Men, Money and Morality: How Can Trust in Banking Be Restored?

Public lecture, July 6, St Paul's Cathedral, London

First, my thanks to Canon Giles Fraser for making this event possible. Secondly, my thanks to everyone who contributed to the biography of Siegmund Warburg that I have just published. It would be too time-consuming to list you all by name, but I think I really must make special mention of George and Anna Warburg, and also of Hugh Stevenson, without whose encouragement, patience and occasional subtle pressure, the book might never have been completed. Thanks also to St Paul's Institute for hosting, and UBS for sponsoring, this event.

When Lloyd Blankfein, the chief executive officer of Goldman Sachs, told the *Sunday Times* that he and his fellow investment bankers were "doing God's work" last November, there was near-universal incredulity.

In fairness, Mr Blankfein was being characteristically ironic. But it's a harsh reality that irony usually gets lost in translation on its way from the side of your mouth to the headline in a British newspaper.

Let me be blunt. Banking has never looked less like a divine calling. Indeed, in the public mind bankers have achieved what would once have been thought impossible: They have managed to sink lower than journalists. If you doubt it, take a look at recent polls. According to polling by Edelman, between 2007 and 2010, trust in bankers collapsed from 68 per cent of the public to 29 per cent in the U.S. and from 41 per cent to 21 per cent in the UK. Yet 22 per cent of Britons still trust journalists to tell the truth.

Did banks become ethically as well literally bankrupt in the nearly thirty years that have passed since 1982, the year Siegmund Warburg died and, with him, the era of "relationship banking"?

Was the love of money – to be precise, fat bonuses – the root of all the economic evil we are currently enduring?

And, if the answer to both those questions is yes, then is the answer tighter regulation of the sort envisaged in the new American law devised by Senator Chris Dodd and Representative Barney Frank?

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You might well think so. “We cannot control ourselves. You have to step in and control [Wall] Street.” Those were the immortal words of John Mack, former CEO of the investment bank Morgan Stanley, speaking in New York also last November.

We know from the hubristic emails of 31-year-old Goldman Sachs trader Fabrice Tourre just how out of control things were on the eve of the global financial crisis. Back in 2007, Tourre positively gloried in selling “synthetic abs [asset back securities] cdo^2 [collateralized debt obligations “squared”] – the quintessential toxic assets – to “Belgian widows and orphans”, knowing full well that the U.S. subprime mortgages on which these assets were based were already “totally dead”.

“More and more leverage in the system,” wrote “Fab” to a girlfriend in his distinctive franglais, “the entire edifice threatens to collapse at any moment. Only potential survivor, the fabulous Fab … standing in the middle of all these complex, highly levered, exotic trades he created without necessarily understanding all the implications of those monstrosities.”

"Anyway," he went on, "not feeling too guilty about this, the real purpose of my job is to make capital markets more efficient and ultimately provide the US consumer with more efficient ways to leverage … himself, so there is a humble, noble and ethical reason for my job ;) amazing how good I am in convincing myself !!!"

With its sly winks and surplus exclamation marks, Tourre's email perfectly encapsulates the spirit of the age – an age in which clients were merely "counterparties" and conflicts of interest were there to be "embraced".

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To some commentators, this is precisely what happens when deregulation gives free rein to greed. Cocky clever-dicks make a killing at the expense of widows and orphans. Answer: more regulation – a lot more. And that is certainly what is coming Wall Street's way (it remains to be seen just what will change when the Bank of England takes over regulating the City from the Financial Services Authority). The final version of the Dodd-Frank Bill runs to 2,319 pages. I especially recommend the pages designed to regulate bankers' compensation, which concludes by initiating a study to see if excessive bonuses were in fact a cause of the crisis. Legislate first and ask questions later is the order of the day in Washington D.C.

Yet things were not so very different in the more tightly regulated financial markets that produced the secondary banking crisis of the 1970s. That era also had its Bernie Madoff, its Bear Stearns and its Lehman Brothers – though who now remembers Gerald Caplan of London and County Securities, or Cedar Holdings, or Triumph Investment Trust?

