

WHAT LESSONS SHOULD CHRISTIAN ECONOMISTS LEARN FROM THE CREDIT CRUNCH?

Ian Jones

Research Associate, Centre for Business Research, University of Cambridge

1 Introduction

I thoroughly enjoyed the roundtable on ethics in financial services at our Association of Christian Economists conference. My role was to facilitate the discussion and to give our distinguished panellists the opportunity to present their views. The session provided me with an incentive to reflect on my own thoughts based on my particular perspective, a teacher of strategy rather than economics and a former director of a programme which taught the very people who have been involved in the fatal credit crunch decisions as top banking executives.

You could argue that I have therefore a responsibility for contributing to the failure of the banking system. In the direct sense, I am guilty as charged. However, my more considered reflection is that these bankers are not much different from those in other professions which you and I would include amongst their best students.

I will attempt to develop that theme and address the question that immediately follows, namely, 'if it is not the people, then how do we explain the moral failure that led to the credit crunch and what hope is there that this will not be repeated in some similar form? And what might we be able to learn?'

In the context of the credit crunch, bankers have been presented as selfish, greedy, irresponsible, unethical, unconcerned for others, and just plain irrational and stupid. One recent graduate referred to the situation where he was 'selling a product he did not understand to people who did not understand knowing that this product was their disadvantage'. Even if most selling has an exploitative element, this is a very extreme example in my experience.

The superficial case for this is easily made. Mortgages based on self assessment, high leverage in terms of value to loan, with minimal risk spreads, now seems crass. Overreliance on special instruments such as securitisation and wholesale

funding appears equally misguided. So do reward systems which reward returns independent of risk.

However my experience as formative director of the executive MBA at what is now Cass Business School where my students were mainly working in financial services, where contributors were top executives in banks or regulators, and where, in my external role, I got to know personally, many of the most senior people in the City of London, gives me cause to reflect. My impression is that they were much more able than the average executive and no less ethical than any other group of successful executives. The students were very similar to those which we all teach. The best are quite like the students that stand out in our universities. They are ambitious, self confident in their ability, determined to succeed and define their success in terms of material gain.

Clearly as Christians, we acknowledge that people are fallen, and there will always be examples of exploitation, greed, and unbridled self interest. We want to see conduct which is enlightened and aware of the needs of others. But some malpractice is the reality.

Some of the work Michael Pollitt and I have done together picks out how companies have failed to deliver ethical standards. Shell's misreporting of its reserves subsequent to setting global ethical principles is a case in point. Executive pay has been an ill considered issue, ever since Greenbury failed to listen to public perception of good practice. The recent evidence that even in this last year, when many have had pay freezes, CEO pay for major companies has gone up by 6% and the widening differential between lowest paid employee and highest is now 100 times in these companies. Also, many companies have dragged their feet on implementing basics of board governance set out originally by Sir Adrian Cadbury, such as the separation of chair and chief executive and the appointment of sufficient independent directors. Similarly, one of reflections was the need for international standards of regulation to minimise the gain from arbitraging between competitive regulatory systems and establish a common understanding of issues. We recognised the huge political effort that would be required to establish those standards.

To turn to financial services, there is not much evidence that general practice on corporate governance has been much different from other companies. For instance, the composition of boards was probably no worse than other companies and of course the governance of Northern Rock was exemplary in terms of having a former chief executive of a bank as an independent director. There were experienced independent directors. There was separation between chair and chief executive. It is clear now that neither chair nor chief executive was competent for the business, but how many other organisations –universities perhaps, companies certainly who do not have appropriate leaders, especially when the environment has changed rapidly. I can think of one vice chancellor was ‘at sea’ when the external circumstances changed dramatically after he/she was appointed. You could argue that Northern Rock was not much different.

In short, therefore, I am recognising, that in all probability, those in financial services are people averagely fallen, but we cannot afford as a society to allow ‘normal people’ to lead us into disasters like this. There would appear to be something about financial services which requires a different and higher standard of behaviour. It seems interesting to reflect on how financial services might be different, without in any way claiming to be exhaustive in my analysis.

2 Experience of the City

2.1 Systemic risk

Obviously, financial services are fundamental to the stability of the system. My personal experience does not give me any exceptional insight into this special area. Suffice to say, that having got senior figures from the Bank of England to speak to my students about regulatory risk, I never imagined that systemic failure in the UK was no more than a theoretical possibility included for completeness. The shock of Northern Rock was profound for me.

2.2 Creativity

Probably many industries have devices which give special competitive advantage, however it does seem that financial services has more than its share of these tools. This could include the mathematical trading systems are such tools. Very obviously,

sophisticated arbitrage enables market to operate efficiently. Similarly, securitisation is a tool that enables financing in the market place rather than through banks generating the opportunity of lower cost.

However, the ethical issues arise when these tools are used to the disadvantage of others. With the arbitrage systems, algorithms which exploit minor differences may have a miniscule benefit to the market but may generate income for the market trader. The downside is that some of these mathematical systems actually destabilise markets. With securitisation, the problem is similarly what was a good idea was used to excess in this case making the tool a feature of the market place.

2.3 Herd instinct and the capacity for self delusion

There is an ancient joke that bankers follow each other like lemmings. The herd instinct drives them over the cliff. I love that letter to the Times a decade or so ago, which pointed out that this simile was unfair on lemmings, since bankers went over the cliff, but lemmings would stop at the cliff's edge.

It is easy to criticise, but those of us who have been part of investment committees know that it is much easier to conform than to challenge. If you lead the charge against an investment manager's advice, and are proved wrong by events, then you get pilloried. If you sit there like a stuffed dummy and having made your point, allow the decision to go the other way, and it goes wrong, you are safe. Thus it is for investment advisers. It is easy to go with the crowd.

The self delusion in the mortgage market, with its assumption that house prices would continue to rise, is in retrospect unbelievable. How could lenders ignore the risk of negative equity, experienced less than 20 years ago, and offer highly leveraged and self-assessed mortgages?

This simplistic self-delusion reminds of the chief executive of a clearing bank speaking at an international conference I was chairing, stating as if it was rocket science that 'the Japanese were becoming internationally competitive'. It proved an exaggeration, but my principal reflection was how simplistic this is. In strategy we are concerned with 'strategic thinking' which contrasts with the approach that 'stakes

everything on intuition'. I wonder if there is something in the uncertainty or lack of concrete reality in finance that lends itself to unduly simplified inductive observations.

