Have we made banking good?

By

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1) Introduction and Background

This paper reports on the deliberations of a special plenary panel ('table ronde') session organised on behalf of the UK's Monetary Macro, Finance Research Group (MMFRG) at the 31st International Symposium of the Groupement de Recherche Européen (GdRE): Monnaie, Banque et Finance (MBF) on 19th June 2014 by Andy Mullineux (Bournemouth University) with the help of other members of the Scientific Committee for the conference, particularly Antoine Parent, the local organiser and Jean-Bernard Chatelain, President of the GdRE (MBF). They invited Laurent Clerc (Banque de France) to join the panel, which was chaired by Andy. The other panellists were Philip Davis (Brunel University and National Institute of Economic and Social Research, NIESR), Peter Sinclair (University of Birmingham), and Karen Braun-Munzinger (Bank of England).

The '*double entendre*' implied by the chosen title was intentional in the sense that it asked both whether the banking system has been repaired by regulatory initiatives initiated since the 2007-9 Global (or Great, as it is increasingly and more geographically accurately, referred to) Financial Crisis, or 'GFC' in the sense that the system had been rendered safer and sounder and less likely to require taxpayer financed bail-outs in the future. The second meaning relates to the question of whether banks have become better at serving the social and economic, or common, good and less short term profit oriented.

This panel follows on from related panels organised by the MMF at GdRE conferences. Two years ago, in Nantes, the panel focussed on the Eurozone crisis and considered how to break the 'Doom Loop' in (or 'Spirale de la Dette', Mullineux 2013a) where government (and thus taxpayer) insurance of troubled banks, particularly the larger ones deemed 'too big (to be allowed) to fail', lead to a rise in the risk premiums on periphery government bonds. The major banks responded by 'deleveraging' and loading their balance sheets with bonds issued by their domestic governments and thus became increasingly exposed to government debts and their associated default risks; which required no capital backing under the new Basel III capital adequacy and liquidity requirements.

In July 2012, after the conference 'Super' Mario Draghi, the President of the European and Central Bank (ECB) promised to do 'whatever it takes' to save the Eurozone and announced Outright Monetary Transactions (OMTs) that would allow the ECB to purchase bonds issued by governments that submitted to a financing package subject to conditions imposed by the funders. OMT has yet to be used and indeed Ireland and Portugal successfully 'exited' in 2013/14 the rescue packages put together by 'The Troika' (the IMF, ECB and European Commission) earlier in the crisis.

The 2013 GdRE panel in Poitiers discussed the problem of 'Restoring the Bank Lending Channel' (Mullineux, 2013b) amid 'fragmentation' of the money and capital markets in the Eurozone. Bond yields in the 'periphery' Eurozone countries were at an increasing premium to German 'bunds' and small and medium sized enterprises (SMEs) and other companies in 'the periphery' faced considerably higher interest rates on loans from banks whilst SMEs in core countries, particularly Germany where the SMEs and 'the Mittelstand' remained well served by cooperative and savings banks (Sparkassen).

In the UK, HM Treasury (the Financial Ministry) and the Bank of England had jointly introduced a Funding for Lending Scheme (FLS) in 2012, which provided cheap finance to banks that extended new mortgages (home loans) and SME loans. Meanwhile the ECB was operating its Long Term Refinancing Operation (LTRO) which gave the Eurozone banking system cheap access to abundant funds, much of which was re-deposited with the ECB and used to buy government bonds, rather than on-lent to SMEs.

The UK's FLS scheme was adjusted to remove funding mortgages in 2013,when a 'Help to Buy' scheme was introduced as the housing market recovered, arguably too vigorously. However, SME lending did not start to increase until the UK economy began to pick up speed after narrowly avoiding a 'triple-dip' recession in spring 2013 (Armstrong, Davis et al, 2013). The SME focussed FLS scheme was extended in the UK government's April 2014 budget.

In early June 2014, two weeks before the Lyons conference, 'Super' Mario announced a 'big bazooka' initiative involving negative interest rates on deposits by banks with the ECB and Targeted LTROs (TLTROs), which consist of a package of £400bn fixed rate (0.25% initially rising to 0.5%) four year loans to banks that on-lend the borrowed money to SMEs. Full details were yet to be revealed and the package consisted of other stimulatory monetary policy measures, including removal of the 'sterilization' of bond purchases by the ECB. The package aimed to address the problem of restoring, or reviving, the bank lending channel and also to discourage banks from depositing funds borrowed through the LTRO from the ECB, with the ECB, or using them to purchase domestic government bonds; bank holdings of which had continued to increase subsequent to the Poitiers conference two years previously.

