GRATTAN Institute

## *Other People's Money: big finance and where it's taking us*

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Traditionally, financiers looked after people's savings, loaned money, provided a payment system and helped people manage economic risks. Their services were relationship-based, for the long haul, grounded in the real economy.

But today less than ten per cent of bank lending is to firms and individuals producing goods and services. Banks mostly loan money to other banks. Common sense suggests that when a closed circle of people continuously exchange bits of paper with each other, the total value of these bits of paper should not change much, if at all. And in this circle of intangible exchange, who cares if the loans go bad? As they say in the trading room, 'I'll be gone, you'll be gone.'

One of Britain's leading economists, John Kay sets out in his new book, *Other people's money: masters of the universe or servants of the people*, to explain how post-GFC tweaks have not solved the underlying problems in the finance industry. Retired investment banker Harrison Young joined John Kay in a discussion with Marion Terrill, Transport Program Director at the Grattan Institute.

**Speakers:** **Marion Terrill**
**John Kay**
**Harrison Young**

MARION TERRILL: Thank you very much for coming everybody, it's great to see so many people here and I see from the list that you come from a very wide diversity of backgrounds, and that's great too. Thank you to the National Maritime Museum for supporting this event. My name's Marion Terrill and I'm the Transport Program Director at the Grattan Institute. For those of you who are not familiar with Grattan, we're a public policy think-tank and our focus is to be independent, rigorous and practical.

We're thrilled to have John with us tonight and to talk to him about his book *Other People's Money* with Harrison. Our interest at Grattan in the book is two-fold. We're interested in the finance industry for several reasons, we've published quite a bit recently on superannuation, and for the Transport Program I'm interested in the financing of public infrastructure, but we're also really pleased because of the *Prime Minister's Summer Reading List*. Every year Grattan puts together a list of half-a-dozen really great reads for the Prime Minister or for any Australian interested in public debate, and for 2015 John Kay's book *Other People's Money* was on the list.

For those of you who have not read the book, it's a beautifully written book, it's beautifully clear and it's deceptively simple. The questions that it seeks to answer are what is the finance industry for and why is it so profitable? John talks about the four traditional roles of the finance industry which are to loan people money, to look after people's savings, to provide a payment system, and to help people manage economic risks, but today less than 10% of lending is to firms and individuals who are producing goods and services; most of what goes on is banks lending money to one another. As John says, if common sense suggests that when a closed circle of people continuously exchange bits of pieces with each other it's very unlikely that the bits of paper are really going to increase in value.

My favourite line in the book - which I think perhaps could have been the title of the book - is where John sums up the ethos of the finance industry quite brutally: I'll be gone, you'll be gone. I think what's most striking about this book and, for those of you who haven't read it a great reason to read it, is that it's not really written for insiders. It's very easy to understand and it's really for all of us as account holders, as shareholders and as taxpayers. So I'd like to introduce John. John was drawn to economics by the notion that we could use rigorous and logical analysis to get a better understanding of the world and it's a perfect fit for Grattan I feel.

John has been a student and a teacher at Oxford University, he's been a Director of the Institute for Fiscal Studies, he's taken a Chair at the London Business School and established an economic consultancy, London Economics, and he has experience through that in small business as well as in dealing with business. In 1996 he spent three years as a Founding Director of the Saïd Business School at Oxford University. A key experience of John's that I think is very relevant to the discussion tonight is that he has been a Non-Executive Director of the Halifax Building Society and, since stepping down from that role and stepping away from his more academic pursuits, he's focused on popular writing. He's been writing a weekly column for The Financial Times and has published several books before the book that we're talking about today. These days I think he's most interested in the relationship between government and the private sector.

I'm also delighted to be able to introduce Harrison Young. Harrison was born and raised in the US but now lives in Melbourne and he's had a lot of different roles. He's been a reporter for The Washington Post, he's served in the US Army, he's been a Corporate Lending Officer at Citibank in New York and an investment banker at several investment banking houses. He's been a Senior Officer at the Federal Deposit Insurance Corporation where he established the division that resolved 266 failing banks. He's been the Vice-Chairman of Morgan Stanley Asia and the Chairman of Morgan Stanley Australia and he's been a member of the Court of Directors at the Bank of England and Chairman of the NBN Co. These days he's a Non-Executive Director of the Commonwealth Bank and Chairman of its Risk Committee, and in his spare time he's published a collection of romance stories and two novels.

Would you please join me in welcoming Harrison and John?

I'd like to start the conversation by asking you John about one of the important parts of the book which is about the management of risk and the role of the finance industry in helping people to manage risk. The book talks about the ways in which financialization has created a vast edifice of financial claims on a slim foundation of physical assets and, for the average person thinking about the role of banks in looking after savings and making loans, really what John talks about is more akin to going down to the racetrack. So my question to you John really is what level of betting on a particular foundation of physical assets is the right amount?

JOHN KAY: That's not a question that is a simple answer. The underlying point which you picked up correctly is there are two reasons why people trade risks with each other. One is to mutualise them and share them and diversify them. I use in the book the caricature developed by Michelle Albert who talked about two origins of the global insurance industry. One was Swiss villagers getting together to agree that if one of their cows died the villagers would club together to buy a new one, and that's an institution which turned over the centuries into Munich Re and Swiss Re and the German Re insurers.

The other was English gents gathering in Lloyds Coffee Shop to gamble about the health of the king, the results of battles to establish the British Empire and the fate of ships at sea, and that turned into what is still the world's largest marine insurance market today.

