Fondazione Centesimus Annus
Pro Pontifice

Re building Trust in the Banking System

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It is a great pleasure for my wife and myself to be invited to this conference and a privilege for me to take part in this panel discussion. Rome is always a delightful and interesting city to visit but for a Christian it has a special significance and so please accept a special thank you for this invitation.

I would like to confine my remarks today to just one aspect of the conference theme, namely how to rebuild trust in the global banking system following the collapse of trust which accompanied the financial crisis. The public anger and the collapse of trust which has accompanied the financial crisis how to rebuild trust in the global banking system

Catholic Social Teaching

Before I do so however and as someone who is not a member of the Roman Catholic Church but the Church of England, I would like to express my deep gratitude for the development of Catholic Social Teaching especially in the field of economics and business, and in particular for the encyclicals Centenimus Annus (1991) and Caritas in Veritate (2009).

As a student at the London School of Economics in the early 1960's I was left-wing politically. Then after studying economics and living through the failures of socialism in Britain during the sixties I came to appreciate the benefits of a market economy based on enterprise and innovation and the drawbacks of state planning, public ownership, over powerful trade unions, high taxes and burdensome regulation. My special field was monetary theory and policy and on the basis of research I came to the view that in the financial sector there was a strong case on public policy grounds for breaking up cartels in the City of London. It should be remembered that in the late1960's every area of the City of London – the discount houses, clearing banks, accepting houses, building societies, the stock exchange - was a cartel and had been since the First World War. Its increasing competition meant allowing foreign firms entry to UK markets, increasing consumer choice and removing unnecessarily restrictive regulation.

At the same time I had long had a continuing interest in understanding the relationship between my faith as a Christian and economic life. In trying to work this out one seminal moment was a dinner party at the University of Rochester in the spring of 1973 when Milton Friedman challenged me with the question "How can you advocate a free market economy and be a Christian? Didn't Jesus say that it's harder for a camel to go through the eye of a needle than for a rich man to enter the Kingdom of God". It is in responding to that challenge that I have found Catholic Social Teaching to be of great help.

One reason Catholic social teaching is so powerful is that it is biblically based. Its starting point is the Hebrew bible. It is important that the teaching of Jesus is placed in the context of the Hebrew faith because it is from the Old Testament that he would have been taught in the synagogue each week the essentials of his faith. In this context it is not possible to stress too much the Jewishness of Jesus. He was born into an orthodox Jewish home, circumcised on the eighth day, presented in the Temple, given a bar mitzvah at the age of thirteen, ate kosher food and respected the Sabbath as a holy day. His understanding of economic life would have been gained from the Pentateuch, the first five books of the bible, which taught that the physical world had been created by God and was not some accident. In the whole of creation it is only human beings who bear the image of God and are his vice-regents in managing and caring for the created world. The Mosaic Law was important as a way of preserving the dignity of the human person which in the context of economic life meant the freedom to buy and sell to own private property, the requirement to pursue social justice and the responsibility to help the poor and disadvantaged.

The economic ideal set out in the Pentateuch is a simple market economy, fenced around by laws which ensure fairness and justice and which are embedded in a culture in which God is at the centre. The important point is that it is neither left wing nor right wing neither libertarian nor Marxist, and it is this which Catholic Social teaching ever since Rerum Novarum in 1891 has set out so clearly.

Centenimus Annus opened up a new chapter for Catholic Social Thought. It showed how communism collapsed because it had a deficient view of the human person, an inadequate anthropology. By contrast economies which allowed greater economic freedom – the freedom to exchange, invest, take risk, search for work and so on - and anchored those freedoms in private property rights, created opportunities for enterprise and entrepreneurs which was based on an altogether different view of the human person. It emphasized it was the human person and not the economic system which should be the key concern of economic life. Economic systems exist to serve people and not the other way around.

