

Flight from the City 'DISASTER MYOPIA'

Jeremiah

'Why did no one see it coming?' That was the question posed by the Queen in the course of her visit to the London School of Economics in November 2008.

To try to answer the question, the British Academy hosted, in June of this year, a meeting of economists, civil servants, financial journalists and politicians. The result was a letter sent to the Queen, explaining that: '...the difficulty was seeing the risk to the system as a whole... Politicians of all types were charmed by the market. Their views were abetted by financial and economic models that were good at predicting short-term and small risks, but few were equipped to say what would happen when things went wrong as they have... Everyone seemed to be doing their own job properly on its own merit. And according to standard measures of success, they were often doing it well. The failure was to see how collectively this added up to a series of interconnected imbalances over which no single authority had jurisdiction... in summary, Your Majesty, the failure... was principally a failure of the collective imagination... to understand the risks to the system as a whole.'

Some might wonder why the response failed to mention things like irresponsibility, negligence and sheer greed. They needn't have sought to spare the Queen's sensibilities. She wanted answers.

Nonetheless it is true that ignorance was part of the problem – ignorance of what is now seen to have been systemic risk. Andrew Haldane, the Bank of England's Executive Director for Financial Stability, explored the issue in February of this year when he called attention to the failure to build in the 'correlation' of dependencies within the new capitalism. He called these 'network externalities' and he described the failure to take these into account 'disaster myopia.'

It was not that people were unaware of the excessive

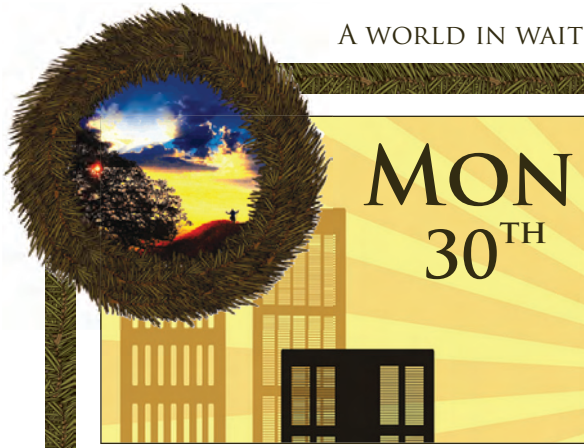
element of risk in financial markets. That had been all too evident since the crises of the 1980s and 90s. The irony about the current financial crisis is that, in large measure, it was brought about by people who, reacting to the excesses of the 1980s and early 90s, were coming up with financial instruments that were meant to provide safer ways of managing risk.

The 'solutions', however, eventually became part of a bigger problem:

- people came up with more and more complex instruments that could control and diffuse risk (Collateralised Debt Obligations [CDOs], Collateralised Debt Obligations of Asset-Based Securities [CDOs of ABSs], Credit Default Swaps [CDSs], Special Purpose Vehicles [SPVs], Special Investment Vehicles [SIVs], etc.);
- this gave a sense of false assurance to people who did not understand these instruments but followed the herd in using them;
- it tempted people to play this low-risk high-gain game with large amounts of borrowed money (high leveraging); and
- trading in these instruments and packages of instruments were often hidden from public scrutiny as they were increasingly being done not through the exchanges where they could be more accurately priced, but over the counter.

And it all purported to be virtually risk-free. It seemed too good to be true. And, of course, it was.

That brief description is, necessarily, a huge over-simplification. But it illustrates the point that what was being created was a double illusion – an illusion that value existed where it did not, and that risk did not exist where it did. The element of risk was being so diffused throughout the system that it seemed as though no one party was likely to be holding very



much. And this in turn prompted people to introduce into the system products with higher and higher degrees of risk, both in the housing market (sub-prime mortgages) and in the corporate sector as well. In effect a virus was being introduced throughout the system and no one could be sure who was most infected. So panic set in and lenders and investors took flight.

But ignorance is not always excusable. Was the ignorance which contributed to the credit crunch innocent or was it culpable? The very fact that some people were on record as warning of what might happen suggests that dangers could and should have been seen by those who wished to see. As early as 12 May 2005, Timothy Geithner, now Secretary of the Treasury of the United States but then President of the New York Federal Reserve, warned in the Financial Times that: 'Changes in the structure of the financial system and an increase in product complexity could make a crisis more difficult to manage and perhaps more destructive.'

Ignorance has limited value as a defence. Systemic risk was a failure in and of the system but it was a failure caused by human beings who set up and used the system. Behind the ignorance lay deeper human factors. It has become fashionable to speak of 'animal spirits' at work, since a book by that name was published by George A. Akerlof and Robert J Shiller earlier this year. But this cannot come as news really. Not for nothing have the images of 'bull' and 'bear' markets traditionally been used.

