Lessons from a Career in Banking

By Harrison Young[1]

When I got this appointment, I consulted an old friend who's had an academic career. I wanted to know what to expect? "They'll probably ask you to give a little talk about your work," he told me. I guess this is it.

I should emphasize at the outset that I am speaking strictly for myself, and not on behalf of any of the organizations with which I am or have been associated.

There is serendipity to most careers. I became a commercial banker because I didn't get into law school and when I got out of the Army I needed a job. Citibank taught me accounting and corporate finance and credit analysis. I became a specialist in financial institutions because, when I arrived at Morgan Stanley four years later, they put me on a team advising a commercial bank in Cleveland that was feeling queasy. I tried to tell them I'd been lending to airlines and aerospace companies and knew very little about banks, but Morgan Stanley in 1975 was not an organization that paid much attention to what first year associates said or wanted. So I went off to Cleveland, did some number-crunching, and discovered that the bank in question was sicker than it realized. This got me tagged as "good at banks." I resisted for a couple of years, raising capital and arranging mergers for manufacturers and public utilities, but banks and insurance companies kept asking for help, and eventually I stopped fighting destiny.

In the course of my career, I've done business in twenty countries, helping banks and other financial services firms raise capital, strategize, restructure and acquire. I've advised a dozen governments on financial system matters. I helped found a commercial bank in Bahrain and an investment banking firm in Beijing. I served as a bank regulator in Washington and as a member of the wonderfully named Court of Directors of the Bank of England. Not surprisingly, I have opinions about what works and what doesn't,

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[1] Remarks on 14 March 2014 at the commencement of his appointment as an executive-in-residence and honorary fellow of the Department of Finance in the University of Melbourne's Faculty of Business and Economics.

which I'm happy to share with anyone who wants to come by my office. What I hope to do now is tell some stories and introduce a few themes. I suppose that to a department of finance, an executive-in-residence is a specimen – so what follows is data.

The bank in Cleveland was my first exposure to the important concept of *risk culture*. They had lovely offices. They were polite and amusing. But they tolerated muddle. In the early 1970s, Citibank's culture didn't. My part of the Army hadn't liked muddle either, so I'd assumed intolerance of muddle was a characteristic of all grown-up organizations. It isn't, of course. In some organizations, muddle is positively cherished. It can be a defense against institutional bullying. My friend the professor tells me that muddle is the University of California's core competence. But it isn't good for banks.

The poet Randall Jarrell once defined the novel as "a prose narrative of some length that has something wrong with it." In that spirit, a bank could be defined as a mismatched institution with a data problem. The sincerity of its struggle against that problem tells you a lot about a bank's risk culture.

The bank in Cleveland had three overlapping lists of problem loans floating around their headquarters, compiled by different departments under different criteria. I had to draw the chief executive a Venn diagram. "Oh my," he said.

But knowing what you have is just the start. Most of the assets and liabilities on a bank's balance sheet have imbedded options, which don't necessarily get exercised when you'd expect. Banks must be perpetual students of their assets and liabilities – developing a sense of how they "normally" behave, and how they might behave under stress. So a healthy risk culture includes both a passion for accuracy and regard for instinct.

One reason I decided I was happy to be pigeon-holed as a banker to banks is that banks are heavily regulated. I found the interplay of commercial and public policy considerations interesting – and gravitated to assignments where you had to wrestle with both.

What ultimately put the bank in Cleveland in mortal peril was double leverage, which consolidated financials hide. It had borrowed

at the holding company level to inject equity into the bank. If the bank couldn't pay dividends, the holding company would not be able to pay interest. A bank with the bad loan problems our client had shouldn't have been paying dividends, and the Fed wanted it to stop. But if its parent couldn't service its debt, the bank's depositors would start pulling their money out of the bank, which would face a liquidity crisis and might easily fail. Our job was persuading the Fed to be pragmatic. We saved the bank – but I've been opposed to double leverage ever since.

I worked on a lot of cross-border transactions, such as National Westminster Bank buying National Bank of North America in New York and Bank of Montreal buying Banco Brascan in Brazil. This typically required explaining one system to denizens of another system, which in turn involved examining differences and identifying blind spots.

For example – and I still feel we failed them on this – NatWest never absorbed the fact that American banks, including the one they'd bought, had fixed-rate residential mortgage portfolios. This proved to be a painful oversight when Paul Volcker went after inflation in 1980 and deposit rates soared. NatWest was a conservative institution. The flaw in their culture wasn't excessive risk appetite but a lack of imagination.

