The Mais Lecture

Restoring Trust in the Banking System

Cass Business School

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It is a great honour to be invited to deliver the Mais Lecture this year, the 38th occasion on which it has been given. It is also a particular personal pleasure.

I was appointed to the Chair in Banking and International Finance at The City University in 1976. The funds for the chair had been raised by a previous Lord Mayor, Lord Mais and so out of recognition for his contribution I felt it appropriate that we establish a lecture in his honour. Hence the Mais Lecture.

The first Mais lecture was given in 1978 by Sir Gordon Richardson, the then Governor of the Bank of England, who told me that it was the first time a Governor of the Bank of England had set out in detail the design and implementation of UK monetary policy. The event was a huge success and the text of the lecture was reproduced in full the following day in The Times newspaper. (The lecture has subsequently been given by central bank governors, finance ministers, prime ministers, a French president, a journalist, a chief rabbi and a number of distinguished academic economists including Frederich von Hayek and Lord Robbins. This year I'm afraid you come down to earth!)

The subject I have chosen for this lecture is restoring trust in the banking system and by the banking system I mean central banks, bank regulators and commercial banks. I should make it very clear that this lecture is my own personal view and not that of Goldman Sachs, though I acknowledge a great debt to my colleagues at the firm for their valuable insights.

Since the financial crisis began in 2007 the reputation of the City, and trust in the banking system, have never been more challenged. The UK Parliamentary Commission on Banking Standards described the crisis as "a collapse of trust on an industrial scale." (Paul Tucker, A deputy governor of the Bank of England has described (with hindsight) the associated failure of regulation as "shocking, astonishing…catastrophic" which "left the credibility of financial regulation in tatters!"(Paul Tucker, Brookings Institution, Regulatory Reform, Stability & Central Banking, January 2014)). A review of what went wrong in one major UK commercial bank concluded that trust in commercial banks had been “decimated” by the crisis.

(The pre-crisis factors which led to this loss of trust have been well documented in books and research papers and commented on in plays, novels, films and the news media by academics, journalists, novelists, playwrights and filmmakers.) Since the crisis each of the countries involved has undertaken a sweeping review of its regulatory structures, resulting in the creation of new institutions (the PRA and FCA in the UK), new regulations (covering capital, liquidity, compensation, resolution planning, governance and conduct) and more comprehensive and intensive supervision (UK Senior Managers Regime). Internationally, countries have worked together through the G-20 Financial Stability Board to facilitate harmonization and cross border regulation.

Yet ten years later and after this immense effort, trust remains low. Only 20% of the UK population think banks are well-managed, down from 80% in the 1980’s. ((In a recent survey in Germany only 26% of the population expressed confidence in the banking system)). The independence of central banks has been challenged in the US, the Eurozone, Japan and the UK. The view of the new regulatory structures by academics and commentators is ‘could do better’.

(One respected commentator concluded a recent piece on the UK claiming “the haze of mistrust continues to hang over the whole City”, (Juliet-Samuels, D-T, 7th April 2017), while in the US context another remarked that “the world has not come to terms with the crisis of 2008. Justice has not been seen to be done. Remedies to prevent a repeat have not been seen to be applied. Dodd-Frank has failed to instill confidence.” (John Authers, F.T., April 15th 2017))

If a modern advanced economy is to function effectively it needs a sophisticated financial system which is trusted by the public. They must believe that it benefits society as a whole, and not just bankers. They must believe that the services sold by banks are appropriate to their needs and competitively priced. They must have faith in the competence and integrity of bank leadership, and respect for banks’ corporate cultures. The financial system must be seen as making a contribution to society, not being an island within it.

Against this background I wish to explore three challenges which I believe must be met if trust is to be restored and maintained in the banking system.

Preserving Central Bank Independence

The first challenge we face is preserving the independence of central banks from political control.

