London Review of Books

Let's consider Kate

John Lanchester asks what is to be done about the banks

As the new governor of the Bank of England, Mark Carney, takes up his job, it's a good moment to reflect on the nature and scale of the work ahead of him. In the rear-view mirror, he can see how our banks reached their current condition – a story full of failure, scandal, greed and incompetence. That, as far as the overall picture of modern Britain is concerned, is the fun part. The difficult thing is looking forward and trying to work out what to do next. That's because in their current condition our banks are an existential threat to British democracy, a more serious one than terrorism, either external or internal. As Andrew Haldane, director of stability at the Bank of England, put it in a historical overview a few years ago, 'there is one key difference between the situation today and that in the Middle Ages. Then, the biggest risk to the banks was from the sovereign. Today, perhaps the biggest risk to the sovereign comes from the banks. Causality has reversed.' Yes, it has: and the sovereign at risk is us. The reason for that is that in the UK bank assets are 492 per cent of GDP. In plain English, our banks are five times bigger than our entire economy. (When the Icelandic and Cypriot banking systems collapsed the respective figures were 880 and 700 per cent.) We know from the events of 2008 and subsequently that the financial sector, indeed the whole world economy, is in an inherently unstable condition. Put the size together with the instability, and we are facing a danger that is no less real for not being on the front page this exact second. This has to be fixed, and it has to be fixed soon, and nothing about fixing it is easy.

We need two things from our banks. One of them is to keep lending money, especially to small businesses, which are essential as the engine of economic activity – the route out of the state we're in. The government has poured unprecedented amounts of money into the economy in an attempt to get it moving. It's done so through quantitative easing, which involves buying back its own bonds using money that doesn't actually exist. It's like borrowing money from somebody and then paying them back with a piece of paper on which you've written the word 'Money' – and then, magically, it turns out that the piece of paper with 'Money' on it is real money. (Note: don't try this.) Another way of describing quantitative easing would be that it is as if, when you look up your bank balance online, you had the additional ability to add to it just by typing numbers on your keyboard. Ordinary punters can't do this, obviously, but governments can; then they use this newly created magic money to buy back their own debt. That's what quantitative easing is.

The idea is that since interest rates are so low, it's in no one's interest to sit on this newly created money. If you are one of the bond-holders who has sold your government debt back to the government, you will now go and spend your new cash on something that yields a higher rate of return. You'll buy shares with it, or invest it in your business, or something – anything – else. In the UK, the government has spent magic money on QE to the tune of £375 billion, 23.8 per cent of our GDP. An amount equal to a quarter of our entire annual economic activity has therefore been willed into being in an attempt to stimulate the economy. If they'd just given the money directly to the public, perhaps in the form of time-limited, UK-only spending vouchers, it would have amounted to just under £6,000 for everyone, man, woman or child, in the country. Can anyone doubt that the stimulus effect of that would have been much bigger?

We don't know if QE has worked; the consensus among economists is that it has but no one knows to quite what extent, and it's also the case that nobody knows what's going to happen once QE stops. In fact the 'unwinding' of QE is on many people's lists as a possible trigger for the next market meltdown. (Bear in mind that the numbers for American QE are even bigger: $2.3 trillion in magic money.) It is manifestly the case, though, that however much money has made its way back out into the real world, the figure is nowhere near £375 billion. The problem seems to be that people are too anxious to spend the money. Confidence is low, and when confidence is low, companies and individuals tend to save money rather than spend it. This means that a lot of the magic money has ended up being deposited in banks – a point on which the Bank of England's own website, offering the official explanation of QE, sounds interestingly defensive. 'The asset purchase programme is not about giving money to banks. Rather, the policy is designed to circumvent the banking system.' To which the correct answer is: 'Yeah, right.' One way or another, much of the QE money has found its way onto the banks' balance sheets.