You don't have to be a bank to have this problem, of course. The larger and more successful any organization is, the more likely its managers are to be captured by their picture of the world. Subconsciously, they assume the world as they know it isn't going to change.

Brazil's approach to inflation at that time was very different from Volcker's. It involved quarterly statutory increases in the face values of both assets and liabilities. The way the math worked, owning a bank was almost guarantied to be profitable. The regulatory context in which a bank operates is always *part* of its business model. For Banco Brascan, the regulatory set-up *was* the business model.

One of the most memorable transactions I worked on was Marsh & McLennan buying its London equivalent, C. T. Bowring. The financial engineering had to accommodate the tax, legal and

accounting requirements of both the U.S. and the U.K. The regulatory hurdles were significant. The human dynamics were delicate.

Because Lloyd's didn't allow foreign firms direct access, Marsh, the biggest insurance broker in the world, was Bowring's largest customer. So both sides pretended it had to be a friendly deal until the very end. Friday afternoons were particularly tense, as Bowring's advisors strung out the negotiations to the point where we *almost* couldn't catch the last flight to New York.

Our client was going to have to pay for Bowring with its own shares, which required finding a path through Britain's exchange controls. Great was our excitement when we called on the Bank of England, drank tea served by pink-coated "ushers," and were given what our British colleagues assured us was a Delphic hint that these controls were about to be loosened.

For an Anglophile, as I admit to being, it was enormous fun. In 1979, when we started work on the project, London was on the threshold of big changes, but traditional eccentricities were still alive and well. We stayed in Claridge's, admired the hall porter's 18th Century livery, ate grand dinners, read the *Financial Times* each morning, learned the names and functions of dozens of tiny specialist firms – brokers, stock-jobbers, discount houses, accepting houses, underwriters, names agents – and met some extremely clever men who could have been invented by Charles Dickens.

In the ensuing years, "Big Bang" happened. Merchant banks bought brokers and jobbers. Commercial banks bought merchant banks. Compensation exploded. The hall porter stopped wearing knee-britches. For the most part it was exhilarating, but it left me both sadder and wiser.

The wisdom part is a persistent expectation of discontinuous change, a conviction that banks can never entirely relax. The barbarians may not be at the gate, but they are somewhere in the forest across the river.

The sadness involves the disappearance of S. G. Warburg & Co. To do a take-over in London, we needed the help of a London merchant bank, so we brought them in, and they were superb.

Sigmund Warburg died in 1982. The firm he'd founded continued to do very well for a while, but as the City changed, it too changed. It grew rapidly, faltered, tried but failed to merge with Morgan Stanley, was absorbed into what is now UBS. I'll say some more about the Warburgs of 1979 later on.

At Christmas time in 1980, twenty-four hours after being promoted to vice president, I was given the "opportunity" to spend six months in Bahrain, helping a group of distinguished Kuwaitis establish something called United Gulf Bank. There was a lot of money washing around that part of the world. The Ruler of Bahrain had decided to grant offshore banking licenses. Everyone in the world wanted to cozy up to Arabs. Manama, the capital of Bahrain, was a bit dusty, but there were some good hotels and you could buy a drink. I was told I was lucky.

What I learned, primarily, was what a bubble looks like. There were these things called "investment companies," which were shell corporations full of cash, set up by Western-educated Arabs. The first investment companies to be floated had the good fortune to buy silver just as the Hunt brothers decided to buy a *lot* of silver. It is better to be lucky than smart. The first investment companies doubled their capital in a few months. So the next half-dozen investment companies to be launched opened trading at twice book.

In Kuwait, there was a growing market in un-margined forward purchases of shares – a structure offering infinite leverage for six months. In the end, Kuwait's share market collapsed and a lot of people went bankrupt. Happily, United Gulf Bank never participated.

Sitting in my office in Manama, I would hear my telex machine come to life each day when London opened, with offers of participations in loans to Brazil at the established rate of 2 ¼% above LIBOR. As an alumnus of Walter Wriston's school of banking, I believed his dictum that "countries can't go broke," but 2 ¼% above LIBOR made me cautious. The Dutchman we recruited as general manager of United Gulf Bank had also worked at Citibank, but he thought Wriston was mistaken, so we never did any sovereign lending, even at less extravagant spreads. Because lending money has so much more downside than upside, banking has sometimes

been described as a business of not making mistakes. The Dutchman was a very good banker.