This independence has only been recently won. The independence movement began in the late 1990s with the central banks of England (1997), Japan (1997) and then Sweden (1999), along with the ECB (1999). It was a response to the Great Inflation of the 1970's and the accompanying stagflation of low growth and rising unemployment. Central bank independence cannot be taken for granted. We forget the 1970's too easily. In 1974 inflation in the UK averaged a staggering 27%. For short-term political reasons, control of the money supply was neglected and replaced by control of the price of credit (the interest rate) and direct controls on credit allocation to certain sectors of the economy (such as real estate and housing).

The reason the independence of central banks is important is that they alone among all the economic institutions in our society have the ability to provide stable prices. Price stability is important because it is a foundation for an efficient functioning market economy and a pre-requisite for confidence, growth and prosperity. Stable prices enable market participants to have confidence in the value of the money they use for exchange, its future value as an asset and its dependability as a unit of account.

Stable prices in turn depend on central banks setting appropriate short term interest rates to control the money stock. Any politician making such a decision will at some point succumb to short term political pressures. That is the day-to-day reality of politics in a modern democracy. But it will inevitably mean a loss of focus by politicians on maintaining medium term price stability. Independent central banks are therefore uniquely the guardians of stable prices in a democracy.

Deflation can be as serious as inflation. After the financial crisis it was this independence, along with transparency and accountability, which enabled the major central banks to confront the threat of falling prices and enable the global economy to return to a path of recovery.

Despite this success, the value of central bank independence has recently been questioned.

The Bank of England is facing political criticism for its continued policy of Quantitative Easing. After nine years it is judged as counterproductive in stimulating investment, and a cause of growing inequality by helping those on the property ladder at the expense of those who cannot afford to buy their own home. If continued it is judged a threat to its independence. (WM Hague, Daily Telegraph 18th October 2016).

In Germany a group of economists and entrepreneurs has challenged the legitimacy of the purchase of sovereign and corporate bonds by the Bundesbank, on behalf of the European Central Bank (ECB), on the ground that it crosses the line between monetary and fiscal policy and unduly burdens the ECB with troubled government debt.

In the US the vice-chairman of the Financial Services Committee of the House of Representatives (Patrick McHenry) in a letter to the chair of the Federal Reserve (Yellen) stated that it was unacceptable for the Fed to continue negotiating financial stability rules “among global bureaucrats in foreign lands, without transparency, accountability or the authority to do so.”

These could perhaps be dismissed as the views of politicians and commentators. More difficult to dismiss however are the considered judgments of former central bank governors who are respected academic economists such as Mervyn King and Otmar Issing and the views of the central banker’s bank, the Bank for International Settlements.

In its 2016 Annual Report the BIS stated that “the extraordinary burden placed on central banking since the crisis is generating strains. During the Great

Moderation, markets and the public at large came to see central banks as all-powerful. Post-crisis, they have come to expect the central banks to manage the economy, restore full employment, ensure strong growth, preserve price stability and foolproof the financial system. But in fact this is a tall order on which the central bank alone cannot deliver. The extraordinary measures taken to stimulate the global economy have sometimes tested the boundaries of the institution. As a consequence risks to its reputation, perceived legitimacy and independence have been rising" (P 22).

Facing up to these risks poses difficult as well as controversial challenges.

The most fruitful starting point I believe is to recognize that the world in which we live is best characterized by Frank Knight's concept of *true uncertainty,* or Mervyn King's *radical uncertainty,* rather than a world of risk, in which the outcomes of alternative decisions can be measured in a probalistic sense. In a world of radical uncertainty we simply do not know what the future will hold. We do not know with any precision the connections between banks and financial markets. Similarly we have limited knowledge of the connections between the financial sector and the real sector of the economy. Forecasting is an inherently complex business with great limitations. (Because we live in a world of true uncertainty, we then shroud our ignorance by resort to expressions such as animal spirits, irrational exuberance and hubris to explain economic behavior.)

