Trust and Trustworthiness in Banks and Bankers

Speech by Sir David Walker, Barclays Chairman at the Federal Reserve Bank of New York workshop on reforming culture and behaviours in the financial services industry.

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Introduction

I am grateful to the philosopher Onora O'Neill for reference to very relevant advice from Confucius that three things are needed for government: weapons, food and trust.

"If a ruler cannot hold on to all three, he should give up the weapons first and the food next. Trust should be guarded to the end. Without trust we cannot stand".

It is not only rulers and governments who prize and need trust. Each of us, and every profession and every institution needs trust. We need it because we have to be able to rely on others acting as they say that they will and because we need others to accept that we will act as we say we will - in other words that they and we ourselves are trustworthy.

Neither trust nor trustworthiness in respect of banks can be defined in absolute terms. Banks may be trusted by retail clients for some business, management of a current account, but not for other business such as advice on savings or investment. An important specific issue is whose trust is in question. A paradox is that the articulation of concern about trust comes particularly prominently from politicians and the media, in whom there may be comparably little or even less trust than there is in bankers. Situations have existed and no doubt continue where the degree of trust placed in a bank by its regulator, on the basis of superior knowledge, is less than that of its customers. There is also a quite widely-held retrospective view of an earlier golden age when, supposedly, bankers dependably behaved to high standards and earned trust in consequence. But in a much less complex banking environment than that of today, characteristics such as bundling of products, opaque charging arrangements and less intense competition meant that such trusting attitudes at the time were in some cases at best only partly justified.

A different environment

Despite the importance of appropriate perspective, there has undoubtedly been a major erosion in the trust placed in and perceived trustworthiness of banks over the past two decades. One over-arching element has been a much sharper focus on short-term performance. Intense competition for revenue and market share in a boom environment coupled with the persistence of obdurately stubborn excess capacity led to a widespread cutting of corners. Clients for whom caveat emptor was inappropriate were increasingly treated as counterparties. The huge scale and growth of turnover in financial markets was accompanied by slippage in standards at trading desk level of which boards, senior managements and regulators were in many cases largely or wholly unaware. All of this change, and many of its negative aspects, were accentuated by transition to a remuneration environment in which variable became a much more significant part of the total.

Though trust is largely a qualitative phenomenon, quantitative evidence of the erosion that has taken place prominently includes the extent of regulatory and enforcement action in respect of past misconduct. Some penalties may be regarded as disproportionately big, and mistrust has in some degree been fed by application of modern regulatory standards to market practices that were long regarded as acceptable to the extent that they were under

any earlier form of regulatory oversight. Nonetheless the cumulative overall scale of enforcement initiative can only be regarded as indicative of grave failures in banks. What confidence can we have that, while much of this action relates to legacy issues, there are not underlying problems that persist?

Three ingredients in trust in banking

I want to propose a three-part taxonomy for thinking of trust in banks. The first relates to the financial stability of individual banks and of the banking industry. I do not address this aspect of trust much further here because, while there is a huge continuing schedule of work to be done, great progress has been made since the crisis in strengthening the robustness of individual banks and of the whole system. Society can feel more secure that banks will not fail, at any rate to detriment of the retail depositors or the taxpayer, and on this basis trust in banks and banking is enhanced.

The second ingredient relates to the operational resilience of banks in terms of their systems and processes. Technology has supported radical improvement in the capacity, efficiency and auditability of these processes, and it is now a critical responsibility of bank boards to ensure and of regulators to monitor continuing operational resilience. I will not address this further here save to note that, first, trust in any situation is partly a function of expectations, which have been substantially raised by the huge increase in the quality and array of product and service offerings opened up by technology; and, second, that, while technology has massively improved the capability of systems and processes, they have concurrently also become much more vulnerable to cyber-attack. This is plainly an area of grave concern for boards of banks and their regulators, though perhaps a somewhat lesser factor in the degree of trust placed in banks by clients and customers.

Financial integrity and resilience relate to what might be seen as the "hard" ingredients in trust. The third ingredient is "soft" and relates critically to the "how" rather than the "what" of banking business. This "how" in banking is the way in which a bank treats its customers and all those, including its own staff, with whom it deals. This way reflects a bank's purposes and values and how fully they are sustainably embedded in its behaviour. This is a bank's culture.

