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Virtuous Banking

Placing ethos and purpose at the heart of finance

David T. Llewellyn, Roger Steare, Jessica Trevellick

Edited by Adam Wildman

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About the Authors

Professor David T. Llewellyn is a Professor of Money and Banking at Loughborough University, and is also currently Chairman of the Board of the Banking Stakeholder Group at the European Banking Authority (EBA). He has published widely in the area of financial regulation, acted as a consultant to regulatory agencies in several countries and was a Public Interest Director of the Personal Investment Authority.

Professor Roger Steare is Corporate Philosopher in Residence and Professor of Organizational Ethics at the Cass Business School, City University. Roger is a leading thinker and practitioner in the development and delivery of moral leadership, governance, culture and ethics programmes for organizations such as BP, Citigroup and PwC. Roger is also the author of ethicability: How to decide what's right and find the courage to do it.

Jessica Trevellick is a Senior Researcher at ResPublica. Jessica began her career at Santander where she held positions in retail banking and asset management. She then moved to the Financial Services Authority and has worked in regulation ever since. She is interested in issues around encouraging financial planning for the future and the role of the new 'twin peaks' regulatory regime in protecting financial stability and consumer rights.

Adam Wildman is a Research Manager at ResPublica. He co-ordinates ResPublica's research output through the three core workstreams, and is currently focused on ways in which to create moral markets, engender ethical corporate cultures and reform the banking sector. His previous work as looked at NHS reform, small business lending and ways in which to close the protection gap.

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Executive Summary

Now that we are nearly five years into this parliament, there is a tendency to presume that the task of banking reform is now done. But the job is probably best described as half complete. Despite ample reform, it is still the case that many of our small businesses lack the finance they need; customers are bereft of the advice and care they require in order to make sound financial choices; and consumer trust and confidence in the banking sector is at a new low. But why is it, after all this time, do we not have the banking sector we deserve?

It certainly cannot be from a lack of policy activity. Since the Coalition assumed the reins of power, we have had the Independent Commission on Banking Standards, the Financial Services Act 2012, the Financial Services (Banking Reform) Act 2013, numerous Government consultations and the Parliamentary Commission on Banking Standards. Yet none of these have significantly shifted public opinion, nor have they done much to improve the lot of hard-up businesses and consumers.

Throughout its programme for reform, the Government has largely focused on regulatory and prudential issues in the name of financial stability. While it cannot plausibly be argued that a systematically stable system is not to be desired, the current approach focuses far too much on this and ignores the crucial root cause of the banking crisis: a calamity that has its origins in the profligate and irresponsible actions of a significant number of bankers and banking institutions, urged on by a banking culture that was at its core fundamentally self-serving. There was on the part of organisations and people, a systemic disregard for the regulatory system, a belief that the pursuit of individual advantage would act for the advantage of all. The banking sector had, in short, lost its ethos. Instead of a culture that prioritised its own self-interest, it should look towards the fulfilment of a broader common good and its wider social purpose.

Given this root cause, it is our proposition that more of the same regulatory and prudential responses to the ongoing crisis in banking will do very little, if anything, to improve the underlying culture of British banking. In order to restore the wider good to its proper place at the heart of banking, we should at first explain what virtue as a goal and ethos as its practice mean.

Virtue as a moral theory goes back to Aristotle, and aims primarily at human flourishing. It does not assume that we are all the same and does not, because of this, advocate for the imposition of a unitary, rigid moral regime as most ethical systems do. It recognises that people's needs are different and, as a result, argues for the flourishing and fulfilment of people in all of their uniqueness.

It is this aspect that makes virtue theory potentially such a good resource for reforming the culture of the banking sector. It argues for the diverse needs of customers but makes a universal claim on the banking industry that means that it should endeavour to cater for all needs and not just for a few. In short virtue in banking is about purpose, it is about what banking is for and why it is needed. With banking, virtue theory allows us to argue for a greater economic and social purpose to banking than is currently postulated.

Character and its formation are crucial to any proper real world development of virtue theory. For character gives a person the strength and resilience to pursue purpose in spite of complexity and difficulty. To be of good character is to have absorbed moral teaching into ones daily habits and actions. Most ethical systems are formal and empty and they assume that merely following the rules will ensure a good outcome. But virtue theory is about content and the ability to understand the spirit not the letter of the law. Given the failure of rule following ethics as evinced by the crash and multiple scandals, bankers evidently and most obviously need to be of good character. Bankers need to know the good, do the good and be good.

Virtue allows us to reintroduce and restore the notion of good purpose. Banking must go beyond self-enrichment or basic transactional services. It not only performs a clear macro-economic function, it also has a key role in promoting prosperity and safeguarding the long-term financial interests of its customers. The abandonment of much traditional high street banking has left far too many people without the 'wrap around' advice and personal financial planning that they urgently need. This is in part why we save so little and take on so much debt.

So the notion of virtue is not a vague euphemism for carrying on as before – it is a call for the re-introduction of purpose into banking as both an economic need and a moral necessity. Ethos for us is the daily practice of inculcating that purpose into all of the industries' operations and behaviour. If we achieved that then we would change culture in the industry and re-create a sector that truly served the needs of society.

We argue that there are three key areas that policy makers must explore in order to recover virtue and ethos in the banking industry.

The first area to improve is the internal governance structures of the banks. This report argues that it is fundamental to the success of the banking industry that the leadership of banking institutions understand the key social purpose of banking. They must also promote, to the best of their ability, the underlying ethos that a bank needs in order to fulfil this social purpose. In addition to the actions of the banking leadership, all bank employees must, in order to ensure the right culture is inculcated throughout the firm, possess a sense of ownership by taking collective responsibility for their organisations conduct. Finally, beyond collective approaches, there must also be a high level of personal responsibility from all bankers, which should promoted by developing a better sense of professionalism and ethics within the banking industry.

The second area that is need of reform is competition. Various reforms have addressed this already, but for us, competition is about more than just market entry or regulation, as important as they are. Competition can only be considered to be truly effective if it is customer-led, and simple market concentration measures are not an accurate indication of this. Key to this approach is the strengthening of consumer rights, particularly for small businesses. Firms of this size suffer the same disadvantages as individual consumers, but are mostly exempt from much of current consumer legislation. This is an omission we would want to see corrected. Further, we would also like the bankers to adopt a better sense of care for their customers. In particular, we would want them to do more to help their customers plan their finances and offer more bespoke advice that meets their often complex needs.

Lastly, the banking sector must possess significant levels of diversity. This is not the same as competition, which is more about market power dynamics between firms and customers. Diversity is not only the total number of firms within any given sector, but how diverse the range of firms and business models. This is important because all consumers, especially banking customers, have a wide range of wants and requirements that need fulfilling from an equally diverse range of products and services. Such a situation cannot not be achieved by a homogenous banking industry made up of the same plc model. It instead requires the sector to be suitably diverse and varied. With this, this report maintains that the sector must possess a diversity of ownership and business models; a multiplicity of national and local banking institutions; and variety of high street and online platforms to choose from. All of these need to be pursued in order to reach the required levels of diversity.

In short, if we want to place ethos and virtue firmly at the heart of banking, policy makers will need to ensure that there are suitable internal checks on banking institutions through better governance, and that there are adequate external checks on banking behaviour through improved competition and diversity. The ten recommendations below outline how such a programme for reform could be pursed in the next parliament, regardless of which political party assumes power.

1. Define and enshrine an overarching purpose for banking: A criticism often levelled at the banks is that they either perform no clear social purpose or, if they do, this is often not reflected in the actions of bankers. This lack of purpose clearly permeates through banking institutions and does little good for the reputation of the industry. In light of this, and the need to solidify the industry around a clear social objective, we recommend that the new Banking Standards Review Council adopt the description of the purpose of banking we advocate in this report. We have based our description of the purpose of banking on three core principles that we believe the industry should always endeavour to adhere to: *Ensure systemic prudential security*; *work for the prosperity of customers*; *promote the responsible creation of value.*

Governance

2. Co-design codes of conduct to place customers at the heart of standards: Key to instilling the customer-centric culture that banks need are the thoughts and opinions of the customers that will ultimately be most affected by any changes to standards and behaviour. The views of the customer are completely vital to ensure that bankers act in accordance to the high standards members of the public require of them. As such, we recommend that the new Banking Standards Review Council, as one of its first actions, undertake a joint open public and industry consultation to create a Code of Conduct founded on the opinions and desires of all relevant stakeholders, with a prioritisation given to the views of the public.

3. Require all bankers to swear the Bankers' Oath: Consumer trust and confidence is at an all-time low. We believe that, if bankers were required to swear an oath akin to the Hippocratic Oath that doctors affirm, this would signal a serious commitment from bankers towards the pursuit of greater professionalism. In light of this, we recommend that the British Bankers' Association, the Building Societies Association and the new Banking Standards Review Council ask all of its members adopt the Banker's Oath as detailed in this report. Such a statement of intent from these three bodies would be a momentous event, and could prove the turning point for how the general public regard our banks.

4. Toughen shareholder fiduciary duties to promote activism: A key role of shareholders is to hold the banks they own to account. Yet, shareholder inactivism has been widely acknowledged as one of the key drivers for the last banking crisis. To answer this criticism, we recommend that the British Bankers' Association conduct a review of shareholder activities in our banks to determine the scale of this inactivism. We would also like to see recommendations that outline how shareholders could have a much more active role in the governance of our large banks. In particular, through improvements to current fiduciary duties that require shareholders to take a much more active role in the stewardship of banking institutions.

Competition

5. Encourage the banks to compete on customer satisfaction: A truly competitive market is one that competes, not just on price, but on other measures such as levels of customer satisfaction. In order to create a better functioning market, we recommend that the FCA require all large banks and building societies to display customer reviews and ratings on their websites and in their high street branches. The FCA should also display the performances of the leading banks in a league table format to both enlighten the customer and foster competition amongst the banks. The industry should look to the innovative rating systems that online retailers like Amazon and Ebay use as examples of how such a system might work.

6. Reclassify small businesses as consumers: Despite good progress being made in the field of individual consumer rights through the current Consumer Rights Bill, there still exists a lack of commensurate protection for small businesses. Given that small firms are likely to suffer the same disadvantages in terms of limited knowledge and access to professional financial advice as individual consumers, we recommend that the Government adopt a single definition of the term 'consumer' that incorporates small firms in future consumer protection regimes. Secondly, we also recommend that the ceiling for Financial Ombudsman Service eligibility be raised to include not just 'micro' businesses, but those that are considered 'small' enterprises. Raising the ceiling in this way would significantly extend the ambit of this vital body to include thousands of struggling small businesses.

7. Launch a competition to kick-start the online advice market: A lack of affordable and sound advice from the banks is an ongoing concern for regulators, and perhaps indicates a failure in their duty of care. Given the ongoing trend in branch closures, the only viable option for providing this advice lies in better online advice. As such, we recommend that the industry run a high level competition amongst the largest banking providers, in conjunction with leading technology firms such as Google and Microsoft, to develop a tool for online advice that empowers their customers to make sound financial decisions. The winning entry should then be actively promoted by Government through the Money Advice Service to maximise the impact of such a tool.

Diversity

8. Conduct an immediate review into the diversity of UK banking: Too little attention has been given to the contribution diversity makes to the stability of the banking sector. Given the numerous benefits of having a more diverse banking sector, we recommend that the Prudential Regulation Authority immediately conduct a review of the current state of financial diversity in the banking sector. As part of this, and given a lack of good existing data, we recommend that the Government and research bodies also endeavour to improve the quality of data and research available for the assessment of diversity in British banking. This is to ensure that this key component of a healthy banking sector can be sufficiently recognised and monitored by regulators and the academic community.

9. Localise the British Business Bank through LEPs: Given the potential benefits that a local banking network could bring to the British economy, we would recommend that the Government build on the formation of the British Business Bank (BBB) to assess how this organisation could be 'localised'. One possible means of achieving this could be through transforming Local Enterprise Partnerships into local 'branches' of the BBB. These would offer BBB products and funded advice similar to a high street bank. Such a move could give England the national tier of local banking that it currently lacks and which most of our European competitors possess.

10. Utilise public funds to boost the digital finance market: Innovative online digital finance platforms are leading the way in promoting consumer choice and service excellence. In this digital age, these platforms and vehicles are clearly the future of customer-focused, ethos-led banking. As such, and in recognition of the economic opportunities that a further expansion of digital financial services could bring, we recommend that the Department for Business, Innovation and Skills conduct a review to determine the viability of utilising local government funds to increase lending to small businesses and social enterprises through digital lending platforms. By way of example, Funding Circle already operates a similar scheme with a number of local authorities, and has met with some success.

By adopting these ten recommendations, we believe that the banking industry can be made to be much more responsive to the needs of its customers and the country in which it operates. By instilling a culture in banking that promotes behaviours that strive towards the common good, we believe that consumer trust and confidence will increase and bank customers will get the service they need and deserve.

