Good Culture

Does the Model Matter in Financial Services?

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Social Market Foundation

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EXECUTIVE SUMMARY

The financial crisis has caused a reassessment of the role businesses play in society and that culture plays in capitalism. The events of the last seven years have demonstrated both the systemic importance of the financial services sector to the economy, and the many opportunities within financial services for things to go wrong. The complexity of financial services markets means that all firms face corporate governance challenges around oversight, accountability, compliance and risk management.

This report examines the role culture can play in financial services firms by creating the norms and guiding principles which encourage good business behaviours. We explore:

- Consumer views of business behaviour by financial services firms and how this affects consumption decisions
- The impact of ownership structures on business behaviours in financial services firms
- How policymakers could intervene in financial services markets to encourage the development of good corporate cultures

The findings and policy recommendations draw on specially-commissioned survey data examining the views of UK consumers and interviews with a variety of financial services firms exploring what firms think of as good corporate culture.

WHAT IS GOOD BUSINESS BEHAVIOUR?

For consumers in the UK, good business behaviour is partly about customer service, pricing structures and product quality, but also about fundamental values like “fairness”, “honesty”, “transparency” and “responsibility”. Survey evidence gathered for this report finds that consumers believe these qualities are scarce in financial services firms:

- On average, the British public believe that seven out of ten financial services companies are putting shareholders and profits before customers.

- The same proportion of firms are believed to be making high profits at the expense of good customer service, and putting pressure on staff to engage in behaviours that are not in the customer's best interest.
- The public think that fewer than half of all financial services firms offer simple, easy to understand products to a wide range of customers, act in a transparent manner or offer fair prices.

Given that the financial services sector lies at the heart of the economy, touching nearly every transaction, it is clear that something has to change. This report sets out three areas where the next government should act to put good culture at the heart of financial services and create an ecosystem supportive of better business behaviours.

COMPETITION AROUND CORPORATE CULTURE

UK consumers report both an interest in the business behaviours of financial services firms and a willingness to switch providers to encourage better business behaviour. Four in ten consumers would consider switching financial services providers if an alternative provider was behaving in a particularly ethical way, rising to 60% if the individual felt their current provider was behaving unethically. However, customers' abilities to act on these preferences depend on their ability to recognise good business behaviour. Survey data collected for this report shows that, despite their stated preferences for certain business ownership types, in practice consumers struggle to distinguish the ownership structures of financial services providers. The average British consumer can correctly name the ownership structure of just two of the UK's 15 largest financial services providers.

This suggests that a lack of information is currently acting as a barrier to competition on business behaviour among financial services firms.

We propose that an umbrella body of industry stakeholders, including representatives of consumers, financial services providers, regulators and academics, should work together to create a broad set of standards, above and beyond the requirements of regulation, which financial services providers could aim to subscribe to: a Good Culture Kitemark.

The availability of such a kitemark, and the potential to lose it for bad behaviours, would help to neutralise individual incentives within firms to misbehave, helping to create a self-regulating internal culture of positive business behaviours. To avoid capture and ensure this scheme remains effective over time, a ratings scheme could be implemented, differentiating more precisely between firms on the basis of behaviour but retaining the visibility of a kitemark scheme.

This policy tool is designed to provide information quickly and easily to consumers, without the need for them to develop specialist knowledge or undertake further research into the business behaviours of financial services providers. However there is an extent to which, at present, consumers have delegated responsibility for behaviour in financial services providers to government. Nearly three quarters of consumers (71%) believe that it is the government's job to set rules and make sure financial services companies behave well. The prevalence of this attitude means that, at present, there is little competition between providers on the grounds of relative safety and security. We believe that this is – at least in part – a result of the UK's generous deposit insurance scheme, which has removed the impetus for consumers to worry about the safety of their savings. While consumers should be protected against the worst excesses of the financial services sector, competition over business behaviour will be most successful when financial services providers feel they have something to lose if they are perceived as taking excessive risks.

Reducing the level of deposit insurance on offer could help encourage consumers to carry out their own due-diligence, particularly when deals sound too good to be true.

DIVERSITY

Our research shows that UK consumers believe that customer-owned businesses are most likely to engage in good businesses behaviours, while shareholder-owned PLCs were seen as the least likely to create strong corporate cultures.

Despite these reported preferences for customer-owned mutual financial services providers and the benefits associated with this form of business, at present these companies make up a relatively small minority of the UK's financial services sector. The lack of diversity in the UK's financial services sector is limiting the ability of consumers to pick providers who meet their preferences for corporate culture. The customer-owned mutual model is well-suited to overcoming some fundamental governance difficulties faced by financial services firms and predisposed to displaying good corporate cultures, thanks to the conflation of customers and owners through membership. However, financial mutuals face significant barriers to operation and expansion in the UK. To help level the playing field, we recommend that:

- Regulatory bodies should provide parity of esteem for financial mutuals and PLCs. Supporting diversity should be established alongside the promotion of competition as an objective of the Financial Conduct Authority (FCA) and secondary aim of the Prudential Regulation Authority (PRA).

