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Reforming the Culture of Banking: Restoring Trust and Confidence in Banking

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Abstract

The focus of this article is on the issue of culture in banking and the problems for Trust and Confidence it has caused in recent years most especially in the UK. A new paradigm of research and public debate is emerging which focuses on culture and incentive structures in banking. It seeks to explain not so much *what* banks do but *why* they do it and sometimes behave in ways that are detrimental to consumers. This in turn raises the issue of whether bank culture should become an issue to be addressed by bank supervisors.

The starting point is that in many ways banking and the retail financial services industry in the UK (but also in some other European countries) have failed the consumer which has undermined consumer trust and confidence in major parts of the industry. The analysis considers why Trust and Confidence are important in finance, and the key central issue of culture within financial firms. With respect to the last-mentioned, particular reference is made to the Shareholder Value model and the incentive structures it creates. We consider that culture may be different in the mutual/Cooperative model of financial firms. The article considers certain structural issues with particular emphasis given to the lack of diversity in the UK financial sector (most especially with regard to ownership structures and business models), which is in contrast to virtually all other European countries. Various approaches to reforming bank culture are considered.

There is a limit to what regulation can achieve for consumer protection and the enhancement of consumer interests if the underlying culture is hazardous and, therefore, if there is not a major change in the underlying culture and ethos of banks. One approach is to create industry-wide standards to change the underlying ethos and culture of banking. A major step forward in the direction of such collective self-regulation has been the establishment in the UK of the Banking Standards Review Council to develop plans for an independent professional body to promote high standards in banking.

There are clear economic, systemic and welfare benefits to be derived from a successful mutual or cooperative sector in the financial system. 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 is, therefore, a public policy interest in fostering diversity in the financial system.

Keywords: Bank Culture; Consumer Protection; Financial Sector Diversity; Trust and Confidence in Finance; Shareholder Value V. Stakeholder Value Business Models; Banking Standards Review Council.
JEL Codes: G00; G14; G18; G21; G28; G38; M14; M52.

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«Over the past 20 years, the norms of behaviour in important parts of the banking sector have fallen below what the public has a right to expect»
«A loss of trust in the banking sector as a whole has broad and damaging consequences»
Consultation Paper, Banking Standards Review, February 2014

The focus of this article is on the issue of culture in banking and the problems for Trust and Confidence it has caused in recent years. The scandals surrounding British banking in recent years are well known: the banking crisis, several examples of banks mis-selling financial products to vulnerable consumers, the attempts to rig LIBOR and to manipulate the foreign exchange market, and mis-treatment of SMEs. As a result, record fines have been imposed on several banks. All of this has created a lack of consumer trust and confidence in banks: as put by the Banking Standards Review (2014): «there is no dispute that the banking sector taken as a whole has lost the trust of the public, and needs to earn it back».

In this context a new paradigm of research and public debate is emerging which focuses on culture and incentive structures in banking. It seeks to explain not so much *what* banks do but *why* they do it and behave in sometimes hazardous ways to the detriment of consumers. This in turn raises the issue of whether bank culture should become an issue to be addressed by bank supervisors and, if so, in what ways.

Although the article draws on recent experience in the UK for illustrative purposes, much of the analysis applies in varying degrees to other European countries. For instance, Lindley (2014) indicates that many of the problems focussed on bank culture and incentive structures faced by bankers in the UK apply to many other countries.

Our starting point is that in many ways banking and the retail financial services industry in the UK (but also elsewhere) have failed the consumer which has undermined consumer trust and confidence in major parts of the industry. After a review of this central proposition, this article considers why trust and confidence are important in finance and the key central issue of culture within financial firms. With respect to the last-mentioned, particular reference is made to the Shateholder Value (SHV) model and the incentive structures it creates. We then consider that culture may be different in the mutual/cooperative model of financial firms. The paper then considers more structural issues with particular emphasis given to the lack of diversity (most especially with regard to ownership structures and business models), and structural differences between the UK and most other European countries. Various alternative approaches to reforming bank culture are also considered at various points.

1 Problems in the Retail Finance Industry

Our starting point is that in several respects the retail financial services industry in the UK is not serving a wide range of retail customers as well as it should or could. In no small way this partly reflects a fundamental issue of culture. Several structural and behavioural elements of this market failure can be identified:

– Partly as a result of a succession of high-profile scandals, **Consumer Trust and Confidence** in finance is currently low though, because of the nature of financial products and transactions, and the potential vulnerability of retail customers, trust and confidence is crucial in retail financial markets.