2.4 Measuring Risk and Return

Rather following on from this reflection about potential in finance for limited perspectives is connected with the difficulty of assessing risk and return together in this field. My limited experience of consulting in the area is that the strategic models of return do not easily apply. The reason is the difficulty in separating the level of return from the return for risk. Clearly there are much more sophisticated means of assessing risk have been developed since then, and I was not an expert in banking. However, it does illustrate the difficulty that board members and senior managers must have in reviewing areas outside their immediate experience, especially those that offer high financial returns. Some of the major errors such as the collapse of Barings arose from this lack of understanding. There may be a sense that some of destructive cost for Royal Bank of Scotland in its acquisition in the ABN Amro was a result of the difficulty of calibrating the risks.

I do not condone such ignorance. If it is too hot in the kitchen, people should get out and leave the job to someone who understands. However, this reflection does give some sympathy for those who get caught. I am also struck by how difficult it is to measure risk and return. Part of the damage in the market place was done by divorcing the return from the risk, either temporarily or between actors. In the first case, taking the return in the short term, and underplaying the risk in the longer term. In the second case, taking the reward and passing the risk on to others. Several of the bank failures in the past, Barings, the rogue trader at Societe General, to name two, were due to the senior people, the board members failing to recognise that the exceptional returns could have been due to undue risk. Top management did not understand.

How banks failed to see the risk of above 100% mortgages is almost impossible for someone who observed, in the early 1990s, low paid colleagues facing huge negative equity on property they had bought to get into the housing market, can scarcely believe that the experts could ignore that possibility.

I am reminded of a small management assignment, that I undertook at an investment bank several years ago. There were records of the revenues, but no easy way to categorise the businesses strategically. None of the models seemed to work. On reflection, the missing factor was the levels of risk. I seem to remember that senior executives handled their business as reflecting their proprietary acumen or client relationship in equally safe businesses, rather than as I now suspect, their appetite for risk. What is true internally at board level about the need for measuring risk and return, presumably also applies for the process of monitoring by the regulator.

2.5 Pressure from the investor

A former chairman and chief executive of a worldwide European owned multinational was reflecting how easy it is to fall into excessive demands on companies for return from their investments. He was extolling the importance of a close relationship between company and financial markets and then reflected that as chair of the company final benefits pension fund, he wanted the best return from his funds. A measure of the pressure this puts on the investment manager is illustrated by the way a company like his took its pension investment advisers to court for bad advice and won. One wonders how much this drive for returns reinforced the Royal Bank of Scotland's uninhibited acquisition of ABN Amro.

2.6 Role of authorities for managing hope and expectations

Praise for those in the City exaggerated their self belief and sense of performance. They were feted. So much of the economic growth and tax revenue that the government need to fund its huge social programme relied on the growth of financial services and its dependent industries. Political power, in London and even in Edinburgh may have been underpinned by the wealth creation and even the international reputation of financial services. This mutual interdependence between government and finance, is illustrated by the close relationship between Gordon Brown and Sir Fred Goodwin for example. Politicians were acting out of self interest.

There is perhaps always going to be an element in business of expectations and hope. In each of the successful founder enterprises, for example Virgin, Easyjet, Amstrad, there were occasions when the businesses nearly collapsed and were sustained by the hope of the founder and his immediate team. Indeed, founder

enterprises, typically rely on supporting expectations and hope from financiers to keep them afloat. If business needs these hopes, than finance, with its separation from the mundane and its borrowing short term and lending long, is probably particularly susceptible to mood and expectations. Febrile hope and bubbles are perhaps endemic to finance.

I think that the authorities have a particular responsibility to lead these expectations and recognise that their policy objectives or their taxing policy shapes the mood. Taking this view, the government's mantra that there had been an end to 'boom and bust' was irresponsible fuelling the continued expectation of house price inflation. In the US, the government commitment to what we call social housing, fuelled subprime lending and corrupted the mortgage market, in a way that it was politically dangerous to reverse.

2.7 A culture of high rewards

Reward systems must have been a factor with the opportunity to earn huge sums without a direct link between reward and performance. This has been done to death by the media and regulators since the crisis started and I do not have much to add except to say that intelligent person is rational and will respond to reward systems in place. Thus if rewards are tied to an inappropriate measure of performance, then the rational actor will respond to the incentive system in place. One could draw a parallel with academic incentives which favour research over teaching and perhaps in the past quantity rather than quality of research. The government should be surprised if the academic skews his career development in that direction rather than towards teaching and administration. The moral failure is in the designers of the system rather than those being incentivised.

As well as this potential dehumanising effect on values in banking, the industry has been catastrophically hit by the high income/high bonus culture. I have little ethical trouble with high rewards and expect a longer term market clearing effect whereby a supply of appropriately qualified people are attracted by the higher salaries. I wonder whether chief executive salaries which have increased much faster than average pay and shareholder returns over about 20 years is exploitation of a monopoly. However, the immensely high returns, for short term profits on deals with

potential high risk medium term losses, are crassly conduct distorting. A rational banker would be hard pressed not to respond to such incentives.

2.8 Need for higher standards of trust and being honourable

In preparing a talk to an international banking audience, I dug out a banking text book – you know the kind; the equivalent of an introductory manual – which dated from the 60s. There was an entire chapter on the subject of trust being at the heart of banking. Although that trust was associated in those days with a kind of non-conformist hectoring and disciplining about the careful use of money, which was probably a barrier to a competitive cost of capital and fair access to capital, the principle would appear to be the same, banking is so fundamental to our society, we need those in the industry with a higher sense of values than the average.

Sharp practice like tying up loyal customer, rewarding almost by accident the promiscuous buyer with repeated new customer offers are indulged in by telephone companies and utilities and much to my own annoyance. However, the cost to the average customer in % of their income is relatively small (though not necessarily negligible). Retail banking play the same games (eg unauthorised overdrafts and encouraging expensive debt financing on credit cards) but impact can be much more serious.

We were all probably shocked by the behaviour of Goldman Sachs selling products which were directly opposite to their own assessment of the mortgage market. It is shocking that they were prepared to create products which ran counter to their own thinking, to dress them up with apparent credibility and sell them on to trusting clients. One was tempted to mention Goldman Sachs as a model of strategic thinking when they anticipated the risk in the mortgage market and reduced their exposure. Now, one is left wondering whether their profitability and strategic success are a function of acting dishonourably.

2.9 Engagement

Banking is notorious for its ability to disassociate itself from the consequence of its actions. Many policy makers have campaigned for a more involved attitude to lending to entrepreneurs and small businesses. One is reminded of the Florentine bankers who paid others to fight their wars for them. It does give rise to the sense that

they do not care about the consequences, it is not their problem. One area where this applies is in its philanthropy. Michael and I have investigated how corporate philanthropy serves the communities best if it creates social capital, usually involving the corporate donor in engaging in the project and providing expertise. Engagement also involves the exchange of learning and understanding that can influence strategy. The corporate is reminded that no one is an island.

