The Beckly Lecture

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Shall I cast the first stone? A Christian reflection on the financial crisis?

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Good evening and thank you for giving me the privilege of delivering this year's Beckly Lecture.

According to the original charter of the Beckly Trust "the function of the Lectureship shall be to set forth the social implications of Christianity and to further the development of a Christian sociology and the expressions of the Christian attitude in reference to social, industrial, economic and international subjects." I am sure John Henry Beckly would have approved of my attempt tonight to throw one Christian's perspective on the financial crisis and in particular one aspect of public reaction to the crisis that I find troubles me. I have not found out enough about Henry Beckly to make a guess as to whether he would have agreed with my conclusions and I think you may find some of my ideas quite controversial. If they are thought provoking as well then I will have achieved my mission.

Today's lecture is in two parts:

I will first talk for a while about the background to the financial crisis, what I see as some of the underlying causes and issues and to remind us of some of the key events.

In part two I will move on to my personal reaction to the crisis and offer a few thoughts and reflections from the point of view of one Christian still active in the area of corporate governance.

Although we have all experienced the financial crisis in one way or another I want to start off by reminding us all of today's context and a little bit of an historical overview.

I had a lot of training while working for BP and one of the courses which made a great and lasting impression on me was when I was trained as a fatal accident investigator. The two great insights for me from this experience were that a fatal incident always has multiple underlying root causes, and that hard evidence evaporates very quickly leaving unreliable and often contradictory recollections of what actually happened. In these two respects the current financial crisis has similarities to a fatal accident.

I had to put my training into practice leading the investigation into a fatal accident involving a fall from a delivery truck in Beira in Mozambique. Although the accident had only occurred forty eight hours before we reached the scene seven out of the eight eye witnesses claimed and genuinely believed the driver had fallen on his head. In fact he sat down very heavily after falling feet first from the top of the truck, the only explanation consistent with his injuries. As a result of the findings and recommendations of the investigation the terminal loading facilities were completely redesigned and rebuilt to reduce the possibility of a repeat of this human tragedy.

In constructing this brief and condensed review of the financial crisis I have drawn from various sources, readings and conversations which to me seem to make some sense. By the way among those sources were Vincent Cable's book "The Storm" and a book called "Animal Spirits" by Akerloff and Shiller. For anyone wanting to look at a couple of different perspectives on the financial crisis, they are both a very good read. Akerlof and Shiller in particular point our that they believe there is a fundamental flaw to conventional economic analysis in that it assumes perfectly rational and logical human responses to economic stimuli. They argue and I am inclined to agree there are human psychological drivers in addition in which they include confidence, fairness, corruption and bad faith, "money illusion" where people are strongly influenced by nominal rather than inflation adjusted real money amounts, and stories which then feed back into confidence and the perception or otherwise of fairness[1].

My story is of necessity somewhat streamlined and abbreviated.

One of the big underlying causes of the current financial crisis or "credit crunch" was undoubtedly the so called housing bubble. But how did this happen? Partly it arose as a result of government policies to widen home ownership to historically disadvantaged groups mainly in the USA and UK. The era of subprime mortgages had started. This combined with low interest rates arising from very large capital inflows from developing nations with budget surpluses such as China and also capital inflows from oil producers.
Inflation was generally kept low by cheap imports from low cost developing economies. The housing market however became seriously overvalued relative to incomes. Even though house prices in the UK have fallen by 20 to 30 percent they are still around 20 percent higher than the long term average versus average incomes.

People including those supplying mortgage facilities to buyers told and retold the story that property prices could only increase, and this became accepted wisdom and a common conversation amongst friends, family and colleagues. Housing became seen as a good thing to invest in and the "buy to let" market became very fashionable and took off. With this increase in wealth on paper at least, people generally felt more prosperous, confidence rose and folk bought more goods and services, generally increasing their credit exposure. This in turn led to higher corporate profits. So far this looked and felt like a virtuous circle.