One set of 'animal spirits' – not least, greed – helped inflate the financial asset-bubble that created the illusion of ever-expanding risk-free wealth. When the bubble burst, another set of 'animal spirits' came to the fore – fear, panic, destruction of trust, paralysis.

The lesson? That the answer does not lie in creating ever more clever financial instruments, more sophisticated mathematical models, more comprehensive theories. The problem is that, by definition, the unpredictable cannot be predicted. It's a lesson that this time we may just have learned.

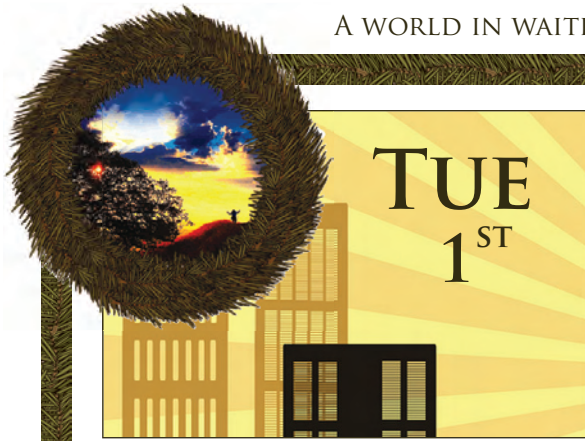
But the real answer, in the end, is about us. The economy is about people. It is we who need to face up to our responsibilities – and to know that we will be held to account.

ACTION

What Are We Waiting for? Witnessing to Hope

William Temple Foundation
<http://www.wtf.org.uk>

Paul Woolley Centre for the Study of Capital Market Dysfunctionality (LSE)
<http://www.lse.ac.uk/collections/paulWoolleyCentre/Default.htm>



RISK IN THE CITY

Jeremiah

Dick Whittington was lucky. When this young orphan arrived in London some 500 years ago he found, as so many have, that the streets of London were not paved with gold. Disillusioned and discouraged, he was about to give up and return home when he heard Bow Bells ring out: 'Turn again, Whittington, Once Mayor of London! Turn again, Whittington, Twice Mayor of London! Turn again, Whittington, Thrice Mayor of London!' Turn again he did, back to London, with his cat. The cat! That was the answer. There were in those days, as today, plenty of rats in London. And that cat proved so adept at catching rats that he was much in demand. Eventually Dick Whittington decided to sell his cat at a handsome profit and on that foundation he built his fortune.

The moral of the story? For some it's simply about luck. It all came together: the bells, the cat, the rats, the buyers. That is the way some look at the City today. The world of finance is like a big casino. But that gets the story out of focus. There are some mighty big differences.

First, unlike in the case of Dick Whittington, the gains to be won in the City are astronomical. What is more it can all be done by risking other people's money, whether it is borrowed from banks or deployed on behalf of investors. And to top it all off, what's different about this casino is that the odds are not stacked in favour of the house. On the contrary, a shrewd investor can make big gains whether share prices go up or down, out of distressed debt, or bankruptcies. And even when the commission has to be foregone, there are always the fees to be picked up for services rendered. What a gambler's paradise: the gains are privatised, i.e. they belong to those playing the game, but the losses are socialised, i.e. they are picked up by the house, in the form of bailouts from the public purse. A pretty good deal? But hardly fair play. Nothing very moral about that 'moral'.

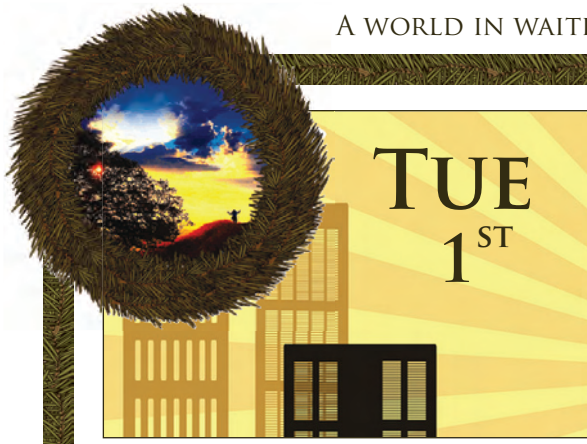
Maybe then we need to look deeper. The real moral of the story is not about how to play the game but how to offer something useful. Dick Whittington was not just lucky. He was useful both to those who purchased his cat's services and, indirectly, to the wider community.

But there is also a moral to the story that applies not just to individual behaviour but to the financial system as it currently operates: how to make the relationship between risks and rewards more just? Or, to put it differently, how to balance up the 'goods' and 'the bads' which the City produces for our economy.