The banks' own version of events features two mutually contradictory stories: one, we are lending lots of money; two, we can't lend as much money as we'd like to because the regulators keep nagging us about risk. But the numbers for that line of argument don't stack up. When you look at their balance sheets, it's clear that lending to the real economy hasn't gone up, whereas wheeling and dealing within the banking sector is thriving as much as it ever has. To take just one example, my own bank, Barclays, makes a fuss about being a British high street bank serving British people's needs: but loans to customers (meaning businesses and individuals) are only 28.6 per cent of its business. What it mainly does is stuff other than lend to us, principally because, from the point of view of a bank trying to make a lot of money as quickly as it can, we're not all that exciting. QE money that ends up on the banks' balance sheets will by and large go somewhere else – i.e. not to us and our needs.

Buried in all the horror of the payment protection insurance scandal, which I wrote about in the last issue, was a killer detail showing how bad the banks are at helping the real economy. The PPI fines being paid by the banks are a form of transfer from the banks to the real economy: picture Smaug in *The Hobbit*, lying on his mountain of gold, being reluctantly forced to part with a few coins by Middle Earth's version of the Financial Conduct Authority. The recipients of the money do exactly what the banks/Smaug won't: they spend it on goods and services. The Office of Budget Responsibility is the body set up by George Osborne in response to the fact that people had stopped believing official Treasury pronouncements. In their response to last year's budget, the OBR included a modest boost to 'household consumption growth', i.e. people spending money, thanks to the effect of PPI repayments. The OBR's assessment of Osborne's other policies showed no effect on household consumption growth. So the OBR reckons that the PPI repayments have done more to help the economy than all the other stuff the chancellor is trying to do put together! Another body showed the effect of PPI fines to be a boost of 0.2 per cent to GDP: a significant figure at a time when GDP was hovering between zero and something with a minus sign in front of it. That's really amazing. The banks are so bad at their primary function, lending money, that it's better for the economy if they pay billions of pounds in fines to the customers they ripped off.

The main government attempt to get banks out of Smaug mode was brought in last August: a policy called Funding for Lending in which banks were allowed to borrow money even more cheaply than their other government borrowing, provided they lent the money to businesses or individuals. The government has lent £16.5 billion through the scheme so far but – gasp! – the banks haven't done their bit. In the last three months of 2012, lending fell by £2.4 billion, and in the first quarter of 2013 by another £300 million. Some of the banks stood out, with the two state-backed megabanks excelling: RBS borrowed £750 million in the twelve months before June, and shrank its lending by £4 billion; Lloyds-HBOS borrowed £3 billion and shrank loans by £6.6 billion. Bad – very bad. The banks' collective defence is that the ultra-cheap money lent to them (at a rate of 0.75 per cent) has been passed on to us not so much in the form of loans per se but in the form of lower interest rates for our own borrowing. Well, maybe, but that wasn't the explicit plan, and to many credit-desperate businesses all over the country, Smaug looks as if he's lying very comfily on his hill of gold.

That impression is misleading. We need our banks to lend money, but even more important than that is the other thing we need them to do: we need them to be safe. That's the overriding priority, since it is the thing which, if it goes wrong, could break our polity. In the words of Mervyn King's last speech as governor of the Bank of England, at Mansion House on 19 June:

> the sheer size and complexity of global banks have led to failures of governance.Governments, regulators, prosecutors and non-executive directors have all struggled to come to terms with firms that pose a risk to taxpayers, cannot be prosecuted because of their systemic importance, and are difficult to manage because of their size and complexity. It is not in our interest to have banks that are too big to fail, too big to jail, or simply too big.

He was right about that, but let's hope he was wrong about what he said next: 'Solving these problems is the work of a generation.' It's not clear that we have that much time.

