The Cost of Certainty – the hidden cost of banking. Or to put it another way: "It's not me, it's you – the impending divorce of deposits from loans". Why banks are flawed and how marketplaces can take the lead.

Rhydian Lewis speech to New City Agenda, Houses of Parliament, 20 April 2016

Preamble

Good morning everyone and a special thank you to the New City Agenda for asking me to speak today in this most venerable of settings. I am honoured and delighted to be able to contribute to the ongoing debate about the future of finance.

It is a very timely and important debate: the financial crisis shook long-held assumptions and exposed chronic weaknesses; at the same time, we are living through an age of massive technological change which is opening up new possibilities. It is also an urgent debate: I sense the window of opportunity for real change is starting to close; as we approach a decade on from the crisis, the forces of gravity are slowly but surely pulling us back to the status quo. The very system that failed us so dramatically in 2008 is fighting a rear-guard action to preserve its existence and familiar assumptions are sliding back.

On the flipside, the failure of one system encouraged a multitude of new models to emerge that together offer a credible route to a more coherent world. The tools are now available; we just need the will and courage to act!

Introduction

Today, I will be focussing on a concept that lies at the heart of finance: the ability to give certainty. We shall see how banks somehow came to be the guardians of that certainty, in spite of the fact that they themselves are riddled with uncertainty. We shall see how banks have become unwieldy conglomerates – on the one hand offering crucial services that require certainty of outcome; while, on the other hand, being gatekeepers to risk capital – and how this has resulted in uneconomic entities that cost us dear. We shall see how this inherently flawed structure – this mixing of risk and certainty – is so fragile that it requires the crutch of a state subsidy that no-one wants but everyone seems to tolerate. We shall then re-imagine an alternative way – one that focuses on resilience and value. The recent banking agenda amounts to nothing more than a sticking plaster over a failing system and unfortunately it won't stop it failing again in the future. A chronic problem calls for a radical response – we need a New City Agenda!

Certainty: its value, its cost and why banks can't deliver it

So, to certainty. The desire for certainty is a natural human instinct. We look for certainty in many areas of our lives, not least in business where the question *"can you guarantee that?"* is often asked. And it is a valid question: certainty oils the wheels of business. Certainty is valuable and absolute certainty can be invaluable. Nowhere is absolute certainty more valuable than when dealing with money.

But certainty is difficult to deliver. As we all know, the world is an inherently uncertain place. Despite our greatest endeavours – from the application of science to sophisticated computer models – we are never able to be certain of the future. One only needs to watch BBC weatherman Michael Fish tell people not to worry ahead of the deadly Great Storm of 1987 to appreciate how hard predictions are; or see outsiders win Premier Leagues, Golf championships and Grand Nationals to appreciate the challenge of predicting the odds. Worst of all, humans have a blind spot with regards to the outlying risks: the 1,000-1 shots – or, in the world of financial jargon, the "fat tail risks". As humans, we can compute most risks but always underestimate – or perhaps simply deny – the presence of the catastrophic risks at the margins.

So, we see that certainty has a value – but it is hard to deliver and so has a cost. The greater the level of certainty, the greater the cost. So, the question becomes: what level of certainty do we want from providers of financial services and what costs are we willing to bear? Should we tolerate marginal certainty – a game of odds – to deliver such basic services as deposits or payments or should we demand a system that can deliver absolute certainty, unaffected by any odds.

The question also becomes: who best to deliver this certainty? Are banks the right entities to provide certainty? Banks purport to be safe and there is an implicit social contract that they will be. The issue is that they can never be wholly safe – they can never give absolute certainty. Yes, they may give comfort against most outcomes – they provide a good each way bet – but they can't deliver a sure thing. So, why would we entrust the role of safekeeping our money – in other words, the role of delivering absolute certainty – to highly leveraged and inherently unstable entities? In short, why do we look to banks to be the providers of certainty?

To answer how we got to this point, let's first go back in time. There are many suggested origins of "banking". For the purposes of today, let's take 17th century Britain as a starting place when the first "deposit-takers" emerged. The frightening truth is that they emerged not by design, but by accident. The story goes that during this time men of the wealthy nobility kept their treasure – in other words, their money – in the seemingly impregnable vaults of the Tower of London.

