*"**When timidity triumphs…**"*

Speech by Robert W. Jenkins, Senior Fellow at Better Markets

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Mr. Secretary General, distinguished guests, ladies and gentlemen: good evening. As you have heard, I had the honour to serve at the Bank of England. It was an exciting time. The banking system was undercapitalized. Greece threatened the euro zone. The euro zone threatened the banking system. The bankers threatened the politicians – lest the politicians threaten the bankers. And as I left, political leaders were leaning on the regulators not to lean too heavily on the banks.

"Too big to fail, bail and jail" summed up the challenge. Capital and accountability framed the regulatory response. There has been much activity. But though the motion has been great, the movement has not. Leverage remains high and accountability low. Sadly, the courage to address either seems lacking.

Capital, accountability and courage. All other issues pale in comparison. Allow me a word about each.

Capital

I will start with capital. We continue to work our way through the greatest credit bubble in history. Now bubbles are not new. They are always the same – and always a little bit different. They always feature heavy doses of greed, stupidity and leverage. What distinguished our recent episode from all past experiences was the degree and magnitude of leverage. Now we will not abolish greed. We cannot outlaw stupidity. But we can and must address excessive leverage. Have we done so? No.

It has not been for lack of trying. The first attempt involved a rewrite of Basel. The new rules tighten up on definitions of banking risk and place an overall cap on leverage. Are the rules tougher than before? Yes. Are they tough? No. Most importantly, are they sufficient to ensure stability? No.

*Take an example. Remember CDOs squared (collateralized debt obligation) – that mini masterpiece of financial engineering that spread panic throughout the market? The instrument still features on the roster of Risk Weighted Assets. And the RWA regime determines the amount of capital required in support of such risks. So, how much loss absorbing capital do you think the "tough" new rules require of a bank to carry an investment in a debt obligation, backed by a debt obligation, backed by a pool of loans made to US subprime residential homeowners? Oh, and assume that the package is once again rated triple AAA. What do you think? 20% of face value? 10%? 5%? Well for your information the tough new rules require less than 1.4% of equity funding for a security that neither banker, regulator, rating agency nor investor was able to understand.**

**Mind you, the regime it replaced required but .4 pct capital. And if you were a sophisticated institution with convincing risk modeling, authorities let you operate with .14 pct. The banking lobby may therefore tell you that new capital requirements are a multiple of what applied in the past. But less lenient does not equal sufficient - much less "tough."*

Fortunately Basel III introduces a backstop. Banks are now subject to a cap on the total leverage at which they operate. It's a very good idea. But as currently set, this "leverage ratio" allows balance sheets to balloon to 33 times their loss absorbing equity. At that degree of gearing, a 3 pct decline in the value of bank assets wipes out 100% of bank capital. A mere 1 pct decline leaves the institution leveraged 50 times; a 2 pct decline – 100 times. How confidence- inspiring is that?

Evidently not confidence-inspiring enough – witness the proposals in a number of jurisdictions to raise the 3 pct ratio to 4 or even 5. Would these be tougher? Yes. Would they be sufficient? No. Those ratios would translate into bank balance sheets some 20 to 25 times their loss absorbing equity. Hedge funds by the way operate on average at 3 times leverage.

There is more of course. To such top-ups regulators have added stress testing and "TLAC." These steps are potentially positive but compared to capital - represent a problematic patchwork. Why? Well, for stress testing to be effective regulators must know which risks to stress and by what degree to do so. However hardworking and intelligent they may be they are also human. They, like the bankers they regulate will at some point get it wrong. That is why there is capital. Capital is there not just for the risks we think we understand – it is there for the ones we don't!

As for TLAC – total loss absorbing capacity, it is potentially a sound building block but it is one that rests on a shaky foundation.

First of all, the target for the loss absorbing capacity of a bank is set in terms of a percentage of Risk Weighted Assets. And we have just seen how poor a reference point that may prove to be. Second, various forms of bank debt are deemed to be loss absorbing. Here the presumption is two fold: 1) that the authorities will have the guts to force losses on debt holders – they didn't last time; and 2) that at the first hint of trouble, debt and equity holders are going to wait around to find out. Would you?

In short, the banking system remains and is set to remain undercapitalized. Basel III is a busted flush. The many measures to compensate serve only to confirm this fact - without adequately compensating for its failure.

Accountability

If capital is vital to the survival of our market system, accountability is critical to its legitimacy. That bankers behaved badly in the run up to the melt-down is old news. That corporate culture was a culprit is now consensus. We have just heard our panelists' thoughts on incentivising good behaviour. Let me say a word about an equal or greater need for disincentives to bad behaviour.

An ethics-free zone?

But before considering what's to be done let us recall the magnitude of what financiers did. The charge sheet of misdeeds - both acknowledged and alleged is lengthy. Here is a partial list:

- Mis-selling of payment protection insurance
- Mis-selling interest rate swaps

- Mis-selling credit card theft insurance
- Mis-selling of mortgage-backed securities
- Mis-selling of municipal bond investment strategies
- Mis-selling of structured deposit investments
- Mis-selling of foreign exchange products
- Fraud related to the packaging and selling of mortgage-backed securities that institutions knew to be “toxic waste”
- Misleading statements to investors involving capital raising rights issue
- Misleading investors in the sale of collateralised debt obligations
- Abusive small business lending practices
- Predatory mortgage practices
- Abusive or in inappropriate foreclosure practices
- Aiding and abetting tax evasion
- Aiding and abetting money laundering for violent drug cartels
- Violations of rogue-regime sanctions
- Manipulation of Euribor
- Manipulation of FX markets
- Manipulation of gold fixing (London)
- Manipulation of commodity markets via metals warehousing practices
- Manipulation of electricity markets (California/JPM)
- Manipulation of the swaps market benchmark index (Isdafix)
- Collusion relating to credit default swap market dealing in violation of US anti-trust laws (“settlement” reached with authorities to resolve allegations)
- Filing false statements with the SEC (London Whale)
- Keeping false books and records (London Whale)
- Reporting failures relating to Madoff
- Withholding of critical information from Italian regulators
- Bribing civil service employees in Japan
- Mis-reporting related to Barclays emergency capital raising
- Stealing confidential regulatory information by a banker
- Collusion with Greek authorities to mislead EU policy makers on meeting Euro criteria
- Financial engineering with the aim of moving Italian debt off-balance sheet
- Manipulation of risk models with the aim of minimizing reported Risk Weighted Assets / capital requirements

