# THE SEVERN FORUM

## "Was the financial crisis a moral crisis? Biblical reflections on the 2008 crisis and its consequences"

**by**

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The financial crisis of 2008 and its aftermath continue to engage the attention of policy makers across the world. In the UK alone, official enquiries have included the Independent Commission on Banking chaired by Sir John Vickers, which reported with detailed proposals for reform of the banking sector in September 2011; and the Parliamentary Commission on Banking Standards (on which the Archbishop of Canterbury, Justin Welby, played a prominent role) which reported in June 2013. The issues have been kept alive in the public perception by ongoing controversies over bankers' bonuses, scandals such as the 'fixing' of the LIBOR (a key interest rate for financial markets worldwide) by a group of London banks, the perceived failure of banks to lend to small and medium sized businesses, and the timing of returning the part nationalised banks, RBS and Lloyds TSB, to the private sector.

In this talk, I plan to go behind the headline issues to explain: first, the purpose of financial markets and institutions in an advanced capitalist market economy; second, developments in financial markets since the 1980s; and third, the genesis and consequences of the 2008 crisis. These explanations lead naturally into Christian reflections, based on biblical materials. The reflections will address both structural issues (is the system itself flawed?), and market conduct (was/is 'bad market behaviour' the problem?). Finally we will briefly consider what might be done to ensure that financial crises do not recur with the same devastating effects.

**Financial markets and institutions – what are they for?**

Our daily interaction with the financial system is through the systems of payment that are associated with bank accounts. We can draw cash from ATMs, we can make payments with debit cards, cheques or on-line transfers, we can set up standing orders and direct debits, and we can receive payments (salaries, pensions) directly into our accounts. Without a functioning 'retail banking' system of this kind, the market economy would soon grind to halt. It was for this reason that the monetary authorities all over the world moved very swiftly in the 2008 crisis to shore up the banking system, to avert the nightmare situation of account holders not being able to access their cash, and of payments through the banks not being executed.

The other major role of the financial system is to collect savings and to route those savings to those who need to borrow. The savings of households can be direct: the household spends less than its income in a given period, and the difference represents savings which need to be placed. If the period before the savings are needed is short, then they may just be added to current or savings accounts with easy access. Saving for the longer term may be lodged directly in fixed term investments, bonds, and equities – or via investment vehicles such as private pensions, life insurance policies, and 'unit trusts'[2]. For many households saving is automatic in the form of contributions to pension funds deducted at source from salaries paid to those in employment.

The financial system lends on savings to those who need to borrow. These may be *individuals and households*, who use borrowing to smooth consumption over time. A major part of this is borrowing on mortgages in order to buy a house. But some borrowing may be for large household items such as furniture, white goods, and cars, or even to finance current expenditure such as holidays. Borrowing may take the form of loans from banks or building societies, or using credit cards (though for some a credit card just functions as a useful way to make payments, and the debt is cleared every month). Less satisfactory are other forms of credit such as resort to payday lenders, where the rates of interest can be astronomical. The financial system also lends to *business*, in the form of loans, bonds and equity, to finance production, trading, investment and innovation. These represent the core drivers of a market capitalist economy in the longer term. To put it simply but starkly, if the savings coming from pension funds and other long term instruments are not channelled into productive investment and activity generating real returns, then the pension funds will not be able to meet their long term pension obligations.

The financial system has another important role which is the management and reduction of risk. A financial institution such as an investment bank faces two risks. First, it has the risk that those who have entrusted savings to it will need those funds at short notice. If it has passed on the savings in the form of long term loans for productive investment (e.g. building and equipping a factory), then it will be impossible to get the money back quickly. In the jargon, financial institutions borrow short and lend long. So it needs to keep sufficient liquidity to allow a depositor to withdraw funds, while lending long to generate returns. Second there is always the risk that borrowers will default. A household may find that its circumstances change (unemployment, long term sickness) so that it can no longer keep up the repayments on a mortgage or other loan. A business venture may fail for good or bad reasons, and be unable to repay the loan. Hence a financial institution will expend much time and energy in evaluating potential borrowers, whether they are households or

[2] The official designation is *oeics* - open ended investment companies.

businesses, to make sure that loans are not made where the risks of default are great. And it may attach conditions to a loan, such as asking for collateral, which can be realised in the case of default. With a mortgage the property itself is implicitly the collateral, since it can be repossessed in the event of default on payments.