The point about needing to make our banks safe escapes nobody: it's a question of how and how fast. The government's response to this predicament was to appoint an independent commission on banking, known as the Vickers Commission, and then to incorporate its findings into the banking bill that is currently making its way through Parliament. At the same time Parliament was conducting its own inquiry into banking standards. This led to an interim report on HBOS, published in April, and a final report, which came out in June. It would be hard to improve on the opening summary of 'Changing Banking for Good', the parliamentary commission's report:

> Banks in the UK have failed in many respects. They have failed taxpayers, who had to bail out a number of banks including some major institutions, with a cash outlay peaking at £133 billion, equivalent to more than £2000 for every person in the UK. They have failed many retail customers, with widespread product mis-selling. They have failed their own shareholders, by delivering poor long-term returns and destroying shareholder value. They have failed in their basic function to finance economic growth, with businesses unable to obtain the loans that they need at an acceptable price.

Yes to all that. Because the banking bill is still in Parliament, the government has said that there is time for it to incorporate some of the commission's recommendations. As things currently stand, the main components of the banking bill come from the Vickers Report. The first of them has come to be known as the 'ringfence': an internal separation inside banks between the parts of the business that interact with the public by taking deposits and lending money, and the other, more casino-like activities. The ringfence, furthermore, will be 'electrified': there will be penalties for breaching it, and a new regulator, the Prudential Regulation Authority, with the power where necessary not merely to fine banks but to enforce their breaking up. The retail bit of the bank will have implicit guarantees of taxpayer funding to protect depositors. Other bits of the bank will have no such guarantee and will be allowed to fail if they go broke. Also, to encourage increased competition between the banks, and thereby to increase lending to the rest of the economy, it will be made easier to switch bank accounts. (Note that this bit of the bill is much milder and weaker than the other part: it's not easy to regulate your way towards more bank support for the economy.)

These suggestions are very easy to summarise – misleadingly so. It's not just the devil that's in the detail but also the flesh-eating bacteria. Many observers thought, and some still think, that it would have been simpler and clearer to legislate a full split between retail and investment banking. The banks lobbied hard to prevent this, claiming that the costs and complexities and risks of enforcing the separation would outweigh the benefits. The Vickers Commission accepted their arguments. That was a mistake, not least because the point about the separation is that it would have been more clear-cut; the arrangements in the bill are so complex that I don't think an outsider can properly assess whether they would work in practice. That might not have seemed a flaw to the insiders who drafted the bill but it is a problem even so. Too complicated for the taxpayer to understand is too complicated for the taxpayer to subsidise. This might seem a populist point, but in relation to bank safety, a degree of populism is in order. We need our banks to be safe. It's not complicated. Maybe the rules shouldn't be either.

By way of trying to fix things, the parliamentary commission came up with some other proposals that the government has said it will consider adding to the bill. The most high-profile concerns a proposal to jail senior bankers when things go badly wrong. This was part of the commission's focus on the issue of accountability in the banks; they also proposed systems for making named individuals responsible for areas of a bank's actions, in order to create a chain of accountability if/when there are serious failures. Reading the report, you get the strong impression that the MPs were powerfully struck by how unaccountable and oblivious the bankers had become. Their separate report on HBOS, 'An Accident Waiting to Happen', is blistering on the subject. It has a section called 'The Best Board I Ever Sat On', whose last point observes that 'membership of the board of HBOS appears to have been a positive experience for many participants. We are shocked and surprised that, even after the ship has run aground, so many of those who were on the bridge still seem so keen to congratulate themselves on their collective navigational skills.' *Even after*? Wow.

The broader report, 'Changing Banking for Good', comes from a very similar place. It's clear that the commission was amazed by the lack of personal responsibility inside the banks. In an attempt to do something about that, the report's first and largest set of recommendations concerns the question of 'making individual responsibility a reality'. The report defines 'the problem' thus:

> Too many bankers, especially at the most senior levels, have operated in an environment with insufficient personal responsibility. Top bankers dodged accountability for failings on their watch by claiming ignorance or hiding behind collective decision-making. They then faced little realistic prospect of financial penalties or more serious sanctions commensurate with the severity of the failures with which they were associated. Individual incentives have not been consistent with high collective standards, often the opposite.

