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GOVERNING BANKS: A BRITISH PERSPECTIVE

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Abstract

This conceptual paper considers the corporate governance of shareholder owned deposit taking banks in light of the Global Financial Crisis (GFC). Deposit taking banks present a special corporate governance problem because depositors (and taxpayers) are stakeholders. The GFC revealed significant weaknesses in the regulation and corporate governance of banks. The UK government commissioned the Walker Review of the corporate governance of UK banks in February 2009. Its recommendations are discussed in the context of the wider governance (including regulation) of banks. Regulation and corporate governance systems should focus on the establishment of effective internal risk control mechanisms and the good management of banks.

Keywords: Walker Report, Bank corporate governance, Stakeholder interest

JEL Classification: G43

1. Introduction

The idea for this paper was sparked by the decision of the United Kingdom (UK) Prime Minister, Gordon Brown, to ask Sir David Walker, in February 2009 to undertake a review of the corporate governance of UK banks and to report by the end of that year. The post September 2008 banking crisis had revealed weaknesses in bank corporate governance and internal risk controls, as well as bank regulation and supervision in the UK.

The focus of the paper is on deposit taking, joint stock, limited liability banks that have existed in the UK since the 1866 Banking Act and its scope does not extend to consideration of other banking structures based on mutuality, partnerships, re-enforced by the need to maintain fair reputation, non-limited liability and double liability arrangements, or state-ownership. The corporate governance implications of each are different and warrant separate consideration, especially if big and complex banks are in the end to be broken up to deal with the moral hazard entailed in the *too big to fail* problem and conflicts of interest within the complex banking structures combining retail and investment banking. Nevertheless, some of the considerations may also apply to other shareholder owned financial institutions that do not take deposits. Mullineux (2006) considers the corporate governance, or principal-agent (or agency) problem, relating to limited liability shareholder owned deposit taking banks and reviews related literature.

The rest of the paper is organised as follows. A brief discussion is attempted on bank corporate governance in section 2. Pertinent facts are gleaned in section 3 on the GFC. In the next three sections, an attempt is made to examine the sources of banking risk, need for re-regulation and a template for corporate governance. We describe the contribution of the Walker Report in section 7, which is followed by a concluding section 8.

2. The Corporate Governance of Banks

We first need to consider why the corporate governance of shareholder owned deposit taking banks should be any different from non deposit taking firms operating in the field of finance or elsewhere. It should be remembered that such banks typically hold liquid reserves that are a small fraction of their deposit liabilities. With the management as *agents* and the shareholders as *principals*, the solution to the standard Principal-Agent Problem is to align the interests of the management with those of shareholders using an incentive-compatible remuneration package.

To the extent that it was not fully understood before, one of the lessons of the sub-prime and subsequent GFC is that such alignment is easier said than done and that the remuneration packages of bank employees (especially traders) also need to be carefully designed to avoid incentivising excessive risk taking and the *miss selling* of products, such sub-prime mortgages in the run up to the GFC because of fee-based incentives providing too much temptation to the mortgage sellers.

In the case of deposit taking banks, the depositors are clearly also stakeholders and the interests of depositors differ from those of shareholders, who are willing to take on more risk in pursuit of a higher return. Depositors in contrast accept lower interest in return for safety and at times such as the years after the crisis, there is hardly a safer choice for deposit than to leave it in low-yielding deposit accounts.

Thus, even if they could be designed, the remuneration packages that incentivise management to take risks in line with shareholder preferences would lead banks to take *excessive risks* from the depositors' perspective. Furthermore, shareholders are not a homogeneous group and instead consist of small shareholders, hedge funds and domestic, and increasingly foreign, institutional investors (such as pensions and insurance funds etc.), and indeed bank management.

This leaves individual banks open to runs by depositors as a result of a combination of asymmetric information and the banks' holding of reserves that are a small fraction of deposits. This situation is unlike in money market mutual funds, whenever there is a concern about the steadfastness of a ban and the all important trust in banks is lost.