The ECB also announced plans to engage in 'credit easing' focussed on buying securities backed by receivables (interest and capital repayments) from packages of SME loans and to explore ways of re-invigorating the 'securitised' bond market that had collapsed, apart from the 'covered bonds' segment, after the GFC as a result of miss-pricing of risks in the mortgage-backed securities (MBS) market and the related derivatives (Collateralized Debt Obligation, or CDO) market. This policy is thus somewhat controversial and speculative, but is supported by other central banks, including the Bank of England.

Another goal of the stimulus was to attempt to reverse the falling actual and expected inflation rate in the Eurozone, which is particularly problematic for periphery countries attempting to adjust through 'internal devaluation'.

If the package does not do the trick (and uptake of the TLTRO auction in September 2014 proved disappointing), and the German government support for it through its attempts to raise German real wages fails to ease pressure for reduced real wages in the periphery sufficiently, Mario Draghi has promised that the ECB is 'not finished yet'; which means that Quantitative Easing (QE) through direct purchases of government bond issuance, hitherto anathema to the Bundesbank, may have to be employed to enhance the monetary stimulus, and weaken the euro against the US dollar, further.

For the banks, holding domestic government bonds has proved beneficial because falling risk premiums, and thus yields, after the July 2012 promise to 'do what it takes' to save the Eurozone, resulted in capital gains on their bond holdings and made it cheaper for them to issue new bonds, including contingent convertible ('Co-Co') bonds that count towards Basel Tier 1 capital ratios. The 'Doom Loop' has been turned into a virtuous spiral and Spain, which averted the need for recourse to OMT and thus a conditional rescue package, was able to fund itself more cheaply in June 2014 than the US was able to!

The Lyons 2014 panel met in light of a warning in the previous week, from Christine Lagarde, Managing Director of the IMF, that housing bubbles were inflating in a number of countries and a warning from Mark Carney, Governor of the Bank of England, and George Osborne the UK's Chancellor of the Exchequer (Finance Minister) that (UK) house prices inflation was the biggest threat to financially stability in a UK economy experiencing accelerating growth.

An increasingly robust recovery in the US was also raising the question of when and how fast interest rates should be raised towards more normal levels, or 'normalised', once the liquidity stimulus through quantitative and credit easing had been terminated in October 2014.

Residual worries about the robustness of the recovery in the UK and the US, given that levels of indebtedness remained at historically high levels, and below target inflation with falling expected inflation, have led to calls for postponing or progressing slowly with interest rate normalisation and instead using new, and largely untested, 'macro-prudential' policies to curb asset (including housing in the UK and junk bonds in the US) price inflations in order to prevent bubbles that tend to inflate following prolonged periods of 'cheap money'.

This suggested that the topic for the 2015 GdRE conference in Nice, should be: "Monetary Policy after the Financial Crisis: What will the 'new normal' be?"

Meanwhile, the Eurozone was awaiting the outcome of the ECBs 'Comprehensive Assessment' of its banking system risks and capital adequacy. This consists of an 'Asset Quality Review' conducted by the ECB and bank balance sheet 'stress tests' conducted by the European Banking Authority ahead of the ECB, in conjunction with national supervisory authorities, taking over responsibility for banking supervision in November 2014. The resulting 'Single Supervisory

Mechanism' (SSM) is the first step towards forming a European Banking Union (Mullineux, 2014).

Fragmentation in the Eurozone had declined substantially by June 2014, but non-performing loans (NPLs) in the periphery were still rising and there was a concern that they were being under-recorded and under-provisioned for. Harmonisation of the diverse methods of measuring and provisioning for NPLs is clearly required under the SSM. Much needs to be done to improve practice in light of the fact that Spain was widely regarded to have put in place an exemplary forward-looking provisioning policy prior to the crisis, but it provided to be inadequate following the onset of the crisis. Recently accepted international accounting standards will facilitate forward looking 'general' provisioning. Until these issues are addressed, and NPL rates decline, SMEs in the periphery can expect to face higher risk margins and thus borrowing costs, however strong the uptake of TLTRO turns out to be by their generally smaller, and less well capitalised, domestic banks. Meanwhile, there is a concern that the Co-Co's issued by the bigger European banks may turn out to have under-priced the contingent risks.