When you start to get your eye in with this sort of establishment-speak, you notice that the biggest zingers often don't signal their own zinginess, but are delivered as unstressed apparent asides. Those words 'often the opposite' are a classic example: they mean that the structures of senior banking were set up to encourage unethical behaviour. The report makes it clear that some of this behaviour was negligent and/or criminal, and yet it has gone entirely unpunished – has in fact, in many cases ('often the opposite'), been lavishly rewarded. There exists in the City a North Korean-sounding entity called the Approved Persons Regime, which is supposed to monitor and establish standards for senior bankers, but which has instead 'created a largely illusory impression of regulatory control over individuals, while meaningful responsibilities were not in practice attributed to anyone'. The report has some proposals for fixing that, the crucial one being that 'all key responsibilities within a bank are assigned to a specific, senior individual' and that this responsibility must go as far as it can: 'A criminal offence will be established applying to Senior Persons carrying out their professional responsibilities in a reckless manner, which may carry a prison sentence.' This, as it was probably intended to, translated into tabloidese as 'Jail Bad Bankers.'

*

These proposals would, I suspect, concentrate the minds of senior bankers if they became law. But that is quite a big 'if'. Human rights law will play a role here, if it looks as though bankers are being subjected to a regime which in any way treats them as distinct from the rest of us; and we can be sure that the City will lobby hard against anything that looks likely to put this regime into practice. Let's note that the PPI scandal involved clear criminal fraud on an industry-wide scale. The relevant clauses are in the Fraud Act of 2006, in Section 3, which deals with 'fraud by failing to reveal information'. Such as the information that the policy you've just been sold is of absolutely no use, and the salesman knows it perfectly well, and so do his managers. But there seems to be a complete silence on the issue of the criminal law and PPI, an evident unwillingness to roll over this particular stone. No doubt if searches were made and arrests followed, too many of the people caught up in them would be low-level employees whose name happened to be on paper trails. Many, most, of the people really responsible for the policies would get away unscathed. And yet it might make the banking industry pay a little more attention to the way it's supposed to behave. Will this happen? No. The political and prosecutorial will evidently isn't there. This is a clue to what's likely to happen to the proposal first to make bankers responsible, and then if that hasn't worked, to jail them. As for the commission's other proposals – to reform the way bonuses are paid, and to reform incentives in banking more generally – they are well-intentioned and the cumulative effect of all of them is likely, over time, to be positive.

*

Will all this be enough, though? Is the cumulative impact of Vickers and the parliamentary commission, as mediated through the banking bill, big enough to make our banks safe – to take away the existential risk? A hint as to the scale of the difficulties was given by Mervyn King (again) in his last public appearance as governor. Talking to the Treasury Select Committee – his 103rd appearance in front of Parliament, surely an all-comers' record – King said: 'It's also important that banks don't leave conversations with the supervisors' – meaning the regulators – 'and feel that the next step is to telephone Number 11 or even Number 10 Downing Street, and lobby officials or politicians to put pressure on the supervisors to back down on their judgments.' King was expressing a belief that bankers can't be trusted not to try to circumvent normal democratic procedures in an attempt to secure their own preferred outcomes. For a man whose job was to supervise those very same bankers, and who has spent his working life in close contact with the City, that is really something to choose as a note to go out on.

As for the bankers being active in private, at least that explains what they're up to now that they have entirely disappeared from the public debate about banking. I can't be the only person to have noticed that, quite simply, you never hear or see a banker anymore, on any broadcast medium. A TV bigshot told me that this is a known fact: 'They won't do accountability interviews.' When *Newsnight* had an item the day before the parliamentary report, there appeared as spokesman for the banks a sweet old buffer who retired from his job at Barclays twenty years ago. He said that talk of bankers going to jail was 'overdramatising it'. That was the best the industry could do in terms of finding someone to speak for it. The banks will no longer defend or explain themselves in public, and a big part of that is their conviction that they can get what they want by lobbying for it in private. Their history and experience teaches them so. Just as King said, that's the first problem for any proposed bank fix.