If the telex traffic gave me a glimpse of the future, one episode gave me a glimpse of the Middle Ages. Our principal shareholder had purchased a jet. It wasn't a big jet, but he didn't have the requisite six million dollars in his checking account that month. Could we make him a bridge loan? It was agreed that lending to your biggest shareholder would be a bad look, but perhaps some of my new friends in the dozens of offshore banking units that had recently been established could oblige. I called a fellow at National Commercial Bank who had bought me lunch the previous week. He consulted head office in Jeddah. "Sorry," he told me the following day. "It turns out we have a strict policy never to lend to royalty."

United Gulf Bank dodged a lot of bullets – primarily because its founder, a childhood playmate of said royalty, was innately conservative. He'd learned his trade some years earlier at a bank in Kuwait, where his mentor had been a very nice American seconded from Morgan Stanley's cousin, Morgan Guaranty Trust Company. The innate conservatism that characterized Morgan Bank in those days had rubbed off on our founder. This was another lesson in risk culture.

In 1982, back from the Gulf, I had the opportunity to play investment banker to my employer. I learned a lot from that assignment, so I'll spend some extra time on it.

Morgan Stanley had traditionally been an underwriter of high-quality stock and bond offerings, which required good judgment but very little capital. A handful of partners would sit around a table in a wood-paneled room, study a meticulously prepared "exhibit" called a "multi-company comparison," and decide whether the coupon ought to be 6 ¼% or 6 ½%. The firm's prestige was such that the market tended to accept their decision.

In the early 1970s, however, with markets getting more volatile, it became clear that you needed to have at least a modest sales and trading operation to make such judgments. That required capital. In fact, it required two kinds of capital.

One, which we called "regulatory capital," was a function of rules laid down by the Securities and Exchange Commission. Any shares or bonds on a firm's balance sheet had to be "haircut" by a certain percentage, and after all these notional discounts had been absorbed, the firm had to be solvent on a *pro forma* basis. You had to pass the test every night.

The other thing we needed was borrowing power. Securities firms didn't have deposits. Our trading inventory of shares and bonds had to be financed with commercial banks. As I remember it, you could borrow 100% of the market value of U.S. Treasuries, 96% of the value of high-grade corporate bonds, and much lower percentages for riskier securities. So for every position you took on, you needed a certain amount of "cash capital." In a sense, this made the securities financing market an alternative regulator.

Requirements for regulatory and cash capital could differ significantly. You had to pay attention to both. The chief financial officer of Morgan Stanley had set up a management information system that allowed him to track them in real time, of which he was justifiably proud. Then one day he asked a harder question: "How much capital *should* we have?" Someone decided I was the person to answer that question.

The problem, for an organization accustomed to consulting multi-company comparisons, was that most of the major securities firms were private partnerships. There weren't any points of reference. I asked several senior partners how to proceed and got what amounted to elegant shrugs.

A meeting was arranged with the chief financial officer of Goldman Sachs, which had more significant sales and trading operations than we did. "How much capital should a securities firm have?" I asked him. "More than it thinks," he told me. He had been through the crisis in the commercial paper market that occurred when Penn Central went bankrupt. "It scarred him for life," I was told. I thought he made a lot of sense, actually.

The approach I eventually settled on was to sit down with the men running each of Morgan Stanley's seventeen lines of business, try to understand how they did what they did, examine their monthly results over the past three years, and agree on a reasonable worst

case loss. Depending on the business model, that loss could happen overnight or result from high overheads and three months of inactivity. I suggested – and I'm simplifying here – that we should have equity equal to the sum of those seventeen worst cases.

I said it was unlikely that everything bad we could think of would happen at once. This is actually not true. In a crisis, all correlations lurch abruptly toward 1 or -1. Everything *does* go wrong. But I hadn't learned that then. What I did say was that there were probably bad things we hadn't thought of. And if people felt I was being too aggressive or too conservative, they could adjust my figure up or down. At least I had given them a point of reference, from which to apply judgment.

I guess the partners liked my answer. "Hmmm," they said. My point-of-reference "risk capital requirement," was a bit less than the firm's existing equity account, which made them feel smart. Anyway, I was never asked to do any follow-up work. I wish I had been – not because I would have come up with a better answer but because it would have given me a glimpse of how this collection of experienced businessmen wrestled with the problem. *That* would have been interesting.