2. The Panel Discussion

The first panellist to speak was E. Phillip Davis, currently working at Brunel University and a Research Fellow at the NIESR, who has previously worked for the Bank of England, from which he was seconded to the European Monetary Institute (EMI); which was the precursor to the ECB in Frankfurt. Phil also currently works as Pastor of Penge Baptist Church, South London, and started by observing that Jesus said that "No one is good but God alone" (Matthew 10:18), so, *can* banking be made good? The charging of interest on debt was made permissible by Calvin under the 'law of love' and was previously permissible under Judaism, but does not comply with Islamic Sharia law, or the medieval Catholic view. Nevertheless, rates on 'payday loans' and allegations of irresponsible, if not predatory lending to subprime customers, especially with regard to the US subprime home loans crisis that contributed to the GFC might be regarded as excessive, or 'usurious'.

Phil asked if the economic functions of banking: transfers of resources across time and geographical space; liquidity insurance; 'delegated monitoring' *inter alia* were being performed well. Was banking disruptive of the wider economy, and what was wrong with banking? He identified a number of problems areas. Banks were lending inadequately to some sectors, such as SMEs (Armstong, Davis et al, 2013), and excessively to others, such as housing and commercial property. There was also excessive risk taking through untested innovation beyond prudent levels. Little account was taken of systemic, as opposed to individual, banking risks and there was herding behaviour at the sectorial level in banking and 'disaster myopia' and short term memories; resulting in the lessons of previous crises being forgotten by the banks and regulatory and supervisory authorities.

In addition, there were incentive problems, with the 'too big to fail' problem creating a moral hazard leading to excessive risk taking by large banks. Further, the incentives in the pay and rewards structures, and particularly the bonus culture, led to excessive risk taking and short–term profit seeking behaviour.

Banking crises are recurring events, as reviewed in Davis (1992, 1995), and warning signals were clear from case studies. Favourable shocks, easing of entry conditions, innovations, debt accumulation, asset price booms, risk concentration, lower effective capital adequacy, and then a negative shock sparking a crisis.

Is there a wider moral malaise reflected in this recurrence of banking crises, he asked?

Phil then briefly reviewed recent empirical results, noting that SMEs face extreme credit rationing (Armstrong *et al*, 2013); banking crises have been preceded by property booms, current account weakness and low capital and liquidity of banks (Barrell et al, 2010) and a rise in off-balance sheet activity (Barrell et al 2013). Further a rise in banking competition raises the risk in banking (Davis and Karim, 2014), whilst risk taking increases with time since that last crisis (Craig et al, 2005) and large, and particularly more rapidly growing, banks, take on more risk (Barrell et al, 2011).

Can banking be made better? One approach is better prudential regulation with more capital of the right sort (Tier 1, rather than Tier 2; which enhances risk taking) along with the new and justified attention to liquidity requirements under Basel III.

Product regulation should perhaps require stricter testing of innovations before they are widely marketed, as with pharmaceutical drugs. There would be a problem of preventing innovation being taken up by the offshore and shadow banking markets, however!

As regards market structure, larger, too big to fail, banks have a greater incentive to take risks than smaller ones, increasing their contribution to systemic riskiness. Breaking up the big and complex, systemically important, banks might be preferable to 'ring fencing' core retail and utility banking activities, as proposed in the UK. Would a bigger role for mutual banks such as credit unions, as proposed in the UK, help? Phil noted that the de-mutualised UK building societies all failed as a result of GFC, while the remaining large mutual, Nationwide, remained solid.

Phil argued that regulators had hitherto paid insufficient attention to incentives in finance, such as those presented by opportunities to arbitrage, or circumvent, regulations. Is a regular assessment of incentives as a background for regulatory enhancement required? Can banks' reward structures be adjusted to promote 'long termism'?

Abrupt changes in competition should be avoided and necessary reforms should be gradually introduced, he argued. Particular attention should be paid to the behaviour and viability of new entrants and financial firms granted new powers; such as the demutualised building societies being allowed to lend outside the housing market after the 1986 Building Societies Act.

Competition in SME lending needed to be encouraged in the UK, where the four biggest banks dominate the market, whilst too much competition in the home loans market had led to excessive and complex product differentiation in the run up to the GFC. There was perhaps need for a a greater role for loan guarantees in SME lending and the use of macro-prudential policy to calm the frothy home loan market.

As regards macro-prudential policy, the key focus should be on property lending and property prices, but there should also be a focus on incentives and the dynamics of competition. Given the political reality, how easy will it be for central banks to 'take away the punch bowl' whilst the party is getting under way?

The presence of disaster myopia and memory loss calls for rules, rather than the discretion implied by macro-prudential policy, as it is currently envisaged.

