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'Our distrust is very expensive'

Article

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She has recently published a study of bank regulation in the UK in the twenty-five years after the Second World War, titled *The Regulation of the London Clearing Banks, 1946–1971: Stability and Compliance* (Cham, Switzerland: Palgrave Macmillan, 2018), see: https://link.springer.com/book/10.1007/978-3-030-00910-6.

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'Our distrust is very expensive': How do we restore trust in banks?[1]

For those interested in the development of banking and bank regulation in the UK over the last four decades, three trends are remarkable. First, from the 1970s the banking system has become less stable, certainly in comparison with the twenty-five to thirty years after the Second World War. That earlier period of stability in banking ended in December 1973 when the secondary banking crisis broke, part of a wave of banks failures in 1973 and 1974. Globally, there were an estimated 147 banking crises between 1970 to 2011, a period which included the global financial crisis of 2007-09.[2] The journalist Martin Wolf has opined that "The age of financial liberalization has, in short, been an age of financial crises."[3]

Second, banking operates – certainly in the UK and possibly in many other countries – against the backdrop of a quite dramatic change in attitude towards banks since the 1980s. The *British Social Attitudes Survey* reported in 2013 on "perceptions of how well major

1 The quotation is from a lecture on 25 January 1841 by Ralph Waldo Emerson to the Mechanics' Apprentices' Library Association, titled 'Man the Reformer'.

2 Laeven, L, and F Valencia (June 2012) 'Systemic Banking Crises Database: An Update, WP/12/163', IMF Working Papers: 1-32.

3 Wolf, M (2004) Why Globalisation Works, London: 280.

institutions are run." In 1983, 90 per cent of respondents regarded the banks as being well run. By 1994, the figure had fallen to 63 per cent and by 2012 stood at just 19 per cent. This, they observe, was "probably the most dramatic change of attitude registered in 30 years of British Social Attitudes."[4] Insofar as being "well run" is an indicator that a bank is trustworthy, a plausible interpretation of this survey is that there has been a precipitous decline in the perceived trustworthiness of banks over the last three to four decades. The decline began, it should be noted, well before the global financial crisis of 2007-09. Moving beyond the UK, an online global survey by the communications firm Edelman in late 2017 asked people how much they trusted businesses in fifteen different industry sectors "to do what is right." Only 54 per cent of respondents trusted businesses in financial services "to do what is right," which was the lowest score of the fifteen sectors.[5]

In contrast, a notable feature of the banking system in the twenty-five to thirty years after the Second World War was that the London clearing banks were regarded as trustworthy by both the regulator (the Bank of England) and the public. In his 1962 book *Anatomy of Britain*, Anthony Sampson summed up the public perception of banks thus: "In their dedication, their lack of greed, and their sense of quiet service, the joint stock bankers provide a placid, safe centre to financial Britain: one can no more imagine a bank going bust than the monarchy falling."[6] In 1964, BBC Two broadcast a television series called 'Men [sic] and Money: The City in the 1960s: A Portrait of the Bankers who Ran London's "Square

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4 Park, A, C Bryson, E Clery, J Curtice, and M Phillips (eds.) (2013 Edition) British Social Attitudes 30, NatCen Social Research, London: xvi, xv.

5 *2018 Edelman Trust Barometer Global Report*, accessed 11 October 2018, http://cms.edelman.com/sites/default/files/2018-02/2018_Edelman_Trust_Barometer_Global_Report_FEB.pdf: 45. The 2018 Trust Barometer is their 18th annual trust and credibility survey. It measures trust across a number of institutions, sectors and geographies, surveying over 33,000 respondents across 28 countries.