So there have always been these gambling motives and insurance motives in this and both of them can be useful and both of them can be taken too far. If you mutualise risks completely then you reduce people's incentives to control these risks. Equally, a certain amount of speculative activity in financial markets can help stabilise prices, but when speculative activity comes to dominate financial markets then it becomes a potential source of instability, as people in Keynes' famous metaphor are guessing what each other will guess, what each other will guess and so on through many rounds of all of this. Actually we've seen in commodity markets in the last couple of decades a shift from one to the other, where there used to be modest amounts of speculative activity that were largely stabilising and we've had a shift to much larger amounts of speculative activity that are over-riding the actual needs of users and producers of the commodities and are producing instability in commodity markets.

So there isn't an easy way to say "enough is enough" but we should have a very clear idea that enough is enough and we should stop and certainly get away from taking the view that the more trading there is in these markets the better markets are working.

MARION TERRILL: Harrison, as a banker, do you have a view about how much is the right amount of risk, the right amount of betting?

HARRISON YOUNG: In the abstract no. I think when you practice finance for a while it comes to resemble aesthetics and you have a sense of what's too much, but I haven't found an analytical basis to say what that point is.

JOHN KAY: It may help to say one of the ways of identifying bubbles is when many people in the market are trading the item concerned because they hope to flip it on to someone else at a higher price, rather than because they want to use it.

People in England have been talking about a house price bubble now for 15 years. I've never been convinced we have a house price bubble because it's pretty clear that most people are buying houses in order to live in them. It's at the point – which happened, for example, in parts of the United States in their house price boom in Florida and parts of California in an extreme way – when people are buying houses not because they ever want to occupy the house, but because they think they can sell it on to someone else in a few months at a higher price. That's when you know you have a bubble. That's how we should have known, and some people did know, that the internet bubble was a bubble. That's how we should have known, and some people did know, that the credit expansion was a bubble.

MARION TERRILL: Yet some people have an appetite for that kind of risk, and economic theory, I suppose, tells us that for people to be able to give rein to their appetite to risk is not a bad thing in itself.

JOHN KAY: Yes, but economic theory also tells us that people who have an appetite for that kind of risk lose money if they're in business they go bust. Now one of the problems we've had in the financial sector is we haven't allowed institutions to go bust. Indeed, we can't allow these institutions to go bust because they've been essential to our credit system and our payment system, and that's why I argue that we need to set up a world in which firms are sufficiently small and in which we've reduced interdependencies to the point at which people who take foolish risks suffer the penalties that markets deliver to people who take foolish risks.

MARION TERRILL: That leads me onto my next question which is about transparency. Experts and commentators often argue that transparency is really a critical aspect of fixing the problems of financialization and I guess I've tended to accept that. The recent Murray Inquiry, for example, attributed the problems of consumers being sold dud products to inadequate education of advisors and poor product information, so the remedies were fixing those two things. I found it very provocative your argument in the book that transparency in fact is not enough and by the time you're arguing for transparency it's really because a trust relationship with correct incentives has broken down.

So tell us, are we really barking up the wrong tree in pursuing transparency and, if we are, what should we do given where we are today?

JOHN KAY: You know Marion, there's a totally unexpected reason why I'll be perpetually grateful to you and the Grattan Institute for all of this because when you wrote to me I looked onto the Grattan Institute website to see some of the documents you've produced and you've produced one about unnecessary medical treatment.

As it happened, last year I had a knee problem and I went to see a specialist who said, not to my entire satisfaction, "Well, we could do an operation to deal with that, but actually you'd do much better to go away for six months and see if it gets better" which, in fact, it did. The paper that Grattan Institute produced last year looked at a variety of areas in which surgery was often prescribed and was not terribly useful and one of them was this kind of knee surgery, because the characteristic of this is that most people who have the operation get better, but actually most people who don't have the operation get better too.

Actually, when I read the Grattan paper I went away and read the original article in the British Medical Journal on which it had been based and I now know more than I ever wanted to know about knee surgery. But actually what I really wanted in all of that and what I was, I think, lucky enough to get was a doctor whom I could trust and a doctor who was giving me unbiased advice, which is quite tricky in the medical profession because doctors typically get paid according to the amount of work they do. On the other hand, doctors in the British National Health Service get paid independently of the amount they do, so many of them would really rather you went away. But then again, doctors who do knee surgery like doing knee surgery, so if you go along and say, "I've got a pain in my back" they're likely to say, "Have you thought about your knees?"

The bottom line of all of this is what people want is not to read articles in the British Medical Journal. Indeed, I feel kind of lucky because I know where to find the British Medical Journal and I can read it. Most people don't want that, most people want the trust relationship rather than the transparency that says, "You could look at this medical textbook or you could look at that article". That's what we used to have, to some degree, in finance and we've lost, and I think to deliver the services that people actually want that's what we need to get back in finance.

HARRISON YOUNG: Marion, I'd say I don't think much of disclosure as a way to protect people against things that get disclosed. The disclosure is so extensive that even professionals don't have the time to go through it in many cases, unless that's what they're paid to do, unless that's their whole job, and certainly an intelligent non-finance person couldn't possibly work their way through a bank annual report and figure out what it told them. The place where disclosure I think is helpful is that there are things people don't do because they'd have to be disclosed.

MARION TERRILL: Can you tell us a bit more about what kind of things they'd be?

HARRISON YOUNG: Probably shouldn't.