- Financial mutuals should be given access to appropriate capital instruments, which allow them to meet regulatory requirements and potentially expand, without damaging their mutual character.

- A principle of disinterested demutualisation, whereby the proceeds of the sale of shares are placed in a charitable trust rather than distributed to members, should be encouraged. This would remove the short-term financial incentive for members to cash in the assets built up over generations at the point of demutualisation, and ensure that the value of mutuality is preserved.

CORPORATE GOVERNANCE

The report argues that these reforms will lead to a financial services sector that puts a higher priority on good culture. But corporate governance remains crucial throughout the financial services industry, because of the perverse incentives which are prevalent throughout the sector. Information asymmetries, where one party in a transaction has access to better information than the other, and thus more power, are remarkably

common in financial services. More must be done to ensure effective oversight, both through a properly qualified board and engaged owners.

Although the demands on non-executive directors of financial services firms are substantial, this should not be used as an excuse to limit the pool of those undertaking this role, creating a "club" atmosphere of insufficient challenge.

Ultimately, good culture in financial services firms will be developed, regardless of the model, through frequent, high quality oversight, transparency and efforts to design incentives systems in such a way that employees and firms do better by behaving well.

Collective responsibility for behaviour is expected to play a key role and bonus structures should be redesigned to target company-wide objectives rather than individual performance to avoid incentives to manipulate activity to hit personal targets.

None of these policy reforms, individually, will succeed in the difficult task of reforming culture inside the UK's financial services sector. However, by attempting to change the incentives structures facing those in financial services away from opportunities to benefit from bad behaviour to those where good corporate culture should help business flourish, we hope to create a system supportive to good business behaviours.

CHAPTER 1 – INTRODUCTION: PROBLEMS IN THE UK ECONOMY

REDESIGNING THE RELATIONSHIP BETWEEN BUSINESS AND SOCIETY

Seven years after the start of the financial crisis, households across Britain continue to feel the effects. A crisis which originated in the financial services sector has touched every household and business in the UK through sluggish productivity and minimal wage growth.

The scale of the financial crisis has driven a reassessment of the purpose of business and the role of culture in capitalism. After successive waves of scandals, there has been a broad realisation that markets do not exist in the abstract and that bad business behaviours affect us all, as consumers, employees and members of communities. This realisation was vividly set out in a speech given by Prime Minister David Cameron in January 2012. In this speech, Cameron heralded:

"A vision of social responsibility, which recognises that people are not just atomised individuals, and that companies have obligations too".[1]

Both the Liberal Democrats and the Labour Party have also spoken forcefully of the need to reform corporate behaviour. The Coalition Government has introduced new tax incentives for firms to become employee-owned whilst promoting mutuals in public services.[2] Alternative business models and ways to encourage good business behaviours remain a hot topic of conversation four years later as we approach the next general election with major corporate governance failures still making the headlines.

What is good business behaviour?

Good business behaviour is hard to pin down. We want businesses to be effective and efficient, to provide stable sources of jobs and incomes. But we want them to do this while maintaining ethical values and a standard of fairness. There will, at times, be tensions between these motives, and finding a societally acceptable equilibrium is far from easy. The word cloud

below illustrates the terms used by members of the British public when we asked them, in a survey commissioned for this report, what "good business behaviour" meant to them.

Figure 1: Consumer definitions of "good business behaviour"

Source: SMF/Populus, Good Culture polling, August 2014. Respondents were able to respond freely to the question "How would you define "good" corporate business behaviour?"

Firstly, there is an understandable focus on consumer-facing aspects of business behaviour, such as good value, fair prices and quality. These are the issues that consumers deal with in their day-to-day relationships with the business world. Most respondents, however, mentioned these alongside other features of good business behaviour, such as fair treatment of suppliers, payment of reasonable wages and environmental awareness. While consumer-focused elements of good business behaviour were mentioned most frequently, these were rarely used alone to signify good business behaviours; consumers are well aware of the potential problems behind the scenes. Certain words appeared time and time again: "ethical", "honest", "transparent", "fair". In many ways, the values the public

demands of businesses are those we demand of ourselves and each other in our personal relationships.

Yet, in the run up to the crisis, and particularly in the financial services sector, company behaviour deviated from that prescribed by these values. How did this gap between private expectations and corporate behaviour emerge?