Finally, Phil addressed ethical issues relating to the topic (Davis, 2012). He considered whether formal regulation might be overly technical and whether it should be simplified and complemented by regulation that encouraged more basic 'values' to serve as benchmarks for behaviour. Regulatory arbitrage and avoidance through innovation might be reduced by a form of regulation forbidding actions against the spirit, rather than the letter, of the regulations. Such 'principals- based' regulation might be less open to legal challenges. To avoid regulation that promotes values turning into pious lists and a 'box-ticking' exercise, that is otherwise ignored or circumvented or pushed into the shadow banking sector, a crucial complement is the inculcation of 'virtues' (like honesty, prudence, courage, justice, trustworthiness and diligence) that promote the internal conviction of what behaviour is right, along with the determination to follow it through with actions for which bankers take personal responsibility.

Phil believed the most important virtue in this context was prudence – 'the perfect ability of individuals possessing freedom and free will to make morally correct practical decisions' e.g. using experience, data and judgement in the granting of credit (Gregg, 2010). Virtues can be promoted through the example set by senior management, such as Stephen Green, the former Chairman of HSBC (Green, 2009), and appropriately adjusted rewards and incentives. In the wider Judeo-Christian ethical framework, these entail responsibility as stewards of creation and ultimate answerability to God on the Day of Judgement.

Virtues cannot be relied upon alone, however, since values, and particularly regulations are enforceable, whilst virtues are not, but: a "financial system that neither promotes nor rewards such virtues has the seeds of its own destruction" (Davis, 2012).

A balance thus needed to be struck between institutional blame and personal responsibility and the regulatory authorities are struggling to find the balance in fining banking institutions and some traders, as opposed to management, for misconduct. The burden of proof for individual prosecution is higher whilst a bank can often pass the costs of the fines onto their shareholders and customers; at least until they respond negatively. The ultimate responsibility for risk management, pricing and control lies with senior management and the shareholder stewards. UK regulators seem increasingly seem to be requiring senior management to take greater responsibility for the actions of their employees.

The second panellist to speak was Peter Sinclair of the University of Birmingham. 'Evil is the root of all money', it has been alleged (Moore (with Kyotaki), 2001) he noted, as he warmed to the topic, asking: good for welfare, but whose welfare? Good morally? Good for GDP growth? Or, good in the sense of repaired, or safer, with economies (and taxpayers) better protected?

Barclays, HSBC, Standard Chartered and Nationwide were arguably good banks in the sense that they weathered the GFC well and prospered since, though not without challenges, including US fines for money laundering misdemeanours and a slowdown in S.E. Asian economies has more recently taken the shine off the performances of HSBC and Standard Chartered, and HSBC had also become embroiled in UK miss-selling and interbank and exchange rate scandals that emerged after the GFC. But in the North East of England, excessive lending funded by short term money market loans plunged Northern Rock into the first bank run in Britain for 160 years in August 2007 and 14 months later, its Yorkshire neighbours, Bradford and Bingley Building Society and the Halifax component of HBOS suffered insolvency for similar reasons..

To the North, in Scotland, still greater disasters were to follow the Northern Rock debacle. The Dunfermline Building Society entered into administration in March 2009; HBOS, parent of the Bank of Scotland, as part of HBOS, had to be acquired Lloyds TSB at the government's behest in October 2008; and RBS, the Royal Bank of Scotland, briefly the world's biggest bank after some high risk takeovers, was, like Lloyds, unable to survive without a heavy infusion of capital by the government and was all but nationalised; with the government ending up with a shareholding of 82%.

Diversity in banking is clearly important and it is now clear that the GFC was more a US or North Atlantic (excluding Canada) crisis, and not crisis affecting Asia, Australia, Africa and Latin America. Hence it was not a truly 'Global' financial crisis, and consequently it is now frequently referred to as the 'Great' Financial Crisis to reflect its magnitude as a huge earthquake, with its epicentre in the North Atlantic, that was followed by the 'Great Recession'.

Good or better for whom? UK households with mortgages have gained at the expense of depositors and savers. Employees have not done well since the GFC because real wages have fallen and depositors and savers have suffered low nominal and negative real interest rates, and SMEs have confronted intensified credit rationing, or a 'credit crunch'. Shareholders have not done particularly well either, although the shareholders in banks were often protected in bail-outs and the stock markets began to recover in March 2009 and have subsequently boomed as central banks pumped liquidity into the banking system, held interest rates at record lows, and encouraged a 'reach for yield'. Bankers pay and bonuses held up surprisingly well, however, although there were considerable job losses in the sector! The cost of protecting the UK economy from the consequences of a systemic banking failure was a need for fiscal consolidation or 'austerity'.

