

“Capital, Accountability and Courage”

Speech by Robert W. Jenkins, Senior Fellow at Better Markets

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Distinguished guests, ladies and gentlemen: good morning. And thank you for the opportunity to join you in Berlin.

Strengthening the European banking system is the topic of today. It is a challenge that must somehow be met within a highly connected global financial system and an international regulatory regime. So it might be useful to quickly recap the current state of play of global banking reform. Allow me to do so.

Plus ca change...

As you have heard, I had the honor to serve at the Bank of England. It was an exciting time. The banking system was undercapitalized. Greece threatened the euro zone. The euro zone threatened the banking system. The bankers threatened the politicians – lest the politicians threaten the bankers. And as I left, political leaders were leaning on the regulators not to lean too heavily on the banks.

“Too big to fail, bail and jail” summed up the challenge. Capital and accountability framed the regulatory response. What has been the result? Well, there has been much activity. But though the motion has been great, the movement has not. Leverage remains high and accountability low. Sadly, the courage to address either has been lacking.

Capital, accountability and courage. All other issues pale in comparison. Allow me a word about each.

Capital

I will start with capital. We continue to work our way through the greatest credit bubble in history. Now bubbles are not new. They are always the same – and always a little bit different. They all feature a heavy dose of greed, stupidity and leverage. What distinguished our recent episode from all past experiences was the degree of leverage deployed. Now we will not abolish greed. We cannot outlaw stupidity. But we can and must address excessive leverage. Have we done so? No.

It has not been for lack of trying. The first attempt involved a rewrite of Basel. The new rules tighten up on definitions of banking risk and place an overall cap on leverage. Are the rules tougher than before? Yes. Are they tough? No. Most importantly, are they sufficient to ensure stability? No.

Take an example. Remember CDOs squared (collateralized debt obligation squared) – that mini masterpiece of financial engineering that spread panic throughout the market? The instrument still features on the roster of Risk Weighted Assets. And the RWA regime determines the amount of capital required in support of such risks. So, how much loss absorbing capital do you think the “tough” new rules

require of a bank to carry an investment in a debt obligation, backed by a debt obligation, backed by a pool of loans made to US subprime residential homeowners? Oh, and assume that the package is once again rated triple AAA. What do you think? 20% of face value? 10%? 5%? Well for your information the tough new rules require less than 1.4% of equity funding for a security that neither banker, regulator, rating agency nor investor was able to understand.*

*Mind you, the regime it replaced required but .4 pct capital. And if you were a sophisticated institution with convincing risk modeling, authorities let you operate with .14 pct. The banking lobby may therefore tell you that new capital requirements are a multiple of what applied in the past. But less lenient does not equal sufficient - much less "tough."

Now fortunately – as you well know, Basel III introduces a backstop. Banks are now subject to a cap on the total leverage at which they operate. It's a very good idea. But as currently set, this "leverage ratio" allows balance sheets to balloon to 33 times their loss absorbing equity. At that degree of gearing, a 3 pct decline in the value of bank assets wipes out 100% of bank capital. A mere 1 pct decline leaves the institution leveraged 50 times; a 2 pct decline – 100 times. How confidence- inspiring is that?

Evidently not confidence-inspiring enough – witness the proposals in a number of jurisdictions to raise the ratio to 4 or even 5. Would these be tougher? Yes. Would they be sufficient? No. Those ratios would translate into bank balance sheets some 20 to 25 times their loss absorbing equity. Hedge funds by the way operate on average at 3 times leverage.

There is more of course. To such top-ups regulators have added stress testing and "TLAC." These steps are potentially positive but compared to capital - represent a problematic patchwork. Why? Well, for stress testing to be effective regulators must know which risks to stress and by what degree to do so. However hardworking and intelligent they may be they are also human. They, like the bankers they regulate will at some point get it wrong. That is why there is capital. Capital is there not just for the risks we think we understand – it is there for the ones we don't!

As for TLAC – total loss absorbing capacity, it is potentially a sound building block but it is one that rests on a shaky foundation.

Why? Well, first of all, the target for the loss absorbing capacity of a bank is set in terms of a percentage of Risk Weighted Assets. And we have just seen how poor a reference point that may prove to be. Second, various forms of bank debt are deemed to be loss absorbing. Here the presumption is two-fold: 1) that the authorities will have the guts to force losses on debt holders – they didn't last time; and 2) that at the first hint of trouble, debt and equity holders are going to wait around to find out. Will they? Would you?

In short, the banking system remains and is set to remain undercapitalized. Basel III is a busted flush. The many measures to compensate serve only to confirm this fact - without adequately compensating for its failure.

Accountability

If capital is vital to the survival of our market system, accountability is critical to its legitimacy. That bankers behaved badly in the run up to the melt-down is old news. That corporate culture was a culprit is now consensus.