From one perspective the twentieth century could be viewed as a contest between two rival economic systems – socialism and capitalism. The collapse of the USSR and the fall of the Iron Curtain followed by three decades of successful globalization suggest that market based economies better accord with a Judaeo-Christian understanding of the nature of the human person. Market based economies were seen to operate for the common good.

There were of course many questions to be answered regarding market economies such as their sustainability, inequality between rich and poor, the place of monopolies and restructive practices and the culture within which economic life was embedded, all of which could be viewed as undermining the common good. Nevertheless in a choice between two imperfect systems those based on freedom, enterprise and democracy came out on top.

The Financial Crisis and its Aftermath.

This changed dramatically with the financial crisis of 2008. In September 2008 the world was within minutes of a financial meltdown in which banks and central banks would have had to close their doors as the US was forced to do in 1933. The crisis meant that well known banks went to the wall and the banking systems of the US, the UK and continental Europe needed to be rescued at huge public expense. The financial crisis has been followed by a severe recession, though economic recovery is now on the way.

The cause of the crisis is complex and involves not just banks but the mistaken policies of central banks, the active encouragement by politicians of sub-prime borrowing, failure by the rating agencies to assess the risk of asset backed securities, failure by regulators to understand the build up to the crisis and take appropriate action and reckless borrowing by consumers. While the media and politicians have put most of the blame on banks and bankers the picture is far more complex.

The result of the crisis has been a huge loss of trust between banks and the public. The public are angry with the banking system because of the incompetence of banks in making bad loans and taking on excessive leverage. Their greed in paying themselves huge bonuses even though their banks were all but bust, the suspicion that banks acted unethically in putting their own interests before those of their clients; and the fact that the cost of the crisis in terms of higher unemployment, higher taxes and lost output is being borne by the general public and not by banks themselves. Caritas in Veritate recognized that the crisis had led to “the progressive erosion of ‘social capital” which had defined as, “the network of relationships of trust, dependability, and respect for rules, all of which are indispensible for any form of civil co-existence” (CV32)

This was a point which was subsequently expanded later in the encyclical. In paragraph 35 it argued that markets perform a valuable function in society. Wealth creation is comparable to a game in which all players must play by the rules. (“commutative justice”) It then goes on:

> “But the social doctrine of the church has unceasingly highlighted the importance of distributive justice and social justice for the market economy, not only because it belongs within a broader social and political context, but also because of the wider network of relations within which it operates. In fact, if the market is governed solely by the principle of the equivalence in value of exchanged goods, it

cannot produce the social cohesion that it requires in order to function well. Without internal forms of solidarity and mutual trust, the market cannot completely fulfill its proper economic function. And today it is this trust which has ceased to exist, and the loss of trust is a grave loss." (CV 35)

"It also remarks that it is in the interests of the market to promote emancipation, but in order to do so effectively, it cannot rely only on itself, because it is not able to produce by itself something that lies outside its competence. It must draw its moral energies from other subjects that are capable of generating them (CV 35)"

Rebuilding Trust in the Financial System

It's a major task facing bankers today and in addressing it we need to ask ourselves a number of tough questions.

First, what is the right spirit in which to approach these issues?

For banks and bankers the present is an opportunity for reflection, both on the crisis itself and on the build up to the crisis. We need critical self-reflection as to what went wrong. We need to ask ourselves hard questions. Why was there inadequate capital? Should we have kept dancing simply because the music kept playing? Were we only concerned with short term risk taking regardless of long term value creation? Were the Chinese walls robust enough? Did we put our own interests before our clients? Were we economical with the truth?

Most important is that these issues are addressed openly, frankly and in the right spirit. The right spirit must be one of humility, integrity and service. Investment bankers are not masters of the universe. We are the servants of the society which gives us the license to operate.