1 Introduction

"When applying virtue theory to the matter of banking reform, it insists that the banking industry should, to the best of its ability, attempt to meet these diverse needs – it should not simply focus on self-enrichment or basic transactional services. It was an inherent lack of virtue in the banking profession that led to the crash and has, over recent decades, resulted in many citizens being excluded from essential banking services."

Any meaningful assessment of both the economy and society make it abundantly clear that our banking institutions are amongst the most valuable. They regularly perform a whole host of vital functions for us. They provide credit when we're in need; facilitate our daily financial transactions; enable us to become homeowners; help us to save for retirement; and safeguard our wages.

But despite these highly crucial functions, the public currently hold bankers in extremely low regard, and a long memory is required to recall a time when trust and confidence in the banking sector was below its current nadir. But why, after nearly five years of financial reform, is it so implausible to suggest to the public that the banks have our best interests at heart?

It surely cannot be from a lack of reform. The Coalition Government has made it one of its primary objectives to drastically reform the UK banking sector. Since the crash, we have had the Independent Commission on Banking, the Financial Services Act 2012, the Financial Services (Banking Reform Act) 2013, myriad Government consultations and the Parliamentary Commission on Banking Standards. All of these initiatives have almost entirely focused on regulatory or prudential responses to the crisis. This is no accident, and is mostly due to the dominant theories as to the causes of the crash.

The Left of the political spectrum blames the financial crash and ensuing economic crisis on the presence of 'light-tough' regulation. For those on this side of the spectrum, the response is often to call for more stringent regulation and criminal legislation. The Right considers loose monetary policy and risky lending as the causes of the crash. For those on this side, the response is to call for tougher prudential requirements and enhanced systematic stability.

Both of these diagnoses are visibly reflected in the Government's reform agenda. The Independent Commission for Banking Standards argued for structural reform of the banking sector through further competition and tougher regulation. The Financial Services Act created a new regulatory regime. The Banking Reform Act made possible more stringent prudential and ring-fencing requirements. The Parliamentary Commission on Banking Standards was the only review to seriously move beyond regulatory issues and evaluate banker misconduct. Yet even this review's recommendations focused too heavily on legislative and regulatory responses, as if this alone could save the sector from repeating past mistakes.

It is our proposition that neither side of the debate, nor their legislative progeny, comprehensively or adequately describe the root causes of banker misconduct. For us, these root causes lie in the existence of a pervasive and inherent lack of virtue amongst our banking institutions, which we will need to restore if we are to ever truly reform the sector.

As a summary, instead of arguing for a uniform, rigid and unitary response from regulators or the Government, virtue theory recognises that the needs of customers are intrinsically different. As a result, it argues for the fulfilment of people's needs in all of their distinctiveness. When applying virtue theory to the matter of banking reform, it insists that the banking industry should, to the bet of its ability, attempt to meet these diverse needs – it should not simply focus on self-enrichment or basic transactional services. It was an inherent lack of virtue in the banking profession that led to the crash and has, over recent decades, resulted in many citizens being excluded from essential banking services.

With restoring virtue to the banking sector, the presence of good character in bankers is absolutely vital. Character gives a person the strength to pursue purpose in the face of complexity and adversity. To be of good character is to have absorbed moral teaching into ones daily habits. Most ethical systems are formal in nature and, because of this, assume that merely following the rules will ensure a good outcome. But virtue theory is concerned with content and the ability to understand the spirit not the letter of the law.

Advocating for more virtue in banking is not mere academic posturing. For us, it is a call for the re-introduction of purpose into banking. We argue in this report that the purpose of banking goes beyond macro-economic concerns and extends to ensuring the long-term prosperity of customers. Ethos, a recurring and important concept in this report, for us is the daily practice of inculcating this purpose. Instilling ethos and promoting virtue in the banking industry is vital if we are to get the banker sector we deserve.

This is not to say that a banking sector that is better regulated and inherently more secure is not to be supported. It is just that, by ignoring its cardinal cause, policy makers are failing to fully understand the cause of the financial crash and, as a result, are not appropriately preparing for future crises of a similar nature. What we need to do is restore virtue to its rightful place at the heart of banking. In order to do this, this report outlines three key areas that policy makers must prioritise in order to get to the root of the problem.

The first area to improve is the internal governance structures of the banks to ensure the good leadership is present in the banks and the appropriate levels of professionalism and ethics evident. The second objective must be to improve levels of competition. For us, competition is about more than just market entry, as important as this is. Competition can only be considered truly effective if it is customer-led and directed. In order to achieve this we need a better consumer rights regime and the banks must be made to compete on customer satisfaction. Lastly, we need greater market diversity in order to meet the increasingly complex need of customers. This requires the Government to promote different business models, as well as a more local form of banking.

This report will establish how, by pursuing the internal and external checks on banker conduct detailed above, the sector can be made inherently more virtuous.

2 Ethos and the need for virtuous banking

"Ethics, in all sectors of the economy and not just in banking, is about promoting decisions and behaviours guided by values that go beyond a company's legal requirements. It must, if it is to be effective, apply to all aspects of business conduct at all levels of the firm."

In the fallout of the last financial crisis the Coalition Government embarked on a programme of broad financial reform. The Independent Commission on Banking, which was established soon after the 2010 General Election, reviewed the structure of the banking system. In its final report,[1] which was later incorporated in a HM Treasury White Paper,[2] the commission recommended a package of reforms. These included a demand for ring-fencing legislation, measures for increased bank loss-absorbency and proposals that would encourage greater levels of competition within the sector. Many of these have now been implemented through the Banking Reform Act. Prior to this, the Financial Services Act fundamentally changed the regulation of the banking sector, creating the Financial Conduct Authority and Prudential Regulation Authority, and entrusted responsibility for the oversight of the UK's financial system to the Bank of England by establishing a new Financial Policy Committee.[3]

But this regulatory and prudential approach, while essential to creating a more stable banking sector, at best provides only half of the solution. As the Parliamentary Commission on Banking Standards made clear in its Final Report in 2013,[4] banking culture has too often been characterised by an absence of any sense of duty to the customer and an absence of any collective responsibility.[5] Alongside current regulatory or prudential reforms, changes will also, therefore, need to be made to the underlying culture of the banks.

Tackling the deficiencies of banking culture has also been advocated by other inquires. The Financial Service Authority report into the failures of RBS in the lead up to the crash concluded that the underlying deficiencies in management, governance and culture made the bank prone to poor decision-making.[6] Likewise, one of the central conclusions of the Salz Review at Barclays Bank in 2013 was that "across the whole bank, there were clearly no articulated and understood shared values".[7] In short, a lack of a common purpose resulted in the development of an uncertain culture that allowed or even shaped the bank's dishonest business practices and behaviour.

In the absence of the right values and culture, the banking sector over recent years has been typically described as purely profit-seeking and self-serving industry that prioritised its own needs over the customers it purported to serve. The fixing of LIBOR and the PPI scandals are a by-product of this inherent lack of ethos.

In answer to the rapacious behaviour, aimless profiteering and short-termism that is so often evident in the banking sector, this report has as ones of its key propositions an acknowledgement that, while the creation of profit is fundamental to business, it should not always be the primary concern of a successful business. Taking a direct approach is rarely the best way to achieve the desired end, paradoxically, for example, the most profit-orientated companies are not always the most profitable. Indeed, as John Kay argues acting obliquely can often be the most effective way to reach and maintain a desired end.[8]

The creation of profits and meeting the wants and needs of consumers are not mutually exclusive. In a new era for banks, the sector could learn a great deal from the online giant Amazon, which used the mantra of 'customer-centricity, long-term thinking and focus on invention' to become the world's largest online retailer.[9]

When assessing the adequacy of current banking culture, the establishment of the Parliamentary Commission on Banking Standards was undoubtedly a step in the right direction, and it was good to see the Government strongly endorsing its principle findings.[10] Likewise, Sir Richard Lambert's Banking Standards Review, sanctioned by the banks in 2014, is to be commended as it has made a number of recommendations that will almost certain improving industry standards.[11]

However, we believe that neither of these reviews went quite far enough, and an unresolved cultural crisis still persists at the heart of banking. As was mentioned in the preceding section, instilling virtue in the industry is dependent on promoting the right ethos. This approach may be slow and somewhat tedious for politicians and the public alike, but it is the approach needed to improve standards in the industry.[12]

Ethics, in all sectors of the economy and not just in banking, is about promoting decisions and behaviours guided by values that go beyond a company's legal requirements. It must, if it is to be effective, apply to all aspects of business conduct at all levels of the firm.[13] A culture of ethical business, as called for by Mark Carney, Governor of the Bank of England,[14] driven by respect for the customer would "naturally encourage bank employees to display good behaviour".[15]

As Table 1 demonstrates, the large banks have made admirable attempts to define their core values.

Table 1: The core values of the four largest banks

Barclays: Respect, Integrity, Service, Excellence, Sustainability[16]

HSBC: Dependable, Open, Connected[17]

Lloyds: Putting Customers First; Keeping it Simple; Making a Difference Together[18]

RBS: Serving customers, Working together, Doing the right thing, Thinking long term[19]

However, with the well-documented failings of the banks' previous codes of conduct, we should be cautious of internal decisions, unrelated to the objective needs of the wider world, and the creation of separate sets of values for each bank. We should instead encourage an industry-wide set of core values for the benefit of the customer. With this in mind, we would like to see an industry-wide set of values installed by the new Banking Standards Review Council established along the three following principles:

1. Ensuring systematic prudential security
First and foremost, for the safety of the industry and the wider economy the banks should strive to maintain prudential security and ensure financial stability. Measures included in recent legislation to increase leverage ratios and to ring-fence certain aspects of their functions, as well as reforms to the structure of regulatory authorities, all lay good foundations for the prudential stability of the industry and will help to ward off future financial crises.[20]

2. Working for the prosperity and financial security of customers
As a key priority, the banks should strive to serve their customers and help them to be economically active and socially wealthy. Products and services should be designed with the prime focus to meet customers' financial needs, whilst also creating adequate financial return for the bank.[21] Following this principle would discourage incentives to break codes of conduct, such as performance schemes which focus on sales and are not in the long-term interests of the customer.[22]

3. Promoting the responsible creation of value
Arguably our most important and influential sector, the banking industry should endeavour to conduct business responsibly and in a way that produces economic and social prosperity for all their stakeholders. Banks should wholeheartedly embrace the principle of 'shared value', which aims to create economic value in a way that also creates value for society. This goes beyond social responsibility, philanthropy and sustainability – it is a way of achieving real, widespread economic success.[23]

For the first of these principles, it is clear that the Government has pursued this fairly successfully either through legislation, like the Banking Reform Act, or through international commitments, such as Basel III. The other two principles, however, must by their very nature be pursued and led by those in the industry. So far, not enough has been done on how these two principles could be promoted.

Using the above principles, the purpose of a bank must, therefore, be to *provide security and prosperity for its customers, and to enable the flourishing of their communities in a manner that is responsible and creates shared value for society.* The ethos of banking, the underlying culture that underpins the actions of bankers must, therefore, be the foundation of this purpose. We recommend that the new Banking Standards Review Council, when it is launched at the end of 2014, adopt this or a similar description for the over-arching purpose of banking. This core purpose should be at the heart of what all banks do, and we recommend that the industry incorporate such values into their business processes and commit to matching them. The following chapters in this report will outline how a socially beneficial purpose to banking can be pursued and ethos restored to its proper place at the heart of finance.

Trust and confidence

Despite it being clear, even to the most casual observer, that ethos and purpose are critical to corporate activity, why single out the banking industry? Detachment from customers and irresponsible behaviour is a criticism many would level towards firms in all sectors. And indeed, in many ways, a retail bank is like any other retailer. Instead of selling groceries or clothes, a bank sells financial products. So what is it that marks a bank out as different and merits a paper discussing the need for them to adopt a more ethos-driven approach?

The complex nature of banking products, and the potential scale of detriment suffered if unsuitable products are sold, distinguish retail banking from other forms of retail. A defect in an item of clothing bought in a high street store is almost immediately obvious and requires no specialist knowledge of clothing to ascertain. But the fact that your money has been invested badly in a complex form of asset-backed security can be more difficult to determine. Furthermore, with non-financial purchases, any mis-selling is easily remedied through the statutory rights open to consumers looking to return items of clothing or the like. The same level of simplicity or clarity does not, and cannot, exist in banking.

Given the natural complexity of banking services, it follows that possessing trust and confidence in the firm that a given customer is purchasing a particular product or service from is a vital part of that transaction. But what precisely is meant by "trust"? The Oxford English Dictionary defines trust as follows: "firm belief in reliability, honesty, veracity, and justice; confident expectations; reliance on truth without examination; acceptance without evidence; confidence in honesty; person committed to one's care".[24] Thus, for the purposes of banking services, trust encompasses good behaviour of the bank above what is required by law or regulation. This includes that market power is not used against the interests of consumers and that the reasonable expectations held by customers are met. It also implies predictable behaviour, in accordance with what was originally agreed, and not adopting opportunistic or predatory practices.