Those who seek to blame the crisis on deregulation have a job to explain the 1970s. The City of London in 1970 was anything but a free financial market. It was regulated by an elaborate web of traditional guild-like restrictions. The merchant banks – members of the august Accepting Houses Committee – concerned themselves, at least notionally, with accepting commercial bills and issuing bonds and shares. Commercial or retail banking was controlled by a cartel of big 'high street' banks, which set deposit and lending rates. Within the Stock Exchange autonomous brokers sold, while jobbers bought.

Over all these gentlemanly capitalists the Governor of the Bank of England watched with a benign but sometimes stern headmasterly eye, checking ungentlemanly conduct with a mere movement of his celebrated eyebrows, afforced by the head prefect in the form of the Principal of the Discount Office.

This was still a world in which bankers were by convention forbidden to visit stockbrokers in their offices; the latter, no matter how venerable, were obliged to call on the former, no matter how lowly. Bankers, brokers, jobbers and an army of clerks went about their business much as they had before the war. Many of the bankers even dressed as their fathers had, complete with Monty Python bowler hats and black umbrellas. And on top of all this was the complex of exchange and credit controls, corsets and quotas, so beloved of post-war British governments. This world remained largely intact until the 'Big Bang' of 1986. If tightly regulated financial markets are so wonderful, why it was that the 1970s were arguably this country's most financially disastrous decade since the 1820s, witnessing not only a major banking crisis, necessitating bailouts and bank nationalizations, but also a stock market crash, a real estate bubble and bust and double-digit inflation, all rounded off by the arrival of the International Monetary Fund in 1976?

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The real lesson of history is that regulation alone is not the key to financial stability. Indeed, over-complicated regulation can be – as the great Viennese satirist Karl Kraus famously said of psychoanalysis – the disease of which it purports to be the cure, by encouraging a culture of box-ticking "compliance" rather than individual moral judgment.

The question that gets asked in highly regulated markets is not "Are we doing the right thing?" but "Can we get away with this?"

What is surely more important is to instill in financial professionals the kind of ethical framework that was the basis of Siegmund Warburg's life and work.

It may have struck you as rather odd that I, a Scot, born and raised an atheist, should give a lecture about a German-born Jew in, of all places, St Paul's Cathedral. But maybe it's not so odd. Although Warburg's parents were both Jews by birth and upbringing, his mother Lucie raised him with an idiosyncratic combination of Judaism, Puritanism and the German Enlightenment that was not without a strong Christian component.

Warburg once proposed a neat simplification of the Old and New Testaments: “The two basic sins are intolerance – except against intolerance – and violence – except in self-defence.” He was no atheist, insisting that “we cannot bypass God and mystery by rational considerations and tautological formulae”. As he put it in a letter written in 1964 (to, of all people, his barber):

> We are surrounded in this very world by mysterious incursions from another world. Our poor human mind tries to find rational explanations for these incursions and is unable, or unwilling, to proceed with sufficient energy into a field which goes beyond our so-called “rational” reasonings. The word “rational”, invented by, used and gradually being led ad absurdum by narrowly thinking philosophers . . . in fact covers up in a labyrinth of word games a poverty of imagination – a poverty which has been created largely by loss of genuine faith.

God was there for Warburg. Right there – in the individual’s conscience.

The essence of the philosophy imbibed from his mother was that "what had to be done must be done with the utmost thoroughness; what had to be thought over must be thought through to its ultimate consequences; and what had been identified as the right objective, must be pursued with uncompromising tenacity."

Up until he was thirteen, his mother had prayed with him every night before he went to sleep, telling him on the eve of his bar-mitzvah:

> From now on, my dear boy, you must pray alone in the evening, and you must always ask yourself before you pray what mistakes you have made during the preceding day, or what you could have done better. If a whole number of mistakes or omissions do not at once occur to you, then you must look deeper into yourself, until you have attained the necessary self-knowledge. We all make many mistakes every day, and the most important thing is to be critical of your own mistakes in the most unsparing way. That is the only way to arrive at honest prayer.

This homespun mix of monotheism and rationalism – Christ plus Kant, God plus Goethe – provided Warburg with a powerful moral and ethical framework throughout his life. At the core of it was iron self-discipline, based above all on unsparing self-criticism – “agonizing self-appraisal” as he liked to call it.

