From Servant to Master - Roots of Excess: Rebooting the servers

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Introduction

Good evening ladies and gentlemen: I am delighted to be here to give the third in my series of lectures on re-shaping commerce in the post-crisis world.

The title of tonight's lecture is From Master to Servant-Roots of Excess: Rebooting the servers.

In my last lecture, I argued that we have allowed the market to become a master rather than a servant. I want to expand on that today. In particular, I want to examine the position of finance.

To some, finance has become the master - and even an end in itself. The financial crisis and subsequent economic difficulties have been widely, if simplistically, attributed to an overweening financial sector which ran amok.

I accept there have been excesses. We've been through a grave crisis partly caused by personal excesses and by old-fashioned bad banking. And as the scale of the UK's budget problems shows, we are not out of the woods yet.

To borrow a computing analogy, the servers almost went down.

The cost has been a public rescue of private finance on an unprecedented scale. Unfortunately, some in the City have been slow to appreciate the moral obligations which the bailout has placed on them.

While bonus payments are the subject of public debate, unemployment is rising. In the circumstances, public distrust of finance is palpable. We are witnessing a spate of banker-bashing probably not seen since the 1930s, provoking in turn City resentment that all of finance is being tarred with the same brush.

Governments in the UK and elsewhere have responded to the popular mood by imposing special taxes or restraints on pay and bonuses and floating other ideas such as an "insurance" levy on banks to protect against future crises. The Tobin tax - a levy on transactions such as foreign exchange trading - has long been dismissed as impractical. Today, however, it is gathering political support. And although the political runes are hard to read, the fear is that taxes in the UK will be appreciably higher than in the recent past and that supposedly one-off imposts will be repeated.

Papers reflect the sour public mood and are demanding vengeance. An editorial in the City's Bible, the Financial Times, declared recently: "This year's bonuses are the bankers' reward for risks taken with public wealth......[The fundamental problems of compensation] can be fixed only by ending the travesty of institutions too systemically risky to be allowed to fail."

In short, I fear trust between financial institutions on the one hand and government and society on the other has disastrously broken down.

But as the great essayist Francis Bacon said some four centuries ago in his famous essay On Revenge: "Revenge is a kind of wild justice."

The pressing need now is for wisdom not wildness. Certainly there are very important lessons to be learned from the crisis. We have heard much talk about capital provisions, vesting time for compensation, international regulatory cooperation and similar technical safeguards. What has been less well aired, but in my view is even more important, is what we should learn about human behaviour and the values informing our actions, as I discussed in my previous lecture.

However, it would be a perverse vengeance that hobbled one of the UK's most internationally competitive industries in one of the fastest-growing areas of the world economy.

I will argue today that finance is a vital part of a modern economy and is especially important for the UK. We neglect it at our peril. Despite everything that has happened, finance is and will be a huge and dynamic source of comparative advantage for the country. There is no realistic prospect of restoring economic growth and better balance to the public finances in the UK without harnessing the financial sector's power and potential as an engine of recovery and growth. We should encourage it rather than inhibit it.

Indeed, the dislocation in global markets is an opportunity the City should seize to reassert its place as the world's pre-eminent financial centre.

But all this is only possible if trust is restored.

The standoff must end. I believe we urgently need a new settlement between finance, government and the public. Public confidence in the old understanding that finance operate under light regulation in return for creating jobs and wealth has evaporated.

A new settlement would recognise mutual obligations while allowing finance to make the fullest possible contribution to economic recovery and future prosperity.

For its part, finance must show through its deeds that it is a servant and not a master. And it is up to us in the financial community to explain - with humility - why finance is a friend and not a fiend

Government's role is to provide a predictable and reasonable framework in which finance can flourish and the public be served.

Society can contribute by accepting that we must save more and that rewards ought to be commensurate with risks taken.

As opposition to the Anglo-Saxon model seems to mount in continental Europe and the European Commission and European Parliament, the case for a fresh alliance between government, finance and society is all the more compelling. The City needs to reassert is standing urgently. With a new settlement, we can reboot the servers

Economic philosophy

At this point, let us step back a little. I also argued in my last lecture and in an article in the Financial Times that we need to rediscover the moral spirit of capitalism.

We often lose sight of a very important truth: the economy is a human construct, subject to human judgement - Is it good? Is it useful?

Lest I sound unduly philosophical - though bankers do have cause to be philosophical these days - let me point out that the question of whether finance is good and useful is highly practical as well as pertinent.