6 Sampson, A (1962) Anatomy of Britain, London: 375.

Mile".' The second episode, 'A Question of Confidence', was subtitled 'People Trust Banks and the Banks Trust the Government.'[7]

Third, from the 1970s, bank regulation has become increasingly codified and formal, focused on the development of elaborate regulatory and supervisory structures and with a preference for detailed, often technically-complex rules. This may in part be explained by Vogel's hypothesis that free markets require more rules, not fewer.[8] He suggests that the period since around 1975 has not been a period of deregulation, as many assume, but rather a period of liberalization coupled with various forms of reregulation. This reregulatory trend, he argues, has tended to be "juridical" in nature, with informal rules being replaced with legal ones and tacit rules with codified ones.[9] This approach to regulation has prevailed during a period of great instability in banking, and one in which trust in banks has declined.

In light of these trends, and in the context of the UK's departure from the European Union, it is timely to explore the regulatory framework for UK banking. This exploration should take the form of a broad and democratic conversation, not a purely technocratic one. It should focus not so much on the detailed minutiae of regulation, as on the principles which must guide and underpin the regulatory framework for banks. A conversation of this nature will equip us to resist the pressure for the UK to engage in a post-Brexit bank regulatory 'race to the bottom'.

This article will now explore in more detail the second trend noted above – the steep decline in trust in banks. It is argued here that one principle which should underpin bank

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7 Martin, A (ed.) 'Men and Money: A Question of Confidence', *BBC Archive*, accessed 3 October 2018, http://www.bbc.co.uk/archive/menandmoney/6801.shtml. The programme was broadcast on BBC Two on 28 April 1964.

8. Vogel SK (1998) Freer Markets, More Rules: Regulatory Reform in Advanced Industrial Countries, Ithaca, NY: 16.

9. Ibid., 17.

regulation is that effective bank regulation depends upon the placing and accepting of trust, and that this in turn depends upon trustworthy banks and bank regulators. This requires the perception that banks are not trustworthy to be reversed. On one level, the answer to the question 'How can we restore trust in banks?' is straightforward: it is by encouraging and / or incentivising banks to become *trustworthy*. Trustworthiness is the starting point for the placing and accepting of trust and is central to a well-functioning banking system in a democratic society. It is not only a question of having trustworthy banks. The system also requires a trustworthy bank regulator with high levels of legitimacy. This leads to the question: What does it mean to be a trustworthy bank (or bank regulator)?

It is useful in grappling with this question to consider some of the academic scholarship on trust. Nooteboom suggests that we think about the concept of trust together with the concept of control. They can be thought of as existing towards either end of a shared continuum. As trust expands along the continuum, control shrinks, and vice versa. When our approach is one of control rather than trust, this implies that we implement, monitor and enforce rules. In contrast, when we place trust, we do so on the basis of the other person or entity's competence (their "technical ability to act in line with agreements") and on the basis of their intentions – the "will and commitment" to act "according to the best of one's ability, and not to cheat."[10] A trustworthy bank would therefore be a bank which is technically competent, which works to the best of its ability and which does not cheat. Once we are able to place trust in banks because they are trustworthy, we are less reliant on direct controls such as detailed, codified rules. For O'Neill, being trustworthy means being honest, competent and

10 Nooteboom, B (2014) How Markets Work and Fail, and What to Make of Them, Cheltenham: 159-61.

reliable.[11] Mayer et al. suggest that the major part of organizational trustworthiness is explained by three qualities: the ability of the entity we trust (its competence); its benevolence towards us; and its integrity.[12] All three qualities are required. A bank which was technically highly competent, but which lacked integrity or had malevolent intentions towards its trustors would not be trustworthy.

The quality of benevolence towards one's trustor(s) seems to be particularly important and has potentially far-reaching corporate governance implications. A bank's trustors include, but extend well beyond, its shareholders. Its customers are also trustors, for example. The concept of having benevolent intentions towards one's trustors (arguably a more fitting term rather than the attenuated term 'stakeholders') is in tension with the conventional view that the purpose of the firm is, above all, to maximise shareholder wealth, and that the interests of shareholders should be placed above those of other trustors.[13] Moreover, given the special position of banks and of the banking system in an economy, society itself can be considered a trustor of the banking system since society places its trust in, and relies on, that system. Being trustworthy as a sector requires having benevolent intentions towards society.

