What are banks worth?

– Quotes from discussion –

Occupy London, 23 February 2012

Participants:

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Themes:

- Systemic risk
- Discerning "socially useful"
- Subsidy and risk
- Bankers' rewards
- RBS' balance sheet
- Political "rigidities"
- Reform horizons

Systemic risk

Rich: So we're just sort of staring into a mist when we try and work out what RBS is even worth, and what the banks are worth?

WdH: Yeah, so – **I think we have to realise how scary that is.** See, I really thought that when the crisis hit, that this would be a great opportunity to actually turn things around. And **I've been actually flabbergasted since, that politicians didn't take this opportunity, when they sort of had the momentum going, to actually implement some needed reforms. And so actually, in terms of the risk to the system, very little has changed.** And given that we know how deep we can sink, there is a possibility that's going to happen again.

GK: On balance sheet derivatives exposure for these banks is about 1.1 trillion at the moment, steadily rising since the bail-out in 2008, it's been a little bit higher before then.

Discerning "socially useful"

Rich: So do you think [financial services as 9 per cent of GDP] is a reliable figure? – probably not then.

WdH: Probably not!

Rich: How much of the gains on their current balance sheet actually correspond to productive activity – have we any way of telling?

WdH: Actually we don't... The hard thing about the financial sector is even though they get a big share of what we earn together – so in the UK it's roughly 10 per cent – **there's very little known in terms of what is the actual value that they generate** in exchange for that.

KW: If you look at the British banking system in 2008, **84 per cent of its loans are (a) on property or (b) to other banks. I.e. it's completely to do with, basically, debt, property, and the inflation of asset prices – or simply punting bits of paper around inside the banking system.** Now, it seems to me both of those activities, *prima facie*, without Wouter's precision, are unlikely to be socially useful in any sense whatsoever.

WdH: The problem is that this sector is just so complex, so un-transparent – and to be fair, some things are really hard to measure... **If they are just managing to create a spread because they invest in risky stuff, when they lend it out, then they shouldn't call that value added.** If they really find really good, profitable ways to invest, then we should call it value added. The problem is that our world has become so complex, that we don't even have answers to those kind of questions.

KW: Finance is enormously pro-cyclical in the UK economy. **Under both Thatcher and Blair, housing equity withdrawal was larger than nominal GDP growth.** Housing equity withdrawal peaked at 5 per cent, and I think it was above 4 per cent for three years at the end of the Blair premiership. **So as well as actually requiring large subsidies, it's producing an intense economy of boom and bust, persuading everybody who owns house property to behave like a dodgy private equity fund.** This is hardly a major contribution to capitalist civilisation.

WdH: The problem right now is that the system is just so complex that we cannot evaluate risks of institutions and systemic risk. I am actually not that much against bonuses, if it's sort of clear that they actually deserve it. But the way the system is right now, you cannot evaluate it properly.

KW: It seems to me if you look at banking over the last kind of 20 years, what they can't do is judge risk. I mean we're now in the middle of a sovereign debt crisis, 'cos they've got large amounts of stuff on their balance sheets which they thought was risk-free, which turns out not to be risk-free. This comes four years after a major crisis caused by them holding lots of AAA which they thought were risk-free, which turned out not to be risk-free – the credit derivatives and the mortgage debt... Clearly, they should not be allowed to punt on a variety of classes of paper which they believe to be risk-free, because **they're very poor judges of risk**.

GK: In about 2006 I think the total lending to individuals and businesses, which people would regard as the real economy, was **about 3.5 billion of all four banks combined – RBS is about a third of all these numbers. The last numbers we have show that, in 2010/ 2011, that number's fallen to about 3.1, 3.2 billion.** So, all the measures the government talks about about encouraging lending to ordinary society are failing.

Subsidy and risk

GK: I don't actually think any of the shareholders are exercising any influence whatsoever – **I think [RBS] is a loss-making ponzi scheme which has been taken over by its management.** And that's why we ought to have proper regulation.