To conclude this section, the roles of the financial sector in an advanced capitalist market economy are to facilitate transactions, collect savings, lend to households and businesses, and to reduce risk. It is right to evaluate the sector by inquiring about its effectiveness in pursuing these roles.

**Developments in financial markets since the 1980s**

Financial markets in the UK have developed greatly in their scope and sophistication since their liberalization in the 1980s. First, the markets have developed new methods of reducing risks, or rather spreading risks, by the creation of markets for assets that previously could not be traded. The best example, and one that featured prominently in the crisis, was securitisation of mortgages. Suppose a bank has made a large number of mortgage loans to households. Then it might 'securitise' these mortgages by bundling them together and creating a new financial asset/ instrument which could then be sold off to other financial institutions. If it sells off 90%, then it is left with only 10% of the risk, which means that if a particular borrower is in default, only 10% of the loss accrues to the bank – the rest falls on the other institutions who bought a share of the securitised mortgages. Similar arrangements may be made for other lending activity by the bank: for example, a large loan to an industrial borrower may be shared out among other institutions, thus reducing the risk to the bank[3]. Furthermore, the bank may create markets for securitised assets, enabling other institutions to trade their holdings. All these structures reduce the risk to the bank that initiated the loan(s), and hence should make it more willing to lend and at lower rates. However there are some disadvantages. If the initiating bank knows that it will be able to pass on a substantial part of the loan asset to other financial institutions thus reducing its exposure in the event of default, then it has less incentive to do due diligence on the borrower and the purpose for which the loan is being advanced. Moreover the secondary lenders, those to whom the securitised asset is sold on, have no detailed information about the original borrowers. They have to trust the reputation of the initiating bank in marketing the asset[4].

Second, while the risk reduction element of these financial manoeuvres is beneficial, the creation of markets for these financial assets also gives scope for trading activities that are completely unrelated to the real economic activities that underlie the original loans. Examples of such activities are derivatives (new assets created by bundling financial assets in ways that generate high returns), options (enabling traders to take positions to buy or sell financial assets at specified prices at future dates), and hedge funds (based on trading in both derivatives and options). These activities generated very large returns from 'financial wizardry' in the early 2000s. These returns were not of course 'real'. The real economy that lay behind the assets (loans to business or to households) was not generating anything like the level of returns that were reported in the financial press.

Third, from the 1980s the removal of barriers to international financial capital flows worldwide meant that financial markets in 2008 were closely integrated. So securitised mortgage assets created in the United States were held in large quantities by banks in Europe and other parts of the world. Moreover, financial capital could be moved very rapidly from the markets in one country to another. If a bank was perceived to be in difficulties, then international flight of deposits could quickly disable it.

**The crisis of 2008**

There is unanimity among experts as to the source of the crisis – the US housing market in the early 2000s. The policy of the Bush administration in the US was to seek to solve the housing crisis by enabling more Americans to buy their own homes. This was initiated by keeping interest rates for mortgage borrowing very low. The result was a housing price bubble, on the back of which mortgage lenders abandoned all caution as to whom they would lend. The reasoning was simple (though flawed): even if the borrowers could not realistically afford to buy, default would mean that the property would revert to the lender, and given the expectation of rising house prices, the lender could recoup the loan by reselling the property. This thinking was the basis of the so-called 'ninja' mortgages – loans to households with '*n*o *i*ncome, *n*o *j*obs and no *a*ssets'. The housing boom also generated an explosion in consumer debt for purposes other than house purchase: buoyed up by the rise in the value of their properties, households borrowed more to finance consumption. The house price bubble, and the optimism associated with it, came to an abrupt end when interest rates finally began to rise. Many borrowers

[3] These and similar arrangements are referred to as 'credit swaps' or 'collateralised debt obligations' (CDOs).

[4] There is a further element in that the assets will have been assessed by a credit rating agency, which may rely on the overall soundness of the initiating bank in making its judgement, rather than an evaluation of the quality of the underlying loans.

defaulted on their mortgages and handed the keys back to the bank.[5] There was now a glut of unsold properties on the market, and house prices tumbled precipitously. Financial institutions, including numerous UK and other European banks, discovered that the securitised mortgage backed assets they were holding were worthless. In the United States, Lehman Brothers and the two major mortgage providers, Freddie Mac and Fanny Mae, found themselves with huge holes on the asset side of their balance sheets, a pattern that was repeated across the US financial sector and in the UK.

