Taming the Tiger: solving the problems of banks

Why regulation and reforming ethics do not work and why there will be another banking crisis

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Abstract

Tigers, like banks, are kings in their jungle. Both survive because of their strength and both cause public fear when they ‘run amok’. Mankind has always wished that it could tame tigers - and banks. Whilst banks are essential to an economy, this dissertation considers the desire to control the difficulties banks cause.

Using examples, it looks at the problems to which banks and bankers are prone. The traditional problem is of ‘borrowing short and lending long’, but the examples show other problems that have arisen, including those that led to the Financial Crisis 2007-2008. It is suggested that one cause of the problems of banks is of ‘Financialisation’ and, in particular, the demands of shareholders for ‘Return on Equity’.

The dissertation considers two ways used to control banks. Firstly, it looks at regulation, with reference to the example of capital regulation. It outlines how equity capital appears on a bank’s balance sheet, reviews the problems of capital regulation and concludes that bankers seek to circumvent or change regulations that hinder the aim to maximise profit. Secondly, having discussed the limits of regulation, it considers the alternative of changing organisational culture to improve the conduct of bankers. The dissertation looks at different approaches to such cultural change, but concludes that the pressures to produce Return on Equity prevail over exhortations to act ethically.

The dissertation then considers whether shareholder control could ameliorate the problematic conduct of bankers and concludes that shareholders exacerbate the problem. Finally, the dissertation introduces the possible use of alternative legal structures, which are not subject to demands to provide Return on Equity. The dissertation suggests that such alternative legal structures present an area for future research.

Contents

Acknowledgements

My journey that led to this dissertation started during the Financial Crisis of 2007-2008.

I was curious as to why the booming world economy of the first years of the new century had come to the verge of financial collapse. As an Independent Financial Adviser (as well as a Solicitor), I knew about the calculation of financial risk, but was puzzled as why the banks had failed so spectacularly, when their technical experts had created models to overcome such financial risk.

I was already connected to the University of Kent through my involvement as a volunteer adviser and committee member of the Kent Law Clinic and had had regular contacts with its Director, John Fitzpatrick and others who worked for the Clinic. I, therefore, considered that the way to satisfy my curiosity would be to undertake a research degree and so the connection with University led me to apply to the Kent Law School in 2009.

Whilst I have earlier academic qualifications, much had changed since I had completed my undergraduate degree in 1974 and I had had no experience of academic writing or academic referencing.

Having now come to the conclusion of this dissertation, I would like to thank those who have helped me.

Lynn Osborne, the Postgraduate Office Manager, met me on my first day in January 2010 and has been there throughout to help me find my way around facilities and complications of the University of Kent.

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Table of Abbreviations

AIG	American International Group	A very large American insurance company, which was a played a central role in in the Financial Crisis of 2007 -2008 and had to be rescued by the US Government
B.I.S	Bank for International Settlements	Owned by the world’s central banks, it facilitates research and co-operation amongst central banks and acts as the bank for central banks. It is responsible for the process that results in the Basel Accords. (see section 2.3 and footnote 93)
BIPRU	Banks and Insurers PRU	Prudential sourcebook for Banks, Building Societies and Investment Firms.
BNP	Banque Nationale de Paris	Merged with Paribas in 2000 to become BNP Paribas.
CDO’s	Collateralised Debt Obligations	See footnote 25
CDS	Credit Default Swaps	See footnote 27
CEO	Chief Executive Officer	
CRESC	Centre for Research in Socio-Cultural Change	A joint research centre of the University of Manchester and the Open University that considers social and cultural change
D/E	Debt to Equity	A financial ratio
EDM	Ethical Decision-Making	See footnote 142
FCA	Financial Conduct Authority	UK Regulator (successor to the FSA -see below)
FEMR	The Fair and Effective Markets Review	A Report. See footnote 51
FEMR	The Fair and Effective Markets Review	See footnote 121
FICC	Fixed Income, Currencies and Commodities	See footnote 117
FSA	Financial Services Authority	UK Regulator (2001-2013)
FSB	Financial Stability Board	See footnote 135
G 22	Group of 22	G22 or Willard Group were a group of 22 governments that were to meet to discuss reform of the global financial system
Giro	National Girobank	See footnote 174
H of C	House of Commons	
HSBC	Hong Kong and Shanghai Banking Corporation	An international bank
LIBOR	London Inter-Bank Offered Rate	See footnote 31
MiFID	Markets in Financial Instruments Directive	See footnote 119

n.d.	No date	Harvard referencing term
NALGO	National Association of Local Government Officers	A trade union
PCBS	The Parliamentary Commission on Banking Standards	See section 3.10
PEPs	Personal Equity Plans	A UK government introduced incentive savings scheme
PPI	Payment Protection Insurance	See section 1.2.3
RBS	Royal Bank of Scotland	A UK bank
RoE	Return on Equity	See footnotes 6 and section 1.3
S & L	Savings and Loan	See footnote 29
s.l.	Latin: sine loco (no place of publication)	Harvard referencing term
s.n.	(no named publisher) Latin: sine nomine	Harvard referencing term
SIV's	Structured Investment Vehicles	See section 2.4.4
TBTF	Too Big to Fail	See footnote 124
TSB	Trustee Savings Bank	See footnote 172

1. Chapter 1 - Introduction

On 12 December 1912, an old and ailing JP Morgan testified before the Sub-committee of the Committee on Banking and Currency, House of Representatives, (the "Pujo Committee"):

> "Mr. UNTERMYER: Commercial credits are based upon the possession of money or property?
> Mr. MORGAN: What?
> Mr. UNTERMYER: Commercial credits
> Mr. MORGAN: Money or property or character.
> Mr. UNTERMYER: Is not commercial credit based primarily upon money or property?
> Mr. MORGAN: No, sir; the first thing is character.
> Mr. UNTERMYER: Before money or property?
> Mr. MORGAN: Before money or anything else. Money cannot buy it….Because a man I do not trust could not get money from me on all the bonds in Christendom."
> (House of Representatives, 1912); (Bruner and Carr, 2009)

John Pierpoint Morgan had hitherto been seen as the hero of the 1907 Bankers' Panic (or Knickerbocker crisis).[1] However, by 1912 the public had become highly critical of him which in turn led to calls for the regulation of banks which were seen to be a trust (monopoly) in New York (Bruner, and Carr, 2009). The result of the committee's deliberations was the establishment, for the first time, of a central bank for the United States - the Federal Reserve- as well as further anti-trust legislation.

The exchange between Untermyer, counsel for the committee, and the renowned banker exemplifies the ongoing debate between those who consider that the problems of banks

[1] "Knickerbocker crisis" One of the largest casualties of the 1907 New York financial crisis was the Knickerbocker Trust Company. JP Morgan died 4 months later (31 March 1913), 9 Months before the establishment of the Federal Reserve (Bruner, and Carr, 2009) . (The quotation is the actual one rather than the one often paraphrased).

should be dealt with by regulation and those who believe that banking is based on confidence, ethics and trust. Indeed, as Gillian Tett points out in her book "Fools Gold", the word "credit" is derived from the Latin "credere", meaning 'to believe' (Tett, 2010).

Nevertheless, banking crises continue to be relatively common and this dissertation will consider why neither regulation nor morality and ethics have been successful in preventing their recurrence.

1.1 The Importance of Banks

This dissertation will begin with a consideration of the importance of banks within society and the economic system as a whole. It will then consider the 'problems' associated with banks ever since they came into existence. In fact, they always appear to have been problematic[2]. This dissertation will focus, by way of examples, on the problems arising from the Financial Crisis 2007-2008[3] and subsequent banking 'scandals'. It will reflect on the factors, both those arising from the nature of the business of banking and also from the conduct and ethical behaviour of bankers, which have contributed to these problems and become more prominent since the growth of financialisation.[4] It will analyse the two responses which are widely believed to be needed to overcome those problems, namely, regulation and the embedding of an ethical business culture within banks. This dissertation

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[2] From Aristotle (Aristotle, c.384BC) (Aristotle, C400 BC) to Karl Marks there has been a continuing debate concerning the morality of making money out of money and lending at interest (usury) through Plato (Cornford,F, 1945) to St Thomas Aquinas (Akerman, J, 1981); Martin Luther (Lindberg, C, 2003); Adam Smith (Laidler, 2 1981) and Karl Marx (Lapavitsas, 1994,); (Reinhart & Rogoff, 2009).

[3] The "Financial Crisis 2007-2008", also called the Banking Crisis or the Global Financial Crisis (2007-2008), started on 9 August 2007 when BNP Paribas froze three of their funds, stating that they were unable to value the underlying assets of the funds known as collateralised debt obligations (CDOs) (see definition note 25 below). BNP Paribas actions raised concerns about the value of lower quality American mortgage-backed securities ('subprime mortgages' - see note 21 below) and led to a fall in their price. Later that month there was a bank run on Northern Rock. The crisis escalated in September 2008, with the collapse of American merchant bank, Lehman Brothers, which the US government had refused to bail out. This raised concerns about the possible collapse of other banks, with the effect of stagnating financial markets and causing financial institutions to liquidate investments. International trade collapsed and borrowing became very difficult. Central banks and governments acted to cut interest rates, nationalise failing banks and take on bad loan portfolios to return stability to their economies and prevent a bank run (systemic banking crisis - see below). Throughout this dissertation this crisis and related events and consequences are referred to as the "Financial Crisis of 2007-2008"

[4] Financialisation is a term that covers a number of concepts regarding the use of capital. Firstly, it describes the situation where financial markets over the recent decades have become more important than the old agricultural and industrial economies. Secondly, "Financialisation" is an economic system that tries to convert the value of all things, whether tangible, intangible, present or future promises, into a financial product or a derivative of a financial instrument. The intent of financialisation was to convert any service or product into a tradable instrument, such as money, and therefore to facilitate exchange in such financial instruments. Accordingly, governments can engage in deficit spending by financialisation of future promises to repay loans e.g. UK Gilts. Individuals can, by means of mortgages or hire purchase, exchange their promises for future work and pay for a home, cars or other goods. See also section 1.3 Financialisation .

will, however, suggest that attempts at further regulation or the improvement of ethical behaviour will always come up against a fundamental problem, namely, the desire of the shareholders of joint-stock banks[5] to achieve maximum profits for their investment, otherwise known as 'Return on Equity'("RoE").[6] It will consider the suggestion that bankers regard 'regulation' as an incumberance that only needs to be followed by the 'letter'. Secondly, it will consider the belief that bankers use ethics for the purpose of 'window-dressing'.

Few bank shareholders have any concern for their shareholding other than the earnings it produces by way of dividends or capital growth (Ireland, 2005). It will be argued that the need to provide dividends for shareholders places an overarching pressure on bankers to put the generation of profits first. In doing so, regulations and ethical standards become obstacles to bankers in maximising return, when the intent of such regulations and ethical standards is for the protection of customers, the wider society and the economy overall.

The second chapter of this dissertation will look at the background and reasons for regulation, its timing and its limitations. The third chapter will then consider why academic writers who argue that regulation has limitations, suggest that principles of ethics, or principles of social science such as Social Anthropology, Education Theory or Organisation Theory should be used to address the problems of banks.The limitations of both regulation and self-imposed control through ethics or cultural change will be examined and it will be suggested that neither approach, whether alone or in combination, is likely to be successful. It will be asserted that the reason why neither regulation nor cultural change can solve the problems of banks is because of the fundamental need for RoE.

This dissertation will conclude by proposing that, in addition to both regulation and self-imposed ethics, alternative legal structures to those of the joint-stock bank should be considered. Such alternative entities would not, by their legal structure, be expected to maximise profits for shareholders in joint-stock banks and would not be subject to the pressures to make the maximum profit by taking advantage of banking opportunities that are technically legal if not ethical. They would provide customers with alternative

[5] "Joint-Stock Bank" is a bank which is a public limited company issuing shares that are held by investors.

[6] Definition of "Return on Equity" The ratio of net profit to shareholders' equity (also called 'book value', 'net assets' or 'net worth'), expressed as a percentage, as a measure of how well a company uses shareholders' funds to generate a profit."

approaches to banking and would not regard customers as simply 'profit making opportunities'. The hypothesis is that, in doing so, such alternative structures would encourage better behaviour because their aims would not be solely to maximise profit. In addition, because they would provide effective competition to the joint-stock banks, they would raise the level of behaviour of *all* banks, as ethical behaviour would become the norm.

This subject is of significance owing to the fundamental importance of the banking system to the economic structure of any modern society. It is the oil that allows economic activity to function. It provides essential services including assisting with sales and purchases, transfers of money, credit to governments, credit to help smooth cash flows, financing for business, loans for house purchase as well as the preparation for retirement and the holding of savings (ResPublica, 2014). Indeed, banks have had such an important place in the economic system that they predate coinage itself. It was in the temples and royal palaces of ancient Mesopotamia that people could find secure places for keeping grain and other agricultural produce. Receipts for these products came to be used for transfers not only by the depositors but also to others (Davies G, 2002, Chapter 2).

Banks play a critical role in the maintenance and growth of the economy; they borrow short and lend long and, in doing so, they allow the real economy to expand and grow (De Grauwe, 2008, p. 1). Confirming this role, an article in The Economist on the history of financial crises, pointed out the importance of banking and finance when asking the rhetorical question,

> "What is mankind's greatest invention? Ask people this question and they are likely to pick familiar technologies such as printing or electricity. They are unlikely to suggest an innovation that is just as significant: the financial contract. Widely disliked and often considered grubby, it has nonetheless played an indispensable role in human development for at least 7,000 years" (The Economist, 2014).

Continuing to explain the importance of banking and finance, The Economist explains that finance acts as an economic "Time Machine" by assisting savers to move today's surplus into the future when it might be required, and the immediate access to funds by borrowers. It also assists in insuring against the accidents that befall individuals in society and helps investors find the businesses that are most likely to grow so that funds can be injected (The Economist, 2014). However, as will be set out in the following section (1.2), one of mankind's 'greatest inventions' has become one of its biggest modern day problems to such an extent that there were fears at the advent of the Financial Crisis 2007-2008, that such problems would result in the collapse of the world economy.

1.2 Inherent Problems of Banking

1.2.1 Borrowing short and lending long – a fundamental problem

In order to function, banks take deposits, which are returnable to customers at short notice, whereas when they lend, it is either by way of a fixed loan or as an overdraft that has to be recovered from a customer. Banks are able to lend out money accrued from the deposits and, in the knowledge that not all customers would ask for their money back at the same time, they can lend the money out numerous times over (Fractional-Reserve Banking).[7] Banks only keep a small amount of cash in reserve. In normal times, there is a continual inward and outward flow which the bank anticipates and manages. However, if customers lose confidence in the ability of the bank to repay "on demand" or indeed, pay at all, they seek to withdraw their cash as soon as possible. This creates a panic (a "bank run")[8] through a "herd mentality" (Anderson, 2013). The bank may have enough good loans to cover the savings of the depositors, but it does not have the cash to pay depositors who are all demanding their money at the same time. In such a case, the bank exhausts its initial reserves and has insufficient funds to meet customer demands, and, as the fear of a bank default increases, so does the customers' desire to withdraw their cash. The bank reaches the point where it faces a sudden default known as a 'Liquidity Problem'. As one bank faces collapse, customers in other banks may also lose confidence. This is known as "Contagion"[9] and there becomes a fear of a systemic[10] banking crisis (Laeven and Valencia, 2008) where all of a country's banks are under threat, because all customers start to withdraw their money from all banks. This results in an economic recession as businesses are unable to obtain capital from banks that are trying to recover loans in order to repay customers. Indeed, such runs on banks were given as the primary cause of the Great Depression[11] in the United States (1930-1939) (Bernanke, 1983, p. 257).

[7] "Fractional Reserve Banking" is a system of banking where only a small amount of the sums lent are backed by cash in the bank available for withdrawal.

[8] A 'bank run' is usually triggered by customer worries that a bank may be in financial difficulties and results in an exceptionally high number of withdrawals by bank depositors. It is also known as a "run on a bank".

[9] "Contagion" **:** When economic or financial problems spread from one country to another. (The Economist, 2014) (House of Commons Treasury Committee, 2011 at page 14)

[10] Definition of Systemic: "affecting the whole system or relating to a whole system."

[11] Great Depression - see note 18 below

In addition to a bank run, where concerns about a bank's ability to repay become a self-fulfilling prophecy, problems can arise from its use of gearing/leverage,[12] the use of its money and the quality of the loans it makes. This is a known as a Solvency Problem and occurs either where a bank makes unwise loans and the borrower defaults or where the bank, in effect, borrows money from its own customers in order to trade (deal) on its own behalf. The leveraged/gearing increases the return from its transactions but is also a risk, an example being Baring Bros and Nick Leeson.[13]

In an attempt to prevent the use of depositors' monies for speculative trading, the USA passed the Glass-Steagall Act, which separated the investment/speculative arm of a bank from its retail/borrowing arm after the 1929 crash. However, that Act was abolished in the late 1990s allowing retail and investment banks to combine again (Wray, 2015); (Wray, 2009); (FSA, 2009).

1.2.2 The Financial Crisis 2007-2008: the banking problem that affected the world.

It is now a decade since the Financial Crisis of 2007-2008[14] started to unfold with the BNP Paribas preventing withdrawals from three hedge funds, citing liquidity problems, in August 2007. This was followed by a bank run[15] on Northern Rock[16] at the end of August 2007, and was in fact the first UK bank run since the collapse of Overend, Gurney & Company [17] in 1866 (Sowerbutts & Schneebalg, 2016, p. 95).

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[12] "Leverage": see footnote 90.

[13] "Barings Bank": A merchant bank founded in 1762, and considered as one of the most reputable and stable banks in the world., Barings collapsed in 1995 when "rogue trader", Nick Leeson, became involved in unauthorised speculation of derivatives at its office in Singapore and they were unable to meet their cash requirements. (Cassis, 2013) (Tickell, 1999)

[14] Enron Scandal (2001): Enron was a Texas commodities energy and service company. It grew over 15 years, to be America's seventh largest Corporation. It had issues about its profits and stands accused of many unethical dealings, including concealing debts from the company's balance sheet.

[15] WorldCom Scandal (2002): WorldCom was a telecommunications company. Costs were underreported by capitalising them and false accounting entries were used. It Inflated its assets by about $11 billion leading to $180 billion losses for investors.

[16] The demise of Northern Rock was the harbinger of the Financial Crisis 2007-2008. The unfolding collapse was described in "The Crunch" (Brummer, 2008).

[17] Overend, Gurney and Company was established in 1800 and became a well-respected wholesale bank specialising in discounting bills of exchange. They became known as the 'banker's banker'. It was run from 1807 until his retirement in 1856 by Samuel Gurney whose family had a well-established bank in Norfolk. After Samuel Gurney's death its business model changed and it took on long-term debt and invested in railways. A loss of confidence ultimately caused a bank run. The Bank of England, a private bank at the time stepped in and secured market wide lending, in effect becoming the lender of last resort. (Sowerbutts and Schneebalg, 2016).

Just as the Great Depression[18] had followed the banking runs and collapses of 1930 (Bernanke, 1983), so the bank runs on Northern Rock and collapses of Bear Stearns and Lehman Brothers in 2007-2008, led to the "Great Recession"[19] in the United States, recession and austerity in the United Kingdom (De Grauwe, 2008) and the problems of the Euro "European Sovereign Debt Crisis"[20] from 2009 onwards (The Economist, 2014); (Tett, 2010).

The sequence of events that led to the Financial Crisis of 2007-2008 can be found in the expansion of the United States housing market through sub-prime lending[21] to poorer Americans to help them buy (or remortgage) their homes. These loans were indirectly guaranteed by the US government and were bundled and sold as new financial products called "mortgage-backed securities",[22] which were then packaged as investments and sold as low risk securities. It became common for house owners to remortgage their homes which had increased in value, in order to refinance existing consumer credit debt. However, often the lending criteria to those whose incomes had not increased were unsatisfactory (Tetlow and Smith, 2016). This situation led to high failure rates by borrowers which affected the value of the financial products. Eventually when, with increasing borrower default, the value and quality of the mortgage-backed securities fell into question, the liquidity of the banks was affected not only in the United States but in other countries that had similarly invested heavily in such securities (The Economist, 2014); (Tett, 2010). Thus, unlike in the 1930s, the modern global economy and interrelationships between banks made the liquidity problem a global one, rather than a

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18 The Great Depression lasted from 1929 to 1934. It was a period during which economic activity was very depressed and unemployment in Europe and the United States was very high.

19 The Great Recession followed the Global Banking Crisis in 2007. There was a severe decline in economic activity, widely accepted as the greatest fall in economic activity since the Great Depression. The term "Great Recession" applies to both the American recession, officially lasting from December 2007 to June 2009, and the global recession in 2009, which followed it.

20 "European Sovereign Debt Crisis": The introduction of the Euro in certain member countries of the European Union was accompanied by an agreement that each of the member countries would keep their sovereign debt levels below 60% of their GDP. There were concerns about whether a number of those countries that were part of the Euro zone would be able to service their national debt obligations in 2010. This led to substantially increased yields on the national debt issued by these Eurozone countries. The EU with the European Central Bank and the IMF (International Monetary Fund) created a rescue package of some €750 billion to assist.

21 "Subprime Loan/mortgage": "A loan that is made at a higher interest rate than most other loans. Subprime loans are made to borrowers who do not qualify for ordinary loans because of bad credit history or some other reason. There is a higher risk of default on subprime loans." (Farlex Financial Dictionary, n.d.)

22 "mortgage-backed securities": Securities backed by a pool of mortgage loans." (Farlex Financial Dictionary, n.d.)

crisis affecting a single region or state, as the mortgage-backed securities[11] were traded internationally between banks.[23]

The effects of the collapse of Lehman Brothers, Bear Stearns and insurers AIG in the United States and Northern Rock, Royal Bank of Scotland and other banks in the UK had a pivotal role in subsequent economic problems. Whilst there was already a slowing down in incomes in the United States and United Kingdom in the period before 2007 (Carney, 2016); (Woolf, 2010), the Financial Crisis 2007-2008 and consequent recession exposed income inequality. It could be argued that this is one factor that contributed to the election of the 'populist' President of the United States and the Brexit referendum in the United Kingdom. For example, an article "*Squeezed Midwest vs squeezed Midlands: How US and UK incomes Compare*" in the *Financial Times*, commented that there had been a popular revolt which could be seen in the rise of "populist" parties on the right and left. More and more electors believed that the existing system did not support them, and that globalisation gave privileges only to the few (Tetlow and Smith, 2016). A very similar observation was made in an article in the Guardian (Elliott, 2016). This is further examined in the section on Financialisation below.[24]

The Financial Crisis 2007 exemplified both the liquidity problem of banks (Northern Rock) and the solvency problems of many banks starting with Lehman Brothers and the problems affecting banks arising from unwise lending and in particular, from CDOs,[25]. However, there have been a series of scandals affecting banks arising not just from the traditionally regarded liquidity or solvency problems of banks, but, as will be seen in the

[23] Details of the unfolding Financial Crisis 2007-2008, can be found in the number of official reports. The Bischoff Report (Bischoff, 2009)(O'Grady, 2009)was a City sponsored report which was criticised by several academic writers. (Froud & Moran, 2010) (Froud, 2010) (Glynos , Klimecki & Willmott, 2012) (CRESC, 2009)The UK Government's response was in the Vickers Report (Independent Commission on Banking, 2011) and the UK Government Response ((HM Government, 2011)The Parliamentary Commission on Banking Standards produced 5 reports, the final one being "Changing Banking for Good". (Parliamentary Commission on Banking, 2013)and UK Government Response" (HM Government, 2013).
Return on Equity could bring in it is used in calculating remuneration (at page 9) and because of the reluctance of banks to accept capital adequacy restrictions, because they diluted return on equity (Para 40 at page 22)
(Parliamentary Commission on Banking, 2013) (Parker, 2013)"The Turner Review (FSA, 2009) (Pratley, 2009)In addition there were official American reports: the US government Financial Crisis Inquiry Commission (Angelides Commission) (Financial Crisis Enquiry Commission (United States), 2011) and a US Senate report (Levin-Coburn US Senate, 2011).
[24] Section 1.3 Financialisation
[25] "CDO": (Collateralised Debt Obligation) a derivative which can be bought and sold and is tradeable. Capital payments arise from a collection of different financial contracts paying interest and whose capital will ultimately be repaid. CDO's are "collateralised" as it is the promise of the repayment of capital that gives the CDO is their value.

next section, those related to the personal conduct of bankers and financial intermediaries of which examples are provided in the next section. However, it should be borne in mind that these are examples rather than a complete catalogue.

1.2.3 Some Examples of Scandals that have affected Banks

In addition to the Financial Crisis of 2007-2008 being of global proportions, it also revealed other problems affecting individuals and groups, in particular bad behaviour or unethical conduct on the part of banks and bankers. This ranged from the excesses of investment bankers (Tett, 2010), to the selling of sub-prime mortgages to borrowers who could not afford such mortgages by financial intermediaries who then falsified the paperwork on behalf of the borrowers, and of lenders who did not give due consideration to those mortgage applications (The Economist, 2013). Some of the examples arose during the Financial Crisis 2007 - 2008, while others, despite the focus on banker behaviour which the Crisis generated, only came to light after the crisis.