The characteristic of much philanthropy in the City of London is to be generous with the money almost for getting involved in the pain of others. In the old days senior bankers had time to engage in society. Perhaps this was made possible by monopoly rents, but it did mean that they were in contact with the rest of society. Now that people do not have that time, and this is strategically and morally dangerous as it carries the risk of being out of touch. I think that philanthropic engagement that builds social capital is another way in which wealth creating organisations keep in touch with others. Not only does the organisation share its expertise with those in need, but also there is a feedback learning loop into the organisation. In my experience, financial organisations though impressively generous and notoriously arms length, they want to give but keep their hands clean. To be fair involvement, requires executive time, and time is the executive's scarcest resource, as I have mentioned above.

Coupled with this lack of time to engage there is the equally strategically dangerous lack of time for reflection. Bankers are so busy and their time so profitable that strategic discussions may be rare. Certainly I have come across this in my consulting. If it is true, then this may also feed the herd instinct and adopting simplistic themes. Without reflection, the easiest route is to follow the crowd rather than question the prevailing wisdom.

One wonders whether there is a decline in values in banking. Maybe those in finance start out being like us and our students but get corrupted by their environment. Michael and I looked at the relationship between values, codes and action in a multinational pharmaceutical company. We found that, inter alia, established values, especially that of integrity had a direct and identifiable impact on decisions.

I do not personally know the answer. I suppose the natural Christian view is that the love of money corrupts and dealing in money rather concrete goods may lead to the temptation to only think in monetary value. I struggled with the issue of whether working with money only influenced people cognitively and ethically. I sense a cognitive effect, whereby the students from financial services were particularly uninterested in creativity, untypical of the kind of universities that they had graduated from. I therefore devised study weekends where students were able to experience for themselves, the management of creativity. In this, I was sharing my own early career learning of the value of creativity, but I was also trying to stimulate the students' interest in the arts. Whether I was correct in thinking that working in finance had a dehumanising effect, I do not know, but I felt sufficiently convinced by my hypothesis to change the programme to accommodate it. The depersonalisation of the banking/customer relationship may have added to this dehumanisation.

I find the concept of cognitive dissonance thought provoking in marketing. The idea is that a consumer faced with a difference in conduct and attitudes, either changes their conduct or their attitudes over time so the two are consistent. If a product gives a particular and unexpected experience, the consumer who continues to buy gradually allows their attitudes shift towards acceptance to achieve consonance. One wonders whether this has happened in banking. Bankers who have adopted a short term investment approach to earn have got so used to having bonuses and acting short term that their attitudes and values have adjusted, their critical faculties have been suspended, to make their conduct acceptable. This may have happened gradually over time. Some management teachers use the picture of a frog added to a pan of water. If the frog is dropped into boiling water it jumps out. If the frog is put into a pan and the water is slowly boiled then the frog dies. Maybe there has been a slow process of adjusting values. If as it were to confirm this, the way that bankers, in the non rescued banks, are expecting bonuses this year for business which may have been generated as a result of the government's underpinning of their industry, suggest to me that their values are still distorted. It is also politically inept, when so many are suffering, which seems to reflect the point in a previous paragraph, that bankers are divorced from reality.

2.10 Governance and Strategic thinking

Is the governance of banks adequate? I am much in favour of the progression of corporate governance since Cadbury. It has been a steady if slow progress towards effective board best practice. In general terms, post Higgs, the accepted paradigm seems about right; split chair chief executive responsibilities, a predominance of non-executive directors –some technically competent, specialist committees for audit/risk, remuneration, and appointments for the board, to name some of the main ones. It is interesting but sad to note that this paradigm did not work for Northern Rock, where there was both a chair and a chief executive, but neither was appropriate, and there was a distinguished banker Derek Wanless (whose experience was exceptional, even if his achievements (the failure of Nat West) did not match the experience. One could argue that this was the exception that confirmed the rule and I am delighted that there has been no pressure to tighten the structure of boards, neither in the UK nor the US. In fact the example of Derek Wanless could be an indication that the structure is only as good as its application, which is where the corporate governance debate is going. A former senior Nat West executive mentioned that, in his view, Derek Wanless was notorious for pressing for higher market share in mortgages and had tried to do the same when chief executive at Nat West. So rather than ‘challenging the executive’ Wanless would have been pressing executives to do more!

However, an effective board is expected. To change the metaphor, it has to tell the emperor that he has no clothes. Interestingly, almost all the boards failed singularly to do this in financial institutions. Of course, other organisations have been let down by their boards who failed to pick up errors, for instance, the failure of Shell directors to uncover and correct the oil reserve declarations before these became a public issue. However, to continue the argument that financial services needs more, the consequences of this failing to happen in the financial services had disastrous consequences.

I wonder however, if the greatest fault in governance is the failure to monitor remuneration systems and the risk return relationship. I have already discussed the bonus culture and how its weakness was evident and should have been obvious to the chairman and non-executive board members. The simplistic view is that they were all ‘troughing’ too, being part of the same system in other organisations. Although there

is some truth in this, but it does not feel the only explanation. Perhaps it was a lack of courage. I know from my own experience that the chair of remuneration committee who seeks to contain pay rises damages his own relationship and authority with executive board members. I so wish that there were standard procedures for calculating incentive systems so that they could be compared between companies by experts. That would create an accountability by information and reducing asymmetry. I am told by remuneration experts that such an approach is impossible, every situation is different.

Coupled with this lack of time to engage there is the equally strategically dangerous lack of time for reflection. Bankers are so busy and their time so profitable that strategic discussions may be rare. Certainly I have come across this in my consulting. If it is true, then this may also feed the herd instinct and adopting simplistic themes. Without reflection, the easiest route is to follow the crowd rather than question the prevailing wisdom.

3 Lessons

I somewhat abashed that my simple conclusion that bankers were just like us, neither less or more moral, has led me to explore so much. The lessons from these ruminations seem to emerge from this analysis.

Firstly, we must encourage society to continue to respect wealth creation. It is so easy for sceptics to pillory all wealth creation as selfish and greedy. The bad conduct of parliamentarians had further increased peoples distrust giving people freedom to operate. I believe in the Fall. We are all fallen. We all get things wrong. Self interest turns to greed for some. It does not necessarily apply to all. None of my MBA students were saints. Nor were any to my knowledge, and certainly very few in later years were dishonest.