JOHN KAY: That's why there weren't disclosed.

HARRISON YOUNG: My favourite disclosures are the things you get when you buy a computer that go on and on and on and on and on. Somebody reckoned that to stay abreast of the changes in the software and the product disclosure you would have to spend full-time at the project. I don't know anybody who spends full-time reading banker or insurance company annual reports, but it would be a dispiriting exercise.

JOHN KAY: Is there anyone in this room who has actually read the things on the Apple screen before they press the button saying "I agree"?

HARRISON YOUNG: So Apple has gotten us to trust them.

JOHN KAY: Yes and we know that if they abused our practice of not actually reading it they would be in trouble fairly quickly with their customers.

MARION TERRILL: I think also what's different perhaps there is that there is a ready way for unhappy customers to share that with the world, whereas I think it's more difficult with your knee surgery or if I get poor financial advice. It's harder to see that as a systematic problem.

HARRISON YOUNG: I'm not sure, what do you mean by that?

MARION TERRILL: Because the circumstances of each person in their financial dealings are more individual, whereas an Apple disclosure is standard and likely to disadvantage or advantage people in very similar ways.

HARRISON YOUNG: Yes, you're certainly right about individuals, you start from a different starting place with each individual up to a point. That's why as the CBA has tried to remedy some bad advice it's taken an enormous amount of work, because you have to come up to a certain standard of understanding each individual aggrieved customer before you can figure out whether they got bad advice and what it cost them.

JOHN KAY: But in finance we do have rather large groups of aggrieved customers. Knee surgery is tougher because people say, "I had this great surgeon, he operated on my knee and it got better" and there's another group of people who say, "I had this great specialist, he told me not to do anything about my knee and it got better" which is the category I'm lucky enough to be in.

MARION TERRILL: So you've talked a bit about disclosure, but what about incentives for advisors to give good advice to clients?

JOHN KAY: I think that's the tricky issue because in the whole financial system at the moment we have what I describe as a bias to action. People get paid for doing things but mostly they don't get paid for not doing anything and few people are willing to pay very much for what is often very good advice, which is don't do anything. That was the problem my knee surgeon had, but both he personally and people like him in the medical profession have understood enough the value of building up trust relationships with their customers to be willing to give that kind of advice when it's appropriate, and that's where we need to be.

HARRISON YOUNG: I think there's also a problem that individuals don't really like paying for advice and I think it would be hard to create a business which served average citizens with advice. The way that the financial system serves those people now is that they wind up buying the products of another part of the same company and there's a potential conflict there – I hate to use this word because John lampoons it – so you can manage that, but you can never completely eliminate it if the two activities are part of the same overall enterprise. But if you said, "Okay, I'm going to have a narrow single purpose institution - such as you're recommending the world break up into - and my narrow purpose is to give financial advice to people who make less than $100,00 a year" you'd have a hard time.

JOHN KAY: I think to do that well you have to be a computer and that's the way the world is going for these kinds of people.

MARION TERRILL: Another aspect of the challenge of building and maintaining trust is boards. So John, you've been on the board of the Halifax Building Society and, Harrison, you are on the board of the Commonwealth Bank. The book doesn't have much to say on the subject of boards, but I'd be interested John if you could talk to us about the different ways that different countries manage the structures and roles for boards and your sense of what works and what doesn't work.

JOHN KAY: I think Harrison should say more about this because Harrison has told me he's writing a book on this. But my experience of being on the board of what was the Halifax Building Society which turned into a bank was of joining what was a focused institution that performed one single function brilliantly. Understandably it thought it should diversify from these. For other different reasons it also thought it should become a PLC and did, but then instead of going down the route of diversification which I thought was appropriate for it and really the only one which was appropriate, which was of taking the rather high degree of trust which its customers had in it and moving into a broader portfolio of retail financial services, what it did was said, "It's really exciting being a global international bank". And not perhaps incidentally the people around global international banks get paid an awful lot more than the people who run building societies and they have a more exciting life travelling to international financial junkets.

The result was that it was an organisation which rapidly expanded and ultimately, having taken over the equally conservative Bank of Scotland, went bust in 2008 and was bailed out by the British Government. It's a sad story and one that for me, I was out of it well before the bust, I'm glad to say, but one from which I learnt a lot and one thing I learnt was to be quite sceptical about the extent to which boards can restrain ambitious executive management, especially when conventional wisdom broadly supports the views of these entrenched executive managers.

HARRISON YOUNG: John, I was intrigued that you didn't talk about the role of boards very much and my hypothesis was that you didn't think they were effective, and I think you've just said that. I think boards can be and are effective. It requires a certain amount of backbone. It's quite important that you have a Chairman who doesn't see his job purely as keeping the peace. It's a delicate kind of a balance between making trouble and making yourself unpopular on the one hand or insisting that certain things be thought about a second time.

I think the Australian model is the best I've seen actually. When I lived in America I thought the idea that you'd have a Chairman and a CEO who were different was crazy, it seemed to me you'd have warring camps and it would be inefficient. I can now see how well that can work and you can have a very good relationship between a CEO and a Chairman where they balance each other, they get along well, but they don't become buddies and you've got some built-in challenge which increases intellectual honesty. So I think Australia's fortunate to have about the best model you can have.

JOHN KAY: It's tricky and, as you say, I think you need a balance and in the various non-exec roles I've done I've seen both the warring Chairman and CEO and the buddy Chairman and CEO, and neither of them work. What you need is something in-between.