Confidence, on the other hand, is slightly different and has three distinct dimensions in banking: (1) the ability of consumers to make well thought through decisions; (2) confidence in particular financial products; (3) and confidence in the institutions supplying financial services and products.

But, despite their being differences between trust and confidence, they both remain crucial to ethical running of banks and they cannot, as a result of their interrelated nature, be considered in separate enquiries. For the remainder of this report, the two terms will, therefore, be used interchangeably.

There are a number of significant differences that distinguish financial products to other retail products, each of which mean that trust and confidence are crucial to the welfare of banking customers:

- financial products are purchased infrequently, which means that the consumer has only limited opportunity to learn from experience;
- contracts are necessarily incomplete as it is not possible to specify all future behaviour of counterparties in advance, and hence express the ultimate outcome;
- the full cost of the product may not be known at the point of purchase and it can sometimes be concealed from the consumer;
- it is often difficult for consumers to make rational choices due to product complexity, information deficits, a lack of transparency, and costs often being obscure and difficult to calculate.

These characteristics mean that, in practice, the transaction costs for the consumer in verifying the value of products are often quite high. Because of this, the consumer needs to possess trust and confidence in the solvency, integrity and competence of their bank. Sadly, and as previously noted, trust and confidence in the banking sector is at a low point. A raft of scandals, bailouts and injustices surrounding bankers' remuneration have significantly undermined public opinion in the ability of banks to serve the needs of their customers and of wider society.

The breakdown of trust in financial institutions, and the perceived way they conduct business and interact with consumers, can seriously lower the effectiveness of the financial system. Developing a system of external and internal checks and balances that promote virtue and instil in banking are essential if the British banking sector is to both regain the trust and confidence of the general public, and to be the transformative force it needs to be in order to foster prosperity.

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3 Promoting virtue through good governance and leadership

"Historically, executive development in the banking sector has focused too much on training technical competencies and on command-and-control management skills. What is needed is a significant shift in the culture of leadership to one that promotes moral purpose, character, critical thinking and decision-making. In short, this new approach must focus on instilling a strong ethos rather than just adhering to empty regulation."

As was highlighted in the introduction to this report, promoting virtue in the actions of banks and bankers requires both internal and external pressures. This section of the report outlines the scope of the problem facing those seeking to change the underlying culture of our banks. It also details how through better leadership and improved governance, our banks can be much more ethos-driven and better focused on the needs of their customers.

Embedding ethos in banks requires both 'root-level' involvement and strong leadership from the very top of the organisation. A strong chief executive can lead by example and ensure that values are filtered down through the appropriate channels to all employees. It is perhaps of note that the Chief Executive of Barclays, Anthony Jenkins, as made it a key priority of his to instil a new culture within his bank; one much more focused on its customers and the communities they reside in.[25]

Even though this still remains an aspiration at this juncture, it is understandable why Anthony Jenkins would want to lead his bank in a different direction. In recent years, there has been no shortage of governance failures in our biggest banks. In October 2008, RBS Group was bailed out by the British taxpayer to the tune of £45bn. In 2011, the FSA published its report into the failure of RBS and concluded that:

"…multiple poor decisions that RBS made suggest, moreover, that there are likely to have been underlying deficiencies in RBS management, governance and culture which made it prone to make poor decisions."[26]

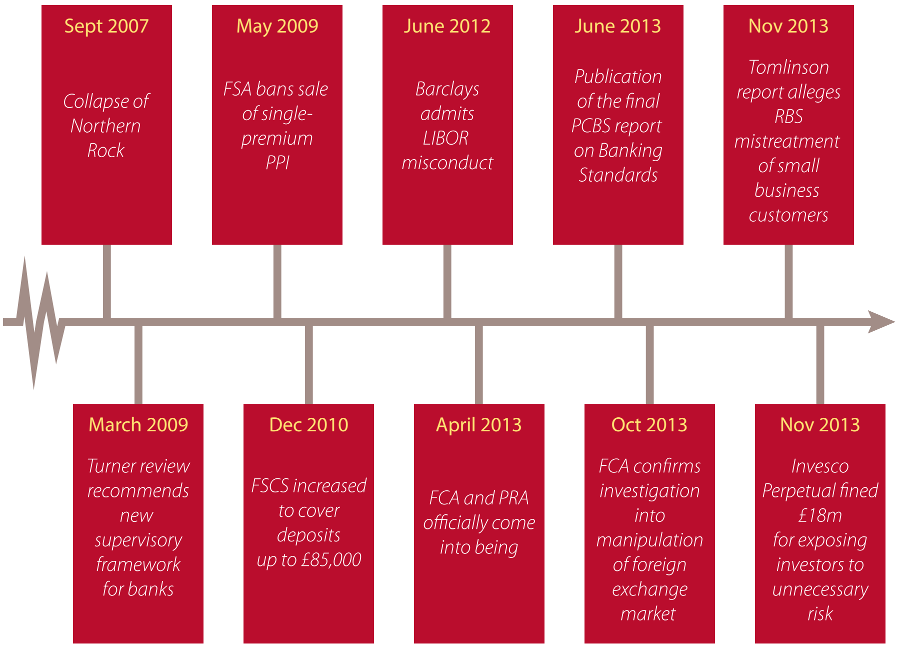
In June 2012, Barclays itself was fined £290m by US and UK regulators for "fixing" Libor. The Barclays Board then appointed Sir Anthony Salz to conduct a review of its business practices. The Salz Review was published in April 2013 and in one of its central conclusions was that:

"We believe that the business practices for which Barclays has rightly been criticised were shaped predominantly by its cultures, which rested on uncertain foundations. There was no sense of common purpose in a group that had grown and diversified significantly in less than two decades. And across the whole bank, there were no clearly articulated and understood shared values – so there could hardly be much consensus among employees as to what the values were and what should guide everyday behaviours. And as a result there was no consistency to the development of a desired culture."[27]

In December 2012, HSBC admitted anti-money laundering and sanctions violations in its Mexican subsidiary. It was fined US$1.9bn by the US Department of Justice for failing to prevent money-laundering in Mexico by drug cartels. In its official press release the Department explained that:

"HSBC is being held accountable for stunning failures of oversight – and worse – that led the bank to permit narcotics traffickers and others to launder hundreds of millions of dollars through HSBC subsidiaries, and to facilitate hundreds of millions more in transactions with sanctioned countries…"[28]

A timeline of scandal and regulatory action since 2007



In December 2013, Lloyds Banking Group was fined £28m by the FCA for serious sales incentives failings. The FCA concluded that:

"Financial incentive schemes are an important indicator of what management values and a key influence on the culture of the organisation, so they must be designed with the customer at the heart. The review of incentive schemes that we published last year makes it quite clear that this is something to which we expect all firms to adhere."[29]

The above timeline highlights a number of major banking scandals and regulatory investigations over recent years:

These investigations into wrongdoing at the largest UK banks have consistently diagnosed fundamental failings in leadership, values, decisions and culture. But what then does good leadership and culture look like? What do senior bank leaders need to do to fix our banks and to restore trust?

Leadership and collective ownership of business culture

Leadership is, to a large extent, about having the right people with the right skills and mind-set in the right jobs – a person's values will shape their leadership and their leadership will shape the culture of the bank. This was noted by the Parliamentary Commission on Banking Standards, which proposed replacing the existing Approved Persons regime with a Senior Persons regime that requires senior management to be pre-approved by the regulator and to take more personal accountability.[30] In its response to the PCBS recommendations, the FCA highlighted that approval might be conditional on an individual acquiring a specific skill-set that it deems necessary to carry out the role properly.[31] The precise details of the new regime are yet to be decided but developments are being followed with interest by the industry.

There are, of course, some outstanding examples of ethos-driven leadership in banks. Whilst the reputation of some of our banking brands is still seen as toxic by many, there are smaller teams in branches, in call centres and on trading floors who are trusted by colleagues and customers. They are led by people who believe in a purpose greater than their own narrow financial self-interest. But how can we ensure that this type of leadership is the norm rather than the exception?

Historically, executive development in the banking sector has focused too much on training technical competencies and on command-and-control management skills.

What is needed is a significant shift in the culture of leadership to one that promotes moral purpose, character, critical thinking and decision-making. In short, this new approach must focus on instilling a strong ethos rather than just adhering to empty regulation.

Because of the scandals associated with banking over recent years, corporate values have rightly received a lot of attention. As demonstrated earlier in this report in Table 1, each of the major UK banks has recently reviewed and published a set of values whose purpose is to guide behaviour. But, in terms of moral philosophy, most of the values described above detail behaviour or formal outcomes, not underlying moral dispositions. What this analysis does suggest is that the leadership teams of these banks failed to examine the question of morality when choosing their values. It also suggests that they failed to understand or appreciate the importance of underlying culture. This is of real concern if the purpose of these values exercises is to achieve good behaviours and fair outcomes for customers.

In light of the clear lack of ethical awareness within the banking industry, the MoralDNA study,[32] which involved a qualitative and quantitative analysis of four of the five major banks, was established to develop a comprehensive psychometric profile of leaders in the banking industry. Since 2010 it has analysed the ethical profile of almost 2,000 senior leaders in these banks. The results indicated that, in eight out of ten of these virtues measured,[33] scores for bankers were above the average for the general population. However, with "humility" and "love" bankers achieved lower than average scores. The low scores on humility are insightful in terms of understanding the attitude to pay of a small minority of senior bankers. But the media and political narrative defines the self-serving attitude to pay in terms of greed. This is true only in part.

Moral values are the building block of human character, but they are also the foundation for culture (if we define culture as the sum of our collective character). However, this culture isn't just the sum of all the values of the individuals, it is crucially shaped by the way a community is organised, and what Rob Goffee and Gareth Jones term "social architecture". We can go further and say that this social architecture also has a political dimension, because social architecture reflects or is defined by a political philosophy. As will be examined in more detail in the section on diversity, political power in a plc tends towards unaccountability. In a mutual, like the Nationwide Building Society, it is often more democratic, with customers (as owners) being actively involved and consulted in corporate decisions. Whilst the vast majority of bankers are good people who want to do the right thing, the social and political architecture of their organisational cultures can either strengthen or corrupt their moral character.

But how do we create the right cultural architecture in banks to promote virtue and foster responsible behaviour? Martin Wheatley has observed that "…*governments over the years have responded to scandal with rules and regulations, without considering that it was 'the obedience culture' that often failed in the first place*."[34] Indeed, every UK bank has already had professional standards, codes of conduct and ethics training in place for years but these did not prevent the wrong-doing that has occurred over the last decade or so. It could even be argued that these contributed to this wrong-doing by creating an environment in which compliance with the letter, rather than the spirit of the rules reigned.

In sum, the existing approach to professional standards, codes of conduct and ethics training has failed because it is based on a compliance and obedience philosophy. In order to avoid a return to the situation described above, values must be firmly embedded within banks such that they lead to a shift in actual behaviour and are tangibly demonstrated by the employees in their daily work. As such, imposing another set of rules like those currently in place is clearly not the answer.

That is not to say that some sort of written documentation is undesirable; it would be impossible to focus bank employees on a set of values and entrench them in the business without a clear and definitive statement to ensure that the messages and expectations around ethos-driven practices or behaviours are clear and consistent throughout the organisation. Additionally, such documents provide a single point of reference against which performance can be measured and action against non-observance taken accordingly. However, these documents must not be merely words on a page to which occasional 'lip-service' is paid, they must be 'living' documents that permeate into the working culture of the firm.

One way in which to maximise the chances of a new culture being adopted by staff, and these 'living' documents to be developed, would be to seek 'buy-in' from all levels of a bank's hierarchy. If staff and other parties are consulted and their views taken into account, the sense of having 'had their say' creates a feeling of ownership and incentivises members of staff to act in accordance with the bank's values. There is also a peer pressure to conform to those values as staff know that they decided on such values as a collective group and want, therefore, to continue to uphold them as a group. They are also more likely to actively monitor others in the group and hold those that do not behave in accordance with the values to account. It could be said that there was a lack of peer oversight in the lead up to the crash, as evidenced by lack of whistleblowers that came forward in the lead up to it. This is made clear by the fact that the FCA has, since it was established in 2013 and in comparison to its FSA predecessor, seen a 72 per cent increase in the number of investigations initiated after a complaint was issued by a whistleblower.[35]

In addition to peer pressure, asking existing employees to help define the values of the organisation ensures that the values are realistic and able to be implemented. Employees know their businesses intimately and are much better placed than regulators to know what will work in practice. It also capitalises on the good elements of the organisation's culture that are already present. Whilst there are a lot of bad elements within the existing culture of banks, there are also examples of good behaviour that should be accentuated and preserved. For example, following severe flooding in Somerset at the start of 2014, Royal Bank of Scotland, Santander and HSBC offered mortgage repayment holidays to help customers affected.[36] A value that results in banks taking extraordinary action to support customers in a time of great hardship is one that requires reinforcing but not transformation.