Public policy responses

In this changed environment of reduced trust in banking and the associated hardening in political, social and media attitudes since the crisis, legislators, regulators and enforcement agencies have become intensely active in the conduct space. There is much more specificity in the form of detailed rules, of which infractions may incur severe penalties.

The objectives of most of these measures focussed on business conduct are in my view appropriate and necessary, even though the precise form and techniques applied may be suboptimal in some areas. But three contextual observations are critically relevant. First, while parts of the more intrusive regulation of conduct will address what may be described as the ethical aspect of behaviour, much of the focus is on promoting the stability of the system by, for example, limiting speculative trading activity or strengthening the robustness of clearing arrangements for derivative transactions. These measures do not address the third of the trust factors that I identified earlier.

Second, while rigorous processes and controls are essential across the whole of banking, and greater specificity was required in many areas, enhanced compliance and audit focus on consistent application of rules does not itself assure embedding of an ethical culture. Good regulation specifies rules and process and should promote good outcomes and the avoidance of bad ones. But reliance on rules alone invites a box-ticking approach that can readily extend to ingenuity in devising means of avoidance. It can also engender such defensiveness that the principal driver in a business unit becomes avoidance of risk rather than culturally responsible risk-taking. This will not itself promote focus on ethical objectives such as putting the client first or the avoidance of deception in all situations.

Third, while full and timely remediation of established client loss should always be a high priority for the regulator, it seems clear that the comparative detachment of many enforcement agencies from the supervisory and regulatory process and the high political and media profile of enforcement actions is not itself conducive to the re-establishment of trust in bankers and banking.

Priority of complementary private sector initiative

In this environment of eroded trust, widespread disbelief in the adequacy of bank culture and the substantial further intrusion of regulation and enforcement into the conduct of banking business, there is, I believe, urgent need for proactive initiative by the banking industry to turn the tide.

First, despite the importance of enhanced regulatory specificity in many areas, closer regulation cannot itself create commitment to purposes and values as the foundation for a bank's culture. Regulators cannot and should not try to regulate culture, which is a matter for the individual entity. The regulatory role might be regarded as, at most, a fourth line of defence. Equally, however, if a bank can build a demonstrably dependable culture, it might reasonably expect regulation in respect of specific regulatory conduct matters to be applied over time with a lighter touch.

Second, most if not all banks proclaim their values, but many continue to see matters of behaviour as "soft" risks as against the "hard" risks involved in exposure to changing credit or market conditions. In practice, the behavioural dimension is much harder to tackle than determination of a specific risk appetite and ensuring that exposure remains within it. The challenge for boards in respect of behaviour is far less binary, requiring translation of the purposes and values proclaimed by the board, what the bank says, into dependable guidance for all employees, focussing on what the bank does. Establishment of a strong behavioural culture within a bank will improve internal effectiveness by promoting greater trust among its employees; will boost its reputation with all of its stakeholders; and will provide a solid plank for its overall position vis-à-vis customers for whom a more competitive banking environment and greater transparency have reduced inertia and traditional bonds of loyalty.

Third, in a much more intrusive and interested political media environment, accentuated by technology, the social accountability of banking, not much discussed in the pre-crisis period, has moved to centre stage. Major financial institutions and utilities such as energy companies are increasingly seen to have a "social accountability" which is much less vague than it used to be and has become much more important for explicit attention as balancing offset to the increased focus over the last two decades on shareholder returns. It is no longer sufficient for a bank merely to act within all relevant regulation. Its responsibilities have a much wider dimension, calling for acknowledgement and discharge of obligations to society that go beyond putting customers first and delivering value to shareholders, important as these objectives are. There can be no universal prescription as to how such obligations should be met, but initiatives commonly include engagement with local communities, promotion of greater access for the under-banked, and support of activity in education, health, youth employment that are seen as importantly beneficial to society as a whole. With greater focus on maximisation for shareholders, the focus on outcomes for other stakeholders now needs to be parallel and explicit. The reaction of society to the financial crisis did not relate as much to the breach of specific regulatory requirements – in many cases there were none – but to a breakdown in confidence in the ethical obligation of banks to society. A bank that does not, over time, build and sustain a demonstrable social accountability is likely to be increasingly vulnerable to political and other challenge and to face increasing erosion of its competitive position, both of which will ultimately work to the detriment of its shareholders.