Shift to short-termism

Economic growth comes from expansion of productive capacity or more efficient ways of using existing resources. Both require investment, and will not immediately repay associated capital costs. For a business to justify investment costs, therefore, they must take a sufficiently long-term perspective. UK businesses, however, have a tendency towards short-termism. The most obvious symptom of this is under-investment in both physical assets and intangibles like research, employee skills and reputation.[3] Research and development (R&D) spending is a prominent example: the UK spends not just a smaller percentage of GDP on developing new ideas than the average OECD or EU economy, but also less than China.

This reluctance to invest is just one facet of a broader fixation on short-term results and profits demonstrated across the UK economy, which prevents the long-term consequences of decisions from being properly considered. Surveys carried out under the Cox Review (2013) found that nearly 60% of senior business leaders thought short-termism was a major or significant impediment to UK economic growth, rising to 92% when SMEs were included.[4]

Owning a stake in the economy

The short time horizons of many shareholders means they have little incentive to examine the long-term prospects of the firm, influenced by factors like investment, branding and reputation. Instead, the emphasis is on elements of the firm's performance which are easily observed, especially profits.[5] The loss of this long-term perspective has led firms to discount poor business behaviours; the cost of the ensuing reputational

damage no longer necessarily outweighs the impetus of short-term profit. Short-termism among the owners of businesses creates a race for returns, leading to a failure to engage with the deeper problems of corporate governance, to take responsibility for the development of business and to maximise the long-term value of firms, leaving us poorer in the long run.

The reluctance of these short-term owners to become involved in the corporate governance of firms and to help develop businesses has spill-over consequences for the rest of the economy and society by creating opportunities for bad behaviour. Rather than being concerned about relationships with suppliers, employees and customers, the focus of businesses can become the immediate bottom line.[6] Owners consider their prospects and profitability without fully assessing the impacts of their behaviour on the rest of the economy. The structures of oversight intended to keep the economy running smoothly have failed as business management has become disjointed from the rest of society and British businesses across many industries have fallen prey to poor governance.

Consumer awareness of business behaviour

But consumers are increasingly aware of bad business behaviour, following high profile scandals across a range of industries from financial services to supermarkets. Our evidence shows that the British public are increasingly willing to change their consumption habits in response to business behaviours. Just over a third of consumers (37%) report that they have previously changed consumption habits in response to business behaviours. A further 51% however, report that they would be willing to change in future if a business' behaviour bothered them sufficiently. Only 12% of consumers suggest that they would not be willing to change consumption habits in response to bad business behaviours.[7]

Problems in the financial services sector

The crisis and subsequent scandals have left the UK's consumers with a grim view of financial services, according to Populus polling for the SMF. The average member of the British public believes that 71.9% of financial service companies put shareholders and profits before customers, and

that over two-thirds of companies (69.2%) put pressure on staff to sell certain products or behave in ways that are not in the customer's best interests. Six in ten (59.9%) financial services providers are still seen as taking big risks even after the financial crisis. The public think that fewer than half (44.1%) of all financial services firms offer fair prices or interest rates, and a similar proportion (45.1%) are seen as behaving in a transparent manner.[8] The operation of the financial services sector depends in large part on consumer trust that systems are effective and fair. In extreme cases, damage to this trust can be sufficient to cause the failure of institutions – as in the case of a bank run. It is thus critical that the UK's financial services providers address these reputational problems as a matter of urgency.

These crises of reputation in the financial services sector can be seen as a symptom of deeper cultural failings across the sector. Financial markets involve complex, frequent transactions. Asymmetries of information are common – between owners and managers, employees and managers and customers and staff. And with millions of transactions taking place every hour, there are both opportunities to manipulate operations for personal gain and the incentives to do so; whether this is by increasing leverage and taking excessive risk to boost profit, or selling products to meet targets rather than the needs of consumers.

The financial services sector sits at the heart of the economy, playing a role in almost every day to day transaction. If there is one sector where we need to ensure culture supports broader societal objectives, this is it.

THE WAY FORWARD

There are thus strong reasons for aiming to develop cultures which support better business behaviours in the financial services sector. However the financial crisis demonstrated that these have been insufficient in the UK. To date, the policy response to the crisis has focused on command and control legislation: regulation governing the products institutions can offer, the hoops they must jump through to do so, and the way staff can be incentivised. There are doubts, however, about whether this structure will remain effective as the economy recovers and opportunities to game

the system begin to reappear. In a sector where misaligned incentives and information asymmetries are so common, something stronger than rules is needed. Financial services providers need strong cultural commitments to behaving in a way that is best for their customers and respectful of the broader economy. Culture, defined as norms and guiding principles of behaviour within an organisation, provides a template for decisions. A clear understanding of an organisation's purpose and values serves as a guide for behaviour in times of conflict, and can help to resolve issues the regulator has not been able to foresee. The remainder of this report considers how this culture could be built. Subsequent chapters consider, in turn, the roles played by diversity, competition and corporate governance in securing good culture in the financial services sector, and the policy actions that could be taken to support good behaviour in each of these areas.

