I became a commercial banker because I didn’t get into law school, and when I got out of the Army I needed a job. Citibank taught me accounting, corporate finance and credit analysis. Then, when I arrived at Morgan Stanley four years later, I became a specialist in financial institutions because I joined a team advising a commercial bank in Cleveland that was feeling queasy.

Risk culture
The bank in Cleveland was my first exposure to the important concept of risk culture. They had lovely offices. They were polite and amusing. But they tolerated muddle. The poet Randall Jarrell once defined the novel as ‘a prose narrative of some length that has something wrong with it.’ In that spirit, a bank could be defined as a mismatched institution with a data problem. The sincerity of its struggle against that problem tells you a lot about a bank’s risk culture.

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

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

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

What ultimately put the bank in Cleveland in mortal peril was double leverage. It had borrowed at the holding-company level to inject equity into the bank. If the bank couldn’t pay dividends, the holding company would not be able to pay interest. A bank with the bad loan problems our client had shouldn’t have been paying dividends, and the Fed wanted it to stop. But if its parent couldn’t service its debt, the bank’s depositors would start pulling their money out of the bank, which would face a liquidity crisis and might easily fail. Our job was persuading the Fed to be pragmatic.

One of the most memorable transactions I worked on was the insurance broker, Marsh & McLennan, buying its London equivalent, C. T. Bowring. In 1979, when we started work on the project, the city was on the threshold of big changes, but traditional eccentricities were still alive and well. We stayed in Claridge’s, admired the hall porter’s eighteenth century livery, ate grand dinners, read the Financial Times each morning, learned the names and functions of dozens of tiny specialist firms – brokers, stock-jobbers, discount houses, accepting houses, underwriters, names agents – and met some
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extremely clever men who could have been invented by Charles Dickens.

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

The wisdom part is a persistent expectation of discontinuous change, a conviction that banks can never entirely relax. The barbarians may not be at the gate, but they are somewhere in the forest across the river. The sadness involves the disappearance of S. G. Warburg & Co. To do a takeover in London, we needed the help of a London merchant bank, so we brought them in, and they were superb. Sigmund Warburg died in 1982. As the city changed, the firm grew rapidly, faltered, and was absorbed into what is now UBS.

Capital and volatility

In 1982, I had the opportunity to play investment banker to my employer. Morgan Stanley had traditionally been an underwriter of high-quality stock and bond offerings, which required good judgment but very little capital. A handful of partners would sit around a table in a wood-paneled room, study a meticulously prepared exhibit called a ‘multi-company comparison’, and decide whether the coupon ought to be 6 ¼ or 6 ½ per cent. The firm’s prestige was such that the market tended to accept their decision.

In the early 1970s, however, with markets getting more volatile, it became clear that you needed to have at least a modest sales and trading operation to make such judgments. That required capital. In fact, it required two kinds of capital. ‘Regulatory capital’ requirements were determined by the Securities and Exchange Commission (SEC), ‘cash capital’ requirements by the commercial banks which financed our inventory of bonds and shares.

These requirements could differ significantly and required attention to both. The chief financial officer of Morgan Stanley had set up a management information system that allowed him to track them in real time. Then one day he asked a harder question: ‘How much capital should we have?’ Someone decided I was the person to answer that question.

The problem for an organisation accustomed to consulting multi-company comparisons was that most of the major securities firms were private partnerships. There weren’t any points of reference. I asked several senior partners how to proceed and got what amounted to elegant shrugs. A meeting was arranged with the chief financial officer of Goldman Sachs, which had more significant sales and trading operations than we did. I asked, ‘How much capital should a securities firm have?’ His reply: ‘More than it thinks.’

The approach I eventually settled on was to sit down with the men running each of Morgan Stanley’s 17 lines of business, try to understand how they did what they did, examine their monthly results over the past three years, and agree on a reasonable worst-case loss. I suggested that we should have equity equal to the sum of those 17 worst cases.

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

I guess the partners liked my answer. ‘Hmmm,’ they said. Anyway, I was never asked to do any follow-up work. I wish I had been – not because I would have come up with a better answer, but because it would have given me a glimpse of how this collection of experienced businessmen wrestled with the problem. That would have been interesting.

I took several lessons away from my stint as Morgan Stanley’s investment banker. First, the need for capital is primarily a function of the volatility of the
business. Second – reinforced by watching events since then – is that forecasting volatility is hard. Markets are more like weather than like dice, where the odds are known. What bankers call risk carries a large element of uncertainty. Third, that ignoring regulations clears the brain. Perhaps because the regulatory- and cash-capital perspectives so often differed – but also, I think, because their personal reputations and fortunes were chained to Morgan Stanley – the firm’s partners didn’t start by asking what the SEC or the financing market required. They asked themselves what they felt comfortable with. Chained as they are to the ‘Basel Enterprise’, banks can have difficulty doing that.

A prerequisite to determining capital policy is understanding the business models being pursued. Having expanded fairly quickly by bringing in practitioners from other firms, Morgan Stanley’s partners knew less about what they were doing than they thought they did. Part of my work consisted of describing those 17 business models as simply as possible. Lesson number four was how helpful that can be.

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

**Washington**

What may have been the crucial turning point in my career occurred in July of 1984, when Bill Isaac, who was then chairman of the Federal Deposit Insurance Corporation (FDIC), called to say that he had to ‘do something’ about Continental Illinois, and could we be in his office that afternoon?

I won’t describe the complex structure by which Continental Illinois was kept open while its shareholders lost their investment – as they should have. Suffice it to say that spending the summer of 1984 in Washington made me a life member
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of the ‘too-big-to-fail’ Debating Society. More significantly from a personal standpoint, it gave me an insider’s understanding of bureaucratic jargon and process, and made me the FDIC’s natural choice as an advisor on major resolutions.