The first example is that of the Abacus Bond.[26] The creator, Goldman Sachs, did not disclose in its marketing materials that the underlying assets were selected by a third party who in turn used another party, a large hedge fund, Paulson & Co. Inc. ("Paulson") to select those underlying assets. Paulson had interests contrary to those of the investors in Abacus, because it shorted (that is, bet against) the Abacus portfolio by entering into credit default swaps ("CDS").[27] This meant it had an interest in the portfolio it was selecting for Abacus underperforming. Accordingly, Goldman Sachs was benefiting through the credit default swaps at the same time as it was profiting from the arrangement of Paulson when acting against the interests of the Abacus bondholders (Hill, 2012, p. 678).

A second example relates to Citigroup. Citigroup marketed and sold a mortgage-related CDO as being of high rated quality/standard. In fact, the CDO was not at all of high quality and Citibank then took a short position (i.e. bet against it). The bank made a profit of $160 million, while investors lost (Hill, 2012, p. 679).

[26] The Abacus Bond is an example of a CDO (collateralised debt obligation), which is a derivative that can be bought and sold, is tradeable and whose capital will ultimately be repaid. CDO's are "collateralised" as it is the promise of the payment of capital that gives the CDO its value.

[27] "Credit Default Swap" (CDS): In a Credit Default Swap, party 1 agrees to provide protection to party 2 in case a corporate bond or national debt is unpaid. Usually party 2 pays an annual sum to party 1 in return for the guarantee of compensation if the bond defaults.

A third example involved Lehman Brothers, which developed and used a transaction structure called "Repo 105".[28] Lehman Brothers had recorded repurchase transactions as asset sales, thereby giving it a far more favourable debt ratio than was actually the case. An examination found that no reason, other than a cosmetic one to improve its debt ratio, could be given for this procedure. The advantage for Lehman Brothers for so doing was to improve its balance sheet, which avoided its credit status being downgraded by the credit rating agencies and enabled it to make further loans and increase profits.

A fourth example is that of the involvement of JP Morgan Securities in arranging a transaction for Jefferson County. When the county was forced into bankruptcy, it was discovered that one of the important contributions to that bankruptcy was a 'swap' transaction[27] arranged by JP Morgan Securities. The bank had bribed local officials and had received 'enormous"' fees for arranging the credit default swap transaction for Jefferson County compared to comparable transactions. Not only was the bribery of local officials illegal, but the bank benefitted whilst knowing that the residents of the county would be prejudiced; the fees that were charged were far too great and were an unreasonable burden on the local taxpayers. (Hill, 2009-2010; Hill & Painter, 2015 Chapter 1).

However, the problems of banks did not start with the Financial Crisis of 2007-2008. A fifth example is from an earlier period, the Savings and Loan Scandal of the 1980s.[29] In this case the loans were made to connected individuals and their friends and business network. It involved making excessive or fraudulent valuations of property to allow larger loans. This created larger asset values on the balance sheet and the ability to make more loans as well as declare larger dividends. In addition, the directors and managers engaged in extravagant expenditure and entertainment (Chavez, 2002, p. 21).

A sixth example is that of Goldman Sachs assisting the Greek government to obfuscate its debt and borrowing to enable it to meet the criteria to become one of the founding members of the Euro. It did so by buying Greek debt in other currencies using an imaginary exchange rate. The result was that Greece met the convergence requirements of

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[28] "Repo": A "repo" is a repurchase agreement. It is a type of short-term loan. The seller of a money market security agrees to buy it back at a specific time and price. The interest rate paid by the seller is known as the "repo rate".

29 The Savings and Loan provided were amongst the safest sources of mortgages for homes in the United States. In 1989 more than 1000 S&Ls collapsed, perhaps, the most significant banking industry crisis since the Great Depression.

debt, so allowing it to join the Euro. It also allowed Greece to continue borrowing and ultimately contributed to the Greek Debt Crisis. Although the Euro has other problems, the effect of the Greek Debt Crisis has been significant on the European Union as well as the Euro itself. Indeed, the problems of the Greek economy as part of the Eurozone featured in the UK referendum campaign. Therefore, the effect of the Goldman Sachs manipulation on behalf of the Greek government has had very significant effects on the European Union and, indirectly, on the United Kingdom[30] (Hill & Painter, 2015 Chapter 1).

A seventh example is the 'PPI Scandal'. For 15 years before 2011, loans and credit card repayments were often sold with an insurance product, PPI (Payment Protection Insurance), to cover the consumer of the financial burden if the borrower died, was ill or disabled. In principle, there was nothing wrong with PPI policies, as borrowers may have wanted insurance when taking out a large loan or mortgage, but for years before 2011, millions of people were mis-sold PPI, often at high rates of interest, without a proper understanding that it was being added to their repayments. Between 2005 and 2017 The FSA fined banks £157 million and £27billion has been repaid by Banks in compensation to consumers (FCA, 2017).

A final, but more recent, example of the problems of banks is that of the LIBOR[31] 'scandal'. LIBOR was first developed in May 1970 to facilitate loan transactions. The problem that affected LIBOR arose from its manipulation.[32] This was caused by a "culture of impunity in many parts of the market, coloured by a perception that misconduct will either go unpunished or undetected." FEMR Report,[33] (HM Treasury, Bank of England, FCA, 2015).[34]

30 "With global financial markets still reeling, Greece announced in October 2009 that it had been understating its deficit figures for years, raising alarms about the soundness of Greek finances" (New York Times, 2016).

31 "LIBOR": London Inter-Bank Offered Rate. It is the average cost of borrowing by banks, and is calculated on a daily basis. Official LIBOR is the average of those rates and is used as a base to price many loans and financial products worldwide. It is calculated on the basis of submissions by 16 banks submitting the costs of their borrowings. The bottom four and top four rates are ignored, and an average is taken of the rest. Accordingly, LIBOR is the average of 8 submissions (The Daily Telegraph, 2015).

LIBOR impacts on the markets in three ways; firstly, it is regarded as a measure of the creditworthiness of banks and therefore effects pricing of the shares. Secondly, it acts as the basis for calculating the interest rate for LIBOR linked investments and lending and thirdly, it is used in the calculation of costs relating to futures and swap (interest rate) markets. (Luna II, 2014).

32 Manipulation was not difficult because the LIBOR submissions were predictable. In cooperation with other contacts in other banks traders could enter figures that affected the submissions, and so over short periods the LIBOR rate could be moved and as a result profits made for those traders.

33 Fair and Effective Markets Review (FEMR)

34 The LIBOR scandal resulted in three Official reports: The UK Treasury's Wheatley Report, which considered the problems arising from LIBOR and other financial benchmarks" (Wheatley, 2012). The

1.2.4 How the press and public react to the problems of banks and how it makes matters worse.

The difficulties that have caused banking crises and the strategies used to overcome them are classic problems of Liquidity and Solvency which have been discussed, debated and reported on throughout the existence of banks (Davies G, 2002). The scandals and problems that have affected banks have brought calls from both public and politicians to ensure "it doesn't happen again". For example, The Overend, Gurney collapse in 1866 [35] was not only followed by emergency measures; it resulted in Walter Bagehot (the then editor of The Economist) writing a treatise supporting the Bank of England's actions in becoming the 'lender of last resort' and suggesting that it should continue to do so (Sowerbutts & Schneebalg, 2016). The panic that affected the New York banks in 1907 was followed by a call by US congressman, Charles Lindbergh, for a full investigation into Bankers' Trusts (monopolies) and the Pujo[36] Committee which led to a US constitutional amendment and the establishment of the Federal Reserve[37] ("the Fed"), (Bruner, and Carr, 2009).

Similarly, the 1930 banking crisis in United States was followed by the Banking and Currency Committee of the United States Senate and the Pecora report between 1933 and 1934, and was in turn followed by the Glass-Steagall Act[38] which separated deposit taking/high-street banks from commercial or merchant banks (Pecora, 1939).[39]

A similar reaction occurred in relation to the 2007-2008 banking crisis. In 2009 Janet Yellen, then President and CEO of the Federal Reserve Bank of San Francisco and, currently President of the Federal Reserve Board, referring to the 2007-2008 Banking Crisis, said,

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Parliamentary Commission on Banking Standards Report (PCBS) (Parliamentary Commission on Banking, 2013)[34] and The Fair and Effective Markets Review (FEMR) (HM Treasury, Bank of England, FCA, 2015) which aimed at restoring confidence in the LIBOR and other financial markets.

[35] see above (Sowerbutts and Schneebalg , 2016).

[36] the Pujo Committee - named after its Chair, congressman Arsène Pujo of Louisiana.

[37] Unlike European countries at that time the United States did not have a Central Bank.

[38] the Glass-Steagall Act is otherwise known as the Banking Act of 1933 (USA) (Pub.L. 73–66, 48 Stat. 162), enacted June 16, 1933.

[39] However the change between the Knickerbocker Crisis, the Wall Street Crash and the Financial Crisis 2007- 2008 was made worse because of Financialisation (see section 1.3 Financialisation and Return on Equity ("RoE").

> "A clear lesson of history is that a 'sine qua non' [40] for sustained economic recovery following a financial crisis is a thorough going repair of the financial system" (Yelland, 2009).

The Economist, in a special article reviewing banking crises over the past 200 years, reflected:

> "The response to a crisis follows a familiar pattern. It starts with blame. New parts of the financial system are vilified: a new type of bank, investor or asset is identified as the culprit and is then banned or regulated out of existence. It ends by entrenching public backing for private markets: other parts of finance deemed essential are given more state support. It is an approach that seems sensible and reassuring." (The Economist, 2014).[41]

The Economist continued by suggesting that a former editor, Walter Bagehot, 1860 to 1877, had argued that financial crises occurred following the flood of "blind capital" from the public into unwise and speculative investments. The reaction to this (regulation) has, in the view of The Economist, made the problem worse (op.cit, 2014). It will be suggested in this dissertation that the implication of these comments is that there is a "knee-jerk" reaction whenever there is a banking crisis. However, the result is regulation that retrospectively looks back to the crisis that has just happened rather than towards future crises.[42] Regulation can only be based on what is known at the current time rather than what may happen in future, as "what may happen" is never known before it happens.

Whilst the Economist might write from a liberal (or, even, neoliberal) capitalist point of view, other authors have recognised the pattern, but have attributed the blame to the bankers and financiers who they suggest have an intention to avoid unwelcome reform (Glynos, Klimecki & Willmott, 2012); (Froud, 2011). The suggestion is that legislators, bending towards public opinion and wanting to be seen to be taking action, have increased investor protection following every banking crisis. However, this has served as the seed of the next crisis, because it has given the banks a degree of protection that is not afforded to

[40] *sine qua non* "a necessary condition without which something is not possible" (Cambridge University Press, n.d.).

[41] This comment in the Economist can be compared with the article on "Cooling out the Marks" (Glynos , Klimecki & Willmott, 2012).

[42] This view is supported by John Lanchester in "*Whoops! Why everybody owes everyone, and no one can pay"* (Lanchester, 2010).

other private-sector companies. The-too-big-to-fail-problem[43], for instance, means that government are under political pressure to intervene to ensure that banks can fulfil their obligations to their depositors, whilst at the same time protecting bankers who have no personal liability (Williams and Conley, 2014).

After each banking crisis, those who sought to prevent future banking crises suggested regulatory reform. For example, the suggestions of the lender of last resort of Overend, Gurney in 1866, the establishment of the Federal Reserve after 1907, the Glass-Steagall Act after 1929, the Enron[44] Scandal (BBC News, 22 August, 2002); (Hill, 2012, p. 691) and WorldCom[45] scandals, led to increased reporting regulations in the Sarbanes–Oxley Act 2002. The banking crisis of 2007-2008 resulted in the Dodd-Frank (Wall Street Reform and Consumer Protection Act 2010) in the United States; in the UK Banking (Special Provisions) Act 2008, for the nationalisation of Northern Rock and the Banking Act 2009, which provided for a special insolvency regime for banks, envisaging that banks could be taken over by the government in the event of failure.

However, whilst the problems of banking crises and the regulation of banks have long drawn public and government attention, academic thought has also looked at the problems from perspectives other than a purely regulatory one. In fact, the issue of culture and ethics in banking has received considerable critical attention, particularly in the last twenty years. The interest appears to have coincided with the importance and growth of financialisation.[46] In effect, generation of profit by use of capital has become more important than by generation through industry or agriculture. Whilst this way of generating

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[43] A company that is "Too big to fail" is one that is so large that a government feels obliged to act to prevent its failure, for fear that if it does not do so there will be systemic effects throughout the economy. In the case of a major national company, if it fails, then smaller companies that may be its suppliers will also fail and jobs will be lost. The political and economic cost of a bailout is calculated to be less than the cost of the failure to the economy; a government may consider that solution. In the case of a bank not only will there be losses to individual depositors, who have invested believing the bank to be safe, there is the fear of contagion (runs on other banks). This is a frequently discussed problem: for example Kay, (2015 at location 1372 Kindle edition); (O'BRIEN, 2012, p. 244); (Carney, 2014, p. 3); ((Minner, 2016, p. 23); (Bischoff, 2009, p. 46).

[44] Enron: see footnote 14**.** Enron were not a bank, but many of the activities were similar and Enron's bankers were instrumental in the misrepresentation that assisted them to fool the rating agencies, the investing public and markets into thinking that they had less debt and more income and cash flow than it actually did (Hill, 2012); (BBC News, 22 August, 2002); (Johnson, 2003).

[45] WorldCom: WorldCom were a telecommunications company. The Chief Executive failed to report costs but capitalised them rather than placing them as expenses of the business as well as increasing income with false accounting entries. The result was that assets were inflated by $11 billion and losses of $180 billion to its investors (Blackburn, 2008).

[46] "Financialisation" -see footnote 4 above and section 1.3 Financialisation .

profit has always existed, financialisation has become significantly more important since the 1970s (Ireland, 2010, p. 18); (Krippner, 2005, p. 82).

Subsequently, an increase in alternatives or enhancements to regulation has been the subject of much recent research with the recognition of the limitations of current attempts to regulate the industry. Those who wanted more regulation were looking to the problems of the most recent banking crisis. However, banks sought to overturn regulations which they considered inconvenient for their purposes (Kay, 2015); (New Economics Foundation, 2011, p.10).[47] As De Grauwe observed, bankers, over the period of the growth of financialisation[48] (1975 onwards) were becoming increasingly less regulated and eventually the Glass-Steagall Act was repealed in 1999. The effect was that retail banks, which took in customer savings and lent them out to borrowers, henceforth were able to pass them to "commercial divisions". Merchant Bank subsidiaries could now use such monies for far riskier activities such as underwriting the offer of shares and trading on their own account. This coincided with the development of new financial products such as derivatives[49] and structured products. De Grauwe argued that all of the activities that had led to the 1929 Wall Street crash had been reinstated and the lessons of history had not been learnt (De Grauwe, 2008, p. 2). There was also evidence of excessive risk-taking which contributed to the banking crisis of 2007-2008 (Cohn, 2012); (Cohn, Fehr and Marchal, 2015). It was suggested that "time inconsistent preferences" resulted in a trade-off by bankers between short-term reward and long-term achievement. These are psychological issues which may have contributed to corporate crime, but certainly led to unnecessary risk-taking, even though those risks may not have been sufficient to be deemed criminal in nature (Painter, 2012-2013). A view was taken that the aim was maximising profit and that the law did not provide sufficiently rigorous processes for decision making (Fichter, 2016). Moreover, occasionally behaviour was simply unethical or dishonest (Hill, 2012).

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[47] One of the speakers at the Good Banking conference, Will Hutton, was mentioned in the report as saying "Banks ran down the capital at the core of their balance sheets, not replenishing and adding to it – but paying it out in dividends and bonuses. If they had paid out just 20 per cent less, calculates the Bank of England, between 2000 and 2007 they would have reserved more than the state paid out" (New Economics Foundation, 2011, p. 7).

[48] See section 1.3 Financialisation .

[49] "Derivatives": derivatives are a financial investment with a value based on the performance of underlying assets (e.g. property, shares, bonds or currency). The main types of derivatives are swaps, financial futures and financial options.

Furthermore, following the banking crisis of 2007-2009[50] other banking scandals continued to emerge despite the profound effect of the 2008 banking crash. The fixing of the LIBOR (London Interbank Lending Rate),[51] Foreign Currency Forward Price-Fixing[52] without the customers' knowledge and to the customers' disadvantage; and money laundering to assist criminals, drug dealers and corrupt individuals were such cases (Hill, 2012, pp. 678-686).

1.3 Financialisation and Return on Equity ("RoE")

The trend towards financialisation has also increased the traditional banking problems of liquidity and solvency.[53] This has not only exacerbated the problems of banks by creating the conditions for banking crises, but has also increased the importance of RoE which in turn has undermined the attempts at regulation and change of culture to deal with banking problems. Given the importance that RoE has in this dissertation, as being the main issue overshadowing any attempts to regulate changes in regulation or banking culture, the concepts of financialisation and RoE are now considered in a more detail.

The traditional view of finance and banking is that they are the lubricant that makes all economies work. Historically, economic development depended on the expansion of production in agriculture and industry and there have always been recessions as part of a business cycle.[54] However, it has been suggested that extremes in booms and recessions will become more severe as they are 'Financialisation Recessions' that is, recessions resulting from crises in the financial system and banking in particular (Bogle, 2005). These increase the high and low points in the business cycle, because, unlike the product of manufacturing - which is transferred into stock or agricultural produce - financial products

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[50] banking crisis see footnote 3 above.

[51] The LIBOR scandal resulted in three formal reports. The Wheatley Report considered the problems arising from LIBOR and other financial benchmarks required a "wider policy response" (Wheatley, 2012). The Parliamentary Commission on Banking Standards Report (PCBS), (Parliamentary Commission on Banking, 2013)[51]. The third (tripartite) report was the Fair and Effective Markets Review (FEMR), (HM Treasury, Bank of England, FCA, 2015) aimed at restoring confidence in the LIBOR and other financial markets. All these reports made proposals for further regulation, but attracted concerns that sanctions "will condemn the bad, but not necessarily develop the good" (Hardowar, 2017) and would concentrate the participants on compliance rather than best practice. In addition, concerns were expressed as to how long it would take for traders and bankers to find new ways to manipulate rates. (Hardowar, 2017).

[52] Foreign currency forward price-fixing was a way in which traders could affect the market price by submitting a rush of orders at the last moment before the market closed. Traders can affect market prices by submitting a rush of orders during the window when the fix is set. They could give an obscured view of supply and demand and so change the market price (BBC News, 20 May 2015).

[53] "Financialisation": see footnote 4 above and section 1.3 Financialisation '.

[54] "Business Cycle", also known as "the economic cycle": the period of time during which an economy moves from a state of expansion to a state of contraction, before expanding again" (F.T. Lexicon, n.d.).

are intangible[55] and are only valued on the basis of other illusory products. For example, a diamond is a carbon crystal, which can now be created through a manufacturing process for use in industry. Its value as a jewel is only based on how much someone wishes to own ‘a diamond’. Similarly, the value of some identically constructed houses can differ greatly depending on the locality in which they are situated. If the attractiveness of a neighbourhood increases, the value of properties in that neighbourhood rises. The neighbourhood may have changed little, but public opinion has given it increased value. For example, Notting Hill was considered as a downmarket bedsit area in the 1950s and is now one of the most expensive areas in London. In a similar way, in a systemic[56] financial crisis, trust is lost in the worth of deposits at banks or other financial assets, as their value is based on the trust that is instilled in them by depositors or investors who previously believed that they could redeem those assets on demand.

The concept of "Financialisation" (‘financialization' USA) has been used by academics [57] in recent years to interpret the way that industrial and agricultural society is being replaced by one that is based on finance, which in turn appears to be autonomous of other industries and has even resulted in an imbalance of democracy in individual countries (Froud, 2011). Finance, instead of being a way of providing capital to support industry and agriculture has become an end in itself and shareholder value (RoE) has become the key driver of growth through financialisation within major economies (Ewald, 2011, p. 108).

Although academic literature on financialisation is extensive and diverse, three main strands can be identified.

1.3.1 Return on Equity (“RoE”)

The most important feature of financialisation under consideration for this dissertation is RoE which arises from the legal construction of the modern company characterised by favouring shareholders over other stakeholders in a company, such as employees or customers. The effect of RoE is not just to benefit shareholders, but also explains the eagerness for corporate takeovers and restructuring as well as executive remuneration

[55] Money could, itself, be described as illusory and not just intangible. It is a creation of the human mind, imagination which is shared with humans, which has made humans unique from other animals. (Mithin, 2001). A banknote is only a worthless piece of paper until a common imagination gives it value.

[57] The concept of financialisation was introduced discussed in the “Financialization of the American Economy” (Krippner, 2005) and in “Financialisation and the World Economy” (Epstein, 2005) and **“**Banking *in the public interest: Progressive reform of the financial sector*” (Sikka , 2014). An American academic writer David Kotz also saw the Banking Crisis 2007-2008 as a crisis of neoliberalism (Kotz, 2008) (Kotz, 2009).

schemes that are based on profits and options on shares. As such financial constructs increase the RoE available to shareholders. The importance of RoE is seen as a consequence of the divide between the owner-manager and the investor ("rentier"), who has no attachment to the company other than the profit that can be extracted from it (Ireland, 2010). Whereas prior to financialisation, industrial corporations would prioritise reinvestment of profits into production, post-financialisation, such companies are inclined to distribute profits to shareholders either by dividends or by repurchase of shares. It is also suggested that RoE has not only been to the detriment of wages, but also that restructuring has resulted in unemployment (Lazonick, 2000); (Blackburn, 2008).

If RoE is calculated as profit divided by equity capital, then an increase in the equity capital will adversely affect the RoE. If equity capital were, say, 100 million and profits 10 million, then the RoE is 10÷100 = 0.1 but if the capital is increased to 200 million the RoE is 10÷200= 0.05 amounting to half the return (Elliott, 2010). Accordingly, in order to increase profits banks would have to increase charges and interest rates. Alternatively, there appears to be evidence that when faced with a requirement to increase capital there is a preference by banks to reduce lending, which allows them to meet the capital regulations, but without raising further capital (Aiyar et al. 2013); (Ratnovski,2013).[58] This would affect the supply of credit/loans available and may have an adverse effect on the economy. Accordingly, it was in the bank's interest to show success in achieving capital adequacy by reducing its equity capital (Kay, 2009).

1.3.2 The Growth of Credit

The second strand of financialisation focuses on the disconnection between rising wages and rising industrial productivity which began in the 1960s. The connection between wages and productivity has been replaced by a growing flexibility in employment markets and the growth of credit, which has enabled consumption when there was no growth in real earnings and which may be diverted to paying returns to shareholders instead of employees. In addition, not only have manufacturing companies expanded into the financial sector (for example, GE Finance (General Electric) or GMAC Finance (General Motors), but such manufacturing companies have also had to pay more to financial companies through interest and dividends, thus reducing their capital available for investment in manufacturing (Krippner, 2005). Further, those who follow the "accumulation" view of financialisation suggest that the reliance on consumption fuelled

[58] See Chapter 3 below.

by consumer credit and rising house values enabled by mortgage credit, were by their nature unstable because they were based on continuing confidence in intangibles, which, in turn, leads to individual debt and housing asset bubbles. This inevitably caused the boom that led to the Financial Crisis of 2007-2008 (Blackburn, 2008).

1.3.3 Growth in Financial Products

The third strand of the financialisation literature focuses on the financial products that have been introduced into the lives of people in all Western societies. Studies have suggested that this has occurred through an expansion of consumer credit, mortgage lending and a range of other financial products (van der Zwan, 2014). In addition, there has been a considerable change in attitudes to credit. For example, in the 1950s and 1960s people who used credit or hire purchase to acquire goods and services were frowned upon by others as buying on the "never-never."[59] In addition, pensions that were formerly funded by company employers or the state are now increasingly based on accumulated financial capital; for example, the replacement of Final Salary schemes which relied upon the company providing pensions rather than with Money Purchase schemes, where the employee invests in his/her own pension. The state has been a participant in such a transition by making reductions in state welfare provision in favour of schemes which are financially based, for example, student loans. This shift to individual responsibility has led to a number of consequences. Whilst some individuals have become stock market investors, most have restricted themselves to increasing personal wealth by maximising the increase in value of their own homes by obtaining the largest mortgage their salaries would allow or by becoming 'Right to Buy' investors. Unfortunately, most individuals do not have sufficient financial expertise to make informed financial judgements and if they have limited income or capital they are exposed to over borrowing and risk.[60] An example of this is when many who acquired shares in the demutualised building societies, but did not sell them, lost out when those building societies, as banks, collapsed in the Financial Crisis

[59] The 'never-never' was a colloquial name for hire purchase. This was a system of making an initial part payment for an item and then making regular small payments until the debt is paid and the item becomes that of the borrower.

[60] Joe Kennedy, a prominent American entrepreneur, is reported to have said - explaining why he withdrew his money from the market in 1929 - "Taxi drivers told you what to buy. The shoeshine boy could give you a summary of the day's financial news as he worked with rag and polish. An old beggar who regularly patrolled the street in front of my office now gave me tips and, I suppose, spent the money I and others gave him in the market. My cook had a brokerage account and followed the ticker closely. Her paper profits were quickly blown away in the gale of 1929." (Rothchild, 1996).