HARRISON YOUNG: Yes.

MARION TERRILL: Also on the subject of transparency, I wanted to have a discussion about the extent of financial services. So John, in the book I felt that you had some nostalgia for an era when financial services were handled on the basis of personal relationships and trust, but I also felt that in that era a lot of people would have been locked out from getting financial services, partly because of rationing and partly because of discrimination. So do you think that a trust-based system can give us the best of both worlds where there's accessibility to wider groups without undue discrimination?

JOHN KAY: I don't see why not. I do have nostalgia for a world of more specialist financial institutions of the kind that existed in the past. I think the nature of that relationship-based finance did exclude people who weren't identifiably middle class largely, certainly from the mainstream financial system, and pushed them into the hands of rather high rate expensive lenders. Equally, I think the introduction of credit scoring and algorithmic credit decision making can make these decisions better. I think what makes them worse, and has been proven to make them worse, is the exclusive reliance on these kinds of algorithmic processes to the exclusion of the kind of qualitative knowledge that was such an important part of life.

Before, the experienced bank or building society manager could get a sense in an interview of whether this person was likely to pay the money back. Equally, I know that every start-up business plan I've ever looked at pretty much has looked great. It requires experience and you have to have to read a few of them to understand which ones are really flaky and which ones might actually stand a chance of making it.

HARRISON YOUNG: The man who started the private equity business of Morgan Stanley used to tell people you aren't a good investor until you've been lied to successfully.

I share John's nostalgia. What worries me or worried me at the time about what I saw when I entered the world of finance in 1971 was simple prejudice. I remember being in Citibank in about 1972 in the Corporate Banking Group and somebody pointed down the hall and said, "You see that guy down there, do you know what he is?" I said, "No, I don't even know his name". He said, "Oh, it's Len Druger, he's the only Jewish Vice-President at Citibank". Now that's not an acceptable arrangement and I'm glad we're past that, but the notion that you can have financial institutions which are populated and run by people who know what the rules are and know that most of the important rules aren't written down is attractive, but you have to police the boundaries of prejudice on that.

JOHN KAY: And in some ways what you've described there was not the worst of discrimination because there were predominantly Jewish banks that were in certain respects as prejudice as the white-shoe banks, but what there were not were banks for a lot of people who were outside either group.

HARRISON YOUNG: And there weren't jobs for women, there were a number of issues.

JOHN KAY: Yes, that's right and yet there's a little bit, as you were hinting, in all of that that was valuable. The fact that the City of London was drawn from a very narrow and socially homogenous group actually meant that a lot of the rules of behaviour did not have to be written down and were not written down, and that was a structure that bluntly collapsed when Americans and grammar school boys got into these positions.

HARRISON YOUNG: Terribly sorry.

JOHN KAY: We can't possibly regret that happening, but we need to recreate structures that involve the kind of trust which people seemed to acquire in their beatings at English public school. There must be better ways of doing it.

HARRISON YOUNG: Can I ask a question John?

JOHN KAY: Sure.

HARRISON YOUNG: The thing that intrigued me toward the end of the book, I wrote down I think 16 policy recommendations that you had and then what you say is many of these things cannot be legislated; many of these things are not going to happen unless there's another crisis that is not wasted. I agree with most of the things that you'd like to see done. Have you any idea how they're going to go about making them happen?

JOHN KAY: Yes, this is my continuing frustration as I go around talking about the thesis in this book, that I don't encounter much in the way of overt disagreement whereas I do encounter a lot of "How do we get there from here?" I think, bluntly, so long as the financial services industry or parts of the financial services industry have the degree of political influence which they have today it's going to be very difficult to introduce effective reform. I think there are different reasons for this in different countries.

I think in the United States, which is by far the most important country for this, it's basically a crude matter of money and campaign finance and the contrast between what happened in 2008 and subsequently and what happened in 1933 and subsequently is very marked, and that is really because after 1933 there was a lot of political mileage to be made out of attacking established interests in the financial sectors. In 2008 there has been none and the people whom Obama appointed to his key roles in relation to this were people who were closely associated with the events that had led up to the 2008 crisis and the lobbying issues in Congress and US politics, fuelled by a great deal of campaign finance, have been intense and continuing.

In France and Germany, in Europe I see the kind of corporatism which naturally equates the interests of Germany and financial services with the interests of Deutsche Bank and similarly in France. In Britain it's somewhere between the two and there's almost an element in this of what some people have described as intellectual or cognitive capture. Politicians see people in the city who are very smart and very rich and they defer to them and are certainly unwilling to challenge either what they do or their assertions about the contribution which they're making to the British economy, which itself is real. Given all of this structure, these are probably the most important countries globally for bringing about reform.

It's difficult to see it except, as I was with a certain degree of despair, describing another perhaps more severe Global Financial Crisis (GFC) that actually makes it harder for politicians not to do something than to do something.

MARION TERRILL: Here in Australia the conventional story is that we came out of the GFC relatively unscathed because we had strong safeguards and strong buffers. On the other hand, I've wondered about the fact that we do have many of the same multinationals here as in the US and the UK with the same remuneration structures and presumably something of the same ethos. So I guess the question I've been wondering about is if there are further systemic crises around the world will the same regulatory paradigm maybe tightened up a bit serve us here or do you think that it's really just not going to be enough?