In 1640, the king – Charles I – found himself unable to balance his books forcing him to raid the vaults and take the money. The King may have promised to pay it back but, nonetheless, such unilateral behaviour understandably unnerved the noblemen. If their treasure wasn't safe in the Tower of London where would it be? Answer: with their trusty goldsmith: with their deep vaults, surely the money would be safe with them?

The goldsmiths were no doubt delighted to see their vaults swell. What's more, they soon noticed that their coffers didn't just swell temporarily – the money stayed there. So the question became: how to make storing this money a profitable exercise? They soon found the solution: lending some of it out and charging interest. Before this development, loans had been given by people directly lending their *own* money; now the goldsmiths, soon to be called "banks", were taking in other people's money and lending it out. And so began the lending of deposits. While the first depositors wanted certainty, what they got was risk.

Zoom forward to today and we take all of this for granted: deposit-funded banks soon overtook direct lending to the extent that they gained either official or unofficial monopolies on lending. And why not, you may ask? Don't banks promise to be safe? Aren't deposit-takers regulated such that the risk of them not being able to keep my deposit safe – in other words, the risk that they are unable to deliver certainty – is so remote as to be irrelevant?

<u>A flawed construct</u>

But are banks truly safe? How does one square this assumption of safety with the fact that every few decades – and we have some vivid recent examples – banks cannot deliver on their promise? Regulation may provide for, let's say, one in 50 year events but what happens when a one in 100 year event occurs, as it inevitably does? Answer: the system breaks down – the money supposedly stored in the vaults is either at risk or simply not there.

One might argue the solution is to increase regulation and tighten the various banking ratios until the system is indeed safe up to a one in a 100 year event. Many authors have explored this spectrum, most recently Anat Admati who, in her book *The Bankers Have No Clothes*, and indeed in this very room, convincingly argued for much, **much** higher capital ratios to make banks unequivocally safe. But then where do you stop? Why not a one in a 1,000 year event? The problem is that the cost of that certainty – the cost of insuring a bank is safe, the cost of insuring a certain outcome – is too high for 999 years and then not high enough for that one crucial year.

This is bad for a couple of reasons. Firstly, it is bad economics. It is intuitively inefficient – and therefore bad value – for a system to be wrong, one way or the other, the whole time: either too safe or not safe enough. People expect certainty from their banks but, as currently configured, the delivery is inefficient. The objective of seeking certainty from deposit-takers is flawed and the cost, irrespective of the level of protection, too high. We all pay for that cost.

Secondly, it is bad at an emotional level. Humans' natural loss aversion means that we find the single year of failure much more traumatic than the cumulative comfort of 999 years of success! When banks fail, the impact is chronic. The issue is that any loss is intolerable, however big or small the failure. Even a bank only being able to return 99p in the £ is a disaster: the world falls in, even though only 1p has been lost. The effect on the national psyche – and with it economic confidence – is traumatic.

So, at both an economic and emotional level this is bad – certainly no way to fund the economic cycle! The equation is fundamentally flawed: matching deposits seeking certainty with loans that are inherently uncertain is wrong. Rather than waste human endeavour trying to get the equation right, surely the answer is to admit the equation *itself* is flawed? Surely it is better simply to spare the time and agony of seeing this play out every few decades and accept that deposits should be divorced from loans? Surely, it is better to accept that no amount of capital can make the deposit truly safe and instead focus on encouraging a more sustainable system of lending?

Unwieldy conglomerates

As well as having a flawed equation at their very heart, banks have become Frankenstein-like conglomerates that do a bunch of things – but all of them sub-optimally. Strip it down and banking, as we know it, involves three main activities: the safekeeping of money (the basic role of providing a safety-deposit box); the moving of money from one place to another (the basic role of a payment company); and finally, the aggregation of capital and provision of loans.

The issue with this is that these are three separate activities: the first two require absolute certainty: certainty that the money is safe; certainty that it arrives where it is meant to. But the third activity is entirely different: it is fundamentally an activity looking for return as opposed to certainty. This co-habitation of basic services and the business of risk intermediation is dangerous and leads to bad outcomes. Trying to serve two masters, banks underperform on both: certainty is compromised by risk; returned is bogged down by certainty.