In May this year, UK-based financial services leaders produced an important analysis of the future of the financial sector: *UK International Financial Services – The Future: A report from UK based financial services leaders to the Government*. Commenting on the report, Martin Wolf, Associate Editor of the *Financial Times* said bluntly: 'If you ask the wrong question you will get the wrong answer.'

The question that needed to be asked, according to Wolf, was not so much about the functioning of the financial sector but about its role in the UK economy: 'The UK has a strategic nightmare: it has a strong comparative advantage in the world's most irresponsible industry...Quite simply, the sector imposes massive negative externalities (or costs) on bystanders...If implicit and explicit guarantees and externalities, including volatility, were fully charged, the sector would surely shrink...So how should one manage a sector that produces such "bads"? The answer is: in the same way as any polluting activity. One taxes it...'

Taxes are not the only way of dealing with the 'bads'. There is also insurance. This approach has been put forward by another *Financial Times* columnist, Tony Jackson. Banks, he suggests, should be required to



take out insurance to cover the cost of a bank rescue, just as they are now obliged to do in order to protect their depositors against loss in the case of bank failure. Besides having the effect of shifting the burden of risk from the public purse back to where it belongs, it might – if the premium required was high enough – also create an incentive for banks to cut back on some of their riskier operations.

Unfortunately, it is not just the ‘bads’ that are a problem. It is also the fact that the ‘goods’ – of which the City provides many – may be causing the entire economy to become unbalanced. Wolf argues the case for a more diversified economy: ‘...while trying to create a stable and favourable environment for business activities, the UK should try to diversify the economy away from finance, not reinforce its overly strong comparative advantages within it.’

The case for a more balanced economy was taken up in another report also produced in May of this year, in the Ernst and Young ITEM Report, Rebalancing the UK Economy. It warns that the UK economy’s exceptionally high degree of dependence on the financial sector has made us particularly vulnerable to the effects of the current economic crisis. It argues that: ‘A return to a more balanced economy is clearly desirable...there is a need for the UK and other economies to diversify into more broad-based activity

if they are to achieve sustainable growth over the longer term.’

The debate really got going in August, when Lord Turner, Chair of the Financial Services Authority, warned that the City was becoming a destabilising influence on the British economy. ‘If you want to stop excessive pay in a swollen financial sector,’ he declared, ‘you have to reduce the size of that sector or apply special taxes to its pre-remuneration profit.’

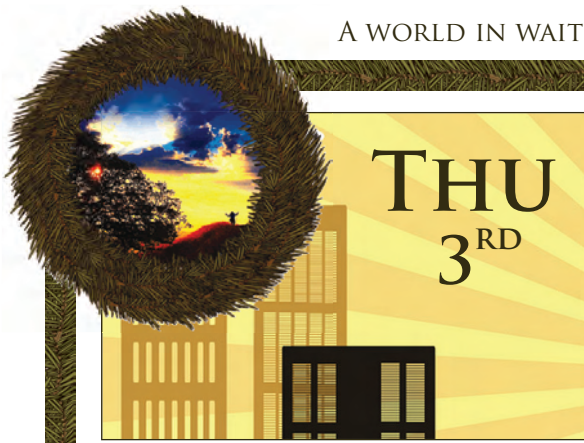
Rebalancing the UK economy will not come without a cost. What it requires, according to the ITEM Report is higher savings, more investment abroad, a weaker pound, less reliance on imports, lower consumer spending. Are we ready to pay the price?

ACTION

What Are We Waiting for? Witnessing to Hope

Christian Association of Business Executives
(CABE)
<http://www.cabe-online.org>

Mission in London's Economy
<http://www.mile.org.uk>



'Be Blameless When He Comes' FINAL ACCOUNTS

I Thessalonians 3:9-13

Remember Arthur Andersen? It was once one of the big five international accountancy firms. Now there are four. Tragically, Arthur Andersen once prided itself on its integrity, insisting that its primary responsibility was to those whose accounts it was auditing rather than to its own shareholders. 'Think straight, talk straight' was its motto.

Then, in 2001, the mighty energy group Enron was found to have grossly distorted its accounts, wildly exaggerated its assets and kept its liabilities off the balance sheets. In the course of the investigation into this criminal behaviour, Enron's auditors conveniently began shredding key documents. The auditors' name? Arthur Andersen.

Although Arthur Andersen's conviction for complicity in the crime was eventually overturned by the Supreme Court, because no evidence of any 'evil intent' on their part had been produced, the firm's reputation nonetheless was shattered. It has been busy ever since defending itself in a number of civil suits for alleged auditing failures.

