Dialogues concerning the banking crisis

The Hume Lecture 2011

19 May 2011

The Rt Hon Alistair Darling MP

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Foreword

Our Annual lecture is the most important date in the calendar of the David Hume Institute. Each year we look for an excellent speaker on an important topic, of interest to a diverse audience. Yet again this year we were successful in meeting these objectives.

We were most grateful that the Rt Hon Alistair Darling MP accepted our invitation to deliver the annual lecture at the Royal Society of Edinburgh on Thursday 19th May. We are also grateful to Professor Alice Brown, a Trustee of the Institute, for acting as Chair for the evening; and of course to the Royal Bank of Scotland for once more supporting the Institute’s Annual Lecture. It was excellent that the bank’s Chairman, Sir Philip Hampton, was able to be with us for the event.

As the Chancellor of the Exchequer throughout the period of the banking sector crisis Mr Darling was exceptionally well placed to address issues related to the sector in his „Dialogues on the Banking Crisis“. We were also privileged that he chose to deliver the Institute’s Annual Lecture when, and I quote:- “for the first time in 23 years I speak for no one tonight save myself. It’s quite a liberating experience”.

It was also most fitting and much appreciated that Mr Darling should chose a title for his address that referred back to Hume himself; and difficult to disagree with his argument that:- “it would be hard to find any sequences of events which better demonstrates Hume’s view that it was passion and not logic which drives our actions than the conduct of bankers in causing the financial crisis.”

Mr Darling’s analysis of these events and their implications has been well covered in media reports of the lecture. Nevertheless this paper merits a further read, in order to ensure that we have picked up his key messages and nuances regarding the way forward for the financial sector and the sector in Scotland in particular; and the inter-actions between the sector and our economy as a whole.
In addition to this excellent lecture Mr Darling responded fully and with great vigour to a remarkable series of diverse and carefully prepared questions. This Q&A session, so ably managed by Professor Brown, added major value and left those present with many issues upon which to reflect.

In sum we had a splendid evening and now we have an excellent publication. We owe Mr Darling a major vote of thanks. Nevertheless in closing I must note that the views expressed by our speaker are his alone and do not necessarily reflect those of the Institute which, as a charity, must remain objective and dispassionate.

Jeremy Peat
Director

The David Hume Institute
Dialogues concerning the banking crisis

It’s a pleasure to deliver the David Hume Institute Annual Lecture in this the tercentenary of his birth.

I want to thank the David Hume Institute not just for the invitation to speak tonight but for its continued commitment to research and for informing public policy.

I suspect, in the light of recent events here in Scotland, your emphasis on evidence based research and non-partisan discussion is going to be needed more than ever. Politics is rarely dull in Scotland. But I think it is going to be more febrile than normal. As you might expect, given my full-time job, I want to touch on these events during my talk tonight.

But before you all stampede towards the door I promise this is not going to be a rerun of the recent election campaign. My main topic is the banking crisis – the impact of which will inevitably be the backdrop of politics now and for the foreseeable future both in Scotland and the UK. I want, before hearing the views of this learned audience, to discuss what needs to be done to reduce the likelihood of a repeat in the future. Any discussion of politics – and the constitutional future of Scotland – will, I promise, be within this context. It is also, I should add, very much my own view. It is now almost a year since I returned to the backbenches.

I don’t miss the trappings of office or the endless phone calls at the weekend. It is nice to realize that when the phone does go, it is likely to be an invitation to dinner with friends rather than news that a bank or country is about to go to the wall. I do miss, however, the opportunity to make a difference which actually is the reason most people, of whatever party, come into politics. But being on the backbenchers does give me the freedom to say what I think.

So for the first time in 23 years I speak for no one tonight save myself. It’s quite a liberating experience.
Nor am I foolish or arrogant enough to speak for David Hume. I will not be claiming that the great philosopher would, from beyond the grave, somehow agree with me. I may from time to time copy his methods of analysis but the conclusions I reach are my own. Except to say that it was Hume who dismissed the idea that it was reason which governed human behaviour. And it would be hard to find any sequences of events which better demonstrates Hume’s view that it was passion not logic which drives our actions than the conduct of bankers in causing the financial crisis.