The literature based on information asymmetry concludes that widespread panic deposit withdrawals or runs on individual banks can develop into systemic crises via domino effects (Diamond and Dybvig, 1983). To reduce the risk of runs and contain systemic risks, the government needs to intervene to provide deposit insurance. However, this increases moral hazard, allowing the shareholders to encourage management to take more risks unless shareholders (and bondholders too) genuinely face the threat of losing their money through bank closures. A pre-funded (with risk related premiums) deposit insurance scheme is required in order to tax risk taking and allow small banks to fail without adversely affecting depositors. To achieve this, bank accounts in failing banks must be quickly transferred to sound banks.

Coco (short for *contingent convertible*) bonds may also be a good idea as these bonds convert to equity, putting bondholders at risk of loss and thus giving them an incentive to monitor bank risk taking, when a bank hits low capital trigger points. Lloyds Banking Group issued a Coco in late 2009 and Rabobank followed in 2010. Further, the Swiss National Bank is requiring the large Swiss banks to substantially raise their capital ratios above the internationally agreed (Base III) minimum by issuing Cocos.

Banks that are too big or too important to be allowed to fail, which were dubbed SIFIs (Systemically Important Financial Institutions) by the Financial Stability Board in 2010, are implicitly insured by the taxpayer above and beyond the bank's contributions to the deposit insurance scheme; which, incidentally, the bankers often argue they should not be required to contribute to because they will not draw on it!

Such big banks, as we shall call them, should be required to pay towards their implicit insurance by being forced to hold more capital or liquid reserves than smaller banks, and perhaps also through a special tax levy, in order to protect the taxpayer; this was proposed by the G20 in Pittsburgh in 2009. New, tougher, capital adequacy and liquidity ratio proposals from the Basle Committee on Banking Supervisors were (Basel III) were approved by the G20 in autumn 2010. Little progress was made on a common international approach to a special tax on big banks and individual countries are unwilling to levy significantly large taxes for fear of handicapping their big domestic banks.

If, however, financial stability is a public good, should not the taxpayers contribute to its funding, along with the banks' shareholders, bondholders, depositors, and borrowers? The more pooled (deposit insurance) and in-house (capital and liquid government assets) insurance there is, the less lending there can be. That means borrowing will be more costly and saving less rewarding; unless, in accordance with the Modigliani-Miller theorem, the capital markets fill the void. The asymmetric information story of modern banking (Mishkin, 2008, Chapter 8) suggests this is unlikely and there is anyway a bias towards debt finance created by the dostortionary tax deductibility of interest on business debt, and indeed on mortgages in the US.

Can we afford to completely eliminate the risk of financial crisis, if indeed that can be done?

3. The Global Financial Crisis (GFC)

The GFC did not result from a traditional bank run by retail depositors, but from the collapse of interbank wholesale money markets and ultimately the shadow banking system collapsing (shadow banking is a new structure that grew outside the bank regulators' watch after the financial sector de-regulation during 1994-2004,). It started with a North Atlantic Liquidity Squeeze in autumn 2007 (Mullineux, 2008). Counterparty risks were re-assessed as a result of the subprime crisis and its implication for derivatives, the collateralised debt obligations, (CDOs) and the mortgage backed securities that subprime mortgages underpinned. A wholesale deposit run by the banks themselves rather than retail depositors, and also the shadow banks effectively emerged.

The collapse of Lehman Brothers in September 2008 led to the collapse of the shadow banking system based around money market mutual funds, hedge funds, special investment vehicles (SIVs) and conduits, all interacting with the banks. This made deleveraging necessary and resulted in a much stronger than normal credit crunch in August-September 2008, leading to a major global recession thereafter.

There was widespread failure of bank regulatory and supervisory systems, and bank corporate governance and internal risk control systems, and also the auditing of the internal controls and in the risk-pricing of non-marketable financial assets. As before in the Latin American Debt Crisis of the 1980s that led to the initial Basel Accord (Basel I), banks had become severely undercapitalised given their risk exposures and historically astronomical leverage ratios.