Building a sustainable culture

I want to describe what I see as the key ingredients in enhancing trust in and the trustworthiness of banks. If there are specific process or control objectives for the delivery of which regulation is appropriate, then let there be

regulation. But I do not believe that, beyond a stance of high level interest and encouragement, the regulator can play a constructive role in the development and embedding of a positive culture in a bank. Indeed, more intensive regulation may well be inimical to the development of a robust internal culture which is likely to draw much more from behavioural psychology than from external interference.

Despite this serious reservation about the relevance of statute-based regulation in this context, there may be scope for self-regulatory initiative through which, separately from the regulators, the banking industry as a whole demonstrates its commitment on its own initiative to creating an environment of greater trust. Thus, in the UK, the major banks have established the Banking Standards Review Council as a self-regulatory initiative designed to promote, on an industry-wide basis, commitment by individual banks to high standards of behaviour wholly separate from any formal regulatory process. The intention is that, in signing up to this initiative, individual banks are making a material commitment to conform through the medium of their own cultural model. The expectation is that a combination of visibility as to commitment and peer group pressure will ensure that few, if any, banks will choose not to participate. To be clear, this is an industry-wide initiative designed to help restore trust in and, through enhanced behaviours, the trustworthiness of banking as an industry.

But whatever principles are advanced on an industry-wide basis, the critical necessary condition for development of a sustainable culture within a bank is clear articulation by the board of the purposes and values to which it commits alongside a business strategy and operating model consistent with them. Three cautionary notes are, first, that this board determination cannot itself mandate a culture, which will only emerge as the end-result of a process in which purposes and values are embedded. Second, consistency with the entity's business strategy will be critical; in particular, accomplishment of the desired cultural change will be more difficult the greater the focus on short-term revenue or market share performance. Third, the facility with which purposes and values can be embedded in the organisation is likely to vary inversely with their complexity. Simplicity in the message will limit the scope for nuance, but uncomplicated clarity is the better prize.

While the cultural objective is for the whole board, the wide array of issues arising in my view justifies delegation to a board-level committee of independent members to guide and oversee the executive effort applied to those ultimately behavioural issues. What may be regarded as "conventional" financial risks have generally been under much better board oversight and control in the period since the crisis, marking a substantial advance in overall financial risk governance. But a similar degree of confidence would not generally be justified in respect of conduct and reputational risks. In common with governance and support normally associated with the financial risk committee, a board's ethical or conduct and reputational risk committee should, in my view, be served by a functional member of the group's executive committee with clear solid-line accountability to the chairman of the committee alongside his or her accountability to the chief executive.

With this clear articulation of the purposes and values determined by the board and such governance architecture in place, the focus then turns to the challenge of internal transmission of the board's purposes and values so that they are embedded from the top to the bottom of the organisation. There is no single model for achieving this. The approach adopted will reflect a bank's organisation and structure but, whatever the approach, there are, I suggest, four essential elements.

The first is a programme of induction and training designed to communicate the company's purposes and values to all employees as far as possible on a customised basis focussed on specific, local issues within a business unit or function. A company's internal code of conduct will be importantly supportive. But dedicated time commitment to direct personal engagement through briefing sessions and workshops will be the most effective means of

demonstrating the seriousness of the board's expectation of continuing conformity with its purposes and values on the part of all employees in all that they do. This will have special importance if a board embarks on a new cultural initiative and in respect of newly-recruited employees, but engagement is most likely to be kept "live" through regular repetition and refreshment for all employees.

The recruitment process is an area for particular emphasis. Employment protection, human rights provisions and litigation exposure severely limit the reliance that can be put on any input from previous employers in relation to potential recruits. These constraints have undoubtedly reduced barriers to movement of "bad apple" employees among banks, with seriously negative consequences in some cases. All this means that the rigour of the recruitment process requires greater emphasis than it has often been accorded in the past in an environment of rapid business expansion.