– There have been numerous and costly episodes of systematic **mis-selling of some financial products**.

– **A Lack of diversity** in terms of ownership structure of financial firms, corporate governance arrangements, capital structure and, above all, business models. Three particular observations are to be made in this area: (1) the degree of diversity is considerably lower in the UK (because of the dominant position of the SHV model) than elsewhere in Europe; (2) empirical evidence indicates that diversity has decreased in the UK while it has tended to increase in other European countries, and (3) the critical mass of the mutual model has been substantial eroded in the UK compared with other European countries.

– The lack of diversity is particularly marked with respect to **business models** of financial firms which has the effect of reducing consumer choice and effective competition.

– ***Relationship Banking* has given way to *Transactional Banking***, which in turn has promoted a sales culture and potentially hazardous incentive structures within banking and other financial firms.

– There has been a serious erosion in the application of the principles of the ***Treating Customers Fairly*** regime which was imposed on the retail financial services industry by the then regulator – the Financial Services Authority (FSA).

– Training and competence regimes within financial firms evidently give a low priority to ethical standards.

– **Incentive structures** are often perverse within financial firms at two levels: inherent in the SHV model (maximising shareholder value), and within financial firms: bonuses based on sales, etc.

– Evidence has emerged that some life assurance firms have engaged in **opportunistic cross-subsidies** by offering new customers better returns than legacy investors.

– **Lack of truly effective competition** (both *structural* and *behavioural*) in some retail markets. This is partly because of structural weaknesses in the competitive environment; a lack of diversity in business models; the difficulty in some markets for consumers to make rational choices between products and firms (e.g. because of complexity and lack of transparency, etc.), and sometimes high transaction costs of switching between different suppliers and products.

– **Unjustifiably high charges** (especially exit costs) for many investment products purchased by retail consumers.

– **Complexity of charges, prices and some financial products together with a lack of transparency**. This clearly limits the extent to which competition is truly effective as it is difficult for consumers to make informed comparisons. What is often «excess complexity» also makes it difficult for consumers to fully understand the true costs of some products and their risk characteristics. Over-complexity can reduce consumer welfare both because it makes it difficult for consumers to understand the full characteristics and risks of products and may, as a result, result in consumers buying inappropriate products. But equally, such complexity might deter consumers from buying products that they should be buying. Either way, consumer welfare is harmed.

– There is an **unnecessarily complex intermediation structure** between the consumer and the ultimate supplier of products which adds to overall costs for the consumer. This amounts to an unnecessarily complex value chain in some financial products and high distribution costs.

– **Lack of access** (financial exclusion) to financial firms and products for some (low income and vulnerable) consumers.

– **The market for independent advice** for consumers is weak at a time when it is essential for such advice to be available. There is clear evidence of the extent to which, partly as a result of recent regulatory changes, several retail banks have exited from the independent advice market.

There are several generic reasons why these problems have emerged in retail finance (and to some extent also wholesale finance) and can be divided between structural and behavioural factors:

1. The nature of financial products (such as complexity and their long-term nature) which means that opportunistic behaviour can remain undetected for a considerable time.
2. Allied to this is a lack of consumer understanding of sometimes complex products. A recent OECD report has highlighted this problem and not only for the UK.
3. Cultural issues (such as *inter alia* the emergence of a sales culture, incentive structures based on remuneration models) in the banking industry and in individual financial institutions which mean that the consumers' interest is not always the over-riding principle.
4. Business objectives (in particular a focus on short-term rate of return on capital) which may be achieved in the short-run by opportunistic behaviour.
5. The nature of the industry itself and in particular in some financial markets weaknesses in effective competition which may, in part, be due to a lack of diversity and the mono culture of a single, shareholder-value model.

There may be other structural factors associated with the way that large banks are organised: bank personnel often being remote from their customers, a silo mentality in large organisations and an inability of very senior officers to know precisely what their banks' business practices are; lack of personal responsibility for decisions; and the steady erosion of relationship banking in favour of transactional banking. Furthermore, regulation is often regarded as a «box-ticking» exercise rather than a focus on the spirit of regulation, what it is trying to achieve, or a focus on the customers' true interests.