CHAPTER 2 - DEVELOPING DIVERSITY IN THE UK'S FINANCIAL SERVICES SECTOR

Nearly two-thirds (60%) of consumers believe that ownership structure can make a difference to the business behaviour of financial services companies, and more than half (57%) agree that business ownership structure has a significant impact on the culture of a financial services firm. Consumers believe that customer-owned firms are more likely to engage in good business behaviours, according to polling evidence: 60% of the public believe that customer-owned companies are likely to engage in good business behaviours, but only 22% believe the same about PLCs.[9] Of those who thought that consumer-owned businesses were most likely to display good business behaviours, more than half (55.1%) suggested that the structure was attractive due to the accountability it entails or its democratic nature. 54.1% also suggested that consumer-owned companies were likely to be in touch with the needs of consumers and to work in their interests. By contrast, of those who thought PLCs were most likely to demonstrate good behaviour 42.1% suggested this was due to accountability or market discipline and one in ten (8.2%) reported that the transparency of the model was attractive.[10]

Despite these reported preferences for customer-owned mutual financial services providers, at present these businesses make up a relatively small minority of the UK's financial services sector. The lack of diversity in the UK's financial services sector is one factor limiting the ability of consumers to pick providers who meet their preferences for corporate culture. This was acknowledged in the Government's Coalition Agreement in 2010: 'We want the banking system to serve business, not the other way round. We will bring forward detailed proposals to foster diversity in financial services, promote mutuals and create a more competitive banking industry.'[11]

A LACK OF DIVERSITY

The PLC model dominates the UK's financial services sector.[12] All of the big high street banks, with the exception of Nationwide, are PLC-owned, as demonstrated by current account market shares in Figure 2. PLCs

accounted for at least 82% of the UK current account market in November 2012, and probably more when the "other" category is disaggregated.

Who owns businesses?

Shareholders – publicly listed companies (PLCs) are owned by shareholders. The primary business objective of these companies is to make profit for shareholders. Shares are held by institutional investors, such as asset managers, insurance firms or pension funds, who make investments on behalf of their stakeholders as well as individuals. Shareholders receive frequent reports on company performance and can vote on key governance issues, but they can also sell their shares if they choose to.

Customers – consumer-owned mutuals are owned by the people who buy from the business. The aim of these firms is to provide value for their current and future customers; they make profits, but only to invest and ensure the firm's long-term survival. Common forms of consumer-owned mutuals are building societies, traditionally formed to provide mortgages, and friendly societies, developed to provide insurance services. Customers are given the opportunity to vote on key measures, and may also be consulted on other business issues. The company can only stop being mutually owned if a majority of members agree to sell the business.

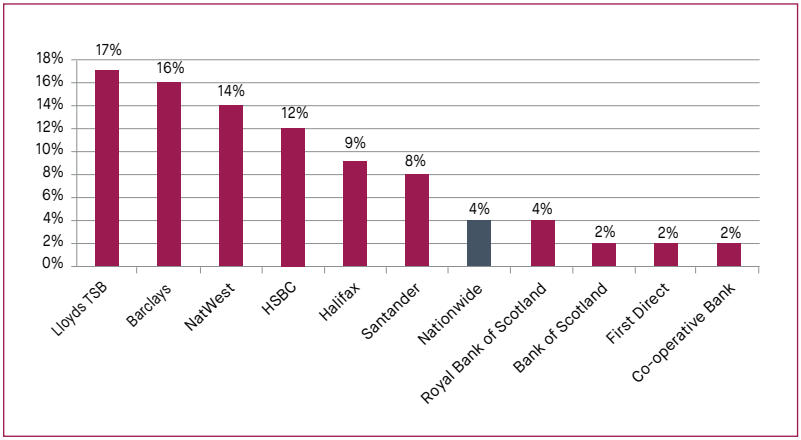
Employees – The employees of a business may own shares in the company and take home a share of profits. In this case, employees will have a stake and a voice in the management and strategic decisions of the business.

Private equity – Private equity groups are financial organisations which aim to make profits by buying businesses, investing in some change and then selling the firm again at a higher price, or by investing in rapidly-growing businesses. Their investments are often short-term, however they can play an important role in rescuing businesses which have started to struggle and need a change of management or providing a capital to fast-growing firms.

Partnership - The business is owned by two or more partners, who hold the shares in the business. In an ordinary partnership, partners are liable for the costs of business and any losses, and share profits. Larger companies are often set up as limited liability partnerships, reducing the liability of partners for the business' debts in the case of business failure to the amount they invested in the business.