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11 O'Neill, O (June 2013) 'What We Don't Understand About Trust', *TED: Ideas Worth Spreading*, accessed 3 October 2018, https://www.ted.com/talks/onora_o_neill_what_we_don_t_understand_about_trust/transcript?language=en.

12 Mayer, RC, JH Davis, and FD Schoorman (July 1995) 'An Integrative Model of Organizational Trust', The Academy of Management Review, 20(3): 709-34.

13 The Companies Act 2006 requires directors to act in the way they consider "would be most likely to promote the success of the company for the benefit of its members as a whole." It would be difficult to interpret the word "members" as meaning anything other than shareholders, although the Act does then require directors to "have regard to" other stakeholders. See "Companies Act 1946, chap. 46 [United Kingdom]" *legislation.gov.uk*, accessed 5 November 2018, https://www.legislation.gov.uk/ukpga/2006/46/contents: Part 10, Chapter 2, 172.

From these definitions we can begin to distil the essence of trustworthiness as meaning that for a bank to be trustworthy, it must possess certain qualities (including integrity, technical competence and benevolent intentionality).

How does a policy objective of supporting banks to increase their trustworthiness relate to bank regulation more generally? O'Neill argues that increasingly, regulation has tended to be seen as a substitute for trust. An agent cannot be trusted, so regulation is required. One problem with seeing regulation as a substitute for trust is that it may lead to an infinite regress.[14] A bank cannot be trusted and so needs to be regulated. Furthermore, the regulator of that bank cannot be trusted and therefore needs to be regulated as well, and so on. A hint of this logic of regulation as a substitute for trust is evident in the trend in many countries in the last several years to establish independent 'fiscal watchdogs', such as the UK's Office for Budget Responsibility (OBR). The very existence of the OBR assumes that the existing agents or agencies who have responsibility for monitoring the public finances cannot be trusted and a regulator is required to monitor them as well.[15] O'Neill argues that, on the contrary, regulation must rest upon trust – it complements trust, as Nooteboom would see it.

This is particularly the case in the context of contemporary banking and bank regulation. Nooteboom suggests that in situations of high uncertainty, or in situations where monitoring is difficult, one necessarily becomes more reliant on trust. Since the 1970s, many banks and financial institutions have become more complex in terms of the nature of the

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14 O'Neill, O (20 November 2014) 'Building Trust', a lecture at Saïd Business School, University of Oxford.

15 'What We Do', *Office for Budget Responsibility*, accessed 3 October 2018, http://budgetresponsibility.org.uk/about-the-obr/what-we-do. The OBR was established in 2010.

products and services they sell, the structure of the industry, the global nature of their operations, and their corporate structures. Herring and Carmassi point out that even in the aftermath of the global financial crisis, it has not been possible to stop or reverse the trend towards more complex financial institutions: "the overall degree of complexity (as measured by the number of subsidiaries) has not decreased since the crisis."[16] This necessarily makes monitoring more difficult and requires us, according to Nooteboom's logic, to rely more on trust than direct control.

If we accept that bank regulation must rest upon trust (rather than replace it) and that we are necessarily reliant on trust given the complex nature of contemporary banking, the challenge for policymakers is to develop policies which encourage and / or incentivise banks to become trustworthy, or more trustworthy. Three suggestions follow. First, in the area of corporate governance, it is worth considering whether the UK Corporate Governance Code should include a requirement that boards have an obligation to strengthen their company's trustworthiness. It might also be appropriate to require company directors to have a duty to strengthening a company's trustworthiness. Second, policymakers should ensure that regulators can monitor the trustworthiness of banks. For example, using O'Neill's definition (that being trustworthy means being honest, competent and reliable), these qualities can inform the nature of the information submitted periodically to the regulator (the provision of information being a very common regulatory tool in many regulated sectors). In practice this