Outside the UK, there has been considerable variation in the pace, character and scale of legislation and official action to restore banking systems to health. Action in the US was particularly prompt in the form first of the Troubled Assets Relief Program (TARP) in October 2010, which injected federal funds into major banks and other financial institutions and the late 2010 Dodd-Frank Act, which included the 'Volcker Rule' limiting proprietary trading that was finalised and incorporated in the Act in 2014. In contrast, Ireland's government guaranteed all its bank bondholders in September 2008, raising its national debt by a third of its GDP. Following the onset of the Greek debt crisis in May 2010, a government debt crisis ensued in the Eurozone periphery countries affecting Ireland, Portugal and Spain, as well as Greece, and later Cyprus and Slovenia.

Has it got better? Is it getting better? Regulators have been very busy behaving like swans moving serenely across the water whilst paddling furiously below the surface.

As Japan had done previously, the Eurozone elected to adopt the 'option value of waiting', rather than forcing early balance sheet restructuring on banks, in the hope that the problem would go away. Under the new government of Shinzo Abe, Japan finally adopted aggressive quantitative easing in 2013. The Eurozone had not yet followed suite due to German opposition. Having forced banks to re-capitalise using state funds through TARP, the US authorities followed up with fairly aggressive stress testing, both of which restricted banks' ability to pay dividends, and to a lesser extent bonuses, whilst capital adequacy was raised to increasingly higher levels prescribed by tightening regulations.

With the exception of the Volcker Rule, there has been little consideration of further structural reforms in US banking. The UK's Vickers Report (2013) recommended the 'ring fencing' of retail and some commercial banking activities in the UK, and the EU's Liikanen Report (2012) had also proposed structural reforms; but these have yet to be fully implemented and banks have lobbied strongly to limit their restrictiveness. Implementation of a full separation of commercial and investment banking, as in the US Glass-Steagall Act (1933), is not proposed and nor is the breaking up of banks deemed too big or interconnected to be allowed to fail. Such systemically important financial institutions, mainly banks, or SIFIs, will continue to pose systemic risks.

Some protection to taxpayers is offered by the EU policy of 'bailing-in' bank creditors, other than guaranteed depositors, before taxpayers' money is committed to bail-outs. However, bank resolution regimes, especially those involving cross-border banks, remain far from finished business. Large complex, 'universal' banks have also failed to produce the convincing 'living wills' that are needed to make ring fencing a reality

There have been proposals in the EU for a Financial Transaction Tax to throw 'sand in the wheels' of financial trading, as advocated by Tobin (1978) and the IMF has proposed a Financial Activity Tax (FAT) on bonuses plus profits to serve as an aggregate Value Added Tax (VAT) on big banks. Individual countries have instead introduced special bank levies, and the EU is now proposing that a Eurozone-wide bank levy is used to fund combined resolution and deposit guarantee funds for its banking union, which is also work in progress (Chaudhry *et al*, 2014). The view from City of London is that such taxes should be globally implemented to assure a level playing field.

As regards bankers' bonuses, there has been some success in reining them in and introducing 'claw backs', but salaries have been raised to some extent in compensation. Further, the legality of claw backs and the need for re-imbursement of losses make them difficult to implement, so that deferral of bonuses is perhaps a better option.

The UK financial sector has continued to get caught up in mis-selling and cartel price rigging scandals post crisis and peripheral parts of the sector, such as pay-day lenders, have increasingly looked predatory as they take on subprime borrowers shunned by banks. Justin Welby, the Archbishop of Canterbury, is trying to help Credit Unions (small mutual banks) to compete for subprime lending business by making Parish Churches available for them to provide services and encouraging churches to set up their own. The government too is promoting the expansion of credit unions, but it is unclear that they really want to take on subprime members.

Fiscal neutrality is required between equity and bond issuance. There is currently bias towards loans and bond (debt) issuance since the interest (coupon) payments are tax deductible, unlike dividend payments on equity. Removal of tax deductibility would however be problematic for SMEs, which remain largely bank, and thus debt, dependent and have little access to equity financing outside the target areas of venture funds, such as high tech growth firms. Islamic-style 'profit and loss sharing' financing might possibly provide an alternative approach to SME funding.

The 'zero lower bound' of nominal interest rates has proved problematic as it tends to compress the spread, or margin, between loan and deposit rates; making it difficult for banks to profit from traditional commercial banking business and leading them to seek fee earning underwriting, broking and asset management, and also trading profits.

