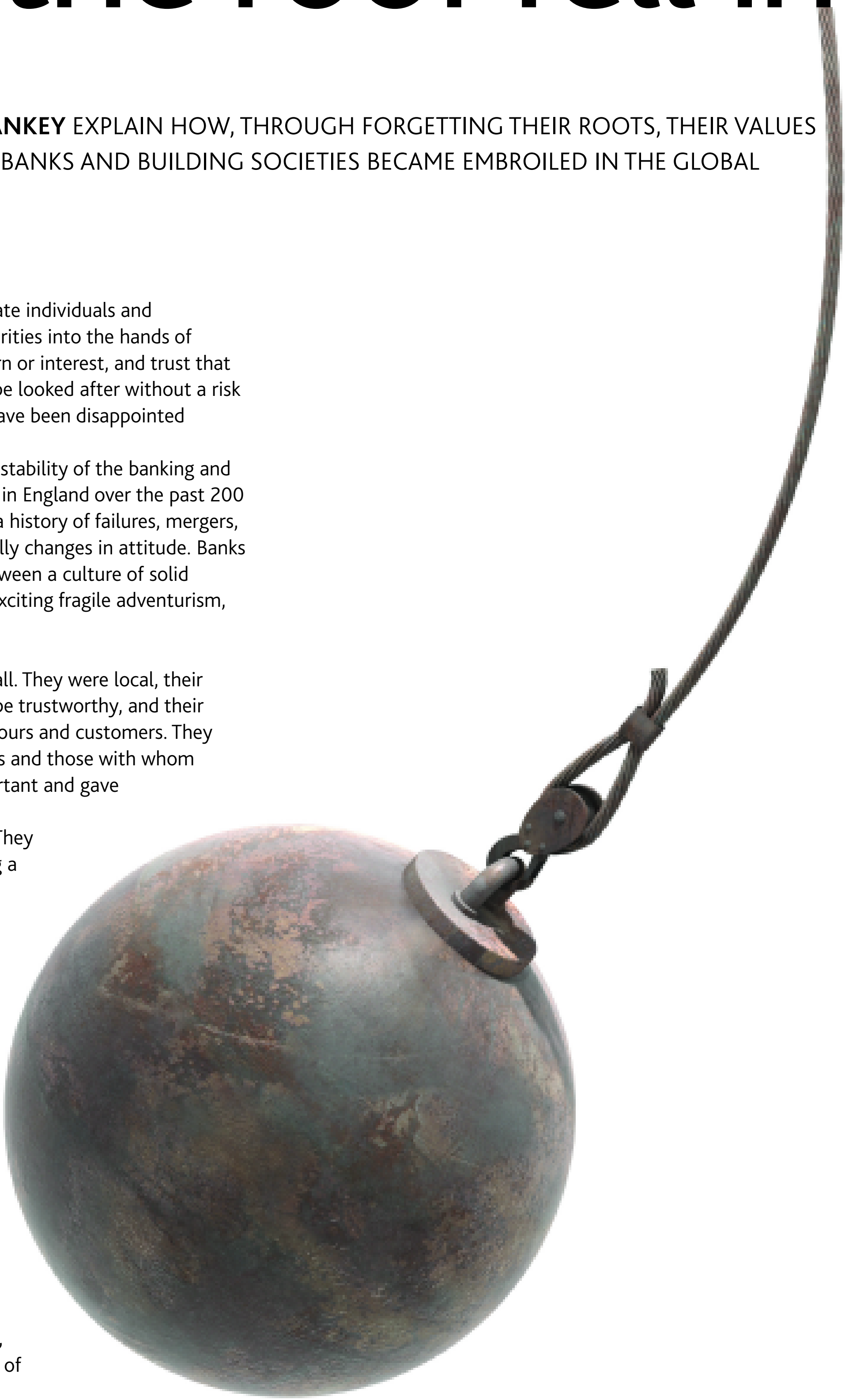
Why the roof fell in

JOHN POPE AND **EDWARD SANKEY** EXPLAIN HOW, THROUGH FORGETTING THEIR ROOTS, THEIR VALUES AND THEIR HISTORY, THE UK'S BANKS AND BUILDING SOCIETIES BECAME EMBROILED IN THE GLOBAL FINANCIAL CRISIS.