Families - Members of the founding family own a controlling stake in the business.

Figure 2: Main current account providers to UK consumers, November 2012

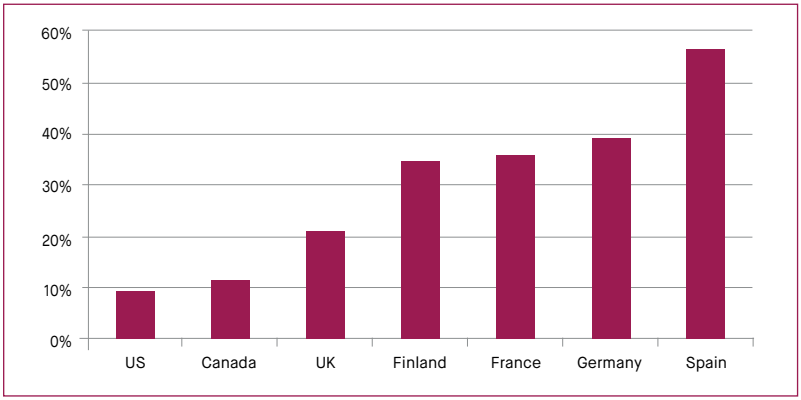


Source: Office of Fair Trading Review of the Personal Current Account Market, Annexe C: data tables of the results of the consumer survey, accessed online http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.oft.gov.uk/OFTwork/markets-work/othermarketswork/pca-review (last accessed 07/11/2014).

Nationwide is the only true mutual to hold more than a 1% share of the UK's current account market (the Co-operative Bank holds 2%, but is only 30% consumer-owned). Many building societies, however, do not offer current accounts, so these data are perhaps not the best representation of the role mutuals play in UK markets for financial services. When we look at all private sector deposits, savings as well as current accounts, businesses as well as households, the picture looks slightly more balanced, but financial mutuals still account for just a fifth of deposits (21%), while PLC and privately-owned banks account for close to three-quarters (71%).[13]

The lack of diversity among financial services providers in the UK is particularly stark in contrast to other European countries and developed economies, as illustrated in Figure 3. In terms of the relative size of mutuals and cooperatives in the financial services sector, the UK much more closely resembles the North American tradition, with its focus on PLC ownership, than the continental European tradition where mutuals and savings banks play a greater role. While financial mutuals account for just 21% of deposits in the UK, the German banking sector is more evenly split with nearly 40% of deposits held by savings banks and cooperatives. Spain's cooperative banks, however, have been hard hit by the crisis and their market share is likely to have fallen significantly since 2008 when this data was last produced.

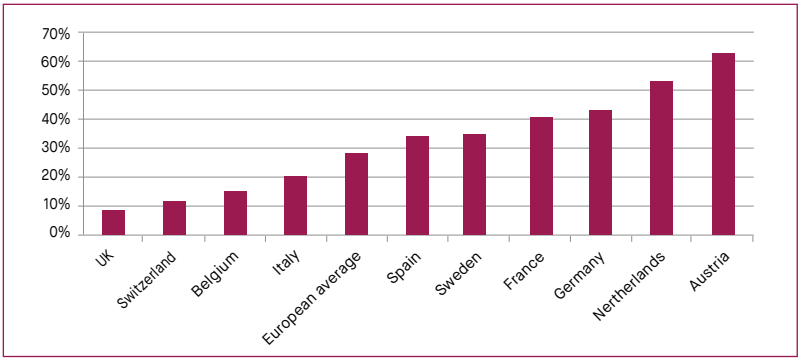
Figure 3: Share of private sector deposits held by mutuals, cooperatives and savings banks, 2008



Source: OECD Banking Statistics: Financial Statements of Banks, Building Societies Association Statistics, Author's calculations

This pattern carries across to the insurance sector, as Figure 4 illustrates, with mutual insurers accounting for a much higher proportion of the market elsewhere in Europe. At just 8%, the share of the insurance market held by mutuals in the UK is significantly below the European average of 28.4% and much lower than in other major European economies like France and Germany where mutuals service more than 40% of the insurance market.

Figure 4: Share of insurance market held by mutuals, 2012



Source: International Cooperative and Mutual Insurance Federation (2014), Market Insights: Europe 2012, The European Insurance Market Share As Held By Mutual And Cooperative Insurers.