Traditionally, finance has oiled the wheels of commerce. Trade and commerce built the City's fortunes long before finance assumed pre-eminence. Finance was patently useful because it was closely linked to other economic activities - and was therefore good in the broader sense of serving a social need.

More recently, however, finance has come to be seen as an end in itself, a system which showers riches on some but bears little relation to normal or even desirable economic activity. Too many practitioners lost sight of the morality which underpinned the principle of serving the wider economy and capitalism slipped its moral moorings.

Partly as a result, financial institutions are condemned as the essence of "casino capitalism" - a sink of speculation which is neither useful nor good. This sense of moral deficiency has strongly influenced the mood of government and public alike.

There is, therefore, a profound question of ends and means. What priority do we give to means - promoting commerce and the wider good of society? To what extent can or should finance be a separate activity? Is finance necessarily the antithesis of the good and the useful?

Peculiarities of finance

The answers to these questions bear heavily on the kind of settlement we establish. And to answer the questions, we have to think about the nature of finance.

Finance is different in critical ways from other kinds of economic activity such as manufacturing or agriculture or even other kinds of service industry.

Its raw material is abstract - money. Money is very odd. It is imbued with a unique combination of attributes: a medium of exchange, a unit of measure and a store of value. Money is all of these things at once, but at any one time for any one person a particular attribute of money may be more important than the others.

Money also has another very peculiar property: it can be created by fiat or credit. Unlike natural raw materials, say oil or even gold, money is not finite. It can be created and re-created.

This quality makes a financial system possible. Financial institutions, notably banks, give life to money's attributes. They can turn short-term deposits into long-term loans, so-called maturity transformation, and through credit provide the wherewithal to spend where previously there was none.

So control over money or the ability to create money allows the holder to invest or speculate in endless ways. And because people want to be rich, money confers prestige. As Mark Twain said: "Make money and the whole world will conspire to call you a gentleman."

But wealth from finance is often hard earned. At the heart of money lies risk taking. The relatively high risk/return ratio inherent in investment or speculation can yield immense profits - and losses, as we have seen.

This why to many people finance just looks like making money out of money. Conversely, losses resemble a strange alchemy by which the apparently solid can be reduced to dust. The moral as distinct from the statistical relation of risk and reward seems out of kilter. Even if people understand and accept the risk-reward ratio inherent in finance they are not necessarily confident that a given reward is justified. What have people done to deserve such ecstasy (or agony)?

The fact is that people sometimes find risk hard to understand as a concept. Distinguishing between a single event you might experience personally from all such events experienced by people in aggregate can naturally be difficult. Falling under a bus is a common metaphor for an accident; but falling down the stairs at home is a more likely danger.

The misunderstanding is compounded when the risk is abstract - as with money. The abstraction, moreover, also hides the benefits of taking risks. When a bank helps a farmer to lock in a wheat price and secure payment for his harvest, it should receive a reward commensurate with the risks attaching to future wheat prices. But it also oils the wheels of commerce. Without the financial assistance the farmer might earn less or the wheat might never be produced at all.

All this has important, down to earth consequences. People find finance hard to understand, and that provokes suspicion. Rewards are often viewed as disproportionate and unjust when compared with other labour which may be viewed as socially more beneficial.

Such considerations have gained currency over the last 30 years or so for another reason: finance is peculiarly suited to our times.

There are several causes. Finance becomes more important in a mature, highly productive, service-driven economy as other sectors such as manufacturing and agriculture relatively decline and capital intensity rises.

You can see the change in the shifting composition of the UK economy. Between 1970 and 2007, finance's share of national output grew from 5.1% to 8.3%. Real estate, a closely related sector, saw its share go up from 10.8% to 23.6%. And while these two areas were expanding, manufacturing contracted from 31.7% to 12.4% -- though still bigger than the City, it should be noted.

In general, more economic activity requires more finance to oil its wheels. Thus in the quarter century after 1980 world output doubled in value but world trade more than trebled in value. Between 1998 and 2005 alone, net private capital flows to developing countries - whose economies and trade tend to grow the fastest - rose about two and half times from $199 billion to $490 billion.

A long period of prosperity and increasing productive power has seen wealth accumulate on a scale never seen before. In essence, finance is how this stock of wealth - people's savings - is managed. The French writer Alexandre Dumas fils summed it up: "Business? It's quite simple. It's other people's money."

Modern technology - the digital revolution of computers and communications - is tailor-made for finance. Nothing converts into 0s and 1s - the electronic pulses of the digital age - more easily than the numbers in which money is expressed. Not for nothing are financial institutions engaged in a never-ending and monstrously costly technological arms race to win a millisecond of advantage over competitors.