The precarious state of the banks was exacerbated by the financial models that they had pursued in the boom times. So both Lehman Brothers under Richard Fall in the States, and RBS under Fred Goodwin in Scotland, had grown rapidly with acquisitions financed by issuing debt. Most banks had been far too optimistic about the future ('disaster myopia'), and did not have either the capital to sustain heavy losses or the liquidity to meet withdrawal of funds by frightened depositors. A particular, albeit technical, issue for many banks in the UK was that they had developed their business on the back of very short term borrowing in the London 'wholesale' money markets, rather than rely on depositors. When the money market funds dried up (and in particular banks would no longer lend to each other), these banks were unable to continue to fund their lending. The intersection of the collapse of asset values in the mortgage market, and the reliance of banks on short term finance, resulted in insolvency. Unsurprisingly depositors in threatened financial institutions began to withdraw their deposits, leading in the extreme case to a 'run' on Northern Rock as people queued in the streets to get their money out. In the UK, HBOS was taken over by Lloyds in a move engineered by the monetary authorities, and both Lloyds and RBS had to be rescued by the authorities being partially nationalised. In the case of RBS the government ended up with most of the equity. The immediate crisis in retail banking was averted by the commitment of the monetary authorities to support the retail banking sector, so that ordinary depositors could continue to withdraw funds for every day needs, and ordinary payment transactions would not be affected. There is general agreement that this was the right thing to do, but it came at a price. The losers were shareholders, including the pension funds which traditionally had large holdings in the shares of UK banks, and taxpayers who had to underwrite the debts of the banks. (No UK bank was made bankrupt, unlike the US where Lehman was allowed by the authorities to go under by a failure to intervene which shocked Wall Street: but Lehman, unlike the main UK banks, was not a retail bank operating bank accounts for small depositors).

The question which we now have to address is whether the financial crisis was at root a technical failure, or whether there are fundamental moral issues at stake. For some, including many Christian commentators, the problem was 'bad' (if not criminal) behaviour by 'the bankers'. Others agree that the leadership of the banks in the period running up to the crisis was incompetent and myopic to the dangers of the course of action they were pursuing, but are not so ready to attribute moral blame. To be unwise and to make poor decisions is indeed a serious defect in a banker, but it is not necessarily a moral failing. In what follows, we examine the moral significance both of the structure of the financial system, and of the behaviour of the different groups involved in the crisis.

**Using the Bible in ethical thinking about economic life**

Using the Bible to address moral problems in economics is not new. John Calvin made extensive use of biblical material in his teaching about the economy in Geneva in the first part of the 16C. His contributions were based in his acute observation of how markets functioned in the city and elsewhere, and his prescriptions were remarkably nuanced and prescient about the pitfalls as well as the advantages of the market system[6]. Traditionally both Catholic and Anglican teaching has owed more to Natural Law than to biblical exegesis, as evidenced by the development of Catholic Social Doctrine since the Encyclical *Rerum Novarum* in 1891, and in Anglican social thought since William Temple's writings in the 1920s and 1930s culminating in his *Christianity and Social Order* in 1942. But Vatican II paid much more attention to the biblical text in the development of social teaching, and this is reflected in the extensive biblical material in the *Compendium of Social Doctrine of the Church* published in 2004. On the Anglican side, Evangelicals have become more confident in the use of biblical material in commenting on economic issues, beginning with the notable contributions of Lord (Brian) Griffiths in the 1980s.

How then might we use the Bible in this discussion of the financial crisis? First, we note that both the Old and New Testaments contain an outline of how God's covenant people (Israel in the Old, and the early Church in the New) ought to live their lives in community. We see these as models or paradigms of a just

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[5] Many mortgage arrangements in the United States enable the defaulting borrower simply to hand back the keys, and walk away debt free, unlike the situation in the UK, where the debt remains with the borrower even if dispossessed.

[6] See the very detailed discussion in Andre Bieler, *Calvin's Economic and Social Thought,* English translation 2005, WCC, Geneva

society. But second, these paradigms are culturally specific, reflecting the economies of their day. So we need to go beyond the cultural specifics to identify the underlying principles. This does not rely on 'proof texts' but looks at a variety of passages and examples to understand what principles are being advanced or exemplified. These derived principles are always provisional: further study and reflection may lead to a principle being modified or qualified. The third stage is application to the world we currently inhabit. The principles provide both a framework for interrogating economic structures, behaviour and outcomes, and an ideal against which these can be judged. There is also likely to be some iteration – issues that arise from consideration of current economic arrangements which require us to go back to the biblical material to see whether we can gain further ethical insights to deal with them. Our ethical judgements also underpin any proposals for changes in the way things are currently: but such proposals need to take into account that we are dealing with flawed human beings, and that in human affairs there is a bias towards behaviours and outcomes that fall short of ideal. So there has to be realism about what might be feasible, and an acceptance that we can seldom achieve more than a very second best outcome.