DIMENSIONS OF DIVERSITY

Not only is mutual ownership comparatively low but there are also very few significant privately-owned or partnership-owned financial services providers and no employee-owned financial services providers.[14] Furthermore, as PLCs have come to dominate the financial services landscape their preferences have been increasingly absorbed by the regulator, creating further difficulties for non-PLC financial services providers. Over time, privately owned, family owned and mutual financial services firms have become PLCs, while regulation has made it very difficult for new firms to use other ownership models, stifling diversity. In addition to the resulting lack of diversity of ownership structures, there is very little geographical variation among financial services providers. After demutualisation, the industry has become deeply skewed towards London and the South East.[15] The UK, therefore, has a relatively homogenous financial sector, in terms of geography as well as ownership status.[16]

How did the UK's financial sector come to be dominated by PLCs?

As recently as the early 1990s the UK had a relatively vibrant non-PLC financial services sector. Mutual financial services providers, including mutual insurers, friendly societies and building societies have played a historic role in the UK's financial services sector. Initially formed as self-help societies as early as the 18th century, they were the first source of financial services products for the mass market.

However through the last decade of the 20th century the UK witnessed a remarkable trend towards demutualisation. The "Big Bang" reform of London's capital markets in 1986 marked the start of the trend. In addition to the legislation which allowed investment banking activities to begin, this year also saw laws introduced which allowed building societies to diversify, away from their key mortgage markets into new product types, and to demutualise if they could win sufficient support from members. Many of the UK's biggest building societies demutualised and floated on the stock exchange.

These demutualisations withdrew around 70 percent of assets from the mutual building society and insurance sectors, substantially reducing their size.[17]

Their members received significant windfalls, in effect receiving compensation for the loss of the benefits associated with mutuality. In some cases members were offered financial incentives to vote for the demutualisation of the society, taken from historic profits and reserves built by past members, for the benefit of future members. Some societies were also captured by "carpet-baggers", speculative investors who opened accounts in order to gain membership, vote for demutualisation and win a share of the spoils. However, few of these organisations fared well under their new ownership structures, with many involved in increasingly risky activities, with damaging effects for themselves and the economy more widely.

Demutualisation also severely reduced diversity in the insurance market. Prior to 1990, mutual insurers and friendly societies held over 50% of the UK insurance market; by March 2013 they accounted for less than 10%. Despite the inherently mutual concept behind insurance – the pooling of risk across a community to solve a shared problem – these ancient businesses (the first act of parliament to define a friendly society was passed in 1793) have been gradually dismantled.

A lack of diversity and its consequences

In the lead up to the crash, the dominance of PLCs and short-term motives left the UK's financial services sector vulnerable to crisis, as a culture of risk-taking and profit-making prevailed. Financial mutuals, by contrast, are less vulnerable to these problems, as they face limits on the proportion of non-member capital they can raise and are accordingly less able to increase their leverage. Financial markets with a level of diversity of corporate ownership thus have a type of built in "firewall", providing resilience in times of crisis.[18] The small relative size of mutual players in the UK meant that they were unable to counterbalance a shift from retail (deposit-based) funding to wholesale funding and increase in risk-taking

by PLCs in the years preceding the crisis. While mutuals are vulnerable to corporate governance problems just as PLCs are, they face fewer incentives to act against consumer interests, to take excessive risks and to pursue profit at the expense of all else, making their corporate cultures quite distinct.

There are two main reasons to believe that greater diversity of business models in the UK financial services sector, in particular a higher market share held by mutual businesses, could help to avoid a recurrence of these problems in future: risk diversification and better alignment of interests.

Reducing risk and a longer-term perspective

Different business models are associated with different risk profiles. Diversity of ownership structures could help to reduce systemic risk within the financial services sector, by ensuring a variety of business strategies are in use at any one time.

The separation of ownership and management in shareholder-owned firms can lead to an emphasis on profit at the expense of the long-term success of these firms. When owners can easily sell shares if they do not like the direction of the business, managers are placed under pressure to ensure short-term results meet expectations. Equity markets operate in such a way that they encourage shareholders to exit when times are hard, rather than playing an active role in the management of the company.[19] Frequent changes in ownership associated with ease of exit lead to a focus on the monetary value of a company, measured through share prices, rather than an assessment of the long-term value of a firm represented by research, staff skills and brand value.

The problems of shareholder ownership in PLCs, in particular the failure to consider systemic risks and short-termism, have been compounded by the short investment horizons of the average shareholder. The average length of time that a bank share was held in the US, UK and Europe fell from around 3 years in 1998 to just three months in 2008.[20] As the average shareholder in a bank looks to benefit from their investment over a horizon of less than a year, there is little scope for long-term, sustainable development of the

business. Instead, the relentless market focus on returns to equity leaves financial services firms with strong incentives to ramp up leverage or find other ways to boost immediate returns. These risks, in turn, make banks less attractive prospects for long-term investors, providing a feedback mechanism which further embeds short-termism in the management structures of financial services firms. This short-termism is not a necessary feature of PLC companies, but rather a manifestation of the culture which has emerged in response to deregulation, growing opportunism and technological advances including the growth of high-frequency trading. In addition to this, the dominance of PLCs has meant that this short-termism was, to an extent, internalised by the sector's regulators prior to the financial crisis, reducing their ability to create rules which will stand the sector in good stead over the longer-term.