The second necessary element relates to the contribution of the compliance function. Historically, this second line of defence has focussed on monitoring conduct in conformity with internal controls and regulatory requirements. This underscores the policing and enforcement role of the compliance function, with an associated emphasis on this type of compliance experience in the recruitment and building of typical compliance teams. But inculcating commitment to the bank's purposes and values in business units is likely to require a different approach in which the traditional and policing monitoring role of compliance is complemented by a more advisory, mentoring capability. The object is to ensure that the desired behaviours are fully integrated within the normal conduct of business in the business unit, the first line of defence, without continuous dependence on policing by compliance. High standards of conduct in line with the board's purposes and values will not be dependably achieved if this is not clearly embedded in the business unit. This has important implications for the mix of skills required in the compliance team. The need is for migration to an increasingly mentoring role calling for specialist capability drawing, importantly, on behavioural psychology. The aim should not be displacement of the traditional policing role, but development of this critical mentoring capability alongside it. I want to add here that Barclays feels so convinced of this element that we have formed a partnership with the University of Cambridge Business School and established the Cambridge Compliance Career Academy, through which over 2,000 colleagues will pass over the next two years. The primary objective is to equip compliance professionals with the skills necessary not only to strengthen their capability to monitor, but also to play an explicit mentoring role with business units.

The third necessary element requires consistency and alignment of financial incentives and career advancement to the declared purposes and values. This is unlikely to be achieved where the business thrust is weighted toward top-line growth and the short-term. A degree of regulatory prescription has, in my view, an appropriate role to play through proportionate provisions in respect of deferral, malus and clawback. But only the board and executive of the bank can ensure the essential alignment between the objectives and timeline of the business model and the values and behaviours to be embedded. One necessary caution here is that despite the priority and determination of the ambition to embed values, the chosen approach should avoid undue complexity. The criterion should be one of comprehensible simplicity so that this approach can be embraced and effectively communicated both internally, to clients and to all other stakeholders. Messaging can be usefully reinforced internally by overt encouragement and recognition where individuals or teams display exemplary commitment to the values in particular situations; and, equally, by prompt remedial or disciplinary action in respect of individuals or teams whose behaviour falls short.

The fourth element relates to the way in which performance might be measured both over time – as an indicator of progress, or lack of it – and, to the extent possible, vis à vis relevant peer groups. There is abundant experience of measurement by reference to financial metrics such as return on equity and earnings per share. But there is now need for greater focus on performance outcomes across a broader range of stakeholders in the areas of customers

and clients, colleagues, citizenship and conduct. There is an array of different possible approaches. In respect of employees, one approach involves measuring the expressed personal values of individuals against those that they observe in the entity at a point in time. These results can then be set against the desired values determined by the board, with the gaps between them serving as a potentially rich indication of areas for special focus. This type of approach can, for example, throw a very useful light on the persistence of "limiting values" where one individual's necessary control is another's bureaucracy. Within Barclays we have developed a balanced scorecard model which explicitly introduces a long-term dimension into the setting of short-term objectives for individuals, essentially as an antidote to the short-termism which can exert so negative an influence on patterns of behaviour. All employees are assessed through the performance management system with a composite rating based on what they deliver alongside their living of the values, the "how". In respect of the bank itself, one specific metric seeks to measure customer advocacy, which serves as a guide to areas where specific further effort may be required in terms of attentiveness to clients.

Metrics of this kind signal to the board and the executive where they are on the cultural journey at a point in time and what more needs to be done to reach the desired target point within the target timeline. A combination of relevant experience and insight from behavioural psychology is needed to improve the quality and value of these metrics, many of which are necessarily experimental. But as such measures evolve, my expectation is that they should and will be deployed publicly as part of the accountability of a bank for its performance vis à vis all of its stakeholders.

Culture, the bank and the regulator

Where a bank finds an effective means of embedding its values, its culture will take shape. The bank will be more trustworthy and more trusted in consequence. This is a journey to which the best support from the regulator is likely to be in the form of high-level and relatively detached encouragement rather than prescriptive rule-making, which is all too likely to be counterproductive. The substance and speed of achievement of the desired outcome will be determined by the wisdom and vigour of action taken by the board and the executive. Whatever priority was given in the past to the balance between the bank's operating model and its culture, in this new environment the visibility and credibility of the bank's culture is certain to be a clear differentiating factor in overall performance.