Secondly, we must ensure that the values with which financial services espouse are at least equal to those in other activities, and where actions put the system or dependent actors at risk, we need higher standards. Values come from the top. I have suggested that more engagement with the community, social capital building would build sensitivity to others. Ethics codes are a means of embedding value based good conduct. If I had my way, I would totally revise the charging structures and

offer vanilla accounts with few rules, punishments which reflected the cost incurred by the institution, earning reasonable interest etc. It if led to a small accounts charge then people should be prepared to pay in return for the service. The way that the bankers code has shifted reluctantly with every improvement, destroys trust in a way that they do not seem to appreciate.

Our panel discussion considered the role of faculty in disseminating moral standards of conduct. As someone who sponsored a Business Ethics course led by a member of ACE as long ago as 1985 and approached Imperial College to set up a joint course in order to disseminate the initiative, I am clearly committed to the value of such courses. However, I do not think that they are that significant. As a senior person in a business school, I would favour appointing the best researchers and teachers, and would not expect them to be especially moral. In fact, some of the best are pretty driven people and part of their education will be to enable students to see patterns in markets which can be exploited. That message does not come over very well if the students are being asked to constrain their energies. Having said that, I draw a very clear line, advantage must only be sought within general standards of integrity. I stopped using a lecturer who advocated exploitative use of transfer pricing.

To expect Business Schools to raise standards of conduct is misguided therefore. Encouraging discussion of moral and environmental issues and providing frameworks to analyse situations is essential. Ultimately Business Schools are not harbingers of moral values. Where I think my alma mater was wrong in the 1970s was in preaching excessive competitiveness and commercial success without reflection of the costs. When I was programme director, I eschewed that message and made sure that staff and students knew what my moral framework was even if they did not share the basis for those values.

Thirdly, outsiders have to accept their responsibility for stimulating the expectations that sustained the bubble. Knighthoods and invitations to Chequers influence. Investment analysts overregging their demands for growth and better results have to share responsibility. Playing games with pension taxation has deleterious consequences. If perceived risk and return is strongly influenced by expectations,

then government are morally responsible for ensuring the expectations they create are realisable.

Fourthly, corporate governance comes to the top of the agenda. I am highly relieved that the government has not indulged in tightening the Higgs structural model, even though Northern Rock and perhaps other banks demonstrated that structure not to be sufficient. David Walker would appear, I believe sensibly, to be placing the emphasis on conduct rather than structure. Furthermore, it would be good to see the board addressing issues such as values and ethical codes and engagement as mentioned above.

Fifthly, maximising the quality of the measurement of risk and return, at all levels within the financial institutions, with the regulator and perhaps more generally. There are technical issues about what is measurable which are beyond my knowledge. However, this appears to be at the heart of the matter. It is a simple biblical principle of openness and accuracy (in the sense of integrity). I know that years ago banking supervision involved huge quantities of information which did not always shed light on the key issues. Conceptually, more accurate recording of risk and return would enable the regulators to focus their demand for data. I would like to think that such information would empower the non-banking expert independent directors too. Clearly, this discussion gets at the rating agencies who have the additional issue of conflict of interest.

I believe in creativity as God's gift. We as those redeemed by Christ's death are enabled and empowered. I expect crisis to generate solutions. Past examples within the banking sector are that following the 1973 secondary banking crisis, Nat West, which is rumoured to have been bankrupted then, put in a more sophisticated risk measurement which correlated risk. This had the result that Nat West performed better than its rivals in the sovereign debt crisis of 1980s. It did so because it was able to relate the sovereign and commercial risk in each country. A similar example is a gilt edged market maker who learnt from a regulator that their portfolio risk measurement was the exact opposite of reality. They corrected this and perhaps as a result, they weathered the changes in the market five years later and remained the leading UK player when others failed. More recent examples outside the finance industry are Shell's efficiency in correcting its reserves measurement (after the cause

celebre of course) and the way that the British Army has recently remedied the inferior treatment of returning wounded soldiers. Apparently, the medical attention has been 'armyified' and the problem resolved. I have confidence that the financial world will transform the use and risk measurement of securitised instruments.

4 Conclusion

At the heart of the debate lies the association of risk and return, with return being offered that is commensurate with openly recognised risk. Regulation has to balance between conformity and creativity. Creativity provides some hope that the system can be self correcting as organisations learn from their mistakes and see the need to put matters right. I am relieved that the authorities have not pushed the standard board governance model in response to the disaster and Walker's tweaking is in the line of present thinking. The US overregulated with Sarbanes Oxley and made the US a less competitive place in which to do business. The danger is that the UK, or perhaps our European partners will over-regulate more specifically financial activities and have the same effect on London. Finance and the world of ideas is highly mobile. Political humphing may win votes in the short term, but medium term losses could be immense and without gain since the –apparent excesses- will only be replicated somewhere else in the world.

Within a framework of moral practice, we Christians should embrace wealth generation. We should acknowledge the risks due to the fallenness of man. We should clearly encourage the discussion of moral purpose and how ethics and values can be hardwired into organisations. We should challenge the waywardness of government and politicians seeking deleterious short term advantage.

I am conscious that my reflections have not resolved the key question about delivering higher standards of conduct in the financial world. I will have to leave that to the wisdom of others. I hope however my experiential and partially anecdotal reflections stimulate those with the necessary skills to suggest how long term standards can be delivered.

Appendix: Glossary of terms

Securitisation is a structured finance process by which many individual assets are combined into a pool so that investors may buy interests in the pool rather than in the individual assets. All assets can be securitised, so long as they are associated with cash flow. Mortgages are a typical of this kind of asset. The credit quality depends on how the transaction is structured. If properly done and the pool performs as expected, the portfolio risk is shared. If improperly structured, the affected tranches can experience dramatic credit deterioration, as happened with mortgage securities in the credit crunch.

Corporate Governance is the 'system by which companies are directed and controlled'. There are several aspects to corporate governance, the ownership of control whether private or public (by markets). There is the basic structural difference between a unitary board as in the UK or a two tier system with a supervisory board as in Germany. There is also the way that boards are led and influence the company, the board effectiveness perspective.

The paper essentially refers to the board effectiveness perspective. There have been several initiatives to improve the structure and conduct of boards starting in the early 1990s. Almost without exception each review has been provoked by corporate crises and evident bad behaviour, starting with Maxwell using pension funds to bolster the company's share price to avoid breaching loan covenants and continuing up until the credit crunch and the failure of Northern Rock and Lehmans, taking in Enron on the way!

The Cadbury report of 1992 was the seminal one which has shaped almost all the prescriptions since, in the UK, the Commonwealth and much of Europe. The most significant recommendations were:

Separation of chair and chief executive

Formation of board sub-committees to focus on Audit (and risk),
Remuneration and Nomination

Reporting governance systems to a listing authority on a comply or explain basis, in other words without legislative compulsion

A substantial proportion of non-executive directors with the independence to challenge the executives and bring an outside perspective, and provide a link with shareholders.