At the same time banks with their investment bank arms, hedge funds, corporate risk managers and trading companies were engaged in what is known as "Over the counter" trading. These are largely unregulated markets, company to company, making it difficult to see the size of the market, the prices or the individual positions and total exposure of any one trading entity. Often these deals are heavily debt financed or to use the trade expression "highly leveraged"

One of these markets was for bundles of mortgages of varying quality packaged together called collateralised debt obligations or CDOs. Many of these CDOs had good quality ratings from the ratings agencies, again partly based on their confidence in a rising housing market. Another influence was the conventional statistical probability based approach to risk concluding that not many of the mortgage holders would in practice default. One thing is clear in retrospect which is that actually a lot of these subprime mortgages were sold to people who could not repay them.

Herein lie some of the issues or questions I would like us to consider. Is it ethically or morally right to sell a mortgage to someone that you have serious doubts about their ability to repay? Or on the other hand is it right only to grant a mortgage to those who are economically advantaged thereby excluding a large section of the population from the perceived benefits of home ownership? What are the individual incentives driving the behaviour of the mortgage salespeople and brokers? To what extent have fraud and bad faith had an impact here? Are the ratings agencies in a position of real independence when valuing assets or are they rather in a position of conflict of interest? After all they receive their fees from the institutions they are rating. Please hold these thoughts and questions. I feel I ought to warn you now that I shall have more questions than answers during this journey though the financial crisis.

One thing is certain, during 2007 belief and confidence in rising house prices, other asset values including the value of companies and faith in future corporate profits began to diminish. What had been a feedback loop reinforcing an uptrend rapidly began to create a feedback loop downwards. Mortgage defaults led to repossessions and foreclosures and various writedowns of risky asset portfolios of the lenders had to be taken under accounting rules. The rot had started.

But much worse was still to come. The financial system through massive expansion of risk and credit had become extremely vulnerable to a sudden downturn. This threatened the viability of some of the world's largest investment banks. A rescue deal with a loan backed by the Federal Reserve was organised for Bear Stearns but the authorities in the USA and other countries including the UK were now faced with the dilemma known as "moral hazard". Because the investment banks are dependent on each other through the complex web of day to day trading between them, if one is allowed to fail, the damage to other banks is widespread. When this happens trust disappears and the basis on which banks are prepared to lend to each other becomes hugely more expensive. So governments feel the need to step in and rescue the banks so that depositors are protected and credit facilities to the wider economy at large continue to function. But here is the dilemma of moral hazard put in its most simplistic form: A bank takes excessive risk, makes big profits and the executives and traders get big bonuses. The bank starts to fail, putting depositors and the wider economy at risk. The government steps in and puts public money to rescue the bank. So if the bank takes big risks and makes money there is upside for the executives and the investors. If the bank loses money it is saved by the government. The taxpayer and future generations of tax payers will have to foot the bill. This is not a recipe for prudent banking. It may encourage even bigger risk taking in the next cycle leading to a future crisis of even greater proportions.

Northern Rock in the UK had a flawed business model selling mortgages, taking on a long term credit risk and obtaining their funding from the short term money markets. When Banks would only reluctantly lend to each other at a high price, Northern Rock had no way to cover its funding requirements.
The most decisive event however was yet to come with the failure of Lehman Brothers. Faced with the dilemma of moral hazard, the US authorities decided to allow Lehman Brothers to go bankrupt and file for protection from its creditors under Chapter 11 in the middle of September last year.

The remaining banks no longer trusted each other and interbank lending became scarce and high priced. Eventually governments around the world had to step in to provide funding to try to minimise damage to the non-financial real economy which depends on the availability of credit to consumers and businesses in order to be able to keep normal day to day activity going.

I now want to move on to Part 2 of my talk. This is where I want to share some thoughts on our individual and collective reaction to this series of events through my personal perspective. It's through the lens of a person who as a Christian is engaged in business. I will explore the "Blame Game" that has taken place and how I see the Christian message as relevant to me in this area.