As an aside, I made two other observations. One was that the firm's dividend policy was the retirement schedule of its partners. The other was that our inability to borrow on an unsecured basis was a strategic weakness. Morgan Stanley addressed the first of these issues four years later by going public. Once retiring partners could sell their shares in the market, the firm had permanent equity, and the ability to raise more for expansion. The other issue wasn't really addressed until the Global Financial Crisis.

I took several lessons away from my stint as Morgan Stanley's investment banker. The first was that the need for capital is primarily a function of the volatility of the business. The second – reinforced by watching events since then – is that forecasting volatility is hard. Markets are more like weather than like dice, where the odds are known. What bankers call risk has a large element of uncertainty to it.

The third lesson was that ignoring the regulations clears the brain. Perhaps because the regulatory capital and cash capital

perspectives so often differed, but also, I think, because their personal reputations and fortunes were chained to Morgan Stanley, the partners of the firm didn't start by asking what the SEC or the financing market required. They asked themselves what they felt comfortable with. Chained as they are to the "Basel Enterprise" – of which more later – banks can have difficulty doing that.

A prerequisite to determining capital policy is understanding the business models being pursued. Having expanded fairly quickly by bringing in practitioners from other firms, Morgan Stanley's partners as a group knew less about what they were doing than they thought they did. Part of my work consisted of describing those seventeen business models in as simple a way as possible. Lesson number four was how helpful that can be.

Good internal communications turns out to be a core competence of successful banks. Studies done in the wake of the Global Financial Crisis suggest that "siloed" institutions did worse than those where information was shared among senior executives and collective judgment could be brought to bear on major risk decisions. Even when banks get very big, those whose culture has a "partnership feel," tend to make fewer mistakes.

What may have been the crucial turning point in my career occurred in July of 1984, when one of my colleagues went out for an early lunch. Our boss wanted to take him to a meeting in Washington but couldn't find him. So he took me. Bill Isaac, who was then chairman of the Federal Deposit Insurance Corporation, had called to say that he had to "do something" about Continental Illinois, that Continental had Goldman advising them so he though he ought to have Morgan Stanley and could we be in his office that afternoon? The beauty part, from my perspective, was that my boss always took a long summer vacation in Italy, so I got to run the assignment.

The reason Bill Isaac had to do something about Continental Illinois was that, under U.S. law, the FDIC is the receiver of failed banks. The bank had made enough bad loans that it was *probably* out of capital, but more urgently, it had lost the confidence of the wholesale money markets where it obtained a large fraction of its funding. It was a national bank but under Illinois law it was only allowed to have a single office. It was becoming increasingly difficult for the Comptroller of the Currency not to remove its charter and

shut it down. What made the situation tricky was that it was quite a large bank, it had operations overseas, and it borrowed overnight "Fed funds" from scores of tiny U.S. banks. Closing Continental Illinois could have enormous repercussions.

I won't describe the complex structure by which Continental Illinois was kept open while its shareholders lost their investment – as they should have. Suffice it to say that spending the summer of 1984 in Washington made me a life member of the Too-Big-To-Fail Debating Society. More significantly from a personal standpoint, it gave me an insider's understanding of the bureaucratic balance of power that was and is U.S. bank regulation, and familiarity with the jargon in which the participants expressed themselves. As I used to put it, I learned to speak Lithuanian – and was therefore the FDIC's natural choice as an advisor on all but one of its subsequent major resolutions.

Eventually, at Christmas time in 1990, Bill Seidman, who had succeeded Bill Isaac, persuaded me to quit my Wall Street job and join the FDIC to establish and lead a division of resolutions. (This was not the S&L clean-up, by the way, but a parallel effort directed at banks.) I spent almost four years at the FDIC. We handled 266 bank failures. It was the lowest paid and most rewarding job I've ever had.

Even before my first trip to Washington, I had read Bagehot's *Lombard Street* and Kindleberger's *Manias, Panics and Crashes,* and knew a bit about the way central bankers and other supervisors use market discipline, signaling and ambiguity to preserve systemic stability. In 1993 I gave a speech at the Chicago Fed's annual conference, summarizing the history of bank regulation as "more risk, then less risk, and now more risk." I can probably talk about the subject longer than most people want to listen. But let me leave you with two memories, images that characterize the challenges of the "system-minding."