Hume was also ready, when necessary, to challenge the Scottish Establishment – and suffered for it. They ganged together to prevent him gaining a succession of university posts, forcing him into virtual exile in France. Although how much a punishment was life in salons of Paris when the alternative was a cold winter in 18th century Edinburgh, I will leave it to others to decide. So I too will follow his lead and challenge what I suppose we must call the new Scottish establishment. His rejection of received wisdom and a demand for a rigorous examination of the facts and arguments is a good guide whether we are discussing Scottish politics or banking. So let me make my first attack on what has become, at least in some quarters, the received and comfortable wisdom.

Despite what some suggest, the calamity which hit the Scottish banking industry wasn’t imported from London but was homegrown. I am not trying to shrug off Government responsibility for any mistakes made over regulation nationally or globally and I’ll return to this in a minute. And it is true that Scottish bankers were not alone in their misjudgments. The same mistakes were made in London, New York, in Dublin and Reykjavik to name just a few cities. But when people talk about boom and bust, Scotland’s bankers took up the challenge in spectacular fashion. And they all got themselves - and everyone else into trouble - for much the same reason. They didn’t understand what they were doing, the risks they were taking on or often the products they were selling. I remember one leading banker at the height of the crisis telling me with pride that his bank had just decided they would no longer take on any risk they didn’t understand.
I think this was supposed to re-assure me. It didn”t. It horrified me.
Not surprisingly, we – and here I mean you the tax-payer – soon ended up owning much of his bank.

We all know the result of this failure to understand the risks they were undertaking. The banks collapsed causing the worst economic crisis for at least 60 years. And it could have been a great deal worse. We came at times perilously close to total melt-down.

Even so, the pain is being felt by every family in the country and across much of the world – and it will be, I”m afraid, for a long-time yet. Not as a result of the bailing out of the banks. We will, as I always said, get our money back. But because of the recession which the financial crisis sparked.

So I am not surprised that there is anger at the way the banks have behaved - and, of course, at the size of the bonuses they continue to pay themselves. But we have to be careful. We can”t be ambivalent about this industry. It is just too important to Edinburgh, to Scotland and the UK. It provides 10% of Scottish GDP. 100,000 people employed directly, maybe 1 million in the UK. Not just in banks but in fund management, insurance, legal advice, accountancy and other services. And this industry is vitally important to us not just as an employer. We can”t have a functioning, successful economy without a functioning and successful banking system.

It is why I have no regrets at all about the unprecedented action I took in Government to rescue the banks. The cost of letting them fail would have been far greater.

I make this point because it”s very fashionable today to have a downer on banks and bankers. Here Hume”s admonition to prefer reason is important. We have to make our minds up. Do we want this industry or don”t we? And the answer to me is emphatically yes.

That doesn”t mean that we don”t need to regulate it properly or that we don”t offer criticism where it”s deserved.
But we should also remember that there are many other parts of the world which would love to have what we have in Edinburgh and London. And just because we are globally a major player in financial services now doesn’t mean it has to remain that way. Our engineering excellence was for generations the envy of the world. We essentially gave it away through neglect.

I am, let me be clear, totally in favour of rebalancing our economy. But we need to do it the right way. The wrong way is to shrink the financial services industry, either deliberately or accidentally. This will only mean we become poorer as a country and people. The right way is to create the conditions where we can also grow other sectors like manufacturing or in education which is something else where we are a world-leader. Which means, by the way, ensuring we fund our universities in Scotland properly rather than pretending we can continue to duck the tough decisions made over higher education finance south of the border. We don’t have to reach the same conclusions. We do have to address the question. So of course we must do what we can to encourage manufacturing.

But we also need to be very clear that we need a strong banking and financial sector including insurance and fund management, a great deal of which is based in this city. Let’s remember, too, that Edinburgh’s strong position in financial services depends on London’s global pre-eminence in this sector. This city may be the fourth largest financial centre in Europe but a close relationship with London is absolutely essential to our future. We should not kid ourselves – or let anyone else kid us – that we can have the luxury of independence without the consequences of separation.

There is one other important point from the banking crisis which I think is relevant to Scotland’s constitutional future. And here we turn to the problems of Iceland and Ireland which were once talked about, of course, by the nationalists as a future path for Scotland. Iceland, with a population about the same as Wolverhampton, simply could not cope with the folly of its three banks. Their failure has bankrupted the country.
Ireland decided effectively in 2008 to underwrite the debts of all its banks. The result was that it was eventually forced to go cap in hand to the IMF and European Union - not because of the Government’s behaviour but because the bank’s debts had become Ireland’s debts.