The Greenbury report of 1995 concentrated on Directors remuneration

This strengthened the non-executive element on the remuneration committed and required remuneration committee chair to be accountable to shareholders and widened the reporting required.

The Hampel report of 1998 was a relook at the Cadbury recommendations and essentially confirmed them and provided greater codification.

The Turnbull report of 1999 addressed the control systems and making risk management more strategic.

The Higgs review of 2003 coupled with the Smith report reinforced many of the Cadbury prescriptions, notably the separation of chair and chief executive, the independence, number of board, time given to role of non executives. It emphasised the need for review and induction and created the role of Senior independent director who had specific roles in relation to shareholders.

Walker of 2009 was a consultation which confirmed that the structures and systems were adequate but needed reinforcing in the way they were carried out – the conduct in the board room. There was insufficient disciplined process of challenge, perhaps preparation.

Sarbanes-Oxley Act 2002 was the US response to the failure of Enron. It was a root and branch reform. Differing from the UK principles based approach and typical of the American SEC culture it was rules based. This increased the amount of ‘box ticking’ conformity, but more seriously added to considerably to the cost of doing business. Particularly costly has been implementation of the section that requires companies and auditors to review all internal financial controls.

This could be an example of zealous overreaction to a corporate disaster. Those who take this view cite Sarbanes-Oxley as the kind of overreaction which is politically attractive but to be avoided. There is a sense that in the UK, both the

Higgs and Walker review were intended to head off misguided international pressures for tighter regulation.

WHAT LESSONS SHOULD CHRISTIAN ECONOMISTS LEARN FROM THE CREDIT CRUNCH?

Andrew Henley

School of Business and Economics, Swansea University

1 Introduction

A lot has been written already about the economic and financial events of the last two years. Indeed it now seems clear that, at its nadir a year ago, the world's banking system was hours away from meltdown. It is hard to imagine what the world might now look like has this happened. Perhaps Christians should consider that it was an act of grace that prevented this. The proximate cause of the credit crunch would seem to me to have been a massive breakdown of trust between financial institutions. Financial institutions need to trust each other to convey reliable and accurate information about their respective creditworthiness. Trust is a commodity, even a virtue, which is central to the Christian worldview. In human terms it is difficult, costly and time-consuming to create but is very easily and quickly destroyed.

But why did this trust breakdown happen? Ultimately the issue was recklessness on the part of financial institutions across the world in their investment and risk management policies. Given that banks have fiduciary responsibilities as deposit takers to the owners of those deposits and as creators of fiat money to society at large, this is ultimately a moral issue.

2 What sort of recklessness?

In the United States in particular the first aspect of recklessness was lending to the non-credit worthy. So-called "ninja" (that is "no income, no jobs or assets") mortgages could be seen as the promulgation of debt slavery, and yet those institutions in the US which were pursuing this were doing so as a *de facto* instrument of government policy, designed, arguably misguidedly to extend homeownership to otherwise excluded social groups. This points to a massive failure to provide affordable, public housing in one of the world's (on average) richest societies.

A second aspect was the failure of risk management. This seems to have arisen as a result of the development of increasingly complex financial instruments

designed to ship risk off corporate financial balance sheets. The explosive growth over the previous 15 years in markets for collateralised debt obligations (CDOs) (and further securitised versions of these securities, CDO squared's etc) and credit default swaps (CDSs) could in my opinion be seen as a massive Ponzi game in which, rather than paying a nominal stake in return for getting a load of gullible people to pay you a massive future return, you pay a (far too) small stake to sell off your risk in return for getting a load of other gullible people further down the line to cover all that risk for you. It is difficult to see, from a Christian moral perspective, that this can be viewed purely as a technical, regulatory issue. Everyone assumed that the game could continue forever, but this could only be the case if the world had managed to abolish the credit cycle for good. The exponential growth in the markets for these bewilderingly complex financial instruments can be seen in the fact that the estimated net revenues of Lehman Brothers around its peak in the summer of 2007 was around \$20bn, around 600 percent higher than when it became a public company in 1994. Commentators have also pointed to the collusion of the ratings agencies who failed to deal properly with the serious conflicts of interest that they faced in continuing to maintain top ratings for financial paper that was of highly dubious long term value.

A third aspect was political recklessness. At fault here are global leaders who with astonishing hubris announced that the credit and business cycle had been abolished and that we could look forward to ever continuing economic growth. They should have read Ecclesiastes (and perhaps also the parable of the wise and foolish builders). This recklessness feeds into the issue above about risk management. The world had entered a permanently less risky economic era, because the politicians had announced it to be so.

A further aspect of political recklessness, to which I have already alluded, concerns the manner in which financial institutions are regulated. Nations such as Canada who have maintained a strict separation of commercial and investment banking and operating prudential reserve requirements have been amazed (and in fact rather cross) about the way in which governments in the UK and US have behaved. Paul Martin, former Canadian PM and finance minister, made exactly this point in a speech to the Association of MBAs in Montreal in May 2009. The "prudent" nations

are further amazed at the way in which governments have been prepared to tear up any notion of prudent management of national budgets and debt in order to tackle the crisis (but more on this below). What might be Christian response here? Firstly, although we might take that view that the existence of markets in themselves is morally neutral, there is a moral view to be taken on the limits to the operation of markets, especially where the fortunes of the poor and disadvantaged are ultimately at stake. The Basel 2 Accord on international banking might be seen in this context – had it been implemented already, we might not have got into quite such a mess.

3 What are the consequences of the crunch?

Richard Higginson recently made a plea for commentators to stop referring to the current crisis as a “credit crunch”. He says that this nomenclature trivialises what is going on and perpetuates a view that it is a little local difficulty in the financial system. I am inclined to support his call. There was a phoney war period during the second half of 2007 and early 2008 when some still hoped that the problem could be fixed before it hit the “real” economy. This was always going to be a vain hope. As Christians we know that it is rarely easy to quarantine the consequences of moral failure. I have argued above that the crisis has indeed been in part the consequence of moral failure. As the contemporary historians get their teeth into an analysis of what has happened the whiff of corruption and corporate greed has grown. Social sin is just that – it affects us all. And virtually no sin is anything other than social (if you are not convinced reflect on the 10 Commandments for a moment!). Richard Higginson of Ridley Hall Theological College would prefer to call the crisis “the Debt Comeuppance”

The consequences of this “comeuppance” are manifest on a global scale. Others here are far better qualified than me to comment on the consequences for the world’s poor. In the UK it is notable just how quickly it has led to a situation where the biggest impact in terms of job losses (in the non-financial services economy) are in the peripheral regions, such as northern England and south Wales, and it is the low-skilled and unskilled who are most vulnerable. If one is tempted to feel sorry for unemployed bankers, then consider that it will be far easier for university-educated, persuasive, communicative people to get back into some form of gainful employment, than a low skilled temporary contract operative in a contact centre or branch-plant

“screwdriver” operation in the north east of England who has been laid off because of a collapse in demand. Perhaps the pain of high unemployment will not last as long as in the 1980s, because there is evidence, in the form of greater willingness on the part of private sector workers to negotiate pay cuts to protect jobs, of greater labour flexibility now. However debate amongst experts, in terms of recent media comment, seems divided on this point. Forthcoming reductions in public sector budgets are likely to hit public sector employment levels in the future. Here so-called concession bargaining may be more difficult to achieve.