Split this up, however – with separate instruments for certainty and for return – and you release value: certainty at a fair and transparent cost; risk and return at an economic rate. Both sides of the deal are happy: no muddling up; no broken promises. Returning to our 17th century goldsmiths-turned bankers, allow them to stick to their core business of keeping the treasure safe but don't let them muddy the waters by introducing lending risk. Banks simultaneously being providers of certainty and returns simply doesn't work.

Why does this matter and who pays the cost?

Why does this matter and who pays for this? The answer is that we pay for the incoherence and instability of banks in a number of ways.

Firstly, the need to ensure certainty – what I call the "cost of certainty" – infringes on the ability of banks to pay anything close to a decent return to depositors.

Secondly, incoherent conglomerates have spawned fiendishly complex regulation which creates a barrier to entry and is a dead-weight cost: like a bindweed, it strangles value and entrenches sometimes surreal and unnecessary complexity. The provision of different services – some core utilities; some discretionary risk businesses – results in a form of regulatory capture with the valid pursuit of risk becoming a prisoner of its bedfellow, certainty.

Thirdly, banks as conglomerates are able to internally cross-subsidize across distinct products, neutering the ability of superior business models to break through at a product level – in this way, we pay the cost of delayed innovation.

Fourthly, we have seen that the straight-jacket banks put themselves in – whereby any loss, however small, causes disproportionate trauma – inhibits their own room for manoeuvre and, with zero margin for error, holds the economy to ransom. It is insane to rely on highly leveraged, unstable and incoherent conglomerates to be the primary source of funds for the economy.

Finally, and perhaps most revealingly, the inefficiency and fragility of banks seems inexorably to lead to state subsidies – whether that be explicit (think bail-outs, emergency liquidity lines) or implicit in the assumption of "too-big-to-fail". If the man on the street knew quite how unstable banks really were they would rightly ask how on earth we got into this mess.

As well as a flawed transmission mechanism, we also see a form of weakness – and cost – in the form of deposit insurance. Today is not the day to go into the rights and wrongs of deposit insurance – there are those who swear by it; there are those who see it as the epicentre of all that is wrong with modern-day banking. It is worth pointing out that some countries have resisted deposit insurance, notably New Zealand which chose to introduce it as a crisis measure but subsequently dismantled it once the storm has passed. Much has been written on subject (Andreas Wesseman's recent *The Abolition of Deposit Insurance – a Modest Proposal for Banking* is an enlightening read for anyone interested) and time prevents us from digging too deep. Suffice to say, the flaw at the heart of banking – the promise of certainty amidst a business model based on risk – regularly ends up at the door of deposit insurance, which we all know has a cost. In trying to bring certainty to a flawed structure, I am reminded of the saying from Matthew on "Rock & Sand":

"…But everyone who hears these words of mine and does not put them into practice is like a foolish man who built his house on sand. The rain came down, the streams rose, and the winds blew and beat against that house, and it fell with a great crash."

Is a new way emerging?

Poor systems survive for a while…in the same way houses built on sand survive for a time…but then they collapse. They collapse under the weight of their own incoherence. When collapses happen (and in banking they happen – sure as night follows day – every few decades), a period of soul-searching follows, reviews are conducted, numbers are tweaked and furniture is re-arranged. But what happens when a collapse is so severe that it breaks a paradigm? The answer is acute pain but also acute creativity: suddenly everything is up in the air; tailor-made solutions spring up. The financial crisis of 2008 felt like one of those paradigm-changing moments: the trauma was severe; and so, like a seesaw, was the response.

Why marketplace lending needs to be part of the solution

One such response is the emergence of peer-to-peer lending. Like many things, P2P – or "marketplace lending", as it has come to be known – was a response to a need, namely the huge un-met demand for credit after the banking crisis. But beyond that the question now is whether marketplace lending could actually be the more resilient and sensible way for money to be lent and for the economy to be funded. In many ways, it is a brave new world – matching lenders and borrowers through exchanges as opposed to through the intermediation of a bank – but in many ways it is "Back to the Future": back to the days when lending was conducted by people lending directly. It pre-dates the goldsmiths turning deposits into loans.

Encouraging marketplace lending doesn't mean a reduction in the supply of credit. Lending wouldn't need to slow down. It may not have the dubious capacity to create money in the way banks do – the alchemy of fractional reserve banking – but instead involves the deep well that is investment capital. Some people call this capital "the real money funds" – it does beg the question what the bank money is!

The advantages of marketplaces are clear.