2 The Trust and Confidence Issue

Consumer Trust and Confidence are essential in retail finance because retail financial transactions are fundamentally different from most other economic transactions. Firstly, consumers often lack confidence in making judgements about financial products and can be nervous when making substantial financial commitments. Secondly, the amounts of money involved are sometimes substantial for individual consumers. Thirdly, consumers need to have confidence that sellers of financial products have the consumer interest at heart and are not simply selling products in order to enhance their own personal income through, for instance, sales-related remuneration incentives. Furthermore, consumers often have only limited ability to confidently judge the suitability of sometimes complex financial products.

And yet trust in the industry is low and has been declining in recent years partly as a result of the banking crisis but also major episodes of mis-selling of inappropriate products. 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 (Haldane, 2009). Evidence arises from time to time of a lack of consumer confidence in three dimensions: in the ability to make rational decisions, in the integrity and competence of financial firms, and in the understanding of financial products. There is evidence of a lack of consumer awareness about issues such as the suitability of products, their risk characteristics, the nature of products and their return characteristics, and consumers' own requirements. This is potentially fertile ground for financial firms to exploit their asymmetric information advantages, and the evidence shows that in some areas they have done so.

In many financial transactions, a relationship is created by the transaction. However, relationships break down in the absence of trust. Lack of Trust and Confidence can be regarded as a market failure for two main reasons: (1) there is likely to be a sub-optimal demand for financial products and services as some consumers exit the market, and do not buy what they should buy, and (2) conversely, inappropriate products may be purchased and therefore consumers end up with sub-optimal portfolios. There is a clear welfare loss if consumers buy inappropriate products perhaps because the product is willfully misrepresented or the consumer does not understand the nature of the product. Equally, there is a welfare loss if consumers do not buy suitable financial products because of a lack of Trust and Confidence in the products or their suppliers. In the current context in the UK, this could be particularly important if there is a need to give higher priority to long-term savings.

Potential consumer detriment can occur in one or all three stages of a transaction and post-contract behaviour: the *pre-contact stage* (inadequate or misleading information disclosure), the *contract stage*, (selling inappropriate products), and the *post-contract stage* where behaviour of a financial firm after a contract has been sold can significantly affect the value of the contract or product to the consumer. In this regard, significant differences exist between financial and non-financial services and transactions (Llewellyn, 1999) to an extent that trust and confidence are crucial in the consumer's mind-set:

– financial products are not purchased frequently which means that the consumer has only limited experience or ability to learn from experience and past mistakes,

– contracts are necessarily incomplete as it is not possible to specify all future behaviour of counterparties in advance, and hence the outcome and ultimate value is uncertain,

– post-contract behaviour by the supplier can powerfully influence the ultimate value of the contract to the consumer,

– the full cost of the product may not be known at the point of purchase and it can sometimes be concealed from the consumer,

– value is not immediately clear at the point of purchase: the consumer often cannot know if a bad product is being purchased,

– it is sometimes difficult for consumers to make rational choices because of complexity, information problems, lack of transparency, costs and returns often being obscure and difficult to calculate, etc.

– the consumer often lacks confidence in making purchases of sometimes complex financial products,

– it is easy for a financial salesperson to conceal relevant information and/or mislead the consumer and when it is difficult to detect misrepresentation at the time of purchase,

– principal-agent relationships are involved and purchases often create a fiduciary relationship between the consumer and the company which takes on the responsibility of managing the client's investment or savings,

– a long-term relationship is created by the transaction: relationships break down in the absence of trust,

– it may be a long time (if at all) before the consumer becomes aware of the value and faults of a financial contract. This limits the potential of reputation as an assurance of good products. Even if, in the long run, reputation is damaged by bad behaviour, consumers' wealth is impaired in the meantime,

– while a faulty product can be replaced, a bad financial contract cannot be surrendered and replaced other than at (sometimes substantial) penalty costs,

– the consumer requires advice when purchasing financial products, which gives rise to further potential principal-agent problems and moral hazard.

These characteristics have three implications. Firstly, the transaction costs for the consumer in verifying the value of products (even when this can be done at all) are high. Secondly, because of the nature of the products and contracts, producers can easily mislead the consumer and this may not be detected for many years, and sometimes not until the contract matures by which time irreparable damage may have been done. Thirdly, in these circumstances, it may not be sufficient to rely on the reputation of the supplier.