The basis of banking is trust. Private individuals and institutions put money and securities into the hands of bankers. They expect some return or interest, and trust that their money and securities will be looked after without a risk out of proportion to the return. Many have been disappointed recently, and not for the first time.

There is nothing new in the current instability of the banking and financial system. The history of banking in England over the past 200 years is one of continuous change. It is a history of failures, mergers, new initiatives, cost cutting and especially changes in attitude. Banks and related institutions have swung between a culture of solid conservative respectability and one of exciting fragile adventurism, almost from one extreme to another.

IN THE BEGINNING Banks started small. They were local, their founders were well known and seen to be trustworthy, and their behaviour was observed by their neighbours and customers. They were careful in choosing their customers and those with whom they dealt. Their reputations were important and gave their customers confidence.

Building societies also started small. They chose their members carefully, requiring a good record of regular saving. And they were prudent before they lent money on a mortgage on real property. They did not lend beyond the borrowers' ability to repay.

Likewise, savings banks, such as the Yorkshire Penny Bank, started small and catered for the very small saver. Some became substantial, such as the TSB, later swallowed by Lloyds. They were very prudent lenders.

Those building societies and banks were a major and essential part of the monetary and trade infrastructure supplying business and personal finance. Their positions were visible. Their depositors were, in general, quick to assess their stability: the safety of their money was their chief concern.

BIGGER INSTITUTIONS
Commercial banks then began to emerge. Some were established to specialise in a particular industry, such as the British Linen Bank, which issued its own banknotes. They raised money for business, as did merchant banks, although they also dealt in the stock markets, which were to be found in the major cities, where they were visible to local investors. Some of those markets specialised in local companies, which were also visible to local investors.

Knowledge of their chosen market sector was crucial and they specialised. They were alert to changes and the likely effects on their customers. They kept in as close touch with their customers as they could, especially when times were difficult. They shared information and were better able to assess the risks. Though some of these banks failed from time to time, the risks of overlending were generally well understood and controlled. Failure had no significant effect on the general public. Small depositors were not involved.

TIMES CHANGED Building societies changed, perhaps to cope with the increasing demand for home ownership. Some became very competitive and took the route of becoming big. Societies ceased to have the same close relationship with their members. In their desire for growth they lent heavily to risky customers.

Banks had been local and they grew. Their major activity had been in tiding business or individuals over a short-term need for funds, or financing well-trusted local businessmen and their businesses. After mergers of many small banks, the Big Five clearing banks emerged – Lloyds, Barclays, National Provincial, Westminster, Midland – and became dominant in England. Each had their own particular strengths and a regional flavour. Their basic strength still lay in knowing their markets and their customers, and their lending was prudent. Local managers of different banks shared information and gossip about their customers and the state of trade, unofficially and informally. Since profit in retail banking seemed constrained, they were encouraged to sell other financial products, car insurance and so on. In doing so, they ignored the warning found in some pubs: "The banks have agreed that they will not sell beer; in return we have agreed not to lend money."

When building societies started, their few members were very committed to their society. Home ownership and membership grew, and though they still used their local knowledge to assess the value of the properties they lent on, they started to lend heavily regardless of the creditworthiness of the borrowers. That business looked attractive to the bigger institutions, and many were swallowed up, often after a brief period of being public companies.

MORE CHANGES, FASTER GROWTH That financial infrastructure was relatively expensive to run. The development of IT systems accelerated the changes. As many more people owned their own homes and got bank accounts, banks became more aggressively competitive and bank cartels were broken. Banks issued their own credit cards, dealt in shares and in a wide range of "financial instruments", some of which were difficult to understand and value. High-street bank managers were increasingly targeted on lending as the source of income, encouraging higher levels of personal and small business debt. Formerly cautious banks took on more risk as they grew or got into areas they did not understand.

WHEN THOSE IN THE FINANCIAL WORLD ARE STRONGLY INCENTIVISED DIRECTLY ON THE RESULTS OF THEIR ACTIONS, OR INDIRECTLY ON THE RESULTS OF THEIR PART OF THE ORGANISATION, THE RISKS INCREASE DRAMATICALLY.