Firstly, because this investment capital is not looking for certainty – instead it is looking for return – matching it against risk assets such as loans results in a balanced equation. The tension with providing a guarantee simply doesn't arise. It is neater and cleaner as a result.

The model is simple. This is not a concept that requires cross subsidies from one product to another. It leads to greater transparency – investors want to know what they are investing in, the track record of performance and information about the risks. Marketplace lenders publish a wealth of data from default rates to full ledgers of their entire loan books – try asking for anything like that from your bank! I am a great believer in the merits of transparency, and would argue that it is very healthy and builds trust.

And the bottom line is that investors receive a more direct share of the value in the form of fair returns. This reintroduces the concept of value in finance – as opposed to just safety. Most encouragingly, the advent of the internet has allowed these exchanges to be *accessible to all* – with everyday investors and borrowers alike now enjoying superior value.

In the absence of a promise of safety, there can be no call upon the Government to act as a back stop. Too-big-to-fail and moral hazard disappear.

This is not to say investors cannot seek protection as well as value – it is just that it is delivered by made-to-measure solutions. At my own marketplace, RateSetter, we have pioneered the concept of a Provision Fund to provide a level of predictability for investors. In short, the Provision Fund takes a risk-weighted contribution from each borrower, which is placed in the Fund. In the event that a borrower misses a repayment or defaults, the Provision Fund reimburses investors. Over 6 years, the Provision Fund has ensured every investor has received exactly the returns they expected – delivering value straight to their pocket.

Marketplace lending – and solutions such as the Provision Fund – do not seek to give certainty. Unlike a deposit which tries to do two things at once – deliver both certainty and value – systems like RateSetter try to do one thing: match risk capital with risk assets. Unburdened by the cost of certainty, the focus can return to value. It doesn't give false promises; it is explicitly risk and return. I would argue it is better by design.

A New City Agenda!

So, time for a bold New City Agenda!

Anat Admati argued for much, much higher capital ratios to copper bottom banks – to make them as unequivocally safe as they claim to be and as society assumes them to be. While we agree this makes a lot of sense, we would argue that this is a solution with diminishing returns. Instead, we could start from the other end and say that the lending of deposits itself is a fundamentally misconceived concept that is bound to fail again. In its place we should look, first and foremost, to investment capital – risk capital – to fund loans. Such matching of risk capital with risk assets can be transparently conducted via exchanges – whether that be capital markets or modern online marketplace lenders. This would simply bring loans in line with equities which are all funded with risk capital, whether that be on public exchanges or private markets. The cycle of banking – so damaging when it turns and so exacerbated by the leverage of banks – can be mitigated. Loans can be funded by real money.

Banks, for their part, could return to the role of their forefathers, the goldsmiths, and focus on the business of keeping the treasure safe and moving it from one place to another as fail-safe payment institutions.

History tells us change is hard…but possible

History tells us change is hard. Even after times of turbulence, old assumptions often re-impose. You only need to see the restoration of Charles I's son, Charles II, to understand how establishments return. The banking agenda has returned to the same assumptions: increase bank ratios and hope for the best.

But if we don't learn from the last disaster, how are we going to improve? As the French minister, Talleyrand, said of the returning Bourbons after their own restoration: *they had learnt nothing, nor forgotten anything*. If we fall into the trap of once again just tweaking a fundamentally flawed structure, are we not missing an opportunity? Why not use the moment to make the system more stable, for good?

Recent banking reforms are in reality nothing more than a sticking plaster over a failing system and unfortunately won't stop it failing again in the future. The system is fundamentally unbalanced, and yet, it still cannot provide a cast iron guarantee that deposits will be safe. It is proven not to work.

Conclusion

This is a radical new agenda. It is clear that change is needed. It is difficult but it is possible. To continue the historical analogy, no doubt it can be some form of constitutional monarchy – not an all-out revolution but a world in which banks have a reduced and reformed role: guardians of certainty maybe, but not the gatekeepers on the provision of capital. We must resist the forces of gravity that want to preserve the – broken – status quo. We have in our sights the possibility of a more balanced system – in fact, we are already seeing its emergence with the growth in capital markets and marketplace lending. We now just need the courage to act and push for a more coherent world where certainty and risk are kept apart. You wouldn't design the banking system as it is today; why would we keep it this way?

Thank you.

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