The first is from 1998, a few years after I'd moved from Washington to Asia. I was calling on the deputy governor of Bank Indonesia, the central bank. In the front lobby of the headquarters building, there was an enormous pile of carrying bags made of woven plastic strips. You could look through the plastic lattice and see that each bag was stuffed full of bricks of paper currency. Workers were carrying the bags to a long procession of panel trucks in the parking

area. The trucks were being dispatched to branches of banks all over Jakarta. The International Monetary Fund had insisted, as a condition of its assistance during the Asian Financial Crisis, that Indonesia purge itself of moral hazard by closing sixteen small, unquestionably insolvent private-sector banks. Indonesia had no deposit insurance, so this meant significant losses for the households and small businesses that used those banks. The result was that there was a run on the rest of the country's private-sector banks. The panel trucks were trying to meet the demand for currency.

My second memory is of the press conference, in 1984, at which Bill Isaac announced the resolution – or as the press called it, the "bail-out" – of Continental Illinois. Financial markets were skittish. Continental Illinois wasn't the only major bank that had made a lot of bad loans. Most had large unreserved exposures to developing countries. More money could easily have left Continental Illinois, or any of the other majors. Much depended on the market's collective response being, "Oh, good. That's taken care of." The Fed, which takes the lead in system-minding, was particularly worried. But they were not in a position to provide definitive reassurance. The strategy they adopted was elegantly simple and happily it worked. Paul Volcker attended the press conference. He didn't sit on the stage. He stood at the back of the room. But he's six-foot-eight and hard to miss. When Bill Isaac finished explaining what was going to happen, Volcker muttered something that sounded like approval and left the room before anyone you ask him a question. It was enough.

I was approaching the natural end of my stint in Washington when Morgan Stanley asked me to help establish China International Capital Corporation, a joint venture investment banking firm in Beijing. I learned a lot in the ensuing three years. The most interesting lessons had to do with governance.

China was corporatizing, and looked like it would privatize, some of its largest state-owned-enterprises or "SOEs." We hoped that would mean business for CICC, so I was eager to understand the process. I had dinner with a vice minister who spoke English well and radiated intelligence. "What's the hardest thing about restructuring SOEs?" I asked him. His answer has always stayed with me. "Finding the owner," he said.

Privatizing an SOE, I learned, wasn't just a matter of replacing the government with new shareholders. It amounted to a renegotiation of the undocumented bargain among various stakeholders – including workers, customers, suppliers, local government officials, for whom the SOE had been a source of prestige and patronage, and the relevant ministries in Beijing, which had to adjust from being owners to being regulators. As always, "restructuring" meant sharing pain.

China being China, the process was opaque. As a foreigner, I struggled to interpret the offstage noises and wisps of smoke I heard and saw. But the overall impact was that I began to see the classic shareholder-controlled enterprise as a special case. Or perhaps I should say I came to regard that model as an oversimplification of reality.

You often hear Western businessmen assert that the purpose of their company is to make money for shareholders. My take is a bit different. The *purpose* of an enterprise is to create value. How that value is shared among stakeholders is a matter of permanent negotiation. And a corporation is but one of many legal contexts within which such a negotiation may be conducted.

I'd had some exposure to these ideas already. For most of my career, America's largest life insurance companies had been mutuals, a form adopted early in the 20th Century to shield policyholders from rapacious owners, but which arguably made the companies inefficient. A colleague who specialized in insurance companies once told me: "The Prudential is owned by its own law department, whose function is to tell everyone else what they can't do." In Washington, I'd worked on modifications to the process by which mutual savings banks "converted" to shareholder ownership. The existing rules allowed those few depositors who understood what was happening to capture the institution's intrinsic value. But like most corporate finance practitioners, I tended to view mutuals as *sports*, to use the botanical term, as exotic exceptions. In China I came to see that *life* is a mutual.

This view was of course intensified by being the quote chief executive of a joint venture. We'd spent a year negotiating the contracts but that was just so much history. As they say in China, a contract is a pause in the negotiations. And the contracts weren't the

fundamental agreement. The fundamental agreement wasn't written down. It was little more than an understanding that Morgan Stanley and China could do a lot for each other, and a commitment of various individuals' prestige to making the project a success. Some days I was a respected teacher of my Chinese colleagues and some days I simply had to accept that my power as chief executive was entirely theoretical.