JOHN KAY: It's a question that I find very interesting and it's particularly provoked by visiting Australia, which is why is it that of the countries of the world that have well-developed financial systems and reasonable size probably the two which were most resilient to the 2008 GFC were the two old British Commonwealth countries of Australia and Canada? In thinking about that I go back to my roots in Edinburgh and the conservative Scottish banking tradition that prevailed really up until around 2000 when basically crazy guys got control of Bank of Scotland and Royal Bank of Scotland and ran them into the ground in the decade that followed. I think that culture pervaded banking in Canada and Australia and oddly, to some degree, in Hong Kong and Shanghai where HSBC was, to a very large extent, a Scottish bank even if it was based in Hong Kong. We abandoned that culture.

I think also the regulator is both cause and effect, that the regulator is a product of a banking culture around him and, in turn, feeds back in the banking culture that exists. So it wasn't that you had a very different regulatory structure so much as there was a common set of assumptions about the people in charge of these banks and the people running the regulatory system that reinforced each other, and notably in Australia I think you did not have the banks ultimately being taken over by the traders to the degree that we encountered in the UK and has happened in the US.

HARRISON YOUNG: I don't think that the banks here went into the GFC with anywhere near the risk profile that banks in several other parts of the world did. Partly that's because they all got badly scared in the early '90s, partly it's because I think there are pretty good regulators here. One factor, having spent some time in crisis management in my career, I think it was notable here the way the government and the heads of various agencies got together and decided what to do pretty fast. I think that if they'd wanted – America has so many different regulators and in some ways the most important regulators are the Chairman of the House and Senate Financial Services Committees; they can dither for a very long time and dithering's not a good way to deal with a financial crisis. And then China was helpful.

JOHN KAY: The fact that you were in the middle of a commodity boom was pretty helpful as well wasn't it?

HARRISON YOUNG: Yes.

MARION TERRILL: Yes.

HARRISON YOUNG: That's what I meant.

JOHN KAY: Yes.

MARION TERRILL: I've got one more question before we go to the floor for questions and it's about my own area of particular interest which is infrastructure financing. There's a great story in the book where you talk about the British Treasury building which you describe as "ugly but iconic". This building is owned by a private firm that does nothing else, is highly leveraged, and has borrowed to fund this investment at a premium of 1.65% on the government's borrowing rate and it's quite hard to see what the government is getting for paying that premium. Since your book came out the UK Auditor General has reported that in 2012/13 the effective interest rate of all private finance deals for government was 7% to 8%, which is double the government effective interest rate on borrowings of 3% to 4%.

So the book talks about who is deceived by this sort of thing, of getting such expensive finance for things that are essentially very low risk? I feel that you don't really answer the question, but I would love to know. It's clear that it's not the bond traders, it's not the rating agencies and it's not the Opposition. Who is deceived?

JOHN KAY: It's something that's puzzled me. I asked the question why didn't the UK Government enter the funding competition itself and undercut the 1.63% premium over its borrowing rate which was being paid and I try to envisage in my mind the scenario in which the UK Government defaults and the private company's special purpose vehicle repossess the British Treasury and I just find it hard to think through that scenario in any real world.

So you're asking the question what is the point of this and who is being deceived? As far as I can see, the only people who are being deceived are the politicians themselves who authorised these transactions. What I think has gone wrong in terms of this type of infrastructure financing is we have had the good idea of subcontracting to the private sector the project management and the facilities management of these buildings, which are things the public sector was pretty bad at, but have also subcontracted the one thing government is particularly good at which is borrowing. The result of that is that we are paying this premium and, at the same time, we are being locked into extremely inflexible long term contracts.

So the whole range of benignly obvious things, someone was talking to me, I'm not sure it was the Treasury case, but about how much you had to pay to get the private contractor to authorise and erect a Christmas tree in the lobby. This is what comes of tying yourself into a 30 year contract with a single institution which then has you over a barrel in relation to even the most minor changes in contract specification over the life of the contract. The London Underground PPP contracts reportedly had provisions in them defining the appropriate length of toilet breaks for London Underground drivers discriminated against by male and female so that there were different lengths authorised for the two genders. We don't want to be writing contracts like that anywhere.

MARION TERRILL: What do you think Harrison, who is being deceived?

HARRISON YOUNG: Somebody must be being fooled or at least quieted. I mean, certainly government budgets can be hard to figure out unless you're a professional in that field and if somebody says, "Our budget is balanced" that sounds like something to be happy about, and if it's balanced because you've taken some things completely off the table and put them in a special purpose entity, which is actually an expensive thing to do, the supply of people who can understand what you've done and who want to make a fight out of it is limited. I think that's what it comes down to. I don't think there's a magic answer to the question of why would you pay 1.3% above the government barring rate? It's not very complicated I don't think.

MARION TERRILL: Let's go to the floor now for questions.

AUDIENCE: John, you mentioned that it wasn't possible for the banks to go bust because they were so interconnected and we needed smaller banks for that to be possible. Do you still think it was the right decision to bail out the banks or should we have let one or more of those that actually went bust and were bailed out by the government go to the wall to enforce this commercial discipline, if you will, on the management and overcome the problem that you've alluded to, that people see the problem but there isn't any catalyst for change behaviour?

JOHN KAY: I think probably the better solution in 2008 would have been a compromise which would have taken over and properly nationalised some of the failed banks, Citigroup, certainly HBOS and Royal Bank of Scotland in the UK, several continental European banks, and then restructured them as entirely different institutions, floating off the retail components, shutting others and selling bits that could be viable. I think we did probably what was exactly the right thing in the short term which was to keep institutions in being, but that was exactly the wrong thing from a long term point of view. We certainly didn't find the right compromise between these two different objectives so that by 2010 a large part of the financial sector was saying to itself, "Phew, thank goodness that's over" and that wasn't where we should have been.