One consequence is that capital is the only factor of production which really flows freely. Despite years of free trade agreements, goods and especially labour are nowhere nearly as mobile.

In other words, finance has grown mightily and mighty in our times - and it grew for good reasons.

An outbreak of excess

But that does not lessen or excuse the recent excesses.

Easy money fuelled debt accumulation and speculation in assets from property to paintings. Financial institutions were undoubtedly lax and extended credit too willingly. Official economic and monetary policy should also take some of the blame because the structural cause of easy money was global imbalances, principally Chinese saving and US dissaving.

The mixture was explosive and the danger of abuse great. It is distressingly clear, for example, that on moral as well as financial grounds many sub-prime loans should never have been made.

Banks became excessively leveraged. In the five years to 2008 the average leverage ratio (total assets to shareholder equity) of European banks roughly doubled to 35 and some reached around 60. Over the same period, the assets of banks in the UK also doubled, to £8 trillion.

Credit - money - was created like never before in history. Now the chickens have come home to roost. In September, the IMF estimated that the financial system's bad debts could be an almost inconceivable $3.4 trillion.

The crucial distinction between investment banks managing risk and high street banks avoiding risk was muddied, partly because of the growth of proprietary trading, but mainly - to be blunt - because of poor banking decisions. In effect, the savings of ordinary depositors were leveraged for speculative activity that prudent institutions guided by their fiduciary responsibilities should have shunned.

Although they did not turn out to be systemically fragile, hedge funds set the tone in some ways by taking usually short-term and often arcane risks and reaping substantial rewards. Their generous pay structure contributed to the bonus culture. But, in fairness, I should add that the proprietors of hedge funds, unlike bank executives, were placing their own capital at risk. To that extent, rewards to hedge funds corresponded to risks taken.

But, overall, finance often seemed to be disconnected from other parts of the economy. There is no single reason for finance confusing ends and means. The then prevailing structure of bonuses, which failed clearly to relate short-term performance to long-term results, undoubtedly created perverse incentives. But they were as much a symptom as a cause, a point which seems to have been obscured in recent debate.

Information technology was perverted to create instruments of such complexity that ultimately nobody knew how to value or control them or with whom the risk really lay - with the disastrous consequences that are only too familiar to us.

Regulators and governments failed to rein in credit creation and contain asset price bubbles. Shareholders did not hold managements properly to account. Ordinary people allowed themselves to be seduced by apparently boundless credit and runaway asset prices, notably property.

In short, finance seemed to take on a life of its own. It ignored wider responsibilities as it became an end in itself.

The servers went down.

Misunderstanding finance

Of course, finance has existed as long as trade and business have been conducted on any scale. Banking developed in Italy in the Middle Ages to fund trans-Alpine and Mediterranean trade.

Suspicion of finance is equally nothing new. Literature and life are littered with examples of financiers society has loved to hate. Shylock in Shakespeare's The Merchant of Venice embodied the opprobrium heaped on money lenders. In his play Marriage à-la-Mode, the seventeenth century poet John Dryden has one character say to another who has recently married: "I find you have sold yourself for filthy lucre." Augustus Melmotte in Anthony Trollope's The Way We Live Now captured the mood of the financial scandals of the 1870s.

In a more contemporary vein, Gordon Gekko, the villain of the movieWall Street, was supposed to typify the spirit of the 1980s. His infamous pronouncement, "Greed, for want of a better word, is good", has haunted finance ever since the movie appeared in 1987.

Fiction can often be shrewdly perceptive of reality. But the unflattering portraits of fictional characters also - one suspects unintentionally - crystallise widespread misunderstanding about the nature of finance in general and risk in particular. And such misunderstanding can get in the way of resolving the problems we face now.

As I have suggested, the world is full of risks - or, to sound less gloomy, we all weigh up the pros and cons of a given course of action in our daily lives. Is it too windy to climb the ladder to mend the roof today? Is it worth moving from a job I like to one which I might like less but which pays more?

We accept such calculations as the everyday stuff of life. Why then is a commercial deal based on calculations which are similar in principle any less natural? When bank helps an airline to hedge its fuel costs or develops a derivative for an industrial client to reduce interest rate exposure it is performing a useful function for those companies: it reduces risk and raises profits to the benefit of shareholders and employees.

Some call this speculation, but the value to the client explains what can be high returns to the bank. And that is why we should be careful about using phrases such as 'socially useful'. Who decides? On what criteria? For what purpose?