The linked difficulty, or the overarching problem of which this is a sub-category, is to do with bank culture. Let's for a moment propose a counterfactual, in which one of the big banks was headed not by a banker but by someone whose central focus in life was the attempt to be better, both personally and in the corporate sphere. Let's raise the stakes and make this person a professional ethicist, greatly admired by his peers, who writes books about the need for banking to be a moral enterprise. Leadership is important; although plenty of people who specialise in bullshit love saying that, the fact is that it's true: leadership is very important. So what would a big bank be like with a person of that calibre and focus in charge? How much difference would he or she be able to make? As it happens, we know the answer. The bank was HSBC, and the person in charge as CEO and then as chairman of the board was Stephen Green, who is an ordained minister in the Church of England. One of the four biggest UK banks literally had a priest in charge. His first book on banking ethics is *Serving God? Serving Mammon?* and his second is called *Good Value: Reflections on Money, Morality and an Uncertain World*. As for how that worked out, well, it was on his watch that Mexican drug-dealers made special boxes to deliver drug cartel money over the deposit counter. It was while the Anglican minister was running things that HSBC undertook criminal actions which led to a fine of $1.9 billion. So the counterfactual isn't really counter to anything. There's no reason to think that an emphasis on ethical banking, from the head of the company down to the troops, is likely to have any effect. These banks are huge and hugely complex institutions, whose separate components are fragilely and fleetingly linked. That is the reality of 'universal banking', in which these colossal institutions, each of them roughly the size of our entire national GDP, offer everything from your grandma's life insurance to your toddler's savings bonds to light-speed proprietary trading, derivatives and swaps, as well as Libor manipulation, drug-money laundering, PPI mis-selling, and all the rest.

My moment of clarity on this subject occurred a few years ago when my own unbeloved Barclays made a mistake with a US dollar cheque that I'd paid into my current account. A cashier put the wrong payment code on the cheque with the result that instead of taking a couple of weeks to clear, the cheque, for a few thousand dollars, was going to take a couple of months. While it was clearing, Barclays began sending me snotty letters saying that my account was in arrears and that unless I paid money into it they would fine me and/or close the account. I rang up to point out that this didn't seem fair; that since they had had a payment from me six weeks before – I had the deposit slip – and since the delay was their fault, it wasn't reasonable to threaten to close an account belonging to a customer of 25 years' standing. I pointed out that I also had a mortgage with them and my other accounts were in credit. Wouldn't it be possible to check their own payment system for the whereabouts of the cheque, or for that matter to verify with the mortgage department that I was in credit in my other accounts, or simply look at the computer and see that I'd been with them for a quarter of a century and was unlikely to run off and join the Foreign Legion, or whatever else the computer had been worried about when its software told it to send me a snotgram? The bank employee, wearily, and as if talking to a very very stupid person, said: 'Barclays is a very big company. I don't have access to that information. There's nothing I can do.' So I ended up transferring the funds because, according to their systems, there genuinely was no alternative. The dollar cheque cleared a couple of weeks later.

When I reflected on this afterwards, an entirely trivial incident which is also fairly typical of what the big banks are like to deal with, the thing that stayed with me was that the woman on the phone was telling the truth. There *was* nothing she could do: the cheque stuck somewhere in the bank's payment system truly was inaccessible to her, and none of the other ways of fixing the problem that was available to common sense and goodwill was available to her. That just wasn't how the bank worked: these were all separate components. This is one of the nubs of it. Our banks are so big and so complicated that it isn't clear their cultures are amenable to change in the way we need. Joris Luyendijk, a Dutch journalist who has been running a two-year project interviewing bank staff, reached the same conclusion. His experience was that banks are fragmented and atomised places, and that in many parts of them employees regarded themselves as working not so much for the bank as against it:

> The picture emerging from those interviews is of big banks not as coherent units run by top bankers who know what they are doing. Instead these banks seem, in the words of Manchester University anthropologist Karel Williams, 'loose federations of money-making franchises'. One risk analyst talked about her bank as 'a nation engaged in perpetual civil war', while a trader said: 'You have to understand, it's us against the bank.'

