivised to take the short-term view on business growth and profitability. Only when bank management is not rewarded based on short-term financial performance can we be less concerned that bank managers will take excessive risks for near term bonus or share option value. Only when board directors understand that they are accountable not only to shareholders but also to customers and society more broadly through the regulatory agency can we be confident that effective governance and internal controls will be put in place. In short, banks need to own the common goal and to promote the appropriate culture, values and practices across the firm, which are to put the safety of the bank and the interest of depositors and customers ahead of the banks' own commercial interests, just as the old fashioned bankers did in the past. Only when this happens will bank managers and employees change their mindset from "what can we get away with" to "what is the right thing to do". Only when this happens can the banking industry regain the trust and respect that bankers used to enjoy in the not so distant past.

22. I am a pragmatist and not blind to the challenges that lie ahead in achieving what I have just described. However, I am also an optimist. Looking to the owners of banks, whilst shareholding may be diverse, there are "clusters" of shareholders, such as pension funds and sophisticated institutional investors, who understand that short-termism tends to produce negative outcomes over time and as such should be prepared to counter such tendency. As for the boards of directors, I am hopeful that the independent non-executive directors will play an increasingly important role in instituting and monitoring proper governance and internal control systems within banks, provided they are suitably empowered and supported by the shareholders and regulators. As for the management and staff of banks, desired behavioural changes will come if the owners and boards show the way and institute the right values, controls and compensation arrangements.,

Conclusion: a matter of choice

23. Ladies and gentleman, I am not entirely sure whether, in making this speech today, I will make myself any more or less popular amongst bankers. But this is not relevant at all. The important thing is that I am very pleased to be given this precious opportunity to share with you my heartfelt thoughts on why bankers have lost a great deal of public trust and respect and how they might regain these sentiments. Bankers clearly have a choice on what to do and where they want to go. By the same token, regulators also have a choice on what to do, but that choice depends crucially on what the bankers themselves elect to do or not to do. I sincerely hope that the public sector and the bankers can work together to ensure the sustainable and healthy development of the banking industry. At the end of the day, the society also has a choice. After all, no profession or industry can evolve or develop independently from or against the wishes and expectations of the society. Thank you very much.