2007-2008. Another example is PPI[61], which large numbers of individuals agreed to when taking out credit.[62]

1.3.4 The effect of Financialisation on Banks

Financialisation can thus be seen to have had three main consequences which relate to the problems of banks. Firstly, it has encouraged, through the new culture of accumulation which has encouraged borrowing, a reliance on future earnings or the increasing value of property. This was made possible because of the availability of credit but resulted in the over indebtedness of individuals and asset bubbles in housing. Secondly, it has led to the 'popularisation'[63] of finance, in which far larger numbers in society are involved in using credit and risk taking. This in turn necessitates increasing involvement with the providers of finance, namely, banks. Thirdly, RoE, places pressures on those employed in joint-stock banks to maximise returns and to place RoE above all other considerations including compliance with regulation and ethical practice.

In 2011, the New Economics Foundation held a *Good Banking Summit* which reported that the lending of the top 10 UK banks came to 450% of national output whilst in the USA the lending by such banks was only 60%. They also noted an observation made by US Treasury Secretary Tim Geithner that UK "light touch" regulation attracted business from other banking centres and resulted in £1.3 trillion of extra public UK debt. The Good Banking Summit also reported that banks in Britain had a RoE of 15-25%, with insurance companies and finance accounting for 30% of FTSE 100 profits. It also recognised that under pressure to maximise profits, banks had become involved in proprietary trading[64] in wholesale markets and mass selling (for example, PPI) in retail banking. It suggested that traditional companies had failed in preventing risky behaviour as there was, in effect, joint enterprise between finance traders and shareholders, with the traders receiving up to 45% of net turnover[65]. The different working groups at the Summit examined a range of issues

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[62] In *"The end of the experiment? From competition to the Foundational Economy"* (Bowman, 2014) of CRESC (Centre for Research on Socio Cultural Change), *"Mis-selling for Return on Equity"* seeks to explain how the problems of commercial (retail) banking arose from moves in the 1980s to chase higher Return on Equity which pressurised banks to push products for profit (e.g. PPI and 'free-if-in-credit-banking', which obfuscated customer choice (Bowman, 2014, Ch. 4).

[63] Others have described the 'democratisation' of finance whereby financial products are made available to a wider society (van der Zwan, 2014) and consumer literacy (Zokaityte, 2015).

[64] "Proprietary Trading": the activity of a bank or other financial institution trading on its own account rather than for a customer using bank capital often in speculative trades.

[65] The symbiosis between shareholders and managers/traders is a continuing theme in this dissertation.

and, in particular, the recently published Independent Commission on Banking (Independent Commission on Banking, 2011) which suggested that the Commission had not gone far enough in suggesting reforms to banking. One of the working groups did in fact look at alternatives to the current banking structure. However, such consideration was relatively brief and its focus was limited to the example of a Post Bank (New Economics Foundation, 2011, p. 21).

Official reports have tended to ignore the concept of Financialisation; it is not a term that appears to be found in any of the major UK reports[66] and the absence of the consideration of financialisation was criticised by a number of writers (CRESC, 2009); (Ewald, 2011); (Froud, 2011). Nevertheless, financialisation is set down as a key background cause of the Financial Crisis 2007-2008 by a number of writers (New Economics Foundation, 2011); (Ireland, 2010); (Sikka , 2014); (Krippner, 2005); (van der Zwan, 2014); (Klimecki & Willmott, 2009); (Glynos, Klimecki & Willmott, 2012); (Froud & Moran, 2010). However, the neoliberal view is that the Financial Crisis 2007- 2008 was a result of regulation, in that it failed because the regulation set the limits of *behaviour* rather than encouraging *sound commercial judgement*. In this case, regulation protects the bankers against failure and removes the need for banks to act wisely. Neoliberalists argued that the free market and competition would control banks (Jacomb, 2011).[67]

However, it is argued that taking the effects of neoliberalism in financialisation further, by emphasising the effects of maximising profits for shareholders and RoE, shareholders commonly take a short-term outlook whilst free markets and competition are concepts of the medium to long term (Talbot, 2013). Attempts to enhance the powers of shareholders are misconceived because whether capital is held by individual shareholders or financial institutions the goal is to maximise liquidity and attain maximum return on profits. Managers and traders whose bonuses are linked to profits are therefore compliant. Even the suggestion that shareholders should assert their voting power is mistaken because it provides the false impression that it will provide a regressive method of corporate control (Talbot, 2013). Indeed, it is argued that the promotion of the idea that shareholders have a role as stewards rather than that of purely seeking to maximise capital will result in further banking problems (Dignam, 2013); (Graafland, JJ van de Ven, BW, 2011).

[66] See footnote 23 above for details of the Official Reports.

[67] Other examples can be found in newspaper reports. For example, the Financial Times reported that, when the Vickers commission was considering ring-fencing, Sir Bob Diamond suggested that such regulation would encourage Barclays Bank to leave the UK. (Goff, 2011). Newspaper reports in the Financial Times also revealed pressure from other banks (Jenkins, Goff and Parker, 2011).

1.4 Research Potential, Methodology and Outline of Chapters

The issue to be addressed here is why banks have the problems they have, and why the proposed ways of dealing with those problems have been unsuccessful. Neoliberalists have suggested there should be less regulation. Another school of thought suggests that the problems can be overcome by regulation. There is a debate within the latter as to whether regulation is sufficient and whether there should be even greater regulation. The other school of thought suggests that regulation, certainly on its own, will not be sufficient and an ethical and cultural change will have to be effected. According to such a school of thought, the importance of the human need to achieve, strive and “win” is considered (Bell, 2013, p. 15). This dissertation argues that alternative legal structures other than joint-stock banks (for example, publicly owned cooperatives or mutuals) may be required to allow the proposals of either the regulators, ethicists or social scientists to take effect.

The methodology of this dissertation is library-based focusing on government and non-governmental reports, and academic literature on and existing scholarship in the areas under consideration, namely, banking and its problems and, in particular, literature on regulation of banks and literature that considers ethical, moral and culture change in relation to financial institutions.

Chapter 2 focuses on how banks are regulated and how regulation is undermined by the effect of the demands of RoE. Whilst the literature, and, in particular, the official reports[68], show that the continuing aim of governments and central bankers is to try to address the problems of banks by means of more regulation, for example greater capital reserves; the conduct of banks and individual bankers remains a problem, as the scandals subsequent to the Financial Crisis 2007-2008 have shown.[69] The official reports, whilst sometimes recognising that there is an ethical problem, fail to suggest solutions other than sanctions and penalties. On the other hand, those who look at the subject from an ethical or social science aspect, are unable to answer how - whatever the ethical decision-making process, ethics training, emphasis on leadership qualities or cultural change within an organisation - to reconcile the demands of shareholders and the pressure to meet such demands to maximise profits, particularly when the profits are linked to senior bankers’

[68]See footnote 23 (above) for details of official reports.

[69] LIBOR, PPI foreign currency swaps et cetera.

remuneration[70].

As it will be argued in Chapter 3, discussions of ethical theories may have an effect at the level of the individual. However, individuals' behaviour must be seen within the context of the organisations in which they are employed. Inevitably, the pressure for RoE places burdens on bank employees to perform and maximise profit. In the conflict between attaining targets and being paid for doing so on the one hand, and ethical behaviour on the other, ethical behaviour loses to the pressure to maximise profits. It will be suggested that this will continue even if ethical training has taken place or if a bank has adopted ethical principles. As numerous writers have reported and, as was indicated by JP Morgan in the opening statement (above), trust is the most important commodity a bank can have. It is when customers lose trust in their bank that bank runs take place with all the concomitant economic problems that follow.

However, one aspect that has received very little consideration is how the corporate structures of banks are related to their problems and the ethics of those who work in them. In *"Better Bankers, Better Banks: Promoting Good Business through Contractual Commitment* " (Hill and Painter, 2015, Chapter 2) the question of limited liability is shown to encourage risky behaviour by bankers. The authors suggested such a structure could be replaced by covenant banking, where a senior banker pledges to make a specific payment in the event of a loss (at location 2374 Kindle edition) or assessable stock (at location 2918)[71].

It would therefore appear that there is an opportunity to research into how alternative banking structures could play a part in improving the ethics and behaviour of bankers. Such structures are likely to be mutuals, similar to building societies, but established by government or local authorities. They could also be cooperative structures. In the concluding chapter of this dissertation, it will be suggested that such alternative structures could have the effect of having ethics as their basis or primary call, rather than the priority

[70] A number of works refer to the problems of ethics and give examples, but do not suggest how the problem of unethical behaviour can be resolved (Boatright, 2013). Business culture and dishonesty in the banking industry: (Fehr & Marechal, 2014); (Di Lorenzo, 2005); (Graafland, JJ van de Ven, BW, 2011). A number of studies by Claire Hill and Richard Painter have recognised that there are problems in regulation and enforcing the law in financial services: (Hill, 2009-2010); (Hill and Painter, 2015). Some writers have used a Social Science based approach (Williams and Conley, 2014). Other writers have considered an ethical approach (Chavez, 2002); (Rhodes, 2010) and used Ethical Decision Making Theory (Kohlberg, 1975); (Rest, 1975) combining them with other social science approaches: (Fichter, 2016); (Fichter, 2017); (Hardowar, 2017).

[71] "Assessable stock": If the bank is in financial difficulties then an assessment has to be made and a payment made by the original stockholder.

of paying shareholder dividends. In addition, it will be argued that if they were to achieve sufficient market strength, then the competition may work to make other banks provide a similar level of ethical service.

2. Chapter 2 - The Limitations of Banking Regulation

Banking crises not only have political consequences, but also personal ones. Consider the 2015 banking crisis in Italy which involved four small regional banks. Not only were depositors at risk, but inexperienced Italian banking customers who held risky subordinated debt[72] lost monies they had entrusted to the banks. They had been mis-sold the subordinated debt when they thought they were making high interest deposits. Ordinary depositors were eventually repaid but the subordinated debt holders, whose holdings form part of the bank's equity capital, were not so fortunate. A pensioner living near Rome was reported to have committed suicide after having lost €110,000 in Banca Etruria. Another customer, Letizia Giorgianni, who lost €100,000 in Banca Etruria and was the leader of a customer protest group, warned that failure by the government to take action would cause further damage: "Think about the psychological impact. What kind of confidence will citizens have in their banks after this? What savings are safe?" An Italian politician, Guglielmo Picchi, declared "When you take money out of people's pockets, they get angry" (Politi & Sanderson, 2015). Nine months later the crisis affecting the regional banks led to concerns about the solvency of Banca Monte dei Paschi di Siena, the third largest Italian bank, and considered to be the world's oldest bank. The Guardian reported:

> "The big question now is whether worries about the banking sector, coupled with anger over the economy's slow growth and concerns about the ongoing migration crisis, will pose a further risk to [Prime Minister] Renzi's chances of winning the referendum in the autumn" (Kirchgaessner, 2016).

One month later the referendum was lost and the Italian Prime Minister, Renzi, had resigned.

2.1 Introduction - The Objectives of Regulation

The failure of banks differs from that of most other businesses. When other businesses fail, it is the creditors and the shareholders who have to share the losses. However, when a bank fails, it is also the customer deposits that are at risk. It is therefore in the interest of the depositor to be the first in the queue to withdraw their savings. When a queue forms at the

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[72] "Subordinated debt": debt that ranks lower than other debts when there are claims on the assets of a company. If there is default, someone who has subordinated debt, which is also known as "junior debt", cannot receive their money until the claims of all superior holders of "senior debt" are met.

doors of the bank, it becomes conspicuous to other customers who in turn wish to withdraw their own money for fear of losing their savings. Even if the bank is fundamentally sound, the rapid withdrawal by savers of their cash results in the bank becoming illiquid and failure becomes a self-fulfilling prophecy. Banking failure is followed by government intervention or support. Such intervention is costly, both financially and politically[73].

It is important to illustrate how the structure of banks has changed since the nineteenth century,[74] from partnerships to larger joint-stock companies, both of whose members had unlimited liability, to limited liability companies, where the members maximum liability is to the value of their shareholding (Davies G, 2002). However, these developments did not prevent banking crises. Crises brought public pressure and political demands for action and intervention, in the form of regulation. However, this section will show that attempts at regulation have failed to solve the problems of banks, and the requirement for "capital adequacy"[75] will be looked at as an example of the failings of regulation to control banks.

Various authors have set out the objectives of regulation.[76] The first objective is the reduction of risk to those who lend to banks: "prudential regulation". The second objective is to reduce problems arising from economic or banking conditions that may result in "contagion": runs on more than one bank" and "systemic risk". The third objective is to avoid banks being used for criminal purposes such as money laundering. The fourth objective is to direct credit to favoured sectors such as homeownership. The final objective is to ensure that customers are treated fairly (Klomp, 2012); (Barth & Caprio, 2004); (Rochet, 2009); (Adenas, 2013); (Benjamin, 2010).

Bank rescues are expensive. According to the National Audit Office, the cost of providing support to British banks at the peak of the 2007-2009 financial crisis was £1,162 billion (£1,162,000,000,000). (National Audit Office (UK), n.d.) or 60% of the UK's GDP (Schildbach, 2010). By contrast, the amount of total taxes borne and taxes collected, from banking activity amounted to approximately £63.0bn or 11.6% of total UK government tax receipts (Price, Waterhouse, Coopers, 2012). It has been calculated that the fiscal costs after recoveries could average 13.3% of GDP and could be as much as 55.1% of GDP (Laeven, 2008, p. 23).

[74] For a more detailed synopsis of the development of financial regulation, see (Davies G, 2002; Davies G, 2002).

[75] "Capital Adequacy": a test that shows if a bank has sufficient capital to meet potential losses on lending.

[76] In addition to the writers who have looked at the objectives of regulation, there are many authors who have looked at the technical aspects, for example, (Laux, 2009); (Rochet, 2009); (Cranston, 2003); (Benjamin, 2010) . Such works are largely descriptive. Whilst they recognise the interrelationship between bank capital and the return on equity, they do not focus on the effect that shareholder requirement to maximise profit has in seeking to minimise capital requirements.

These objectives are achieved by various regulatory means. The first major measure is that of a capital requirement[77] in relation to banks' assets. While it is called "capital", it is, in fact, what other companies would call (equity) shareholding (Admati, 2013, pp. 6,7).[78] A second obligation is a reserve requirement.[79] This is the amount that a bank must hold to meet the request for return of funds lent by customers. From the fact that banks are often large organisations, if proper systems are not in place and supervision is lacking, there are likely to be problems. For this reason, corporate governance is regulated to ensure a bank is properly managed and does not become a liability (Admati, 2013, p. 127).[80] Other regulatory measures include credit rating requirements, exposure to large risks and restrictions on certain activities/partnerships (ring fencing). These measures are outlined in (Klomp, 2012); (Barth & Caprio, 2004) and (Rochet, 2009).

Whilst each of these measures could be critically scrutinised, this chapter will look at one area of regulation in particular, capital adequacy.[81] Capital adequacy will be considered as it is arguably deemed to be one of the most effective forms of regulation (Bank for International Settlements, 1988 (and updated)). A focus on this form of regulation serves the purpose of illustrating the reasons why regulation has been unsuccessful in dealing with the problems of banks. To see why regulators seek to control bank capital it is important to understand how banks lend and how equity capital forms part of a bank's balance sheet. This will be dealt with in the next section (2.2). The method of controlling the amounts banks can lend, 'Capital Adequacy', in relation the amounts of equity capital they hold is then considered (2.3). The chapter then concludes by considering the problems associated with using capital adequacy as a way of regulating banks.

2.2 Equity capital in the bank's balance sheet.

[77] "Capital requirement": the amount of shareholders' equity that a bank or other financial institution must have as required by its regulator/government to operate safely in relation to the amount that it may lend. Capital requirements also known as "regulatory capital" or "capital adequacy".

[78] The bank definition of capital includes other assets owned by the bank rather than being lent to it (Farag, 2013, p. 204).

[79] "Reserve Requirement": the minimum amount of cash and bank notes to be held by a Bank.

[80] Following the Financial Crisis 2007-2008 the Prudential Regulation Authority was established in the UK with a general objective to promote the safety and soundness of the financial services organisations; in relation to insurance firms, to ensure protection for policyholders and a subsidiary objective to encourage competition.

Before the concept of capital adequacy is scrutinised, it would be useful to consider how equity capital features in the balance sheet of a bank. Using double-entry bookkeeping, a simplified bank balance sheet has two sides - assets and liabilities. Assets consist of central bank reserves, loans and mortgages to customers and bond holdings, other securities and other assets (e.g. buildings). Liabilities consist of the current and savings accounts of depositors (as well as borrowing from institutional investors such as pension funds and on the wholesale market from other banks) and equity capital. In diagrammatic form, this double-entry bookkeeping looks as follows:

Assets	Liabilities
Central Bank reserves	Customers' deposits
Loans to customers	
Government bonds and other securities	Equity capital
Other assets (e.g. premises/goodwill)	

On its day of opening, before it starts trading, a bank may have the following balance sheet, one side balancing the other:

Assets	Liabilities
assets (office building) (A) £1 million	Equity capital (C) £1 million

On its first day, the bank lends to Mr Smith who wishes to borrow £500 to purchase a new car. After checking the credit worthiness, the bank makes the loan and the balance sheet looks as follows:

Assets	Liabilities
	Deposits £500
Loans to customers £500	
	Equity capital £1 million
Other assets £1 million	

The bank has at the same time created a loan as an *asset* and a deposit as a *liability* on the balance sheet. The bank does not need to have any money from savers. It has created credit “out of thin air”, by means of an accounting entry.[82]

If Mr Smith pays for the car using a cheque, which is paid into another bank, there is a liability from the first bank to the second bank. Again, this is a bookkeeping entry and the bank’s balance sheet has increased, as if by magic. However, this becomes a problem if Mr Smith defaults on his loan; or he seeks to withdraw the deposit to pay for the car by cash; or the second bank wishes the first bank to settle its account. In the case of Mr Smith defaulting on his loan, this eats into the equity capital. If it is a complete default the £500 failed loan is shown as a reduction of £500 on the equity capital. If he had borrowed £5 million instead of £500, then the bank would be insolvent. In the other cases, the first bank must access reserves at a price at which it can afford to pay them, otherwise it has a liquidity problem.

The above description shows that it is not the deposit that creates the loan; it is the loan that creates the deposit. L Randall Wray stated, “In the real world, banks extend credit, creating deposits in the process, and look for the reserves later” (Wray, 2015, p. 2034). In fact, the view that a bank does not need to have the reserves before it lends was supported by the chief economist at Standard and Poor’s (Sheard, 2013).

Banks lend on short-term overdrafts or as longer-term loans. They use their customers’ deposits to provide themselves with liquidity and the success of a banking business depends on ensuring that loans are made to creditworthy customers, that such loans are adequately secured and that there are sufficient reserves to repay depositors when they ask for their savings to be returned or when cheques/ transfers are made.

It is when bankers seek to maximise RoE by taking imprudent lending risks that are too great, that problems are likely to occur. Accordingly, understanding ‘how banks lend’ is important not just for a comprehension of how banks operate, but also for appreciating how they should be regulated. As will be seen below, the approach to capital regulation is

[82] This is known as the credit creation theory of banking and was demonstrated in an empirical exercise by Richard Werner in cooperation with Raiffeisenbank Wildenberg a regional bank in Germany. The macroeconomic effects are that banks are not just agents. As an alternative theory “financial intermediation theory of banking” would suggest that banks have an effect in increasing the money supply (Werner, 2014) .

based on an assumption, by those responsible for formulating the capital regulation requirements, that the financial intermediation theory is correct.[83]

2.3 Capital requirements

Banks lend in a variety of ways, for example to those who want mortgages, personal, business and other loans (e.g. to government). In normal times, banks know that not all depositors will require their money back in a short space of time and therefore they can lend the deposits many times over ("leverage").[84] This practice by bankers is known as "Fractional Reserve Banking".[85] In addition, as well as leveraging depositors' money, as seen in the previous section the bank can, through accounting practice, create further money which it is then able to lend. The challenge for bankers lies in balancing prudent lending with maximising the return on the potential lending they can make. They must maintain sufficient liquidity or be able to obtain sufficient reserves from other banks or the central bank to honour customers' cheques and repay deposits. If they are unable to do so, then the bank fails and customers face the prospect of losing their deposits.

Equity Capital is shown on the liabilities side of the balance sheet. It is a source of funding, but the balancing item on the asset side includes cash assets, reserves at the central bank and realisable bonds. These are held as realisable assets for any potential liquidity crisis (Farag, 2013). As seen above, the difficulties banks face come from problems of illiquidity and insolvency. A solvency crisis occurs when borrowers fail to repay their loans to an extent that the bank's book of assets, that is, its loans, is worth less than its liabilities (deposits and capital). This happened in the Financial Crisis of 2007-2008, when sub-prime mortgagors failed to repay their loans. As will be seen below, banks hold a buffer in equity capital to absorb those initial losses. Accordingly, if a bank has equity capital of £20 billion, it can absorb £20 billion of losses on loans before it becomes insolvent. In those circumstances, the creation of new deposits by making new loans would have no effect, because the amount of loans and the liabilities, that is, new deposits, would be exactly the

[83] "Financial Intermediation Theory": banks are just financial intermediaries; they only take in monies and reallocate them. (Werner, 2014).

[84] "Leverage": the number of times a customer's deposit can be lent by a bank. The leverage ratio is the ratio of capital to total assets. It demonstrates the ability of a bank to absorb losses into its capital. The higher the leverage (i.e. a low ratio of capital to total assets), the riskier the bank.

[85] " Fractional Reserve Banking": a method of banking where only part of the loans made by banks is represented by cash available for immediate withdrawal. See also an example and diagram in section 2.5 Would abolition of reliance on bank deposits overcome the question of capital adequacy? below.

same, but would have no effect on the assets and liabilities. In such circumstances, a bank must reduce its liabilities or increase its assets (or do both) in order to regain solvency.

A liquidity crisis (a cash flow insolvency) occurs when a bank is unable to repay deposits (or honour cheque payments and transfers) when repayment of those deposits becomes due. This is because there is a maturity mismatch between loans being repaid and deposits being withdrawn and happens because, apart from overdrafts, most loans are long-term (for example, a mortgage or car purchase loan). Although some monies are borrowed short-term on the money market[86] and some savers want longer term deposits in return for a higher interest rate, most customers wish to have the ease of withdrawing their money when they wish to do so and therefore hold their monies in a current account or instant access savings account. If confidence is lost in the bank, then many customers may withdraw all of their savings at the same time causing a "bank run". The position can be made worse because banks only hold a small proportion of reserves, as they know that in normal circumstances, customers are unlikely to demand all of their cash at the same time.[87] The bank holds a certain amount cash reserves, but once these are used, it needs to sell its loans (assets) in order to obtain central bank reserves to pay savers and other banks. If it has to drop the price of those assets, it may find that the value of those assets becomes less than its liabilities and it faces an insolvency crisis. As noted above, this problem is exacerbated if one bank gets into difficulties, then depositors in other banks may become concerned and seek to withdraw their monies ("contagion"). The collapse of banks then becomes a systemic bank run affecting many, if not all banks, in the country. As a result of the severe effects on a nation's economy and damaged individual savers, governments then become involved in enabling banks to survive as they are considered the Lender of Last Resort (Ryan-Collins, et al., 2012).

Capital requirements have been the main instruments of banking regulation since the 1990s (Admati, 2013). Whilst capital requirements will be the example of bank regulation to be

[86] For example, Northern Rock was highly dependent on short-term money. Out of total liabilities of £101 billion Northern Rock had capital and reserves of £ 7.7 billion only, £22.6 billion of retail deposits whilst borrowing £ 24.2 billion on the wholesale market with £40.2 billion as securitised mortgages and £6.2 billion as covered bonds. Its share of retail deposits dropped from 62.7% at end 1997 to 22.4% at end 2006 (Milne, 2008).
[87] There may be differences in balances on a day-to-day basis, but a system equates the monies and is likely to leave them with approximately the same amounts to and from other banks and the central bank reserve. This system is known as Real Time Gross Settlement (RTGS). The clearing banks each have a reserve account with the Bank of England and rather than each of the 46 banks having to settle separately with each other they send payment instructions to the Bank of England's RDG system increasing or reducing each bank's reserves as appropriate (Ryan-Collins, et al., 2012, p. 76).

focused upon, there is an interrelation between banks' capital and their reserves (liquidity). If depositors believe that a bank is becoming insolvent, then they are likely to withdraw their funds. If a bank has to sell off its assets in an emergency, it is less likely to achieve a good price for them and this in turn may affect its solvency.