In what follows we explore five biblical themes that appear to be relevant to evaluating the financial crisis and its aftermath: economic responsibility, the making of loans, wealth and possessions, caring for the poor and disadvantaged, honesty and integrity in financial behaviour. The first two concern structural issues in financial markets. The other three focus more on behaviour. In each case we list the most relevant texts, then briefly indicate the principles embedded in those (and other) texts, and then use these principles to reflect on aspects of the financial crisis.

**Biblical theme 1: on economic responsibility**

*Genesis 1: 26, 28.* Then God said, "Let us make man in our image, in our likeness, and let them rule over …. all the earth…" God blessed them [male and female] and said to them,
"Be fruitful and increase in number: fill the earth and subdue it. Rule over… [all living creatures]".
*Genesis 2: 15.* The Lord God took the man and put him in the Garden of Eden to work it and take care of it.
*Numbers 26: 52-54.* The Lord said to Moses, "The land is to be allotted to the people as an inheritance based on the number of names. To a larger group give a larger inheritance, and to a smaller group a smaller one…"
*Matthew 25: 14-30.* [Parable of the talents].
*1 Thessalonians 3: 10.* We gave you this rule: "If a man will not work, he shall not eat".

These passages identify the responsibility of humankind, under God, for the resources of the natural order, and for their use. We suggest three principles to capture the scope of that responsibility:

- We are to be stewards of resources, both natural resources and our human abilities, to provide for human flourishing – that is, to provide the goods and services that the human community needs – food, clothing, shelter and means of social interaction
- We are responsible for determining the use of resources and gifts: each person is accountable to God for his or her stewardship.
- Work is the means of exercising stewardship: human beings have a responsibility to work.

These principles help us to think about the structure of financial markets as currently constituted. First, we note the near impossibility of exercising responsible personal stewardship for our savings. Consider deposits at interest with a bank or equivalent institution: these funds are lent out by the bank on the basis of return and likely risk of default. In general, the lender will not consider whether the borrower's activity is for the common good of the community, though it may well be such. However the point is that the ultimate provider of the finance has no say in the loans, and indeed will have no idea about the activities of the borrowers. Alternatively, consider a financial investment in the equity of a joint stock company. Despite being a part owner of the company, it will be very difficult for me to exercise any influence over its activities, unless I happen to be a major shareholder. Moreover, if the company should get into financial difficulties, then it can go into liquidation with debts unpaid, and I bear no responsibility for the losses, although I have been rewarded with dividends when the company was flourishing. All I stand to lose is my initial investment. Now evidently the joint stock company has many advantages – as demonstrated by its long survival as an institution. It is for example hard to imagine innovation without some such arrangement to limit liability of investors. But the fact remains that as a shareholder it is hard to act responsibly in respect of the activities of the company, though there is always the option of selling out if there are obvious ethical failings. But of course, most wealth holders, especially those with relatively few assets, do not have any direct control over how their wealth is invested. Thus for many people their largest financial asset is their pension 'pot': but that is invested by the trustees of the pension fund to generate the returns necessary to meet the future pension obligations of the fund. Alternatively, it is common

for people to have some of their wealth in a life insurance policy, but have no idea how the life insurance fund is constituted. And similar considerations apply to unit trusts.

A second ethical observation about the structure of financial markets concerns the activities of those who make gains solely from operations in financial asset markets. Whatever one may think about these activities, the fundamental point is that they do not contribute in any way to the development and functioning of the real economy. Indeed, many would say that they are parasitic upon the real economy, as they take gains in such a way as to reduce the incentive for other investors to contribute savings for developing the productive economy. This is probably the most serious ethical failing of modern financial markets: they have forgotten that the purpose (*telos*) of economic activity is the production of goods and services to serve the purposes of human flourishing both now and in the future.

**Biblical theme 2: the making of loans**

*Deuteronomy 23: 19, 20.* Do not charge your brother interest, whether on money or food or anything else that may earn interest. You may charge a foreigner interest, but not a brother Israelite, so that the Lord your God may bless you…

This is the most comprehensive of many texts in the Old Testament that prohibit the charging of interest on loans. The underlying principles seem to be as follows:

- Lending at interest is not prohibited in all situations, but loans to the 'brother' Israelite should be interest free.
- However loans to 'foreigners' at interest are not prohibited, though the rates should not be exploitative.