TG: We calculated [implicit subsidy] for 2010, it was still £46 billion for the big five banks. That is the benefit of then they gain from being essentially guaranteed by the taxpayer. Now **if they actually**

had to pay market rates according to the true riskiness of their activities, then yes, they wouldn't be making any – well, they'd be making even less money. But they could get back into profit if they paid sensible rates of dividends and salaries to their staff.

KW: If you look at the objectives which were set for UKFI, and via UKFI for the banks, they were – almost unbelievably – to create shareholder value, so that the banks could be sold at a profit – **even though shareholder value, and double-digit returns on capital were what had produced the leverage and the risk-taking which got us into the mess.**

TG: When you hear a Chief Executive of a bank saying, We wanna make 13 per cent, 15 per cent return on capital – right, do not put your money anywhere near it. Because you cannot make that sort of return without taking huge risks – but of course they're happy to take those risks, because they know that if the gamble turns wrong, they don't have to pay the tab – we do.

TG: I would suggest, if investment bankers create so much wealth for the economy, then let them take over the investment bank, and then they can gamble with their own money, and pay themselves bonuses out of their own money – and if they blow it up again, they can lose their own jobs, and their own houses, and their own pensions.

GK: The interesting thing here is that all the chaps doing this sort of activity... are well aware of this – they're well aware of the insolvency of their own bank. They are totally obsessed only with the amount of personal cash they can take out of the system. I would ask any of them to defend themselves by demonstrating **how much voluntary money they've put into buying shares at any of these banks – I think we'll find the answer is very trivial indeed.**

TG: I see that the Chairman of RBS this morning called, pleaded in fact, for the bank to be allowed to run on commercial lines. Well, how ironic could you possibly be? Was it being run on commercial lines when it went on a reckless acquisition spree? Was it being run on commercial lines when it mis-sold financial products to people, some of whom were very vulnerable, for which it's been called up and made a provision this year? Was it being run along commercial lines when it inflated asset booms, when it got involved in sub-prime US lending? And was it being run on commercial lines when it continued to pay massive bonuses, or remuneration, despite the fact that it's a loss-making, indeed insolvent company? **The last person in this country who should give a lecture on running anything on commercial lines is a banker.** Unbelievable.

Bankers' rewards

KW: What this year's figures bring out is, **they're changing the form in which they're paying the workers, but they're not dramatically reducing the pay.**

KW: What we should all be focusing on is the comp ratio. Comp ratio was typically between 40 and 45 per cent in investment banks on Wall Street before 2008 – presto! it's 41 per cent in RBS right now. **What change? – no change at all, other than a diminishing proportion of pay being paid in the form of bonuses, where it's deferred. All theatre.**

KW: So the bonus pool is down by some 50 per cent, but if you actually look at fixed pay – that's been increased, as it has in Barclays and other firms, to compensate for smaller bonuses being paid in deferred security form... **We're still talking about a system whereby pay is linked in to the turnover of the business**, the so-called "comp ratio" system, which they had before 2007, is still in operation, and in effect we've got a kind of profit share between the senior investment bankers and the shareholders.

TG: The branch staff are getting a 1 per cent pay rise yet the core bank is profitable, notwithstanding lots of nasties on the balance sheet. The investment bankers are still getting healthy bonuses, despite the fact that they're losing lots of money.

WdH: It's likely there are rents there, and it's not that easy to sort of, compete – and then if they extract rents, then **a big part of the 9 per cent is just these guys being lucky that they have this position.**

WdH: Wages in the financial sector have gone up, a lot more than in other sectors. If you control for observables like the education that they have, then you cannot explain it, especially in the last ten years. **Before the last ten years, part of the increase in wages was explainable by better education, better productivity, but especially in the last ten years – there's a gap** there that is not to be expected.