However, in practice, with many millions of pounds being transacted on a daily basis, at the end of each day some banks will be short and some will have an excess of liquidity. They will therefore either have to borrow from the central bank or trade overnight with another bank on the London Interbank Market using liquid assets such as gilts (government stock). The London Interbank Market is preferred by banks because the interest rate is usually better than that which can be obtained from the Bank of England. This is always subject to the banks having confidence that their loans will be repaid. This confidence disappeared in the Financial Crisis of 2007-2008. If the Bank of England, as a central bank, makes loans to banks to assist with their reserve account deposits, it does so through its Open Market Operations, through secured loans called 'repos.'[88]

Equity Capital is raised from shareholders as was described in the previous section. It is for holders of this Equity Capital that bankers seek to maximise RoE. However, unlike deposits, the shareholding (Equity Capital) cannot be withdrawn by the shareholders. It can, however, be traded on a stock market, although shareholders may be reluctant to do so, if there is a fall in the price of the shares or if potential purchasers of shares are unwilling to buy. It is permanent funding in exchange for a share in the bank. Capital also consists of retained profits and subordinated loans (loans which the lenders agree to rank as liabilities after depositors' savings). Its aim is to protect the business against losses arising from bad loans, which would render it insolvent in cases where losses on loans exceed capital. If it did not have this equity capital, then should there be any losses at all on loans, the bank would be insolvent as its assets would be smaller than its liabilities. If, however, there is Equity Capital, the losses are simply reflected by a reduction in the capital. In addition, unlike interest that a bank is obliged to pay to depositors, shareholders anticipate receiving a dividend out of profits, that is, RoE. If there has been a period of unprofitability, then distributions to shareholders can be reduced or cease altogether. In contrast, reserves are in place to protect the bank against too many depositors withdrawing their cash at the same time. If a bank were unable to do this then the bank would be "cash-flow insolvent" (Farag, 2013, p. 203). In such circumstances, the bank will draw on

[88] "repo": see footnote 28 above.

reserves from the most cost-effective source. Firstly, it will be from cash or liquid reserves already held by the bank and it may sell assets. It could also obtain reserves from other banks or from the Central Bank. If the bank is forced to ask to use Central Bank reserves then the Central Bank usually asks for collateral, often a Treasury security for which it receives a discounted sum (Wray, 2015, p. 2058) .

It must be said that all bank lending involves the risk of loss. However, the level of losses depends on a number of factors such as the creditworthiness of the borrower, the nature of the loan and whether or not collateral has been supplied. However, as banks have an historic experience of lending they should be able to predict the level of expected losses. However, there are unexpected losses that can occur when unforeseeable circumstances arise as happened with the Financial Crisis 2007-2008.

It follows that the first aim of capital requirements regulation is to increase the amount of a bank's own equity, that is, money invested in it by shareholders and others as a capital contribution, in order to reduce the proportion of depositors' funds relied upon. In fact, the state protects banks because of their importance in the economic system. In the UK, the state gives savers a Deposit Guarantee of £85,000[89], provides reserve facilities, acts as Lender of Last Resort and may ultimately nationalise or bail out a bank. As a result, the state wishes to ensure that banks have adequate capital buffers to guard against insolvency. The problem arises from their knowing that they are "Too-Big-to-Fail" ("TBTF") and can expect to rely on support from the state if they experience either insolvency or illiquidity. In such cases, their borrowings are relatively less expensive because the risk of default is carried not by the bank, but by the government. Knowing this, they are then prone to take on too much risk or lend excessively, with as low a level of capital as possible knowing that ultimately Government support will be available (Admati, 2013); (Rochet, 2009). Indeed, this also affects depositors who know that they will be protected in the event of collapse and may, as a result, take less care in placing their money in a risky bank.

[89] "Deposit Guarantee": The Financial Services Compensation Scheme (FSCS) operates a deposit compensation scheme for deposits placed in UK banks and 'subsidiaries' of foreign banks in the UK. The current compensation limit is £85,000 per person per authorised firm (raised from £50,000 in December 2010) (FSA, 2010).

A further aim of the regulation of capital requirements is to prevent banks from using excessive leverage with banks which become insolvent due to unwise lending.[90] Microprudential regulation seeks to ensure that individual banks account for risks by requiring them to manage their operations with sufficient liquidity and capital to reflect the risks and ensure they are properly accounted for (Farag, 2013). One of the primary objectives of such prudential regulation is to ensure satisfactory capital requirements are maintained (Farag, 2013).

The rules for capital adequacy are now set down by the Bank for International Settlements in the Basel Accords (Bank for International Settlements, 1988 (and updated)). It was felt by the 'Group of 10' countries, those with the largest economies, that through their central banks an international agreement on capital requirements and risk-weighted assets was the best way forward as it allowed comparisons between banks operating in different jurisdictions. These capital adequacy rules set out the internationally agreed requirements for capital adequacy in Basel I, Basel II and Basel III. As the more the banks can lend the greater is their RoE so the attention of the Accords was to ensure that there is sufficient Equity Capital to protect against the risks of default.

The calculations required by the Basel Accords (currently Basel III, which is being implemented in stages until 2019), set out the capital requirements (and in the future, liquidity requirements) for banks, and these are - subject to local interpretation - implemented in each country. The Basel standards require that each time a bank makes a loan it must set aside a certain amount of equity capital. The Basel standards in Basel III have three sections or "pillars". The first Pillar deals with capital and risk using a system known as "risk weighting" which sets out the requirements for specific risks such as house loans, corporate loans or government loans[91].

The second Pillar deals with supervisory reviews of the bank's capital adequacy in relation to its risk profile. The supervisory authority can impose additional capital requirements if it is thought there are further risks. Such risks could be potential failures in internal procedures or risks from market fluctuations such as changes in interest rates that could

[90] The leverage ratio is a measure of the riskiness of a bank calculated by dividing its capital by total assets. However, some assets carry a greater risk, which needs to be accounted for (See section 2.3.1 Risk-Weighted Assets below).

[91] For more details of "risk-based assets" see section 2.3.1 Risk-Weighted Assets2.4.1 Problems with Risk-Weighted Assets, below.

affect the bank's profitability. Basel III also required two further capital buffers. Firstly, a "capital conservation buffer", equivalent to 2.5% of risk-weighted assets, must be secured to assist where banks face stress periods and a "discretionary counter-cyclical buffer", allowing regulators to require up to an additional 2.5% of capital during periods of high credit growth. A further buffer must be in place for systemically important institutions to allow for further capital requirements where there are risks that are not catered for elsewhere.

The final pillar, Pillar 3, sets out standards for information to be disclosed[92] including key risk information, which allows the monitoring of the capital adequacy of a bank by the market. There are additional requirements as to the *type* of capital. For example, 4.5% of the 8% first Pillar requirement must be "common equity Tier 1".[93] As 2.5% of the capital conservation buffer must also be from the highest class of capital, "common equity Tier 1", the total is 7% although this may increase, when the other buffers referred to are put into effect.

2.3.1 Risk-Weighted Assets

Where there is discretion on the part of a bank, there is always a greater possibility of that discretion being used to maximise profit. A bank must hold some equity capital for each loan that it makes. However, not all loans are regarded the same as some loans have a greater degree of risk than others. Loans that carry a higher degree of risk are 'weighted' and require a greater amount of equity capital to be set aside to cover them. Each class of assets can be given a weighting according to the risk it is assessed to carry.[94] This therefore

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[92] Pillar 3 disclosure is effected in the United Kingdom through the Financial Conduct Authority BIPRU 11.5: "Technical criteria on disclosure" of market information. This includes disclosure of risk management objectives, response to the requirements of the Banking Consolidation Directive, capital resources, capital adequacy, exposure to risk, securitisation and remuneration, (FCA, 2007).

[93] Under the Basel Accords (Basel III), Tier 1 is considered to be Core Capital consisting of equity capital (primarily ordinary shares) and balance sheet reserves. Tier 2 allows, in addition, in certain circumstances, depending on national accounting variations, supplementary capital. This could include undisclosed reserves (for example, profits that have not yet been allocated as retained or as part of general reserves), revalued (rather than historic cost) reserves, general provisions against losses not yet identified, hybrid debt instruments having characteristics of both debt and equity and subordinated term debt, which would be paid out after ordinary customer deposits. (International Convergence of Capital Measurement and Capital Standards (July 1988, updated to April 1998); (B.I.S, 1998).

[94] "Risk-Weighted Asset: the value of the asset is altered depending on its risk. An asset with a low risk is multiplied by a small number whilst one with a high risk is multiplied by a higher number. For example, government stock would be regarded as zero risk. A loan to a government carries considerably less risk than a loan to a start-up business. (If the United States government were to have difficulty repaying any loans to it, it could just print more dollars). Government bonds therefore receive a zero-risk weight. Mortgages, as they are secured on property, are also considered to carry far less risk (King, 2010).

alters the value of the assets and so capital requirements are expressed as a capital adequacy ratio which is the ratio of core capital[95] that must be held as a percentage of risk-weighted assets. Capital requirements govern the ratio of equity to debt, shown on the liabilities and equity side of a bank's balance sheet. For example, if a mortgage on a £200,000 property has a 50% risk-weighting, the risk-weighted asset would be £100,000. In the case of credit card and other personal loans which are assessed as 75% risk-weighting, that would be £75 for loan of £100. In relation to overdue debts the risk weighting may increase to 100% or over. There are various methods of assessing risk-weighting but the two most prominent are the 'Standardised Approach' in which institutions rely on rating agencies and the 'Internal Ratings-Based approach' in which banks are allowed to use their own methods (Elliott, 2010).

However, while certain categories of loans can easily be classified, such as government bonds, others are less easy to quantify. Banks were therefore allowed from the 1990s to create their own risk models (Ryan-Collins, et al., 2012, p. 2155). The rationale for this was that they had more up-to-date information and ways of assessing the risks, but the regulators appear to have failed to consider the conflict between the requirements to have a sound banking system and the opportunities to assess risk in order to take on more profitable business by downgrading the assessment of risk (Admati, 2013).

2.4 Critical Assessment of Capital Requirements and Basel III

The second of the Basel accords, Basel II, was effective from 2004. However American and European banks found ways to create high leverage and avoid the requirements by moving risks to Off Balance Sheet entities[96] or concealing them behind inaccurate risk models or mistaken credit ratings (Admati, 2013). When the Financial Crisis of 2007-2008 started the equity capital required was of 2% or 3% of their total assets (Admati, 2013).

[95] "Core Capital: i.e. Tier 1 money provided by shareholders' equity and continually subordinated debt, Tier 2, supplementary capital which is formed of undisclosed reserves, revaluation reserves, general provisions, hybrid instruments and subordinated term debt. Both Tier 1 and Tier 2 capital must be convertible into ordinary shares or written down when the regulatory authority deems the bank is no longer viable.

[96] "Off balance sheet financing": If an item in a corporate balance sheet is not definable as debt, it can be excluded from a company's balance sheet. The advantage of this for the company is that it can improve accounting ratios such as return on equity and leverage. It does so by failing to reveal the true activities of the company, giving a better reflection of its liabilities than, may, in fact, be the case. Examples of off-balance sheet items include, factoring of debts, special purpose vehicles, leasing or leaseback arrangements and "repo's. See also 2.4.4 Off Balance Sheet Entities.

Although Basel III has increased the percentage of equity capital that banks must hold from 4% to about 7%, such percentages are small in relation to deposits received from customers and total sums lent. A comparison could be made with an individual with a deposit of only 7% having a 93% mortgage. It is suggested that banks can still get around the regulation and have as little as just 3% equity of their total assets. If a bank with such a small amount of shareholder equity knows that it will be rescued by government should it become involved in reckless transactions, it is suggested that there is little to protect it from insolvency (Admati, 2013).

At the time, the banks lobbied intensively to restrict increases in capital requirements in Basel III. The Guardian reported that the British Bankers Association were to tell the Chancellor,

> “that up to £1tn is poised to be drained from the financial system, hampering economic recovery and depriving households and businesses of loans and other forms of credit” (Treanor, 2010).

The article was entitled “*Tighter banking rules will drain £1tn from financial system, study shows”*. The suggestion, promoted by the banks, was that economic growth would be hampered by the increased capital requirements. In fact, as has been seen above, capital can be used either for reserves or for lending. That “capital” is not “set aside” so it cannot be used. Even the word “capital” causes confusion because in other contexts, for example, manufacturing, it refers to assets. In the case of banks, it refers to shareholdings/equity which appears on the liability side of the balance sheet. The bank has loans and other assets including reserves which are funded by equity and debt.

Similar lobbying was reported by the Financial Times which claimed, “HSBC and Standard & Chartered call for Basel III rewrite” and warned that if “tough capital rules” were not “toned down, world trade could be severely hampered”. By 2015 the Financial Times was reporting that “Bank trading reform would lift capital needs by up to nine-fold”. The article reported on the review of the way banks assessed the risk factor of their trading (known as the Fundamental Review of the Trading Book). However, on reading the article, it appeared that whilst the increase was a startling 74%, the actual increase of the average bank capital requirement was only 4.7% (to approximately 8%). Bankers were reported as suggesting they would have to "quadruple the amount of capital they hold" and that a Basel IV was being imposed on them although this was denied by regulators (Binham & Noonan, 2015). The aim of such lobbying was to reduce the amount of equity capital the banks had to retain for Capital Adequacy.

However, the lobbying was effective, as the Financial Times reported in January 2016:

> "Global banking supervisors have softened new rules forcing investment banks to hold much more capital against their trading books, after heavy lobbying from the banking industry" (Noonan, et al., 2016).

The effect of this softening was to reduce the increase from 74% down to 40% with a mean average of 22%. The article reiterates the bankers' complaint that increases in equity capital "will drain liquidity in key markets" (Noonan, et al., 2016) as well as increasing the banks costs in implementation of the new rules.

As has been seen above, the rules on capital regulation only deal with the question of the proportion of a bank's funds that must be raised by issuing shares and cannot be lent to borrowers. It does not tell banks what to do with those funds (Noonan, et al., 2016). The concept of capital adequacy can be criticised because, it is a clear example of the bank suggesting that the capital will be placed in abeyance, rather than being used.

The claim that equity capital is expensive for banks can also be critically examined. Firstly, it can be pointed out that it is unusual for companies to rely on such a small amount of equity capital and such a large amount of borrowing. Most non-financial companies have borrowings of no more than 50% of their total capital. Some companies such as *Apple* have no borrowings. If equity capital is so much more expensive than borrowing, then it is logical to ask why non-financial companies have far more of it. There are other reasons suggested as to why banks prefer to borrow rather than issue equity capital. Why use equity capital when borrowing is cheap and the real cost is met by the taxpayer? Secondly, as they have the protection of the state, they have higher risk ratings afforded by the Credit Ratings Agencies, which reduce the rate of interest at which banks are able borrow.

Historically, it also appears that whilst banks in the United States and the UK used larger portions of equity in the past, that is, in the early part of the 20th century, their performance did not appear to be worse and the spread of interest rates and loans did not appear to be higher. Conversely, it was suggested that there was a paucity of evidence that growth rates increase with increases in bank leverage (Ratnovski, 2013). Authors also point out that the costs complained of by bankers are small in comparison with the cost of rescuing the banks (Miles, 2011). It was noted previously that the cost of the Financial Crisis 2007-2008 to the UK government was £1,162 billion. Although the implementation cost of Basel III - as estimated by the lobbyist in the Financial Times article as being $100m-$150m for each bank to implement over three years - this is small in comparison to the costs of bailing out the banks.

However, whilst the Modigliani-Miller Theorem[97] may suggest, all other things being equal, that the value of a company is not affected by how it is financed, the special position of banks is a departure from this principle. One reason for this is the belief that should the banks fail, they would be supported by funding from the central bank. This results in a lower premium for the risk in lending to a bank by a customer. There is no extra reward for the risk that a customer may face in losing his deposit as it is guaranteed by the state and this makes borrowing cheaper than raising capital through equity. The cost of this premium is, in effect, borne by the taxpayer (Admati, 2013, p.8).

It is suggested that even prior to considering the effectiveness of the Basel Accords, which culminate with Basel III, the background to their preparation exemplifies the problems of banks; lobbying by banks was effective in diluting the equity to borrowing ratio. It has been noted that banks have used their lobbying power to minimise the amounts of equity capital they are required to hold in relation to the amount that they can borrow. The concept of capital adequacy is, however, affected by a number of factors that prevent it from being adequately dealt with. These arise from the nature of the criteria that are used in assessing capital adequacy which are, by their nature, subjective. The following section looked at examples of problems with capital adequacy arising from the Basel Accords.

2.4.1 Problems with Risk-Weighted Assets

Even without any conscious or subconscious manipulation, factors such as the assessment of mortgages as being of lower risk led to problems that contributed to the Financial Crisis 2007-2008. Throughout the period leading to the financial crisis, banks were expanding their loan books of mortgages, as they were regarded to be of lower risk. However,

[97] The Modigliani-Miller Theorem starts from the basis that there are three forms of funding; borrowing, retained profits and equity capital. It suggests that all other things being equal, there is no difference between whether a company is financed by debt or equity. It is also known as the capital structure irrelevance principle.

consideration of the lending during this period shows that, as mortgage lending expanded, less care was given to the reliability of the loans or the borrowers (Tett, 2010). For example, in June 2007, only months before its collapse in autumn 2007, Northern Rock received a Basel II waiver, on the grounds that it satisfied the UK Financial Services Authority that it had "Advanced Approaches"[98] to risk management which even allowed it to increase its dividend. Its chief executive, Adam Applegarth, explained:

> "when you get your Basel II approval, the relative risk weighting of certain assets in your balance sheet changes. So, what we had, because of the quality of the loan book was you saw our risk weighting for residential mortgages come down from 50% to 15%. That clearly required less capital behind it, so that links to why we were able to increase the dividend" (Milne,2008, p.6).

Whilst Northern Rock may have used risk-weighting to enable itself to increase its dividend, the overall promotion of mortgage-based lending increased property prices and consumer borrowing. As property prices increased, so did the ability to borrow against them. However, this created a "systemic risk" and as the Financial Crisis of 2007-2008 developed, the situation reversed with property prices falling and consumers facing difficulties in repayments (Tucker & Hall, 2013).

Further problems as to the assessment of risk in assets arose from the "securitisation" of packages of loans known as CDO's or collateralised debt obligations. The rationale for securitisation was to reduce the risk of any individual loan by placing it with others. Whilst some loans may default, the majority would be sound. In the case of mortgages, they would be backed by collateral of a mortgage on the property. These CDOs, with the help of the Ratings Agencies (see below), were promoted as having lower risk and good credit ratings (AAA) placing them on the same level as government debt. This allowed banks to hold these CDOs with the minimum of equity capital being used, because they were rated so highly. However, the holders of such packages of loans had little way of assessing their risk. When the Financial Crisis of 2007-2008 developed, both the individual risks of such packages and the systemic risk of the property market declining became apparent and was a major contributor to the Crisis (Admati, 2013, p. 185) .

[98] See Financial Services Authority Handbook, BIPRU 1.3, Applications for Advanced Approaches

It is suggested that it is difficult, if not impossible, to have satisfactory adjustments to capital adequacy using risk-weighting. Apart from the inherent incentive of the banks to have the most favourable risk assessments in order to maximise the most profitable loans, which are those with the highest risk, the level of risk in assets can change as happened with the mortgage-backed securities[29] in 2007-2008, and what can be considered as security, for example, property, can also change in value. The ability to dispose of such assets to assist in increasing bank liquidity is impaired as such assets have incurred losses and are difficult to sell (Admati, 2013, p.186).

2.4.2 Manipulation of Impairment Provision

Normally, there is a period between the time the bank suspects that a loan has "gone bad" and the time it writes off the loan. Whilst there are accounting rules that state when such an 'impairment provision' should be made (Farag, 2013), it is very much a subjective view as to when and how long it should be until the debt is finally considered irrecoverable or even suspected as being so. When a loan is written off, it appears as a reduction in capital on the balance sheet and affects the requirements for capital adequacy and the amount that the bank can subsequently lend. It is therefore in the interests of the bank to prevent an impairment provision for as long as possible. Capital adequacy can therefore be manipulated by maintaining that debts are more likely to be recoverable than, perhaps, is the real case.

2.4.3 The problem of capital adequacy promoting procyclicality

The effect of procyclicality[99] in recessions is that risk-based capital requirements, such as those required by the Basel Accords, become greater, whilst at the same time losses on loans increase and reduce the capital holdings of the bank. If a recession is looming, it also becomes more difficult for the banks to raise new capital and their ability to lend, given capital requirements, falls. At the same time, if banks were to lend more, a recession may result in higher defaults on those loans. There is a continuing debate between those who believe that the effects of procyclicality have to be absorbed and those who believe that there should be specific correction of procyclicality (Repullo, 2013).

Basel II was criticised for encouraging lending growth in an economic cycle. The more the world economy boomed, the more the banks lent as they were driven by maximising RoE.

[99] Procyclicality describes how an economic trend is related to economic fluctuations. Its opposite is countercyclicality. It shows the tendency to accelerate in the same way as economic growth and in the opposite direction when the economy declines.

However, when the cycle entered a downturn, the worsening effects were accelerated. If banks make more profits during an economic boom and reinvest those profits in lending (Ryan-Collins, et al., 2012, p.2143) or capital requirements fall during such periods, then banks, especially those that are well capitalised, feel able to lend or consider themselves to be "Too Big to Fail", often taking less care in their lending decisions. The suggestion was that the banks' motives for taking advantage of procyclicality was because during boom periods they can take advantage of market conditions, increase lending to willing borrowers and as a result maximise profit and RoE.

Accordingly, procyclicality encourages lending growth in the upside of an economic cycle, where banks have the opportunity to increase shareholder value and achieve greater RoE, because of the upturn. However, if there is a recession not only do lending losses affect the capital of a bank, but capital adequacy requirements become higher as a result, and in order to protect RoE, banks would reduce their lending rather than increase their capital adequacy requirement (Libertucci, 2013).

The Turner Review (FSA, 2009) recommended introducing overt counter-cyclicality, which would result in the increase in the equity capital required during boom periods and would create "capital buffers" which would be available during recessions and which could be drawn on as losses increased during those periods. Basel III reached a compromise between the two conflicting views. Whilst attempting to enhance the quantity and quality of the capital requirements required, it also sought to create buffers. One was capital preservation and the second, a countercyclical buffer. The intention is to build up reserves in the times of boom which can be released in the times of recession. However, whilst Basel III recommended such provisions to deal with procyclicality, no timetable was introduced and the requirements for extra capital adequacy during these periods have yet to be introduced. This is despite warnings of booming mortgage and consumer credit (Berry, 2015) and the urging by the Bank of England following the referendum on 23 June 2016 (Gov. of the Bank of England, 2016) when £250 billion of liquidity was announced.[100]

Whilst Basel III is regarded as an attempt to address the problems of procyclicality (Rubio & Carrasco-Gallego, 2014), the compromise taken, illustrates the pressures brought to bear to ensure that the banks can still maximise profits and RoE.

[100] However, Basel III has come in for criticism in relation to procyclicality. For example, it adopts a single approach which may result in a contrary effect, unless there are means of counteracting the fluctuations of the minimum requirements of the regulations. It is suggested that as a result, they may perversely endanger the "counter cyclical toolkit" and have a counter-productive effect (Enria & Quagliariello, 2010).

2.4.4 Off Balance Sheet Entities

Whereas it might be hoped that banks would comply with the spirit as well as the letter of the capital adequacy rules, “off balance sheet entities” disclose opposite practice.

In order to comply with capital adequacy rules, banks comply with the regulations and ensure that the debt to equity (D/E) and leverage ratios stay within the requirements. However, if an item is removed from the bank's balance sheet, it does not fall under consideration for capital adequacy. The shareholder equity therefore is enhanced and the RoE for shareholders (and any profit related remuneration schemes) is greater. By using off balance sheet entities, RoE for shareholders is enhanced, whilst keeping to the ‘letter’ of the capital adequacy rules.

The use of off-balance sheet finance may have beneficial outcomes for a bank when financial savings are produced or liquidity is enhanced. However, they can be used to obfuscate the financial position of the bank, for example, the use of repo 105 by Lehman Brothers[101]. These have included operating leases where the asset is taken off the balance sheet and only the rental expense for the use of the asset is reported in the accounts. Other examples include research and development partnerships and joint ventures (Yeoh, 2007).

Another frequently used method is for banks to move their assets to special companies that they set up in order to remove loans from the bank’s balance sheet. Often these are “Structured Investment Vehicles” which are set up by the banks. These consist of a group of assets aiming to create a profit from the use of short and long-term structured debt and are funded by continually issuing and rolling over short-term debt instruments (borrowed short-term money on the capital markets). The funds received are then invested in longer term investments (bundles of loans from the banks) which are less easily realisable but pay higher rates. Often higher leverage is used to create larger returns.

Such SIV's have passed the tests of independence for capital adequacy purposes. However, such off-balance sheet companies are dependent on the banks that created them and caused considerable difficulties for their associated banks during the Financial Crisis 22007-2008. As the primary purpose of such special purpose entities is to overcome the capital

[101] See section 1.2.3 Some Examples of Scandals that have affected Banks above.

adequacy rules of the Basel accords, it throws doubt on the utility of the Basel Accords in maintaining capital adequacy (Elliott, 2010).

2.4.5 Reliance on Credit Rating Agencies

The best known of these agencies are Standard and Poor's and Fitch and Moody's. In its consideration of the Financial Crisis 2007-2008, the Parliamentary Commission on Banking Standards reported that credit agencies were based on an inherent conflict-of-interest, because they are funded by those whom they purport to independently assess. In addition, the Commission noted there were economic barriers to entry which reduced competition and that rather than just being an 'extra opinion', the ratings agencies had become a convenient bookmark for risk for the regulators as well as participants in the market (Parliamentary Commission on Banking, 2013).