16 Herring, R, and J Carmassi (April 2015) 'Complexity and Systemic Risk: What's Changed since the Crisis?' in AN Berger, P Molyneux and JOS Wilson (eds.) The Oxford Handbook of Banking, 2nd edition, http://oxfordindex.oup.com/view/10.1093/oxfordhb/9780199688500.013.0004.

means that information submitted should provide among other things "adequate, useful and simple evidence" of a bank's trustworthiness.[17]

It is sometimes assumed in policymaking that the fundamental driver of behaviour is material incentives, particularly financial incentives, and that achieving the behavioural outcomes we desire is a case of designing the right incentive structures. However, it should also be acknowledged that behaviour is shaped by the broader institutional framework, the dense thicket of institutions which shape our behaviour. The term 'institution' as it is used here has a different meaning from the term 'organisation'. Drawing on North, we can think of institutions as the entire array of "humanly devised constraints that structure political, economic and social interaction."[18] Institutions can take one of two forms: formal and informal. Formal constraints include constitutions, laws and property rights, while informal ones include sanctions, taboos, customs, traditions and codes of conduct. Policymakers need to consider how best to use not only formal constraints, but informal ones, too. The 2013 report of the Parliamentary Commission on Banking Standards, 'Changing Banking for Good' observed that, although a professional qualification had never been a formal requirement for being a banker, there has been a steep decline in membership of the professional body for bankers, the Chartered Institute of Bankers, in recent decades:

> In the 1980s, there were as many as 150,000 members of what was then the Chartered Institute of Bankers (CIB), and approximately 10,000 members of the Chartered Institute of Bankers in Scotland (CIOBS). CIB membership had fallen to no more than 22,000 by 2010, with CIOBS/Institute membership remaining relatively constant at 10,500. It is clear, however, that of the approximately 450,000 individuals employed

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17 O'Neill, O (June 2013) 'What We Don't Understand About Trust', *TED: Ideas Worth Spreading*, accessed 3 October 2018, https://www.ted.com/talks/onora_o_neill_what_we_don_t_understand_about_trust/transcript?language=en.

18 North, DC (Winter 1991) 'Institutions', Journal of Economic Perspectives, 5(1): 97-112.

> in UK banking today, only a small proportion are professionally qualified in banking and members of a recognized professional body for bankers. In particular, only a small proportion of senior bankers are members of a recognized professional body for bankers.[19]

It is a characteristic of a profession that its members abide by a "code of ethics by which they are required to put their client's interests ahead of their own."[20] A third suggestion is that there is a role for policy in supporting the revival of banking as a profession.

This article has explored the idea that effective bank regulation depends among other things upon the placing and accepting of trust, and that this in turn depends upon trustworthy banks and bank regulators. It is one of several principles which are needed to guide and underpin the design of a regulatory framework for banks appropriate to a democratic society. On the surface, trust and trustworthiness are highly abstract concepts, too abstruse to contribute in a practical way to the policy discussion of the UK's post-Brexit bank regulatory framework. There will be an inexorable momentum for that policy discussion to become a technocratic one. It is incumbent upon policymakers to resist that momentum by reflecting on the fact that that trust in banks is an essential component of a well-functioning banking system. Trust in banks will be restored once people are convinced that banks are trustworthy. The question for policymakers therefore becomes: What policies will guide, incentivise and encourage banks to be trustworthy?

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19 This information was provided to the Commission by Simon Thompson, Chief Executive of the Chartered Banker Institute. 'Changing Banking for Good: Report of the Parliamentary Commission on Banking Standards Volume II: Chapters 1 to 11 and Annexes, together with formal minutes', accessed 8 November 2018, https://www.parliament.uk/documents/banking-commission/Banking-final-report-vol-ii.pdf.

20 'Profession(s)' in BS Turner (ed.) (2006) Cambridge Dictionary of Sociology, accessed 7 November 2018, https://search-credoreference-com.idpproxy.reading.ac.uk/content/title/cupsoc?tab=entries.