Bankruptcy procedures had shown inadequate forbearance. You cannot get 'blood out of a stone' – more debt forgiveness should have been granted to debtors to help resolve the US housing crisis, especially to subprime debtors, Peter argued. There is evidence that the banks have been keener to resolve the larger debts of households with bigger mortgages and more valuable houses in order to meet the targets set by the relevant US government regulatory agency for debt forgiveness more easily.

The apportionment of risk needed to be more efficiently distributed – who should bear the risk and associated losses in bad states? The relative seniority of creditors must be clearly delineated and apportionment of the claims of cross-border creditors clearly identified. The problem of 'hold-out' creditors impeding efficient resolution, as in the case of Argentina, must also be resolved.

The 'too big to fail' problem also remains to be fully resolved, if indeed it can be whilst some banks remain too systemically important to be allowed to fail. Without a resolution to this problem, market capitalism cannot operate effectively because the allocation of capital becomes distorted.

Peter concluded that banking was a little bit better than immediately before and after the GFC, but there was a long way to go before it was fully restored to health – it was on the road to recovery, but the recovery was still very much 'work in progress' because deleveraging would be very slow and little progress had been made in reviving lending to SMEs. Further, other than the recipients, few thought that large bankers' bonuses were warranted or 'good' in any sense. Attempts to cap or reduce them had met with limited success, and the efficacy of required imposition of deferrals and the potentiality of 'claw backs' in the UK had yet to be proven or tested. The hope is that they will discourage excessive risk taking and the pursuit of short term returns (Sinclair et al, 2009).

The third speaker was Karen Braun–Munzinger who works on prudential policy at the Bank of England. At the outset, Karen made it clear that the points she would make were her own thoughts and should not be taken as reflecting the views of the Bank of England.

Karen noted that there had been significant progress already, but that we were too early in the policy cycle to judge actual outcomes given that policies had not yet been fully implemented and thus to assess whether or not we were "making banking good" Banking regulatory authorities, including the Bank of England in the UK, were well advanced in implementing a massive reform agenda decided upon by the G20 and aim to complete the reform effort in a number of key areas at the G20 meeting in Brisbane in November 2014. However, policy decisions and consequent legislation are not equivalent to full implementation. In order to make the transition viable, reforms would come into force gradually over the coming years.

Karen asked where these reforms are heading and considered whether they will lead us to a better place. Have we made banking regulation good? There has been important progress in making the banking system safer already. But we could not stop at this point: not only were final pieces of the policy agenda yet to be considered, but also a critical task of implementation and so we would need to come back to consider the question , once all relevant measures had been fully implemented.

As one potential measure of 'goodness', Karen suggested looking at public opinion, noting the bad press banking - and other financial sector actors – had received as a result of the GFC Prior to the crisis, bankers' reputations were apparently not interesting to pollsters and were often not included in the list of professions. Post GFC, a YouGov tracker found 73% of its respondents said the industry 'had a bad reputation', which puts them towards the bottom of the distribution. Even though they didn't top the reputational tables, the trust and confidence of the public in UK banks reached an all-time high in the run up to the GFC, and then nosedived after the crisis. Thus, public opinion may not be the best guide for judging whether the banking sector is behaving in a way that is favourable, or good, for the economy. Trust in banks had after all been increasing over the same period as banking risks were, with hindsight, accumulating.

Karen suggested we could think of another measure of achieving 'good banking' as moving towards a situation where incentives and the ability of banks to take risks are more supportive of what is prudentially optimal. Banking is closely linked to economic growth. The banking system provides payments services, financial intermediation and facilitates insurance, but the combination of these with potential fragility can make banking the source of costly crises.

Major banking crises are often followed by deeper recessions, with larger losses of output relative to the prevailing trend than 'normal' recessions. The main cost of crisis is not the costs to the taxpayer of bank 'bail-outs', though these may already be substantial, but the potential for post crisis recession and associated credit crunch, de-leveraging and increased unemployment.

Once the crisis has been staunched and the banking and wider financial system has been stabilised, the aim should be to put the financial system into a better position to reduce the incidence and depth of future crises by establishing better standards for banks and other financial firms, better tools for the regulatory and supervising authorities and by removing distortionary incentives to take excessive risk.

The GFC revealed that banks were not resilient because they did not have sufficient capital and liquidity reserves. Further, the system was not robust enough to cope with increasing inter-connectedness within the banking and wider financial systems. Also, banks had grown so large, complex and inter-connected that they became too big or systemically important (to be allowed) to fail and so governments had to bail them out using taxpayers money.