HARRISON YOUNG: My view on this is that too big to fail is not a problem, it's a fact. I think it would have been better in the US I as a policy matter for the government to have put in equity that they actually got equity for. They provided temporary equity and the shareholders sort of kept more of the companies than they probably should have in fairness. I don't think that you can make banking frightening enough to prevent people like some of the people who've gotten to be heads of some of those banks from doing stupid things. You're on a roll, you've had good fortune, you're a master of the universe and you're going to take absurd risks just inevitably if you're allowed to and if your board lets you, first of all. Adding instability to the financial system in the hope of dissuading Fred Goodwin from buying ABN AMRO with short term money seems to be penalising the public with a deeper crisis without really achieving very much in terms of preventing stupidity.

JOHN KAY: I don't think Fred Goodwin had in his mind "It doesn't matter if I go bust buying ABN AMRO because the government will bail me out".

HARRISON YOUNG: No, he didn't think he'd go bust.

JOHN KAY: I know the people who provided the finance for RBS taking over ABN AMRO believed correctly, as it turned out, that if RBS got into trouble the government would bail them out and they believe that today. It's not I think that allowing banks to go bust would get rid of the hubris of overambitious managers like Goodwin, it's rather that people worrying about counterparty risk, as they largely feel they don't have to do in relation to these too big to fail banks, would impose some more effective market disciplines on the system.

HARRISON YOUNG: It's a guess, but I think the place that counterparty discipline, if you want to call it that, is going to be very interesting to watch is in the categories of loss-absorbing capital which are senior to common stock but junior to bonds. As those instruments are sold or fail to be sold - because there are certainly some investors who thought about them and said, "The risk is not worth it to us" - that may impose some market discipline, but we'll have to wait and see about that.

JOHN KAY: Yes, I think we will see if and when these securities are finally called upon. After all, they did exist before 2008 and they weren't called on.

HARRISON YOUNG: Right. When Continental Illinois failed one of the things that most upset people who were close to the transaction was that the preferred stock was made whole. It had to do with detail that I can't recall anymore, even though I was advising on it, and that almost no-one understood, but how did that happen? Well, in fact, it would have been chaos if we'd tried to haircut the preferred.

JOHN KAY: Yes, I remember the evening in 2008 when the Irish Government in the first stages of the spreading crisis announced they'd guaranteed Irish banks and I thought, "Well of course that's right, they have to guarantee Irish deposits". Then I saw what they'd said and discovered that they hadn't just guaranteed Irish deposits, they'd guaranteed absolutely everything, and thought "They do not realise what they've done".

HARRISON YOUNG: Well the Australian Government guaranteed short term wholesale borrowings, not just deposits.

AUDIENCE: John, you were saying about bubbles, that when people are using the assets that prices increase and that doesn't indicate a bubble, but that doesn't really take subprime into account where people were using the assets and they were no longer able to service the debt when interest rates increased. Would it be true to say that bubbles can be predicted or identified when debt growth exceeds income growth?

JOHN KAY: No, I don't think it can. Debt growth has dramatically exceeded income growth across the West over the last 20 or 30 years.

HARRISON YOUNG: It's called financial deepening.

JOHN KAY: Yes.

AUDIENCE: That's called a bubble.

JOHN KAY: No, it's happened for two reasons. One is that home ownership has spread more widely and over the last 50 years that's actually the largest cause of the increase in private sector debt. The other is that interest rates have fallen dramatically so that the cost of servicing the same volume of debt has fallen.

AUDIENCE: Which allows the bubble to increase freely.

JOHN KAY: You're defining a bubble as an increase in prices, but the increase in prices may be justified by economic levels.

AUDIENCE: No, it's an increase in prices relative to income. When the prices increase and they get to a point where income can no longer service that price, that debt, that's when the bubble bursts.

JOHN KAY: No, I don't agree with that because house prices in London are today spectacularly high, but almost all of these houses are being bought by people who more or less by definition can afford either to buy the houses or service the debt.

Now you're describing the subprime phenomenon in which loans were being made to people who had no realistic prospect of servicing the debt. That is just dumb lending and the best answer to that problem, which to a degree happened in the United States, although not enough, is that the institutions that make these lousy loans go bust. But the business of lending to no-hopers was largely a particular phenomenon in parts of the United States in the years 2003 through 2008 which was, in turn, generated by the fact that you could sell residential mortgage back to securities at silly prices or prices which were silly if you'd any idea what was in the market, the mortgage-backed securities. That particular problem is not likely to recur at least for a reasonable –

HARRISON YOUNG: At least for ten years.

JOHN KAY: At least for ten years, yes. The next crisis is very rarely the same as the last crisis.

AUDIENCE: John, as the person who introduced me to the phrase "regulatory capture", the thing that just keeps on coming back to me is, whether in your writings or the writings of Paul Volga, what's been pretty clear is that for whatever reasons the people on the outside post the financial crisis looking at re-regulation of the banking system have had pretty stark and pretty clear views about what to do and, as you say, they correlate with each other extraordinarily. The question I'd ask you on the edge of policy is what do you think is going to be the path home for rolling back regulatory capture? Because I don't think it's about what's to be done, everybody broadly can see it's about what's to be done; it's how are you going to find some mechanism at a societal level to introduce a rollback of regulatory capture?