My interest in this area was sparked off by my personal reaction to the individual vilification of Board members of various formerly highly respected banks. I did not and do not doubt that many mistakes were made and that serious bad judgement of the risks to the firms was, with the benefit of hindsight, clearly evident. However I could not make the leap to the conclusion that these Bank board members were fundamentally bad people who had gone into work with the intention of destroying the future of their companies. I've worked with Board members of companies of varying sizes over my 36 years of paid employment. I've worked with tough but fair board members, with kind and caring board members, even with philosophical board members and some with a volatile temper when provoked. But they have all had one thing in common, a conviction that they were doing their best for the firm and that they put the company's interest and future ahead of their own. So for me the media caricature does not fit with my own observation.

I want to pose a question about a question. It's indirectly connected to my misgivings about the popular image of board members.

Is there a better question to ask than the ever popular 'What's wrong?' I ask this because the question "What's wrong?" has a fundamental problem. That is because there is really only one logical follow up question which is "Who's to blame?" This then will normally result in what can end up by being a distracting witch hunt for a guilty party. It seems we are hard wired for this conversation and it is the foundation of much of today's political discourse. I confess I have myself participated in many conversations like this and it seems there is even some individual satisfaction to be gained. It's a very popular and seductive approach. Economic and political commentators have made their reputations using it to demonise their targets. But I ask you to consider - is it a Christian approach? Is it even useful?

My contention is that it is neither. I'll address the usefulness first. If our primary goal is to understand and learn from events and circumstances so that we can do things differently and hopefully better in future then looking for a person or persons to accuse creates a context of conflict and tension that obscures understanding of what actually did happen. With the exception of where there is a pretty clear case that the law or regulation has been broken I don't believe "What's wrong? And who's to blame?" is useful. If we are not very self aware and careful blame can often be a device used to deflect from one's own responsibility for a bad outcome.

Now on to the question: is this a Christian approach? Here I will first reflect briefly upon the so called "Golden Rule" In my most commonly used version of the Bible Matthew 7 verse 12 the translation of Jesus' words in the Revised English Bible reads "Always treat others as you would like them to treat you: that is the law and the prophets". Different expressions of the same theme are found in almost all religions and traditions from as long ago as 3000 B.C. For example from the Vedic tradition of India "This is the sum of duty. Do not unto others that which would cause you pain if done to you." Although this is expressed in the negative the message is clearly the same.

I have made people wrong in conversations and debates many times in my career and my private life, sometimes with intention and sometimes carelessly and I have come to recognise it is always corrosive to any relationship. This in turn damages the opportunity to learn from mistakes as an open conversation becomes more difficult. The conclusion I have reached is that nobody like to be made wrong. Let's test this out with a bit of audience participation. Will anyone here who likes being made wrong please raise their hand?

So if "What's wrong?" Followed by "and who's to blame?" isn't a useful or Christian question then what do I suggest would be better?

A wise person in BP once told me that the price of criticism is to come forward with a better alternative.

A device I have used and which was widely adopted across my former employer is to substitute the question "What's missing?" instead of "What's wrong?" "What's missing?" enables focus on possible solutions and avoids or at least defers the hunt for the guilty party. Also "What's missing?" is simple enough that almost everyone can remember it. I encourage you all to give it a try for a couple of weeks and see if it makes a difference. This linguistic device actually came to me and to BP from a group of consultants called JMW associates who were focussing via management training events on the power of conversations to change outcomes, behaviour and performance. For me it fits perfectly well in the context of a Christian approach to life.

Of course I'm not going to stand here and try to convince you that people who are responsible for various contributions to the financial crisis should not be held to account for their mistakes, misjudgements or in some cases for outright wrongdoing. Ultimately as a Christian I believe I will be in any case held to account in the life to come.