Basel I, implemented from 1988, had pushed risk related capital adequacy ratios up from 4 per cent to 8 per cent, whilst Basel II, implemented from January 2009 in the EU, allowed large banks to drop their ratio back towards 4 per cent. Further, especially in Europe, a significant proportion of banks' Tier 1 capital consisted of hybrid assets, rather than core equity capital. Meanwhile, from the mid 1990s, the big banks had become increasingly reliant on short term wholesale funding (consistent with the rise of the shadow banking) as opposed to retail deposits, and had reduced their liquid reserve holdings of Treasury Bills etc. to less than 1 per cent; thereby dramatically increasing leveraging. Leveraging was further increased by the use of off balance sheet SIVs and conduits to hold assets with much lower capital backing than required for on-balance sheet.

It should be noted that, whilst there was lots of slicing and dicing of securitised assets to alchemically form CDO^2s of triple A through to toxic ratings, there was much less distribution of risks going on than the supervisors realised. Why was this? The originate to distribute model was perceived as good, risk reducing, securitisation, allowing the mortgage originators to securitize the mortgages and distribute the mortgage backed securities (MBS) to institutional investors and, beyond the banking system to insurance companies etc.; thereby spreading the risk. Credit risks on assets were also seemingly being dispersed using credit default swaps (CDS).

It turned out, however, that the buyers did not understand the risks, or were misled by credit rating agencies (CRAs: Standard & Poors accepted a fine in 2007), which earned fees for helping design the CDO^2s. The CRAs thus faced a double conflict of interest in that they are paid by the entities they rate, rather than the bond purchasers. They helped, in return for a fee, design products that needed to be sold by banks to turn a profit.

The collapse of Lehman Brothers in mid September 2008 revealed that the issuing banks were not only holding onto tranches of CDO^2s, but in addition some were buying the triple A CDO^2s of other banks (e.g. European wholesale banks such as IKB and WestLB in Germany), and holding them in off balance sheet conduits.

Unless securitisation resumes, and with it increased leveraging (though the G20 want this capped), credit will continue to be much harder and more expensive to access. Removal of the tax deductibility of debt has often been mooted, is normally opposed by small business associations, partly because venture capital alternatives are not well developed, creating a chicken and egg problem, and is extremely unlikely to be initiated in a recession or a weak recovery period in which small and medium sizes enterprises are complaining about lack of access to affordable finance. There may however be a case for removing tax deductibility of interest on bonds from banks to discourage leveraging. The objective must be to assure that, in the future, risks are correctly priced and appropriately distributed.

The underpricing of risks in part reflects the risk inducing remunerative structures of management, who were increasingly paid like investment bank, or hedge or private equity fund managers, rather than deposit taking retail bank managers, and the fee and bonus structure of the traders and the mortgage brokers. The US mortgage brokers had an incentive to sell large quantities of inappropriate mortgages to subprime borrowers to earn fees. The investment bankers were eager to earn fees from securitising and *derivatising* these mortgages following their aggregation. It is the fee-and-high compensation scheme creating adverse incentives to increase risk in what should be a lower risk deposit banks.

The credit rating agencies earned fees for advising on the design and pricing of these innovative financial products and yet had little prior experience in rating derivatives (as opposed to bonds) and ended up using inappropriate models based on the Normal Distribution of probabilities, with no fat tails that allow for low probability, high impact, events. The MBS and CDOs were often enhanced (underwritten or insured) by monoline insurers: these too had little or no experience having formerly specialised in the enhancement of bonds issued by US municipalities.

Where do we go from here? First let us reflect on the sources of banking risks.

4. Sources of Banking Risk

Extending loans automatically leads to credit risk (that is, default, and late or partial re-payment). Banks are delegated monitors (Diamond, 1984) because the direct finance by depositors of borrowers is inhibited by information asymmetries.

Credit risks are costly to screen and monitor and automated credit scoring techniques have become widely used for consumer loans, leading to a decline in relationship banking, whilst arguably increasing banking efficiency through cost reduction. Loan to income ratios remains a choice variable for bank lenders and so do loan to (house) value (price) ratios.