It is suggested that Credit Ratings Agencies have affected the ability of capital adequacy to control the problem of banks in several ways. Firstly, it is suggested that in assessing the credit rating of banks, Credit Ratings Agencies may give higher ratings to the debt of banks than would be the case, if there was not the implicit guarantee that banks would be bailed-out if they were to fail (Admati, 2013, p. 9). Secondly, Credit Rating Agencies have a role under Basel III in assessing risk weightings. The more favourable a risk weighting a Credit Reference Agency gives, the better the capital adequacy and the more a bank is able to lend and, in turn, the more profit the bank makes. Finally, Credit Rating Agencies assessed the securitised packages of debt, often giving them AAA credit ratings, when on careful consideration they were far from that.

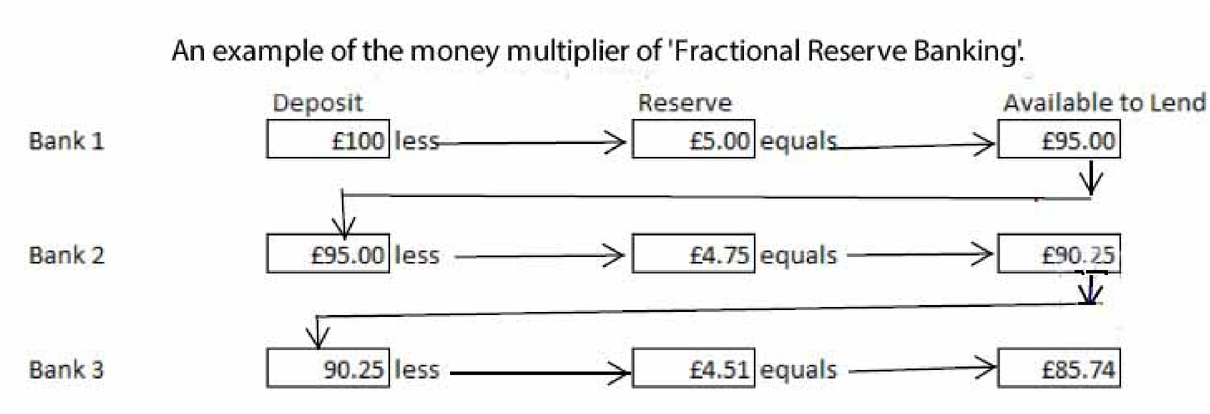
2.4.6 Problems Caused by the Credit Creation Theory of Banking

As has been stated above, the Basel capital adequacy rules are based on the 'Financial Intermediation Theory of Banking'. If the 'Credit Creation Theory of Banking' [102] is correct and banks can create money out of "thin air", doubt must be thrown on whether Basel III is a satisfactory way of regulating banks. If banks *can* create money out of "air", higher capital requirements will not necessarily help in preventing banking crises or economic cycles, as even with increased capital requirements, banks could still enable money supply expansion, pushing up the price of assets with the effect that some of this new money could enable a bank to increase its capital (Werner, 2014, pp. 2, 17).

[102] "Financial Intermediation Theory of Banking" and "Credit Creation Theory of Banking" : See footnote 82 above

2.5 Would abolition of reliance on bank deposits overcome the question of capital adequacy?

As opposed to Credit Creation Theory, the theory of Fractional-Reserve Banking proposes that banks are just financial intermediaries; they do not create money, but by interacting together they achieve its creation. This is done by using the money multiplier, whereby an initial deposit is expanded each time it passes to another bank. In the example below an initial deposit of £100, requires for example, a reserve of 5%. This allows the first bank to lend out £95 which if deposited in a second bank, after 5% reserve is deducted, allows £90.25 to be lent by the second bank. This passes to a third bank, which again deducts 5% for reserves, allowing it to lend £85.74. By this method the initial deposit is multiplied many times over (Werner, 2014) .



As an alternative to allowing banks to lend the deposits it receives, some economists have proposed 100% or Full-Reserve Banking. Under such a system banks must keep the full amount of the depositors' savings in "demand deposit accounts" or cheque accounts (Tomlinson, 2010). Such sums would not be lent by the bank, but would be made available to satisfy demands for withdrawal. Monies for lending would be acquired through term deposits or through use of equity capital.

John Cochrane points out shares/stock are immune from bank runs. If you sell shares, the company will not go bankrupt and you cannot demand that the company repays the shares:

> "If a bank has 2 percent equity capital, loses 1 percent of the value of its assets, and (as the story goes) cannot quickly issue more equity to rebuild capital, then it has to sell half of its assets to restore its capital ratio. If the bank has instead 50 percent

equity capital and loses 1 percent of the value of its assets, it only needs to sell 2 percent of its assets to get back to a 50 percent capital ratio. And if the bank is 100 percent equity-financed, it doesn't have to sell anything" (Cochrane, 2014).

It is suggested that equity-based capital is expensive compared to short-term borrowing from depositors (Jenkins, 2010). Cochrane challenges this assumption when he draws attention to the fact that the expense of guarantees, subsidies, financial regulation and crises are omitted by those suggesting that equity capital is expensive, as such costs should be included in calculating the comparative cost of equity capital and borrowing from depositors (Cochrane, 2014, p. 28). He also addresses concerns that 100% Reserve Banking would limit the amount available for lending and suggests that securitisation would overcome this. Debt which has been securitised can be passed to secondary markets and does not have to be financed by bank depositors' securitised debt (op. cit. p. 28).

Admati and Hellwig agree that full reserve banking (narrow banking) would provide effective protection for the depositors without any need for government intervention (Admati, 2013) . However, they suggest that Full-Reserve Banking would not eradicate the problem of instability in the rest of the financial system unless it was regulated (Admati, 2013, p. 271); (Turner, 2010). For example, it is suggested that Narrow Banking would not have prevented the run on Northern Rock, nor the collapse of Lehman Brothers, which was not a retail bank (Turner, 2010). Nevertheless, they are highly critical of current capital requirements and the Basel Accords, suggesting that Basel II assisted rather than prevented the Financial Crisis 2007-2009. Leverage was high because, prior to the crisis, banks could calculate their capital adequacy requirements based on risk models that sought to reduce equity and even treated risks as non-existent if they thought it appropriate to do so (Admati, 2013, p.184). Admati and Hellwig therefore argue that rather than having a Basel III level of 7% – 8% equity requirement (Admati, 2013), it should be at a far higher level of 20-30% of bank assets. This view is supported by Lev Ratnovski, who suggests a similar figure of 18% (Ratnovski, 2013).

As has been noted, increases in capital requirement may result in banks preferring to reduce lending to keep within those capital requirements, rather than raising additional capital through the equity markets. If equity capital is not increased, it becomes no harder to increase RoE. Research has shown that in such circumstances unregulated banks/shadow banks[103] increase their share of the lending (Aiyar, et al., 2013). This is disadvantageous because such banks are not subject to regulation and their potentiality for failure is greater.

2.6 Conclusions – Regulation has limits

Economist John Kay also sees the capital adequacy system as fundamentally flawed and claims that the “rules proved worse than useless” (Kay, 2009, p.7). He points out that in general banks entered the Financial Crisis 2007-2008 with more capital than was prescribed by the Basel requirements. Indeed, some continued to have capital adequacy that was compliant even though they were being supported by governments during the period. He suggests that this was due to inadequate assessment of the risks involved. In addition, he argues that the use of “off-balance sheet” financial vehicles was intended to evade the Basel requirements and concealed failures in capital adequacy from the regulators and often from management itself (Kay, 2009, p.8). Furthermore, Kay concludes, “No rules on capital adequacy, however complex, can account even approximately for the varying circumstances of all the banking institutions in the world. This problem is fundamental and is not soluble, even if committees sit in Basel until the River Rhine, or at least the local hostelries, run dry” (Kay, 2009, p. 8).

Whilst it is accepted that Basel III improves on Basel II in relation to the amount of equity capital required, critics suggest that the concept of capital requirements is inadequate, if not flawed. The proportions of equity capital required at 7-8% are small and give little protection. Some of the banks such as Northern Rock that appeared to meet the Basel II requirements at the start of the financial crisis were soon found to have serious difficulties and became dependent on government support. The Basel Accords cannot cope with the varying nature of banks. Low equity capital requirements, whilst assisting banks achieve higher RoE, increase the requirement for supervision and the risks for the Lender of Last Resort or government rescue. In other words, the critics suggest capital requirements increase rather than prevent the problems of banks.

Capital requirements are Pillar One of the Basel III Accords. This suggests that they are considered to be the most important of the regulatory controls on banks. However, as has been seen above, not only was there extensive lobbying to reduce the proportion of equity capital borrowing in the Basel III Accords, but banks have substantial latitude in

[103] Shadow Banks: financial institutions that together conduct traditional banking activities, but do so outside of banking regulation

interpreting the risk weighting assets, deciding when loans become "impaired" in dealing with procyclicality and in their use of Credit Reference Agencies. The closer to Full-Reserve or 100% banking, the less likelihood there is of depositors' funds being at risk. However, at approximately 7-8% equity capital to deposits, the protection is much reduced.

Even if regulation were to prevent the liquidity and insolvency problems experienced by banks, these are only some of the problems. Section 1.2.3[104] gives numerous examples of unethical or dishonest behaviour by bankers that have no relationship to capital adequacy or could easily be dealt with by regulation or with controls (Hill, 2012). These will be considered in the next chapter.

If there are limits to the effectiveness of law and regulation, can the culture of banks be changed, and can those changes be embedded so that the standards of behaviour and conduct that would be hoped of banks might be achieved? Beyond the strict limits of the law there are levels of good behaviour, conduct and ethical values that are questions of judgement rather than questions of legal interpretation (Group of Thirty, 2015, p. 12). If the ability of regulation to control bankers is limited, could culture supplement regulation? The next chapter will look at conduct and behaviour that could be altered by cultural change. It will consider examples of the different social systems that can create a corporate culture. It will also look at the attempts to improve corporate culture within banks and explain why, despite those attempts to improve corporate culture, the overarching requirements to maximise shareholder return run contrary to those attempts.

[104] A similar opinion is expressed by Gillian Tett (Tett, 2015).

3. Chapter 3 “Why cultural change is not enough”

The core values of the four largest banks:

Barclays: Respect, Integrity, Service, Excellence, Sustainability
HSBC: Dependable, Open, Connected.
Lloyds: Putting Customers First; Keeping it Simple; Making a Difference Together
RBS: Serving customers, Working together, Doing the right thing, Thinking long term
(Llewellyn, Steare, Trevelli, 2014).

3.1 Introduction

The core values[105] of each of the four largest banks are intended to be a statement of their inherent culture. These may come as a surprise given the problems that UK banks have experienced over recent years. From the Financial Crisis of 2007-2008 and the mistreatment of small businesses, as well as the manipulation of foreign exchange markets, it appears that banks have moved from one crisis of public confidence to another. Each has challenged the ethical credibility of banks. In 1987, the "Complete Book of Wall Street Ethics" (Walker, 1987) was written as a joke, all its pages being totally blank. However, what was regarded as a joke in the 1980s became a widely held public attitude towards Wall Street, the City and bankers twenty years later, when the Financial Crisis of 2007-2008 unfolded as is evidenced by books such as “The Seven Sins of Wall Street” (Ivry, 2014), “Fool's Gold” (Tett, 2010), “Citiphilia” (Lanchester, 2008) and “Whoops” (Lanchester, 2010).

The previous chapter suggested that regulation, on its own, was insufficient to control the damage that banks can cause to a national economy or, as was shown in the Financial Crisis of 2007-2008, to the world economy. It was also shown that banks sought to avoid or change regulation, if it impeded their ability to maximise profits for shareholders.

[105] The core values of a business organisation are the fundamental beliefs and values which are the basis upon which they conduct themselves and work. They act as principles which guide behaviour and assist staff and others in determining the correct path in fulfilling the organisation’s goals.

This chapter will explore the suggestion that if cultural change is embedded into a banking organisation it will assist in resolving the problems of banks. It will consider the changes in the world system of monetary and exchange rate management and how computerisation and information technology as well as financialisation have affected the culture within banks. It will also consider the idea that there are “limitations to the law” and that, given those limitations, culture and ethics can assist in controlling banks once law and regulation reach the limits of effectiveness. This chapter will suggest that the problems arising from culture are often different from those of regulation. It will look at a number of contributions from different academic disciplines and perspectives. It will consider examples of the problems of the culture that may exist in banks, but will conclude that all cultural change, ultimately, will be unsuccessful in solving the problems of banks, because of the overriding need to achieve the best financial returns to meet the demands of shareholders. Proposals to change banking culture can take different forms and different proposals will be critically examined. It will be suggested, however, that, whilst such change is desirable and should be possible, ultimately the desire to get the best RoE, will override any such initiatives.

This chapter will examine the concept of culture in banks and the accepted definitions of “culture”. It will also assess the claim that the law has its limitations in dealing with the problems of banks and, as a result, the law has to be supplemented by cultural concepts. It will then critically consider suggestions to strengthen corporate culture as well as the limitations of such proposals. It will conclude by stating that the need of bankers to provide returns to shareholders affects both regulation and attempts to make banks and bankers more ethical.

3.2 Culture: How Changes in the Business Model of Banking have Sought to Change the Ethics of Banking.

Before considering the effect of culture on banks or other organisations, the accepted definitions of culture and corporate culture should be considered. It can be stated that culture is the prevailing ethos that leads a group or organisation to consider the problems that face it and to behave in a particular way without the need to consider formal rules, thereby providing self-regulation. Culture can be defined as “an integrated social system which promotes the effectiveness of the organization and the well-being of all its stakeholders” (Racelis, 2010 cited in Hardowar, 2017). A further definition of culture is the “assumptions, beliefs, goals, knowledge and values that are shared by organizational members" (Schwartz H and Davis S, 1981). The stakeholders in banks are the "employees, customers, suppliers, and competitors" and culture affects "how a firm will interact with these key actors" (Barney J B, 1986).

In 1989, just three years after the "Big Bang",[106] and two years after the publication of the "Complete Book of Wall Street Ethics" (Walker, 1987), a former Deputy Chief Executive of NatWest Bank, Charles Green, in praising "Business Ethics in Banking" was able to say, "A banker's role is one of stewardship based on trust. We are trusted by those who ask us to look after their money and we have a duty to lend that money responsibly" (Green, 1989, p. 632).[107] In considering the future of banking, he added:

> "We should not allow commercial expedients to overrule our fundamental moral attitudes and responsibilities. In today's fast and changing market that resolve is being tested every day. The pressures on us personally and, as corporations, will increase as we move forward. Competition for market share and the battle for survival may tempt us to compromise our ethical stance. Increasingly, we shall be asked to manage complex and conflicting ethical issues. As we look to the future, we have to remember that a company, like an individual, is an accountable moral agent. And I believe our commitment to ethical behaviour has to be continuous if we are to manage in the longer term."
>
> (Green, 1989, p. 634)

Charles Green was a member of the 'Old School' of bankers whose conduct had been followed in England for most of the 20th century (Green, 1989). However, such ethical conduct had resulted in a cartel of the leading banks, with little to distinguish between them and little competition. Competition was, at that time, considered to be unethical in that a banker would not poach a customer from another bank, would not compete on price and would not involve themselves in hostile takeovers (Chavez, 2002, p. 17).

The change in attitudes from those expressed by Charles Green resulted in the type of the misconduct exemplified by and commented on by central bankers in Chapter 1, [108]

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[106] The Big Bang occurred on 27 October 1986. "There were several parts to Big Bang: it abolished minimum fixed commissions on trades; it removed "single capacity", which since 1911 had separated the role of brokers, who acted as agents for clients, and jobbers, who made the market and provided liquidity by holding stock on their books; and it allowed foreign ownership of UK brokers, to fix capital shortfalls at many firms" (Slater, 2016).
[107] This reflects the words of JP Morgan at the start of the introduction to this dissertation.
[108] See section 1.2.3 Some Examples of Scandals that have affected Banks, above.

following the end of the post-war phase in banking. At the end of the Second World War, the strength of trade unions, together with controls on capital and the fear that communism could encompass the whole of society, led to a weakening of financial interests. This coincided with companies becoming more socially aware and resulted in the improvement in employee earnings and benefits. However, with the ending of the Bretton Woods agreement in the 1970s,[109] shareholder interests began to reassert themselves (that is, a wish to maximise their return on their shareholdings). The fall of communism - which had led to governments ensuring that their peoples were “content”- as well as the loss of power of the trade unions, resulted in the decreased influence of labour on the requirements of business (Harvey, 2005). In addition, share option schemes for managers together with other performance measures and bonuses meant that the share price and profit of the companies became increasingly important. Thus there was a direct correlation between bankers’ bonuses and shareholder reward (Ireland, 2011). In other words, RoE became the predominant aim of banks and bankers.

The "Big Bang" not only brought new technology into trading in the City of London, but it also allowed "Wall Street" to have access to it either directly or through acquisitions of London financial firms. In addition, the 1980’s saw the promotion of an 'equity culture' in Britain by the Conservative Government. The Conservatives wished to encourage a 'property and shareholding democracy'.[110] Homeownership was encouraged, for example, through the 'right to buy' scheme, which allowed Council house tenants to purchase their rented homes at a substantial discount and, with assistance from the local council, lending tenants the monies to purchase those properties. The Conservative Government also saw the denationalisation of state industries and utilities as a way of improving efficiency, increasing the capital raising powers of such industries and utilities, as well as a way of obtaining government revenue by selling shares in those industries and utilities. A further advantage was that the shares in those industries and utilities were marketed to the public through mass advertising and this was aimed at increasing a “shareholding democracy”.

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[109] The Bretton Woods agreement was established under the auspices of the United Nations in 1944 for post-war monetary and exchange rate management. It was developed at a conference held in Bretton Woods, New Hampshire in 1944 and set up the IMF and World Bank as well as a system of exchange rates with the US dollar pegged to gold as the world's reserve currency. The system introduced strict exchange and capital controls to maintain a fixed exchange system with the dollar. Nevertheless, even though these movements appeared to constrain the financial sector, in fact the result was to strengthen it with the result that financialisation has been named the “unplanned child” of Bretton Woods (Nesvetailova, 2013).

[110] “We've trebled the number of shareholders in Britain and privatised twenty major industries. That's good, but not enough. We want more shareholders and more workers to own shares. So we'll privatise the major ports; then we'll tackle British Rail [applause]—with more to come. [applause] We have enabled three million more people—half of them council tenants—to become new home-owners. Good—but not enough.” (Thatcher, 1990).

Private pension provision increased as a result of lobbying by insurance companies and also the reduction of the value of the basic state pension. This resulted from the change in its being linked to prices instead of wages, and led to a reduction of its value against average earnings (Ireland, 2011). The government also introduced incentive schemes such as PEPs (Personal Equity Plans) to increase indirect and direct share ownership. A number of mutual companies,[111] particularly those involved in finance, such as insurance companies (for example, Norwich Union and Friends Provident) and building societies, (for example, Abbey National, Alliance & Leicester, Bradford & Bingley) also demutualised by issuing shares to their members.[112]

Nevertheless, whilst many who had not held shares before, acquired them through denationalisation sales or on demutualisation, it appears that most of the British public confined their property owning to more easily understood house and property ownership (Ireland, 2005). However, as Financialisation grew, so did the opportunities for financial institutions to sell financial products to the public who often had insufficient financial understanding of such products. This resulted in an increase of RoE, but as seen in section 1.2.3 above, such products were on occasions mis-sold.

3.3 Unethical Behaviour

Literature relating to ethics in banking refers to “Morality” as the concept of right or incorrect behaviour or conduct, whereas “Ethics” are the standards which govern the conduct within a profession, organisation and its membership (Hardowar, 2017). Alternatively, ethics can be defined as, “a discipline dealing with what is bad or good, right or wrong, and which determines moral duty or obligation. Ethics is also the principle of conduct governing an individual or a profession" (Chavez, 2002, p. 21). However, the concepts of “Morality” and “Ethics” are often used interchangeably (Jones, 1991, p. 367).

[111] Definition of Mutual Company: an organisation that distributes its surpluses to its customers depending on their financial participation in the organisations’ business. Most members normally have an equal vote notwithstanding their commitment.

[112] Six building societies, Abbey National, Halifax, Alliance & Leicester, Northern Rock, Woolwich, and Bradford & Bingley demutualised in the late 1980s and 1990s. At the time it was argued that it would bring competition to the banking sector. Members were given shares which they kept or sold. The conversions resulted in £1 billion in fees and commissions to the city and those who kept their shares lost when all went bankrupt or were taken over by Santander or existing banks.

A parliamentary enquiry calculated that the cost of the demutualised banks had increased by 35% and those who achieve most were the top employees. For example, a CEO of demutualised building society increased by 293% between 1993 and 2000 (Inman, 2008).

Ethics are, “standards of behaviour and are designed to respond to the particular dilemmas presented by the context” (Sinclair, 1993). In relation to the conduct of business, ethics are considered to be “Moral rules or principles of behaviour that should guide members of a profession or organization and make them deal honestly and fairly with each other and with their customers” (Longman, n.d.). Ethical decisions are those that are accepted as being both legal and morally excepted by a wider society (Jones, 1991, p. 367). Behaviour is considered unethical when it offends what is commonly regarded as acceptable conduct, adversely affects others, (Tett, 2015) (at Kindle location 1521); (Ho, 2009.); (Robson, 2014). In relation to banking, unethical behaviour can arise from “sins” such as “greed, pride, overindulgence and envy” (Ivry, 2014).

In the wake of the LIBOR manipulation, Mark Carney, Governor of the Bank of England recognised that there has been an “ethical drift and abdication of responsibility within the industry for guaranteeing financial stability” and advocated “higher standards” and “cultural change” (Carney, 2014). The Financial Crisis 2007-2008 has therefore been called an ‘ethical crisis’ but there is ample evidence to show that unethical behaviour existed before and since the Crisis, and in countries not affected by it (Argandoña, 2011). However, this chapter will show that whilst ethics were certainly a problem, they were not the determining factor; and that concentration on ethics (and other social science approaches) alone, will not suffice to address the problems banks face. Whilst bankers pay due respect to the concept of ethics, pressure to ensure maximum RoE is a more important determinant of their behaviour.

The Introductory Chapter 1 (section. 1.2.3), provided examples of the problems that have arisen from banks, prior to and following the Financial Crisis 2007-2008. However, few criminal prosecutions have taken place and very few criminal convictions. The reluctance to bring prosecutions resulted from a fear that financial markets would be undermined through a failure in confidence. In addition, prosecutions can only be brought for a breach of the criminal law, in effect, because the accused has acted in a way that is knowingly dishonest. Given the complexity of financial transactions, it is difficult for prosecutors to prepare a case and even more difficult for a jury to follow its complexities This could well result in prosecutions being unsuccessful when brought for bad or unethical behaviour, or for reckless investment or business decisions (Treanor, 2016); (di Vincenzo, 2005). Nevertheless, although conduct may not be *unlawful* it may still be counted as *unethical* or unacceptable (Chavez, 2002).

Banking scandals such as those mentioned in Chapter 1 follow certain themes of unethical or unacceptable behaviour, including the mis-selling of mortgages by brokers to individuals[113] or the reckless preparation of CDO's (Tett, 2010). In the USA, the public crisis of confidence in bankers was exacerbated as senior banking executives, who 'probably caused the crisis,' went on to advise the government on how to extract itself from that crisis (Boddy, (2011). Top executives of the insolvent companies - Bear Sterns, Lehman Brothers and AIG - retained their fortunes intact. Officials, such as Timothy Geithner,[114] who had advised that Lehman should be allowed to collapse, were promoted within government and bankers continued to be given billions in bonuses after the government bailout (Inside Job, 2010). Academic economists who had wanted relaxation of banking regulations became consultants (Casselman, 2012). Accordingly, no one was punished and the incentives to change were absent.

The regulatory failures that caused the Financial Crisis of 2007-2009 are detailed in numerous official reports.[115] In addition, it was shown that bankers did not understand what they were selling, or they did understand, but still sold, toxic securities to customers, who understood them even less. Furthermore, bankers proceeded recklessly ignoring the wider effects on the economy including house price inflation and an unsustainable credit boom (Hill, 2012, p. 676). The prevailing ethos not only encouraged the behaviour, but externalising risk and searching for loopholes in regulation became an object of pride (Hill, 2012, p.676).

One example given in section 1.2.3 was the LIBOR scandal, which revealed a number of causes of the manipulation of the interest rate. In fact, there were a number of theories as to the causes. Pride was proposed as being a factor, as demonstrated by the "Reputational Account Theory", where banks tried to conceal they were not strong by submitting lower rates, thereby not giving the impression that they needed to use the London Interbank Market to raise money (Rauterberg, G and Verstein A, 2013). According to the "Positional Account Theory," another factor was greed, in that banks were manipulating rates in order

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[113] The individuals were lent monies against the security of their home, but could not afford them and did not understand the, often complex, details of the mortgage conditions. For example, some of the mortgages sold in America had a high initial discount, which meant initial repayments were initially low, but then led to repayments at the full rate which the borrowers could not hope to afford (Tett, 2010).
[114] Timothy Geithner was the President of the Federal Reserve Bank of New York (2003 to 2009) and then US Secretary of the Treasury under Barack Obama (2009 to 2013).
[115] For example: Financial Crisis Enquiry Commission (United States, 2011); the *Levin-Cockburn Repor*t (Levin-Coburn US Senate, 2011.); Vickers Report, (Independent Commission on Banking, 2011).

to increase their profits (Hardowar, 2017). Finally, there was the “Rogue Trader Theory" which demonstrated the greed of traders wishing to increase their earnings by pressurising participants to submit LIBOR rates which would enable them to maximise personal gain from their dealings (Hardowar, 2017). The description of the scandal above shows how the system was available to be exploited by bankers who acted unethically and resulted in the three reports[116] and consequential reforms.