The scale of government stimulus and financial system support packages across the globe introduced in response to the crisis has been mind-boggling. What we now know that it could take a generation to return the UK government finances back to a position of healthy surplus with debt levels returned to European Union guidelines. I have always been somewhat ambivalent about Keynesian macro-economic policy. The economist in me recognises that without the massive injection of government spending and electronic printing of money (for that is what “quantitative easing” really is) over the last six months the impact of the crisis would have been a lot worse. There seems now to be widespread professional consensus on this point. Indeed I think it is very highly likely that we would have ended up with a 1930s type slump, with massive future political consequences. The Christian in me is morally very concerned that we are shipping the cost of our collective folly onto our children and grandchildren. I think there is a serious need for all our politicians, regardless of party allegiance, to be honest with the electorate about this, and not to seek to play games which who is promising or threatening what in the forthcoming general election. There is now growing evidence of increasing realism amongst politicians on this issue.

It is important to consider the wider geo-political consequences as well as the fiscal consequences of sorting out the mess. There have been some siren calls for economic protectionism in one form or another. Christian economists must stand up to this. The Archbishops were absolutely right before the recent European elections to warn of the consequences of courting the extreme right wing. It is human nature to cast around for people to blame – but it is utterly ridiculous to blame the “strangers and aliens” in our midst, and it is quite wrong to refuse them future hospitality. But in

the 1930s the crisis became a depression because governments adopted “beggar-your-neighbour” protectionism, and the failure of liberal democracy led the fascism and eventually war. This was exacerbated by politicians, such as Herbert Hoover, who were reluctant to use fiscal policy and took the view that the financial system would be self-righting. I don’t want to scaremonger – but Christians have a responsibility in the present time to draw the connection between misguided economic policy and political consequence. Capitalism, supported by a liberal democratic political system, has experienced a serious malfunction, but it is not broken beyond repair. It will break down again in the future, but if we learn to drive more carefully the engine ought to have a few more miles yet in it.

4 So who is to blame?

There is little sense in politicians and academics spending a lot of effort in trying to answer this question. So I am not going to answer it, except to say that ultimately it is all of us, and therefore there is a need for Christians to call for an act of societal repentance and recommitment. But I have listened to and taken part in discussions in various forums recently where professional groups have begun a process of painful introspection about the question of blame. At a recent international gathering of business school Deans there was a significant discussion about whether our universities and business schools had been at fault for turning out MBAs with too much technical knowledge about financial derivatives and insufficient attention paid to educating them on good corporate governance and corporate responsibility. From a British perspective I’m not sure that I recognise this characterisation.

However it is important that business educators redouble their efforts to balance the technical content of the curriculum with appropriate discussion of leadership integrity and corporate responsibility. Perhaps we might also consider finding more gainful future employment for unemployed PhDs in physics, so that they are not inclined to see the creation of bewildering financial instruments as future gainful employment!

I have also listened to discussion about economists blaming their own profession. They have become obsessed with economics as a technical and morally neutral subject with insufficient attention given to what used to be called “political

economy”. Undergraduates and postgraduates in economics no longer seem to read extensively in economic history, as a valuable counterpoint to acquiring technical skills. In Genesis 1.1 we read that God created the world out of chaos and confusion. A recent letter in the FT jokingly claimed that economists must be the oldest profession in the world, when one thinks about the question of who created the chaos and confusion in the first place!

I have even recently heard blame implicitly passed to the newly industrialising, “surplus-saving” economies, most notably China. Here the argument is that some economies, especially China, have saved too much and have had to recycle those savings, inflated by artificially high exchange rates, back through the global financial system to create credit and hence demand for all the manufactured goods that they are producing. This is a technical argument about the global, spatial balance between consumption and investment, but behind it perhaps lies a rather stronger moral point about the unstoppable rise of the consumption ethic, and the need to avoid what Marxists would call “realisation crisis”. Aside from the question of exchange rate levels, it seems unreasonable to blame the economic prudence of a large part of the world’s population for the consumption excesses of those of us in the developed world.

5 Conclusion

An obvious conclusion to draw is that the world could have seen this coming. Indeed some people did. Former City economist Peter Warburton published a prescient warning of the delusion of global debt and predicted that all this could happen 10 years ago, and he was pretty much right (*Debt and Delusion*, 1999). Governments acting in concert will need to establish for the future a new tighter regulatory environment in which the unbridled growth in “off balance sheet” financial activity can never be allowed to occur again. However the type of regulation to be put in place focuses on the technical solutions. The future worries me from a moral perspective as well. It gives very serious cause for concern because it is still far from clear if politicians across the world, and in particular in the UK, have really yet understood and taken on board the moral aspects of the “debt comeuppance”. Until they do so, society will not fully understand the hard, yet easy message that “godliness with contentment is great gain (1 Timothy 6:6). Until that point we will

continue to inhabit a world in which “History repeats itself. Has to. No one listens.”
 (“History Lesson” by Steve Turner).

WHAT LESSONS SHOULD CHRISTIAN ECONOMISTS LEARN FROM THE CREDIT CRUNCH?

Stephen Beer

Senior fund manager at the Central Finance Board of the Methodist Church.

www.stephenbeer.com

1 Introduction

I will begin my remarks by outlining briefly what the credit crunch was including my experience of it. I will describe the debates market participants are having now. I will outline some key lessons before asking ‘what next’?¹

2 Origins of the credit crunch and recent developments

The credit crunch was a combination of a bubble and some esoteric financial instruments. Ultimately it all came down to debt (or leverage) again.