Equally, the existing values in employees' personal lives do not need changing. Bank employees are not, though the media might beg to differ, bad people. In their personal lives, they are guided by the same inherent sense of right and wrong, of prudence and care that guides us all. To be a good person in civic life does not require us to live according to professional standards, adhere to codes of conduct, or attend compulsory ethics training. Furthermore, when things go wrong, there is a proven mechanism for making them right, through admission, contrition, restitution and forgiveness. Employees should, therefore, be encouraged to bring their personal humanity to work and apply it accordingly. Finally, for existing employees, the process of self-reflection and attempting to understand the underlying motives for actions taken and decisions made that, with hindsight, proved imprudent may, of itself, prove valuable in terms of changing attitudes and priorities.

However, this is not to say that external perspective is not valuable. As observed in a report by Deloitte, "the most insightful cultural observers often are outsiders, because cultural givens are not implicit to them."[37] Indeed, it is the bank's customer, both wholesale and retail, who will be on the receiving end of the decisions that are ultimately made and based on behaviour that is driven by these values, so their contributions would be very valid. Also, if customer-centricity is to in some way be enshrined in the values, consulting customers in the creation of the values represents a powerful signal of commitment to listening to them from the get-go.

The Nursing and Midwifery Council (NMC) recently launched a public consultation on its new Code of Conduct.[38] It is seeking the views of both professionals within the medical and care industry (i.e. nurses, midwives, doctors) but also patients, relatives of patients and the public at large who could be affected by changes to the Code with the aim of creating standards that are fit for the modern realities of nursing. The consultation is still open so the success of this approach as a means to developing the end product remains to be seen but it sets an interesting precedent for a public consultation on a banking code. Nursing, like banking, has been rocked by a number of scandals in recent years as past failings in care that resulted in great suffering of patients have gradually been brought to light. Also, like banking, trust and confidence is integral to nursing as, similar to the information asymmetries that exist within banking transactions, medical professionals have expert knowledge that the layman does not and their judgment is similarly relied upon.

The new banking standards body should, therefore, consider widespread consultation with a range of stakeholders on proposals to change values and culture in banks. Indeed, we recommend that the new banking Standards Review Council as one of its first actions, undertake a joint open public and industry consultation to create a Code of Conduct founded on the opinions and desires of all relevant stakeholders.

Staff professionalism and personal responsibility

Perhaps another means of achieving this 'root-level' involvement from staff employees in the development of a responsible banking culture would be through implementing a 'Hippocratic-style' oath whereby employees publicly voice their commitment to the stated values. This was ruled out in the Banking Standards Review but has been adopted by other organisations; indeed, the Dutch Banking Association ordered its 90,000 members to swear an oath.[39]

An interesting discussion of the various pros and cons of an oath took place at Harvard where, following four years of work by the faculty's committee on academic integrity during which there was an investigation into the largest case of suspected examination misconduct, it was decided that new undergraduate arrivals in 2015 will be asked to 'affirm' the school 'honor code'. Though they concerned an academic rather than commercial environment, it provides food for thought and perhaps indicates that the new banking standards body should take a second look at the possibility of introducing an oath.

At Harvard, the faculty concluded that in institutions with such codes, violations of academic integrity were reduced. They also argued that, by making expectations about behaviour explicit, such codes would enhance integrity, encourage conversation about conduct, and promote confidence in the academic community as a whole. It was stressed that this code is not merely a system of new rules designed to prohibit or provide a mechanism for punishment of non-compliant behaviour which is, in light of the lessons learned from recent events and neatly summed up by Martin Wheatley above, exactly what must be avoided in reform of the financial sector.

Having an 'honor code' designed to simply provide additional means for rooting out misconduct would, as one Harvard professor said, be a "creepy, Orwellian reason for having such a code".[40] It should, instead, play a role in helping students come to a joint and common understanding and endorsement of the value of collective enterprise. Indeed, this idea of 'collective enterprise' is a powerful one. The psychology of 'group mentality' is complex but, in brief, it creates a sense of shared responsibility fostering a peer pressure environment to conform to agreed standards and not be the one that lets the rest of the group down for fear of destroying not just one's own reputation but that of the group to which you voluntarily have subscribed. There is also an element of peer monitoring whereby pledgees of the oath seek to keep each other's behaviour in check. Indeed, this is recognised in the Harvard Business School MBA oath which was voluntarily created by a group of students in 2009, and from which the new undergraduate oath, in part, draws inspiration; the oath ends with: "*I will be accountable to my peers and they will be accountable to me for living by this oath.*"[41]

The Harvard MBA oath speaks of "responsible value creation". It asks its pledgees to "recognise [that their] decisions can have far-reaching consequences that affect the well-being of individuals inside and outside [their] enterprise, today and in the future" and to "act with utmost integrity", "manage [their] enterprise in good faith, guarding against decisions and behaviour that advance [their] own narrow ambitions but harm the enterprise and the societies it serves" and "strive to create sustainable economic, social, and environmental prosperity worldwide." All of these are values that should be welcomed in banking and, if properly observed, help to create a more ethos-driven sector.

So how can this apply to banking? The exact wording of the oath that the Dutch bankers' association required its members to swear was:

"I swear that I will do my utmost to preserve and enhance confidence in the financial-services industry. So help me God."[42]

While such a move by the Dutch banking association is a welcome one, it is perhaps too vague for our purposes and doesn't really detail what the key responsibilities of bankers are or what the underlying culture of banking institutions should be.

Taking into consideration the Harvard 'honor code' detailed above, as well as the three underlying principles of banking outlined in the preceding section, perhaps an oath that the British Bankers' Association (BBA) could adopt for British bankers could read something like the below:

"I swear to fulfil, to the best of my ability and judgement, this covenant:

I will do my utmost to behave in a manner that prioritises the needs of customers. It my first duty to provide an exemplary quality of service to my customers and to exhibit a duty of care above and beyond what is required by law.

I will apply myself to ensuring that the work that I perform is in line with values that engender the responsible creation of value. It is my duty to conduct my business in an ethical manner and to ensure that my actions impact positively on the wellbeing of people both inside and outside my enterprise.

I will confront profligacy and impropriety wherever I encounter it, for the conduct of bankers can have dramatic consequence for society.

I will remember that I remain a member of society, with special obligations to the financial security and wellbeing of my customers, their families and the communities they reside in.

If I do not violate this oath, may I benefit from the prosperity that comes from serving customers well. May I always act so as to preserve the finest traditions of my calling and may I long experience the joy that comes from supporting the needs of society.

This oath I make freely, and upon my honour."

The Bankers' Oath

If those in banks that are engaged in banking activities swore such an oath, this could have considerable benefits with regards to public trust and confidence in our banking institutions. In and of itself, such an oath is meaningless. But what it represents and symbolises is perhaps a turning point in the outlook of the banking sector. There is a certain level of professionalism that separates bankers from doctors, lawyers and architects. In the latter professions, and unlike banking, the professional motive is not only to do the best for the client but also to adhere to the well-established principles of that profession. These standards are often maintained by the industry itself and go above and beyond what is required by law. In medicine, the Hippocratic Oath provides or did provide the centre-piece for these overarching principles. We believe that the Bankers' Oath could perform a similar function in banking.

If bankers swore an oath akin to the Hippocratic Oath, we believe this would go some way to restoring trust and confidence in our banks by signalling an intent to the public that banking is on an upwards path to professionalism. We recommend that the British Bankers' Association, the Building Societies Association and the new Banking Standards Review Council all adopt this, or a similar oath, for all of their members. Such a statement of intent from these three bodies would be a momentous event, and could prove the turning point for the public regard of our banks.

Good governance and active accountability

The aforementioned report from the Parliamentary Commission on Banking Standards (PCBS) also noted the importance of internal challenge. In relation to non-executive directors, a supposed key component of internal governance procedures, the PCBS stated that they should provide a genuine check on the actions of executives, but often do not. There were several suggestions in the PCBS Final Report that detailed how the role of non-executive directors in banks. These include giving them access to independent advice, introducing rules to ensure effective monitoring of the skills of the board, and requiring non-executive vacancies at banks above the ring-fencing threshold to be publicly advertised.

However, the FCA noted in its response to this report that introducing more overly prescriptive regulation might encourage a 'tick-box' approach to governance, which as noted earlier, is exactly what should be avoided. Consultation on these matters will take place shortly. With regard to compliance and internal audit functions, the PCBS found that employees feared speaking up about failings and wrongdoings that they discovered in the firm and has made a raft of suggestions to improve protection for whistleblowers, which are to be welcomed.

Whilst the PCBS recommendations mention non-executive directors, regulatory compliance and internal audit functions specifically, there is no reason why governance structures within banks should not allow staff of all ranks to demand justification for a decision or an action when they believe that it is not conducive to the organisation's stated ethos. The "Stop the Line" scheme was first introduced on Toyota's assembly lines and gave every employee a responsibility to stop production if they noticed a defect on the assembly line. This scheme was considered to afford grater personal accountability to employees and provided a mechanism for peer challenge. This approach was successfully adapted to a healthcare environment at Hinchingbrooke Hospital in Cambridge, where all staff have the power and responsibility to 'stop the line' on any activity which they think could harm a patient.[43] When the line is stopped, the issue is automatically escalated and executive manger must come immediately to address and rectify the problem.

Pondering some of the 'unethical' and irresponsible behaviour that has taken place in banks over recent years, it is almost inconceivable that someone, somewhere in the organisation did not notice that, for example, PPI policies were being sold to people who, because they were self-employed or retired, would not be eligible to claim. A similar system to 'Stop the Line' in our banks would give all ranks of staff the responsibility and power to intervene where they believe there has been misconduct or an infringement of ethos. The problem would then be immediately escalated to managers. This means that, no matter how junior the member of staff might be, issues such as mis-selling would be highlighted early on and ignorance of the issue would be no defence to senior management. Indeed, as noted by the FCA, if staff "… *feel secure about speaking out, they will inform senior management when they see malpractice occurring, through both informal and formal channels.*"[44]

Alongside empowering staff, another internal check on the behaviour of the banks are the powers that company shareholders possess to exert pressure on the board. Shareholders exist in a grey area, in that they are neither internal nor external from the bank in question. By law, they are the members and owners of the company, but they are not generally involved in the day-to-day running of the business. Nonetheless, shareholders have the potential to exercise considerable power through the voting rights attached to their holdings and can, therefore, act as a powerful voice within the company.

In recent years, however, shareholder apathy and short-termism has meant that this voice of challenge has largely been quiet. Both the investors and policymakers have, however, started to wake up to the potential for shareholders to exercise considerable influence on the shaping and maintenance of good governance. Institutional investors are increasingly no longer content to just be called on at the AGM and are insisting on meeting one-on-one with representatives of the companies beyond just the investor relations officer. The *Kay Review of UK Equity Markets and Long-Term Decision Making* explicitly suggested that asset managers work to improve engagement with the companies in which they invest,[45] and the European Commission has recently proposed measures to increase shareholder engagement and give them a greater say on directors' remuneration and related party transactions.[46]

Indeed, increased shareholder engagement promises to be mutually beneficial to both investors and companies. Growing numbers of asset managers are subscribing to the Financial Reporting Council's Stewardship Code,[47] demonstrating their acceptance that the exercise of ownership rights to ensure companies are properly governed and behaving prudently can improve long-term performance. Sign-up to the Code also helps them in their client relations by providing additional transparency with the investments they make on the client's behalf.

Further research into the benefits of increased shareholder engagement and the best ways in which to elicit it is much needed. ShareAction, for instance, has advocated clarification of investors' fiduciary duties by way of legislative amendment, but accepts that this is merely one step in the process of enacting behavioural change.[48] We would recommend that the BBA conduct a review of shareholder activities in plc banks to determine the scope of shareholder inactivism in our banking institutions. We would also like to see recommendations, alongside those mentioned above, that outline how shareholders could have a much more active role in the governance of our large banks. In particular, we are very keen on the idea of the improving or extending of current fiduciary duties to ensure shareholders take a much more active role in the governance of banks.

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4 Promoting virtue through greater competition

"By introducing a system of customer led peer-review, many banks would undoubtedly be incentivised to be more innovative with their products and services. Having a league table of customer satisfaction would also encourage competition, not only on price-point, but with customer feedback as well. This would represent a clear commitment to developing a more ethos-driven approach to banking, and is something that the banks must pursue if they really intend to put the customer first."