JOHN KAY: Yes. We've got to the point, it seems to me, in financial services of having a rather extreme version of regulatory capture in which you have a regulation industry that consists of regulators, compliance and risk professionals in financial institutions, and consultants and lawyers who mediate between them. And, like any industry, they have a vested interest in the expansion of the activity which is the reason why, despite the failures of regulation before 2008, we've actually had this growth an intensification of it since. I think the only way to do it is to try and rip up this regime and start again, and when I talk in these terms people say, "But that kind of thing is impossible" but I take examples from other industries in which it has actually happened.

It has happened to a degree in transport and the archetype I often talk about is the airline industry where we started with the regulation of airline safety and people then thought in order to regulate airline safety we have to regulate the capitalisation of airlines and their fares and entry to different markets. We ended up literally in the 1970s where you had committees deliberating over the definition of an airline sandwich to stop airlines competing with each other by offering higher quality food. That's a kind of proliferation of rules which everyone who's worked in financial services can recognise and it just goes on forever. What happened in the airline industry was this was all swept away really, in the first instance, in the United States by a mixture of people on the Right who thought free markets would work better and people on the Left who thought that this was a racket being operated for the benefit of large corporations, and actually they were both right.

Two things have happened now, one is that you get very little economic regulation of the industry and effective competition and the other is that you have a focus on airline safety, which is what we really care about, which not goes into co-operation between airlines on airline safety issues, honest investigation of airline problems and accidents, and the development of what people in the business call a "just culture" in which you're encouraged to report things that go wrong and share that kind of information in the first instance with your employer and subsequently with other firms in the industry. I think there's a model there for what should happen in financial services. How we actually get there, given the vested interests which I've been describing, is another matter.

HARRISON YOUNG: As I said earlier John, a lot of what you've recommended is aspirational, so I'll just add to that list of aspirations and say that I've worked with a lot of regulators around the world. Some of them are outstanding and I think if it were possible to give a little more credit to the very best of them and give them more moral support there'd be less regulatory capture.

JOHN KAY: I think that's right and I don't know which I find more boring, the people outside the industry who say that of course regulators were asleep at the wheel etc. or the people inside the industry who say of course we need much less regulation. And this is a measure of the degree of regulatory capture when I then say, "Well look, let's start, let's look at which regulations you would like to do away with first", they rarely come up with constructive suggestions. They don't have alternatives for how things would be done better.

HARRISON YOUNG: The notion that the market will take care of it is, in my view, false, but an awful lot of people revert to that if the subject gets too complicated or begins to touch their pecuniary interests.

JOHN KAY: Yes and doing without regulation is impossible if only because of the reason that there is no industry more potentially vulnerable to fraud than the finance sector because that is where the money is, in the famous words of the robber who was asked why he robbed banks.

HARRISON YOUNG: Yes, it goes back to the medical profession you know, it was called Sutton's Law and there was a famous medical research paper written called *Fevers of unknown origin* and the principle established in that paper is "Do first that test which will confirm your intuitive diagnosis". And it's called Sutton's Law because you go where the money is.

JOHN KAY: Yes.

MARION TERRILL: One of the questions that was provided in advance, John, was nominate one change to government regulation of commercial banks to better serve the public interest. So to move beyond the aspirational, what specifically would you recommend?

JOHN KAY: The first specific move is to ring-fence retail banking from investment banking. That's in order to eliminate the taxpayer implicit guarantee of investment banking activity and it's because the culture of investment banking and retail banking are, in my view, fundamentally incompatible. One ought to have a bureaucratic culture that is a hierarchical organisation in which you deal with millions of transactions every day with a very high degree of accuracy and you build up trust relationships with your customer. The trading activity at the other end of the spectrum is by its nature entrepreneurial, buccaneering and risk-taking, and these just cannot be done sensibly within the same institution.

HARRISON YOUNG: I don't think it's going to happen, but if I were presented with a requirement to ring-fence my inclination would be to divest. I think that a large financial institution which had ring-fenced its retail business would spend so much energy trying to figure out how to optimise and arbitrage and work around that it would be quite counterproductive.

JOHN KAY: That's my view too.

HARRISON YOUNG: I say that as a director, not as a policy boffin. I just think it would be in the interests of a bank to simplify what it was trying to do.

JOHN KAY: My view is we would know ring-fencing had worked when the banks themselves made that investiture decision.

HARRISON YOUNG: Right.

JOHN KAY: Yes.

AUDIENCE: I just wanted to add onto that where you thought the change was going to come? Surely going to the banks and the government to bring about change where homeowners are faced with the massive cost of houses that start out about 20% of the actual build cost the amount of money that they have to pay. Going to the government to bank is a bit like going to your in-laws to complain about your spouse, neither party is going to listen to you.

But surely people like yourself, Harrison, must have some sleepless moments at night when you look at people like Uber and the young people and their savvy and connectedness and their willingness to act very quickly and very effectively. If they chose your bank and said, “We’re sick of the Commonwealth Bank, we’re sick of the misbehaviour in the financial planners, we’re sick of the gouge of taking my money and giving me 0.1% and charging a home borrower 5%, 6%. We’re just going to choose your bank and no more new business with your bank” that has surely got to wake you up in the middle of the night?

HARRISON YOUNG: We spend an awful lot of time thinking about customer service, we think that serving customers well is the only possible foundation for a successful enterprise. What keeps me awake at night, and that doesn’t happen very often, is the reflection that the business model of commercial banking has not changed a great deal in 150 years and that’s a long time.