The central point is that there are significant differences between many financial products and services compared with non-financial products which means that the consumer needs to have trust and confidence in the solvency, integrity and competence of financial firms.

With regard to incentive structures, in the case of the imposition of a £28 million on Lloyds Bank by the Financial Conduct Authority (FCA) in 2013, the FCA concluded that:

Financial incentive schemes are an important indicator of what management values and a key influence on the culture of an 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.

More generally, the former Financial Services Authority (FSA) argued as follows: «In many markets for retail financial products and services the incentive structure for firms to treat their customers fairly has not always been robust enough to deter all firms inadvertently or deliberately taking advantage of the relative weakness of the financial services customer» (FSA, 2004).

3 The Key Issue of Culture

Several high profile scandals have resulted in heavy fines imposed on banks and other financial firms by regulators: a total of £786 million by the FSA in 2012 and 2013. Banks have also been required to compensate customers including a current total of around £20 billion for PPI mis-selling alone. In many important respects, the behaviour that led to these fines being imposed reflects how the culture of banking has changed. A major issue is the central role of **culture** within financial firms. In this regard, particular emphasis is to be given to:

- transactions- v. relationship-based business practices,
- the emergence of a dominant, and sometimes, aggressive sales culture,
- internal incentive structures and remuneration systems which are often perverse in terms of the interests of the consumer: the culture of an organisation is often powerfully influenced by the remuneration systems in place, (New City Agenda, 2014),
- whether focussing on maximising shareholder value itself creates a particular culture and incentive structures that may produce hazardous behaviour to the detriment of customers,
- a short-termist focus with respect to maximising profits in Shareholder Value banks,
- what seems to be the demise of the concept of «treating customers fairly» as formulated many years ago by the former FSA,
- internal governance arrangements,
- the size of banks, the impact of technology, and the more remoteness from customers may also have impacted on culture.

There is a further over-arching issue of whether banking needs to become a true «profession» with concomitant standards as are found in other professions.

4 Alternative Approaches to Reform

There are basically three alternative generic approaches to reform to address the issues discussed in earlier sections and later sections: (1) individual self-regulation by banks, (2) externally-imposed regulation, or (3) collective self-regulation by an industry-wide body. The first-mentioned cannot be relied upon because of free-rider problems, the lack of certainty and credibility for the consumer and other banks, and *moral hazard* and *adverse selection* problems (good firms may be induced to follow the opportunistic behaviour of bad firms because it can be profitable in the short run – moral hazard – or may exit the market if the hazardous norms of their competitors come to dominate the market).

Throughout its programme of reform since the banking crisis, the UK government has focused on regulatory and prudential issues in the name of systemic stability. Whilst recognizing that this must be a part of any reform programme, it ignores the over-riding issue of bank culture and incentive structures. This has also been recognised by regulators when Martin Wheatley (chairman of the FCA) argued that «governments over the years have responded to scandal with rules and regulation, without considering that it was 'the obedience culture' that often failed in the first place» (Wheatley, 2013).

There are also problems with regulation: in particular, a voluminous structure of regulation has not prevented scandals arising over the past few years, and it often induces a box-ticking mentality within financial firms. Lambert (2014) has also argued that an over-reliance on statutory regulation tends to reduce competition and build barriers to entry and innovation. In practice, and unless regulation is to become draconian, there are limits to what regulation can achieve if the underlying culture and incentive structures within banks are hazardous.

The problem, therefore, is that individual self-regulation cannot be relied upon, and there are limits to what can be achieved by external regulation in the absence of cultural change in the industry. In which case, there is a case for an industry-wide collective regulation by the industry itself. This amounts to establishing industry standards to change the underlying ethos and culture of banking. The over-aching issue is the extent to which it is realistic and feasible to shift banking in the direction of being a true «profession» as is commonly understood. The underlying principles of a profession are that there are collective standards which are universally accepted; these standards are created, monitored and enforced by a professional body; there is a discipline of enforcement with sanctions imposed when the code of behaviour is breached; the consumers' interest is at the forefront, and there is a general loyalty and commitment to the collective ethos and standards of the profession.

There is a limit to what regulation can achieve for consumer protection and the enhancement of consumer interests if the underlying culture is hazardous and, therefore, if there is not a major change in the underlying culture and ethos of banks, and a greater sense of corporate responsibility in the banking industry. Perhaps the focus should be more on culture (that is based on ethical values) than on formal regulation. Furthermore, as noted in Payne (2012) «some insiders have argued that structure regulation may exacerbate misconduct by promoting a culture of formal compliance, as opposed to one based on substantive ethical values».