It is important to emphasize that it is because of the success of central banks that parliaments around the world have given them increasing mandates. In the UK the Bank of England's responsibilities now cover price stability, financial stability, prudential regulation, fair and effective markets as well as cyber security, fin tech and Brexit as they affect the banking system.

However these increased mandates bring with them risks.

One risk derives from the central banks' responsibilities for delivering financial stability. To start with there is a serious debate to define what it means. Presumably it includes preventing future asset price bubbles and financial crises. However a failure to prevent a future crisis (and as sure as night follows day there will be future crises) will be perceived as a failure in judgment and execution by the central bank, which could easily undermine confidence in its ability to achieve its monetary policy objective.

Another risk is that the central bank will be perceived as designing policies impacting the distribution of income and wealth and which should properly be the preserve of elected politicians. Simply because of the need to set interest rates central banks will have an impact on the distribution of income and wealth. Over the cycle rates will rise at times and fall at other times. However a general consensus has been established that such a result is acceptable in order to achieve price stability. However targeting financial stability with direct controls (such as loan to income ratios for residential mortgages) and indirect controls (such as setting the minimum capital required to make loans to certain sectors of the economy) will lead to winners and losers, so making central banks open to the criticism that the implementation of these policies should be taken by politicians rather than unelected officials.

A further risk arises from the fact that sometimes monetary policy has been used as a cover for what is in reality fiscal policy. One example of this was the proposal by the European Central Bank (ECB) to engage in outright monetary transactions (to do "whatever it takes") by purchasing the government bonds of countries that have not pursued prudent fiscal policies in order to keep down their cost of borrowing. Such a policy is effectively a fiscal transfer from countries that have run their public finances well to those that have not and for some this was a clear violation of the no-bail out clause of the European Treaty. The independence of the ECB has been further questioned by its participation in the design of bail out programmes along with the IMF and the European Commission.

In the light of these risks to the reputation, legitimacy and independence facing central banks, the question arises "Have central banks been overburdened by the increased mandates they now have and has it created exaggerated expectations of what they can deliver?"

This is a serious and difficult question because while central banks must be independent of political control they cannot be totally isolated from political environment they operate.

For this to be addressed I believe there needs to be greater realism and public acknowledgement about what central banks can and cannot achieve. In this regard I am always inspired in reading Otmar Issing's work by the emphasis he places on the need for humility on the part of central banks, simply because to reduce the behavior of a modern economy with a complex financial system operating in a global environment to a set of equations is exceedingly difficult if not possible. In addition it is important that there is clarity regarding the responsibilities of central banks and those of other economic policy makers.

When the Financial Policy Committee was first set up the statement made by the then Chancellor of the Exchequer was that the Bank "will have the tools and the responsibility to look across the economy at the macro issues that may threaten economic and financial stability and take effective action in response" (George Osborne, Mansion House speech, June 2010). This is a very broad remit indeed which in my judgment blurs the line between monetary policy, fiscal policy and structural policies and ultimately poses a risk to central bank independence.

As a result I believe there is a strong case for requiring the central bank to give priority to what only it can do; namely setting a medium term numerical target for inflation. This will come to be seen as the expected rate of inflation, and have credibility because of the central banks ability to control money supply growth. In the short term, in a world of radical uncertainty, there will be deviations in prices and output from their medium term path. Because of this central banks should have discretion over the period of adjustment in returning to the medium term target. And in all of this they should of course be held accountable for and transparent in their actions.

Regulation in a World of Radical Uncertainty

I now turn to the second aspect of restoring trust namely through ensuring that regulation can be effective in a world of radical uncertainty.

The years since the financial crisis have seen an immense increase in the extent, detail, complexity, cost and supervision of bank regulation. In the UK, the US, the EU, Japan and other G20 countries the pendulum of regulation has been allowed to swing as far as necessary so as to give the public a firm assurance that taxpayers would not have to pick up the bill for bank failures, in a future crisis.