Lending commonly also involves mismatching by maturity, and possibly also currency, leading to foreign exchange risk. Regulators have expected foreign exchange risk to be limited and/or hedged using derivatives since the Herstatt Bank collapsed in the early 1970s. But what of the recent mortgage lending in Euros or Swiss Francs by foreign owned banks in Central and Eastern Europe to customers earning salaries in local currencies?

Some maturity mismatching is inevitable to the extent that a large proportion of retail deposits are repayable on demand, or at short notice and used by banks to make longer term loans that are not callable at short notice. This gives rise to re-funding (liquidity) risk and interest rate risk, unless the latter is passed onto borrowers using variable interest rate loans. Such loans increase credit risk exposures because sharp and sustained rises in interest rates can make loans unaffordable. Hence bank lending requires an appraisal of the credit standing of the borrower (due diligence applied to customers) and a choice of maturity exposure.

Covered bonds, which are underwritten by the mortgages and other bank balance sheet assets and not just the receivables on the mortgages, of matched maturity could for example be used to fund fixed interest fixed term mortgages (as in Germany). The use of covered bonds to fund mortgages was actively being considered by the Australian regulatory authorities in 2010. The incentive to borrow short to lend long is greater the steeper the (positively sloped) yield curve is.

The degree of leveraging capital and of retail deposits through exposure to wholesale funding risk (liquidity) is also a choice variable. Higher leverage (capital) ratios and liquidity ratios could discourage this and so could reduce loan to retail deposit ratios, as proposed by the Basel Committee of Banking Supervisors (BCBS) in 2010.

Asset price changes impact on the asset side of the balance sheet through *mark to market* accounting rules and collateral value risks. It will also affect the cost of funding. For example, banks can choose which assets, in addition to loans, to hold and what sort of, and how much, collateral to hold through their choice of loan-to-value ratios on mortgages. They can also choose whether to hold the assets on their trading book or hold them to maturity.

Leverage and liquidity ratios could be raised by regulators in response to asset price acceleration and reduced in response to deceleration, leaving the short term interest rate instrument free for inflation control. Proprietary trading by banks (through in house hedge and private equity funds, etc.) had increased dramatically in the run up to the GFC and could be damped by increased capital or margin requirements. Alternatively, proprietary trading could be restricted (applying the Volcker Rule) to reduce conflicts of interest in investment banking and the use of retail deposits for casino banking. A Tobin financial transactions tax could also be used to discourage excessive trading

The banks can, of course, potentially hedge, for a fee, many of these risks using derivatives, but more risk (potentially) leads to more profits, at least in the long run! Banks also act as counterparties to high fee generating, and probably often mispriced over the counter (OTC) derivatives (including CDS). The regulators in the US and the EU have responded by proposing to bring the issuance and trading of derivatives onto markets with well capitalised central counterparties. The central banks will have to stand behind the counterparties of increasingly international exchanges. However, international burden sharing agreements are required, as they are for resolving problems in SIFIs with a global reach.

5. Re-Regulating the Banks

Ideally, the regulators should try to build in countercyclical automatic stabilisers based around risk-related deposit insurance and capital requirements, leverage and liquidity ratios, and forward looking general, and specific, provisioning. These would complement established fiscal automatic stabilisers, with the regulations serving as non revenue generating taxes on financial risk taking. Some discretionary override will be required when asset price inflation accelerates. Fraud would still need to be monitored and prosecuted.

Competition or anti-trust issues in particular will need to be dealt with if the banking markets continue to operate at their current high, and post GFC increased, concentration levels. An alarming statistics in the USA is that the top seven financial firms have assets worth 40 per cent of the GDP of the country! Cartelistic practices need to be monitored and prosecuted and mis-selling of retail financial products and services likewise.

There is a strand of literature that posits a trade-off between competition and systemic stability in banking and another that alleges that banks would be unable to raise sufficient equity without a strong franchise value resulting from monopoly or rent seeking power. Financial innovation can be seen as an attempt to create market imperfections to extract economic rent by generating discriminating monopoly powers.