AUDIENCE: You have almost as many staff in four banks as the Commonwealth Government has, you have 180,000. 80% of your profit comes from home loans, more than 50%-odd of the four big banks in Australia are owned by three overseas banks. The tax that you –

HARRISON YOUNG: I’m sorry, I didn’t understand that last point.

AUDIENCE: I think 50%-odd of the four largest banks in Australia are owned by HSBC and a few others.

HARRISON YOUNG: No, they aren’t the owners; they are the transfer agents of the trustees. They’re holding the shares on behalf of shareholders and what gets reported is what they’re holding, but they are not equity owners of the bank.

AUDIENCE: That might be true, but if it walks like a duck and it quacks like a duck it’s probably a duck.

HARRISON YOUNG: Okay, we could talk about it. In terms of ownership what we keep in mind all the time is that basically we’re owned by Australian households. Whether it’s the 800,000 individual investors, many of whom invested when the bank was privatised, or through their superannuation funds, basically we belong to the population of Australia as an equity matter.

AUDIENCE: Going back to speculation and how markets have developed over particularly the last 20 years, but it’s been progressive as well, very much the speculation and listed markets has just changed exponentially to the extent that billions get swiped off and added in such a short amount of time, shorter than has every happened previously. There seems to be some anecdotal evidence that companies that have listed previously to participate in the market are making decisions to delist now. Do you have any commentary or thoughts around whether that trend will continue, the fact that companies as they build are choosing not to list in markets anymore and are choosing to stay private and what that might have as a knock-on effect for financial markets?

JOHN KAY: I have rather more than anecdotal evidence on this. I did in 2011/12 an inquiry into equity markets for the UK Government. One of the things that was very evident in that was rather more than anecdotes about the extent to which successful medium-sized businesses in the UK were no longer looking to listings as a way of developing their business, and if they were looking for an exit at all they would look first to a trade sale or a private equity deal. Similarly, many companies which had recently listed told us that they regretted it.

That goes back to a deeper point I think which is that the kind of stock markets that we're used to fundamentally came into being in the 19th century in order to fund railways and railroads. These were businesses where you had to raise large amounts of capital for a very specific purpose and you did it from a wide range of relatively well-off households in small amounts. Stock markets were needed to provide some kind of secondary market for these investors and that model was then applied to retail banks and to the large manufacturing corporations that came into being in the late 19th/first half of the 20th century, breweries, automobile plants, petrochemicals, etc.

Modern business isn't like that anymore. Business is much less capital-intensive. Apple has the largest value of any company in the world at round about $600 billion. The actual tangible operating assets of Apple account for less than $20 billion of that. They don't use very much capital, the capital they use is fungible in the sense that it's offices and shops that needn't be owned by these businesses and typically aren't. I was rather amused to look up the Apple retail store in London, which is the flagship European outlet, which is actually jointly owned by the Queen and the Norwegian Sovereign Wealth Fund, which is the way things go in this world. These companies are cash-generative by the time they're big enough to think about listing.

So the view I've come to is essentially that public equity markets as we know them are actually creatures of the 20th century and in the 21st century we should be looking much more to direct substantial holdings of corporate businesses by asset managers and basically shorter chains of intermediation in which asset managers have direct relationships with their savers on the one hand and the places they're putting money on the other. And actually the kind of large pension funds which were established notably in Canada but also in Australia as well are undertaking a large part of their activities in-house which may, it seems to me, be a large part of the model for the future, but that's seeing how these markets are going to develop over the next few decades.

AUDIENCE: You just mentioned then about the shorter supply chain or intermediation chain between the borrowers and lenders etc. I've always thought that the financial services sector has been brilliant at adapting digital technology and innovation. Do you see a role for the blockchain in perhaps being the next round of innovation or anything to do with that type of new technology that's coming on stream?

JOHN KAY: I'm not sure about that. I'm sure there is going to be fundamental disruption continuing in the payment system and that in 20 years' time the idea that we made deposits with banks will probably seem pretty weird and the idea that we went around with folding bits of paper in our pockets in order to pay for coffees and taxis will seem very weird indeed. But I think in terms of this kind of internet-enabled innovation there should be less intermediation than there is now, but the right amount of intermediation is not zero. I think peer-to-peer lending either moves to become something that looks very like a bank used to be or it degenerates into a lot of fraud and scams.

I said earlier that when you first read the business plan of anyone who wants to set up a business it looks great. It takes you quite a lot of time and experience to distinguish the wheat from the chaff in that. That's why crowdfunding may work for new businesses that have, as it were, a social dimension as well as an economic dimension, but as a means of finding capital for start-up businesses I'm very sceptical about whether this is really the future. I think the question of what the future really is is important because if we've understood, and this follows from what I said earlier about capital-light businesses, that the most urgent need for capital in business is to fund start-up losses for new businesses, then we do not have financial institutions which are well-adapted to providing that kind of finance and we need to try and make it happen.

MARION TERRILL: I'm afraid we're out of time so I'd like to wrap up now. It's a fantastic book and I do encourage you to read it if you haven't. It's been very interesting talking to you John about some of the things that we know about, but I think also some of the very fresh ideas and the biggest one for me really is the challenge to the notion of transparency as a way of dealing with some of the problems in the financial system. I'd also like to thank you very much Harrison for bringing an Australian perspective and a banker's perspective to this conversation. I'd ask you all to join me please in thanking our two speakers.

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