The reasons for the first stipulation are apparently a desire to protect the poor from exploitation, and to prevent wealth accumulation not based on personal effort and enterprise. The reason for the exemption for loans to foreigners appears to be that such loans would be for commercial purposes (e.g. to merchants trading into the community), and would therefore carry an element of risk for which the lender needed to be compensated. In general, both in Judaism and Islam, lending for productive or commercial activity has to be on the basis of equity: the lender takes a share in the profits of the activity, not a fixed return of interest, thus participating in the risk of the venture.

The application of these principles to the financial market structure is not straightforward, not least given the historic prohibition on usury that was part of the teaching of the Church from the earliest time until the 16C. Much has been written about the ban, which had roots in both the Old Testament texts, and in the position adopted by Aristotle that money is not productive in itself and therefore should not earn a return. As is well known, the breach in the ban came with the Reformation and in particular the writings of John Calvin, based on the experience of trade and industry in Geneva. His view was that commercial loans were permissible, as they were not between 'brothers' but at arms-length, and hence were equivalent to loans with foreigners. Moreover he countered the Aristotelian argument by noting that financial capital was productive in that it enabled production and trade to take place. He also noted that commercial loans inevitably carried an element of risk sharing, and this justified a reward. However he was opposed to loans for consumption purposes, and in particular lending to the poor, which could easily be oppressive and make poverty worse. So lending in Geneva was strictly regulated, both as to its purposes and the level of interest that might be charged (set at a level below that charged in other financial centres across Europe).

The conclusion for current financial markets is that lending for productive and commercial purposes is acceptable, but it needs to be carefully regulated. Interest is justified where there is an element of risk which the lender has to carry, and where the loan enables economic activity and creates employment, thus generating a return that can be shared with the lender. There remains a question mark over lending to finance consumption (though not perhaps mortgage finance), and over loans to those in poverty. More on these matters will follow in the next two sections. [Note that in the next three sections the focus shifts from *structural* features of financial markets to the *behaviour* of those involved in those markets.]

**Biblical themes 3: wealth and possessions**

*Deuteronomy 8: 10-18* (self-satisfaction with wealth)

*Luke 16: 13* Jesus said, "No servant can serve two masters. Either he will hate the one and love the other, or he will be devoted to the one and despise the other. You cannot serve both God and Money".

*1 Timothy 6: 6-10.* But godliness with contentment is great gain. We brought nothing into the world, and we can take nothing out of it. But if we have food and clothing, we will be content with that. People who want to get rich fall into temptation and a trap and into many foolish and harmful desires… For the love of money is a root of all kinds of evil.

These passages are a selection from numerous biblical passages that warn of the dangers of wealth and possessions, and especially (for our purposes) of the 'love of money'. They can be summarised in the following two principles:

- Wealth can easily become an idol, drawing a person away from God (and hence from the person's good)
- Consumption and possessions – the rule is contentment, not more and more.

The application of these principles to the financial crisis does not need much imagination! There is much anecdotal evidence that those working in financial institutions and markets were indeed motivated by greed (the 'bonus culture'), short termism (looking for short term financial gains rather than long term returns from productive investment), and the pursuit of power (the hubris of those who were self-styled 'masters of the universe' in financial operations in asset markets). There was also evidence of households wanting more and more, with the addiction to debt-financed consumption. In round numbers, the average household debt in 2012 was £8k in consumer debt (overdrafts, credit cards etc.), and £56k in mortgage debt (where at least some of that debt was 'equity withdrawal' to finance consumption where house values had risen). Added to that there was a definite change of culture with it no longer being seen as a moral failure to default on repayments on a loan. Finally, it is evident that there is a culture of 'living for today' in consumption, demonstrated by the failure of younger working people to provide adequately for retirement by savings.

**Biblical theme 4: caring for the poor**

*Deuteronomy 15: 7-9.* If there is a poor man among your brothers in any of the towns of the land that the Lord your God is giving you, do not be hard hearted or tight fisted towards your poor brother. Rather be open-handed and freely lend him whatever he needs.

[This passage requires some context for it to be understood. In the Old Testament economy, those who were landless, and so unable to work to support themselves, would inevitably be 'poor'. This group included non-Israelites and widows, who were to be provided for by sharing harvests and food; and those who had lost their land through debt, who were to be helped back into productive work as quickly as possible, either by providing paid employment, or by redeeming their land. But a family could be poor for other reasons than landlessness; in these cases, loans should be forthcoming from neighbours, in the expectation that these could be repaid (no interest allowed) when circumstances permitted; but such loans were to be forgiven after seven years.]