After the last crisis regulators around the world effectively sat down with a clean sheet of paper and set about a root and branch reform of the system. A number of academic economists and commentators advocated the most radical structural change, namely ending the fractional reserve system of banking and requiring banks to hold 100% of their assets in liquid form. (This proposal was originally put forward in 1933 in the US following the financial crisis of the early 1930's. It was known as the Chicago Plan after its author Henry Simons who was a professor of economics at the University of Chicago.) and has subsequently been supported by some of the leading names in the economics profession including Frank Knight, Irving Fisher, Milton Friedman and James Tobin.

Their argument was that because money is a public good which is vital for the efficiency and stability of a market economy, it is important to separate the creation of money from the creation of private sector credit. Narrow banks would have their deposits matched by 100% liquid assets which would consist of deposits at the central bank and government securities. Providing the public have confidence in governments to fund future expenditures, there would never in future be a reason to have a run on banks. As Irving Fisher put it, "nationalize money but do not nationalize banking".

However following the 2008 crisis this approach was considered a bridge too far.

One reason was the disruption which such a huge change would entail as banks reorganized their activities into 'narrow' banks, backed only by approved liquid assets, and 'wide' banks which could perform activities such as corporate lending. In addition a rigid separation might well hinder beneficial innovation, including more flexible forms of borrowing or lending. Such a change would also transfer risks to non-bank financial intermediaries, with the prospect that the cost of capital of investing in real assets such as plant, machinery and houses would rise.

At the same time governments recognized that *in extremis* they have an ultimate responsibility to provide catastrophic insurance to support the financial system. Although a 100% reserve banking system would prevent a run on banks, if there was a shock to the economy resulting in a sharp and significant reduction in total spending, central banks and governments might still have to step in and rescue ‘wide’ banks, rather than let households and firms bear the cost of significant falls in asset prices, including those of houses.

One result of the pragmatic and piecemeal approach which governments and central banks have taken is that the banking system is far more robust today than it was in 2008. Retail depositors are ring-fenced from the complex risks undertaken by investment banks and the payments system is more stable. Banks are better capitalized, have limited leverage, and hold far more liquid assets than before. Investors are better informed about the potential risks of investing in banks. New compensation structures for bank executives reward longer-term performance and discourage short-term risk-taking, with increasing use of deferred stock awards and claw back provisions instead of cash bonuses. Resolution planning (special bankruptcy procedures) allows banks in financial difficulties to sort out their problems without disrupting their basic services to clients: in other words banks can fail but without systemic repercussions. Finally, the UK Senior Manager’s Regime holds specific senior individuals personally and directly accountable for their actions, with reckless mismanagement of a bank a criminal offence subject to a maximum of seven years in prison and a fine.

These are significant achievements which deserve to be recognized.

However despite these achievements the new regulatory structure has come in for significant criticisms.

One is the charge of complexity.

International prudential agreement among banks first started with the Basel Accord of 1988, a 30 page document. Basel II in 2004 was 347 pages. By 2010, Basel III reached 616 pages! In the US the Glass-Steagall Act of 1933 ran to 37 pages, whereas the Dodd-Frank Act of 2010 runs to 2,300 pages, not to mention the growing thousands of pages covering detailed supporting rules.

Bank capital requirements account for much of this paperwork. UK banks must hold a variety of different types of capital in proportion to their risk weighted assets including: (common Tier 1 equity, additional Tier 1 equity including perpetual subordinated debt instruments, a capital conservation buffer, an additional equity buffer for internationally systemic banks, risk-specific equity, a PRA buffer and a time-varying counter cyclical capital buffer. Banks are also required to issue bail-in bonds which convert debt to equity upon certain trigger events.) The measure of "risk weighted assets" which regulators use to calculate the ratios is subjective, complex to determine and can change significantly and quickly in a crisis. Banks are additionally subject to stress testing, which is highly subjective, but whose results will inform regulators in setting certain of these buffers. Equally complex calculations and reporting requirements apply to holdings of liquid assets, the structure of compensation and resolution and recovery planning.