It is thus particularly important that the problem posed by systemically important financial institutions (SIFIs) (mainly, but not exclusively, banks) is resolved. Perceptions that such firms might be bailed out could lead to moral hazard, reducing the ability of smaller and generally less complex banks to compete effectively with them. This could lead them to become yet bigger and more dominant.

Policy makers have responded by reforming the existing prudential framework and, in particular, addressing systemic macro-prudential thinking more explicitly. Such a systemic view will help ensure that regulators do not simply swap one problem for anot**<u>her</u>**. The regulatory framework is changing to respond to these systemic risks, by aiming to reduce both the probability and impact of failures by both enhancing capital and liquidity adequacy and by removing adverse incentives.

There is also work under way to increase the diversity of market based funding for borrowers and reduce barriers to entry and expansion for smaller ('challenger') banking.

Basel III induces an explicit macro-prudential instrument, the counter cyclical capital buffer and international accounting standards have been amended to allow forward looking 'general' provisioning against bad and doubtful debts, particularly non-performing loans. In addition, Sifis are subject to enhanced capital adequacy requirements and the wider usage of leverage ratios by regulators limits their ability to leverage their capital by employing favourable risk weighting.

To manage the impact of failure and the TBTF problem, complementary reforms to 'bank resolution' regimes are required. As with other reforms, Karen believed that a lot of progress had been made, but final policy questions had to be settled and new measures implemented. In particular, orderly resolution without exposing taxpayers to losses needed sufficient liabilities capable of absorbing losses In another words, there needed to be sufficient 'gone concern loss absorbing capacity' (or GLAC), in the right form at the right time and in the right place to allow a bank to be safely resolved. Equally, the necessary agreements for cross border recognition of resolution actions regarding contractual stays had to be put in place. The Financial Stability Board (FSB) and the International Swaps and Derivatives Association (ISDA) are leading the work in progress in this sphere.

Karen acknowledged that she had talked about achievements and gaps on the policy front, but what did it all mean for the question of whether banks were getting better?

Though implementation is not yet complete, there has been progress towards making the banking sector more resilient. Big banks in the UK and elsewhere now hold a great deal more capital than they did before the crisis. 'Disclosure' had been increased in both quantity and quality. TBTF incentive distortions were decreasing, as evidenced by credit rating agencies removing the rating uplifts resulting from market expectations of government bail-out support for banks. Other policy issues remained to be resolved, however, and the final judgement must await full and consistent international implementation.

Karen concluded that there was a lot to feel good about: the clear recognition of the importance of a system-wide perspective along-side institution-specific regulation; lots of progress in agreeing new policies with regard to capital and liquidity adequacy as well as other reforms; and a clear roadmap for completion in areas where further work is needed; but it all needed to be implemented coherently and with mutual international trust.

Finally, the new regulatory and supervisory regime will need to be responsive to new risks as they emerge and sufficiently flexible to deal with new fault lines or shocks!

The 4th and final panellist to speak was Laurent Clerc, who is in charge of the Financial Stability directorate at the Banque de France. Laurent asked whether the intention had indeed been to make banking good and felt that this was surely the case for the public and the politicians they had elected. There had been a strong negative reaction against the past actions of banks and banking. The sense of injustice in the public had been fuelled by the large taxpayer support and 'outrageous compensations' in the banking industry. There was a widespread view that bankers had privatised their gains and mutualised their losses.

In the political context, a 'good bank' makes loans to the real economy; does not engage in speculation activities; does not put the whole economic system at risk; accurately aligns compensation to risks; and is not too-big-to-fail, but is instead resolvable. This may require structural reforms along the lines proposed by Vickers, Volcker, Liikanen (and Barnier) and related French proposals to separate retail and utility banking activities from risky and speculative activity; and aggressive litigation against bankers and/or banks in order to achieve a sense of justice and to act as a deterrent against future excessive risk taking in pursuit of profit and personal gain.

From the perspective of the regulators, the objective is somewhat different. Their aim is to build more resilient financial institutions and systems, in order to address systemic risks by combining micro and macro prudential perspectives. This implies that banks should be better and more highly capitalised; have greater liquidity coverage and reserves; be less leveraged; and not take too much risk; and be resolvable in an orderly manner. The aim is increasingly to build general loss-absorbing capacity (GLAC) and reduce the risk of contagion, whilst not impeding credit supply unduly. Regulators also think about structural reforms, but with very different approaches across jurisdictions and much to be done with regard to aligning compensation risks.