*2 Corinthians 8, 9.* [St Paul's collection for the poor in Judaea. In 2 Corinthians 8: 13, the apostle introduces the important concept of equality of material goods within the Christian community]

*Luke 18: 22.* When Jesus heard this, he said to him, "You still lack one thing. Sell everything you have and give to the poor, and you will have treasure in heaven."

*1 John 3: 17.* If anyone has material possessions and sees his brother in need, but has no pity on him, how can the love of God be in him?

Once again the biblical material is rich and diverse, but there are strong common themes, which may be summarised in the following principles:

- Every person has a right to share in God's provision for humankind for their basic needs: these needs are to be met primarily by productive work.
- Personal stewardship of wealth does not imply the right to consume the entire product of that wealth: the rich have an obligation to help the poor.
- Debts should be forgiven, not allowed to accumulate.

These principles can help to evaluate one characteristic of financial market behaviour that had a major impact in the crisis – the growth of mortgage and other lending to poor households, particularly in the United States. It is inappropriate to lend to the poor for the necessities of life, especially if there is no realistic prospect of repayment of those loans. Their needs should be met in other ways: first, by ensuring that everyone who can work has paid employment; and second, by redistribution from the relatively better off to the poor. Mortgage lending to poor households is not a sensible way of providing them with housing. Housing will have to be supplied by another means, such as social housing or a rental sector with housing benefits to enable poor households to pay market rents. Debts should not be allowed to accumulate over time, where these arise from incomes that are inadequate for household's basic consumption – food, clothing, utilities, and transport. Indeed where incomes are inadequate, other means of addressing the problem need to be found, rather than loans that cannot be repaid. But if debt does accumulate, then mechanisms for debt forgiveness should be put in place.

**Biblical theme 5: honesty and integrity in market dealings**

*Deuteronomy 25: 13-15.* Do not have two differing weights in your bag – one heavy, one light. Do not have two differing measures in your house – one large, one small. You must have accurate and honest weights and measures… For the Lord your God detests … anyone who deals dishonestly.

*Proverbs 21: 6.* A fortune made by a lying tongue is a fleeting vapour and a deadly snare.

The requirements of these biblical passages (and other passages in Proverbs particularly) can be summarised as follows:

- Integrity in all financial market dealings.
- Avoidance of misrepresentation in selling financial products, especially to those who lack the expertise to evaluate them.

Regrettably there is ample evidence of multiple breaches of these requirements in the financial crisis. Examples are: the miss-selling of payment protection insurance by all the major banks; the scandal over the fixing of the LIBOR rate by the same banks; the discovery that HSBC had been turning a blind eye to money laundering by Mexican drug dealers; and the revelation that Goldman Sachs had marketed hedge fund products to customers in the full knowledge that these products were bound to fail, given the way in which they were set up.

**Never again? (1) A revolution in values**

In this section and the following two sections we will ask what might be done to ensure that there is no recurrence of the financial crisis. In this section we will consider a revolution in values affecting behaviour in financial markets: and in the sections which follow regulation and structural reforms.

The need for a revolution in values in financial institutions and markets has been the theme of much Christian commentary on the financial crisis. A representative and authoritative voice is that of Stephen Green, who was chairman of HSBC (now a Government minister sitting in the House of Lords) and is an ordained Anglican priest, in his book *Good Value: reflections on money, morality and an uncertain world*. He argues for a complete change in culture in the City of London to focus the activities of banks on service to the real economy, and on the long term rather than short term gains. Specifically on behaviour in financial markets, he deplores the bonus culture in banking and calls for bonuses to be reduced in size and scope, and he suggests that an emphasis on integrity is essential to restore trust in the financial system.

In respect of household behaviour, many have called for the 'debt culture' to be replaced by more prudent consumer behaviour including an unwillingness to incur debt to finance consumption, and a greater willingness to save both for large purchases and for retirement.

The problem with such proposals is the difficulty in promoting the change in values that will be necessary. For financial institutions and markets, the Parliamentary Commission on Banking Standards has proposed that those who work in banking should be required to pass 'professional' examinations that would include ethical training, and that there should be a professional body (modelled on professional bodies in medicine and law) to uphold ethical behaviour in practice. Household behaviour is a more difficult culture to change, and it is hard to see how a major change in behaviour could be brought about. More effective teaching about financial matters in the school curriculum would be a good start, but reaching the general public is complex. It would, after all, be completely counter cultural, as is evident from even a cursory exploration of advertising extolling consumption of goods and services in the media.