My education in financial *real politic* continued when I moved from Beijing to Hong Kong just as the Asian Financial Crisis was getting underway. Thanks in part to my experience in Washington, I was able to get Morgan Stanley hired to advise the governments of Japan, Korea and Thailand on the sale to foreigners of one or two of their banks. Or to be more accurate, if cynical, we were hired to help those governments appear to be conforming to the "Washington Consensus" until the weather changed.

One day in Seoul, as I waited in Morgan Stanley's office while my Korean colleagues attempted to arrange a difficult meeting, I sat down at a word processor and wrote an article for *Euromoney* on governance. My message was essentially that economics is a branch of politics, that politics is a game that is played by changing the rules, and that in the years ahead, governance was going to get a lot more attention. No one has yet written to tell me I was right, but I think I was.

I do not believe banking can be understood from a purely commercial or economic perspective. This is not an uncontroversial view. You can find plenty of people who believe banks would work much better if the government got out of the way. Some of these people are successful bankers who, to be honest, find regulation annoying. Some are distinguished economists, who worry about moral hazard. "Banking is just a business," both tend to say, "a business like any other."

My forty-three-year career in banking has convinced me that this is not the case. Banking is special, as Volcker likes to say. The business model of banking reflects the fact that it is *not* "just a business."

Society and therefore governments need banks. Economic growth requires credit, which in theory governments might provide,

but governments make terrible owners of banks because they are under all kinds of pressure to make what will turn out to be bad loans. Even in the best of countries, government-controlled banks seem destined to fail. Private sector banks make bad loans too, but they are *less* likely to do so, or less likely to do so on a system-threatening scale.

I agree with Hyman Minsky that financial systems are inherently unstable because the longer the sun shines, the less risk-averse people become – making a crisis inevitable. So even the wisest banks benefit from supervision. And banks are only able to do what they do when they have a lender of last resort and *potentially* capital support. In short, banks need governments. They need each other.

I liken banks and governments to an old married couple. Both have their defects. They grumble about each other all the time – and indeed, a little marriage counseling in sometimes necessary. But they will never separate.

If you read Edward O. Wilson, the evolutionary biologist and world authority on ants – I bought one of his books when I was visiting the Washington zoo one time – you can find yourself wondering why economies have come to depend on such fragile entities as banks. They lend long and borrow short. Their assets are opaque. Considering the risks they take, they don't have *that much* capital. If you leave them in the sun too long they go troppo. And there is deliberate ambiguity about what the government might do in a crisis. Why is this a good arrangement?

My answer is that banks work best when they are permanently on edge. Anxiety induces thoughtfulness and moderates the Minsky dynamic. The *vulnerability* of banks requires them to pay attention. When your business model has far more downside than upside you need to do that.

For this reason, outsiders have traditionally made the best bankers. Precisely because they are not at home in their surroundings, outsiders tend to be watchful, polite, covertly clever, skilled at maintaining intellectual and emotional distance.

Sigmund Warburg exemplified this phenomenon. The historian, Niall Ferguson, describes him as "the personification of the rootless cosmopolitan." Born into a banking family in Hamburg, he recognized early in the 1930s where the Nazis were headed and opened a small firm in London. After the war, he put his name on it, and cautiously accumulated a collection of brilliant, quirky, driven employees and partners. The firm I encountered in 1979 had risen to the top of the London pecking order in thirty-three years.

Most of Warburgs' work was advisory. They avoided risk and disliked display. But they had a definite style. In contrast to the long City lunches we had heard about, Warburgs entertained in shifts. Guests came at either 12:30 or 1:30, and were expected to know when to leave. Sigmund wouldn't have shiny annual reports with photographs. They didn't advertise. But no firm was better at managing the press.

Interestingly, they were *obsessive* about internal communications. Two ladies were employed to come in before dawn, open all the mail and make a summary that would be on every partner's desk when he came in. If you had breakfast with a Warburgs man in New York, he could tell your what *your* colleague had said at lunch that day in London.

I remember my first visit to their utilitarian building in Gresham Street. We were taken to a conference room. There was a battered wooden table surrounded by similar chairs, a matching sideboard with bottled water and glasses, a neat pile of yellow pads and a cup full of sharpened pencils. You knew that famous take-overs would have been concocted there, but none of the framed "tombstones" or other mementos bankers like to give themselves were evident. Every conference room was the same. Their Spartan elegance grew on us. "Antiques?" someone finally asked. We were tourists, after all. "Good copies," we were told. "Bought the lot from a provincial hotel that was going bankrupt."