4.1. Reform of Culture: *A Cultural Mission*

Financial firms always claim that they strive to treat customers fairly and to offer good value products and services in competitive markets. But time and again major lapses have occurred including serious episodes of systematic mis-selling of products to potentially vulnerable consumers. There always will be isolated episodes of hazardous behaviour by financial firms: mistakes will always occur from time to time. And yet experience over the past decade and more looks increasingly as if, in some cases, the problem is more systematic and based on a sales culture and internal reward and incentive structures.

In a detailed study of the weaknesses in the culture of banking, and the way that the financial sector has in many respects failed the consumer, a report from ResPublica (Llewellyn *et al.*, 2014) made several recommendations including *inter alia*: improvements to internal governance structures of banks, enhanced competition, greater diversity in the banking sector, establishment of codes of conduct with the customer at the heart of standards, tougher shareholder fiduciary duties to promote activism, and encouraging banks to compete on customer satisfaction.

Change in underlying culture is difficult to achieve in any organisation. But an outline of a strategy can be given along the following lines in what might be termed a *cultural mission*:

– Financial firms need explicit ethical standards in their missions based on the general principle of «treating customers fairly» along the lines indicated several years ago by the FSA and yet which did not prevent major episodes of mis-selling.

– Training and Competence regimes within financial firms need to explicitly incorporate such standards.

– Whilst the cultural ethos needs to be established from the top of an organisation, it needs to be «owned» throughout the organisation.

– Ethical standards, and the principle of «treating customers fairly», need to be monitored and clear mechanisms established to enable systematic internal audits to take place.

– Internal reward structures need to change away from a bias towards a sales culture.

– There needs to be systematic and universal mechanisms to investigate the risk characteristics of products, contracts and services and that these are clearly understood by front-line staff at all relevant levels.

– There needs to be credible complaints-handling mechanisms and procedures which have the confidence of, and credibility with, customers.

In essence, the desirable culture is one of **strong ethical standards in dealing with all customers and which have the principles of «treating customers fairly» as a central guiding principle**. In a 2014 ResPublica report, Llewellyn *et al.* propose that bankers should commit to a Bankers Oath where they commit «...to behave in a manner than prioritises the needs of customers... and to exhibit a duty of care above and beyond what is required by law... to conduct my business in an ethical manner».

In order to sustain credibility in the minds of consumers, all of the elements of the *cultural mission* should be monitored by the relevant supervisors. In other words, not only should the elements of the *cultural mission* be a strategic issue for financial firms, they also need to be part of regular on-going supervisory procedures: they are both strategic and supervisory issues.

5 Culture, Trust, Confidence and The Mutual Model

In many respects, mutuals should have an intrinsic advantage in Trust and Confidence not the least because they have «members» rather than exclusively customers and this is likely to create a different culture. This means that consumers already have a firmer, more explicit, and higher level of relationship with the mutual than with other companies by virtue of «membership». This also means there is no conflict of interest between consumers and external shareholders. The corporate governance objective of a mutual is to behave in the interests of members rather than external shareholders. Although not all customers in a mutual are necessarily members, the distinction between owners and customers is less in a mutual than in other companies

Evidence from a variety of surveys in the UK suggests that consumers do in fact have more trust and confidence in building societies than in, for instance, Shareholder Value banks. Research conducted in July 2013 shows that customers of mutuals consider that their provider delivers on various aspects of service to a superior extent than do consumers at banks: being more trusted to act in their best interests, mutuals outscore banks by 17 PP; being open and honest, mutuals outscore banks by 11 PP; having high ethical standards mutuals have a superior score of 24 PP; in the area of treating customers fairly, the superior score is 10 PP, and in being valued as a customer mutuals outscore banks by 16 PP. In terms of overall satisfaction, in mortgages mutuals have an excess score of 12 PP and in the savings market it is 10 PP. An IMF study (Fonteyne, 2007) suggests that as consumer-owned institutions, Cooperative banks have a comparative advantage in gaining the trust of their customers.