Laurent next considered whether the objectives of the politicians and the regulators were consistent, and concluded that, to a certain extent they were, but: regulatory initiatives and reforms may have detrimental effects if the cost of credit in the short run; were too dismissive of potentially 'good' securitisation, as opposed to the 'bad' (complex and mispriced) securitisation often linked to derivatives, such Collateralised Debt Obligations, or CDOs that had proved so damaging in the GFC; and negatively impact on long term finance, an issue under consideration by the FSB.

There appeared to be a particular problem with regard to access to affordable finance by SMEs and the Basel Committee and the International Organisation of Securities Organisations (IOSCO) had been considering ways of re-invigorating good securitisation. As noted earlier, the UK's FLS scheme and the ECB's new TLTRO scheme aim at providing cheap financing to banks that on-lend to SMEs. More reliance on loan guarantees might also be considered, in line with Paul Mizen's suggestions in last year's panel (Mullineux, 2013b), it can be noted.

Finally, Laurent asked what the outcome might be? He considered that in the near future, banks may not be 'good', but they surely will be different as a result of: far reaching changes in the incentive structure of the whole financial industry due to regulatory reforms; and changes in the corporate governance of banks, as a consequence of new resolution regimes involving bail-ins.

However, currently proposed bail-ins, resolution and GLAC procedures may in fact result in bigger, rather than smaller, institutions; and banks have already started to adapt their business models to become less dependent as wholesale funding and more reliant on guaranteed depositors, whilst a major restructuring of universal banks and investment banks is underway, with potential negative side effects on market making capacity.

Hence there were trade-offs and the devil was indeed in the detail, so that 'unintended consequences', might yet to be revealed as the regulatory reforms are progressively implemented in the coming years. There may, for example, be an incentive for SIFIs to become much larger once the threshold for becoming a SIFI is crossed, in order to spread the relatively fixed regulatory costs and so an oligopolistic market structure may emerge internationally.

Price Fishback (University of Arizona and National Bureau of Economic Research, NBER) a keynote speaker on issues arising from the escape from the crisis, following the 1929 Great Crash, in the 1930 and 1940s at the conference managed to squeeze in a question before the panel adjourned for the Gala Dinner! He asked whether lessons from the past might be a guide to the sort of banks we want in the future?

Andy Mullineux, the chair responded by saying that we probably do not want a bank managed by the fictitious Captain George Mainwaring from the popular UK television series 'Dad's Army' (the British Home Guard during the 1939-45 war). British banks at the time primarily served the professional and upper middle classes. A better model might be the fictitious mutual 'Bailey Buildings and Loan Association' run by George Bailey in the favourite US Christmas movie: "It's a Wonderful Life", made in 1946. George Bailey reluctantly stuck with the management of the Buildings and Loan Association, whilst the town's shareholder-owned commercial bank manager (Henry F. Potter) repeatedly tried to force it out of business, but failed despite sparking a run on the mutual and alleging embezzlement of its funds.

In that story, the mutual was the good community bank, and so perhaps what we need is a more 'level playing field' that allows mutual banks to prosper. There is a concern that the new regulations are primarily designed to make shareholder-owned banks safer, especially the big ones, but may squeeze out smaller mutual banks, and with it the community and relationship banking that so benefits households and SMEs in the US, Germany and elsewhere. At minimum, diversity in banking should be preserved and excessive bigness and complexity in banking avoided, for evidence or economy of sale, and especially scope, is mixed and ongoing changes in information technology may well favour smaller banks and niche internet-based specialists. It may be that the relatively fixed costs of regulators compliance are unintentionally creating countervailing incentives for banks to seek bigness.

There is also a growing realisation that the old partnership structure, involving unlimited liability, that was prevalent in the merchant banking and broking and dealing that preceded modern limited liability investment banking, may have better aligned management responsibility with risk taking. Willingness to accept bonuses should be associated with responsibility for risk taking and compensate structures, regulatory fines and criminal prosecution should perhaps reflect this.

3) Conclusions

The overall conclusion of the Lyon panel's discussions was that: whilst regulatory reform was underway and broadly on track, the international consistency of implementation was far from assured and that the 'too big to fail' problem had not been resolved through structural reforms. Indeed, post crisis consolidation had increased concentration in banking markets and an unintended consequence of crossing the regulatory threshold to become a systemically important financial institution (SIFI) might be to encourage them to accelerate their growth in order to spread their additional regulatory costs.

There was also a feeling that diversity in banking was beneficial and that mutual and community banking should be preserved and not permitted to be squeezed out by an evolving regulatory regime which is primarily designed to protect taxpayers by controlling the systemic risks posed by large and complex shareholder-owned banks.

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