This is important. For at the time RBS collapsed it had a balance sheet only slight less than the size of the entire output of the UK – not Scottish - economy. It was difficult enough for the UK to intervene. It would have been harder still for an independent Scotland. It is a practical example of my belief that Scotland is better, stronger, more prosperous as part of the United Kingdom. Which brings me to the constitutional issue which has dominated our politics for all my adult life – and is certain to dominate the next five years as well.

Now I happen to believe strongly that Scotland has more pressing problems than changing the constitution. But I accept that the constitutional arrangements will be top of the agenda for the next five years – and I am not afraid of the debate. I am not going to disguise the fact that the Scottish election results were bad for my party. Whatever the seemingly endless campaign was about, however, it certainly wasn’t a vote for independence. The issue was hardly raised. When it was, it was quickly downplayed although, of course, that’s all changed since the results. We are now told that independence is inevitable. I don’t believe it is.

But now we are going to have a referendum on independence, I am not sure why– except for the Nationalists’ fear about the result – we have to wait until the second half of the Parliament. Why not hold it now? Let’s find out what the settled will of the people is? The question has been asked so let us answer it.

I fear, however, the plan is to spend the next two and a half years deliberately provoking trouble with Westminster, stoking up a sense of grievance. If efforts are to be spent building resentment rather than tackling Scotland’s problems within existing powers, then it will prove a very damaging period for the country and indeed for our psyche.
The First Minister is already demanding more borrowing powers and the devolution of Corporation Tax. I can guess that the Treasury will be very reluctant, in this economic environment, to allow Scotland to opt out of borrowing controls when the decisions will still affect UK borrowing levels. I think it will be difficult, as well, to argue that someone living in Newcastle, for example, should meet the costs of this additional borrowing without any say in how it is spent or any benefit from the extra spending. And the issue of Corporation Tax immediately raises the future of the Barnett Formula. I don’t think you can continue to demand more and more powers to raise money without looking at the way in which the bulk of Scottish public expenditure is funded here.

There is a lot of talk in relation to banks about being too big to fail. But in politics for all political parties Barnett has been too big to fix. Despite being introduced as a stop gap measure to get over political awkwardness in the late 70s, it’s been here for 30 years. And because of the huge disparity between levels of public expenditure, it has become very difficult to undo. I don’t have a ready answer to this problem. If I did, we might have tried to reform it in the last Government.

This difficulty is why maintaining the Barnett formula was the policy of the previous Government as it is the present Government. What I do know is that you can’t unpick parts of the Constitution without being prepared to look at all of it - and if you are going to do that, you have to examine the downsides as well as the upsides. If we are going fundamentally to change the constitutional arrangements between north and south of the border, we need to know what the result is likely to be.

As I have said, the First Minister frequently used to hold out Iceland and Ireland as a potential future for an independent Scotland. Indeed, you may remember the term “the arc of prosperity”. I can understand why he has gone quiet on such comparisons. They may be independent in name but it certainly does not seem like it to their citizens
Which brings me back to the banks - and the future.

Firstly, the future of RBS. I was responsible for taking control of RBS. I also want to see control returned to Edinburgh when the shares are sold. The Clydesdale is now owned by the Australians. The Bank of Scotland brand might be here but the decision making rests with Lloyds in London. That leaves us with RBS, the only major bank still based in Scotland. At some point the Government will start to sell RBS shares back into the market.

As I have said, I am confident, with the charges we are rightly making, that we will recoup the money the tax-payers’ spent on rescuing RBS and the other banks. But when the shares are sold, it is a matter of real concern to me that its headquarters – and the decision-making - stay here in Edinburgh. Losing RBS HQ would be very bad indeed for Edinburgh and for Scotland. And that’s something that we north of the border need to be very clear about when it comes to the sale.

Political uncertainty doesn’t help. A local income tax, for example, would cause real difficulties for the financial sector. But that’s all the more reason not to wait to decide where our constitutional future lies. A referendum should not be used for party advantage. It is for all of us to have our say.

As well as making sure RBS stays in Scotland, we need to see more competition in the banking industry across the UK. I know my decisions helped reduce the number of major banks to five when I agreed the merger of HBOS and Lloyds. But the alternative was that HBOS would have gone down.

We need now to encourage more entrants into the field. It would be quite possible to carve out a new bank of sufficient size to provide more competition on the High Street to help lower borrowing costs. But competition, while important in itself, is not going to prevent a repeat of the crisis we have just suffered.
We have to make sure that we have the right framework to allow our financial institutions to flourish without risking the entire health of our economy if they fail. And here, I am not sure we have yet learned the right lessons from the recent damaging crisis or arrived at the right solutions.