That regulation on its own has not been successful and that there is a problem of morality and ethics in banking has been recognised by the regulators themselves. The Financial Crisis 2007-2008 and subsequent scandals have led to calls for a greater emphasis on ethics in banking from a number of leading central bankers. Thomas Baxter, the executive Vice President and General Counsel of the New York Federal Reserve observed in a speech in 2015: "The bad behaviour that contributed to the Financial Crisis was evidence of a culture that was not strongly ethical" (Baxter, 2015). He suggested that, if financial services organisations had a strong moral base, they would avoid poor banker behaviour. Such poor banker behaviour, Baxter suggested, would often lead to regulatory investigations which resulted in large fines. These will adversely affect the financial services firm’s reputation (Baxter, 2015). However, Baxter’s suggestion that enforcement actions “often” happen must be questioned. Investigation and enforcement only takes place if the regulatory breach is discovered. It is the suggestion of this thesis that, as the desire to maximise return for shareholders is predominant, bankers are encouraged to take risks, in the hope that they would avoid enforcement action. Even if there were to be a regulatory investigation, by the time the regulator investigates, the bank employees concerned may well have left, having received their bonuses for their contribution to shareholder profits.

Mark Carney, Governor of the Bank of England, observed that the failure in ethics came from bankers becoming “detached from end-users”. He noted that when transactions became more important than customer relations, banking instruments meant to assist business became ways of increasing financial returns for banks. He suggested that when bankers became detached from their customers the only reward was money (Carney, 2014). In other words, the Governor was endorsing the view that RoE predominated. Nevertheless in his speech the following year, Carney recognised that the Fixed Income,

[116] The Wheatley Report, (Wheatley, 2012); the Parliamentary Commission on Banking Standards Report (PCBS) (Parliamentary Commission on Banking, 2013); the Fair and Effective Markets Review (FEMR) (HM Treasury, Bank of England, FCA, 2015).

Currencies and Commodities (FICC) markets[117] had relied on an informal set of understandings and codes, which may have been applicable in past times, but with changing markets and financial products was no longer the case. He particularly noted the misconduct in those markets which resulted in a loss of public confidence and threatened financial stability (Carney, 2015). William Dudley president and CEO of the Federal Reserve Bank of New York was another to recognise that despite the Financial Crisis of 2007-2008, examples of unethical conduct of bankers continued despite intervention and regulation (Dudley, 2014).

However, when asking the question: “Do employees understand their job to be maximizing revenues in any way possible so long as they do not do anything illegal, or do they understand their job to be maximizing revenues in a manner consistent with a broader set of considerations?" (Tarullo, 2014), Federal Bank Governor Tarullo raised a central concern of this thesis; namely, do bankers see their role as creating the greatest possible financial returns, so long as they keep within the law, or should they be bound by wider ethical considerations?

3.4 The Limits of the Regulatory Standards

The Financial Crisis of 2007-2008, the LIBOR scandal and the other examples set out in the Introduction have generated an increasing debate over the extent to which the law alone can effectively control banks by regulation. Whether the law is limited in its ability to control banking behaviour, and whether a cultural change can assist in controlling banks, when the law does not, or cannot do so, should be examined. The focus will be the suggestion that the imperative for RoE is key in affecting the conduct of bankers.

The law is limited in controlling banks for a number of reasons. Many financial instruments are very technical and change frequently making it impossible for regulation to keep track of these and modify rules to meet fast-moving changes (Hill, 2012). Regulation sets the standard below which those who are regulated must not fall. In doing so, it creates the problem that regulation sets the *base* standard rather than the *bes*t standard. Regulation does not set a horizon of good standards to be achieved. Sanctions are imposed against those who break the rules, but regulation does not promote or reward those who develop good practice (Law and Ethics in Finance Project, 2015). Whilst conduct on the wrong

[117] (FICC) Fixed Income, Currencies and Commodities markets: are not one market , but many markets, which range from trading in low risk government bonds to foreign exchange currencies specialising in interest rates and high risk commodity trading.

side of the line is penalised, regulation can encourage poor behaviour that is just on the other (right) side of the line; it is lawful but not necessarily ethical (Hill, 2012). However, in a system where there is pressure to maximise shareholder return, rather than to provide the best service and work for the benefit of society, it is difficult to see how a banker can be penalised for obeying the law and achieving the best financial return for the bank. In addition, the base standard is lowered because, as was seen in Chapter 2, banks use their resources to employ lawyers to find ways around regulations so they can maximise returns, or lobbyists[118] to change them so that they are the base standard, thereby assisting banks to maximise profits rather than maximising banking standards.

One of the results of the limitations on regulation is that further regulation may be considered to overcome the defects in existing regulations. Another disadvantage of regulation is that the greater the number of rules that exist, the greater the compliance problems. Compliance itself, or meeting compliance standards, becomes the objective, rather than the means to achieve the objective. As a result, attempts to create regulations that cover all conduct give rise to complexity and confusion with the result that the regulations themselves become less effective[119] (Law and Ethics in Finance Project, 2015).

A further limitation of regulation is that, if regulations are vague or imprecise, it allows bankers to deny that either a breach has occurred or that there is responsibility on their part for such a breach. (di Vincenzo, 2005). Another factor that suggests there are limitations to the effectiveness of regulation is the cost-benefit evaluation made by bankers on a course of unethical behaviour (that is, bankers come to a decision as to whether the risk of being found out is less than the opportunity to achieve a greater profit by following a particular course of behaviour). Enforcement of regulations is also made harder by the burden of proof required by the court,[120] which leads to compliance in form, but avoidance in effect (di Vincenzo, 2005).

[118] A detailed account of the power of lobbyists in Washington during the period following the financial crisis 2007-2008 is contained in "The Payoff: Why Wall Street Always Wins"(Connaught, 2012). It illustrates reticence of the government to take active steps for reform, the reliance of the government on the Wall Street experts who had not prevented the crisis and the opposition who were benefiting from campaign donations from Wall Street financiers.

[119] For example, The Markets in Financial Instruments Directive [MiFID] was criticised for being complex, difficult to follow and to enforce with substantial costs falling on the investor rather than investment firms (Burke, 2009).

[120] The burden of proof required for a criminal prosecution is 'beyond reasonable doubt'. It is very difficult to prove that a banker was acting fraudulently rather than recklessly in implementing a regulation.

Often overlooked in such discussions are the financial constraints on regulators compared to the industry they are trying to regulate, as well as the fact that the reward schemes offered to bankers are attractive to the poorly paid employees of regulators. Regulators are often well trained and therefore good sources for recruitment by the banks. An employee of a regulator hoping to be employed by a bank would not wish to create a bad reputation with potential future employers by becoming too 'difficult' with them (Luyendijk, 2012).

3.5 Changes in corporate culture as an alternative approach to the problems of banks

Whilst the Financial Crisis 2007-2008 and the other banking scandals referred to in the introductory chapter have led to further consideration of regulation, there have been alternative views and increased calls for there to be a moral or ethical approach, within the whole of banking and finance sector rather than on an institution-by-institution basis (Hill, 2012). The interest of academics in such an approach has been echoed in official reports. For example, the Parliamentary Commission on Banking Standards considered culture in the UK banking sector and professional standards following the LIBOR rate-setting scandal with the intent of ascertaining the lessons that could be learned from the LIBOR scandal, and made recommendations in a report "Changing Banking for Good (Parliamentary Commission on Banking, 2013)". This was followed by the Fair and Effective Markets Review,[121] published in July 2015. Whilst that Report had a "headline" of increasing sentences for those involved in market abuse, it spent much of the report considering raising professionalism and standards of the participants in the market. They included recommendations for ascertaining and developing methods for aspiration to the highest standards, a strong ethical culture within businesses and the development of strong code of personal ethics, with self-review (HM Treasury, Bank of England, FCA, 2015). In addition, the Prudential Regulation Authority considers that its objectives rely on banks having the highest regard for those objectives and that they should be reflected in the banks and their "standards of behaviour" (The Prudential Regulation Authority, 2014).

The Financial Crisis 2007-2008 and the subsequent problems that have affected banks have attracted much academic attention. Not unnaturally, most academic writers approach the

[121] The Fair and Effective Markets Review (FEMR), (HM Treasury, Bank of England, FCA, 2015) was established by Treasury together with the Bank of England and The Financial Conduct Authority, to investigate the manner in which the wholesale financial markets operate, with the aim of restoring confidence in those markets following scandals with LIBOR and the manipulation of the foreign exchange markets.

problems from their own particular academic disciplines or interests ranging from a philosophical or ethical view to a socio-political viewpoint. Banking is therefore viewed from anthropological, organisational or socio-psychological viewpoints as well as using concepts of Ethical Decision-Making, Psychology and Education theory. However, academic suggestions as to the cause of the problems are often limited to those particular academic fields, whether it be the law, philosophy, psychology or social sciences. Nevertheless, this chapter will suggest that whilst each of the approaches to the problems of banks from the different academic disciplines makes a contribution, no single discipline (or even a combination of disciplines) provides an exhaustive explanation of the problems or has the solutions. It will suggest that on their own the "soft skills" approach is likely to fail when faced with the pressures to maximise profits and RoE.

3.6 Explanations for the Ethical/Moral Problems in Banking

The examples of unethical behaviour given above,[122] as well as the concerns expressed by central bankers in keynote speeches, [123] show that regulation has not been successful in dealing with the problems of banks and that there are ethical and moral shortcomings that are not dealt with by regulation.

A number of explanations are given as to the reasons why there are ethical and moral problems in banking. Firstly, it is suggested that the compensation/payment system rewards short-term performance and gaming (either manipulating personal targets or gambling with other people's assets). Such pay schemes are linked to income generating targets. They therefore align the bankers' interests to be financially rewarded with the shareholders' interests to maximise profit. In addition, if a banker receives a large bonus, it is a mark of that banker's success, both within the current organisation and, if he or she wishes to move to work for another bank, it sets a benchmark from which he or she will receive future remuneration in the new employment. The criteria for performance are short-term and judged against financial, rather than wider performance targets, because financial targets governed by accounting rules are easier to measure than moral or ethical standards (Hill, 2012).

Secondly, a problem is recognised in bankers trading on their own account. They have much to gain if they are successful and, ultimately, are protected personally by the limited

[122] See section 3.3 Unethical Behaviour, above.
[123] See section 3.3 above (Tarullo, 2014).

liability of banks if they fail. Often the banks are TBTF[124] and bank traders know that, ultimately, the State will step in to save them (Hill and Painter, 2015). Thirdly, there is a problem in the explanation given to customers who may become embrangled by the instruments or the procedures the banks are recommending and accept the assurance by the bankers that "everybody's doing it" (Hill, 2012). Customers rely on the banks' guidance and just because everybody is (or is said) to be "doing it" is not a justification for recommending an unethical course. This concept can be referred back to the work of Kohlberg and the concept he propounded of 'levels of ethical decision-making' (Kohlberg, 1975) (cited by Fichter 2016).[125] In this case, the customer, and, indeed, the banker, would be at the level of decision-making where the decision-maker justifies the decision by relying on what peers and contemporaries are said to be doing ("conventional level of morality") rather than on the higher level, "post-conventional level of morality", where the decision-maker relies on his/her own interpretation of what is morally correct.

Fourthly, problems arise in that bankers are a sub-community, often working long hours together, becoming isolated and seeking to prove their individual worth by outdoing each other. The group begins to develop its own values and norms, which seek to exclude the values of others, including those of wider society. The ethical problems that arise from bankers becoming a sub-community or "silo" could be considered from the aspect of Organisational Theory (Fichter, 2016) or, possibly, from an anthropological viewpoint (Tett, 2015).[126]

However, underlying each of the four explanations above is the desire to maximise RoE. Pay structures reward those who maximise profit on deals and transactions; much can be gained by taking risks and there is little to lose because of TBTF. Customers are enticed into transactions on the guidance of bankers, who have much to gain in fees and commissions from profitable transactions. Finally, in relation to the "Silo effect", as Governor Mark Carney suggested, "When bankers become detached from end-users, their

[124] 'Too-Big-To-Fail' (TBTF): describes the idea a business has become so large that a government will always prevent its collapse, as failure could start a systemic bank run adversely affecting the entire the economy. A Government may decide that the cost of an intervention is less to the economy than the cost of the failure.
[125] "Levels of Ethical Decision-Making": stages one and two were the pre-conventional level where rules are obeyed because of penalties imposed for non-compliance; stages three and four are "the conventional level" where people follow rules because of the behaviour of their peers and contemporaries; finally stages five and six are the "Post conventional level of morality" this is where individuals rely upon their own interpretation of what is morally correct. Rest took these principles and turned them into a "Defining Issues Test". ((Rest, 1975, p. 30) .

only reward becomes money” (Carney, 2014).

Whilst the preceding examples may, at times, show illegal conduct, they also show conduct that is unethical, relating in particular, to greed and pride. In order to see how these ethical problems can be addressed, the next section will look at the concepts of ethics and morality in more detail.

3.7 The Introduction of Ethics and Morality as a way of dealing with the Problems of Banks

It is suggested by some academics that a culture of ethics can only be successfully implemented if the banks individually internalise ethical values through their formal organisational structures and informally through a culture of ethics (Hardowar, 2017). Others argue that this crisis is a crisis of leadership or governance in numerous institutions, which is, in effect, a reflection of the failure of an economic and social model grounded on certain anthropological and ethical assumptions, and it is these assumptions that have failed and led to the wrong managerial approaches[127] (Argandoña, 2011). However, in a competitive environment, where the race is to achieve maximum RoE, there is inevitably a clash of interests between the structure of a joint-stock bank[128] with shareholders seeking the best return, and a duty to the customer and wider society to place ethics ahead of profits.[129] Most academics accept that ethics and morality do not stand on their own and that they have to be part of either culture, an organisation or “trickle down” through leadership (Law and Ethics in Finance Project, 2015). These concepts will be considered later in this chapter.

Different social science disciplines have looked at the problem from their own perspectives. Not only does this reflect academic and public interest in the problems of banks and the Financial Crisis 2007-2008, but it brings different approaches to the subject. These disciplines include those based on social science, business studies, philosophy as well as lawyers looking at the issue from the perspective of the limitations of the law. The next section will consider the approaches of these different academic disciplines.

[127] In incentive, accounting, reporting and monitoring systems as well in the selection, training and remuneration of personnel and in business culture.
[128] A Joint-Stock Bank is a bank which is a public limited company and issues shares that are owned by investors rather than by an institution, government as a mutual.
[129] See section 4.3 Why not rely on shareholder control?” below.

3.7.1 Too-Big-to-Fail ("TBTF")

Some academic disciplines have analysed the problems of banks and bankers and others have proposed solutions. Anthropology, for example, has looked at the interaction between individuals working in banks. Sociology has considered banks within society, whereas psychology has looked at bankers as psychological types. Social psychologists in particular, have argued shareholders were unwilling to accept lower returns, even though the regulatory requirements of BASEL III [130] required banks to hold higher capital (see section 2.4). Continued shareholder demands for RoE led banks' lobbyists to seek to minimise the effects of Basel III. Another example was contained in an Oliver Wyman[131] report, which suggested that a number of fundamental problems that existed prior to the Financial Crisis of 2007-2008 had not been resolved (Wilkinson, 2011), but that the pressure to maintain a RoE was leading banks into the less regulated shadow banking system or into the creation of asset bubbles (Keen, 2017); (Williams and Conley, 2014, p. 102); (Wilkinson, 2011). Overall, scholars within these disciplines suggest that a number of the banking problems concern, firstly, the TBTF [132] problem, secondly a culture of insecurity and, thirdly, remuneration structures that promote the taking of risk and self-interest.

TBTF financial institutions are recognised as having five problems. Firstly, such TBTF banks may feel they can take on excessive borrowing, because of an expectation of government support should they run into difficulties.[133] Secondly, they receive higher credit rating agency[134] scores, because such agencies believe that TBTF banks will not fail as, ultimately, they will be supported by government. Thirdly, as a result of their contacts with government, TBTF financial institutions hold excessive political influence. Fourthly, their lending may become reckless, because creditors expect banks to be safe when they

[130] Basel III followed from the earlier Basel I and Basel II Accords. It aims to improve the ability of banks to improve and strengthen risk management, make the dealings of banks more open and deal with financial stress. A particular aim of Basel III was to create greater resilience at the level of individual banks so as to reduce the risk of systemic shocks.

[131] A global management consulting firm : http://www.oliverwyman.com/who-we-are.html

[132] "Too big to fail" describes the idea a business has become so large that a government will always prevent its collapse, as failure could start a systemic bank run adversely affecting the entire the economy. A Government may decide that the cost of an intervention is less to the economy than the cost of the failure.

[133] There are of course numerous organisations upon which a society depends to run smoothly and could equally be described as too big to fail (for example, a railway network or a health service). It does, however, appear only to apply to banks with the temptation/pressure to lend in order to maximise profits.

[134] "Credit rating agency": a credit rating is the calculation of the ability of a borrower to repay a loan or other financial obligation. The borrower could be a state, local authority, company or an individual. Such assessments are undertaken by companies known as credit rating agencies, the best known of which are Standard & Poor's, Moody's or Fitch. A problem comes from the fact that the objects of the assessment are those that pay for the credit rating and therefore there is a conflict-of-interest.

are guaranteed by government. Finally, there is a social problem in that people see the system as "privatising gains and socialising losses" (Williams and Conley, 2014, p. 110).

Mark Carney, Governor of the Bank of England, recognised the problem:

> "Perhaps, the most severe blow to public trust was the revelation that there were scores of too-big-to-fail institutions operating at the heart of finance. Bankers made enormous sums in the run-up to the crisis and were often well compensated after it hit. In turn, taxpayers picked up the tab for their failures. That unjust sharing of risk and reward contributed directly to inequality but – more importantly – has had a corrosive effect on the broader social fabric of which finance is part and on which it relies" (Carney, 2014).

In his speech to the Conference on Inclusive Capitalism, Carney suggested that the Financial Stability Board[135]- having identified the TBTF institutions- had subjected them to higher standards in 'stress tests'.[136] The Financial Stability Board was also developing methods to ensure that if they did fail, such a failure could be resolved without damage to the financial system as a whole and risk to the taxpayer (Carney, 2014). In the United Kingdom, the Prudential Regulation Authority is charged with promoting the "safety and soundness" of financial services companies, including banks it regulates (Prudential Regulation Authority, 2013). Whilst it seeks to ensure that major financial institutions including banks are sound the Prudential Regulation Authority states it does not support a TBTF regime suggesting that it would allow firms to fail, but in a manner that would not affect financial stability (Cunliffe, 2014). However, the efficacy of such methods will not be known until they are tested in another financial crisis as 'stress tests' are regulatory creations. For example 'Stress tests' do not affect the banks' influence on the Credit Ratings agencies, nor the political influence exercised by TBTF banks, as stress tests look at the bank's ability to deal with the crisis rather than its influence and lobbying powers.

[135] The Financial Stability Board (FSB) is an international body established in 2009 following the Financial Crisis 2007-2008 by the G 22 to promote global financial stability by coordinating the development of regulatory, supervisory policies. The areas dealt with are purely regulatory and do not involve improving the culture or ethics of banks.

[136] "Stress Tests": bank stress tests are assessments of how a bank would cope in difficult economic circumstances. They are an analysis conducted under unfavourable economic scenarios. Risks assessed include credit risk, market risk and liquidity risk to ascertain whether a bank has sufficient capital to cope with the impact of adverse developments. Whilst the Bank of England's 2017 Stress Tests include 'Misconduct Costs' (that is, fines) as a Stress factor, the Bank of England's Stress Tests involve accounting and are quantifiable rather than attempting to assess the business culture of a bank under stress test assessment (Bank of England, 2017).

Regulatory changes may seek to control banks, but until the bank is successfully allowed to fail and not result in a bank run, the culture of too big to fail will still be embedded amongst bankers (Williams and Conley, 2014).

3.7.2 A Culture of Insecurity

In addition to the TBTF issue, social anthropologists have recognised a culture of insecurity as another cause of problems in banking. Employment is seen as volatile and insecure, particularly, at lower and middle levels. This is very different to the culture that Chavez (Chavez, 2002) identified in the London banking culture of Charles Green.[137] In the days of Charles Green, banking was a career starting from when a banking entrant left school and continued until he 'got his gold watch" upon retirement. However, Bankers find themselves in very different circumstances today. Karen Ho, a social anthropologist, worked at Bankers Trust and found herself part of a downsizing exercise. She quotes one of her co-workers:

> "I think that every single day you realize that your job could be gone the next day. You have a downturn in the market and they lay off hundreds of people or you have a downturn in just your desk['s] [particular product area] performance; all of sudden they need to lay off people. Your company decides they don't want to be in that product anymore; they lay off an entire department. I just think that's part of life here" (Ho, 2009).

Not only was their work insecure, but the only thing the employees' line managers were interested in was 'how much money have you made for me today?'' In a dog-eat-dog environment, staff that did not perform and achieve their financial targets would find that they were summarily dismissed (Ho, 2009). This business culture of short-termism results in any worker protecting their own interests by making as much money as they can before the job is no longer there. They have no concern for the company or its customers; this culture makes them put their own interests first. In such an environment, any considerations for ethics, 'to treat customers fairly', or a longer-term view of the consequences of any actions, will be laid aside by the insecure employee. A combination of the competitive and individualistic culture of the TBTF financial institutions thus creates an environment where the management of risk and compliance are seen as encumbrances,

[137] See section 3.6 Explanations for the Ethical/Moral Problems in Banking, above

rather than precautions.

3.7.3 Bankers' Bonuses - the Remuneration Problem

One of the major problems is identified as the remuneration (known as "compensation" in the USA) system (Hill, 2012); (Hill and Painter, 2015); (Williams and Conley, 2014). Many have been attracted to banking over the years because of its high remuneration (Bok, 1993). However, the remuneration system works to exacerbate the ethical problems of banks. Firstly, it is suggested that the system of, in effect, re-insuring the risk of banking transactions (for example, by packaging and then reselling them) leads to more transactions and therefore more payment to those involved. Secondly, the size of their payments allows bankers and their institutions to have a far bigger effect on influencing government and political campaigning. The mentality the remuneration system creates, particularly when combined with the level of insecurity, is one of "get it while the going is good". The compensation and payment system rewards short-term performance and gaming, either by manipulating personal targets or gambling with other people's assets (Hill and Painter, 2015). This led to a 'manic search' for deals and transactions and, when combined with the competitive and individualistic culture of the TBTF financial institutions, creates an environment in which the management of risk and compliance are seen as encumbrances, rather than precautions (Williams and Conley, 2014, p. 112). The remuneration system of performance-related bonuses ties the banker into the return on equity culture and thereby bankers' financial rewards are based on profit rather than ethics.

Moreover, the criteria for performance are short-term and set against financial rather than true performance targets. Using performance-based targets that can be quantified in accounting terms is often easier, as performance can be judged against the value of deals or profits made and bonuses given accordingly. However, it does not take into account other contributions to the success of a business such turning down a 'deal', which although profitable, may not be in the best interests of a customer (Hill, 2012).

There have been a number of proposals to bring bankers bonuses closer to the long-term prosperity and security of banks (for example, bonus clawback, holding of shares for a period before encashment). However, such schemes may not be sufficient to change the behaviour of bankers. If they already have substantial assets, such bankers may be happy to risk a part of those assets when there is the possibility of a very large bonus if the risk succeeds. This may even extend to the shares they hold in the bank as well as any bonuses, provided that they could maintain their wealthy lifestyle. Other bankers may be willing to take such risks if their personal assets - other than their shares in the bank- were not at risk, even if there were risk to the bank itself (Hill and Painter, 2015, Introduction).

Having looked at the problems from an anthropological and sociological point of view, motivations for such human behaviour are now looked at with consideration to Organisational and Social Psychology. These fall into three categories: firstly, "instrumental motives", for example, self-interest and the need to control one's environment and circumstances; secondly, relationship motivation, which is based on the desire to belong to groups (families, countries workplaces) and, finally, moral motivation, which arises from the need to have a meaningful existence (Williams and Conley, 2014, p. 114).

The criticism of the sociological/anthropological approaches is that whilst they analyse the problems and make broad suggestions, no framework is proposed as to how those ameliorations can be effected, particularly against the existing bankers' status quo. For example, in a culture where jobs are insecure, how do you prevent line managers with departmental targets from threatening their subordinates?

3.7.4 The Individual Psychology of a Banker

Social psychology and anthropology look at banks, bankers and banking culture as a group or organisation. However, the problem of bankers can be considered on an individual basis, by considering the psychological make-up of the persons who are bankers.

In particular, the psychological processes by which bankers approach questions of ethics and honesty can be considered. Money Intelligence Theory[138] research suggested that a "high love-of-money individuals have higher Machiavellianism" [139] and therefore "are more likely to use manipulative strategies, take high risks, and engage in unethical behaviour" than those who do not share the same "high love-of-money" aspirations (Tang & Chen, 2008). It is suggested that, in general, bankers fall into the category of "high love-

[138] "Monetary intelligence theory asserts that individuals apply their money attitude to frame critical concerns in the context and strategically select certain options to achieve financial goals and ultimate happiness." (Tang & Chen, 2008 in Hardowar, 2017).