Would a successful campaign to change cultural values materially reduce the probability of a new financial crisis? It would certainly help, but it is not obvious that values were a major contributor to the crisis. Many of the 'bad' practices were in place for many years before the financial collapse without provoking a crisis. Moreover, good behaviour may not be enough if the structure and incentives in financial markets are flawed. A banker of impeccable integrity may be making decisions that are not conducive to the flourishing of society, because they prioritise the wrong areas for lending and investment.

**Never again? (2)Regulation?**

The immediate reaction to events like the financial crisis is that those involved should be stopped from behaving in the same way in future. The institutions and market behaviour should be regulated, with rules for conduct that circumscribe how the institutions and market participants may act in particular circumstances.

The first question is what institutions should be regulated. The financial sector is made up of literally hundreds of firms, some like the major banks are international companies with huge assets and activities, but

others may be relatively minor players in particular market niches. The Krugman rule is that if an institution is 'too big to fail' then it should be regulated. 'Too big to fail' is an institution which would have to be bailed out by the monetary authorities (and eventually the tax payer), if it got into difficulties, because the consequences for depositors and other asset holders if the institution went bust would be serious for the economy as a whole. Pretty evidently all the major high street banks fall into this category. Smaller institutions could be allowed to go into liquidation, because despite losses to the shareholders and depositors, there would be no need for the authorities to step in. The only caveat is if a number of related small institutions were on the brink of failure, as a collective failure might trigger other systemic problems, for example a number of other otherwise financially sound institutions suffering serious losses. Regulation may then have to be applied to a whole sector of the financial markets, and hence to all institutions in that sector.

What kinds of regulation might be needed? Generally the focus has been on rules for capital adequacy, and on liquidity. Liquidity is a requirement to keep sufficient funds that would be immediately available should a large number of depositors seek to remove their deposits simultaneously. Evidently there is a trade-off here: less liquidity indicates that the institution is lending more to long term and risky borrowers, who will in general pay a higher return, but with the downside of exposure to the risk of depositor withdrawals; more liquidity reduces risk, but also reduces the return on all the institution's assets. The authorities may set liquidity ratios to curb long term risky lending by all the institutions, looking as much to the stability of the whole banking system as to the position of individual banks. Similarly the authorities may require banks and other financial institutions to finance more of their lending by their own capital (raised from shareholders or retained profits), rather than relying on deposits or short term borrowing in money markets. Own capital can then take the losses if the institution gets into difficulties rather than lenders or depositors being at risk of losing their funds.

The authorities may also seek to regulate sectoral lending. The obvious example is the housing market: if it is apparent that the index of house prices is rising much faster than general inflation, the authorities could in principle instruct the banks to reduce their mortgage lending. Similarly, the authorities might indicate to banks that the growth of consumer credit should be reduced, or that the criteria to be applied to a loan should be tightened. For example, borrowing by households might be constrained by a given ratio to household income: this historically has been applied by banks and building societies to mortgage lending, with loans being restricted to given multiples of household income, and to a given percentage of the value of the home. Sometimes the regulation will have the form of 'moral suasion' when the central bank makes it clear that it would like the banking sector to extend more (or less) credit to small and medium sized businesses to stimulate economic activity. There was much more regulation of this kind before the liberalisation of capital markets in the 1980s, but it fell out of favour with the belief that 'interference' in markets would result in misallocation of funds.

Economists tend to be sceptical about the effectiveness of financial regulation. One reason is that financial flows are 'fungible', that is it may be relatively easy to find a way around regulation (if circumvention is profitable, which it may well be) by relabeling the use of funds. For example, banks may be able to take particular assets and liabilities 'off balance sheet' if they can match particular depositors and borrowers directly without the relevant assets and liabilities appearing in the bank's accounts. A squeeze on one kind of lending is likely to result in an expansion of lending in a related field. A second reason is that regulation gives the regulated institution something to 'aim at': that is, the institution will do only what is absolutely necessary to conform to the regulation – the 'letter', rather than the 'spirit of the rules'. A third reason is that regulators often find themselves playing 'catch up': they tend to be one step behind the regulated institution which is constantly looking for ways to circumvent the controls (as is well documented in tax avoidance). This problem is exacerbated by the circumstance that financial institutions may well be able to pay for the services of the experts in the field, including lawyers looking for more relaxed interpretations of the rules.