And currently under investigation…

- Manipulation of precious metals markets (gold/silver/platinum/palladium - Switzerland)
- Manipulation / collusion of the US Treasury Market auction/client sales
- Manipulation of energy markets
- Short changing clients a second time in not paying settlements in full

- Violations connected with emergency fund raisings
- Electronic FX trading related market manipulation (NY DFS investigation)
- Falsifying customer data and records
- Misleading clients over dark pools
- Misleading shareholders ahead of RBS rights issue
- Misleading shareholder information with respect to Lloyds takeover of HBOs
- Conspiracy to force small businesses into bankruptcy to the benefit of the lender
- Insertion of illegal rate floors in Spanish mortgage lending
- Faking customer files to justify predatory foreclosure practices
- Misleading profit and capital statements based on questionable accounting practices

And what has been done? Well, there has been a lot of breast beating on the topic. Hearings have been held. Commissions have been commissioned. Investigations have been legion. Large fines are frequent. But no bank has lost its banking license. No senior has gone to jail. No management team has been prosecuted. No board or supervising executive has been financially ruined. Many have kept their jobs, their salaries, their pensions and their perks. Among those dismissed, very few have been banned from the field for the future. As to the fines, they have been paid by the shareholders, not by the perpetrators. No doubt some executives see these as a cost of doing business; and politicians - a handy source of revenue. Few believe them to be an effective deterrent. Perhaps it provides a perverse incentive. Message to wayward youth: go back to school – there's more money at less risk in white collar crime!

Is there any wonder that the public has lost faith in finance? Restoring accountability is vital to restoring a sense of fairness. It is also key to reducing recklessness. For the first line of defense in financial risk-taking consists of the attitudes and practices of the risk-takers on the front line. If they do not know the difference between right and wrong; if "wrong-doing" is left unpunished, much less rewarded, then we deserve what we get.

As to progress on this point, I was once hopeful. I am no longer optimistic. I was hopeful because for a while regulators, politicians and practitioners were all making the right noises. Parliament took steps to strengthen sanctions for financial wrong-doing. The US Attorney General declared that no bank was too big to jail. FSB Chair Mark Carney called for "clear consequences, including professional ostracism" for failure to live up to the necessary standards. More recently Chancellor Osborne declared that "there is no trade-off between high standards of conduct and competitiveness." Banking executives individually and collectively were also talking the talk.

But of course actions speak louder than words. And actions to date fall short of what was both needed and possible. Making crimes a criminal offence is helpful. But enforcing the laws already on the books can and must happen first. Adding new speed limits when you have not enforced the old ones is a shaky basis on which to slow traffic.

The disturbing fact is that laws have been broken but law breaking has not touched senior management. In the US "deferred prosecution agreements" are the order-of-the-day. Although such "settlements" are announced with fines and fanfare, the detailed evidence and findings that led to such agreements often

remain hidden from the public eye. Eric Holder boasted that banks would be held accountable. But, as the dictionary reminds us, accountability involves not only "the obligation of an individual or organization to account for its activities, and accept responsibility for them, but also to disclose the results in a transparent manner."

Similarly, existing rules and tools have sat untouched. The UK's Financial Services Authority and its successor have long had the ability to oust bank management and board by striking them of the "approved persons list." Have they done so? Not to any significant or visible extent. How can this be? Look again at the litany of wrong-doing? Either senior management knew what was going on or they did not. If they knew, then they were complicit. If they did not, then they were incompetent. Alternatively, if the deserving dozens have indeed been banned from the field let the list be known – that we might see some of that "professional ostracism" of which Governor Carney speaks. One person who did lose his position and quite publicly at that was Martin Wheatley, the UK's courageous conduct enforcer.

Meanwhile the Chairman of Europe's largest bank remains in situ – despite having been on the Board since 1995; despite having signed off on the acquisition of Household Finance; and despite having had oversight of tax entangled subsidiaries in Switzerland and money laundering units in Mexico. Oh, and you'll love this: the recently retired CEO of Standard Chartered is reportedly an advisor to Her Majesty's Government. Standard Chartered was among the first to be investigated for violations of rogue regime sanctions. The bank was fined heavily and may be so again.

Courage

In his new book, Ben Bernanke speaks about the courage to act. Central Bankers did indeed act courageously and decisively to bring the banking system back from the brink. They had the full support of the political elite to do so. We owe them all a debt of gratitude. But in reforming the system they so successfully saved, the authorities have been unwilling or unable to stand up to the politicians who in turn have been demonstrably unwilling to stand up to the banking lobby. "Why" - is no doubt a theme for a subsequent conference.

*But today's theme is **Confidence, Ethics and Incentives.** I have responded with capital, accountability and courage. Unless we address leverage we cannot have confidence in the resilience of the system. Without better behaviour we cannot have faith in the market that underpins it. Without penalizing the perpetrators and their seniors we will not get better behaviour. And without greater courage from policy makers and regulators, we will get none of the above and more of the same. Ladies and gentlemen, when timidity triumphs, the taxpayer pays. Alas, timidity is the order of the day.*

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