Another key way in which we can ensure that banks operate an ethos-driven, customer-focused approach would be to create a much more competitive environment in the banking sector. If the competitive conditions are right, customers can, if not satisfied that their bank is not serving them as it should, 'speak with their feet' and take their custom elsewhere.

The success of competition as a means through which customers can compel banks into prioritising the continued observation and proliferation of good ethos depends heavily on the incumbent banks judging that there is a real and significant probability, rather than a merely theoretical possibility, that customers will switch to a rival if they do not see responsible or appropriate behaviour being demonstrated.

This situation is clearly dependent on, amongst other things, the existence of an alternative provider. Unfortunately, the limited number of retail banks that customers can currently choose from hampers effective competition. In this way, competition is unable to act as a 'check' to ensure that banks operate in accordance with their stated ethos.

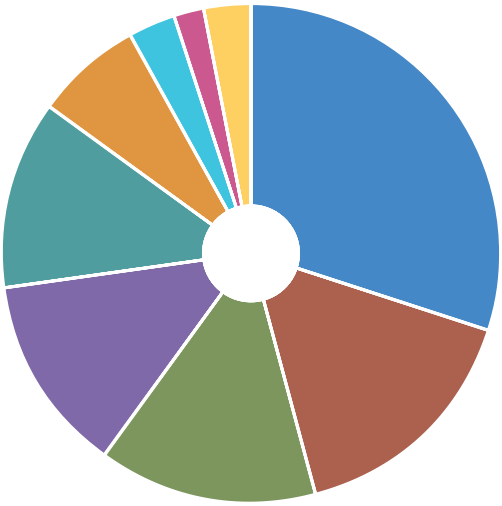
With the banking sector as it exists at present, if a customer believes that their bank is not acting in accordance with their best interests at heart, there is a limited choice of alternative providers to turn to and customer will, as a result, feel that there is little recourse or means by which to voice their discontent. This does not make for a more ethos-driven banking sector, nor does it do much good in restoring lost trust and confidence.

Clearly, more providers of banking services are required if the customer can feel more empowered and take their custom elsewhere if they are not receiving the service they deserve. Expanding the pool of available retail banking providers is, thus, an important part of creating a competitive environment in which consumer choice can encourage strong ethos in the banking sector.

One way to expand the pool is to stimulate new market entry. Regulatory barriers to entering the market have already been investigated by the Prudential Regulatory Authority (PRA) and significant changes made in respect of minimum capital and liquidity requirements and the authorisations process as a result.[49] An initial review of the changes made was published in July 2014 and was largely positive, noting that five new banks had been authorised between 1 April 2013 and 31 March 2014, three of them choosing to use the new 'mobilisation' option.[50] However, it is still early days and the BBA has already called for a further capital reduction against the safest forms of lending.[51]

In light of the ever-evolving nature of the retail financial market, especially the continuing emergence of new technologies such as mobile apps, it is clearly advisable to examine barriers to entry periodically. As a result, we recommend that the Prudential Regulation Authority carry out a review of barriers to entry to the banking sector every five years. This cycle would be sufficiently long to allow enough time for any changes made to be embedded and their effects observed, but also frequently enough to avoid the continuation of a regime that is no longer fit for purpose.

Fig 1: Market shares of personal current accounts (%)



Source: OFT 2011, Review of barriers to entry, expansion and exit in retail banking http://www.publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/612/61204.htm

Competition is about more than market entry

Often customers will not opt to switch banks if the alternative providers in the market offer very little different from their current provider. Effective competition, which is needed if the banks are to regain and retain the trust of customers, cannot be simply be about possessing a greater number players in the sector, there must also be significant level of product innovation. Otherwise it cannot be said that customers are being adequately served by this increase in 'competition'.

Key to product innovation is ensuring that customers are empowered to make informed choices, which would then increase pressure on the sector to align product or service supply with consumer demand. Focusing simply on the mere number of players in the market or about to enter the market, without an understanding of how customers in that market will effectuate this increased competition, misunderstand what is means to have a truly competitive market.

In comparison to our European counterparts, the UK banking sector is not particularly concentrated.[52] Nonetheless, it can be said that product innovation is currently limited in the UK banking industry. A Usurv survey found that 46 per cent of current account customers stated that it was not worth switching banks because product offers vary very little across the industry.[53] The survey further indicated that there is at present no real choice, merely the opportunity to select the least-worst option. A snapshot of the current account market highlights the dominance of the market by a small number of firms.

Effective competition would be best supported by enabling customers to make an assessment of how certain product offers are more or less are suited to their particular wants and needs. A customer review system, which incorporates the experiences and processes of online retail, could be one way of doing this.

Consumers do already make use of price comparison websites to help them shop around for the best deal. However, the fact that that a product in question is the cheapest does not necessarily make that product the most suitable. For example, a customer may decide to select the cheapest home insurance on a price comparison website, and then discover that the terms of the policy preclude them from claiming fully under this policy due to the fact that they live in an area of underlying subsidence. The Financial Conduct Authority (FCA) is currently assessing this issue and others surrounding price comparison websites,[54] and the conclusions of the investigation will be eagerly awaited. But in order for bank customers to achieve a more comprehensive understanding of the market, a system or review and rating needs to be developed that goes beyond simple price comparisons and measures the all-round service and product-offer of the bank in question.

Amazon, the world's largest and most successful retailer, is a company proud of its customer-centric values. It is a key priority of the firm to ensure that its service is of the highest quality. This is mostly assessed and monitored via customer reviews and ratings posted in a very succinct and accessible format on their website. As so many customers now chose to bank online, a similar system of online ratings and reviews should be introduced for high street banks.

In light of the opportunities such a system could provide, we recommend that the FCA require banks and building societies, in partnership with the British Bankers' Association (BBA) and the Building Societies Association (BSA), to display customer reviews and ratings on their websites and in their branches. Independent verification of these reviews, ideally by the BBA and BSA, could then be displayed in a competitive league table format, which in-turn would allow consumers to access the quality of products and services through the feedback of fellow customer. Such a move by the industry would boost consumer choice, encourage effective competition, and empower customers to make a much more informed choice.

By introducing such a system of customer led peer-review, many banks would undoubtedly be incentivised to be more innovative with their products and services. Having a league table of customer satisfaction would also encourage competition, not only on price-point, but with customer feedback as well. This would represent a clear commitment to developing a more ethos-driven approach to banking, and is something that the banks must pursue if they really intend to put the customer first.

Strengthening consumer rights will strengthen competition

In addition to customers being empowered to 'speak with their feet', if a service is found to be lacking, customers must also have the option of seeking legal redress in they feel they have been wronged or mis-sold.

Significant progress has already been made in the area of individual consumer rights. The introduction of the Current Accounts Switch Service by the Payments Council in September 2013 has reduced the time that it takes to switch to 7 days and provides a guarantee, supported by banks and building societies, to fully reimburse any financial loss in the event a problem occurs during the switch. This service has strengthened the rights of consumers and highlighted how consumers can exercise their rights to improve their service.

The success of the Switch Service demonstrates the importance of empowering consumers by making them aware of their rights to support competition as a force for change. Indeed, as noted by the Department for Business, Innovation and Skills in its Impact Assessment for the Consumer Rights Bill, it is only when consumers understand their rights that they feel confident enough to move between providers, and try new market entrants and innovative products.[55] A simple and easily intelligible consumer protection regime is, therefore, vital to effective competition.

Unfortunately, even though much progress has been made with empowering individual consumers, the current consumer protection regime is failing our struggling small businesses. The FCA has a duty to promote effective competition in the interests of consumers for regulated financial services.[56] The broad definition of consumers used in this context does encompass Small and Medium-Sized Enterprise (SMEs). Such a definition is not replicated in other elements of consumer protection legislation, and is, because of this, ineffective as a regulatory objective.

The Consumer Rights Bill, which is currently making its way through parliament, seeks to consolidate key consumer rights covering the contracts of goods and services, digital content, and the law concerning unfair terms in consumer contracts. It introduces easier routes for consumers and small and medium businesses to challenge anti-competitive behaviour through the Competition Appeal Tribunal. It is estimated that the total benefit of this Bill to consumers could be in excess of over £4bn.[57]

While this move by legislators is clearly to be welcomed, it is unfortunate that, in the case of this Bill at least, a 'consumer' is defined as "an individual acting for purposes that are wholly or mainly outside that person's trade, business, craft or profession", which obviously excludes smaller firms and sole traders. This means that, whilst these businesses are covered by the overarching competition objective, they are unable to avail themselves of certain protections under other pieces of legislation. For example, a small business has no recourse for challenge under the Unfair Terms in Consumer Contracts Regulations 1999 despite the fact that, particularly when you consider the very small end of the spectrum, the business is likely to suffer the same disadvantages in terms of limited knowledge and access to professional financial or legal advice as individual consumers.

To add to the complication, the definition of an SME is similarly variable. The aforementioned Switch Service and accompanying Guarantee will apply to some SMEs, but not others as it only covers businesses with an annual turnover or a balance sheet total that does not exceed €2m (or sterling equivalent) and less than 10 employees. These 'micro-enterprises' are also the only SMEs that have recourse to the Financial Ombudsman Service (FOS). The Department of Business, Innovation and Skills' Business Population Estimates for the start of 2013 indicate that there are 186,745 small businesses in the UK. As most of these are larger than 'micro-enterprises', they are consequently excluded from the Switch Service Guarantee and Financial Ombudsman's remit.[58] The potential detriment of applying such a strict staff headcount ceiling was noted in the Financial Service Authority's pilot scheme for redress for mis-sold interest rate hedging products; a B&B may look significantly larger on paper than it is in reality because it employs seasonal staff.[59] Such a business may overstep the 10 employee threshold, taking it outside the definition of a 'micro-enterprise'.

Having such rigid thresholds for FOS eligibility puts our smaller firms at a distinct disadvantage with regards the banks. Indeed, over the recent years, there have been plenty of reasons for SMEs to seek redress against the large banks. For example, the Tomlinson Review, which looked into the lending practices of the banks, alleged that, with regard to its small business customers, RBS had unnecessarily been engineering loan default to shift small businesses out of local management and into their turnaround divisions, which generated increased revenue through fees, better margins and devalued assets.[60] Though a subsequent independent report by Clifford Chance did not find clear evidence to support these claims, it still highlighted the prevalence of poor behaviour and ill-treatment of customers; for example, internal valuations were not carried out in accordance with set assumptions made by surveyors employed by the bank rather than in line with best practice guidance contained in the Royal Institute of Chartered Surveyors' Red Book.[61] The FCA has subsequently appointed Promontory Financial Group and Mazars to carry out a further independent skilled persons report into the matter.[62]

Smaller businesses have more generally suffered disproportionately since 2008. As had been mention in ResPublica's 2014 report *Markets for the Many: How civic finance can widen access and open up markets*,[63] since the Crash, small business lending from our largest banks has fallen by more than 25 per cent,[64] and loan rejection rates in the UK are twice that of our major European competitors: France and Germany.[65] Clearly, no more than ever, our smaller firms need a consumer protection regime that would help them to survive in such a tough economic and financial environment.

This is not to say that small businesses have no option for redress. SMEs can seek court action against the banks if they consider their bank not be acting in their best interest, but this is costly and time-consuming process. Indeed, it is highly unlikely that an SME that is struggling and in need of urgent finance or banking advice will be in a position to pursue a legal case against a national bank. This problem is compounded by the fact that, as mentioned above, small businesses do not have a body outside of the courts that they can turn to for assistance and advice.

In response to these clear disadvantages, we recommend two things. Firstly, we recommend that the Government adopt a single definition of the term 'consumer'. It is a damaging lacuna that allows SMEs to be protected under some consumer protection regimes but not others. Accordingly, amendments should be made to the current Consumer Rights Bill as it progresses through parliament to ensure that SMEs and sole traders are included as part of the regulatory consolidation process.

Secondly, it seems laughable that such a large proportion of our SMEs are unable to seek redress through the Financial Ombudsman Service. Given this, we recommend that the celling for FOS eligibility be raised to include those that re-considered 'small' enterprises under the relevant guidance. These would be firms that have less than 50 employees and that have a balance sheet total or annual turnover of less than €10m. Raising the ceiling in this way would significantly extend the ambit of this valuable and vital organisation to include thousands of struggling and disenfranchised small businesses.

By adopting both these recommendations, we believe that the consumer power of small businesses in the UK could be boosted and their standing improved with relation to the banks. This would bring almost instant, tangible benefits to consumer choice and banking competition.

The banks must demonstrate a clear duty of care

If competition is to be promoted in favour of the customer, banks must outwardly demonstrate their ethos and commitment to customers beyond what they have done so far. The large high street banks each have considerable Corporate Social Responsibility budgets to demonstrate their commitments to customers and their communities. But, whilst the donations made to good causes are laudable, many of these can be viewed as mostly PR gimmicks, designed to dispel the image of 'unsympathetic bankers' rather than demonstrate a deep commitment to a root-and-branch company commitment to an ethos of care. So, how can banks demonstrate their obligations to their customers and promote a culture of care?

