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Trust & Check

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When the Bank of England's Mark Carney, on 25 October 2013, voiced a number of concerns that have become more clear not only since before the last financial crisis, one would hope that for once they are seriously taken care of for good to restore at least a little bit of trust in the "financial system". It can hardly be called a "system", except that 'systematically' the last crisis is put under the carpet and then, with full speed or deceptive apathy, a new bubbly crisis is "emerging", by "accident", of course…except, that if you don't plug the holes in a boat, you will face leakage troubles again, what wonder! It does not take a rocket scientist to get it (although it is a complex task to execute, no doubt). And as the author of this blog post knew as a child when looking at the "grown-ups", it is not intellect that makes a great scientist, but character. Oh, well, thanks, Einstein, that you confirmed it, in one of your aphorisms. Consequentially, if the City or the Street (and their proud derivatives around the world) want trust, respect and credibility, they should themselves enforce an honorable transaction culture. Let's see how much they will strengthen the chorus.

It is honorable that the wisdom foretold is emphasized, that London's, and all other financial centers' success depends and rests on the matters above. The FSB is going in the right direction; it needs full support by all market participants though. Further, a general definition of Systemic Risk which is not limited by its mathematical approaches, model assumptions or focus on one institution; and which is also the first operationalizable definition of Systemic Risk encompassing the systemic character of financial, political, environmental, and many other risks is available since 2010. It solves for resilience; saves the system from 'to big to fail', self-reinforcing asset price and credit cycle; continuously purifies the system in general from ill-conceived products, unethical transactions and misbehaving institutions; avoids socialization of private losses by causal attribution; and increases trustworthiness in all parts of the market.

While several hundred billions of dollars "conduct costs" do not at all reflect fully the extent of trillions of dollars damage done, the "return to ethics" is at least setting the compass in the right direction, and "improved regulation" will help not just to trust (belief moves mountains), but to verify (the hard work and checks that put the tunnel through). Verification is necessary re (i) regulatory compliance, (ii) deserved trust, and (iii) learning as a means to prove changed behavior and culture.Yet, on the matter of "accountability" there seems to be still confusion between 'revenge' and 'justice'. Acting on causal allocation of conduct cost or misbehavior consequence, a desire for more and heavier, lasting punishment of individuals and organizations in/directly responsible is seen as justified since damages have not been repaired except for minor sums (compare the many trillions "lost in the financial system" to the few hundred billions "paid for misconduct", unfortunately viewed as a cost of doing business).

What, then, is just? Revenge may be individual action; subjective judgment; defined, but not limited by person/minority; out of proportion; offensive; nongeneralizable; predominantly for personal re/gain, but does not have to be unjust. Justice is supposed to be public action; objective judgment;defined and limited by society's morals; balancing; impossible to be unjust,but can be appealed; generalizable; righting a wrong for future normalization of society; and should not be unjust. When revenge is just(ice), it might lead to retributive justice. In the end, individuals or groups should be restored to the level on which they were before the harm done to them, plus interest and inflation.

The LSE Conduct Cost Project is leading the way in helping (i) financial institutions improve their self-respect by owning up to their (repeated, see CCP project releases and original analysis by author later) misbehavior and (ii) the public in understanding the extent to which trust can be granted to these institutions and (iii) to clarify how much further checks on these institutions need to be carried out to be able to fully trust them, if that ideal can ever be reached. Finally, regulators, authorities and central banks as well as financial institutions need to prove beyond doubt that they are not in unhealthy liaison; otherwise get corrected to the norm or be shut down and out of the system for good. After all, collateral global market clearing depends on exactly this level of integrity, transparency, robustness and proper valuation. It will even help fix shadow banking (which was heavily used e.g. for ARS) and drive globalization with more open, safer, free markets.