Whilst no claim can be made that mutual financial firms are necessarily paragons of virtue, their ownership model and basic business model suggests that the internal culture is likely to be less hazardous for consumers than is the case with SHV institutions:

– they are not shareholder value driven with the incentive structures that often go with this model,

– the typical mutual seeks to maximise the benefit of their members and to maximise consumer surplus. The interests of members rather than external shareholders are at the centre of mutuals' business strategies,

– they are less likely to be prone to a short-termist ethos,

– the merging of customers and owners which is a central feature of a mutual is itself likely to create a different culture and, in particular, a lower risk appetite,

– many Stakeholder Value institutions have a «social mission» in their core objectives,

– the fact that building societies and other mutuals are owned by their members (rather than large institutional investors) makes them less prone to the asset-substitution problem and hence less inclined towards risk-taking (Drake and Llewellyn, 2001).

The position has been stated well by the Bank of England:

> Mutuality may do a lot better job of aligning stakeholder incentives than some alternative forms of corporate governance (Haldane, 2009).

6 The Banking Standards Review Commission

A major step-forward in the direction of collective self-regulation has been the establishment in the UK of the Banking Standards Review Council (BSRC) following a series of recommendations made by Sir Richard Lambert who was commissioned by the banking industry to develop plans for an independent professional body to promote high standards in banking. The conclusion of the Lambert review is that: «there is a strong case for a collective effort to raise standards of behaviour and competence in the banking sector, and the best way to deliver this is by setting up a new and independent body to drive the process forward». In particular:

> The objective of the Banking Standards Review Council will be to contribute to a continuous improvement in the behaviour and competence of all banks and building societies doing business in the UK. It will act as an independent champion of better banking standards in the UK, and be driven by the interests of customers and of the wider group of stakeholders with a concern for the well-being of the British banking system (Lambert, 2014).

The plan is that the BSRC will work with the industry to develop a single principles-based code of practice to set standards of good practice and based on high-level principles being established by regulators. It will require participating institutions to commit to a programme of continuous improvement in the areas of culture, competence and customer outcomes. It will rely on public «naming and shaming» of recalcitrant banks. Above all, it will highlight and champion good practice in banking.

7 SHV v. STV Models in Finance

Having discussed some of the problems in the retail financial services industry, we turn to more structural issues and in particular to the role of Mutuals/Cooperatives and the balance between Stakeholder Value (STV) and Shareholder Value (SHV) financial firms in the financial system (the diversity issue). The central theme is that there are considerable advantages to be gained through greater diversity in ownership and business models in terms of effective competition, consumer choice, different cultures, and systemic stability.

We conceptualise SHV banks as those whose primary (and almost exclusive) business focus is maximising shareholder value and the rate of return on equity. In contrast, in the mutual model there are many stakeholders and most especially its members. In the mutual model, while profitability is needed to finance future growth, it is not the exclusive, or even primary, objective. In practice, this means that an STV financial firm will not pursue profit maximisation to the same degree, or with the same intensity, as will

SHV banks, (Llewellyn, 2005). The position is described well in Christen *et al*. (2004) and in Ayadi *et al*. (2009) as «Double Bottom Line» institutions. A key difference between Mutuals/Cooperatives and SHV banks is that in the former the customers are themselves the «owners» (members) whereas there is a separation of the two in the case of SHV institutions.

In many ways, mutuality may be particularly suited to the provision of some financial services, and especially those relating to longer-term contractual relationships such as mortgages and life assurance. This may be due in part to the possibility that financial mutuals are able to address agency problems more efficiently. As a result, they also have a comparative advantage in establishing trust (Kay, 2006) which is important in three cases in particular: consumer «lock in» (transaction costs or penalties of exits are high); where there is asymmetric information between the firm and the customer, and in the case of longer-term contracts.

8 The Case for Diversity in Finance

In contrast to many other European countries, the degree of diversity with respect to ownership structure of financial institutions in the UK is low and has been in decline for several years. A major factor in this decline was the conversion to SHV status in the 1990s of many of the largest mutual building societies and insurance mutuals. As a result, the British financial system has come to be dominated by the SHV model which has created something of a mono-culture in the banking and financial sectors which is in stark contrast to virtually all other European countries.

There is a public policy interest in fostering diversity in the financial system (see Llewellyn and Wildman, 2014, and Llewellyn *et al.*, 2014). A key issue is the extent to which enhancing the role of the mutual sector, and fostering greater diversity of models in the financial system, can contribute to alleviating at least some of the market failures identified at the outset. Our thesis is that they can largely because of differences in culture that are likely to exist between STV and SHV institutions.