A second criticism of the current regulatory system is the increased deadweight cost to society of the new regulation. In advanced countries regulatory bodies employ significant numbers of employees and consultants. In 1980 there was one regulator for every 11,000 people employed in the UK financial sector; by 2011 there was one regulator for every 300 people employed. This pattern is repeated in the regulatory reporting, compliance and internal audit departments of regulated firms. At my own bank we have one compliance officer for every 30 bank employees - which is not unusual for major banks. When added together the number of people engaged in regulation runs to several hundred thousand.

A further criticism of the increased regulation is that it undermines trust and moral responsibility. Under the present system the primary duty for risk managers is making sure that certain numerical targets are met. "Does this undermine a sense of personal responsibility and ownership?" Instead of bankers being held accountable for determining appropriate amounts of capital and liquidity which in reality are unique to the risks and nature of each business, detailed regulatory prescriptions can become a prop on which they can lean. John Kay has stated the problem succinctly "Regulation based on detailed prescriptive rules has undermined rather than enhanced ethical standards, by substituting compliance for values." (Kay, J *Other People's Money* P273, Profile Books 2015).

A fourth and perhaps the most important of all of the criticisms of the present system is that it fails to address the challenges to bank regulation of an economy characterized by radical uncertainty. In a world of radical uncertainty it is not possible for regulators to determine the appropriate amount of capital or liquid assets that individual banks should hold. What might seem the right amount at one time can easily change to be inappropriate in a relatively short period of time. As a result banks should be made to think much more deeply about the way they deal with uncertainty in order to improve their management of risk.

The most comprehensive and innovative approach to reducing the complexity of current bank regulation is I believe that outlined by Mervyn King in his book, '*The End of Alchemy'* and consists of a number of elements.

First a maximum leverage ratio, i.e. the ratio of total assets to total equity. Second a liquidity rule that 'effective' liquid assets should exceed effective liquid liabilities, (where effective liquid assets are holdings of bank reserves at the central bank and a collection of pre-selected short term securities which could be used, subject to a haircut agreed in advance, as collateral on which the central bank would advance funds to the bank in the event of a run on deposits: This is the central bank acting as Pawnbroker for All Seasons rather than as Lender of Last Resort (LOLR)). Third that the scheme should be implemented gradually over a period of ten to twenty years. Fourth, during the transition period existing prudential regulation and ring fencing restrictions imposed in recent regulation should be retained. Finally, the scheme should apply to all financial intermediaries, banks and shadow banks which issue unsecured debt with a maturity of less than one year (above a *de minimus* proportion of the balance sheet, which is an arbitrary figure and open to debate).

The benefits of this system are that it would drastically simplify regulation. Complexity would be replaced by two rules: a minimum leverage ratio and a liquidity requirement. It would dispose of detailed capital and liquidity rules and the challenge of defining what constitutes risk weighted assets. It would be introduced over a decade or two. It avoids banks having to make a choice of being either a narrow or wide bank and it enables competition among banks but at the same time limits private credit creation. (Central banks would still have to make discretionary judgments over the leverage ratio and the assets which banks could hold as collateral and the haircuts which would be attached to them).

To sum up on regulation. The architecture of bank regulation which has been built up since the crisis has resulted in a better capitalized, more liquid, more long term focused and more resolvable banking system. This is no mean achievement. As a protection for tax payers facing a future financial crisis it is a distinct improvement on regulation pre-2007. However it suffers from excessive complexity and deadweight cost, and stresses managing risk to regulatory standards rather than intrinsic risk. For the longer term the challenge is to move to a system which reduces complexity and cost and is fit for purpose in a world of radical uncertainty. And so far and by far the most promising alternative is the proposal of Mervyn King.

Restoring Trust in Banks

Having considered the independence of central banks and the regulatory structure in which they operate I would now like to turn to the steps necessary to restore trust in commercial and investment banks.