Here the focus is not so much what happened to Arthur Andersen but how and why it could happen that such a respectable firm lost its innocence. What makes this question so important is that the same forces that tempted Arthur Andersen to take the wrong turning are still at work.

What are they? They are the opportunities for new and even richer forms of profit for accountancy firms that opened up as far back as the 1980s for using their skills to offer consultancy services as well as auditing services. And with that opportunity came a heightened danger of a conflict of interest. This was on top of the existing risk of a conflict of interest which arose from wanting to continue to be engaged for lucrative fees by the same major firms year after year. With such serious conflicts of interest, accountability was no longer fully independent. As a result, reputations were ruined and

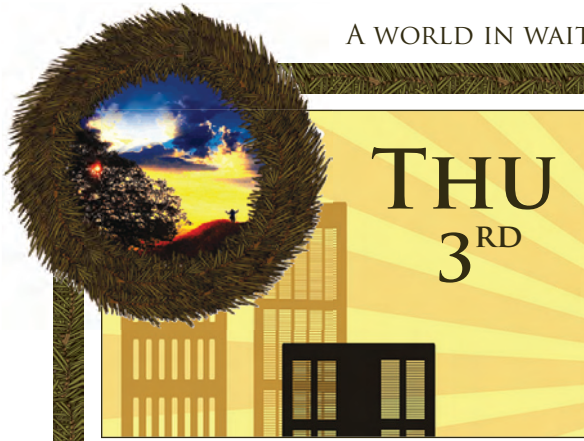
mighty firms were brought down.

In a world where thousands of billions of pounds are being deployed, independent accountability is crucial but it is under threat, and not just in the world of auditing. Conflicts of interest are rife in today's financial world. For example, credit rating agencies are charged with the task of providing investors with ratings that give a true picture of a body's credit worthiness yet they are paid by the body they rate (and which sometimes pays them for consultancy services as well). Banks' researchers are charged with the task of providing independent information on the value of firms listed on the stock market, yet Citigroup was charged with providing biased research information to investors. 'Independent' financial advisers purport to give investors unbiased information yet – in a practice that will soon be outlawed – they operate on the basis of a commission from a particular bank or investment fund.

Does it matter? Of course it does. First, as a matter of principle, there is a duty owed to the people whose funds are being handled. But secondly, given the global economic power of today's financial and industrial institutions, it is imperative to know how such power is being used.

For example, inaccurate scores by ratings agencies have been accused of being partly to blame for the credit crunch. The leading agencies gave triple A ratings to hundreds of billions of pounds of bonds backed by risky mortgages. Now these securities have since been downgraded and are in many cases simply worthless.

As for the mortgages themselves – not just sub-prime mortgages – building societies such as Chelsea and Bradford & Bingley are having to set aside hundreds of millions of pounds to cover potential losses on fraudulent mortgage applications, some of which were, of course, down to the applicant, some to aggressive



marketing by the lenders and some to professional collusion on the part of allegedly independent intermediaries, such as developers, valuers, surveyors, solicitors and advisers.

What can be done? Action can be taken on three fronts – by government, by shareholders and by creditors. The US government, for example, is taking action to try to reduce conflicts of interests. In July, President Obama issued proposals to bar rating firms from acting as consultants to the companies and to eliminate the problem of ‘ratings shopping’ in which a corporation solicits preliminary ratings from multiple agencies and only then pays for and discloses the highest rating it received. Many feel these measures are far too modest.

Secondly, the power and involvement of shareholders can be increased so that they can have easier access to full information about the issues of concern to them and can influence company policy.

Thirdly creditors can take legal action for negligence against auditors who have failed to spot fraudulent or misleading reporting. Banks and hedge funds have indeed been lining up to do just that.

Is that enough then? Not really. It is not just the interests of shareholders and creditors which are at stake. The decisions taken by powerful financial and industrial firms have profound effects, most immediately on the lives of their employees, on the livelihoods of their suppliers, and on the stability of

local communities, but often also on people across the world as well as on the environment.

That is why in addition to shareholder power there is a growing demand for stakeholder power. The same principle that applies in the political arena should apply in the economic arena as well, viz. those whose lives are deeply affected by those with power should have some say in how that power is used.

It's a wider and necessary extension of the principle of accountability, although never likely to be perfect. But that is not the point. The point is to promote awareness that we are all accountable for the way we treat the resources over which we have some power. Accountable to each other – and ultimately accountable to God. The season of Advent reminds us that now is a good time to prepare.

ACTION

What Are We Waiting for? Witnessing to Hope

The Evangelical Council for Financial Accountability
<http://www.ecfa.org>

AccountAbility
 (The Institute for Social and Ethical AccountAbility)
<http://www.accountability21.net>