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Ethics and economic growth: Preventing culture from going south as profits head north

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Summary

- It its first year the FCA has been strongly promoting the requirement for both firms as well as the wider financial services sector to improve culture and ethical behaviour.
- The financial services sector was, historically, strongly associated with the importance of integrity but more recently, and particularly post economic crisis, public perception of the sector appears to be more akin to the *Wolf of Wall Street* than the Quaker values of yesteryear.
- Considerable strides are being made to rebuild public trust and improve the culture and ethics of the sector by individual firms - but there is a danger, according to the FCA, that any future economic recovery will reassert the bad old ways and good culture will revert to being a second or even third order issue.
- Martin Wheatley sets out the danger of the cycle of the 'something must be done' reaction to crises and scandals which often leads to increased regulation and this can reinforce the 'obedience mentality' which can reinforce the problem in the first place.
- Mr Wheatley argues for creating an improved culture now which will be able to resist future economic pressures and future short-termism. He argues that along with structural changes in the sector the promotion of strong ethics in firms is a non zero sum game and will benefit not only the firm itself by the wider reputation of the sector.
- It is impossible to avoid all future crises but it is in all of our interests to choose long term sustainable growth over short-term 'enchanted wealth'.

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CII Introduction: The CEO of the FCA Martin Wheatley has, since the inception of the FCA a year ago, focused strongly on the importance of re-setting the culture and ethical performance of the whole financial services sector. The CII has supported this focus and indeed has produced three guidance documents to support our members in thinking about and developing good culture at firm and sector level to help promote the public interest and better consumer outcomes. This Thinkpiece based on a recent speech by Mr Wheatley offers a salutary warning that progress towards a better culture and behaviours needs to be 'locked in' now while there is a strong public focus and attention on this and must be sustained through future economic good times as he puts it starkly, where there is a need "to prevent culture from going south when profits head north".

As we look to understand and rectify all that went wrong pre-crisis, it's easy to forget that pre-pre-crisis, the growth of financial services was inextricably connected to social responsibility of this kind.

At the start of the 20th century, Max Weber famously linked the expansion of Western European capitalism to the Protestant work ethic, Calvinism and a belief in predestination. The idea that we all have a calling in life.

Two of our largest domestic firms, Lloyds and Barclays, were given to us by the Quaker movement. And this focus on ethics and integrity continued, largely untroubled, well into the 20th century. For a long time few questioned the social utility of finance.

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Today of course, the world is very different. The string of post-crisis crises has fashioned a new, Wolf of Wall Street public narrative. LIBOR emails, angry traders ripping their own shirts off their backs, mis-selling, opacity, casino-banking and so on and so forth.

So, we're now, essentially, in a position where the financial sector is confronting a world with fewer advocates than it would like: but also perhaps fewer advocates than it deserves.

Over the last 18 months or so, we've seen a mini-cultural revolution taking place. The majority of big banks and firms now have change programmes in position. Ross McEwan last week openly talked about RBS scrapping the likes of teaser savings, cashback offers and zero per cent offers on credit transfers. He also challenged RBS' rivals to follow suit.

At the same time, we're seeing the rise of new models of banking and finance from entrants like Aldermore, Handelsbanken and Crowdfunder. On the one hand complementing existing players in the market: on the other confronting them.

The sustainability question

A priority challenge for leaders in regulation, in politics and industry, is how we keep this emphasis on culture as we enter the next phase of the UK financial cycle?

My serious concern is that if we're not careful, economic recovery will bring so much investor pressure for growth stock that questions of culture will become second or even third order issues.

We've already seen annual, global dividend pay-outs total more than $1tn for the first time. What are the odds that in five, ten or 15 years, expansion becomes an irrepressible force for short-termism, with chief executives pushed and pushed for year-on-year, quarter-by-quarter growth?

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Will we then see more 'interest only negative-amortizing adjustable-rate' subprime mortgages? A form of 'enchanted wealth', as Thomas Carlyle described it after the industrial revolution. Or will we instead see growth and profitability based on productivity, high quality products and high quality client service?

FCA responsibility

For all of us today, these are questions of the greatest societal importance. We have the narrowest of windows here to make cultural change stick before memories of financial crisis fade. The narrowest of windows to restore the long link between ethics and growth that dominated financial services for most of their history. The key challenge is how we take advantage of this 'opportunity', if you like.

Two key areas of focus that I want to touch on here. First, the importance of creating effective, future-proofed regulation. Second, the importance of effective self-regulation. On the first, our priority issue at the FCA has been, and will continue to be, moving the regulator away from a low value culture of reacting to events.

Warren Buffett, the only man alive with his name in more book titles than the Dalai Lama, famously remarked that in

the business world, 'the rear view mirror is always clearer than the windshield'.

For the official sector, this problem has been particularly acute. Around the world there's been a culture of reacting to conduct issues; whether mini-bonds in Hong Kong, currency swaps in Korea, structured agricultural products in Australia or of course PPI in the UK.

So the first FCA priority is simply to anticipate better and be more forward looking, if you like. In other words, to prevent culture from going south as profits head north.

Key examples so far include the positive work the FCA has done with banks on areas like interest only mortgages: writing to some 2.6m homeowners and alerting them to the importance of having capital repayment plans in place. And, in June last year, the new retry system: effectively, an agreement by lenders that if an account payment is unsuccessful in the morning, it will be attempted again later in the day - saving retail consumers an estimated £200m a year.