First, the public must be convinced that the remorse expressed by banks regarding past failures is genuine and that they are sincere in wanting to reform.

One evidence of banks commitment is the time and resources they have devoted to strengthening their processes of control. Most if not all bank management of systemically important institutions have undertaken comprehensive reviews of their business, followed by reforms, which have then been fed back into training programmes. The compliance and internal audit functions have conducted meticulous reviews of failures in their own institutions and of the lessons which can be learnt from publicly reported failures in others.

The numerous and sizeable fines imposed on banks in recent years has regrettably only served to reinforce the perception of a lack of remorse. Some fines relate to legacy issues which go back many years. Others which relate to more recent violations in the Libor and FX markets and anti-money laundering only increase the challenge banks have in convincing the public of their commitment to change. Until however the public sees results from bank reforms - such as an extended period of time with few if any major regulatory problems, the public will remain sceptical.

Next in order to restore trust the public must be convinced that what banks do is of value to society and not just themselves and their shareholders. The social value of retail banks is readily understood by the public through ATM machines, debit and credit cards, cheque books, on-line banking, loans and mortgages. By contrast the social value of investment banks is not well understood. Their clients are not the general public. Their financial products and services are complex. (The clients of investment banks are other banks, asset managers, large public and private companies, governments and public sector bodies but not the general public. Many of the products and services the investment banks provide, such as interest-rate derivatives, credit default swaps and structured finance are complex, involving private, innovative and highly specialized markets of which most people have no understanding at all.) However, these banks are of value to society because they raise funding for companies and governments and allocate capital to its most productive uses either through lending directly or through the capital markets in which risk is competitively priced.

A third step in restoring trust in banks is that if banks are to be trusted they themselves must demonstrate that they are trustworthy institutions. Trustworthiness has a number of elements. One is competence. Basic to competence are the skills, knowledge and experience of those working in banks to undertake the business. Along with competence, consistency in delivering a first class service is important. Competence and consistency together mean that banks can be considered reliable in the services they provide and the transactions they execute for clients. In providing these services they will incur certain obligations to clients, which they and their clients need to be clear about, and when necessary fully documented. Both individuals and the institutions for which they work must accept accountability for their performance.

For banks to be trusted, bank culture is important. We know that poor cultures have resulted in large fines.

James Heskett, Professor Emeritus at Harvard Business School spent more than four decades, researching the relationship between business culture and business performance both in the field and through case studies. On the basis of his research he claims that an effective culture can explain as much as half of the difference in operating profit between companies in the same business sector. By an effective culture, he means one that unifies those who work in a bank in achieving its goals, whilst promoting a supportive work environment. The reason the relationship is not simple is that the strength of a culture by itself is not enough to guarantee improved performance. It must be accompanied by effective leadership, an openness to adapt to change and new ideas, continuous quality improvement and by benchmarking the company against the world's best.

When these are present a strong culture has maximum impact. An effective culture can be a source of competitive advantage because of higher job satisfaction, higher retention rates of staff, a reduction in hiring costs due to employee referrals, employee ownership, increased productivity and improved relationships with customers.

Culture is important for reasons other than performance. A good corporate culture is a good in itself. The culture of any business is an expression of the purpose of the organization. A business is a community of people who need to feel that what they do day after day serves a greater purpose. People come to work not just to earn money. They want to believe that what they do matters, that it is valued by society and that the organization for which they work is a force for good in the world. People take pride in their work. They need to feel that the services they offer have a quality tag attached to them. They need to feel at home in the institution in which they work. They expect that throughout their career it will help them develop as persons. Effective cultures create great places in which to work. They want the bank for which they work to be regarded as more than a profitable money machine.

If an organization is to serve a greater purpose it is not enough simply to maximize profit within the law. Client's interests must come first, relevant information must be disclosed, conflicts of interest must be managed and the commercial activities of the bank must be seen as contributing to society. Because of this, when discussing a piece of potential business, bankers must ask themselves key questions. Is this piece of business legal? Is it commercial? But also is it the right thing to do? Put differently, not only can we do this piece of business? But also, should we do this piece of business?