But I believe I need to be very careful here on earth not to make hasty judgements about the actions of others before I have examined my own actions. Again, From Matthew 7 Verse 3 to the end of Verse 5, Jesus is clear about hypocritical judgement of others. I particularly like the way this is translated in the revised English Bible because we are having a lot of building work carried out on our home! Thankfully this is close to completion. The quotation is of course “Why do you look at the speck of sawdust in your brother’s eye, with never a thought for the plank in your own? How can you say to your brother “Let me take the speck out of your eye,” when all the time there is a plank in your own? You hypocrite! First take the plank out of your own eye, and then you will see clearly to take the speck out of your brother’s.” Having mentioned planks I’ll come back to stone throwing a bit later in the lecture.

I think it is time to see who in the chain of events leading up to the financial crisis might be held to have had some part of the responsibility for how badly things turned out.

Let’s start with the banks and the boards of banks. I want to assume that they had fundamentally good motives to create wealth for their shareholders by performing a socially useful activity. They were under pressure to produce short term results from investors. The big name high street banks are big components of pension funds so many people are indirectly beneficiaries of good bank performance. Many banks had over time increased their exposure to the subprime mortgage markets to improve returns. Many had increased their exposure to derivatives markets to apparently manage their portfolio risks. I doubt whether the Board members really understood the magnitude of the risks in their total portfolio. Perhaps they had not taken into account the risk of possible failure of a large market participant. So yes the banks, their Chief Executives and the Board have a share in the accountability for the financial crisis.

However they are not the only ones with some share of accountability. Governments have also to take a share. Governments via regulatory institutions and processes create the framework in which the market operates. If I ask my question, “What’s missing?” one of the answers is a better system of regulation. There is a balance to be struck here and no system of law or regulation can cover every eventuality. Changes need to be made taking into account the international context or dealings will migrate to the least restrictive jurisdiction. Governments also create political context and stories that are influential. I suppose we all remember “no more boom and bust” for example. As I referred to in part one, the USA and UK governments both encouraged wider home ownership and this was a factor in the creation of a growing subprime mortgage market.

Mortgage Brokers and Estate Agents also should take some responsibility for enabling the housing boom. Driven by their incentive for commissions and fees they can have had little interest in moderating the housing bubble.
Hedge Funds and short sellers are popular targets for stone throwing. Published analysis of their impact so far indicates they have actually had less of a part to play. The practice of borrowing shares, selling them and giving them back later may seem to many to be a strange and perhaps wrong thing to do. My own view is that the presence of short sellers in any market allows the proper price and value on the day to be revealed. Short sellers take risks and in the stock market pay fees for the stock

they borrow. If they get it wrong their losses are without limit. While they may have put pressure on bank share prices perhaps they were justified in doing so. I'm probably biased in my views having spent many years in the world of energy commodity trading. I'll save my stones for the time being.

Let's look at some more big players who in my view have a share in the responsibility. I don't think the pension funds and institutional investor should go without mention. They exert a lot of pressure both in public and in private for short term outperformance in each sector. I remember a former boss of mine saying "Remember, the next five years is only twenty quarters" and the pressure to achieve quarterly targets as well as the long term strategic goals is pretty intense. If a bank with low subprime exposure was being outperformed by one with a high subprime exposure I imagine there would be investor questions along the lines of "why are you not doing that too?" But here I am speculating.

Let's think about those people who took on mortgages, perhaps on a self certified basis, perhaps with no income, no job, no assets, otherwise known as "ninja" borrowers. Did they have some accountability for making sure that they could repay? Or if someone who was being paid a commission to sell them the loan was happy doing it was that then OK?

What about the media and the so called "Robert Peston" effect? I could view the media as neutral commentators but have they from time to time added fuel to the bonfire?

The role of excessive remuneration packages has been much talked about, although developments in the Westminster expenses story have taken a bit of the spotlight away. My last job in BP was head of Human Resources for the BP Group and I soon discovered that getting the right balance between long term and short term incentives, cash versus restricted shares, what performance indicators would trigger what payout, what penalties would follow what failures is very complicated and very difficult. Although I was not responsible for the Board pay and benefits, which were determined by an independently advised committee of non executive directors, I and my team needed to make sure there was a pathway for the top performers in the company to progress to executive director pay. If you make it too complex and formula based then it becomes hard to understand, and if you make it simple it can point executives in the wrong direction. There should always be room left for judgement and management discretion and major changes in the operating and competitive environment. In my view executive pay is an area that is very hard to legislate well but there probably were some errors of judgement and too much focus on short term performance and payout.