**Never again? (3)structural reforms**

Economists tend to prefer structural solutions to perceived failures of economic institutions to deliver good outcomes. A simple example from competition policy makes the point: it will generally be better for competition in a market to prevent competitors from merging, than to deal by regulation with a dominant firm created by a proposed merger. Let's consider what structural policies might be effective in preventing another financial crisis.

First, it would be good to arrange matters so that financial institutions took a longer term view of their activities. One possibility would be to put in place a tax on financial transactions which would reduce the gains from short term manoeuvres in financial markets: this would be a form of Tobin tax, first proposed to deal with the impact

of short term international money flows that can destabilise a currency and may arise from 'bubbles' in foreign exchange markets. There is little doubt that such a tax, if it could be imposed effectively, would remove some of the incentive to pursue very short term gains in asset markets by creating 'exotic' financial instruments. An alternative would be to taper capital gains taxes so that the rates on gains from assets held long term were very favourable, compared to those on gains from short term holdings. The aim is to encourage financial institutions to take a long view of their holdings: this might have a further benefit of increasing shareholder involvement in companies, rather than the detached stance of portfolio holders who simply sell if they lose faith in a company to deliver returns.

Second, there is something of a consensus that a structural change to ensure separation of functions within major banks would be beneficial. This is the significance of the Vickers' Report referred to in the introduction to the paper. Essentially major banks perform three functions by providing: retail banking for households and firms to enable transactions to be facilitated; investment banking, arranging for the financing of major corporations, including raising new equity and bond finance for productive investment; and operations in asset markets on their own account. As previously noted, the danger of this model is that if things go badly wrong in the asset market operations, then the damage may spread to the whole bank and imperil the retail operation. Enforced separation of functions could in principle make the whole banking sector much less vulnerable. It might also be in the interests of shareholders and depositors, who could decide which activity of the bank they wished to invest in. Evidently retail banking is relatively risk free and 'boring', so returns will tend to be low but stable. By contrast, market operations are inherently risky, but can generate high returns for those willing to participate in the equity. While the arguments for structural separation are relatively straightforward, the implementation is not. The aim is to prevent 'leakage' of funds from the retail activity into the other more risky activities. The 'devil is in the detail' as the careful analysis and recommendations of the Vickers' Report makes clear: and those recommendations have not been universally agreed upon. However it seems inevitable that some form of separation of functions will be part of the UK banking sector in future, and this should make the financial system less fragile when and if things go wrong. In particular, it should no longer be necessary for the authorities to intervene to support a bank which has got into trouble, simply because of the necessity of maintaining the retail operations. The trick will be to allow the asset markets operations arm of the bank to go into liquidation (if that is where the problems have arisen) with losses for those shareholders, but not requiring a bail out from taxpayers.

The third area where structural reforms are needed is in provision for the 'poor' – low income households. The growth of firms offering short term loans, the so-called 'pay day' loans, has been much reported on in recent weeks, including the embarrassment of the Archbishop in discovering that Anglican Church funds are invested (very indirectly) in Wonga, which is known for charging astronomical rates of interest to borrowers. Solutions to this problem have tended to focus on controlling rates of interest and the terms on which loans can be made (the regulatory approach), and longer term on better education in financial matters for those likely to find themselves needing such loans. But there is an alternative approach, which is to ensure that social security is more alert in responding to needs of those in need, both long term inadequate household income, and short term emergencies, and that social housing is more available and affordable. Together these could put the pay day lenders out of business. But that is not the direction in which social security and the provision of social housing is currently headed.

**Brief conclusions**

It will be evident from the discussion that it is right to see the financial crisis as a moral failure. But too much attention has been paid to 'bad behaviour', and too little to structural questions about the purpose (*telos*) of the financial sector. The biblical material suggests that we should pursue the latter question. An institution that has 'lost its way' may be efficiently run with full integrity but none the less fail to contribute to the human flourishing which is God's will for all humankind. The financial sector needs to be redirected towards supporting the real economy, creating employment and providing goods and services to meet human needs. The household sector needs to weaned off its cultural devotion to current consumption as the meaning of life, and directed towards a more prudent lifestyle both in the present and in provision for its future. And society generally needs to examine its attitudes towards the poor and disadvantaged, and ensure that effective social security and social housing policies provide for basic human flourishing, and prevent people falling into debt.