Restoring public trust in a new financial order

By Calvin Benedict | October 2014

While recently discussing Martin Wolf's latest book "The Shifts and the Shocks" at a LSE public lecture, Lord Turner, chairman of the FSA, posed the pressing question: How radical do we need to be to have a safer financial system?1

A few years ago, it would have been almost inconceivable to predict that the conduct costs incurred by the ten leading banks over a five-year period to the end of 2013 would be just shy of £160 billion.2 There is no doubt that conduct costs represent a significant threat to a safer financial system. Professor Roger McCormick and Chris Stears aptly commented on this issue:3

> "Rising conduct costs will increase a bank's overall operational risk profile and, consequently, its regulatory capital requirements. The 'operational risk charge', which will take account of conduct risk, takes the management of legal risk from what was perhaps considered in the past to be a 'soft issue' for financial services firms, firmly onto a quantitative, bottom-line basis".

Compounding this issue, conduct costs have negatively impacted the 'investability' of banks. "Fine inflation" for past misconduct was cited by Neil Woodford, a high-profile City fund manager, as the rationale behind his decision to sell his fund's stake in HSBC last month.4 In a sense, we are dealing with a double-edged sword: To what extent do we punish banks for their transgressions - particularly the egregious ones - by imposing financial penalties, whilst still appeasing the desire for a safer financial system?

It is clear that the banking sector is undergoing rapid changes, from evolutionary to sometimes revolutionary. The steady stream of conduct costs (and their root-causes and influences) serve as a timely reminder that a new way of operating is required. Banks now face the long arm of a seemingly zero-tolerance regulatory regime; and its unintended consequences. Make no mistake, a new financial order (or perhaps disorder) is in prospect.

1. Restoring trust

Yet, the question remains: In years to come, what will be the cornerstones of this new financial order? Will we be able to avert the onset of another financial crisis? Although the future is uncertain, one thing we certainly need is *trust* - that is, trust in the financial system and its integrity; trust in the banks who hold our deposits; trust in the regulators to meet public expectations; trust in the politicians to champion reforms that engender

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[1] "The Shifts and The Shocks: What we've learned – and still have to learn – from the financial crisis" *London School of Economics Public Lecture* (September 16, 2014). Accessed online: http://www.lse.ac.uk/newsAndMedia/videoAndAudio/channels/publicLecturesAndEvents/player.aspx?id=2581

[2] "Summary Table and Results" *Conduct Costs Project*. Accessed online: http://blogs.lse.ac.uk/conductcosts/files/2014/07/CCP4-Summary-Table-and-Results.pdf

[3] Roger McCormick and Chris Stears "Banks: conduct costs, cultural issues and steps towards professionalism" *Law and Financial Markets Review 2014, S.8, 134-144* (June 2014).

[4] Neil Woodford "Bank Withdrawal" (September 1, 2014). Accessed online: https://woodfordfunds.com/bank-withdrawal/

inspired change; and the trust that every banker understands the importance of their profit-making abilities in a wider societal context.

Therein lies the subsequent focus of this article: restoring of trust in a new financial order. The discussion of trust will be primarily focused on breaking down the barriers of compartmentalisation and the 'public veil'.

2. Bursting the bubble of compartmentalisation?

In our twenty-first century capitalist systems there will always be trade-offs: between profits and ethics; between law and morality; and ultimately between what is right and what is wrong. This can lead to compartmentalisation, whereby we promote the agenda that benefits us the most, even at the expense of others. However, if we open ourselves to a broader perspective of the human condition, we may be surprised and inspired by what we see. The famed novelist J. K. Rowling once remarked that:5

"Imagination is not only the uniquely human capacity to envision that which is not, and therefore the fount of all invention and innovation. In its arguably most transformative and revelatory capacity, it is the power that enables us to empathise with humans whose experiences we have never shared".

Elsewhere I have discussed the call of Mark Carney, the Governor of the Bank of England, to foster a sense of the systemic. More precisely, the Governor argues that:6

"When bankers become detached from end-users, their only reward becomes money. Purely financial compensation ignores the non-pecuniary rewards to employment, such as the satisfaction from helping a client or colleague succeed. This reductionist view of the human condition is a poor foundation for ethical financial institutions needed to support long-term prosperity. To help rebuild that foundation, financiers, like all of us, need to avoid compartmentalisation – the division of our lives into different realms, each with its own set of rules. Home is distinct from work; ethics from law; the individual from the system".

The Governor's approach to defining 'compartmentalisation' has been followed in the article, and the word is used in the context of unethical and/or immoral conduct in the banking sector.

2.1 What drives our desire for compartmentalisation in finance?

As mentioned above, one of the underpinning drivers for compartmentalisation is the notion that the individual is separate from the system. For bankers there are several factors that make the allure of compartmentalisation (to the detriment of ethics) all the more tempting. Long working hours, dealing with unknown counterparties, being a 'cog in the machine', and corporate cultures can instil a sense of disconnect from the wider financial system. There is also a sense of entitlement - the belief per se that if one has the opportunity to make as much money as they could (in compliance with the law, of

[5] J.K. Rowling "The Fringe Benefits of Failure, and the Importance of Imagination" (June 2008). Accessed online: http://harvardmagazine.com/2008/06/the-fringe-benefits-failure-the-importance-imagination
[6] Mark Carney "Inclusive capitalism: creating a sense of the systemic" (May 27, 2014). Accessed online: http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech731.pdf

course) then why shouldn't they? After all, great sacrifices (including investing in degrees from prestigious universities) may have been made to obtain this opportunity.