One of my current roles is as an independent non executive director of an energy commodity clearing house, and I spend a lot of my time focussing on corporate governance issues. There clearly would have been opportunities when the non executive directors could have asked for more detail and more clarity on the risk management within the financial institutions. They could have spent more time with the management getting to know what was going on in the key areas without interfering with the executive management of the firm. I see part of my role as a non executive director to ask searching questions, not just in the Board meetings but where I have a concern I feel needs to be satisfied. I'm happy to say that the CEO and his management team, in spite of being very busy, always seem pleased to respond fully to my questions.

So I believe non executive directors do have a share in the accountability for the financial crisis.

Finally I'm sure you can see where I'm going with this argument which is that I believe many of us in the developed world are responsible individually and collectively, either actively or by our inaction for the financial crisis. From the shopper on the high street building up unrealistic credit card debt to Chairman and CEOs of financial institutions we all had a part to play. As is the case with the effects of dangerous climate change, the poor and vulnerable in the developing world have shared in the pain for which they have had no share in the causes.

I can't comprehensively answer my own question "What's missing?" in relation to the financial crisis and what needs to be put in place so that when the next crisis emerges it will not have such a widespread and devastating impact. Some sensible ideas have been proposed. These include improvements to the regulatory framework, making banks with higher risk activities hold more regulatory capital, and more oversight of the total accumulated systemic risk in the financial system. But on this I agree with Lord Griffiths of Fforestfach when he says "The weakness of focusing on more regulation is that it is being asked to bear an impossible burden"[2] His contention, which I share is that the is a moral and ethical dimension beyond law and regulation and that leadership is about setting the standard for behaviour by setting the example.

If I may go back to the parallels with safety, the mantra I inherited from a predecessor in one of my jobs is" the lowest standard of safety you are prepared to tolerate is the highest standard you can expect" I think the same is absolutely true for leaders where ethics and values are concerned.

In this respect Christians at work can help to supply some of the missing guidance on standards of ethical behaviour based on their own appreciation of Jesus' life and example. I'm on the advisory board of the Christian Association of Business Executives whose purpose is "affirming Christians in leadership roles in the private, public and voluntary sectors in order to exercise influence through our life and work." If you want to know more about this organisation there are some copies of the CABE Principles for Those in Business available here tonight. You can also download a PDF copy through the web.

I'd like to just share one more process that I have found very useful when looking back at a difficult situation that I want to improve for the future. Actually it is four questions used by the US Army after any exercise, real or simulated. They sit down as a group and in a "no blame" but no holds barred way have a more explicit "what's missing?" type of discussion. The four questions in order are:

1) What was supposed to happen?
2) What actually did happen?
3) Why was it different?
4) What did we learn?

They call it an after action review but I've found it really helpful in getting people to find real learning in their mistakes and for me to find the same in my own.

Now I think it is time to check to see if I want to cast my first stone!
The often quoted passage "An incident in the temple" normally included in John 8 is actually only included as a footnote reference in my favourite Revised English Bible. Nevertheless it has become a part of our language and culture and it recalled for me the feeling I had when the leading UK Bankers were being vilified. "Let whichever of you is free from sin throw the first stone at her."

On reflection I think it would be more appropriate to give it to a poor person from a developing country to throw at me.

Thank you very much

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[1] Animal Spirits – How Human Psychology Drives the Economy and Why it Matters for Global Capitalism by George A. Akerlof and Robert J. Shiller 2009 Princeton University Press
[2] The Times April 9th 2009 Markets can'*t be improved by rules.* Only by personal example Brian Griffiths