The US housing market experienced a variety of innovations over the years and in combination with increases in leverage and securitisation it proved the trigger for the financial crisis. In his book, ‘Liar’s Poker’, Michael Lewis describes his experience working for Salomon Brothers in the 1980s after they had worked out how to package up mortgage debt and sell it on to investors. The crisis has its origins, years later, in the packaging up and securitisation of US sub prime mortgage loans. Collateral Debt Obligations (CDOs) enabled those loans to be divided into tranches with different levels of credit quality (as defined by a credit rating agency). A special purpose vehicle could acquire a portfolio of loans and issue bonds – or CDOs – with varying degrees of credit quality. A miracle had occurred - through the wonders of diversification, poor quality loans (sometimes referred to as ‘liar loans’) had been transformed. An investor did not even need to own one of these CDOs but could buy a synthetic CDO that was constructed with credit default swaps, essentially insurance contracts against a loan or bond defaulting. Furthermore, a CDO consisting of other CDOs could be bought, complicating the investment further.

¹ The text in Section I is drawn from notes I prepared ahead of the discussion session at the 2009 ACE Study Group Meeting.

The US housing bubble faltered. In July 2007, a couple of hedge funds ran into trouble with implications for their sponsoring parents. Very soon, doubt entered the financial system. Banks, knowing they were not sure about their own balance sheet exposure to toxic assets (which came back onto balance sheets), became wary of lending to each other since they certainly did not know the risk exposure of their counterparts.

Money markets reflected this risk aversion with wholesale rates rising well above base rate. In the UK, the first casualty was Northern Rock. It had to pay a much higher interest rate to borrow money than other equivalent banks. Finally, a run on the bank prompted action by the authorities. A year later, Lehman Brothers went under, and almost took the banking system down with it. These were difficult times for market participants.

The debates I hear in markets now focus on the role of the 'real' economy. The collapse of Lehman Brothers seems to have caused a sudden drop in confidence across most sectors of the economy at more or less the same time, in the fourth quarter of 2008 and the first quarter of 2009. As attention focuses towards the expected recovery (even while economic growth in the UK is negative), an important question is whether this time around there will be a simultaneous recovery across sectors. Market participants have become less risk averse than in 2008 and in Q1 2009, with riskier assets rebounding sharply in price (e.g. cyclical stocks). There are also indications that the banking sector is focused again on making money and is taking full advantage of the steep yield curve, the low base rate, and other monetary policy interventions by the Bank of England and other central banks. While so-called toxic assets may remain on balance sheets, with government backing, banks can make significant operating profits in this environment. For example, the base rate is 0.50% but ten year gilt yields are 3.8%. The money market curve itself is quite steep. Borrowing short and lending long is a profitable strategy.

3 Key lessons

Some key lessons we can learn are as follows.

1. Capitalism is inherently unstable. This is a lesson that Keynes sought to teach us, and was underlined and developed by Hyman Minsky². Periods of calm and stability lead to a more relaxed attitude to risk and leverage. Eventually risk-taking increases to the extent that investors make Ponzi-style investments at the height of a bubble. Minsky's answer is that big government is necessary to absorb private sector debts built up in bubbles if a depression is to be avoided.
2. It all comes down to leverage. J.K. Galbraith remarked in '*A Short History of Financial Euphoria*' (1994) that at the heart of any financial innovation is a new way to increase leverage. That has been the case again with the current crisis.
3. Values are required to underpin our economic and financial system. This is an easy conclusion to reach but not so easy to act upon. In the autumn of 2008, City market participants could be heard asking almost epistemological questions as their world appeared to be falling apart around them. Some questioned the basis for their careers and the entire capitalist system. The excesses of the debt bubble period now seemed less sophisticated and rather empty in nature. Not only that, but the necessary action to save the banking sector, by committing billions of dollars of taxpayers' money, challenged the economic presuppositions and ideologies of many working in financial markets. Those who had opposed nationalisation of industries found themselves calling loudly for the largest nationalisation and bail out of an industry in history. This phase of disconcertion has almost passed.

The need for values was identified by a number of bishops, including our two Church of England archbishops. Political leaders too identified this need. Prime Minister Gordon Brown gave a speech in St Paul's Cathedral in April this year (2009) calling for a return to family values in markets. Brown said

² Minsky's *Stabilizing an Unstable Economy* (1986), republished in 2008, I have found particularly useful.

that, *“Our financial system must be founded on the very same values that are at the heart of our family lives, neighbourhoods, and communities.”*

Identifying relevant values as hard work, taking responsibility, being honest, and being fair, Brown argued that a global ethic was possible because, *“a single powerful moral sense demanding responsibility from all and fairness to all runs through the many traditions and faiths. Loving your neighbour as yourself (and the equivalents across faiths) means we also have a responsibility to help the poor and deal with climate change.”*

Brown gave his speech alongside Prime Minister Kevin Rudd, of Australia. Rudd commented afterwards that the economic system required trust, *“A proper balance between markets and government has to be restored. Values such as security, liberty, and prosperity have to be combined with the values of equity, sustainability, and community. We will avoid a 1930s-style depression if we rebuild a values-based system and have the courage to act together.”*³

One value identified as missing was trust, which is vital in financial market transactions. Another value which we can see should in some way be upheld by banks and similar institutions is a commitment to the Common Good. This is easier to miss than it is to define. However, there has been a widespread feeling that the financial sector somehow became separated from the rest of society.

4. When a crisis of this magnitude occurs, there is a general sense that there should be some signs of repentance. In the immediate aftermath, we saw a succession of still shell-shocked bankers express regret at what had happened but highly reluctant to apologise for their actions. Perhaps they did not want to open themselves to legal actions. Yet repentance is more than saying sorry. It is a turning away from a past practice. That is what people seem to be

³ See <http://webarchive.nationalarchives.gov.uk/+/number10.gov.uk/news/speeches-and-transcripts/2009/03/pms-speech-at-st-pauls-cathedral-18858> and also my Guardian comment at <http://www.guardian.co.uk/commentisfree/belief/2009/apr/01/gordon-brown-g20-values-st-pauls>

looking for. Public anger has arisen in part because they are not seeing it. Banks are operating as before, with the bonus culture showing signs of life. There seems too, to be little public gratitude being expressed by bank executives for taxpayer action.⁴

5. Finally, Christian economists need to be prepared to provide a set of robust principles for a reformed economic system. The Jubilee Principles seem a good place to start. It is noteworthy that these principles provide for cancellation of debt every seven years, which is approximately equivalent to the amount of time it takes for banks to find new ways to lose money. The principles also provide for a redistribution of land assets every forty-nine years, or we might say every generation. We might also reflect that a major financial crisis seems to occur every generation, if that is not trying to push the comparison too far. Nevertheless, the Jubilee Principles offer lessons on how to protect an economy against excessive leverage and financial bubbles.

4 Looking to the future

As we look to the immediate future it is apparent that there is a lack of clear leadership. In some way, almost everyone is tainted by this financial crisis. The MPs expenses scandal has helped undermine the political leadership. Few politicians understand finance or business in any event. In addition, there is already a sense that people are forgetting what we have all been through, with the recession a clearer focus in mind. The challenge to Christian economists is to translate the calls for values in economic systems into meaningful and robust proposals for practical reform.