To be clear, Sigmund Warburg was a genius. The bankers who keep the financial system in balance are craftsmen rather than magicians, good workers rather than masters of the universe. If you study men who make their living by physical labor, they never hurry. They aren't lazy. They just know what works, and what they are capable of in the course of a day. Good bankers are like that. "If you

need an answer today," an old boss at Citibank used to say, "the answer is 'no.'" Near the top of a very long staircase in the Palazzo Vecchio in Florence, the Latin motto adopted by Cosimo di Medici is engraved on one of the risers: *Festina lente.* Make haste slowly.

I should also mention that while economics may be a dismal science, banking is not. It is prudence and ambition in harness. One's purpose is helping others achieve their dreams, which is not a bad vocation. And practicing a craft is cheerful work. The best bankers are cautious optimists.

Working in Washington and more recently serving as a director of the Bank of England have given me a point of view on how supervision should work. As to structure, I think Australia has it right. When the United Kingdom put prudential supervision and conduct regulation in a single agency, the FSA, it had the unintended consequence that the latter crowded out the former. I am happy to talk about why that sort of thing happens. The British have corrected their mistake.

A more challenging structural issue is what I referred to earlier as "system minding." People tend to think that's the job of the central bank, especially when the central bank in question is as majestic an institution as the Bank of England. But back in 1998, when the U.K. government put regulation into the FSA and told the Bank to concentrate on price stability, concern for systemic stability more of less got lost. As Governor Mervyn King once put it, the Bank could give sermons and conduct funerals but that was the limit of its power. Paul Tucker, the former Deputy Governor, refers to this as "underlap."

The U.K. Parliament has now given focus to systemic stability by creating a Financial Policy Committee, with the mission of "macro-prudential" supervision. The FPC lives inside the Bank, in parallel with the Monetary Policy Committee and the Prudential Regulatory Authority. The Governor is chairman of all three – and as it happens currently chairman of the supra-national Financial Stability Board. In theory that should make it difficult for something important to fall through the cracks. It also makes the Governor's job almost impossibly demanding.

One of the principles I learned in Washington is that the closer two agencies are to having the same objectives, the more likely they are to fight. The U.S. Office of the Comptroller of the Currency, which charters and supervises national banks – meaning almost all the big ones – could be a bit protective of its children and its own reputation. It sometimes seemed slow to declare a bank insolvent. The FDIC, which supervises thousands of state-chartered banks, administers the Deposit Insurance Fund and arranges resolutions, tended to get impatient with the OCC, on the grounds that delay cost the Fund money, but also, I suspected, out of resentment. The FDIC felt the OCC thought it was superior because "their" banks were bigger and more complicated than the FDIC's. The Fed, of course, treated bank supervision as a minor art, compared to managing the economy, but when the bank in question was big enough to threaten systemic stability, they could get twitchy and oracular.

At an operational level, what kept these three natural rivals working together as we resolved three or four banks a week, was a regular Friday breakfast meeting. It was always at the OCC's offices. Orange juice, muffins and coffee. Those who attended were civil servants, never principals, who under "Government in the Sunshine" legislation, could not meet in private. There was no agenda. There were no minutes. There were only two rules. Tell your colleagues what's about to happen. And if you are annoyed or angry about something, get the matter on the table. To put it another way, there were no rules. But the individuals involved found ways of showing each other respect.

I might add that the same approach works well for that grumpy married couple I mentioned. The best supervision is conversation rather than negotiation. This is not to say that there won't always *be* rules. But a bank can get in plenty of trouble without breaking them. Effective supervision persuades an institution to pause and reflect. And smart bankers want to understand the supervisor's thinking, even if they disagree on some of the conclusions.

When I moved to Australia in 2003, I had to spend time catching up on the proliferation of rules generated by what I referred to earlier as the "Basel Enterprise." This is shorthand for the work of the Basel Committee on Bank Supervision and the other international groups it has spawned. They have spent more than thirty years

trying to make risk and capital comparisons transparent – with the aim of making the global financial system safer.