[139] Definition of "Machiavellianism" in psychology refers to a characteristic of a person who is so focused on their personal interests they our willing to deceive, manipulate and exploit anyone else to achieve their aims.

of-money" individuals, as not only does the work involve money, but the bonus system and performance pay offer high monetary rewards. In addition, as was commented upon above by Mark Carney, the FICC markets had relied on an informal set of understandings which had not kept pace with the changing times and had thereby allowed a new culture reflecting current practice to become embedded. This allowed dishonesty to develop in the LIBOR markets, not just as a criminal offence or regulatory breach "but also a culturally defined psychological construct" (Tang & Chen, 2008 in Hardowar, 2017).

In addition, ethical breaches may arise because of error - "good people making mistakes" out of confusion or ignorance; weakness - "good people having weakness of will", and vice- "bad people choosing to do evil", (Hardowar, 2017). Other research shows that people like to consider themselves to be honest, yet a dishonest course often provides handsome rewards. This research exhibited the fact that people behave sufficiently dishonestly to profit themselves, but honestly enough to create a self-belief of their own integrity (Mazar, et al., 2008). This research shows that bankers can act unethically to maximise profits, while at the same time, believing themselves to be acting correctly. The belief that they are fulfilling their role to achieve the maximum return equity, albeit by acting unethically, is subsumed into the self-belief that they are acting correctly.

Another way of considering the psychology of bankers was to suggest that leading bankers were corporate psychopaths[140] and this was a significant factor in causing the Financial Crisis 2007-2008 in addition to other problems identified above (Boddy, 2011). It was suggested that changes in the nature of large corporate organisations in the last part of the 20th century, moving from a slow changing environment to one with mergers, takeovers, rapid movements in personnel and lack of job security, led to the character of individuals being less understood (Boddy, 2011, p. 257). Boddy states that Professor Robert Hare, 'the world's leading expert' on psychopathy "has repeatedly drawn attention to the possible damage that Corporate Psychopaths could cause in major financial and other organizations" (Boddy, (2011).

Psychologists and organisational behaviour consultants suggest that a culture of ethics may prevent "errors", overcome "weakness" (submitters who felt compelled to follow the orders of superiors) and punish "wrongdoers" (Hardowar, 2017). However, the pressure on

[140] Psychopaths are "people who, perhaps due to physical factors to do with abnormal brain connectivity and chemistry, especially in the areas of the amygdala and orbital/ventrolateral frontal cortex" (Boddy, 2011, p. 256).

those employed in banks to achieve a RoE (dividend to shareholders) continues, notwithstanding the attempts to change corporate culture in banks[141] (Wilkinson, 2011). Combined with the insights provided by the Money Intelligence Theory[35] this suggests that attempts to create such a 'culture of ethics', will always have intrinsic difficulties because whilst behaviour is motivated by many factors such as norms, cooperation, fairness, empathy and moral duty (Williams and Conley, 2014, p. 115), it is suggested that alternative motives do exist to those of the pure acquisition of money by bankers and that that changes in organisational culture within banks could have an effect on their ethical behaviour.

3.8 Cognitive Moral Development and Ethical Decision-Making ("EDM")

It has been seen that bankers seek to avoid regulation through the use of lawyers to find 'loopholes', lobbyists to amend regulations that impede them maximising profits and sometimes simply by ignoring regulations altogether. In the previous section, problems connected to 'TBTF', workplace insecurity, remuneration packages that draw bankers into maximising RoE and individual psychological motivations were discussed. An alternative method to explore how bankers reach their decisions is by looking at theories of ethical decision-making.[142] Kohlberg, in developing the Cognitive Moral Development Theory (Kohlberg, 1975), considered decision-making involving ethical problems.

Kohlberg's Cognitive Moral Development Theory[143] suggested that moral selves develop with time and experience. The theory explains that persons operate at three levels. Firstly a 'pre-conventional' level where persons act in particular ways to avoid punishment; secondly at a 'conventional level' where there is conformity resulting from the need for approval and acceptance by others; and finally, at a 'post-conventional' level, which applies to persons who have developed their own moral values independent from others and irrespective of what the law may dictate (Kohlberg, 1975). The theory argues that most persons operate on the 'conventional level' with ethical decisions being made because of conformity and the desire to be socially accepted.

[141] The limitations of such attempts can be seen from way in which the Prudential Regulation Authority identifies failings and culture. It seeks to review valuation methods, assess the independence of risk management and "board effectiveness reviews", and consider remuneration policies. These are regulatory attempts to assess culture by using measures that are quantifiable. Banks will be able to prepare themselves to pass such quantifiable tests without changing underlying ethos-to maximise shareholder profit (Prudential Regulation Authority, 2014).

[142] "Ethical Decision Making it is a process which assists individuals to make difficult choices where there is an ethical problem and where there is no obvious correct answer.

[143] A further useful consideration of Ethical Decision-Making and Cognitive Moral Development Theory can be found in a PhD thesis by Phyllis Rhodes (Rhodes, 2010).

In the hierarchical world of banking, this shows itself in junior employees not expressing a differing opinion through fear that their superiors may exclude them from future projects or because it may impinge on their career prospects. More senior employees accept the prevailing ethos that profits must be maximised per trader or department. There are no encouragements to express moral values that are contrary to those of the prevailing ethos of maximising shareholder value.

Working from Kohlberg's theory, James Rest created an Ethical Decision-Making (EDM)[144] model, the "Defining Issues Test" (Rest, 1975). However, experiments by researchers to ascertain whether gender, age or business ethics courses lead to the exercise of greater moral values in finance, failed to show that there was any statistical difference [145] or correlation between high levels of education and higher scores on ethical decision-making (Chavez, 2002); (Rhodes, 2010). Whilst EDM explains why bankers behave in ways that do not assert ethical behaviour, the theory does not suggest how this can be overcome and although recommendations were made in the conclusions of the research projects, they assert that maximising RoE overrides EDM.[142]

Furthermore, EDM theory is limited as a way of controlling overarching pressure to maximise shareholder value, because it assumes a rational decision-making process. In fact, emotion often plays a role in decision-making which interferes with rationality (Dirkx, 1997); (Yorks, 2002). Similarly, EDM focuses on rules rather than moral standards and assumes that an employee uses his/her own innate skills and moral support mechanisms, which will act as an effective guide to decision-making. It could be argued that, in complex and uncertain environments, such an assumption may not work. For example, an organisation's atmosphere can damage an employee's own moral identity if the organisation is pursuing the goal of profit maximisation and acting less ethically in order to achieve shareholder return. In such circumstances a banker may decide to conform, following the "everyone is doing it" concept (Hill, 2012, p. 690) rather than

[144] Ethical Decision-Making (EDM) Theory seeks "to understand how employees make decisions about ethical issues, it is important to examine the Ethical Decision Making process" (Fichter, 2016, p. 3).
[145] The finding of one of the research projects was a correlation between high levels of education and higher scores on ethical decision-making. However, it was noted that employees with such a higher level of education commanded higher salaries and the pressure for profit maximisation required clerical staff that were less well educated and lower paid (Chavez, 2002, p. 71). The other experimental study concluded that taking ethics courses in business management schools did not increase their test scores over those who had not (Rhodes, 2010). It was suggested that this supported the finding that the approach of such business schools was financial, concentrating on the maximisation of shareholder value (Emiliani, 2004).

acting ethically (Fichter, 2017). Academics have suggested modifications to the core theory of EDM[146]. However, as will be seen, they do not overcome the underlying problem that the pressure to achieve RoE is a prevailing ethos.

There have been various refinements to the theory of EDM to overcome the flaws mentioned. The underlying flaw in the argument that there is an expectation for ethics or morality to control the behaviour of bankers is found in EDM itself. Given that it has been suggested that most involved in banking work on Kohlberg's 'conventional level', that is, acting in conformity to obtain for approval and acceptance by others, they are more likely to be those who commit "crimes of obedience". Whatever the impression that banks may wish to give, the pressure on those operating at "conventional level" is not to put ethics and morality first, but to seek the maximum profits, RoE.

3.9 The Importance of Leadership

Those who believe that moral authority and ethical education can overcome the drive to maximise shareholder value and profit suggest that concepts of leadership and culture are linked. Whatever aspirations to having an ethical culture a bank may have, they will not become embedded unless they are adopted and promoted by the leadership of the bank. An example of this is the conduct of Richard S. Fuld, the CEO of Lehman Brothers. Until the collapse of Lehman Brothers, Fuld was praised for the bank's profitability and his authoritarian excesses were ignored (Stevens & Buechler, 2013). It is argued that the quality of the leadership of a bank is an essential requirement for ensuring that the banking institution encompasses ethical behaviour and that its core values are embedded within the culture, not just platitudes. Leaders holding to the values of honesty, integrity and trustworthiness are seen to be needed to re-establish trust between the organisation and its employees and customers (Doering, 1998); (Minner, 2016). It showed leaders can have an impact by acting as role models, treating their employees and others with respect, standing by their word and not asking for more than they can give themselves (Zwygart, 2014). Leaders must also ensure that the culture they wish to imbue "trickles down" through the

[146] For example, it has been suggested that the concept of Moral Strength could be added with the aim of tackling the pressure to conform, rather than to make an ethical stand (Fichter, 2016, p. 6); (Trevino, 1986) This contrasts with those who are likely to follow unethical directives without question and commit "crimes of obedience". To complain about ethical issues, for example by, "whistleblowing", requires moral strength. A whistle-blower has to be willing to bear the (often considerable) personal risk that whistleblowing may involve; not only will his/her current employment being at an end, but are unlikely to be hired by any other financial institution, who would feel that the person was a potential troublemaker (Fichter, 2016); (Sekerka, et al., 2009, p. 575).

organisation so that those at all levels will eventually implement the ethical lead (Law and Ethics in Finance Project, 2015). [147] Moreover, when employees are committed to an organisation, this has a significant impact on their adoption of those core values. Thus, this study supports the literature which suggests that leadership and commitment are prerequisites for the adoption of values (Wallace & de Chernatony, 2011, p. 397).

However, the fundamental problem for realising the aspiration to embody ethics into the culture of banks to assist in overcoming the problems exemplified above[148] is that chief executives of banks are not appointed for their ethical skills. They are appointed because they increase the profits of the bank and dividends to shareholders. In their time, Sir Fred Goodwin (RBS), Richard S. Fuld of Lehman Brothers and[149] John Varley[150] of Barclays Bank were the "darlings" of the industry, because of the profits they distributed to their shareholders. The shareholders paid little attention to the ethics of those leaders or disregarded them, because their focus was on the profits they made. Not surprisingly, great leaders in banks are generally considered by shareholders to be those who maximise shareholder value and RoE rather than those who may be too 'pious' and thus achieve a lower return on shareholder equity.

3.10 The Role of Organisational Culture in Ethical Decision-Making

For those who suggest that there is a moral or ethical alternative or an addition to regulation to prevent the dominance of the RoE concept, the avenue of change in Organisational Behaviour Theory lies, arguably, in the concept of "Ethical Business Culture".[151] Official ethical goals are found, for example, in business documentation.

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[147] The Law and Ethics in Finance Project started work in 2013 and consisted of a group with expertise in the law, finance and ethics.[148] See the section 3.3 Unethical Behaviour above.

[148] See the section 3.3 Unethical Behaviour above.

[149] Richard S. Fuld produced profits every year for Lehman brothers until its bankruptcy in 2008 including one of $4.7 billion in 2007, the year of its demise. He was nicknamed the "gorilla" because of his competitiveness. Whilst the bank had a code of conduct it appears that it was not used as a strategic document (Stevens & Buechler, 2013).

[150] John Varley was the chief executive of Barclays bank until 2010 and who signed the Barclays code of conduct which included the statement "We expect every Barclays' employee, and others who work on our behalf, to conduct themselves according to consistently high professional and ethical standards." Mr Varley is currently being prosecuted for offences arising out of the Barclays and Qatar rescue during the financial crisis 2007-2008 (Auger, 2013).

[151] An "Ethical Business Culture" involves a bank keeping to its obligations and not deceiving or lying to others. It should also have a Code of Conduct describing how its employees will behave and the quality standards of its product or service. It will exhibit openness, as an ethical business has nothing to hide other than, perhaps, its competitive strategies. Finally, an ethical business is judged by its treatment of its staff and others and seeks to enhance its connection with them.

However, a bank's operative goals (goals that banks use on a day-to-day basis) are the adaption of formal ethical standards into actual behaviours, but, as has been seen above, they are not always adhered to.[152] Moreover, corporate culture can be a double-edged sword if the culture of a financial institution is a purely short-term business culture, that is, one seeking to maximise profit above all else. It is then this very culture that will lead to ethical problems (Hardowar, 2017). When the headline "bank returns to profit" or "bank achieves record profits" gains the readership of banks' plaudits, unethical behaviour can remain hidden until a future date.

Businesses are constantly adjusting to changes in their environment. This results in a tension between official goals ("espoused values"), which describe the business's mission, and the business's operative goals. The competing tensions affect the way decisions are made and how the business's competing goals are reconciled. Espoused values are found in an organisation's mission statement and official reports (Fichter, 2016). However, as can be seen from the expressed core values of the major banks listed at the commencement of this chapter, what an organisation says is not the same as what an organisation actually does (Schein, 2004). An expression of core values is mainly for public relations purposes. What is expected by shareholders and facilitated by bankers who are rewarded by their share profits made by the bank, is the maximum return on their shareholding, whilst at the same time seeking to minimise accusations that they are behaving unethically.

A further complication for a bank may lie with its history as an organisation. This occurs when different sections of a company may have different subsidiaries each with their own ethical standards. The challenge for an organisation is to "close the gap" between its articulated standards and actual practice. The frequently changing operational goals, which are typical in the finance industry, may affect the quality of an individual's EDM (ethical decision-making), and the lack of certainty of operating goals makes it harder to identify problems within the bank. In addition, defensive routines come to the fore when employees are faced with challenging situations. These may prevent constructive internal debate and often cause escalating errors (Fichter, 2016). With such conflicting ethical considerations, an easier path is to pursue the more obvious objective of maximising shareholder value.

[152] For example: Lehman Bros (Stevens & Buechler, 2013).

A further suggestion for cultural change in order to embed a change in ethical standards is the establishment of a banking profession or professions.[153] The rationale for this is that professions observe ethics that go further than legal obligations as it is seen as a professional duty to serve the client. Professions such as the law, medicine or education exemplify not just a duty to the clients, patients or pupils but also have an understanding of the importance of a duty to the system as a whole, for example, the Hippocratic Oath, or the duty of a lawyer to the court (Law and Ethics in Finance Project, 2015).

The Parliamentary Commission on Banking Standards (PCBS), (Parliamentary Commission on Banking, 2013) was set up to report on professional standards and culture in banks. Whilst it recognised the changes in the banking industry as a result of technology, globalisation and forms of remuneration as factors which restrained individual behaviour in banking culture, it failed to mention the former Institute of Bankers. In fact, the Commission recommended a professional body for bankers, which it believed would be a significant factor in itself, and act as a tool for cultural change. Nevertheless, it recognised that such a professional body could be at least a generation away. If banking were to be considered as a profession, the question arises of "who is the client?" In the case of the other professions mentioned, the overriding duty is to the patient, pupil or client (with companion duties to a professional body, education authority or the court). In the case of a bank, is the duty to the employer, the bank shareholder to maximise RoE or to the customer? This is particularly important where the financial services are proprietary[154] and a banker is trading on behalf of the bank itself, rather than on behalf of a customer. Given the pressures to maximise profits, it is difficult to see how there would not be a conflict between professional duty and shareholder profit in a joint-stock bank.[155]

The culture of organisations and, in particular of banks, often fails because it only looks at financial reward:

[153] In 1979 the President of the Chartered Institute of Bankers expressed the objective that the role of the Institute was to equip bankers to become better qualified and occupy more senior positions within their profession as quoted in a book for the Institute's 100th anniversary in which "profession" featured in the book title (Green, 1979, p. 154). It will be noted that this speech was made prior to the "Big Bang" and before Charles Green was writing about the future of ethics in banking (Green, 1989). The idea that banking was a profession has declined since that time and the Chartered Institute of Bankers, having been the Institute of Financial Services, is now the London Institute for Banking and Finance. It is purely an organisation for giving tuition and does not speak of any professional duty.

[154] Proprietary trading is when a trader trades in stocks, bonds, currencies, commodities, their derivatives, or other financial instruments, with the banks owning money rather than the a depositors' cash, so as to profit itself.

[155] However, if there were an alternative banking structure as suggested in section 4.4.4 below, the same conflict-of-interest may not arise.

> “Organisations often punish unethical behaviour but do not reward those who ‘‘do the right thing.’’ Indeed, ethical behaviour is assumed as part of the job. Organisations already understand the power of incentives to drive behaviour and should consider using tools such as compensation, promotion, and recognition to celebrate actions that support and strengthen an organization’s ethical standards” (Group of Thirty, 2015).

An example of how good conduct is not rewarded can be seen in how bankers are rewarded for bringing in high-quality/low-risk new clients, but received no recognition if they decline lower-quality/high-risk clients (Hill, 2012). However, as the profit motive and the return for shareholders is the major concern of a joint-stock bank,[156] it is difficult to envisage a situation where bank employees could be rewarded for *not* bringing in business when pressure is put on them to do so in order to receive their bonuses. Research makes clear that cultural processes have to be aligned with goals and formal mechanisms to emphasise required behaviour and gives the example of bankers’ incentive schemes (Fichter, 2016); (Hill 2012). This also relates back to the statement by Bank Governor Tarullo, referred to above,[157] in which he asked whether bank employees understood their job was to maximise profits provided they remained lawful, or did they believe they were working within a broader set of principles (Tarullo, 2014). It appears that the answer to his rhetorical question is that EDM in its basic form is insufficient to improve bankers’ behaviour, which has led other writers to suggest improvements to the concept of EDM.

However, as bank employees fall into Kohlberg's category of “conventional level-conformity” and by working in a large hierarchical organisation, they would follow behaviour that is accepted by others, either superiors or long-time co-workers within the bank. Attempts to introduce Ethical Decision-Making or a changed culture will always confront the problem of RoE; a joint-stock bank’s legal objective is to return profit for shareholders. Whatever soothing ethical words a bank leadership may speak, as Karen Ho observed, bank employees are judged on the income generated for shareholders (Ho, 2009); they will not be judged on their words but on the profits they make. Accordingly, attempts to embed an ethical culture provide moral strength or ethical learning will always

[156] A Joint-Stock Bank is a bank which is a public limited company and which issue shares that are owned by investors rather than by an institution or government as a mutual.

[157] Statement of Bank Governor Tarullo. See section 3.10 The Role of Organisational Culture in Ethical Decision-Making.

be subject to the ultimate test of how much profit the bank has made.

3.11 Conclusions: Returning to the Limits Regulation

The second chapter considered whether regulation would be able to solve the problems of banks. It concluded that banks sought to avoid, manipulate or change regulation with the purpose of enabling the maximisation profits. This chapter has considered whether a change in culture could embed ethics and moral behaviour to ensure that banks not only followed the letter of regulation, but also the intent of that regulation for the protection and well-being of customers and society as a whole.

This chapter has reviewed the limits of regulation: the failure to control bankers because of a failed ethos, skewed remuneration and bonus schemes, protection against financial risk by the limited liability of the companies for which they work and the TBTF position of many banks. An imbalance of resources between the wealthy banks and public sector funded regulators has added to the problems, as has the inability to regulate all banking behaviour and keep up with the financial structures created by bankers. In addition, banks have sought to ‘say the right thing’ in expressing core values and issuing codes of conduct, while continuing to put profit first in order to provide their shareholders with RoE. The continuing search for legal loopholes in regulations and the use of considerable resources to pay lobbyists to get the regulations changed shows that the commitment is to maximising profit, rather than ethical or moral concerns.

Externalising risk and searching for loopholes in regulation had become an object of pride, with the justification that “everybody’s doing it" and by a sub-community where bankers work long hours together and are detached from the rest of society developing a "silo mentality" (Hill, 2012); (Tett, 2015). Regulation was also "significantly hindered" by the problem of the ethos of banking and the realisation that this was not just an issue confined to rogue bankers, but an industry-wide problem. According to this assessment it is not a question of a few “bad apples” but of the “apple barrel”, meaning that it is not just random employees who cause the problem, but it is the problem running through the whole organisation (Hill, 2012).

This chapter then assessed ways that different disciplines had considered that failure of ethics and morality. Ideas from anthropology, organisational and social psychology, including those of TBTF, short-termism and the culture of insecurity together with the problem of excessive bonuses were examined. In addition, the psychology of bankers was considered. It argued that reliance on changes in culture fail to take into account the behaviour of individuals, their desire for financial reward and the high love-of-money. Next the relevance and impact of social science theories including Cognitive Moral Development and Ethical Decision-Making ("EDM"), as well as theories of Organisational Development and Adult Learning were considered, as were recommendations for changes that could improve ethics in banking.

The argument made in this chapter is that whilst these theories explain different aspects of bankers' behaviour, and while some of the suggestions and recommendations had considerable merit, it is unlikely that on their own or in combination, any of them will succeed. The drivers are fundamentally too great in the existing banking culture, in which all the major banks are joint-stock banks (as are almost all UK financial institutions). Other forms of corporate organisations (for example, public, cooperative or mutual) form such a small part of the market that their influence is insignificant. In the existing system the pressures from shareholders to maximise profit and to achieve the best RoE, are always stronger than good intentions to improve ethical leadership and moral business culture. In the end, bankers regard their duty to their shareholders and because of the remuneration system, which is linked to profits; they have a joint enterprise with the shareholders. As long as the goal is one of maximising return on shareholdings, ethical behaviour will always take second place.

Combining the "soft" tools of ethics, leadership or culture to the inherent problems in banking identified by the different disciplines in order to effect changes in bankers' behaviour is unlikely to succeed. What is required is a totally new approach. In the concluding chapter, opportunities for further research into the changes in the legal structure of banks will be considered.

4. Chapter 4: Conclusions and proposals for future Research

> Polonius: “Neither a borrower nor a lender be, for loan oft loses both itself, and friend and borrowing dulls the edge of husbandry (Shakespeare, 1599–1601).

> “Without reform of the financial system, another crisis is certain, and the failure ... to tackle the disequilibrium in the world economy makes it likely that it will come sooner rather than later” (King, 2010).

4.1 Banking - the continuing problem

Over 400 years separated the above quotations and yet they are linked. In the first, Polonius is warning his over-adventurous son, Laertes, who is about to leave for a young man’s education in Paris. No doubt, Polonius was concerned about the expense. However, the social context for this comment by Polonius in Shakespeare's *Hamlet* was the extravagance in the late Elizabethan court where the aristocracy were borrowing to spend and having to sell off their lands and manors to pay for their extravagance (Stone, 1952).

Four hundred years later, the Financial Crisis 2007-2008 was also preceded by a boom in consumer spending and borrowing. The difference, however, was that the 16th century Elizabethan extravagance was confined to a small section of society, whereas in the period before 2007-2008, financialisation, as described above[158] led to far higher levels of spending and borrowing by those living beyond their means. The effect of over borrowing by the public led to the Financial Crisis 2007-2008, yet the passage of time has brought a forgetfulness of such concerns. The temptations to consumers of cheap car credit and low-rate mortgages have led personal borrowing to rise to record levels (Eliott, 2017). The former Governor of the Bank of England, Mervyn King, writes that another financial crisis is certain to come in the not too distant future ((King, 2016, p. 334 of 432).The credit boom cannot be controlled by raising interest rates, through fear that the recovery from the Financial Crisis 2007-2008 will not be sustained (King, 2016, p. 335 of 432), or through

[158] See section 1.3 Financialisation and Return on Equity (“RoE”)above.

large state subventions to support TBTF banks as it only "perpetuates an underlying disequilibrium" (King, 2016, p. 367). King maintains:

> "Only a fundamental rethink of how we, as a society, organise our system of money and banking will prevent a repetition of the crisis that we experienced in 2008" (King, 2016, p. 287) .

In Chapter 1, the importance of banks in facilitating a growing economy and the historic problem the banks have, in that they "borrow short and lend long", was examined. A new problem was identified, namely, the growth of financialisation and demands of shareholders for RoE. This exacerbated the historic problem, as the more the bank can lend the greater the RoE. Such lending is fuelled by a human instinct to overconsume.[159] However, the effects of financialisation, which led to a failure of wage growth, resulted in the average worker, disappointed at their stagnant living standards, using easy credit to purchase goods and services promoted to improve their lifestyles. In addition, such pressures to produce RoE for their shareholders, incentivised bankers, who, in turn, through their bonuses, shared in the profits that were made and encouraged them to act in ways that were illegal or unethical.

This dissertation has proposed that the two suggestions for dealing with the problems caused by banks were further regulation and improvement in the ethics and culture of banks and bankers. This dissertation has further proposed that neither improvements in regulation nor ethics, singularly or together, would be successful because of the overriding pressure from shareholders to maximise profits and achieve the highest RoE.