The rules, the laws, are annoyances to be fought against and worked around, all in pursuit of the only thing which is real: profit.

The changes to banking proposed by the commissions and the government have to be mediated through the existing culture of banking. Too many bankers share the view of ethics expressed by Richard Desmond at the Leveson Inquiry – 'Well, "ethical", I don't quite know what the word means' – and see complexity, of the sort arising from the proposed legislation, as an opportunity to make money. In fact, the ethical void revealed by the banking scandals is not dissimilar to the one exposed by the Leveson Inquiry. To function effectively, an ethical code needs to be internalised; if you have to explain to someone why something is ethically wrong, the cause is, usually, lost. These internalised codes, once mislaid, are hard to retrieve. That was true in certain sectors of journalism and it's true in banking too. Even with the right laws you need the right culture, and getting that culture is indeed likely to be 'the work of a generation'. Again, it's not clear we have that much time.

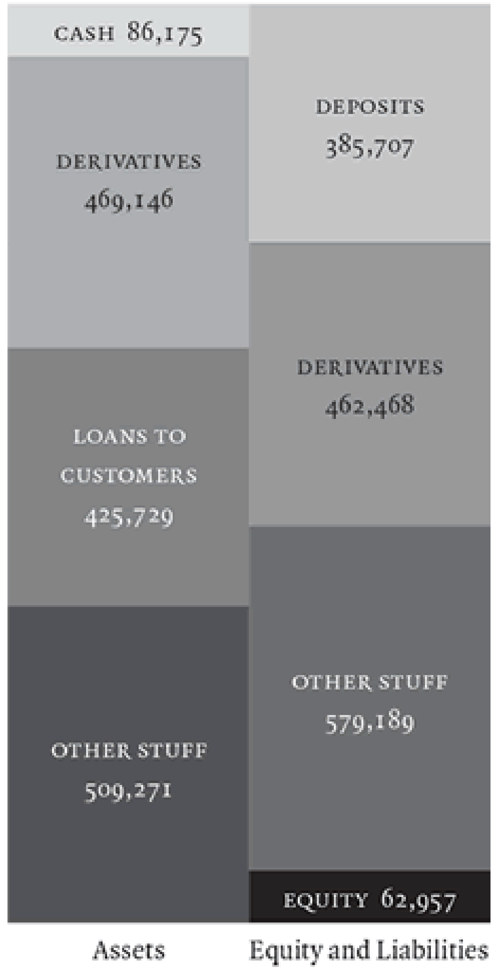
*

As this debate has progressed, another idea for fixing the banking problem has gained traction. The debate has been changed by Anat Admati and Martin Hellwig's book *The Bankers' New Clothes*.[*] Their central notion is both a bigger and a simpler idea than anything currently heading for the statute books. What would be the simplest, crudest and most reliable way of making the banks safe? If there were to be a quick fix, what would it look like? The answer concerns bank capital, which in other contexts is not called capital at all, but equity.

To understand equity, it's best to begin with a typical household balance sheet (actually not all that typical because I've simplified it). Let's consider Kate, whose house is worth £233,976 (the UK average) and whose mortgage amounts to £95,833 (also the UK average). If she has £10,000 in the bank and £1000 credit card debt and no other assets or liabilities, her balance sheet looks like this:

That mysterious item Equity is not a thing in itself: it's the amount by which Kate's assets exceed her liabilities. As we can all see, equity is a good thing: it is the amount by which we, each and every one of us, is not financially underwater. In the world of business, when you invest in a company, you invest in its equity: that's the bit of the business that you own.

Now consider the balance sheet of a typical bank. Might as well stick with Barclays. All figures are in millions of pounds.