There is thus a strong case for a retail banking product and services as public utility regulator, given that banking, and particularly the payments systems, are infrastructures and access to finance, including credits, should be assured to allow consumption smoothing over the life cycle and in the face of irregular incomes. The UK government has decided to follow the Australian model of establishing a combined markets and consumer protection body. In contrast, in the US under the 2010 Dodd-Frank Consumer Protection and Wall Street Reform Act, the consumer protection powers of a division of the Federal Reserve System, the central banking system, are to be enhanced and it is to be given more autonomy. Capital markets regulation remains the responsibility of the Securities and Exchange Commission (SEC) in the US.

Separation of retail consumer product regulation form capital markets regulation seems sensible, especially where, as in the case of the UK, the country is hosting a major international financial centre, the City of London. It also seems strange to place consumer protection inside a central bank tasked with micro and macro prudential supervision, as the Fed has done. It would be much better to establish a dedicated retail banking (and insurance) utility regulator tasked with consumer protection, assuring access to finance, and probably also raising financial literacy or capability.

There should be a macro-prudential supervisor, which should probably be the central bank, given that it needs to protect the lender of the last resort insurance it provides against abuse, with sufficient tools, in addition to setting short term interest rates, to do the job such as exercise discretion to change leverage and liquid reserve ratios as asset price inflation accelerates. The macro-prudential supervisor should also regulate innovation in wholesale and investment banking markets in order to prevent the underpricing of risks. There should also be a micro-prudential supervisor of banks. It should probably be prefunded, with risk related premiums, deposit insurance funds given its incentive to prevent the fund being abused. The FDIC in the US does a good job in this respect.

The micro and macro prudential supervisors would have to liaise with each other, and with the Finance Ministry (or Treasury), which represents taxpayers, when dealing with big and/or important banks that cannot be simply allowed to fail and have their deposits transferred to another bank under the auspices of the deposit insurance fund manager. The utility regulator would need to liaise both with the prudential regulators, the competition authorities and the fraud prosecutors.

The FSA of UK failed not only in its task of micro-prudential regulation prior to August 2007, but it also failed in its consumer protection role. Since the Cruickshank Report (2000) called for a UK payments systems regulator, the UK commercial banks have been under almost continuous examination by one or more of the competition authorities, the Financial Services Ombudsman Service or the Banking Codes Standards Board for anti-competitive practices. There is substantial cross subsidisation underpinning free banking model and *all* customers are simply not being treated fairly, which is a task of the FSA to assure. In 2010, the FSA took over the monitoring of the (voluntary) Banking Codes, hitherto monitored by a Banking Codes Standards Board appointed by the banks. The banks also self regulated (through the Association of Payments Clearing Systems, APACS) the payments system. But as a response to an EU Directive concerning payments system supervision, the FSA took over responsibility in early 2010 for this as well.

The FSA appears to have been too focussed on its consumer protection role and was consequently distracted from its micro-prudential role. Further, it had made relatively little impact in raising financial capability and hived off that activity to the Consumer Finance Education Board (CFEB) in spring 2010. In sum, the FSA seemed to have had too much on its plate to take on macro-prudential supervision as well. No wonder Sir Adair Turner, on taking office in September 2008, as its Chairman asked for more and better trained staff!

The issues of whether investment banking should be separated from retail banking or narrow banking, in which banks only take deposits, but do not lend, should be adopted are not considered in detail here. Narrow banking' essentially creates additional money market mutual funds and requires another bank to lend to small and medium sized banks (SMEs) and households. Additionally, there may well be at least some economies of scope to be derived from universal banking and bank assurance, as well as risk reducing benefits through diversification**.** In line with the Volcker rule (Group of Thirty (G30) Special Report, 2009), proprietary trading (the true casino banking) should not be part of a bank that takes retail deposits.