Chapter 2 considered regulation, with particular reference to capital adequacy. It was shown that by increasing the amount of share capital a bank had to hold to meet customers' calls for return of their deposits, there was an adverse effect on the ability to produce higher returns on equity. It was further shown that banks, by way of lobbying, sought to reduce the amount that had to be held by virtue of the Basel accords (and in particular

[159]It has been suggested that evolution has not developed humans as hunter gatherers, where there were shortages and what was found or hunted was consumed at once. Today's consumerist society -where credit can be obtained easily- allows for short-term consumption, where the brain cannot control the desire for short-term gratification (Whybrow, 2015); (Sterling, 2016); (Higginson, et al., 2016).

Basel III). Further, it was demonstrated that the importance of RoE gave bankers the opportunity to ‘adjust’ risk weighted assets by giving them a lower risk rating than should otherwise be the case. Similarly, there was pressure not to write off bad loans, because it would affect capital adequacy. Finally, by using off balance sheet entities, bankers could reduce the loans on their books and, therefore, lend more with the same amount of capital. The question was posed whether reform of bankers’ conduct would overcome such problems

In Chapter 3, the question was asked as to whether steps that have been taken to improve the conduct of bankers through embedding ethics, cultural change or better leadership would be successful. The concept of Ethical Decision Making as propounded by Kohlberg was considered, together with social science additions, such as Organisational Theory. The dissertation demonstrated that, notwithstanding the work undertaken to improve the culture within banking organisations, the fundamental purpose of such organisations remained. As joint-stock banks, their criteria for success are not how ethical their conduct is but how much they contribute to profits available to shareholders. It could not be demonstrated that changes in culture had overcome the need for RoE to take precedence. In fact, in relation to the question of leadership it was shown that the bankers who are most highly regarded are those producing the most profits.

Accordingly, neither greater regulation nor enhanced ethics will be successful in controlling the excesses of banks because of the inherent pressure of RoE. Mervyn King is not the only voice suggesting that there will be another banking crisis. The Bank of England itself is saying, "History shows that there are two things we can be sure of when it comes to financial crises: there will be another one, and the next one won’t be the same as the last" (Bank of England Knowledge Bank , 2017).

4.2 Suggestions for reform

If, as suggested above, neither regulation nor embedding a culture of ethics will succeed in resolving the problems of banks and, if as the former Governor of the Bank of England, Mervyn King suggests, another crisis is inevitable, what is suggested to address the problem? Mervyn King suggested that central banks should become "Pawnbroker(s) for all Seasons" (King, 2010, p. 268). In effect, this is an extension of the call to end fractional banking (narrow banking") referred to above (section 2.5) [160]. Banks, in effect, would have to pledge their assets in advance to the central bank and would then be able to lend only up to the value that the central bank placed on those assets. The Bank of England speaks of its own reforms. These are, firstly, stress tests[161], secondly, a £85,000 Deposit Guarantee Scheme operated by the Financial Services Compensation Scheme and which protects customers' bank deposits, thirdly a form of ring fencing is being introduced.[162] The Bank of England also now boasts that as there is a living will scheme for banks: "the general public will not pay the price when things go wrong. In the new set-up, there is no need for bailouts" (Bank of England Knowledge Bank , 2017).

By the Bank of England's admission there will be further banking crises and the precautions that it is taking only deal with the symptoms (the excesses of banks) rather than the cause (the desire for maximum RoE). After all, for a century prior to Northern Rock there had not been a bank run.

It is suggested that the limited liability of banks encourages risky behaviour by bankers and that it could be replaced by 'covenant banking' This involves senior bankers in a bank pledging to make a specific payment in the event of loss, or pledge assessable stock which would be forfeited in the event of a bank's default (Hill and Painter, 2015, Kindle locations 1838, 2374 & 2918) . Such proposals do not consider the possibility of indemnities from the bank or insurance schemes to protect their managers against any claims. Accordingly, any such proposals would need careful consideration and further research.

This dissertation suggests that rather than expecting that regulation or ethics within the existing structure of a joint-stock bank will be successful in dealing with the problems of banks, alternative legal structures should be considered, as it is the pressure for RoE that continues to be a cause of problems of banks as well as problematic behaviour of bankers.

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[160] See section 2.5 above.

[161] See footnote 136 above.

[162] Ring-fencing requires a bank to separate its investment and trading division from its retail banking, which was a central recommendation of the Vickers report (Independent Commission on Banking, 2011). Deposits from customers and small businesses would be within the ring fenced (retail) part of the bank and protected from the proprietary trading activities of the investment bank section. However, as indicated in section 2.4 above, the banks lobbied to minimise the effects of ring fencing. They were allowed to share profits, transact and cross-sell products between the ring- fenced and the non-ring-fenced sections and intragroup lending. The result was described "as lenient as the banks could reasonably have hoped" (Binham, 2015); (Smith, 2015).

It is accepted that the existing joint-stock Banks will not disappear, but that by the growth of a far larger not-for-profit sector within banking, that sector may be able to control the excesses of joint-stock banks that result from the pressure for RoE. Further research should investigate whether customers would be attracted to banks that conduct themselves ethically[163] (Ernst & Young, 2010). Secondly, such research would consider whether - if the level of conduct improves in one part of the banking industry - it is likely to affect other participants and thirdly, whether as existing research shows, a less expensive not-for-profit sector would attract the support of sufficient customers to make it able to compete with the existing, profit-driven banks (Casu, 2015). Finally, alternative legal structures for banks would be opposed by the lobbyists acting on behalf of joint-stock banks. They would, in principle, be subject to takeovers and the desire of those in the not-for-profit banking sector would look enviously at the remuneration of those in the joint-stock banks. Accordingly, research would have to be undertaken to consider ways of ensuring that such alternative legal structures did not themselves convert to becoming joint-stock banks or being taken over by them.

4.3 Why not rely on shareholder control?

In Chapter 2, it was shown that the use of regulation in controlling banks was undermined by the predominant effect of maximising RoE/shareholder value. In Chapter 3, it was shown that the use of ethics, leadership and organisational theory was also unsuccessful, because of the same pressure for RoE/shareholder value, which ultimately, always overrides moral criteria. If the pressure to maximise RoE /shareholder value is the major influence, it must be considered whether shareholders, who are the beneficiaries of RoE, are able to control bankers. If they are able to do so, then there would be no need to consider alternative structures in order to overcome the problems of banks and bankers.

There is a view that if the shareholders are passive and that if they were to be less passive they would be able to exercise control over directors and prevent the problems that led to the Financial Crisis 2007-2008 (Dignam, 2013, p. 640); (Stout, 2007).

However, this view of shareholder involvement is flawed for several reasons. Firstly, the legal nature of a "share" and therefore the rights of a "shareholder", are difficult to define.

[163] a report prepared by Ernst and Young found that as a result of the Financial Crisis 2007-2008, 45% of Europeans have lost trust in their bankers. This rose to 56% in the UK, while 60% of those in Germany said the financial crisis had made no difference in their opinion and trust of their banks. A number of respondents said that lack of trust and ethics were a consideration in any decision to change banks (Ernst & Young, 2010, p. 5 and 15).

If a company were to be wound up the shareholders would receive a payment, provided the bank was solvent. However, holding shares in a company does not give a right to corporate assets (Ireland, 1999). There is an ambiguity between the corporate shareholder having a status similar to that of the debenture holder or a "rentier" and the view that shareholders have "ownership". It is also misleading to consider that the relationship between directors and shareholders is that of agent and principal (Ireland, 1999, p. 12). Having let go of a company's assets, it is argued that shareholders have given up the right to have the company act in only the shareholders' interests (Ireland, 1999, p. 25). Ireland argues that corporations should not be regarded as being capable of being *owned by* shareholders as they are in fact a network of personal and business relationships with a common social purpose. Accordingly, increased shareholder activity, would look to the selfish interests of maximising shareholder value rather than those of society. It must therefore be asked if increasing shareholder control would assist any more in controlling banks than the promotion of shareholder interests in maximising RoE (Ireland, 1999).

Secondly, the view that there could be 'shareholder stewardship' is a misinterpretation, because it requires a perhaps out-dated view that shareholders consist of 'ordinary' people and institutional investors (insurance companies and pension funds) who take a long-term view of their involvement in providing stewardship of their companies (Ireland, 1999, p. 19); (Dignam, 2013, p. 640). In fact, research has shown that from 2005 most of the shareholders were no longer the traditional institutional investors and private individuals, but were passive shareholders from overseas; secondly, they were often very short-term holders of shares comprising of activist hedge funds, or traders making profits on the volatility of shares and computers using algorithms to trade (Dignam, 2013). Indeed, the effect of promoting greater shareholder powers will be the exacerbation of pressures for short-term returns by taking greater risks (Admati, 2017, p. 138).

Whilst prior to financialisation, directors would often consider that they ran companies not just for their shareholders but also for other stakeholders, such as employees and the wider community, this has been replaced by the view that company boards have a primary duty to current shareholders to the exclusion of other stakeholders, which when combined with incentivised remuneration packages makes it a more desirable option for directors (Dignam, 2013). The interests of directors, senior managers and traders then combine to achieve the maximisation of shareholder value/RoE, and thus the directors' prime aim becomes seeking short-term advantage, increasing risk and reducing costs (Talbot, 2013).

In this way, closer shareholder involvement increases the problems of banks by demanding a short-term maximisation of RoE, rather than seeking to control them through long-term shareholder stewardship.

4.4 Could banks with alternative legal structures help? Opportunities for future research

If neither regulation nor ethics and cultural change are successful in dealing with the problems of banks and the behaviour of bankers, because of the primary pressure of maximising shareholder value in a joint stock bank, is there the possibility of having other legal structures that are not subject to the pressures of maximising shareholder value?

Using Mintzberg's theory of organisational configurations framework[164] (Mintzberg, 1992), banks can be seen as organisations which are "a divisionalised form." They have set procedures, tight control systems and their key parts use standardised outputs as a prime method of coordination which in many ways, resemble a bureaucracy. This structure is likely to be the same whether a bank is joint-stock with shareholders or with another form of ownership. Further research could be directed at looking at such alternative structures to see whether they overcome the fundamental problem identified in this dissertation that the requirement to maximise shareholder value/RoE is the determinant force in a joint-stock bank. If such alternative banks could overcome the problem of maximising shareholder value, so that the behaviour of those banks is to act responsibly, ethically and to not just adhere to the letter but the spirit of regulations, then it is suggested that not only will customers be drawn to them, but if they constitute a large enough section of the banking market then their positive and ethical influence would affect other banks and bankers.

Moreover, it is unlikely that there will be a nationalisation of existing banks, even if it were to be considered desirable. Indeed, when the UK government had the opportunity to nationalise banks during the Financial Crisis of 2007-2008, it initially declined, ultimately only doing so at arm’s length through UK Financial Investments Limited. In any event, the process of financialisation has given banks lobbying power and importance within the

[164] In the ‘Organizational Configurations Framework’ business management theorist Henry Mintzberg classified organisational structures into five types: The entrepreneurial organisation, the machine organisation (e.g. a bureaucracy), the professional organisation (e.g. a law firm), the divisional (diversified) organisation (a central autonomous HQ) and finally, the innovative organisation ("adhocracy" e.g. a software company). (Mintzberg, 1992).

financial structure to ensure that this would be too difficult politically. In effect, the banking cartel that existed for most of the 20th century gave the state a hegemonic relationship with banks, so all that was required was the 'raising an eyebrow by the Governor of the Bank of England' (Binham, 2015) to gain compliance. However, Bank lending is about the assessment of the risk of lending. In the old banking cartel, bank managers were reluctant to take risks. In alternative legal structures, there would be no personal incentive for bankers to take risks, because their remuneration would be salaried rather than linked to the profits that come from taking risks. In addition, in an institution where caution was valued, they would be criticised for a bad lending decision. This would further deter risk taking to assist business ventures that *might* become successful, but would not have the opportunity without a lender taking a risk on their behalf. Accordingly, future research would have to consider a balance between risk taking, which may provide advantages in supporting lending ventures which may initially prove unattractive, and avoidance of the problems that banks have experienced.

Whilst there were suggestions that there could be alternative ways of dealing with the return of shares held by UK Financial Investments Ltd other than by sale of shares (Hope, 2011), the final shares in Lloyds Bank have been sold (Treanor, 2017) and the Royal Bank of Scotland shares are waiting to be sold at an appropriate time (N M Rothschild & Sons Limited, 2015). Given that the UK Government has tended to defer to the City and the pressure of those who believe in maximising RoE, it is, perhaps, not surprising that this was the outcome (Froud, 2010); (Froud, 2011); (Bryan & al, 2012).

In order to overcome the problems that were found in the banking system, the UK Parliament (H of C Treasury Committee, 2011) recommended that there should be more competition. However, such competition was not suggested to be outside of the existing joint-stock bank model, which as, has been demonstrated above is not subject to the pressures to maximise RoE. Virgin Money has taken over the remnants Northern Rock (Virgin Money, 2012) (Fantato, 2017). Lloyds Bank has hived off a number of its former branches into a new TSB which it sold to Banc Sabadell (Banc Sabadell, 2015). A proposal by Royal Bank of Scotland to divest Williams & Glyn's was abandoned following concerns about Brexit (BBC News, 2017). The Green Investment Bank was established with government support in 2012 (DTI, 2012) with the intention of raising private sector money to fund environmentally friendly private sector projects. Eventually, it was sold to an Australian financial services conglomerate, Macquarie Group Limited. Each of these banks has been taken over by existing joint-stock companies, so their joint-stock shareholder model is no different from existing banks.

There has been some academic consideration of the possibility of alternative models to those of joint-stock banks. CRESC[165] have undertaken work considering the failure of existing joint-stock banks. Using "Critical Business Model Analysis"[166] (Froud, et al., 2016). The study considered the business models of banks as opposed to the markets in which they operated, which were considered to be uncompetitive. The analysis undertaken considered the conflicting interests between shareholders who required RoE, and effects on customers (for example, mis-selling of financial products, unclear charges and cross subsidies). The study recognised that maximising returns for shareholder value/RoE which focused on short-term indicative or on stock market pricing of shares, were "entrenched" and made a general suggestion that alternative models could be considered, but no specific recommendations were made as to what such alternative banking models might be. The study confined itself to making recommendations to change the manner in which such joint-stock banks should act. Accordingly, the work recognised the problem but did not consider the solution of alternative corporate banking structures.

While such research could look at, as yet, unidentified models, many of the alternative models for banking structures have, as will be seen below, already exist. It should be considered whether such alternative models not only have a cooperative/neutral/non-profit-making organisational basis, but how they can compete in a market where they are likely to start smaller when facing the "Big 4"[167]. Ultimately, because of the problems of "new entrants" having sufficient capital to run a business, without the considerations of capital required to meet regulatory purposes, the "Big 4" are likely to win and the smaller banks will either collapse or in turn, sell their shares to the hegemonic Big 4 banks.

This dissertation suggests that there should be further research to consider whether banking structures with different ownership models to those of joint-stock banks could overcome the problem of the predominant pressure to maximise shareholder value. There are, however, limited opportunities to consider new structures that have been created since the Financial Crisis 2007-2008. There are a number of new "Challenger Banks" which have

[165] Centre for Research in Socio-Cultural Change, University of Manchester
[166] Critical Business Model analysis is a generally accepted a generally accepted way of analysing challenges choice and development of organisations (Baden-Fuller & Morgan, 2010).
[167] Lloyds, Barclays, HSBC, Royal Bank of Scotland.

been established since 2010. Currently, these include Atom Bank, Metro Bank, Monese, Monzo and Starling Bank. The best known, Metro Bank, seeks to distinguish itself by offering seven-day week branch banking. Some offer banking services that are limited to smartphone applications. If these banks were to grow as large as the "Big 4" then their model is identical to those of the existing banks and there is nothing to suggest that they would become anything different. It is hard to believe that the owners of such banks are not building them to the stage where they cannot be or bought out by a larger financial institution as the objective of the shareholders is to get the best return on their shareholdings. The history of new entrants into banking has been problematic, as the transformation of building societies to banks has shown. It was, after all, the attempt by the UK Government to create competition to the major UK banks following the Building Societies Act, 1986 that led to the demutualisation of Building Societies. However, this was unsuccessful, as they could not compete with the “Big 4”. Either those 1980s building societies became challenger banks and were taken over by competitors or failed in the Financial Crisis 2007-2008. (Froud, et al., 2016); (Klimecki & Willmott, 2009).

As illustrated above, banks continue to seek maximisation of RoE, because that is the accepted purpose of such joint-stock banks and it binds the senior employees in profit-making schemes with maximising shareholder value for mutual wealth creation., It is proposed that an area for further research should thus be alternative banking structures that are not dependent on the need to provide shareholders with maximum profits and RoE.

However, before the rise of financialisation, alternative (not-for-profit) financial institutions were important parts of the banking system. Building Societies developed from the 18th century as a mutual movement.[168] However from more than 2000 building societies at the start of the 20th century only 44 remain (Casu, 2015). Building societies were given increased powers through the 1980s, so that they could compete and offer similar services to banks (Marshall, 1997). They also were given the opportunity to demutualise and either issue shares themselves or merge with other institutions, which was a course many of them took (Tayler, 2003). Following the Financial Crisis of 2007-2008 a survey showed that the remaining building societies were regarded more favourably by customers than banks and inspired more trust (Atkinson, 2011).

[168] For definition of “mutual” see footnote 111.

Nevertheless, during the Financial Crisis 2007-2008 a number of building societies encountered difficulties. N & P were involved in a mis-selling scandal. The Nationwide Building Society[169] had to take on the three failing societies and others had to merge (Womack, 2010).The Britannia Building Society, which had a public sector link through NALGO[170] was taken over by the Co-operative Bank and led to the Co-op Bank's downfall (Kelly, 2014). It appears that their problems arose largely because they had left their traditional borrowing and lending patterns, which followed the deregulation permitted by the Building Societies Act 1986. Building Societies competed with banks and in the early 1990s prior to demutualisation, achieved RoE at least as great as those of the joint-stock banks allowing them to build up reserves greater than would have been required for regulatory purposes or to assist with future growth (Tayler, 2003). It was suggested that this was a strategy to enhance the value in preparation for demutualisation. (Llewellyn & Holmes, 1991). The conduct of building society managers was also called into question as it was suggested that they looked favourably on demutualisation as they believed it would increase their remuneration and give them share options. Further research is required to consider whether such problems arose from the desire to see themselves as competitors to joint-stock banks or whether such conduct arose because the building society managers were looking to future RoE, even before demutualisation. It may be that the problem itself stems from the predominance of RoE; the course followed by these building societies and their senior managers may be a reflection of the predominant ethos of RoE, resulting from the dominance of the joint-stock banks and the rewards received by their managers in comparison with their building society counterparts together with the pressures towards Financialisation. Future research would have to consider how this dichotomy could be addressed. In addition, any further research would have to address the problem of who ensures that the any new mutual bank would not fall prey to "carpetbaggers"[171].

An alternative business structure to those of joint-stock banks (and of Building Societies) was the Trustee Savings Bank (the "TSB"). The TSB set up as many local banks from the

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169 The Nationwide Building Society was known as the Co-operative Permanent Building Society until 1970 when it changed its name.

170 "NALGO": National Association of Local Government Officers (a trade union)

171 "Carpetbagger": a term originally from the post-Civil War period of the United States. Carpetbaggers were from the northern states and came south to take advantage of the defeated Confederacy. There were so named because they kept luggage made out of recycled carpet. In the period of demutualisation of building societies 'carpetbaggers' became members of mutual building societies in order to vote to make them demutualise and gain windfall profits. The BBC detailed website article contains numerous interviews and information about how building societies attempted to counteract carpet bagging (BBC, 1999).

beginning of the 19th century with cooperative and philanthropic principles.[172] Its customers were, generally, not wealthy, but were craftsmen and workers. The monies paid into the TSBs were deposited into government stock through the Bank of England and were safe for borrowers who had little financial experience. By the middle of the 20th century the combined Trustee Savings Bank movement was the size of one of the four clearing banks (Marshall, 1985). In Germany, however, the equivalent of the TSB, still continues as Sparkasse and Landesbanken in public ownership (Carnevali, 2005). It is also suggested by this dissertation that the German system of banking requires further comparative research [173] as it is estimated that some 82% of banking organisations with 44% of banking assets are not required to maximise shareholder value (Hufner, 2010). Research would examine whether the predominance of such public banks in Germany influences the behaviour of joint-stock banks. It is clear from the German example that alternative banking structures can exist and form a sizeable part of a country's banking system (Hufner, 2010). Indeed, a comparison between banking in Germany and Britain and comparisons of the lending to business by banks in each country would be an area for further research as it is suggested that the German model has been of greater advantage to German business (Carnevali, 2005).

The 1960s and 1970s saw a number of government initiatives in banking that were not owned by joint-stock shareholders, including the creation of National Girobank as part of the General Post Office in 1968, from the Post Office Savings Bank.[174] Although public sector organisations do not have a good reputation for being innovative, National Girobank

[172] The TSB guaranteed depositors' savings which could be fully withdrawn with interest. The funds held by the TSB were transferred to the Bank of England to service the National Debt, which allowed the guarantee to be given to depositors. The "Trustees" of the TSB were voluntary and received no financial benefit (Batiz-Lazo & Maixe-Altes, 2006).

[173] Banks in Germany fall into three categories. Firstly, there are joint-stock banks such as Commerzbank or Deutsche Bank, which comprise about 33% of banking business volume and 1/10 of banking institutions in Germany. Secondly, there are cooperative banks, in which each member has one vote irrespective of the amount saved in the cooperative bank. Cooperative banks are the largest number of banking institutions and have about 10% volume of banking business in Germany. Finally, there are the publicly owned banks Sparkasse (savings banks) and Landesbanken (publicly owned regional wholesale banks), which comprise some 33% of banking volume in Germany. German joint-stock banks are not permitted to acquire public banks. (Hufner, 2010). Sparkasse play a particularly important role in the German economy in lending to small businesses (Carnevali, 2005, p. 146); (Schulte, 2016).

[174] The first public sector bank to be established in over a century, it was the hope of the founders of the National Giro that it would enable many more people, especially those of restricted means to have banking facilities. (Davies G, 2002) (Kindle location 8081) In addition it was hoped that the Giro would become the country's main payment and clearing system. Initially loss-making, by the end of the 1970's, 25% of all cash deposits at banks were through the National Girobank and, by 1985 it had over two million customers. It was sold, as a UK government privatisation measure, to the Alliance & Leicester Building Society in 1990. Alliance & Leicester Building Society subsequently demutualised and following difficulties in the financial crisis 2007-2008 Alliance & Leicester was acquired by Banco Santander.

was the first bank to offer interest bearing current accounts, the first bank to offer a telephone banking service (before First Direct) and was at the forefront of computerisation using Optical Character Reading. Not only was it a bank that had no associated scandal, but was also a forerunner in advancing technology and leading joint-stock banks in service to customers.

Some banks established in the 1960s and 70s and are now almost forgotten. Finance for Industry Ltd was established by the UK government to provide medium-term finance to companies who had difficulty raising funds through the capital markets. A companion venture, Equity Capital for Industry Ltd, was set up in 1976 to be an 'equity bank' (Thomas, 2013). Neither of these public-sector ventures survived. Such organisations were not ones required to maximise shareholder value and could be examined to see whether their structures could be replicated and, if so, whether they would have a beneficial effect on improving banker behaviour. It is suggested that these historical examples, together with the transactions of the Committee to Review the Functioning of Financial Institutions (Wilson Committee, 1975) would be worthwhile areas of research as they would show thinking on banking reform prior to the onset of financialisation (Moore, 1981). They would show that alternative models for banking other than the joint-stock bank have existed and have, in the case of the TSB and National Girobank, become of a sufficient size to compete with 'Big 4'. Research will show why the pressures of financialisation and neo-Liberalism resulted in these non-profit maximising banks being privatised/demutualised and how their existence was in competition to the joint-stock banks and how they set a benchmark for the conduct of joint-stock banks. Further research will be necessary to consider how, if similar banks were to be established,[175] they could avoid the pressures of financialisation to privatise/demutualise again.

The joint-stock banks lobbied against the formation of National Girobank in the 1960s (Davies G, 2002). It is unlikely that such banks would be willing to support new entrants on either a public or mutual/cooperative basis. Any research would have to consider how any such new entrants could be protected from the power of the existing joint-stock banks.

[175] In addition, there are other forms of banking/savings institutions. For example, Credit unions are small mutual organisations that work as cooperatives. They assist members with financial matters particularly small-scale savings and borrowings. There are currently 424 listed credit unions. Credit unions are small but provide a mutual and socially useful service compared to credit card borrowing and payday loans.

History provides models of alternative legal structures of banks, other than the joint-stock model, that had a sizeable market share. They may have been in the pre-financialisation, pre-Big Bang, era of Charles Green, where bankers considered their duty to be "stewardship on the basis of trust" and borrowing was difficult. However, as seen above, public banks continue to do well in other jurisdictions such as Germany. There is an opportunity for further research to see whether such alternative banking structures could, if they managed to obtain sufficient market share, provide competition for customers and also assist in raising ethical standards of the banking industry which their joint-stock rivals would then be obliged to follow.

Taming the Tiger? The truth is that tigers cannot be tamed. However, there are more animals in the jungle than just tigers.

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