2007 / 8 banking crisis: manifestation of a far deeper problem

Q: Which of the following is true?

We are all to blame / nobody is to blame / the system is to blame

A: They are all true!

What is clear is that capitalism is in crisis
- so what to do about it?

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Questions in context - the bigger agenda

- NR / Banking: What went specifically wrong
  - Accounting had a huge role to play; the canaries in the coal mine failed to sing. Accounting establishment ditched core principle of prudence!
  - But it's a much broader problem than banking.
- But what if the system is rotten and corrupt to the core?
  - "Agents" everywhere helping themselves to an annual percentage of wealth they are supposed to be stewarding (advisers through "trail", fund managers, and even company directors and executives through dilutive pay)
  - Financial sector is a "wealth extraction" sector, not a stewardship sector
  - Look at the sacking of Daniel Godfrey as one example.
- And if we want to change it?
  - Need deep understanding first
  - Have to face up to the fact that those with the power are hugely conflicted – so a "people's movement" may be the only way. But they have to be led, and educated, by those with the necessary knowledge.
  - Most people here today look on paper as if they are in the conflicted, rather than the non-conflicted set. Of course they may be exceptions to the stereotypes. ..
  - No complete solutions, but will I propose where we could start

Some things to note

1. The motivation of the presentation is to share ideas and stimulate discussion, in the hope that our collective understanding will improve, and perhaps also that others will be interested to help develop ideas and initiatives for a grass-roots approach to tackling the problems. See slide 1 for contact information.

2. *Nothing in this presentation or talk should be interpreted as financial advice.*

3. Generalised criticism of all sorts of groups is no more than that – whilst the business environment can cause people to act in a way that attracts criticism, there are always exceptional people who behave well. For example company boards who are not greedy and who steward the business well, in spite of short term pressures from "shareholders".

4. All the content represents the <u>current</u> views and understanding of the presenter alone, and does not represent the views of any organisation with which I may be associated. *But UKSA endorses the analysis in general and enthusiastically supports this initiative.* If you believe the suggestions here have value, and would like to help develop them in any way, you should join us!

Transparency Task Force event challenges

What really caused the crash?

- Widespread stewardship failure, so system was bust and deeply unstable – all it needed was the penny to drop

Who was "asleep at the wheel"?

- The establishment as a whole – no courage to face up to the problems, diagnose them, and explain them to the people. But especially the accountants and the regulators.

Have the lessons been learned?

- Martin Wolf at the FT Weekend event 2 Sep 2017: "Lesson one is that we never agree on what the lessons are"

Have the regulators done enough to prevent a repeat?

- Of course not. How can they, when politicians put today's growth and tax revenue above soundness?

Who is actually responsible for preventing another crash?

- The only viable answer is "all of us"

Could it happen all over again?

- Yes, of course – look at the history of borrowing booms, busts and forgotten obvious lessons. Idiot politicians often "go for growth" to get out of their own Ponzi schemes, egged on by too many journalists. Look at the QE policies of today.

Could greater transparency reduce the chances of it happening again?

- Yes, providing the transparency is part of a deeper and more widespread understanding

Will it happen again?

- Almost certainly yes, because the political courage and understanding needed to prevent it is not all that likely – ***but we should all keep trying***!

Preventing another Northern Rock: dead easy in principle, so why doesn't it happen?

- Rubbish financial theories are so embedded in academia: economics profession more of a problem than a solution:
  - Economics as a route to high paid finance job rather than deep understanding of the world
- Politicians without the combination of understanding and courage to provide true leadership
- Accounting standard-setting establishment throwing away primary principle of prudence: academic theory that ignores human nature and the need for resilience and redundancy. Establishment in denial on this.
- Media, including much financial commentary that fixates on share prices and capital gains rather than patient stewardship.
- Above all, the financial sector as a whole for
  - creating and perpetuating a "we take a share of your wealth at every stage in the ownership chain" business model
  - Operating a powerful lobby and a revolving door system that locks in the status quo

References

Some really good books

- John Kay, the great communicator: “The long and the short of it”, and “Other people’s money”
- Mervyn King: “The end of alchemy”
- Joris Luyendijk: “Swimming with sharks”
- Steve Keen: “Debunking economics”

Some other superb references

- Charlie Munger: google “The psychology of human misjudgement”, “tweakmore, wantmore and totalscum”, “Munger accounting sewer”. You will find documents and youtube videos.
- http://www.uksa.org.uk/sites/default/files/responsible_investing_2010_members.pdf
- https://www.johnkay.com/2009/09/15/narrow-banking/
- https://publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/27iv30.htm
- https://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2015/9/cj-v35n3-3.pdf

And some of mine

- http://ec.europa.eu/internal_market/consultations/2011/corporate-governance-framework/individual-replies/martin-white_en.pdf
- https://publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/27ix_we_h18.htm
- http://www.uksa.org.uk/sites/default/files/2017FebUKSA_AssetManagementStudyResponsePDF.pdf

Why did banking look so profitable?