Eventually, late in 1990, Bill Seidman, who succeeded Bill Isaac, persuaded me to quit my Wall Street job and join the FDIC to establish and lead a division of resolutions. I spent almost four years in Washington, where we handled 266 bank failures. It was the lowest paid and most rewarding job I’ve ever had.

Even before my first trip to Washington, I had read Bagehot’s *Lombard Street* and Kindleberger’s *Manias, Panics and Crashes*, and knew a bit about the way central banks and other supervisors use market discipline, signaling and ambiguity to preserve systemic stability. The history of bank regulation can be summarised as ‘more risk, then less risk, and now more risk’, and I can probably talk about the subject longer than most people want to listen. But let me leave you with two memories, images that characterise the challenges of the ‘system-minding’.

The first is an example of overkill. It was 1998, a few years after I’d moved from Washington to Asia. I was calling on Bank Indonesia, that country’s central bank. In the front lobby of their headquarters, there was an enormous pile of carrying bags, each stuffed with bricks of paper currency. Workers were carrying the bags to a long procession of panel trucks in the parking area. The trucks were being dispatched to branches of banks all over Jakarta. The IMF had
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make terrible owners of banks because they are under political pressure to make what will turn out to be bad loans. Even in the best of countries, government-controlled banks seem destined to fail.

I agree with Hyman Minsky that financial systems are inherently unstable because the longer the sun shines, the less risk-averse people become – making crises inevitable. So even the wisest banks benefit from supervision. And banks are only able to do what they do when they have a lender of last resort and potentially capital support. In short, banks need governments. They need each other like an old married couple. Both have their defects. They grumble about each other all the time – and indeed, a little marriage counselling is sometimes necessary. But they will never separate.

If you read Edward O. Wilson – the evolutionary biologist and world authority on ants – you can find yourself wondering why the financial ecosystem has come to depend on such fragile entities as banks. They lend long and borrow short. Their assets are opaque. Considering the risks they take, they don’t have that much capital. If you leave them in the sun too long they ‘go troppo’. And there is deliberate ambiguity about what the government might do in a crisis. Why is this a good arrangement?

My answer is that banks work best when they are permanently on edge. Anxiety induces thoughtfulness and moderates the Minsky dynamic. The vulnerability of banks requires them to pay attention. When your business model has far more downside than upside you need to do that. For this reason, outsiders have traditionally made the best bankers. Precisely because they are not at home in their surroundings, outsiders tend to be watchful, polite, covertly clever, and skilled at maintaining intellectual and emotional distance.

S.G. Warburg & Co.

Sigmund Warburg exemplified this phenomenon. The historian Niall Ferguson describes him as ‘the personification of the rootless cosmopolitan.’ Born into a banking family in Hamburg, he recognised early in the 1930s where the Nazis were headed and
opened a small firm in London. After the war, he put his name on it, and cautiously accumulated a collection of brilliant, quirky, driven employees and partners. The firm I encountered in 1979 had risen to the top of the London pecking order in 33 years.

Most of Warburgs’ work was advisory. They avoided risk and disliked display. But they had a definite style. In contrast to the long city lunches we had heard about, Warburgs entertained in shifts. Guests came at either 12:30 or 1:30, and were expected to know when to leave. Sigmund wouldn’t have shiny annual reports with photographs. They didn’t advertise. No firm was better at managing the press, but it was considered important not to believe one’s own press clippings. They loved to win, and they often won, but never forgot that disaster lurked around the corner.

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

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

To be clear, Sigmund Warburg was a genius. The bankers who keep the financial system in balance are craftsmen rather than magicians, good workers rather than masters of the universe. If you study men who make their living by physical labour, they never hurry. They aren’t lazy. They just know what works, and what they are capable of in the course of a day.
Good bankers are like that. ‘If you need an answer today,’ an old boss at Citibank used to say, ‘the answer is no.’ Near the top of a very long staircase in the Palazzo Vecchio in Florence, the Latin motto adopted by banker and ruler Cosimo di Medici is engraved on one of the risers: Festina lente. Make haste slowly.

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

The Basel Enterprise, directors and managers

Moving to Australia in 2003, I had to spend time catching up on the proliferation of rules generated by the Basel Committee on Bank Supervision. They have spent over 30 years trying to make risk and capital comparisons transparent – with the aim of making the global financial system safer. ‘Basel I’ was little more than an agreement to publish adjusted leverage ratios. We are now on ‘Basel III’.

The Basel Enterprise resembles trench warfare in that while it has cost a lot, and the participants sometimes look exhausted, intractable differences remain. The US never adopted ‘Basel II’. And the fog of war has only thickened. I believe that sheer complexity was a contributing cause of the GFC. Boards and senior executives looked at the stream of Greek letters coming out of Basel and stopped thinking about risk, on the basis that the ‘rocket scientists’ their banks employed had everything under control. They didn’t.

What has come to interest me more than quantitative tools is the character and employment of boards of directors. If banks are frail reeds for economies to lean on, bank boards can look similarly underequipped. Banking is a complicated business. Most directors have never been bankers. In fact, the majority are supposed to not be bankers. They appoint the chief executive and determine his or her bonus, but most of the time they must follow that individual’s lead. (As an experienced non-bank chairman once told me, ‘I work for the CEO until I fire him.’) Directors are expected to challenge management without alienating them, but know they will often be asking uneducated questions. There is a lot to learn and a lot to read, but directors have no staff to assist them. And they must limit the time they spend, lest they lose their independence. Why is this a sensible job description?

As with the banks themselves, the board’s limitations can be seen as virtues. The institution only needs one management. For the board to shadow management would be inefficient and confusing. The fundamental work of a bank board involves answering five questions:

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

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

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