(In the years leading to the crisis banks recognized the importance of culture in their organizations. All major banks, including those which failed and those which were subsequently rescued, already had comprehensive statements of business principles: “the highest personal standards of integrity at all levels”, “complying with the spirit and the letter of the laws and regulations,” “trusted-acting with the highest integrity to retain the trust of customers, external shareholders and colleagues”, “to be a great place for our customers to do business”, “we regard every day as a new chance to earn your trust. It demands hard work, integrity and transparency, but that’s what we do”.)

(These statements were held out as being the moral compass set by bank executives to guide them in making business decisions. They were the ideals banks set for themselves and the culture of their organizations. They were as far removed from a ‘cesspit’, “casino” or even ‘vampire squid’ as it was possible to be. As a result bank customers and the public came to expect certain standards of banks; competence, prudence, integrity, responsibility. One reason the public have become so disillusioned and angry is their perception that the moral compass they were led to believe guided senior management was in fact broken.

Prudence, competence and integrity had given way to recklessness, greed and dishonesty.)

Business principles are the standard to which a bank aspires. A culture is what happens in practice. It is the way a bank does business day by day. What the financial crisis exposed was a glaring divide in some banks between high ideals and daily practice. In the euphoria of the boom years, the principles and values which bank leadership publicly espoused, were not sufficiently robust to prevent bank management sailing too close to the wind and ultimately out of control. In the build-up to the crisis bad decisions and poor judgments resulted from bank cultures in which the pursuit of profit and personal reward became too dominant. Sadly we have seen more examples in recent years.

Building a culture, maintaining a culture and changing a culture are far from easy. All take time and need to be attended to each day in countless small decisions. There are no easy levers to pull but the decisions management must take day in day out, week in week out, month in month out, will in time serve to either strengthen a culture or undermine it.

One area which is important is recruitment, especially recruitment from other financial institutions and businesses. Competence, credibility, commitment, the ability to work in a team and the ambition to do well are important: but the ability to earn revenue should never be at the cost of the character of those hired.

Criteria for promotion are similarly important. A person who is promoted because of the business he or she has built but who lacks integrity will diminish a culture. By integrity I mean being totally open and honest about business selection, the state of the books, valuation procedures, resolution of conflicts of interest, respect for compliance issues, commitment to developing people and concern to ensure that the values enshrined by the company are lived out day by day.

Along with recruitment and promotion another important area is compensation. If compensation is primarily based on earned revenue, regardless of the way executives behave, this will be the strongest possible signal to employees of the real values of the company. Compensation must take into account less tangible qualities, such as reinforcing the culture of the firm and the development of people. In the case of wrongdoing compensation must be impacted. (Individuals must be reprimanded, and deductions made in their compensation with the most serious issues requiring the most difficult decision, namely dismissal.) At the same time, good conduct judged by people being role models for the values of the institution and taking ownership for the development of those who report to them should also be rewarded.

In all areas training is important. It is key to ensuring that the values of the business are understood by everyone involved and the ways in which they are critical to its success. Training must not be sterile recitations of rules and regulations, but embody real life examples from which employees can draw, in thinking how to act in their day-to-day jobs.

(Before we move on from the subject of culture we should recognize that the culture of an individual institution cannot be easily separated from the more general culture in which it is embedded. As traditional banking has become far more competitive and integrated with securities so it has brought with it a different culture emphasizing trading and risk taking. In the 1970’s Daniel Bell who was a professor of sociology at Harvard wrote about the cultural contradictions of capitalism, namely the change which has occurred from a bourgeois matter of fact world view based on rationalism, functionality and optimism to one of unfettered freedom, hedonism and boundless experimentation. Gordon Gekko celebrating the virtues of greed in the film *Wall Street* is about as far removed from the asceticism of Richard Baxter quoted in Max Weber's *The Protestant Ethic and the Spirit of Capitalism* as one could imagine. A contrast which has only become more marked through the growth of social media and the technology revolution.)