At the same time such reflection should look at positive achievements as well as failures. We should not forget that in the three decades before the financial crisis the world economy grew by 3% a year. It was a time when countries such as Russia, India and China entered the world economy in a dramatic way. During this time the ability of these countries to raise capital has changed dramatically. Their currencies are now traded globally. They have developed their own financial systems. Their local companies have grown to be global players. The effects of these changes have been dramatic. In Asia the number of people living on less than a dollar a day had declined by hundreds of millions. These developments have resulted in the G8 countries being expanded into the G20. This would not have happened without the global capital markets which developed over the last thirty five years.

A second question which needs to be asked is “How does investment banking serve the common good? In other words how does it serve the good of us all and not just the good of those who work in banking?

Investment bankers unlike commercial bankers have never been required to explain their business in public debate. As a result they have been poor in explaining to the rest of the world how they add value, how they contribute to the common good.

Banking serves the common good in a number of ways.

- it is the basis of the payments system of modern economies and the global economy
- it provides an extraordinary variety of financial products for savers and investors
- it acts as an intermediary channeling the savings of ordinary people into loans, mortgages and other forms of borrowing which in turn facilitates investment in houses, new private and in the process prices risk appropriately
- it transfers funds between countries and facilitates international trade
- it enables, people and companies to insure against risk.

In all of these ways banking serves the common good but regrettably bankers rarely communicate the social value of what they do.

The third question is “What structural reforms are needed to regain trust?”

The answer to this question is extremely complex and is being addressed by the governments, central banks and regulatory agencies of all developed countries as well as numerous international financial bodies. The one thing which can be said with certainty is that trust will not be regained without certain structural changes. At a minimum banks will be required to hold greater capital against risk assets and especially their trading books, increase the proposition of cash and highly liquid assets on their balance sheets and sign up to certain generally agreed rules for determining compensation which will restrict the percentage of bonuses paid as cash.

The more difficult problem is the “too big to fail” category of institutions, which know that if they find themselves in difficulties will inevitably be bailed out by governments. Because of this they have an incentive to hold less capital and take more risk. Various proposals have been made including creating utility banks which do not take risks, restructuring the risk-taking activities of investment banks and requiring banks to draw up ‘living-wills’ so that in crisis conditions they can be closed down. The danger of politicians going for over kill which in turn will act as a tax and so restrict economic recovery.

The fourth question is “Are structural reforms sufficient to regain trust with the public or do we need a change in the culture and values of our financial institutions?

I believe the answer to this question is an unequivocal yes. The financial crisis is not a purely technical issue. It is not just the breakdown of a financial machine which can be corrected simply through regulatory re-engineering. Structural reforms although essential will never be sufficient. The cultures of financial institutions which reflect their values are critically important. A culture is not the same as business principles or corporate values. A culture is what people do and the way they do business not what they aspire to do. In the build up to the crisis the bad decisions and poor judgments by bankers resulted from values and cultures within financial institutions in which the pursuit of profit and personal reward became far too dominant.

Values and cultures cannot be changed easily. They take time to establish and there are no simple levers to pull. This is where Caritas in Veritate provides important insights. Values and culture require what it calls “moral energies” but argues that the market left to itself does not produce these qualities. This is because they are outside of the competence of the market and therefore in order to discover these we must look elsewhere.

The final question is “what is the role of leadership in restoring right values and a healthy culture within banks?”

My own view is that leadership is crucial to this process. The leader is the embodiment of the values of an organization. He or she sets the tone in a way no one else can. We live in a globalised world and no leader however great their integrity can buck the realities of the market place. To do so would be a disservice to clients, shareholders and tax payers. Within the constraints set by the market however leaders can articulate the values explicitly the values which guide them, set standards for everyone in the organization to observe and show by example that they “walk the talk”.

In conclusion I believe the financial system can regain the trust of the public. It will require regulatory changes. More importantly we need to rediscover those values and then live by them so that the public can see we are there to serve them and not just ourselves. In this we can do no better than take to heart some words from the Encyclical

> “development is impossible without upright men and women, without financiers and politicians whose consciences are finely attuned to the common good”

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