Following competition (antitrust) authority reviews, big banks should instead be split up to increase competition, subject to allowing them to operate at minimum efficient scales. Note, however, that the domestic US banking market is bigger than the UK's, which is bigger than Iceland's, but is Europe perhaps the relevant market for the UK and other EU member countries? In the US, banks are not allowed to take more than 10 per cent of aggregate retail deposits. This may have been waived somewhat as a result of the GFC induced mergers in the US, but not that much because the mergers tended in the main to be between deposit taking banks and non deposit taking investment banks.

A British bank that was allowed to take 10 per cent or less of the UK deposits would be considerably smaller than the Lloyds Banking Group, Barclays or RBS, and much smaller than Citibank and Bank of America and the major Chinese and Japanese banks. In the Baltic States and Iceland *inter alia* the 10 per cent rule would result in miniscule banks. Would the British or Baltic country banks achieve minimum efficient scale and be able to compete internationally? Governments tend to favour promoting their national banking champions, but 10 per cent of EU deposits might be a more realistic ceiling. Studies of economies of scale and scope in banking suggest that a medium sized US bank might be able to reach a minimum efficient scale, but this is a contentious area.

6. The Corporate Governance of Banks

Banks should of course manage their own risk exposures by establishing adequate (audited) internal risk management controls. What were the auditors doing in the run up to the GFC? Evidence of mis-reporting at Northern Rock and RBS emerged in April 2010. Regulatory checks and balances are clearly required to protect taxpayers from abuse of the implicit insurance of big banks, and also to protect depositors and the consumers of banking products and services.

Systems are also need to be put in place to ensure that bank management does not take more risk than even shareholders desire. The institutional shareholders proved to be absentee landlords according to Lord Myners, when he was the UK's Financial Services Secretary, or City Minister.

The Walker Review, launched by the Treasury in the UK in the February 2009, looked into the corporate governance of UK banks and, in its interim report, proposed the bolstering of the current UK (voluntary) Combined Code on corporate governance with respect to banks, and perhaps also other firms. The Federal Reporting Council (FRC), which oversees the Combined Code, undertook in parallel a wider ranging review of the code and also of the role of auditors (especially those of banks!).

Walker's main interim proposals included:

- Better trained chairmen and senior executives;
- Better trained non-executive directors who devote more time to the task; and
- More active involvement of institutional shareholders in 'remuneration committees', and more generally.

7. The Walker Report 2009

The Walker Report was published on November 26, 2009. A number of other developments relating to the corporate governance of banks followed soon.

Despite strong criticism from bankers of the alleged bureaucratic and populist nature of the interim proposals, those proposals were largely maintained intact and were immediately endorsed by the UK government and the Financial Reporting Council (FRC) and was more widely welcomed by institutional shareholders, *inter alia*.

There are plans to give some of the recommendations statutory backing and most of them were adopted by the parallel review of the UK's Combined Code of Corporate Governance, which applies to all corporate entities, not just banks: this was undertaken by the Chairman of the Federal Reporting Council, Sir Christopher Hogg. The Combined Code, it should be noted, is voluntary and operates under a comply-or-explain basis, unlike the US model of statutory guidance. It sets down principles of best practice, rather than well defined rules.

The Walker Report concluded that the crisis was not just a failure of bank regulation and supervision, but rather more a failure of bank corporate governance and internal controls, and thus failure of management behaviour. It demonstrated that the feedback received following the interim report had been considered, for example by being more flexible on the time non-executive directors (NEDs), especially those serving as chief executives elsewhere, should devote to the NED role. The banks' boards of directors would, however, bear the prime responsibility for bank risk management with the support of specialist risk committees.

Sir David Walker urged institutional shareholders to be tougher on the bank boards and this was strongly supported by Lord Myners. The Walker Report also recommended increased disclosure of top bankers' salaries and bonuses, without naming individuals. Lord Myners seemed keen to move further towards naming and shaming individuals. The impact of the 50 per cent windfall tax on bankers' bonuses, also announced in late 2009, might influence the ultimate decision. Most banks tended to pay the bonuses (and thus the tax), rather than curb them, as hoped by the government. This was at the expense of the shareholders, it should be noted. The politically charged issue of bankers' pay and bonuses looks set to run and run. But just may be UK shareholders will be stirred into action and try to influence remuneration, and thus dividend disbursement, decisions!