First, we need to understand what happened. You can’t solve a problem unless you understand what it is in the first place. In essence, the problem with Scotland’s banks and indeed in the UK and wider, was twofold. They took on, as I have said, risks they didn’t fully understand and couldn’t control. Secondly, they failed to appreciate just how interrelated banks now are. For when one got into trouble, it became sadly inevitable that the others would be affected. And because they did not understand how deep the problems were in their own banks but also their competitors, they panicked not knowing whether they could trust each other. And when confidence goes the flow of money stops. The consequences were not just that we had to bail out the banks. Even more damagingly, the banking crisis caused a wider economic crisis the consequences of which we are still living through.

For it wasn’t the financial crisis which directly has left such a damaging legacy. It was the economic crisis it precipitated. What we have to do now is to reduce the likelihood of all of this happening again. We can’t guarantee to prevent a repeat. No one can. But we can reduce its likelihood. And that requires two basic steps. First prevention is better than cure. That means we need to turn our attention to what happens in bank boardrooms and how and what is regulated. Second we need to lessen the wider impact of mistakes which means the banks holding more capital and putting in place the means to cope with a bank that fails. And we have to realise, too, that none of this can be done in one country alone. It needs international cooperation.

So far the Government has concentrated on measures which could be grouped into curing the problem rather than preventing it.
To my mind, they have become diverted by the challenge of whether our banks are too big to fail. I think this is the wrong question to ask. It divides the world’s banks into good and bad – of which the good are our friendly high-street retail banks and the bad are the investment or casinos banks as they are now dubbed. It is the investment banks – or the investment arms of retail banks - which have been in the firing line and get the blame for the crisis. But we don’t have to speculate about whether or not this analysis is right or wrong. We know from the recent past.

Northern Rock was small, not large. It was a well capitalized retail bank. It failed because it was reliant on raising funds from America which it then lent into the British market. When these dried up, it collapsed, creating an infection which badly damaged confidence. We had to step in but its problems caused wider troubles.

A year later, it was the turn of the Lehman Brothers across the other side of the Atlantic. The position could not have been more different. This was a massive investment bank without a penny of savers’ money in it. It was allowed to fail. Its collapse brought the world banking system to its knees.

So we need to be careful about black and white divisions. And it is against this background that we need to consider the report by Sir John Vickers, appointed by the new Government, into the banking crisis. His interim report came out last month with widespread agreement from politicians, the media and City that the solutions it outlined were along the right lines. I have been in politics long enough now to be alert when there is such a consensus.

Vickers in essence is suggesting that banks must hold more capital so they have a greater safety net if problems arise. He also importantly came out against breaking up the banks but proposes firewalls between the risky investment and supposedly safer retail arms. This is intended to make it easier to allow banks which get into trouble to be wound down or the crisis managed without causing such damage to the wider economy.
These are necessary measures but it does not get to the heart of what went wrong in 2008. For we were faced not with the troubles of individual banks but a systemic problem. There is no doubt that contingency plans or living wills as they are sometimes called, would be of great assistance. But I”m afraid that the idea that you could in a crisis let successive banks fail in a slightly more managed way without catastrophic consequences is nonsense. And nor should we pretend that we can draw up plans to save retail banks but let the rest take their chances and fail if necessary. As I have said Northern Rock was a retail bank that got into trouble. But it was Lehmans which came close to bringing the whole house down.

So you can”t just distinguish between investment and retail banks and say one is bad – and should be allowed to fail - while the other is good and needs to be rescued. And while I don”t disagree with the need for banks to have a bigger capital safety net, it doesn”t actually make them safer. Increasing the capital they hold from 10 to 15% might cushion the blow but it”s not going to stop the fall. It”s like reacting when you are told you have faulty wiring in your house by taking out higher home insurance rather than calling out an electrician.

What higher capital requirements do mean is that the banks will inevitably have less money to lend. That is not going to make their job any easier. Our banks, in fact, now find themselves accused of making reckless decisions about lending while being criticized for not lending enough at the same time as being asked to build up capital reserves. So what should we do? Firstly, we need to be clear about what we can regulate and what we cannot.

Regulators can”t stand in the shoes of management but they do need to understand how the businesses they regulate actually work. It is clear that wasn”t the case – hardly surprising, I suppose, as the bankers themselves did not know what was going on. I perfectly understand why the present Government wants to blame what went wrong on the so called tripartite system of the Bank, the FSA and the Treasury.
But that wasn”t the reason for the crisis or the mistakes which led to it. The problem was not the structure but the failure of the regulators to understand the way the businesses they were overseeing worked.