In theory, there is a distinction between investment and speculation. Investment, frequently portrayed as a "good thing", is basically the purchase of capital goods to produce goods or service for future consumption, or the purchase of assets such as a security to generate income or capital gain. Speculation, frequently portrayed as a "bad thing", is the purchase of an asset, for example commodities, for the sole purpose of making a capital gain.

In practice, as these sketchy definitions suggest, the border between investment and speculation is blurred. And in so far as speculation shifts risk, it allocates capital more efficiently than might otherwise have been the case. Blurred though the difference between investment and speculation might be, and the recent crisis notwithstanding, the truth is that a great deal of financial activity a great deal of the time is inherently good and useful. Commerce must have deep and liquid financial markets to thrive. The real crisis in 2007 to 2008 was that the markets seized up just when they were most needed.

What we are suffering from now is an understandable backlash against excess, which almost by definition is unlikely to be socially useful. But excess lies not in taking the risk as such but in bad decisions: conspiring in unsustainable asset bubbles and unethical behaviour. Excess is not the inevitable outcome of investment or speculation any more than drug taking is a necessary outcome of sport.

Moreover, we should not fall into the trap of being too western-centric. In other parts of the world, such as Hong Kong, finance attracts much less opprobrium - indeed, commands strong support. Western financial institutions were at the centre of the crisis and we therefore have responsibility to deal with the consequences. It does not follow, however, that we should turn our backs on finance when others around the world are embracing it. We might even ask: Why do they think differently from us? What might we have to learn?

Rebooting the servers

That said, there is a thread running through all the forces at work: finance forgot its purpose. It might sound strange - especially coming from a financier. But how often in the years leading up to the crisis did you hear the following question: What is finance for?

I suspect that you rarely heard that question asked, if at all. Booms are not generally times for reflection - ironically, because that is often when taking a deep breath is most necessary. But we certainly have now to address the question What is finance for? I would answer: first and foremost, to serve the rest of the economy. Dramatic as recent events have been, it could be argued that the current popular mood and political atmosphere have deep roots in a mounting sense that a genuine respect for service has decayed.

At the retail level, public concern about the quality of service has been growing for some time. The recent crisis followed scandals such as pension misselling, public disquiet over some bank charges, dissatisfaction that call centres had replaced local bank managers and grumbling about high credit card fees. It is no accident that "Know your customer" is one of the Financial Services Authority's most basic commandments.

But service also has a far broader meaning than how customers are treated. I contend that economic activity is not solely about growth and maximising output. It is also about helping to provide the goods people need - collective goods such as a civilised and harmonious society as well as individual consumer goods such as the latest hot video game like Mass Effect 2.

Certainly, finance has a strong story to tell about supporting society in an economic sense. Her Majesty's Revenue & Customs calculates that corporation tax and pay as you earn income tax generated by banking and insurance totalled £32 billion in 2008, compared with £20 billion four years earlier. To put that in human terms, £32 billion is just under a third of annual expenditure on the NHS

This is surely a massive contribution to a value-creating, civilised and harmonious society. But we have also seen the alternative. When it becomes primarily an end in itself, finance has the power to destroy economic goods - as almost happened last year. Rebooting the servers cannot mean going back to a future of business as usual.

For me, rebooting the servers means two things: getting finance back on its feet in a business sense - to be sound and profitable; and getting it back on its feet in a functional sense - to help nurture a civilised and harmonious society

In the process, we can expedite the UK's economic recovery and restore the public finances to a better balance.

To do all this we must engage the critics and reassert the essential role of finance - to oil the wheels of the wider economy, to be a servant rather than a master. Equally important, we have to demonstrate change through actions, to show finance is putting its money where its mouth is.

Regulation has a part to play. Certainly finance is too important to be left to financiers. I support measures such as adjusting capital requirements to risk and relating compensation to long-term rewards for shareholders - although I would also ask whether football clubs and fans are happy with the huge salaries top players earn. It is not always obvious that footballers' pay is closely linked to their teams' results!

Now for the caveat. We must not get carried away. Big banks are vital to the UK's future. It would be a grave mistake to succumb to the attack that some banks have become "too big to fail" and therefore hold the public to ransom. They may have been a problem, but they are also part of the solution.

I do not agree that big banks per se are destabilising.

Size in itself is not the problem. In a global economy, we cannot return to a romanticised world of country banks and prudent partnerships. Big banks - like all big organisations - may be inherently harder to manage than smaller ones. It may also be true that claims for the stabilising effects of diversity by product and geography were exaggerated.