In response to promptings from Walker, Myners and Hogg, the UK's Investor Shareholders Committee, which represents the main institutional investors groups (the Association of British Insurers, the National Association of Pension Funds and the Association of Investment Companies) has beefed up its code covering the responsibility of institutional investors and has renamed it the Stewardship Code. It remains a voluntary comply or explain code, but adherence to it is to be overseen by the FRC, which issued a consultation document on the code in January 2010 (FRC, 2010). Further, the Financial

Services Authority (FSA) will require institutions to disclose their commitment to the Stewardship Code.

The aim of this new code is to discourage free riding by inactive institutional shareholders on the back of (costly) engagement by others. But some institutions feel they have insufficient information for effective engagement and, on a cost-benefit basis, smaller institutions have less incentive to engage. Lord Myners made it clear that he thought that statutory requirements to enforce engagement, as a responsibility to savers with life insurance and pension funds, may still be required and that the Stewardship Code does not go far enough because self regulation is inappropriate. The fact that an increasing majority of shares are held by non-UK institutional investors further complicates matters.

Lord Myners was also concerned that the rapid growth in high frequency trading on the stock exchange and stock lending (to hedge funds, enabling shorting) would lead to increased short-termism, absentee shareholders and ownerless corporations! He has made a number of suggestions about how to combat such developments, including a financial transaction (Tobin) tax, special privilege shares for long term strategic shareholders and a more prescriptive, statutorily backed, institutional shareholder code.

The FRC tightened the Combined Code further than the Walker Report recommended with respect to the annual re-election of all Directors, not just bank chairmen. Sir David Walker subsequently supported this. The revisions to the Combined Code are aimed at changing the tone of the combined code in order to encourage board members to undertake critical assessments of their performance and to engage more openly with shareholders.

Sir Christopher Hogg's review of the Combined Code, like the Walker Report, emphasises that directors should have appropriate skills and devote sufficient time to their jobs and subject to external evaluation every three years. It is not yet clear by whom! The alignment of remuneration to long term interests is also emphasised. The Walker Report was more prescriptive in this respect, recommending that banks defer half of all discretionary pay for three to five years and the EU has subsequently imposed a similar requirement. Overall, there remains a lack of clarity about the relative roles of NEDs, institutional (and other) shareholders and auditors in the UK corporate governance system. This is particularly the case for banks, where fiduciary duties to depositors and taxpayers need to be recognised and auditors risk sparking runs on banks when qualifying the accounts of banks.

There have also been related and widespread calls to improve corporate ethics, especially in banks, not just their corporate governance and internal risk controls. Whether this can be inculcated in future bankers by business schools is debatable, but better regulation and supervision designed to replace the current distortionary regulations are clearly required. These need to be incentive compatible and work with the market using automatic financial stabilisers. Bailouts should ideally be eliminated to curb moral hazard and protect taxpayers, as well as depositors. This may ultimately require breaking up big banks so that they can be allowed to fail since the threat of bankruptcy is an essential part of any capitalist corporate governance system. To curb the moral hazard, there needs to be credible threat of failure in which bondholders, as well as shareholders, stand to lose money. Ultimately, it may be necessary to eliminate all potential conflicts of interest, rather than rely on Chinese Walls or improved moral and ethical behaviour!

The UK government has hitherto eschewed breaking up too big to fail banks and instead Lord Myners proposed in mid December 2009 recovery and resolution plans, or living wills. These are to be trialled on a dozen or so large UK banks with the aim of preventing the uncertainty that followed Lehman's collapse. The various US bank rescue schemes have however potentially increased moral hazard by encouraging big banks to expect future bailouts, if they can be afforded by the taxpayer!

The Basel III framework is tougher than expected with respect to capital, liquidity requirements and leverage ratios. The proposals essentially include phasing out hybrid capital and increasing risk weights and are to be phased in from the end of 2010 over an eight year period. This all seems rather slow given the increased concentration in banking and heightened moral hazard. Banks that get too close to the regulatory minimum capital ratios will not be allowed to pay dividends or discretionary bonuses and banks will be expected to build up buffer stocks of capital in booms.