If anything, the Crisis created a trust 'deficit' between bankers and the public that compliance alone cannot mitigate. Rather, trust must be earned and one of the ways this can occur if bankers factor the societal effects of their actions into decision-making. To do so would require them to think beyond the scope of their organisation, and emerge from the bounds of compartmentalisation created by their job functions. Striking a balance between having reasonable expectations of an employee's actions and their ability to foresee any societal effects is absolutely essential.

Indeed, one completely accepts that compartmentalisation may well be an important aspect of the organisational structure in banks. To be precise the problem is not so much compartmentalisation itself, but rather its use as a vehicle to cause harm to consumers or commit unethical actions (and consequently damage public trust and investor confidence).

For example, following a huge fine the leadership team sends a 'message from the top' for employees to behave more responsibly, and as a sign of sincerity increases the number of staff in risk and compliance. In theory, this message should flow through all links in the organisational chain. The danger, however, with compartmentalisation is that especially in the "'difficult' grey areas"7 of compliance (where law and morality can be quite different): the employee focused purely on their specific job function with a disconnect to the end-user, may plausibly disregard this message to pursue 'legal' profits over morality. And, when banks operate on the basis of profits over morality, even if only in the grey areas, someone will always suffer the consequences and trust issues emerge. That someone is likely the end-user consumer. A few months later, in spite of any moral protestations from the leadership team, that same bank may find itself subject to regulatory investigations for similar misconduct.

3. Removing the public veil

Hitherto, no financial regulator has published a readily accessible, comprehensive list of the conduct costs incurred by banks in their respective jurisdictions. In this instance, the information available to the public - the 'public veil' - from regulators is disappointing. The Conduct Costs Project has fortunately removed this public veil and facilitated a public debate on the topic. However, we cannot be complacent: many other veils must be removed to restore public trust in the banking sector. Petitions for secrecy, public interest, accountability, and materiality come to the fore when we seek to remove these veils.

As a relatively straightforward illustration, let us analyse the newly announced £38 million fine imposed on Barclays for failing to keep clients' money separate from its own.8 The *Financial Times* reports the following:9

[7] Roger McCormick and Chris Stears "Banks pay a heavy price for the crisis, but fail to count the cost" (September 17, 2014). Accessed online: http://theconversation.com/banks-pay-a-heavy-price-for-the-crisis-but-fail-to-count-the-cost-31151

[8] Martin Arnold and Sam Fleming "Barclays faces record £38m fine over client money safeguards" (September 22, 2014). Accessed online: http://www.ft.com/intl/cms/s/0/6e0e88ea-4288-11e4-847d-00144feabdc0.html#axzz3EDGRjK00

[9] Ibid.

i. The fine is said to be a record for this type of misconduct.
ii. As a comparison, it is stated that JP Morgan received a £33 million fine in 2010 for similar misconduct.
iii. Although the sums involved in the Barclays investigation are lower than that at JP Morgan, the bigger fine purportedly signifies the "FCA's determination to punish recidivism as well as the overall increase in the size of penalties".
iv. According to sources, there has been a debate between Barclays and the FCA as to if in fact the intermingled client money was ever at risk or if it would have only resulted in a time delay to untangle it from the bank's own funds if it went bust.
v. Barclays are understood to have been given a 30 per cent discount for co-operating with the FCA's investigation.

Based on the above public veils, one could ask the following questions:

i. We are not told how the exact amount of £38 million was reached. Does the fine match the level of misconduct?
ii. Why have the overall size of penalties risen? Are regulators seeking to punish banks more?
iii. Should Barclays be given a record fine for this type of misconduct if there is the possibility that the intermingled client money would have merely resulted in a time delay to untangle it?
iv. To what degree must one 'co-operate' to receive a discount? How is the 30 per cent discount justified - why not 10 or 20 per cent?
v. How will the fine money be distributed by the FCA upon payment?

To be sure, some veils are important to have. That said, issues arise when veils are used to mask political pressures or nationalistic regulatory agendas. A greater public understanding of the financial system and how it is regulated, would go a long way towards restoring trust.

As an aside, public veils also reinforce the cycle of compartmentalisation as there is less accountability. Rarely, it seems will the names of employees involved in a banking scandal be disclosed and this lessens the motivation of these employees to foster a sense of the systemic.

4. Conclusion

For this new financial order to have a sustainable future, trust must feature prominently. Some are hopeful that banks can regain the public's trust, whilst others do not share this optimism. Equally, some are convinced that ethics, the 'right' culture and professionalism is the way forward. By contrast, others see these things as a thin veneer of contrived niceties in an otherwise for-profit sector. With these varying perspectives, what school of thought should we follow? The truth is we do need a safer (and sustainable) financial system. The Crisis has resoundingly demonstrated that the profit-maximisation ideology of the past does not hold a promising future for the banking sector or public. The changing regulatory approach and exceptionally high levels of conduct costs all point towards the radical measures presently taking place in the banking sector. We have the opportunity to build a new financial order founded on trust by re-evaluating how we practice compartmentalisation in our job functions and removing unnecessary public veils - let's embrace it.

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