A number of points here attract attention. One, isn't it a bit alarming that derivative assets are about the same as loans to customers, since derivatives, we all now know, have the potential to blow up the banking system? Correct answer: yes. Two, isn't it striking that customer deposits are such a small proportion of the balance sheet, at 27 per cent? Correct answer: yes. But the thing that really stands out is the size of the equity. A naive observer, uninstructed in the mysteries of modern banking, is likely to look at the size of the equity and say: Gosh, isn't that rather small? Isn't it odd that Kate, our typical householder, has more equity than one of our five biggest banks? Her house would have to lose more than 60 per cent of its value before her assets were less than her liabilities. Barclays' assets would have to lose 4.2 per cent. Isn't that a bit scary? Isn't it alarming that the biggest bank in Europe, Deutsche Bank, has assets of more than €2 trillion but at the time of writing has an equity ratio of only 1.63 per cent?

That, right there, is the emperor's new clothes moment. Banks hate this focus on their equity. They prefer much more 'sophisticated' measures of the risks they run, their preferred models involving something called 'risk-weighting', complicated calculations which give them different kinds of credit for the stability of particular assets. There are a number of reasons why banks dislike the focus on equity, but the main one is that it reduces their ability to gamble with other people's money. It is much more efficient, in financial terms, to borrow money on the liability side of the balance sheet, and bet it on the asset side, and keep the profits for yourself. If the bets go wrong, most of the money you lose is somebody else's and then – if you're a bank – you get a bailout and are back in business. If you have higher levels of equity, however, more of your own money is at risk. You can lend as much: it's just that you're lending it at your own risk. Banks hate that. They prefer things the way they are.

The current level of equity being discussed as an international standard for banks by the Basel III agreement, and due to be incorporated in the UK banking bill, is 3 per cent. Even that level has the banks bleating. As I was writing this piece, Barclays was in the news complaining about being forced to comply with the 3 per cent ratio, after the new-minted Prudential Regulation Authority told them they were going to have to have more equity to meet the target. (This means the equity position is even worse than it was in the 2012 balance sheet I cited above.) The new head of the bank is 'St' Anthony Jenkins, who has been sanctified by City wags in honour of his many homilies on the subject of the new ethical Barclays. He said on 28 June that the new rules 'could restrict our ability to extend balance sheet availability to customers, including – potentially – lending to the UK and other economies, which' (at this point it is helpful, if you want the full impact of Jenkins's remarks, to imagine him leaning back in a black leather chair, stroking a white cat) 'is something of course we want to avoid'. In other words, if you try to make us safe, we'll stop lending. But this is a non sequitur. Why should the need for more equity restrict lending to UK customers? Look where the equity sits on the balance sheet. Why does needing more of it necessitate lending less to the real economy, on the other side of the balance sheet? If you want to shrink your balance sheet, as banks do, why target the minority of your assets which is represented by customer loans? As I pointed out earlier, only 28.6 per cent of Barclays' assets are real, economy-helping loans. Gee, by being so quick to focus on the way the new rules could hurt the rest of us, it's almost as if St Anthony were making a threat. Hang on, what's he got in his hand, right next to the cute little pussycat? He can't be holding a gun to its head, can he?

*

That's what the banks do when told they need to have more equity and take fewer risks with borrowed money: they say, step away or the animal gets it. The banks talk about having to 'hold more capital' as a result of the proposed changes. But that is a misleading – I'm tempted to say, a deliberately misleading – metaphor. Banks don't 'hold capital' in that sense; this isn't money the banks have to sit on, as an alternative to lending it. This is the gap between assets and liabilities, and because it's the first thing that takes a hit when assets go down and liabilities go up, what it mainly means is that the bank is risking more of its own money. In order to raise more of that money – to have more equity – the banks would have to either issue more shares or stop paying out so much in staff remuneration and dividends.

Admati and Hellwig are brisk: 'If a bank is unable to raise new equity because it has no profits to retain or cannot sell shares, there is reason to suspect that the bank is highly distressed or even insolvent.'