An ethics-free zone?

*But before considering what's to be done let us recall the magnitude of what financiers did. The charge sheet of misdeeds - both acknowledged and alleged is lengthy. Here's a list:**

- Mis-selling of payment protection insurance
- Mis-selling interest rate swaps
- Mis-selling credit card theft insurance
- Mis-selling of mortgage-backed securities
- Mis-selling of municipal bond investment strategies
- Mis-selling of structured deposit investments
- Mis-selling of foreign exchange products
- Fraud related to the packaging and selling of mortgage-backed securities that institutions knew to be “toxic waste”
- Misleading statements to investors involving capital-raising rights issue
- Misleading investors in the sale of collateralised debt obligations
- Abusive small business lending practices
- Predatory mortgage practices
- Abusive or in inappropriate foreclosure practices (Wells Fargo among others:
- Abusive imposition of unwarranted fees and charges
- Conducting false appraisals and charging customers for them
- Aiding and abetting tax evasion
- Aiding and abetting money laundering for violent drug cartels
- Violations of rogue-regime sanctions
- Manipulation of Libor
- Manipulation of Euribor
- Manipulation of FX markets
- Manipulation of gold fixing (London)
- Manipulation of commodity markets via metals warehousing practices
- Manipulation of electricity markets (California)
- Manipulation of the swaps market benchmark index (Isdafix)
- Collusion relating to credit default swap market dealing in violation of US anti-trust laws (“settlement” reached with authorities to resolve allegations)
- Filing false statements with the SEC (London Whale)
- Keeping false books and records (London Whale)
- Reporting failures relating to Madoff
- Withholding of critical information from Italian regulators

- Bribing civil service employees in Japan
- Mis-reporting related to Barclays emergency capital raising
- Stealing confidential regulatory information by a banker
- Collusion with Greek authorities to mislead EU policy makers on meeting Euro criteria
- Financial engineering with the aim of moving Italian debt off-balance sheet
- Manipulation of risk models with the aim of minimizing reported Risk Weighted Assets / capital requirements
- Electronic FX trading related market manipulation
- Process and control failures with respect to dealings with the ultra-wealthy/ “politically exposed persons”. (*Elephant Deal* - Barclays 11/’15)
- Failure to prevent bribery of African officials (Standard Chartered)
- Peddling complex tax avoidance strategies to corporate clients (Deutsche)
- Improperly providing information about a Japanese company to its clients (Deutsche)
- Abuses relating to dark pool trading platforms (Barclays)
- Failure to disclose conflict of interests to wealth management clients (JPM)
- Misleading investors with wrong / incomplete information (JPM London Whale losses)
- Conspiracy to commit multi-million dollar securities fraud (RBS:
- Overcharging customers for FX transactions (Barclays: Times / Oct 30, 2015)
- Failure to meet the terms of the 2013 Mortgage foreclosure abuses settlement (JPM)
- Repeated violation of federal laws connected with sourcing securities for client shorting (GS)
- Manipulation of Korean stock market
- Unfairly jumping the creditor queue to secure (confiscate?) collateral relating to Lehman
- Publishing research and trading in the shares of a company it was advising (Goldman Sachs)
- Other mortgage related abuses including: failing to accurately track payments by borrowers; charging unauthorised fees; and providing false and misleading information in response to complaints by customers. (HSBC)
- Use of minority owned non consolidated subsidiaries to arbitrage capital requirements
- Investment bank analysts altering stock research recommendations to curry favour with companies they were researching. (Deutsche Bank / Feb17)
- Use of illegal offshore schemes to avoid paying income tax on bonuses (Deutsche/UBS)
- Ex Federal Reserve employee working at Goldman conspired with former Central Bank colleague to leak confidential information
- Overcharging custody clients through the use of undisclosed or secret mark-ups on foreign exchange transactions in contradiction of its promise to clients of “best execution rates.” [State Street settles allegations for \$530mio. – July 28]
- Mis-selling of loans to small business customers under the UK’s Enterprise Finance scheme [RBS]
- Offers to procure prostitutes to curry favour with SWF clients [GS/Libyan SWF]
- “Manufactured euros 7.2 billion euros of deposits by sham transactions to inflate reported deposit base during the crisis [Ireland]
- Predatory practices connected with the issuance of banking debit cards

- Supervisory failures connected with Chicago Mercantile related exchange and clearing fee processing which in turn involved overcharging of customers [Merrill Lynch and Barclays Capital US/CFTC fines]
- Falsifying accounts (manipulating mark-to-market pricing of derivatives positions) to reduce reported unrealised losses [Deutsche]
- Dismissal of whistle-blower who complained about the above [Deutsche]
- Creation of fake client accounts and making unauthorised transfers to achieve bonus driven sales targets - involving *some 2 million clients* and no less than 5000 employee offenders over some 5 years (Wells Fargo)
- Misleading investors via misclassification of private client asset accounts with a view to inflate reported Net New Assets for the bank.