Culture and Leadership

In creating, sustaining and, if necessary, changing a culture the role of leadership is crucial. Leadership has the responsibility to articulate the values of a bank. Leadership is about setting out a vision and inspiring the staff. It is about defining the purpose of the business, the standards which are expected, and setting the right example. Leaders are the trustees of the values of a company. Leaders must establish the values, communicate the values, take ownership of the values and then -- most crucially -- live the values.

Perhaps the most important element of the culture of any financial institution is the tone from the top. People in an organization will judge how serious leadership is about its culture not by what leaders say but the decisions they take. Who in the business do they reward? And for what? Who do they promote? Would they remove senior executives whom they knew were damaging the business by behaving inappropriately? Most important of all, do they themselves practice what they preach? One of the founders of a US company quoted on the NYSE ServiceMaster, on whose board I sat for fifteen years, was known for his remark, "if you don't live it, you don't believe it."

Leaders have a responsibility to ensure that the tone from the top reaches down to all levels of the organization especially the middle area which a former regulator described as the "permafrost" within an organization. (A recent survey of over 28,000 individuals working in banks and building societies across the UK conducted by the Banking Standards Board found that only 65% of employees agreed with the statement that there was no conflict between their firms stated values and the way the firm did business.)

Leadership within a bank exists at all levels so that it includes not just the CEO and senior management. This means that leaders at all levels throughout the organization must own the values, communicate the values and most important of all live out the values.

Crucial to the tone from the top is the role of the board. One of the key responsibilities of boards is their role as trustees of the culture of the organization. This involves supporting management in its efforts to build the right culture. It also involves when necessary challenging management. A banks culture is not easy to assess and many boards do not have a structured process for reviewing a firm's culture in the way they do for risk, audit, governance, nominations and compensation. It is a current challenge many banks are grappling with. For banks the issue is how to recruit, promote and nurture first class, competent leadership which recognize the importance of character and values as essential to implementing business principles.

Performance and Character

In this lecture I have sought to argue that restoring trust in the banking system depends on maintaining the independence of central banks from political control with the overriding priority to maintain a low and stable rate of inflation; the importance of regulation for the banking sector but also ways it might be reformed to reduce complexity, cost and managing in order just to meet numerical targets; and within banks the need to set out the purpose of the institution, its business principles, the obligations which doing business entails and the role of leadership in establishing and maintaining an effective culture. Key to this is the personal responsibility of each individual working in the bank which is built ultimately on character and values.

In view of this let me conclude with a personal story. Some years ago I gave a lecture at Claremont College, California on "The Business of Values" to which Peter Drucker gave a response. He described my lecture as the case for business as ethics in action. He stressed that the values of a business are a commitment to action not preachments which are at best only good intentions. The most decisive, unambiguous and visible actions he suggested were those regarding people. Regardless of what the CEO may say in his speech at the annual meeting, what he does in rewarding, placing or punishing people are the values the whole organization sees and takes seriously. He then concluded with a personal story.

“Many, many years ago, at the very beginning of my working life, I had the good fortune to work for a short year for a man of rare integrity and great wisdom. I had tremendous respect for him; and so I was quite shocked when he did not promote an older colleague – let’s call him Tom – who had clearly done an outstanding job. I was so troubled that I took my courage in my hands and went and asked the boss why he had so pointedly passed over our department’s top performer. He looked at me with a smile and said “I know you are too young to have a son but I understand you have a younger brother.” Yes I did. “Would you”, he then asked, “want to have this younger brother work for two or three years under Tom and try to become like Tom? You are right” he continued, “Tom has the performance; but does he have the character?”

It is when an organization asks this question and takes it seriously that its values become action”.

Total Word Count: 6980