Several recent studies (for instance, two reports – Ayadi, *et al.*, 2009 and 2011 – issued by the Brussels-based Centre for European Policy Studies) demonstrate clear economic, systemic and welfare benefits to be derived from a successful mutual or cooperative sector in the financial system. 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. This is what should make the enhancement of diversity a major public policy issue in finance.

There are several dimensions to the a lack of diversity in the British financial system: the dominance of large SHV banks, the balance between SHV banks and mutuals, the power of Too-Big-To-Fail banks and the implicit subsidy they receive, and the decline in the degree of diversity within the SHV bank sector. The conversion of some of the largest British mutual building societies in the 1990s produced a major structural change in the financial system and severely weakened the balance between mutuals and SHV institutions in the retail savings, mortgage, and insurance markets. A de-mutualisation could only occur on the votes of existing members (Llewellyn, 2015). Unlike in continental Europe, de-mutualisation of building societies (and mutual life assurance offices) involved payments to current members as the concept of inter-generational legacy was not enshrined in British law. This represented an inter-generational transfer of benefits and wealth and, under these circumstances, it is perhaps not surprising that members tended to vote in favour of de-mutualisation.

The case for financial structure diversity has been made by official agencies and published empirical research. Thus, the EU Commission published a report in 2007 on European retail banking. The European Parliament subsequently issued a Resolution on 5th June, 2008 which argued:

> the diversity of legal models and business objectives of the financial entities in the retail banking sector (banks, savings banks, co-operatives, etc.) is a fundamental asset to the EU's economy which enriches the sector, corresponds to the pluralist structure of the market and helps to increase competition in the internal market

Two studies by the Centre for European Policy Studies find that

> legal, political, and risk-related considerations serve to highlight the need for a European banking model based on diversity...

Other studies (e.g. Cihak and Hesse, 2007; Fonteyne, 2007, and Beck, *et al*, 2009) have found that European Cooperative banks have been more stable than SHV banks. For instance, the share of Cooperative banks in total losses during the crisis was considerably smaller than their overall market share. Although there are always exceptions, the general picture to emerge from a wide range of studies is that STV banks have a more conservative approach to risk and risk management than the generality of SHV banks. The conclusion of several studies is that the presence of STV banks adds to the stability of the financial system.

The evidence suggests that, across Europe, STV banks tend to be more stable than commercial banks with lower volatility of returns (Groeneveld and de Vries, 2009, and Ayadi *et al*., 2011). Furthermore, such banks came out well in the recent crisis compared with SHV banks.

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 such as SHV institutions and mutuals will be inherently more stable than one populated by either model alone. Furthemore, there is the effect that a strong mutual sector has in enhancing competition because of the different business model. Competition is likely to be more effective when it operates through different business models than by adding more institutions with the same business model.

9 Conclusions

Our starting point was that in many ways banking and the retail financial services sector more generally has failed the consumer. This has been due to a series of *structural* and *behavioural* weaknesses. In terms of structural issues, the advocacy of a greater role for mutual financial institutions, and a reversal of the increasing dominance of the shareholder value model, is based on economic criteria in terms of the efficiency of the financial system, diversity of business models and cultures, the interests of systemic stability, the enhancement of effective competition, and the general advantages of diversity. The objective is to erode the mono-culture of the shareholder value model.

A central conclusion is that there is systemic advantage in having a mix of financial institutions with different business models. The mix means that contrasting business models have different portfolio structures with the potential to reduce overall systemic risk by virtue of institutions not being homogeneous.

Much was lost to the financial system in the UK by the demutualisation of mutual building societies and insurance companies, both in terms of the intrinsic characteristics of the mutual model, and in terms of systemic stability and effective competition.

With respect to behavioural issues, there are limits to what regulation can achieve for consumer protection if the underlying culture and incentive structures within banks and other financial institutions is hazardous. One of the problems with externally-imposed regulation is that it tends to focus on processes which in turn sometimes inculcates a «box-ticking» approach. Scandals have occurred despite detailed conduct of business regulation imposed on banks. In which case, it may be that regulation has focussed on the wrong issues: processes rather than culture and incentive structures. Regulation is a necessary but not sufficient condition for consumer protection. What is needed is a more fundamental change in the culture of banking. This may be more achievable if an industry-supported professional body were to be established to deal with issues that are difficult for regulation to address.

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