With regard to the review of auditors by the FRC, auditing firms will be subject to their own corporate governance code requiring them to appoint independent NEDs to their boards. The UK is taking a lead in this respect, but there are comparable recommendations in the US and the EU.

Increased capital and liquidity requirements and leverage ratios can be expected to lead to more restricted bank lending. An end to tax relief for banks, and other businesses, on interest payments in order to reduce the bias towards debt, as opposed to equity, finance is desirable. This would further increase the relative cost of bank funding and reduce the supply of credit. Equity finance might expand as a result. However, this might improve the corporate governance of banks, and indeed other businesses.

Does more need to be done to ensure that the interests of the depositors and taxpayers, and perhaps Coco bondholders, are properly represented on bank boards? Would a bank utility regulator be sufficient to safeguard the interests of consumers of retail financial, especially banking and insurance, products and services, or should depositors and other consumers also be represented on the boards of banks?

8. Concluding Remarks

Is much tougher regulation of banks the answer to the lessons from GFC? We have been here many times before and each post crisis regulatory tightening is eroded by increased forbearance and regulatory capture in the euphoric belief that the next boom, the one being experienced at the time, is fundamentally different. A major financial crisis followed by an economic depression (Minsky, 1982) will never happen again!

Over tightening of regulations will, in all likelihood, lead to slower growth, but is this true on average over a number of cycles? Will it reduce trend growth? It might even increase it! Too big to fail remains a problem and we might have allowed financial capitalism to develop into a financial oligarchy that thinks it can do what it wants until Armageddon, when the taxpayers cannot afford to bail out the banks.

Better and more focused supervision is clearly required. Micro- and macro-prudential regulation and retail products and services regulation should be separated and the latter should not be combined with capital markets regulation. Remuneration packages for supervisors need to be improved to increase the quality and status of the gamekeepers, but who should pay for the supervision?

Better corporate governance of banks is essential, but do the institutional investors have the incentives to enforce it or are they not increasingly divided in terms of their interests? Can we rely on independent NEDs instead? Prior to the GFC, it should be remembered, institutional investors, seeking high returns on equity, actually encouraged increased leveraging and risk taking to improve returns!

Would a turnover tax help to foster better stewardship, and long termism, and less socially useless short termists' financial activity?

The ideal is better managed banks. Internal risk management controls might be improved by raising the status and remuneration of the risk managers. Auditors should be required to monitor internal risk controls vigorously.

It may be better to restructure the banking and wider financial system to remove the temptations created by conflicts of interest rather than trying to manage them using Chinese Walls. This would require a much more far reaching restructuring of the financial sector in London and elsewhere. It would essentially lead to a return to the pre 1986 Big Bang days of Gentlemanly Capitalism (Augar, 2000), where, in the City of London, underwriting, broking, market making, trading and asset and wealth management businesses are not combined into US style investment banking institutions. Conflicts of interest in retail banking, linked to incentivising sales of products and services such as subprime mortgages and payment protection insurance, regardless of whether they are appropriate to customers would also have to be tackled. This would be the job of retail banking and insurance utility regulator.

The Dutch dyke problem remains in the sense that it is too costly to reduce the probability of flooding in the Netherlands to zero, and, similarly, the cost of eliminating the risk of financial crises. By 2011, post crisis bubbles were arguably already inflating again in commodities and Asian stock markets. Further, the global imbalances that contributed to the generation of the GFC by providing the US and the UK with an inflow of cheap capital from high-growth merging economies have not been resolved.

Finally, the financial oligarchy remains largely unbowed and is clearly hoping for business as usual to resume as soon as possible. So 'IT' could well happen again, and perhaps in the not too distant future, especially now that the 2010 Greek, Irish and Euro crises have demonstrated that the short term Keynesian remedy for preventing an economic depression also has its limits and that there are in fact no riskless medium and long term assets for banks to invest in, not even Western government bonds!

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