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The second FCA priority has been to re-assess the regulatory balance between ethics and rules. Should one dominate the other? In his excellent book *Ethicability*, Roger Steare argues for a more sophisticated interpretation of integrity in business. One that is not simply defined by the ethics of obedience, so what is legally right or wrong, but actually looks towards the ethics of care and the ethics of reason.

Steare talks about rules subordinating ethics, suggesting that, 'at their worst, laws, regulations and red tape have a tendency to multiply because they remove our responsibility for deciding what's right.' His chief concern here: the fact that governments tend to respond to scandal with regulations, without considering that it's this 'obedience culture' that often fails in the first place.

So, if we take the FSA as just one example of this culture. You see its guidance increasing by some 27% during 2005-08, a period that coincides with many of the most explosive crises we're dealing with today.

Now, clearly regulators and firms still require rules to function effectively. But experience tells us red tape is more easily hurdled than principles. So as we move forward, firms will begin to see themselves held up against stricter ethical standards.

Firm responsibility

And this brings me onto my final point today: the importance of good self-regulation by firms.

So the first FCA priority is simply to anticipate better and be more forward looking, if you like. In other words, to prevent culture from going south as profits head north.

The key issue here, how do firms create cultures that are genuinely different from those pre-crisis? And, crucially, how do we encourage change that keeps pace with economic growth? In other words, a culture strong enough to resist short termism. One of the most important issues here is incentives.

In *The Big Short*, Michael Lewis famously uses the example of some US hospitals removing more appendixes than others because they get paid more for doing so, to underline the point that: 'if you want to predict how people will behave, you look at their incentives.'

Within the finance community, rewards are clearly an ongoing matter of national debate. Not just within corporate or investment banking. But on the frontline as well, and the relationship between how we reward staff on the one hand, and how they sell products, like PPI, on the other.

The FCA has published its own analysis of sales incentives.The broad story is extremely encouraging. All the major banks have either replaced, or substantially reformed their incentive schemes.

And I do want to applaud businesses for taking these steps. Clearly, these reforms mirror European efforts to revisit incentives in the City as well, with the introduction of deferred awards, claw backs and the like.

But there is a wider issue here around how boards ensure these positive signals are not corrupted as they move down the line. One of the more worrying stats to emerge last year was a survey of senior executives in UK financial services by the Economist Intelligence Unit.

In a poll that should set alarm bells ringing, some 53% of financial service executives reported that career progression at their firm would be tricky without 'flexibility' over ethical standards - rising to 71% of investment bankers. There are serious questions within these statistics for boards to

consider as we move forward and also serious future risks to manage.

Fairly or otherwise, financial service leaders have not always been held up as great communicators. Alan Greenspan's wife notoriously failed to understand what he was saying the first time he proposed.

How do we encourage change that keeps pace with economic growth? In other words, a culture strong enough to resist short termism.

These Economist figures suggest some business leaders are still struggling to get their message across. That not all cultural reform proposals have been understood or accepted; it is an imperative they are. But I do want to finish with a thank you to boards for at least beginning this difficult conversation around culture in their firms.

Conclusion

Will we look back in 25 years and see this as a turning point? Only time will tell.

Perhaps our best hope for the future, alongside structural changes in the official sector, remains the fact that the promotion of strong ethics in firms is not a zero-sum game; where for one side to win the other has to lose, like a game of football or tennis.

This is, at its heart, a 'non-zero sum game' in which we rise, or fall, in lock step. In his inaugural presidential address in 1937, Franklin Roosevelt said: 'We've always known heedless self-interest was bad morals, we know now that it is bad economics'.

In other words, a crisis does not generally affect only one firm's share value or reputation. It affects the whole world that society and business depends on for growth: per capita GDP, employment, political imperatives, regulation and so on.

We cannot hope to avoid all future crises, or anticipate every issue that bubbles up. But we can safely say it's in all our interests to choose long term, sustainable growth - over short term 'enchanted wealth'.

Note: this speech was given by Martin Wheatley to the International Worshipful Company of Bankers on 4 March 2014 and we are grateful to Mr Wheatley and the FCA for replicating this speech as a Thinkpiece.

If you have any questions or comments, and/or would like to be added to a mailing list to receive new articles by email, please contact us: thinkpiece@cii.co.uk or by telephone: +44 (0)20 7417 4783.

Martin Wheatley is the Chief Executive of the Financial Conduct Authority. He joined the FSA on 1 September 2011 as the Managing Director of the Conduct Business Unit. Martin joined us from Hong Kong's Securities and Futures Commission where he served as CEO for five years. Before this, he held various roles including Deputy Chief Executive of the London Stock Exchange Group plc and sat on the FSA's Listing Authority Advisory Committee.

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Learning Objectives

Having read this Thinkpiece, readers will be able to:

- Better understand the FCA's concern to not only achieve better outcomes and an improve industry culture but lock them in for the future; and
- Identify the division of responsibilities between 1) firms and 2) the FCA in achieving these outcomes.

Reflective Questions

- How might improvements in the culture of firms manifest itself in terms of future regulation, according to Mr Wheatley?
- Mr Wheatley cites moves to a better culture including new requirements for sales incentives. What other measure might firms, and the whole sector, undertake to further achieve this objective?
- Do you believe there is the opportunity for a 'responsibility premium' for firms which proactively develop best practice in culture and customer outcomes, and if so how might this be measured and demonstrated.