The present Government is reorganizing the architecture to put the Bank of England in charge. But there is no evidence to suggest the Bank would have got it any more right than the FSA. What needs to be done is, above all, to identify the key risks and ensure they are understood and monitored.

I am worried that there is a growing body of opinion among regulators that because it is so hard to know what is going on inside an institution, it might be better to rely instead on very much higher capital holdings. Their argument simply put is that you can never know enough and it is difficult to draw the line between what are properly the commercial decisions of banks and where it is proper to impose regulatory requirements. We can”t opt out. We do have to regulate them – and we must. Regulators need to know what is going on in the critical parts of the banks.

With a majority of nearly 80, the Tory-led coalition has the votes to get their reforms through. Even then, it is clear the new regime won”t be in place until 2013. I just ask them to understand that there is no substitute for a regulator actually understanding the business they are policing. And I am not sure the reforms deal with this problem. And we need, too, to ensure they do their job in bank boardrooms. These people take the fees and the perks in the good times. They are paid to ask questions and to hold the chief executive to account. It is clear they didn”t do their job. We have to make sure they do in future. We need to consider how directors feel the pain if they get it wrong. They don”t today.

There is another problem with increasing capital flows which brings me to the international dimension. Unless other countries do the same, it puts our banks at a competitive disadvantage.
It also leaves us open to another crisis infecting us from overseas. The events of the last few years finally brought home to everyone what globalization means. It’s brought a great many opportunities but, with them, a great deal of risk. And that’s why as well as getting the domestic regulatory regime right, it matters as much, if not more, that the international framework is strong and effective.

I want just for a minute to say something about the position of Greece and the euro-zone. At the moment the euro-zone is struggling to come to terms with the continuing crisis. They need to do so quickly. We do know there are banks in continental Europe exposed to these problems. Unless action is taken – and promptly – there is a risk of exactly the sort of contagion we saw three years ago following the collapse of Lehman Brothers. A sovereign default could have similar consequences if not checked.

I am not encouraged by the steps taken so far. The European Stress Test carried out last year didn’t exactly build confidence when they gave a clean bill of health to the Irish banks. The new stress tests, designed to test what would happen to banks if there was a severe economic downturn, will almost certainly show what is blindingly obvious to anyone who has followed this crisis for the last three years.

There are banks which hold bonds issued by governments like Greece where there remain a risk of default. That means they will need more capital. That’s not a question that can be dodged or ducked and my guess is it can only come from governments.

All this means that the sooner the euro-zone accepts its responsibility towards its weaker members, the better for everyone. Muddling through, as we know, does not work. They need to recognize that these members need help to recover.

We also need to take action over the massive shadow banking industry unregulated where no-one is quite sure where the liabilities eventually lie. There are many billions of dollars out of sight and they need to be brought into the open and regulated.
There has been work, over a number of years, to improve international regulation but it needs to be stepped up. We have certainly got to get right international architecture in place. The IMF, for example, needs to have a clear role in identifying some of the big underlying problems in the economic imbalances between east and west. It was this which led to so much cheap credit being available in the United States which in turn fuelled the irresponsible lending that precipitated the collapse of the system. The IMF and through it its Financial Stability Board, needs to identify those banks and groups of banks that are systemically important across the world and to ensure they fully understand what they are doing. Progress has been made but much more needs to be done.

Ladies and gentlemen, I realize I have covered quite a wide field in this lecture. But actually the future of Scotland and the future of our banking system are not that far removed. At the end of the day what will make this country is; what we produce and the standard of living we enjoy, the quality of life and the opportunities for the people who live here. We have got to get the constitutional arrangements right for the 21st century but I am not sure this is what matters most.

We certainly need to get the environment right for the financial industry to continue its major role in our prosperity and that means getting the regulatory framework right in the UK and internationally.

There is now far more experience in what can go wrong and we need to learn from that experience. I am just not sure, looking at the evidence, that we have learnt the right lessons.

I think this refusal to test arguments against evidence would have worried David Hume. In this, as in much else, he was right.
The David Hume Institute

The David Hume Institute was registered in January 1985 as a company limited by guarantee: its registration number in Scotland is 91239. It is recognised as a Charity by the Inland Revenue.

The objects of the Institute are to promote discourse and research on economic and legal aspects of public policy. The Institute has no political affiliations.

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