5 Reflections one year on

5.1 Remuneration

While the size of bank bonuses has been a prominent subject since the credit crisis first began, we have yet properly to tackle it. Banks are once again paying very high

⁴ This point was later emphasised by the Archbishop of Canterbury in a speech to the TUC in November 2009. He also called for virtue to be more evident. See my comment at <http://www.guardian.co.uk/commentisfree/belief/2009/nov/18/archbishop-canterbury-tuc-speech-economy>

salaries with attractive bonuses, even banks owned or part owned by the state. These bonus payments are now often deferred (and paid in deferred stock) but after an initial relative hit, employees benefit from rolling bonus payments from past years.

There is a common response from members of the banking community when asked why remuneration is so high. They reply that they agree that remuneration is excessive, but if an individual bank did not pay a high enough salary it would lose employees actual and potential to rival banks. Game theorists ought to be able to devise a solution to the problem. It might be suggested that bank and executive remuneration represents the market rate. However this ignores the role played by institutional power.

Of course, claiming that remuneration is too high is to introduce a value judgement. Christian economists should not be afraid of doing this but we do need to be robust when making such claims. The Church Investors Group in the UK recognised this need last year and commissioned a report on executive remuneration from two leading theologians. It is the only theological report on this issue aimed at the investment community. One of the recommendations of the report was that investors should encourage companies to limit executive remuneration to a multiple of 75:1 when compared to the lowest ten percent paid in the company. The aim of this recommendation was to move the debate beyond high pay to wider considerations of the relationships within companies and fair pay.⁵ The Church Investors Group report is welcome because across the UK stock market there is little sign of pay restraint by directors.

5.2 Business as usual

In my comments to the ACE discussion last year, I noted that banks were making large operating profits in ideal conditions of high liquidity assisted by aggressive central bank operations. This continued to be the case throughout the year and the yield curve remains steep.

⁵ The Church Investors Group report can be found at <http://www.churchinvestorsgroup.org.uk/~churchin/issues/executive-renumeration> . It was written by Revd Dr Richard Higginson and Dr David Clough.

It has been business as usual in another respect; banks are resisting change. The financial crisis highlighted the failure of regulation and fact that good regulation is necessary but not sufficient. A lesson from Minsky is that regulation will weaken over time. This would surely happen again, with over time even bank capital ratios rules being relaxed. What is required is institutional reform. While even the Glass-Steagall Act did not last forever, it did provide a firebreak for some time. Banking activities should be split between utility banking and more risky 'casino' type banking⁶. The Volcker Rule attempts to do this and new US banking legislation is likely to retain much of Volcker's proposal, even though it does not go far enough. However, all along the way the banking sector has resisted change. This is despite the sector being a risk to society when not properly controlled. Despite the confusion and panic during key points in the crisis⁷, bank executives have yet to acknowledge this, a point typified in many peoples minds by the Goldman Sachs CEO's comment that bankers were 'doing God's work'.⁸ Indications that the Basel III proposals for new regulation will be watered down add to the impression that the banking sector is not going to be reformed in the way that seemed inevitable when all was at stake less than two years ago.

5.3 Sovereign debt crisis

We are now some way into a sovereign debt crisis in Europe. So-called peripheral countries in the eurozone have come under severe pressure in markets. Greece has faced most pressure with constant speculation that it will default on its debt, requiring bailouts from the IMF and European governments. Other countries such as Spain and

⁶ The Christian Socialist Movement promoted an Early Day Motion supporting this last year. One of the signatories was Vince Cable, the current Business Secretary. See

http://www.thecsm.org.uk/Articles/167301/Christian_Socialist_Movement/News/The_Economy/MPs_urge_government.aspx

⁷ I recommend *Too Big to Fail* by Andrew Ross Sorkin (2009) for a highly readable account of events in 2008, particularly the fall of Lehman Brothers.

⁸ See http://www.timesonline.co.uk/tol/news/world/us_and_americas/article6907681.ece

Portugal have suffered too. The ECB has been buying sovereign debt to help retain some degree of market confidence.

The new UK government has announced a more aggressive deficit reduction programme than the previous government had planned, despite those original plans containing severe spending cuts. It appears the new government was persuaded to do this both by its own economic theory and by the Governor of the Bank of England who expressed concern at the recent events in the eurozone: the concern was that market participants might turn on the UK, so raising the price of UK debt and forcing the pace of fiscal tightening. Whether this concern was well-founded is open to much debate. Markets are currently experiencing a bout of risk aversion and the ten year gilt yield is now around 3.36%.

The sovereign debt crisis has seen governments at the mercy of the same credit rating agencies which gave AAA ratings to sub prime mortgage related securities⁹. The financial institutions, which required government (for which read taxpayer) bailouts, now demand that governments retrench quickly.

6 Further lessons for Christian economists

6.1 Values and the financial system

We have to accept that despite exhortations for better values to prevail in markets, little has been done to ensure this will occur. This is due in part to the nature of the market system; it brings together many economic actors via the price signal. To address the morality of markets, we need to look at the morality of market participants. The prevailing value system in society is important.

However, the failure to make progress on promoting values is due also to a resistance to substantial reform. It is possible for changes to be made to market systems to ensure that ethical behaviour is promoted and not squeezed out. Ultimately this comes down to leadership, which has been lacking at most levels. Leadership is required not simply to model good behaviour but to push through necessary structural reform. This lack of leadership has also been combined with a

⁹ An article I wrote for Tribune in January 2010 covers the role of credit ratings: <http://www.tribunemagazine.co.uk/2010/01/08/credit-where-it%e2%80%99s-due/>

deficiency of vision. For example, the City of London could have promoted itself as a bastion of financial virtue, perhaps attracting some business that way. Christian economists have a role therefore in devising reforms which act to reinforce ethical behaviour.

6.2 Power

One over-riding lesson seems to be clear. We must not ignore the importance of political and economic power. Banks have exercised this power during the crisis. At their weakest they were able to rely on the prospect of mutually assured destruction. Now, with the exception of those banks vulnerable to sovereign debt concerns, they have become more powerful. Their power has increased since the crisis because the banks that remain have fewer competitors and new capital requirements have raised barriers to entry. Remuneration remains excessive in many cases. The power of the financial sector is in contrast at present with political power. The power of the taxpayer relative to the sector it bailed out is not great at all.

Christian economists need to address this issue. Capitalism is not always the same as a competitive market system. Monopolies and oligopolies exist. There is a need for a Christian economic approach to financial power, from which we might learn how best to reform the system.