By contrast, the incentives and aims of financial mutuals mean their business models tend to be more stable and less risk-intensive than those of PLCs in the same sector. Mutual financial services providers have a commitment to serving future generations which makes them more likely to take a long term view. Roy Badcock, Head of Corporate Affairs at Cambridge Building Society described the organisation's staff as "stewards, keeping the business moving forward and developing it".[21] This long-term view means mutual banks typically have lower asset risk and better loan quality than other private sector banks.[22] Financial mutuals find it more difficult to access external sources of capital; unlike PLCs they cannot easily sell equity, due to legal constraints on non-member ownership. This means mutuals tend to be funded with a higher percentage of retail deposits than PLC competitors, limiting the amount of risk that they can take. The stable deposit and customer bases of mutual financial services organisations can also act as a cushion in times of instability; because mutual banks do not have to fear shareholder exit as PLCs do, in hard times they can pass a lower proportion of returns to their members, supporting their capital base and reducing fragility.[23]

Financial mutuals are also less likely to succumb to pressure to increase leverage during periods of strong growth, as profit is just one of the aims pursued by these businesses, alongside sustainability. This allows them to

maintain higher capital reserves, meaning that they have a larger cushion to fall back on if the market should turn. Taken together, these characteristics mean that financial mutuals are more stable than their PLC equivalents; across a sample of 29 OECD countries, mutual banks demonstrate a lower variation in returns over the economic cycle.[24] Having a certain proportion of mutual organisations within the financial sector can thus act as a barrier to excessive risk taking, reducing average leverage across the sector as a whole. This can also help to keep the financial services sector functioning in times of crisis: in Austria and the Netherlands, there is evidence that mutual banks lend counter-cyclically, at downturns in the economic cycle, helping to support economic activity when it is weakest.[25] Moreover, a more diverse sector will boost competition and help address the growing concentration of business, and a well-recognised lack of competition in financial services.[26]

A lack of short-term shareholder pressure means mutuals may also be better placed to provide "patient" finance to the economy – the long-term capital required to finance major infrastructure projects, for example. This sort of finance is essential to an economy's long-run growth prospects, allowing company directors to commit to investment knowing that the full costs of a project are covered, and creating conditions for workers to research and innovate effectively. Long-term investments suit mutuals allowing them to make higher returns and avoid excessive transactions costs, as they are not limited by the need to make short-term profits as PLCs may be.[27]

Aligning interests

Mutual ownership of financial services firms can also help to overcome some (though not all) of the incentive problems inherent within the market for financial services providers, created by the complexity of products sold and persistent asymmetries of information. PLCs have two sets of stakeholders whose interests they have a duty to protect – their customers, and their shareholders. At times, these motives may clash, leading to contradictions in the ways financial services firms behave. This is particularly problematic in the case of complex products which

operate over long-time horizons, where the damage of being sold an unsuitable product is not recognised by the consumer for years. PLCs, in a market which emphasises short-term profits, could be tempted to take advantage of these asymmetries of information. Customer-owned mutuals, by contrast, may be less predisposed to become entangled in these difficulties as their customers are also owners, meaning there are fewer opportunities for perverse incentive structures to arise. In this sense, mutuals may be predisposed to corporate cultures which put the consumer first and are more likely to foster good business behaviours. These benefits are exclusively associated with the model of consumer-owned mutuality; while employee-ownership may bring other benefits, there is still the potential in this model for consumer and owner interests to deviate.

As well as reducing some of the information issues which arise in the sale of financial services, mutuals can also bring customer service benefits by reducing the gap between financial services firms and their customers. Mutuals are dual bottom-line businesses, aiming to work in a way that benefits members, and making profits only to the extent they are needed to ensure the continuation of the business. The centrality of members in their operations is clear when complaints data are compared: mutuals accounted for just 4.7% of all complaints to the Financial Conduct Authority (FCA) in the first half of 2014,[28] a lower volume than would be expected given their market share.

Member-ownership of mutuals provides them with a distinct purpose and set of values – to put customer-members first,[29] and to protect the long-term sustainability of the business. This, in turn, influences the internal culture of mutuals. In interviews carried out for this research, representatives of mutuals consistently referred to their duty of stewardship towards members, the need for fairness and to provide member value. While each of these principles may also apply to PLCs, the lack of shareholder interest in mutuals creates a culture where the interest of the customer is also the interest of the firm, and of the individual employee. Mutuals, therefore, may be more predisposed to displaying good behaviour.