Banks bought up stockbrokers and building societies; some bought merchant banks; and they realised that by means of careful balancing and leverage they could juggle with their depositors' money, often though an in-house investment bank. Some banks became international, a few became worldwide. They became dominant in an industry or in a local community, as was Northern Rock. They were seen as being too big to be allowed to fail because of the political consequences.

They certainly became so big that they lost touch with the individual depositors who provided the retail finance. They required wholesale finance from other big financial institutions, pension funds, unit trusts and others, although many of those sources often relied on individual deposits and savings, which were not just from one country. At each adventurous step, they moved further from their origins, further from their knowledge base, further from well-understood dangers, and into the unknown.

FINANCIAL PRODUCTS BECAME MORE COMPLEX Over the last 10 years there has been rapid development of innovative financial products and services. Most recently, the growth in global liquidity and credit provided a demand for such products and services.

The investment banking and wholesale market activities of financial institutions became very profitable. Success depended on being fast in action and delivering deal volume. The demand for investment opportunities from clients led to increasing prices of instruments and underassessment of risks.

Some financial institutions stayed in one field of banking, investment or in retail, or in commercial or traditional corporate finance. But a significant number of the largest banks were in several fields and highly international. In such institutions the investment banking and wholesale markets activities were very influential and the business and management methods they used seemed to deliver better profits. The retail, commercial and corporate finance banks started to feel their influence, through funding linkage, risk taking and culture.

In retail and commercial banking, the values of knowledge of customers, risk aversion and diligence in lending and collateral management became increasingly regarded as hindrances to profitability. The 2008 crisis showed that some banks had become very aggressive lenders, with decisions on loans being taken remotely and to a formula. However, when there was a market that would buy loan portfolios, or the risk element on the loan portfolios, this seemed to reduce the risks.

AN UNSTABLE STRUCTURE When the economy was booming and there was plenty of money around, all looked well. But the financial system had become unstable, complicated and not well understood. What started as a concern about sub-prime (i.e. high-risk) mortgages in the US caused a chain reaction and ended up bringing down well-respected institutions. Governments of all shades felt obliged to step in. Many bankers were saved, perhaps unnecessarily, from the consequences of their own folly. It is to be hoped that the lessons will be learnt.

There are risks in every business or transaction but when risk-taking is encouraged by the prospect of substantial, sometimes enormous, personal wealth, the risks are multiplied many times. Overconfidence and the pride which comes from striking a successful deal in the course of which an opponent is vanquished can act as a powerful motivation to many, and multiply the risks.

When those in the financial world are strongly incentivised directly on the results of their actions, or indirectly on the results of their part of the organisation, the risks increase dramatically.

We now see the consequences of risky behaviours. Not all of it is entirely the bankers' fault. Government policy, extravagance and imprudence set up the conditions, which, with incentivised pride and overconfidence, encouraged all forms of risky behaviour, the checks on which were not effective.

There had been an apparent synergy within banking as very different types of business were bundled together. It looked good while things were going well. This has severely weakened banks (some, fatally) and damaged the banking system. Contact has been lost with the customers in the real economy, who are also bearing the brunt of the banking crisis.

Bankers' bonuses discouraged prudent behaviour and were not aligned with shareholders' interests. The bundling together of such different types of business has led to the position where such banks were considered too big to be allowed to fail because of the political implications and damage to the financial infrastructure.

The deposits at retail and commercial banking divisions enabled full-range banks to fund more of their investment banking activities and hold more assets in the bank's name before selling them. Banks making money out of structuring "innovative" financial products were also using their own capital to retain some of the profit by investing themselves.

The apparent profitability of these products led to pressure on the retail banks to package and sell their loan book, so the asset matching of the clients' deposits changed from a low-risk loan book, held for the life of the loan, to higher-risk assets, which a bank expected to be able to sell if the capital returns were poor.

THE WAY FORWARD Taxes on financial institutions and on bonuses will not change behaviour or prevent a recurrence. One part of the solution is to separate the main types of banking, which have no more similarity than there is between, say, a regional power supply company and an electrical equipment manufacturer – and no-one has so far put those two together. But the other part of the solution is for banks to return to prudent management, to consider the risks they run, to withdraw from markets where they cannot assess the risks, to check over-risky behaviour of their staff and to stop over-incentivising them. A permanent change in attitude is essential. Failure to change will bring drastic regulation.

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