One clear way in which banks should take more of a lead is with financial education. Taken in a broad sense, financial education extends from financial literacy classes in schools to helping customers with their financial management and budgeting on an ongoing basis. While the former is important, and financial literacy in our schools would be a welcome addition to the curriculum, it is with financial management and personal budgeting that banks could be of the most assistance to their customers.

Indeed, in bygone days, this was the key role of your average bank manager. Customers would be warned by their bank manager, who they often knew personally, of dangerous overspending and advised to take different financial decisions. Recreating this sense of guardianship, of active care and interest in the welfare and prosperity of its customers, would be an excellent way for banks to demonstrate a more ethos-driven approach to banking. With banks closing 348 branches in 2013,[66] and more planned closures already announced for this year, banks must strive to install a culture of care in their institutions that in some way re-instates this relational form of banking. Given their decreasing presence on the high street, the only way in which such a move could be completed is through an improved and more personalised use of online technologies.

This is not to say that some banks have not made considerable investments in their digital offers. Lloyds currently offers its customers the Money Manager and Save the Change® facilities. The former allows customers to track spending by category and date range, helping them with their financial planning, whilst the latter rounds payments made using debit card to the nearest pound and transfers the extra pennies to a savings account. However, there is still room for improvement with regards these and similar facilities offered by other banks. For instance, Money Manager is retrospective in that it only notifies a customer of what they have so far spent. Whilst this is useful to know in terms of planning in order to avoid the same mistake next month, it offers little by way of advice for future transactions and spending decisions. An American online bank, for example, offers the Safe-to-Spend® product that, instead of simply showing a 'current balance' figure, highlights what is "safe to spend" by subtracting upcoming bill payments, pending transactions, and any savings contributions.[67] This would be perhaps preferable method of promoting through-life financial responsibility and is, in this digital age, a highly appropriate means of connecting with the customer.

In the energy sector, 'smart meters' are gradually being rolled-out by energy providers to help customers keep track of their energy usage and anticipate the cost of their monthly bills. We believe that there is room for such a development in banking as well. Indeed, in this area of forward-planning and advice, and given the additional commitments to care the banking sector will need to demonstrate, innovation by individual firms in this area should be firmly encouraged by regulators and industry bodies. As such, we recommend that the BBA run a high level competition amongst the largest banking providers, in conjunction with leading technology firms such as Google and Microsoft, to develop a tool for online advice that empowers their customers to make sound financial decisions and adequately plan for the future. The winning entry should then be actively promoted by Government, possibly through the Money Advice Service, to maximise the impact of such an online advice and financial management tool. The Government's current announcement on free, independent advice being offered to consumers looking to make use of new pensions regulations that will allow people to draw-down their pensions savings as a lump sum could act as a helpful case-study.[68]

By encouraging banks to develop a greater sense of care for their customers by assisting them with their finances through the use of improved online technologies would, we believe, create a market for basic advice that would both increase the opportunities for competition between banking institutions and supply a level of advice that is currently lacking from the market, which would then give greater utility to bank customers.

Overall, when assessing recent reforms targeted at increasing competition in the banking industry, the Government has made a fair amount of progress by opening up the sector to new market entrants. The barriers to entry are now greatly reduced and there is an indication that the barriers to expansion within the sector are also beginning to be a top priority. But competition must be more than market entry or simple market concentration, and must be promoted in a more comprehensive fashion if it is to be truly effective. The Government and the industry should ensure that the needs of the needs of the customer are placed as the heart of all competition reforms.

By encouraging better peer-review procedures, strengthening consumer rights and installing an improved duty of care based upon sound financial advice, we believe that the banking sector could become much more virtuous and better able to restore lost trust and confidence.

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5 Promoting virtue through increased market diversity

"This diversity could be in the form of ownership, mutual or non-mutual; it could be in scale, national or local; and it could be in access, online or on the high street. Whatever form diversity takes, it is absolutely essential to the proper function of the banking sector. It is an unfortunate fact that the sector as it currently stands lacks the necessary levels of variety and choice."

It almost goes without saying that a healthy and well-functioning market is one that is able to meet the complex needs of its diverse customers. Diversity enables the differing needs of distinct customers to be met. Profit driven and cost saving financial businesses wrongly believe that standardisation is the only viable economic model, but this is not the case, a higher level of bespoke care creates the macro and micro advantages that can foster the widening of prosperity. Only a culture that promotes virtue as the distinct flourishing of all, whatever their circumstances or needs can reorient banks to genuinely meet the needs that confront them in the market place. Clearly, diversity is an essential quality of financial market as the needs of consumers vary according to their circumstances. Further, given the disparate financial requirements of businesses, individuals and families, it is clearly doubly important that diversity is promoted in the banking sector.

This diversity could be in the form of ownership, mutual or non-mutual; it could be in scale, national or local; and it could be in access, online or on the high street. Whatever form diversity takes, it is absolutely essential to the proper function of the banking sector. It is an unfortunate fact that the sector as it currently stands lacks the necessary levels of variety and choice.

The dominance of one type of ownership and business model (plc bank), in addition to overly centralised and often outdated forms of banking, hinder the sector's ability to fulfil its economic and social potential. A banking sector with true diversity would offer a range of almost tailored products and services to its customers to match their varying financial needs. This could be for both personal and business finance; the option to invest locally in businesses or social firms; or the ability to access essential products to support family life and personal flourishing.

In short, a diverse market encourages firms, in our case the banks, to take an ethos-driven approach, an approach that promotes a culture that is inherently customer-focused at heart. If there are sufficient levels of diversity, market players either adopt such an approach or face a reduced role in the market. In this crucial way, diversity is absolutely vital to the propagation of virtuous banking.

How does this lack of diversity manifest itself in banking?

In its current form, our banking system fails to provide for the varying needs of society in a number of ways. Over recent years, significant gaps in service and product provision have emerged that significantly impede the banking sector's ability to fulfil its key societal role. These are:

- **The Banking Gap**: Banks primarily perform their deposit-taking role through the provision of current accounts. However, nearly 2 million adults are without access to an individual current or basic bank account, and the number of households without a single account holder is 770,000.[69] Further, there are approximately 9 million people estimated to be excluded in some way from basic banking services. Many choose instead to manage their finances in cash.[70] Having such large portion of the population underserved by the banks is clearly undesirable.

- **The Advice Gap**: As discussed earlier in this report, financial products and services are unique due to their inherently complex nature. It is important, therefore, that customers have access to good advice in order to make an informed decision. In 2012, the FSA introduced a new regulatory regime for independent financial advice under the Retail Distribution (RDR).The additional training and compliance requirements imposed under RDR mean that these new regulations have reduced the total number of high street advisors and re-calibrated the market to focus more on wealthier customers.[71] This clearly makes it difficult for low or middle-income earners to receive advice, and will increasingly lead to many being excluded from advice all together.[72]

- **The Credit Gap**: The failure of the market to match demand for personal credit has resulted in many more low-income customers seeking credit from high-cost loan providers. Payday lending is now used by almost 1.3 million adults, 70 per cent of which are on a low income.[73] Despite the fact that high-cost credit bridges the gap created by a lack of finance from mainstream providers, that still leaves 300,000 individuals who are underserved, many of whom turn to illegal money lenders to solve their financial problems.[74] This is an area where the lack of diversity in banking has a clear and very tangible social impact and cost.

- **The Savings Gap**: The banks do not currently aid families and individuals to prepare adequately for their future. Over two-thirds (68 per cent) of low-income households have no savings, and only one in six are able to save sufficient amounts to preclude the use of credit (saving more than £300). Further, seven in ten low-income households would find it difficult or impossible to raise £200–£300 in the case of an emergency.[75] Having greater banking diversity and increased opportunities for saving would obviously enhance the ability for families to prepare for the future.

The existence of these four gaps in market provision all demonstrate the inability of the sector to fulfil what we earlier defined as its second core principle: *working for the prosperity of the customers*.

Why is diversity so essential to banking?

Diversity in financial services in particular is essential because its existence enhances consumer welfare and enables the flourishing of customers by providing them with the appropriate services and products they require. The gaps identified above demonstrate the failings of the current system and why it is crucial that the variety of consumer demand is sufficiently met by a diversity of product supply.

In promoting a less homogenous sector, it is important to note that competition and choice do not always amount to the same thing. Diversity is not simply achieved by a market possessing a series of similar banks competing and prioritising the same customers, which is the current situation in the UK.[76] True choice can only exist where there is a competitive mix of divergent financial institutions, offering myriad products under various terms via multiple means.

To achieve this, as the Parliamentary Commission on Banking Standards recognised, the traditional bank with an orthodox business model must exist alongside alternative providers. The results of this, as the Commission stated, "can increase competition and choice for consumers and make the financial system more robust by broadening the range of business models in the market". It also commented that the lack of diversity has been to the obvious detriment of consumers and strongly supported moves to create a more diverse retail market.[77] The value of moving towards a more diverse banking system has also been recognised by the Government. Amongst its commitments to banking reform, the Coalition's programme for Government stated that it would bring forward detailed proposals to foster diversity in financial services, promote mutuals and create a more competitive banking industry.[78]

To move towards the bespoke banking services our country needs, we propose that the Government should support and encourage financial diversity in the following three areas:

1. Diversity of ownership
2. Diversity of scale
3. Diversity of access

By focusing on the development of diversity in these three areas, we believe that the banking sector will be able to provide the services necessary to meet the varying financial needs of society. This will lead to a healthier economy, real choice of services and, importantly, help to develop the customer-focused ethos the sector currently lacks.

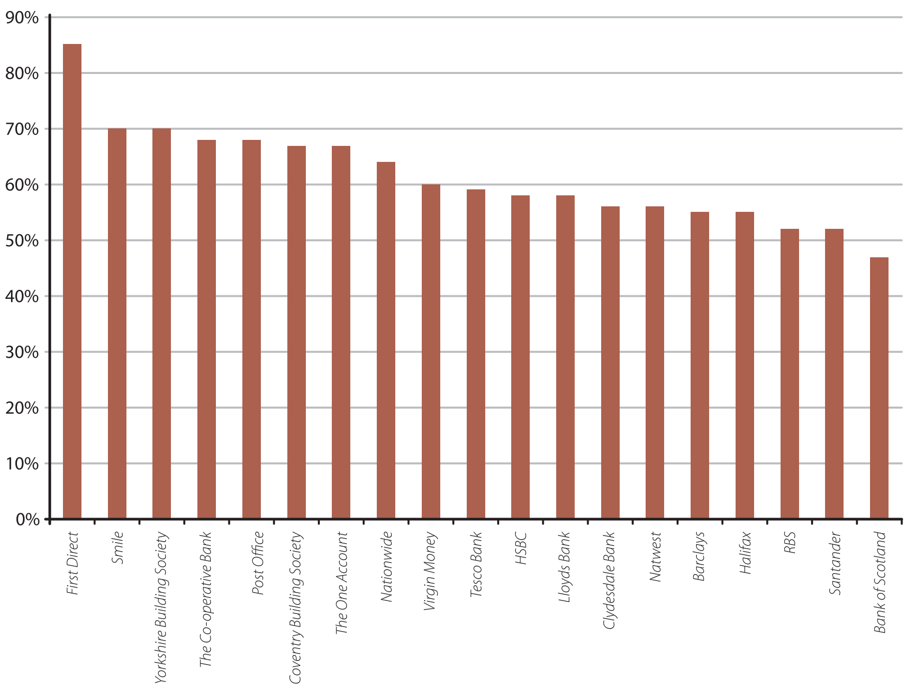
Diversity of ownership

The central theme of an earlier ResPublica report, *Markets for the Many: How civic finance can open up markets and widen access*, was that consumer interest through greater effective competition and systemic stability are enhanced through diversity in the financial system. This was termed the *Civic Approach*, and it was argued that following such an approach to financial reform would encourage diversity in financial services, especially with regard to contrasting business models and in particular the balance between shareholder firms and mutuals, as well as the differences in culture that stem from these different ownership structures.[79]

A generic distinction is made in this section between shareholder banks, which normally operate under plc models, and stakeholder banks. The stakeholder sector in the British financial system includes building societies, mutual insurers, friendly societies, credit unions, and industrial and provident societies.

In continental Europe the dominant stakeholder institutions are co-operative banks and insurance companies, which have a far greater and more extensive role in the financial system than mutuals now have in the UK. Five EU member states (including France and Germany) have more than a 40 per cent share of mutual banks in terms of branch networks, and their overall market share in terms of banking assets has increased from about 9 per cent

Fig 2: Customer satisfaction amongst banking institutions



Source: Which? (2013)
http://www.which.co.uk/news/2013/10/biggest-high-street-banks-voted-worst-for-customer-satisfaction-337859/

in the mid-1990s, to about 14 per cent in 2004.[80] In contrast, British building societies (the dominant form of stakeholder bank) account for a mere 3 per cent of total banking assets.[81] A major factor in this decline was the conversion in the 1990s of many of the largest building societies, mutual insurers and friendly societies to plcs: a move that was in part, a reflection of the free-market consensus that came to favour the shareholder model in banking.