And currently under investigation...

- Manipulation of precious metals markets (gold/silver/platinum/palladium - Switzerland)
- Manipulation / collusion of the US Treasury Market auction/client sales
- Manipulation of energy markets
- Short changing clients a second time in not paying settlements in full
- Violations connected with emergency fund raisings
- Falsifying customer data and records
- Misleading shareholders ahead of RBS rights issue
- Misleading shareholder information with respect to Lloyds takeover of HBOs
- Conspiracy to force small businesses into bankruptcy to the benefit of the lender
- Insertion of illegal rate floors in Spanish mortgage lending
- Faking customer files to justify predatory foreclosure practices
- Misleading profit and capital statements based on questionable accounting practices
- Bribing (“Improper payments”) officials in connection with license applications in Saudi Arabia
- Hiring sons and daughters of senior officials in return for favours
- Fabricating complaint letters after the fact to justify dismissal of a whistle-blower who raised alarms over possible mis-selling of mutual funds.
- “Mis-informing” (lying) to 4500 people over existence of dormant accounts
- Use of “mirror trades” (\$10 billions worth) to circumvent Russian related sanctions (Deutsche)
- Overcharging customers who are past due on their credit cards (HSBC: 14 Dec / Times)
- Market rigging of Gilt trading (Lloyds/CS)
- Hiding failed Loans in its commercial real estate portfolio in 2009. 2010 at a time of issuing new stock to repay government bail-out money. Wilmington Trust, Delaware.
- Non transparent and excess charges for FX transfers by major UK banks to small businesses in the UK:
- Manipulating shareholdings around dividend payment dates to trigger dishonestly acquired tax reimbursements. (DB/Barclays/BNP/GS/UBS)
- Manipulation of the Australian “bank bill swap rates”

- Manipulation of the government sponsored bond market (supranational, sub-sovereign and government agency debt or “SSA market.”)
- Use of secret / undisclosed payments of circa \$500mio connected with emergency capital funding. (Barclays)
- Knowingly acquiring “dirty debt” (a loan used as part of a multi-million pound embezzlement scheme) and using it to demand compensation from an African government (Standard Chartered)
- Conspiracy with borrower to falsify work estimates totaling \$400 million of fraudulent accounts receivable: (Citibank)
- Facilitating fraudulent activity by customers via use of import advance payments (Barclays)
- “Spoofing” in trading of US government bonds (Barclays)
- Laundering the proceeds of Petrobras related corruption (HSBC)
- Mis-selling of “lobo” loans to UK Local Councils
- Fraud and Criminal mismanagement in connection with account management for the former prime minister of Georgia (Credit Suisse Geneva)
- Forcing customers to switch from variable (“tracker”) mortgages into fixed rate mortgages – in a falling / low rate environment. [Ulster Bank-RBS]
- Mis-selling expensive life insurance products to little old ladies in France (Barclays France)
- Facilitating African money laundering on a grand scale (Barclays France)
- Misleading Libor submissions with the aim of boosting confidence in the bank’s perceived credit worthiness (Citi)
- Conspiring to facilitate VAT evasion through manipulative carbon trading transactions (RBS 6/2016)
- Misleading inexperienced officials in nascent Libyan SWF into complex and ultimately loss making derivative trades (Goldman Sachs)
- Mishandling of the proceeds of securities offerings for a state investment fund (Goldman Sachs/1MDB)
- Offering for use, false and misleading valuation opinions on M&A transactions to curry favour with wealth management clients (Goldman Sachs)
- Abusive practices in handling mortgage arrears (Lloyds / 29 July)
- Errors and abuses connected with reverse mortgages and related foreclosures in NY State [NY DFS investigation of Reversed Mortgage Solutions and Champion Mortgage]
- Manipulation of Australian Bank Bill Swap Rate – BBSW. [Lloyds/RBS/HSBC/JPM/MS/UBS/DB/others]
- Forging client signatures to create unwanted credit card account and then harassing the individual for non payment of charges relating to a card never applied for (Wells Fargo)
- Dismissing employees who failed to make their sales targets through fraudulent behaviour [Wells Fargo]
- Forcing distressed banking clients to hire a turn-around consultant who recommended expensive new lending facilities and from whom the banker received personal kickbacks
- Collusion to falsify accounts of Italy’s third largest bank.