"Basel I," as it is now called, was little more than an agreement to publish adjusted leverage ratios, where mortgages had half the weight of commercial loans and exposures to banks and governments had even less. Capital was tangible equity plus certain kinds of subordinated debt. That was about it. "Basel II" introduced the idea that asset weightings could be a function of riskiness as calculated by banks themselves, based on their past experience. This opened the door to a lot of mathematics. "Basel II and a half" was the immediate response to the Global Financial Crisis. "Basel III" is a more considered and from the industry's perspective a more onerous response.

The Basel Enterprise resembles trench warfare in that while it has cost a lot, and the participants sometimes look exhausted, intractable differences remain. Europe is debating the application of Basel III. America never even adopted Basel II. And the fog of war has only thickened. I gave a talk a few years ago suggesting that the sheer complexity of the analysis was a contributing cause of the Global Financial Crisis. Boards and senior executives looked at the stream of Greek letters coming out of Basel and stopped *thinking* about risk, on the basis that the "rocket scientists" their banks employed had everything under control. They didn't.

What has come to interest me more than quantitative tools is the character and employment of boards of directors. Like Morgan Stanley's chief financial officer in 1982, boards contend with two questions: are risks and resources in balance – and by the way, how would we know?

The rocket scientists of the financial world have given us partial answers to these questions. They have done a lot of quantifying. They have given us "VaR" or "value at risk," an often misunderstood measure of the market risk of holding various securities. They have given us "economic capital," which purports to make judgments about the tail of a distribution of losses based on what has always struck me as an inadequate set of observations. But the literature on how a group of non-specialist part-timers should employ these tools is fairly meager.

To their credit, supervisors around the world – and not least in Australia – are now increasingly focused on the role of directors. It has been observed that banks in the same market, and pursuing similar businesses, fared very differently in the GFC. The hypothesis has been advanced that boards made a difference. In some respects, that's a remarkable idea, but I believe it is probably true.

If banks are frail reeds for economies to lean on, bank boards can look similarly underequipped. Banking is a complicated business. Most directors have never been bankers. In fact, the majority are supposed to *not* be bankers. In theory they're in charge, but that often feels like a polite fiction. They appoint the chief executive and determine his or her bonus, but most of the time they must follow that individual's lead. (As an experienced non-bank chairman once told me, "I work for the CEO until I fire him.") Directors determine the institution's strategy and risk appetite, but rely on management to provide the first draft. They are expected to challenge management without alienating them but know they will often be asking uneducated questions. There is a lot to learn and a lot to read, but directors have no staff to assist them. And they must limit the time they spend, lest they lose their independence. Why is this a sensible job description?

As with the banks themselves, the board's limitations can be seen as virtues. The institution only needs one management. For the board to shadow it would be inefficient and confusing. The fundamental work of a bank board involves answering five questions – about the institution as a whole, but probably also about a few of the most important lines of business:

- What is the business model?
- What are the inherent risks of that model?
- How can those risks be measured?
- What is our strategy for managing those risks while earning a return?
- How much risk do we want to take?

Management will offer answers to all those questions. Non-executive directors add the most value by seeing things from a different perspective, by imagining alternative futures. That can only be done if you aren't too closely or continuously involved. You won't smell smoke if you spend all your time in the kitchen.

One thing I'd like to do while I am here is work on a book my friend, Mark Lawrence and I want to write that helps non-specialist bank directors do their jobs. Taken literally, that would mean a very small number of readers, but hopefully a broader audience would find it useful. And writing for generalists is a good discipline. It forces you to be clear.

So what are the interesting questions? Can you tell the future from the past? Does trouble have a shape? Are business models that have served us well beginning to change? How does a group become smarter than its members? What would make the system more resilient? I won't try to elaborate now, as I'm out of time, but I welcome comments and suggestions.

Part of the book we have in mind will be explication. The Basel Enterprise needs that. Part of it will be essays on amorphous topics like risk appetite, liquidity and culture. And in some chapters we will try to map – though perhaps not answer – the public policy issues that seem to generate the most debate.

I am fond of saying that economics is history trying to be physics. I hope that is more than an excuse for not understanding calculus. It is an honor to be associated with the Faculty of Business and Economics. From this account of my personal journey, it should be clear that I know more about the former than the latter. I welcome any tutoring that is offered.

I don't suppose professors want to be compared to bankers. But academics are in some respects professional outsiders – and empowered to ask awkward questions. So I hope to have some good conversations while I'm here.