TG: There's another study that did a very long examination over time, and showed that when banks went through a period of being deregulated then the wage premium rose – and that happened prior to the '29 crash, and then when banks were properly regulated, that premium began to disappear. And obviously what's happened in the last ten, well 20, well arguably **since the 80s, the deregulation has progressively allowed banks to extract higher and higher economic rents, I think you're referring to – the unearned portion, if you like, of what they're paid.** So, like in the early 30s what we should be doing, is properly regulating the financial sector.

RBS' balance sheet

GK: The other interesting thing that emerges from these numbers is [RBS] have taken [in their own accounts] a few billion more in losses... but they're **still 10.7 billion under the 45 billion number that the Asset Protection Scheme records in their accounts [on behalf of RBS] as the expected losses** on this toxic portfolio.

GK: The profits, [the] number that's been declared is a loss of 1.9 billion. **After taking an extraordinary accounting gain of about 1.8 billion, reflecting the drop in value of the market price of their own debt.**

GK: Bonuses are coming directly out of the tax-payer bail-out funds and QE money, so this is a scamming operation using false accounting to convert austerity cash and tax-payer funds directly into banker bonus compensation.

Political "rigidities"

KW: Whether you look at reform in Dodd-Frank, or Vickers, or whatever, **there is no sense in which the intellectual case for reform is actually being reflected in what's being enacted.** Look at the UK at present – there's a very odd kind of situation, which is Andy Haldane, the leading policy intellectual on banking reform, Martin Wolf, the FT's correspondent, **and the whole of the rest of the informed commentariat, and interested economists, believe we need much more radical reforms than Vickers – and yet the three main parties are all of them convinced that the enactment of Vickers as quickly as possible is the thing to actually do.**

TG: Just over a year ago now, the *Financial Times* Lex column... said in all likelihood it will take another crash before any serious reform takes place... **that all three main parties think that the Vickers Report was a good solution is quite astonishing, frankly,** especially given that it's going to take eight years to even implement it – when they expect public services to handle a 30 per cent budget cut in three months, sort of thing... **I just hope that it won't take another crash before we get serious reform, but I'm afraid I am slightly concerned that it will.**

KW: The political classes... were in Britain and America entirely complicit – New Labour, Democrats, Republicans, Conservatives – all of them were completely complicit in what went on before 2008... **If political mobilisation declines, then you get politicians who represent metropolitan cliques, and who become increasingly dependent on funding from corporate business.** That's an exceedingly difficult problem to solve.

GK: I think the legacy we're passing from this crisis to the next generation is what an incredibly inept, incompetent and spineless bunch of regulators and leaders we have supervising the situation. People have talked about regulatory capture, triumph of the vested interests, IFRS accounting being run by this remote IASB board stemming from an agglomeration of the accounting firms... this entire umbrella of regulation is utterly incompetent and frankly, it's a kind of gravy train with everybody involved... couldn't possibly earn the kind of money they get doing these incompetent jobs in the outside world.

Reform horizons

WdH: The most important thing has got to be, is **we've got to make the financial sector more transparent.** Because then it will be much easier to understand what's going on in terms of what their accounting is, and how we should regulate that.

TG: The solution to making banks work better for society is actually to break them up – I mean, break them up significantly. And make sure that we have banks that focus on lending to individuals and businesses. Other countries have this – in Germany they have local banks, in Switzerland, in America – **what you'll find when you look at those places is that lending to small businesses was maintained and increased after the financial crash.** None of the pantomime of Project Merlin in other countries – they don't need it, because they have banks that do what banks are supposed to do. When you also look at those banks, **they might have made profits of "only" 6 or 7 per cent**

return on capital, but they continue to make profits after the crash. Because they were sensibly run banks that served the domestic economy.

TG: We are now shareholders of a bank, and I think it would be a mistake to simply say we must let it go off and try and pursue as much profit in as many dodgy ways as it did prior to 2008 so that we can get back our money. No, what we need to do is make sure that we build a banking system that actually benefits the economy more broadly.