And what has been done? Well, there has been a lot of breast beating on the topic. Hearings have been held. Commissions have been commissioned. Investigations have been legion. Large fines are frequent. But no bank has lost its banking license. No senior has gone to jail. No management team has been prosecuted. No board or supervising executive has been financially ruined. Many have kept their jobs, their salaries, their pensions and their perks. Among those dismissed, very few have been banned from the field for the future. As to the fines, with few exceptions, they have been paid by the shareholders, not by the perpetrators. No doubt some executives see these as a cost of doing business; and politicians - a handy source of revenue. Few believe them to be an effective deterrent. Is there any wonder that the public has lost faith in finance? Restoring accountability is vital to restoring a sense of fairness. It is also key to reducing recklessness. For the first line of defense in financial risk-taking consists of the attitudes and practices of the risk-takers on the front line. If they don't know the difference between right and wrong; if "wrong-doing" is left unpunished, much less rewarded, then we deserve what we get.

As to progress on this point, I was once hopeful. I am no longer optimistic. I was hopeful because for a while regulators, politicians and practitioners were all making the right noises. In the UK, parliament took steps to strengthen sanctions for financial wrong-doing. The US Attorney General declared that no bank was too big to jail. FSB Chair Mark Carney called for "clear consequences, including professional ostracism" for failure to live up to the necessary standards. Then Chancellor Osborne declared that "there is no trade-off between high standards of conduct and competitiveness." Banking executives individually and collectively were also talking the talk.

But of course actions speak louder than words. And actions to date fall short of what was both needed and possible. Making criminal behavior a crime is helpful. But enforcing the laws already on the books can and must happen first. Adding new speed limits when you have not enforced the old ones is a shaky basis on which to slow traffic.

The disturbing fact is that laws have been broken but law breaking has not touched senior management. In the US "deferred prosecution agreements" are the order-of-the-day. Although such "settlements" are announced with fines and fanfare, the detailed evidence and findings that led to such agreements often remain hidden from the public eye. Eric Holder boasted that banks would be held accountable. But, as the dictionary reminds us, accountability involves not only "the obligation of an individual or organization to account for its activities, and accept responsibility for them, but also to disclose the results in a transparent manner."

Similarly, existing rules and tools have sat untouched. The UK's Financial Services Authority and its successor have long had the ability to oust bank management and board by striking them of the "approved persons list." Have they done so? Not to any significant or visible extent. How can this be? Look again at the litany of wrong-doing? Either senior management knew what was going on or they did not. If they knew, then they were complicit. If they did not, then they were incompetent. Alternatively, if the deserving dozens have indeed been banned from the field let the list be known – that we might see

some of that “professional ostracism” of which Governor Carney speaks. One person who did lose his position and quite publicly at that was Martin Wheatley - the UK’s courageous conduct enforcer.

Meanwhile the Chairman of the UK’s (and Europe’s) largest bank remains in situ – despite having been on the Board since 1995; despite having signed off on the acquisition of Household Finance; and despite having had oversight of tax entangled subsidiaries in Switzerland and money laundering units in Mexico. Oh, and you’ll love this: the recently retired CEO of Standard Chartered became an advisor to Her Majesty’s Government. Standard Chartered was among the first to be investigated for violations (some 60,000 instances) of rogue regime sanctions. The bank was fined heavily and may be so again.

The signal this sends to the public is that justice is two tiered: there is one set for citizens and another for the financial elite. This breeds anger amongst the electorate that threatens to limit the room for maneuver should the banking system need taxpayer support. It also spawns ever larger financial fines by authorities who are too timid to go after the perpetrators while hoping that big “settlements” will appease the public. The fines are now of a size that weaken bank balance sheets. Can anyone now doubt that it would have been better to prosecute individual offenders and shame failed management rather than pursue punishment by fines. Surely a “pound of flesh” would have been far more effective than billions of pounds of penalties.

Courage

In his recent book, Ben Bernanke speaks about the courage to act. Central Bankers did indeed act courageously and decisively to bring the banking system back from the brink. They had the full support of the political elite to do so. We owe them all a debt of gratitude. But in reforming the system they so successfully saved, the authorities have been unwilling or unable to stand up to the politicians who in turn have been demonstrably unwilling to stand up to the banking lobby. “Why” - is a deserving theme for a subsequent conference.

But today’s theme is how to best strengthen the financial system. The pre-requisites are capital, accountability and courage. Unless we address leverage we cannot have confidence in the resilience of the system. Without better behaviour we cannot have faith in the market that underpins it. Without penalizing the perpetrators and their seniors we will not get better behaviour. And without greater courage from policy makers and regulators, we will get none of the above and more of the same.

It is against this backdrop that Europe must tackle its banking reform challenge. The global framework in place won’t get the job done - not because it’s too tough but because it is too soft. Perhaps you can do in Europe what has not been done elsewhere – and set the example for others to follow.

Thank you and good luck.

Robert Jenkins is a Senior Fellow at Better Markets. He is a former member of the Financial Policy Committee of the Bank of England.

* This list of banking “mis-deeds” is available and continuously updated at: <https://t.co/fwAyU76VrN>