The banks are complaining loudly, and making their none too subtle threats, about equity levels of 3 per cent. (Vickers recommended a 4 per cent equity ratio, but the banks counter-lobbied and, as per Mervyn King's warnings, got their way.) But that level of equity, Admati and Hellwig argue, and common sense agrees, is far too low. Bankers argue at length that the way banking works is so different from households and other businesses that this crude equity calculation is not relevant, but Admati and Hellwig argue back, convincingly and at length, that it isn't. Their reasoning has influenced the Brown-Vitter bill, put before the US Senate in April, which seeks to mandate an equity level of 15 per cent for banks with assets of more than $500 billion. At the same time, the Federal Reserve and Federal Deposit Insurance Corporation (which has a keen interest in bank solvency because it guarantees ordinary customers' deposits) is starting to lobby for a rate of 6 per cent. Watch this space. This one isn't going away. It is a good omen about Mark Carney that he was on the receiving end of a tirade by Jamie Dimon, head of J.P. Morgan, at a bankers' meeting in 2011, and an even better sign that the subject of the altercation was the need for higher levels of equity. 'If some institutions feel pressure today,' Carney said in a speech a couple of days later, 'it is because they have done too little for too long, rather than because they are being asked to do too much, too soon.'

The reason the banks hate the proposed changes is the same as the reason we need them: because it is a crude but effective way of making them safe, and because it would make them so much less risky. For them, remember, risk is correlated with reward on the upside, and bailouts on the down. Here, the laws going through Parliament have as their main focus the ringfence between retail and investment banking. Imagine that this law goes through, and that it is effective, and that the clever men who spend all day every day trying to work out ways around the rules fail, and that the ringfence works as intended. Under these ideal circumstances, HBOS would still have gone broke. In the words of the parliamentary commission, which I quoted in the last issue, 'this was a traditional bank failure pure and simple. It was a case of a bank pursuing traditional banking activities and pursuing them badly.' Or consider the collapse of Lehmans, which triggered the credit crunch and then led to the Great Recession. Lehmans had no retail arm: it was purely an investment bank. In both these hugely significant cases, the split between retail and investment banking would have had little relevance – but an equity ratio of 15 per cent would have made either collapse impossible. The wider public would have been protected from both the simple incompetence of HBOS and the complex incompetence of Lehmans. It would also have made both banks much less profitable during the boom days, and therefore less able to keep their own top staff in the manner to which they grew so accustomed.

Another global crisis is coming, as sure as Christmas. The euro? China? Who knows – but it's coming, and when it does, we need our banks to be safe, for all sorts of reasons, including, right at the top of the list, the fact that we can't afford to bail them out in the same way as last time. It's manifestly obvious that our banks are too big. So the solution needs to be equally obvious and equally big, and the only solution on offer which meets that description concerns bank equity. I'm not the only one to be sold on this idea: Martin Wolf, a member of the Vickers Commission, has said more than once that *The Bankers' New Clothes* is the most important book to have emerged from the crisis. We need this change, and the split between retail and investment banking, and a new code of personal responsibility and criminal liability inside the banks, and a break-up of RBS into a bad bank and a bank with a specialist focus on small-business lending.

The irony is that if we do all these things, our banking industry will be in good shape. Europe's banks are facing a crisis of unacknowledged debts left over from the aftermath of 2008; in the UK we are at least having difficult conversations about our banks, whereas on much of the Continent there's a deep reluctance to look too closely at the various monsters on bank balance sheets. We could even, if we did all the right things, end up with a genuinely strong banking sector. People in power thought we had one before, around the time Gordon Brown was praising the City for being 'a larger share of our economy than in any other major economy'. We didn't, though: we just had a hugely inflated financial sector, arrived at by deregulation, and by giving the banks all the things they thought they wanted. If we do the things we need to do, we would achieve a strong banking sector the way the Canadians did, by taking the opportunity to give banks a strict regulatory regime which stops them doing the stupidly risky things they will do with other people's money if given the chance. Carney is well placed to know all about that. Modern banks are creations of the state, made by our choices, and we can shape them any way we want. It's time to make our banks do the things we need.

[*] Princeton, 392 pp., £19.95, February, 978 0 691 15684 2.

Vol. 35 No. 14 · 18 July 2013 » John Lanchester » Let's consider Kate
pages 3-8 | 6962 words

 ^ Top