In one of his many aphorisms, collected over the years, but never published, he wrote:

> It is supposed to be good manners not to cry over spilt milk or let sleeping dogs lie, but in fact it is highly educational to cry over spilt milk and not to let sleeping dogs lie.

The same applied to bridges. They should always be crossed *before* you got to them.

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You cannot begin to understand Warburg and his generation of German-Jewish businessmen and intellectuals if you do not grasp what they had lived through. They had experienced military defeat in 1918, hyperinflation in 1923, complete financial collapse in 1931, the suicide of democracy in 1933 and – at one time or another, in Warburg’s case in 1934 – the painful decision to leave a fatherland with which they had all very closely identified themselves. And let us not forget the equally painful decision to align themselves with Germany's foes in 1939.

In writing Siegmund Warburg's biography, I was impressed by few things more than the speed with which he disassociated himself from Hitler's Germany – years before his Hamburg relatives, who clung to the hope that the anti-Semitism would somehow not apply to their rarefied social stratum – and identified himself with Winston Churchill's Britain – years before Churchill replaced the tragically supine Neville Chamberlain as Prime Minister.

So it was not only from his mother's austere philosophy, but also from the harsh lessons of his own experience, that Warburg derived the five *haute banque* principles on which he based his post-war career in London. As he explained in a 1953 memorandum directed at the U.S. investment bank Kuhn, Loeb & Co. (which he believed was deficient in all five), "the important elements of a first-class private banking business" were:

1. Moral standing
2. Reputation for efficiency and high quality brain work
3. Connections

4. Capital funds

5. Personnel and organization

These are principles which today's bankers would do well to revive.

Notice: The maximization of shareholder value was not one of these principles. "Success from the financial and from the prestige point of view … is not enough," Warburg told his fellow directors in 1959. "What matters even more is constructive achievement and adherence to high moral and aesthetic standards in the way in which we do our work." It is hard to imagine any modern bank CEO coming out with a line like that.

"Personally," he wrote, "I am not interested in the waves of despondency and enthusiasm. These are appropriate for people who look upon matters purely from a Stock Exchange point of view, i.e. in a '*Boersianer* spirit'. However, if we want to succeed, we must make up our mind to follow a policy of establishing new values and new procedures rather than to act mainly as traders and sellers of securities which we find relatively easy to dispose of. In other words, we must be aware that we are primarily bankers and only secondarily Stock Exchange traders."

Above all, the *haute banque* style was about reputation. "The reputation of a banking firm for integrity, generosity and thorough service", Warburg once observed, "is its most important asset, more important than any financial item. Moreover, the reputation of a firm is like a very delicate living organism which can easily be damaged and which has to be taken care of incessantly, being mainly a matter of human behaviour and human standards."

And Warburg meant it. As one director recalled, Warburgs staff were instructed never "knowingly [to] breach the Companies Acts, the Takeover Code, or the Stock Exchange Regulations", but the really important "unyielding principles" were home-grown: "Never do anything that would bring Warburgs into disrepute." When veteran director Frank Smith was publicly castigated for telling an "untruth" to Lord Shawcross, the chairman of the City Takeover Panel (Shawcross could not resist the pun that "Mr Smith had been less than frank"), Smith had to resign as a matter of course.

In Warburg's eyes, the customer, too, was not always right. Asked on one occasion "whether we act like barristers for important clients through thick or thin provided that there is at least a faint chance of winning their case or whether even towards extremely important clients we have the courage to refuse to comply with their wishes or views", Warburg replied that "it had in fact always been our policy to express our criticisms to our clients, however much they might dislike it, and even to refuse to act for them if we differed from them on important matters".

This precept was acted upon on more than one occasion – leading, for example, to the dropping of "Tiny" Rowland of Lonrho from the bank's client list – and was regarded by Warburg as the difference between his ideal of the "financial physician" and the (to his mind) less noble approach taken by barristers. Nor should clients in difficulties automatically be deserted: "We should not behave … in accordance with the precept which is unfortunately so frequently followed in the City, namely to bully the weak and to suck up to the bullies." Robert Maxwell was politely shown the door after he had failed to strike the right note in a preliminary meeting.