But a larger number of smaller banks without investment banking arms could equally pose systemic problems because they remain connected and risks spread fast. Nor is separating utility banking from investment banking necessarily a panacea. Northern Rock did not have an investment bank arm, but look what happened. Moreover, I have grave doubts about the practicality of the various schemes proposed for breaking up banks or ring-fencing certain sections of them, such as retail deposit taking.

However, safeguards are possible. Better governance such as having chief risk officers report to the board instead of the chief executive, higher capital requirements for systemically significant institutions, living wills and clearer strings attached to bailouts in the form of penalties for shareholders, bondholders and directors are among the eminently practical ideas under discussion or even being implemented at the moment.

Of course, there is no complete protection or guarantee. Mistakes will be made; failures will occur. Nevertheless, the truth is that without big banks the UK financial sector will not be able to serve the economy as it should and be an engine of growth and recovery, let alone be internationally competitive.

That raises another thorny issue. Successful banks need successful bankers. Barriers do not attract talent. However, financial institutions have responsibilities here as well as governments. Restraint is needed on all sides. But in a fast-moving, global market the relation between risk and reward must be calibrated flexibly and quickly. We will not engineer and sustain a economic recovery without motivating the dramatis personae.

These are the reasons why we need a new settlement between finance, government and society to restore trust between these parties. I suggest we should work towards a public concordat to express that trust and enshrine the service principle. The concordat must be enduring and removed from the normal hurly burly of politics.

Rebuilding trust and restoring finance to being a servant rather than a master demands common ground. There are two points on which all should be able to agree. One is that the UK will not resume economic growth and repair its public finances without the City seizing the moment of market dislocation to assert its powerful advantages as the pre-eminent financial centre. We can debate specifics such as tax rates. But a good starting point is that a modern, service economy needs an internationally competitive financial sector.

The other, perhaps more controversial, point is that we have to see the crisis in the round. "Rocket science" investment instruments have been blamed for the disaster, although myriad bad banking judgements were much more culpable. There was also too much bad borrowing by consumers and government, a regulatory failure to prevent asset price bubbles, spectacularly in property, and a wide disregard for the ethical behaviour on which the legitimacy of any industry rests.

If we accept these two premises we can move to the next stage: forging a new settlement on the role of finance and mutual obligations of the City, government and society.

The concordat should have three crucial elements:

Financial institutions commit to a new openness about their structure, activities and use of capital, particularly their responsibilities to increase lending to small and medium-sized enterprises

Government commits to a stable and predictable framework of tax and regulation which acknowledges finance's value.

Society improves understanding of risk - the media has a role here - and accepts that the obverse of service from finance is responsible saving and borrowing by individuals.

Let me expand on each element. The thinking behind finance committing to a new spirit of openness is that the opacity of many institutions has undermined public confidence in them. I am not saying that there has been deliberate obfuscation. Rather, institutions have tended to believe that adherence to rules and regulations governing disclosure - which can be voluminous - is a substitute for corporate structures, products and practices which people can understand. And one thing people certainly understand is the obligation of financial institutions to support smaller but growing enterprises.

Recent policy moves such as the bonus tax have raised in some people's minds questions about government commitment to a stable framework. But the real issue here is much longer term. Markets, financial institutions and people the world over who work for them must feel confident that they can make decisions the benefits of which for themselves and the wider economy can be fully realised. Protecting the City as the world's pre-eminent financial centre is vital to restoring the UK's economic health. As the rating agencies come knocking on the nation's door, the City must be confident and at peace with government, society and itself.

A new settlement cannot work without parallel commitments from society. As I have suggested, individuals are not blameless even if their actions did not precipitate the crisis. We have borrowed too much and saved too little for too long. The UK's addiction to credit-financed consumer spending is a structural cause of the propensity to boom and bust. Misunderstanding of risk has helped to sow distrust of financial institutions.

Ladies and gentlemen, establishing a new settlement along these lines is so important for the City and the country that

I believe there is a case for launching a mediation effort to find common ground. Mediation is not arbitration and could take the form of a roundtable conference of representatives of finance, government and society. Or it might be a meeting hosted by a think tank or similar neutral body. Or maybe we should imbibe the spirit of the season and place the process in the hands of three wise men from finance, government and society.

I firmly believe that with a new mediated settlement we can draw a line under the past. Finance is a service industry. It is time to reboot the servers in the literal sense of restoring finance to its proper role of servant to the wider economy.

Thank you very much.