- Partly because it was, and often still is, profitable:
  - Polite term is "information asymmetry"
  - Less polite: the customer is there to be fleeced (stories keep emerging…)
  - And it's not just the retail customer that gets fleeced – corporates can suffer from information asymmetry too
- But then there's the "made up" profits (prudent and intelligent accounting would fix this) - and, as John Kay likes to point out, much of the trading is within the sector, so how can that activity possibly be net profitable?
- But the reported profits determine the bonuses, with bonus a big proportion of pay for many of the top jobs

- Enough said…
- Of course, when the profits turned out to be fiction, the execs walked away wealthy and the taxpayer paid up

Fixing banking: some crazy ideas

- Reinstate prudence as No 1 principle, with legal fiduciary duty on boards :
  - Stewardship of customers' money, professional sign off of bad debt reserves against tough stress tests - to ultimate, not just a one year view.
  - Means much more capital, and much slower tax take
  - Guard against systemic risk by having a capital charge on all inter-bank lending, because that's the only way to prevent the domino effect.
  - Insist on total transparency of, or otherwise restrict use of, derivatives – "financial weapons of mass destruction"
- Impose duty of care to borrowers (old fashioned relationship banking)
- Completely change what gets the "well done"; get rid of bonus culture
- Accept much lower return on equity
- Much, much, lower pay
- No share-based payments, no dilutive pay, require senior staff to buy some shares in the open market and keep them.
- Set up customer-interest groups to monitor conduct and also to share "best buy" type information. Including big corporates as customers of banks
- WILL IT HAPPEN?
  - No way, the banking lobby is too powerful, and the tax revenue too enticing
  - So what's the point of discussing it?
  - Good question.. Should we just give up?

Wider problem: corrupted ownership chain

- Individuals are still the main beneficial owners of companies, but often through a big chain of wealth-extracting intermediation, or hidden behind nominees.
- Individuals do not have any body they can trust to tell them the fundamental truths of finance and investing – because everyone is on the take!
- Read those John Kay books if you want to really understand all this.
- IFAs - want to take annual percentage of wealth, but if wealth too small, they don’t want you.
- Fund managers – also take an annual percentage, which isn’t really worth paying, unless it’s a super-cheap passive
- Fund managers – individuals get paid for “asset gathering”, so have a short term perspective. Pay at fund managers is high– see the FCA study.
- “Platforms” think they have a right to an annual percentage of your wealth if you put your money in “funds”. So they promote funds like mad.
- But all the “education” material downplays the importance of expenses, and how to minimise them.
- The consequence of all this is that most company stock is in the name of the fund managers - who have no incentive to ensure companies are run patiently and not greedily. This has bad consequences for almost everyone.
- Intelligent investors want banks, as with all their investee companies ,to be run prudently and not fleece the customers. But those “intelligent investors” : where are they? Paul Myners coined the term “ownerless corporation” for a reason.

Tackling the corrupted ownership chain

- Today, individuals are mostly powerless
  - They lack knowledge, they lack confidence in their ability and intelligence, and the message from the financial sector is "trust us"
  - Sensibly, most people no longer trust the financial sector. But negative emotions lead to "do nothing", so this is one reason for not enough saving.
  - The information asymmetry versus the industry leads to massive wealth extraction
  - The media probably do more harm than good, with over-focus on capital gains; what are people to think? That the stock market is for gambling in.

- But what if individuals were told the essential truths (see next slide for suggestions), and helped / empowered to act accordingly?
  - The power would no longer be with the financial sector, it would be with the customers
- But how could we get to a situation where individuals were told the essential truths (when we have agreed what they are)?

Some essential truths about finance and investment (not the last word, just some ideas)

- Anyone who buys and is capable of working through the 2 John Kay books will understand the issues well enough
  - How wealth is created over time in companies is a long term process, needing a focus on future competitiveness as much as on profits today.
  - And it's fundamentally uncertain, uncertainty you have to live with
  - That market values fluctuate massively over time; you have to use "tricks" and "habits" to avoid making emotion-driven "buy high, sell low" mistakes.
  - One "trick" is to think of your equity investments as things that will generate a (not too certain) future dividend flow.
  - Minimise annual percentage charges above everything – work with other investors to minimise the intermediary take. Mutuals, such as Vanguard are good for this, but a mutually owned stockbroker is perfectly possible too.
  - Understand that pooled funds are no more than a spreading of risks across individual companies; they can not transform the fundamental nature of share ownership
  - Understand your own needs in terms of financial planning
- But people will still need there to be someone to help them put the principles into action – this is the missing "who to trust" body
- That body is only going to exist and thrive if enough of those with the knowledge work together for free to develop a solution with the objective of helping everyone, not just the rich.

But those "essential truths" are so foreign to most people – where on earth do we start?

- How easy are those "essential truths" going to be to assimilate?
- How often do you hear "the solution is better financial education in schools"? But I'm suggesting that just schools is not enough
- Who might come forward to develop financial education material?
  - Yes, the financial sector!
  - We can't have that – that's the entire point! We need individuals to be the masters, not the financial sector as is the effective situation today.
- So it's got to be done by people with the knowledge and passion to transform that situation and empower savers – a nationwide project.
  - It will only take a relatively small number of people to get it going; probably with one thing in common – they'll all be savers
  - UKSA's working title for this idea is STC, standing for "savers take control". Hence the email STC@uksa.org.uk
- STC: a completely new idea – virgin territory!
  - Involves highly knowledgeable investors giving up their time to help others – what could be more worthwhile? Or more potentially transformative?
  - Hugely challenging
  - But also huge fun and very rewarding – anyone interested? STC@uksa.org.uk