Much has been lost from the British financial system by the demutualisation of building societies and friendly societies, both in terms of the intrinsic merits of the mutual model, and in terms of systemic diversity. As a result, the British financial system has come to be dominated by the shareholder model that has created something of a mono-culture in banking. Key figures from the industry have commented on the failure of demutualisation. A former Non-Executive Director of the Halifax when it was a mutual has argued that the conversion inflicted "considerable damage on the UK financial services sector, and reduced competition and led to a decline in customer satisfaction".[82] Andrew Bailey of the Bank of England, speaking at the Building Societies Annual Conference in 2011 stated that "demutualisation, as it developed, was a failed and very costly experiment".[83]

A stronger presence of stakeholder financial institutions in the banking sector would better provide for the varied needs of customers. Several recent studies demonstrate clear economic, systemic and welfare benefits to be derived from a successful mutual sector in the financial system.[84] In 2007, the EU Commission published a report, which was followed by a report by the European Parliament the following year, that argued that the diversity of legal models and business objectives of the financial entities in the retail banking sector is a fundamental asset to the EU's economy that enriches the sector, corresponds to the pluralist structure of the market and helps to increase competition in the internal market.[85]

There is also evidence that the size of the stakeholder sector in a country has an influence on the profitability of shareholder banks, in that the higher the proportion of banking that is conducted by stakeholder banks, the lower tends to be the profitability of shareholder banks.

The financial consultants Mercer Oliver Wyman also find that, in a comparison of mortgage pricing across Europe, low prices have largely been associated with strong mutual shares of the market.[86] A significant presence of stakeholder banks in a financial system tends to constrain the pricing power of shareholder banks, to the benefit of consumers.

Other studies have found that European co-operative banks were more stable than shareholder banks. For instance, the share of co-operative banks in total losses during the crisis was considerably smaller than their overall market share.[87] Although there are always exceptions, the general picture to emerge from a wide range of studies is that a financial system populated by diversity of ownership and governance structures, and with contrasting business models, is likely to be more competitive and systemically less risky than one populated by a single dominant model, whatever that model might be. There can therefore be no presumption that the system as is currently exists, as dominated by the shareholder model, is the most geared towards meeting the diverse needs of its customers and restoring trust and confidence in the sector. This is what should make the enhancement of diversity a major public policy issue in banking.

The characteristics of the stakeholder model can also play a role to raise standards and fashion internal ethos in financial institutions. An essential characteristic of stakeholder financial institutions is that, unlike shareholder banks, the primary purpose of a mutual is not to maximise profits but to focus more explicitly on the interests of customers, who are also their owners. This is a fundamentally different culture from that exists in plc banks, as mutuals are under no pressure to maximise profits and increase returns for external shareholders, many of whom are institutional shareholders and are themselves under pressure to maximise returns – often on a short-term basis.[88]

Evidence from a variety of surveys suggests that consumers do in fact have more trust and confidence in building societies than in plc banks. Research conducted in July 2013 demonstrates that customers of mutuals consider that their provider delivers on various aspects of service to a superior extent than do consumers at banks. On what type of organisations would be more trusted to act in the customer interest, mutuals outscored banks by 17 per cent. With being open and honest, mutuals outscored plc banks by 11 per cent. With regards having high ethical standards mutuals had a superior score of 24 per cent. And in terms of overall satisfaction, in mortgages mutuals had an excess score of 12 per cent and in the savings market it was 10 per cent.[89]

The chart opposite is a case in point, as it clearly demonstrates that those of more innovative (online) or mutual models perform better with regards customer satisfaction.

A regular critique of moving towards a more diverse system is that mutual banks are not as stable as some claim: with the Co-Operative Bank often mentioned as an example of this. As has now been widely reported, the Co-Operative Bank had a £1.5 billion black hole in its financial accounts.[90] Much of the criticism of the failing bank has been directed at the governance issues that derived from its 'mutual' model. But this is an erroneous supposition. The Co-Operative Bank is not, and has never been, a mutual or a co-operative. It is a plc bank run under the shareholder model. It was once majority owned by a co-operative (the Co-Operative Group), but has always received investment from private equity and hedge funds – something that is impossible with mutual banks.

What the Co-Op Bank demonstrates, contrary to popular belief, is not the failure of the mutual model. Rather, it represents yet another failed plc bank, except this bank was not 'too-big-too-fail'. If the Co-Operative Bank had been a mutual, like our many building societies, then it is highly likely that, because of the legislative and regulatory safeguards that exists to protect the members of building societies, that the disastrous episode would have been completely avoided.

Overall, therefore, the empirical and theoretical analysis powerfully suggests clear systemic benefits from the existence of a continuing and thriving mutual sector. A financial system characterised by a mixed array of corporate structures and business models will be inherently more stable than one dominated by a single model.

Table 2: A compelling case for more mutualism in banking

In this context, there are three compelling reasons for creating an enhanced role for mutual financial institutions:

1. The ownership structure, regulation and traditional business model of mutuals (particularly the dominance of retail funding) makes them less prone to risky speculative activity than shareholder-owned banks.

2. A mixed system of different corporate structures is likely to produce a more stable financial system.

3. A larger critical mass of mutuals is likely to enhance effective competition in the financial system. This would result in a wider range of customers being served more adequately than they are currently.[91]

In light of all the benefits having a more diverse banking sector would bring, we recommend that the Prudential Regulation Authority immediately conduct a review of the current state of financial diversity. Too little attention has been attributed to this vital factor in the stability of the sector, and we believe that a review of the current state of diversity in market, alongside recommendations on how diversity could be improved and protected, would help to make the banking sector significantly more robust.

Beyond a single, but very useful, Diversity Index,[92] there is also a lack of good quality data on the exact levels of diversity in the UK financial sector. This is in contrast to the data available for European systems, and perhaps is an indication of the low priority financial diversity has received from policy makers. In light of this, we recommend that more research be commissioned, by both Government and research bodies, to improve the quality of data and research available for the assessment of diversity in British banking. Improving the quality of research in such manner would provide policy makers and those operating in Higher Education Institutes with the tools needed to measure, improve and safeguard the diversity of our most important industrial sector.

Diversity of scale

The second area of diversity that we believe should be encouraged is diversity of scale. Two key distinguishing features of our banking system are the dominance of the industry by national banks and a noticeable lack of locally-based alternatives.
In the UK, our local and regional banks make up just 3 per cent of our banking sector in terms of assets. This is disturbingly small in comparison with our European and international competitors. In Germany, local banks hold 67 per cent of the market; in the US they enjoy 34 per cent; Japan 57 per cent; Brazil 18 per cent and Canada 15 per cent.[93] The deficiencies of such a system have become apparent since the onset of the financial crisis, where financial provision for many parts of society has become severely limited. As explained earlier, this has led to a large number of customers and communities being underserved by mainstream financial institutions.

There are several types of organisations in the sector that attempt to meet this underserved demand, but the two dominant types are credit unions and Community Development Finance Institutions (CDFIs).

Credit unions are not-for-profit mutual finance institutions. Democratically controlled by their members, these institutions mostly focus on the personal finance market and provide personal loans, savings and bank account services. There are approximately 400 credit unions in Britain, managing almost £1bn worth of assets.[94] Despite a sizeable market presence, and the fact that credit unions represent a good alternative to households in need of financial services, only 22 credit unions offer current accounts and many others offer only a limited range of services.[95]

Recognising the role credit unions can play in diversifying financial services, the Department for Work and Pensions (DWP) established the Credit Union Expansion Project in 2013, and committed £38 million to explore how credit unions could be encouraged to expand and develop their capabilities.[96] Whilst this is to be welcomed, and be commended for its intentions, it is a relatively small investment. It will be interesting to see the progress of the project and if the Government decides to continue to support the growth of the credit unions.

Another provider of local finance are Community Development Finance Institutions (CDFIs), which specialise in providing loans and advice to local businesses, households and civil society organisations. CDFIs prioritise disadvantaged communities and focus their efforts on improving economic opportunity, alleviating poverty and regenerating neighbourhoods. In contrast to most high street banks, CDFIs have actually increased the amount of credit available to consumers and businesses since the financial crash, with a 256 per cent increase in the total number of loans reported.[97]

In contrast to the large high street banks, local finance institutions have a wealth of local knowledge that ensures that they are better able to understand the idiosyncrasies of their particular area and market. Two stand-out examples of local financial institutions are the East London Small Business Centre (ELSBC) and Monmouthshire Building Society. Unlike the large banks, ELSBC does not rely on credit scoring to assess the riskiness of a specific business. Instead, it reviews each applicant's business plan individually and in a bespoke manner. An independent panel then evaluates the businesses merits. Once the loan is approved, a business advisor continues to support the business throughout the businesses life, which dramatically improves a start-up's chances of surviving beyond the crucial first five years of its existence.

The Monmouthshire Building Society has a purposely limited geographical mortgage lending area and has savings rates reserved for locals within certain postcodes. Despite its confined geographical reach, Funding for Lending data showed that net lending by MBS (total assets £885m) in the final quarter of 2012 exceeded that of Lloyds (total assets £847bn) and RBS (total assets £1312bn) combined. Indicating that smaller financial institutions can, in their own way, significantly impact on the wellbeing of their customers in their local areas in which national banks simply cannot replicate.

But despite their being leading examples of local banking institutions providing a great service to their local customers, the UK still lacks a deep and widespread network of local banking institutions, which is in stark contrast to our European neighbours, where local finance institutions thrive. The German Sparkassen (Savings Banks) are a good example of how such a national network of local banks functions well and supports local development. As independent credit institutions under public law, they are responsible to the local municipalities. Sparkassen have a public mandate to support the sustainable development of their local economy and hold significant social responsibilities that go beyond the provision of banking services.[98] [99] In the midst of the recession, the Sparkassen played a crucial role in supporting local German business and the self-employed, and provide 42.7 per cent of all finance to German business. In total there are some 600 institutions employing around 346,000 people.[100]

In Britain, steps have been taken to re-create the success of the Sparkassen through the British Business Bank, which is a state-backed economic development bank that aims to support economic growth by bringing together public and private funds to create better finance options for small businesses. On the back of the presumption that the banking sector is far too concentrated, one of the bank's key objectives is to "help create a more diverse market" with a "greater choice of options and providers".[101] Announced in December 2012, and aiming to be fully operational before December 2014 (subject to state aid and regulatory approval),[102] the Business Bank proposes to do this via a range of local partnerships that offer a small amount of public investment, including a £300m investment programme to encourage new lending models that support smaller businesses.[103]

Integrating public funds with lending, in the mould of the German model, can also be seen at the local level in exciting new banks such as Cambridge and Counties. Established in 2012, the bank is jointly owned by Cambridgeshire Local Government Pension Fund and Trinity Hall, a College of the University of Cambridge. Taking a local relationship approach the bank focuses primarily on its heartland regions of Cambridgeshire, Northamptonshire and Leicestershire, coupled with a national broker coverage model. This allows balanced growth across geographies, market sectors and property types, avoiding inappropriate concentration risk. The bank offers retail and non-retail deposit accounts; SME lending to businesses with a turnover of less than £25m; and other business loans between £50,000 and £1 million.[104] This model of local finance is one that could be employed throughout the UK.

Given the potential for further growth of the UK local banking market if compared to the European average, we would recommend that the Government build on the welcome development of the establishment of the British Business Bank (BBB) and assess how this organisation could be 'localised'. Under such a model, Government funds can be divested at a level of government that is more closely associated with the smaller businesses it purports to support. One possible means of achieving this could be through transforming Local Enterprise Partnerships into local 'branches' of the BBB, which would offer BBB products and funded advice as would a high street bank. Such a move could give England the comprehensive tier of local banking that it currently lacks, and could significantly increase the levels of diversity within the banking industry – with all the benefits to ethos this would bring.

Diversity of access

The third aspect to diversity we are concerned with for the purposes of this report is that of access or medium. The rise of the internet and other technological advancements has led to the digitalisation of much of our daily lives. Online and digital competitors have challenged the traditional providers of products and services, offering better choice of price, convenience and service in the process.