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Obviously, not every banker can have Lucie Warburg as a mother. So what, if anything, can we do to instill in our modern financiers something of that extraordinary moral rigour that characterized Siegmund Warburg?

The answer, to repeat, is not thousands of pages of new regulations designed to prohibit every unclean thought or wicked deed.

In my view, business education — and not only in Business Schools — urgently needs to be reformed so that future bankers learn to strive for more than just the "maximization of shareholder value" (code for driving up the share price by fair means or foul).

We need, for example, more financial history and less financial engineering. It is a scandal that so little financial history is taught at the majority of the world's business schools. Harvard Business School, with its long tradition of historical writing derived from the case method and the researches of Alfred Chandler and others, is one of the few exceptions.

I know this because I regularly ask audiences of highly qualified financial professionals whether or not they have read Milton Friedman and Anna

Schwartz's *Monetary History of the United States*, probably the single most important work of American financial history ever written. No matter how large the audience, I never make it into double figures. Most people in banking simply know nothing about the period before their careers began – which, in the case of the CEOs who presided over the financial crisis, was around 1982.

But historical education alone is not sufficient. I also believe the next generation of financiers needs something like a Hippocratic oath, along the lines recently proposed by the Harvard Business School class of 2009.

It was a group of HBS MBA students, led by Peter Escher, and encouraged by our new Dean Nitin Nohria, who last year came up with the MBA Oath. In it, the oath-taker promises, among other things:

I … will not advance my personal interests at the expense of my enterprise or society.

I will understand and uphold, in letter and spirit, the laws and contracts governing my conduct and that of my enterprise.

I will refrain from corruption, unfair competition, or business practices harmful to society.

… I will report the performance and risks of my enterprise accurately and honestly.

Admirable pledges, all!

Admittedly, Siegmund Warburg was no great fan of business schools. Indeed, throughout his career, he reserved a special contempt for graduates of Harvard Business School who, he asserted, “combine[d] conceit and superficial sophistication with an excessive respect for organisation charts and all that this implies”. He was a shrewd man, you know. He also always preferred the Scots to the English.

Nevertheless, I think Warburg would have liked the idea of a banker’s Hippocratic oath. And I can certainly imagine a letter winging its way to the author of the Harvard Oath, inviting him for a cup of tea, a conversation about the novels of Thomas Mann and a little graphological analysis.

It is no accident that Siegmund Warburg thought of himself as a "financial physician". It was an analogy he made public in 1970 when he gave a rare and remarkably frank interview to the journalist Patrick Hutber:

> The motives of a doctor are a mixture of altruism – the wish to help others – and of the ambition to do a good job. He hopes to obtain both the inner satisfaction arising from well-accomplished achievement as well as material recognition. On this basis a good doctor should in the first place listen with great attention to the problems and complaints of his patient and try to gain a comprehensive picture of his strong and weak points, looking not only at the patient's specific ailments but observing the state of the patient as a whole with its physical and psychological ramifications.

How many bankers today would imagine their clients as patients? As opposed to, say, suckers?

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Better education, then, not over-regulation, is what is needed to repair the damage done to our financial system by years of increasingly cynical and reckless “transactions banking”. The traders ended up driving the financial system to the edge of chaos. Without prompt action by central banks and Treasuries, pledging the resources of us, the taxpayers, the Western world might have plunged into a Great Depression.

Even today, nearly three years after the financial crisis began, it is too early to say that it is over and that the danger of a Depression has passed. On the contrary, continuing alarums and excursions in the European sovereign debt market point to the long-denied reality that the conduct and predicament of the continental European banks was no better than that of the British and American banks, and in some cases worse.

It is time to bring back banking in Siegmund Warburg’s sense of *haute banque* or high finance. It is time that we reminded ourselves that without trust, finance cannot function, and that trust cannot be won and retained without consistent ethical behaviour. It is time we reminded ourselves that money itself is a relationship – between the creditor and the debtor – and that without trust it cannot perform its function as a means of exchange or a store of value.

Banking will never be God's work, ladies and gentlemen. But with better education, and perhaps with less needlessly complex regulation, we can ensure that it ceases to be perceived by the public as the Devil's work.