Responding to the digital challenge, all large retail banks offer online banking services. With more than 26 million people in the UK using internet banking,[105] it is not surprising that in 2011 a survey found that one in four adults access their bank account online every day and two thirds claimed it was the preferred way of managing their money.[106]

One consequence of the rise in online banking is that the large banks have gradually scaled down their high street branch presence. In 1990, there were 17,637 high street bank branches, by 2003 there were just less than 12,000. Today there are approximately 9,500, but that is highly likely to decrease even further in the near future.[107] Indeed, since the crisis, Barclays has indicated it could shrink its 1,600-strong branch network by 25 per cent;[108] NatWest has announced that it is to lose up to 361 branch managers;[109] and it is estimated that Lloyds will close 10 to 20 per cent of their existing branches.[110]

Whereas the early closures can be part explained by demutualisation, the retreat from the high street since 2008 points to the sector's recognition that people's banking habits have changed. Appealing to those who do not require the security associated with face-to-face banking, online banking caters to consumer demand to such a capacity that all banks now believe, perhaps wrongly, that running a branch on every high street is no longer necessary.

As with other industries, banking has realised that digital and online platforms are in many cases better for the 21st century customer. Anthony Jenkins, Group Chief Executive of Barclays, has previously detailed his bank's intentions to encourage more innovation and anticipate consumer demands in a digital age.[111] [112]

However, despite the expansion of online banking being a hugely positive thing for customers in terms of convenience, the banks tend to offer very little different than they do in-store – especially in the personal and corporate finance markets. Digital expansion should increase opportunities for further innovation, yet this is not what we typically see in banking. Indeed, the banks have been criticised for not responding quickly enough to customer need in this regard.[113]

Alongside greater diversity of ownership and scale, we all need greater diversity of access. In short, a wider range of channels or access points through which people can interact with their financial institutions. In the digital age, this requires the sector possessing a variety of online platforms that would, by competing with the large banks for custom, drive up innovation across the industry. But what we currently have is a digital financial sector dominated, just like its physical counterpart, by the large high street banks.

This is not to say that progress has not been made. Over recent years, digital finance firms, such as peer-to-peer lending and crowdfunding platforms, have injected much needed choice into the banking sector. The appeal of such platforms has grown almost exponentially since the crash, and many customers now view these as real alternatives to the mainstream banks that they largely distrust.

These two main types of digital finance platforms, despite their many similarities, are not one and the same. Crowdfunders enable customers to raise finance from a range of individuals who choose to pool their financial resources. They often allow start-ups and social enterprises to 'pitch' for equity investment, and have the endearing quality of enabling investment in projects with a social or environmental purpose. For example, Abundance is a crowdfunding platform that allows people to invest in renewable energy projects, infrastructure and business.[114] The Rt Hon Greg Barker MP, former Minister of State for Climate Change, has hailed the potential for crowdfunding to accelerate the development of low-carbon energy generation capacity and the move towards a decentralised energy system. [115] This is an example of finance fulfilling its economic development and wider-social potential.

Peer-to-peer lending platforms, on the other hand, act as an interface between those who seek a return on their money, and those businesses or consumers that need to access credit. In the mould of a traditional bank loan, peer-to-peer lending allows a variety of groups, including councils and individuals to collectively offer a loan of varying size.[116] The peer element in the lending process has also been shown to reduce default rates on loans.

As the Peer to Peer Finance Association, which represents peer-to-peer lenders, said in their evidence to the Parliamentary Commission on Banking Standards, "the widespread availability of digital broadband technology is allowing the cost effective development and distribution of new sorts of financial services products to retail consumers". Although retaining the traditional role of a high street bank, by offering better value and convenience,[117] peer-to-peer lending helps to expand the diversity of options open to customers that wish to access online financial services.

The rise of online platforms has two distinct benefits. Firstly, they empower the customer to access finance on their terms and to invest their money where they want. Secondly, they enable projects that would otherwise note be attractive to investment, i.e. social, local and environmental projects, to start-up and grow. In this way they offer a viable source of competition to the banks as well as an alternative.

As touched on earlier, by integrating such platforms with public funds, digital platforms could provide finance to those underserved by mainstream banks by playing a similar role as the Sparkassen do in Germany. Funding Circle, a leading peer-to-peer lender, has a partnership with a number of local authorities across the UK, whereby it agrees to utilise local government finance to provide credit to firms within the respective local authority's area of jurisdiction.[118]

Such a model could well be replicated across local government, and it is something that the British Business Bank has already made use of.[119] As such, and in recognition of the opportunities that a further expansion of digital financial services could bring, we recommend that the Department for Business, Innovation and Skills conduct a review of the success of the Funding Circle scheme and other similar initiatives to ascertain the viability of rolling out such schemes, with Government support, across the UK for all local authorities. This would have the benefit of both promoting diversity of scale and access.

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6 Conclusions and recommendations

"Given that the actions of bankers impact so heavily on all of our lives, as has been poignantly demonstrated over recent years, restoring ethos to the sector must be a key priority for both the industry and whichever political party gains power after the next General Election."

It is clear to all those who would care to look, that an emptiness exists at the heart of our banking industry where the twin duties of care and stewardship should instead reside. This lack of inherent purpose is to blame for the propagation of a banking culture that, at best, incentivises fervent short-termism or, at worst, advocates the pursuit of greed over the common good.

Given that the actions of bankers impact so heavily on all of our lives, as has been poignantly demonstrated over recent years, restoring ethos to the sector must be a key priority for both the industry and whichever political party gains power after the next General Election. Exactly how this underlying ethos can be restored and virtuous banking promoted has been the key purpose of this report. It is our opinion that the industry can only achieve this goal once governance structures are aligned to the needs of both employees and customers; competition is driven by true ownership and empowerment; and diversity is considered a primary pre-requisite of a well-functioning market.

The ten recommendations outlined below are our suggestions to policy makers and industry leaders on how such a historic re-shaping of the banking industry could be realised.

1. Define and enshrine an overarching purpose for banking: A criticism often levelled at the banks is that they either perform no clear social purpose or, if they do, this is often not reflected in the actions of bankers. This lack of purpose clearly permeates through banking institutions and does little good for the reputation of the industry. In light of this, and the need to solidify the industry around a clear social objective, we recommend that the new Banking Standards Review Council adopt the description of the purpose of banking we advocate in this report. We have based our description of the purpose of banking on three core principles that we believe the industry should always endeavour to adhere to: *Ensure systematic prudential security*; *work for the prosperity of customers*; *promote the responsible creation of value*.

Governance

2. Co-design codes of conduct to place customers at the heart of standards: Key to instilling the customer-centric culture that banks need are the thoughts and opinions of the customers that will ultimately be most affected by any changes to standards and behaviour. The views of the customer are completely vital to ensuring bankers act in accordance to the high standards members of the public require of them. As such, we recommend that the new Banking Standards Review Council, as one of its first actions, undertake a joint open public and industry consultation to create a Code of Conduct founded on the opinions and desires of all relevant stakeholders, with a prioritisation given to the views of the public.

3. Require all bankers to swear the Bankers' Oath: Consumer trust and confidence is at an all-time low. We believe that, if bankers were required to swear an oath akin to the Hippocratic Oath that doctors affirm, this would signal a serious commitment from bankers towards the pursuit of greater professionalism. In light of this, we recommend that the British Bankers' Association, the Building Societies Association and the new Banking Standards Review Council as all of its members adopt the Banker's Oath detailed in this report. Such a statement of intent from these three bodies would be a momentous event, and could prove the turning point for how the general public regard our banks.

4. Toughen shareholder fiduciary duties to promote activism: A key role of shareholders is to hold the banks they own to account. Yet, shareholder inactivism has been widely acknowledged as one of the key drivers for the last banking crisis. To answer this criticism, we recommend that the British Bankers' Association conduct a review of shareholder activities in our banks to determine the scale of this inactivism. We would also like to see recommendations that outline how shareholders could have a much more active role in the governance of our large banks. In particular, through improvements to current fiduciary duties that require to shareholders to take a much more active role in the stewardship of banking institutions.

Competition

5. Encourage the banks to compete on customer satisfaction: A truly competitive market is one that competes, not just on price, but on levels of customer satisfaction. In order to create a better functioning market, we recommend that the FCA require all large banks and building societies to display customer reviews and ratings on their websites and in their high street branches. The FCA should also display the performances of the leading banks in a league table format to both enlighten the customer and foster competition amongst the banks. The industry should look to the innovative rating systems that online retailers like Amazon and Ebay use as examples of how such a system might work.

6. Strengthen consumer rights to improve consumer choice: Despite good progress being made in the field of individual consumer rights through the current Consumer Rights Bill, there still exists a lack of commensurate protection for small businesses. Given that small firms are likely to suffer the same disadvantages in terms of limited knowledge and access to professional financial advice as individual consumers, we recommend that the Government adopt a single definition of the term 'consumer' that incorporates small firms in future consumer protection regimes. Secondly, we also recommend that the ceiling for Financial Ombudsman Service eligibility be raised to include not just 'micro' businesses, but those that are considered 'small' enterprises. Raising the ceiling in this way would significantly extend the ambit of this vital body to include thousands of struggling small businesses.

7. Launch a competition to kick-start the online advice market: A lack of affordable and sound advice from the banks is an ongoing concern for regulators, and perhaps indicates a failure in their duty of care. Given the ongoing trend in branch closures, the only viable option for providing this advice lies in better online advice. As such, we recommend that the industry run a high level competition amongst the largest banking providers, in conjunction with leading technology firms such as Google and Microsoft, to develop a tool for online advice that empowers their customers to make sound financial decisions. The winning entry should then be actively promoted by Government through the Money Advice Service to maximise the impact of such a tool.

Diversity

8. Conduct an immediate review into the diversity of UK banking: Too little attention has been attributed to the contribution diversity gives to the stability of the sector. Given the numerous benefits of having a more diverse banking sector, we recommend that the Prudential Regulation Authority immediately conduct a review of the current state of financial diversity in the banking sector. As part of this, and given a lack of good existing data, we recommend that the Government and research bodies also endeavour to improve the quality of data and research available for the assessment of diversity in British banking. This is to ensure that this key

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component of a healthy banking sector can be sufficiently monitored by regulators and the academic community.

9. Localise the British Business Bank through LEPs: Given the potential benefits that a local banking network could bring to the British economy, we would recommend that the Government build on the formation of the British Business Bank (BBB) to assess how this organisation could be 'localised'. One possible means of achieving this could be through transforming Local Enterprise Partnerships into local 'branches' of the BBB. These would offer BBB products and funded advice similar to a high street bank. Such a move could give England the national tier of local banking that it currently lacks and which most of our European competitors possess.

10. Utilise public funds to boost the digital finance market: Innovative online digital finance platforms are leading the way in promoting consumer choice and service excellence. In this digital age, these platforms and vehicles are clearly the future of customer-focused, ethos-led banking. As such, and in recognition of the economic opportunities that a further expansion of digital financial services could bring, we recommend that the Department for Business, Innovation and Skills conduct a review to determine the viability of utilising local government funds to increase lending to small businesses and social enterprises through digital lending platforms. Funding Circle already operates a similar scheme with a number of local authorities, and has met with some success.

The job of reforming our banks can be best described as half complete. To fully inject a sense of social purpose into our banks, which is sorely needed if we are to ever witness an increase in trust in our banking institutions, then we must ensure that future generations inherit a financial industry that is abundantly more competitive, diverse and ethos-driven. By adopting the recommendations in this report, we believe that the Government and the industry could develop a more virtuous form of banking.

New Economies, Innovative Markets

This publication is an output of ResPublica's New Economies, Innovative Markets workstream, one of the three core workstreams of the ResPublica Trust.

This workstream seeks to provide practical solutions for a moral capitalism and sustainable economy. This includes encouraging new market entry, ensuring supply chain resilience through more localised control, promoting greater diversity of business models and facilitating wider asset distribution, in order to achieve an economy based on trust and reciprocity.

Current and forthcoming work will build upon the ideas outlined in our past output which have had a continuing impact on the British policy landscape. Examples of our successes in 2013 include ResPublica's report recommending a new community energy model to unlock investment in local energy projects, and a paper on increasing lending to consumers and SMEs via improvements to risk profiles through protection products. In 2014 this workstream will encompass our research on financial institutions and intermediaries, re-defining economic competition, SMEs and social enterprise, and governance prerogatives for a more responsible form of capitalism.

The banking industry is Britain's great economic and social enabler. Given the capacity of our banks and building societies to promote growth and empower communities, our financial institutions have the potential to be society's most transformative institutions. Yet this view is not the commonly-held view amongst the general public. The last financial crash highlighted an insidious culture in the industry that revered short-term profiteering over long-term prosperity. Because of this, and despite ample reform, the average citizen remains unconvinced of the social worth of our banks.

Virtuous Banking: Placing ethos and purpose at the heart of finance argues that regulators and the industry must make it a first priority to restore the civic purpose of our banking institutions. In the report, we suggest that the key to this lies in promoting financial diversity amongst banking models and by fostering leadership in the industry through the introduction of new standards institutions.

This report states that the purpose of our banks is to serve their customers well, be they individual consumers or businesses, and to support the communities they live in. Only once this civic purpose has been restored can current attempts at banking reform be considered truly complete.

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