Owned by the customer, for the customer: the benefits of financial mutuals

A theme reflected throughout the interviews with mutual financial services firms carried out for this project was the commitment to customers:

"Everyone in this organisation is targeted on delivering satisfied customers. Now, satisfied customers and doing the right thing by the customer are two different things – you can have someone who is happy but you've still sold them the wrong product. So what we mean by satisfaction is those two things: we absolutely want to deliver an experience that our members are proud of, but at the same time we have got to do the right thing for them." **Alison Robb, Group Director, Nationwide**

"The main aim of the business is to increase member value and we believe a key differentiator for us is the great customer service we provide. We place a great deal of focus on doing the right thing for our customers, paying claims quickly and without fuss, going the extra mile for customers where we can and this really makes a difference to our bottom line in high renewal rates and loyal customers." **Mark Austen, Chairman, LV=**

"Maintaining our commitment to customers, goes through every day including maintaining trust, putting customers first, treating customer as individuals and behaving in a way which is clear, simple and transparent." **Roy Badcock, Head of Corporate Affairs, Cambridge Building Society**

In small building societies, the link between the customer and the society may be even stronger. Penrith Building Society, the smallest in the UK, prides itself on being able to offer a personalised service. This is particularly important in helping them to meet the needs of the local rural community.

"If you ring up with a slightly unusual case, a mortgage that needs more underwriting or something similar, then the member of staff dealing with it can turn straight to the finance director. This means that decisions can be made on a more personalised basis for customers much more quickly." **Amyn Fazal, Chief Executive, Penrith Building Society**

Several organisations also reflected on the fact that mutuality allowed them overcome short-term imperatives and focus on long-term investment. Nationwide, for example, felt that their mutual ownership was critical in enabling them to keep investing in the business through the financial crisis, developing a new internet banking and current account platform.

Levelling the playing field: supporting diverse business ownership structures

A more diverse financial services sector could provide substantial advantages to the UK: greater resilience through a lower average risk tolerance across the sector, stronger competition and a culture which is aligned with the interests of consumers and society at large. At present, however, mutual financial services firms face several barriers in their ability to run their businesses effectively and to expand. Regulation is designed around PLCs, creating barriers to the creation and expansion of financial mutuals.

While legislation governing the management of PLCs is updated relatively regularly, equivalent acts relating to non-PLC models, including mutuals and friendly societies, are updated much less frequently. While the Companies Act was last updated in 2006, the Friendly Societies Act has not been updated since 1992. Many of the provisions within the 1992 Act are now crying out for repeal; for example clauses relating to compulsory retirement age of board members, which breach the Equality Act of 2010. Part of the problem may be the lack of champions for mutuals within government. Explicit delegation of this responsibility could provide a starting point for reform. The process of updating legislation regarding

financial mutuals, however, must be carefully carried out to maintain the characteristics which make the mutual sector distinctive. Australian attempts to modernise similar legislation ended in the repeal of all legislation relating to friendly societies, forcing these mutuals to convert to companies limited by guarantee, either remaining mutual in name only or demutualising. Given the benefits of mutuality, any legislative reform programme in the UK should avoid going to this extreme.

Other regulatory changes are also needed to level the playing field between PLCs and mutual financial services providers. At present, key regulations are designed with PLCs in mind, a result of the regulatory privilege they have been able to achieve over time as the dominant firm type.[30] This leaves mutuals struggling to determine how they should comply with legislation which does not take their management structures into account, significantly raising their compliance costs. A relatively simple step to support diversity would be to ensure all new regulation is created with an eye on both mutual and PLC structures, by building in the relevant capacity at the FCA, PRA and HM Treasury. The creation of an explicit commitment to support diversity, as well as competition, in the mandates of the FCA and PRA would be a first step towards ensuring the importance of diversity is recognised throughout the regulatory framework.

Existing capital regulations make life difficult for financial mutuals. Experience to date suggests that the leverage ratio requirement implemented by the PRA could damage many building societies by failing to recognise the differences between their business model and that of a PLC bank. Regulation has been designed to avoid risk-weighted measures of capital, which had been manipulated prior to the crisis; however this has left mutuals facing much larger capital requirements than previously, when their low risk strategy meant they were allowed to hold fewer reserves. Furthermore, finding the cash will be more difficult for mutuals than for PLCs. Unlike PLCs, financial mutuals do not have easy access to external equity, which can make raising capital to meet requirements very difficult. When Barclays needed to boost its capital holdings, it was able to raise capital through a rights issue. Mutuals are unable to issues shares to non-members, and instead must rely on retained profits, member contributions

or debt issuance to form their capital base. This makes it less easy for them to react to these increased capital requirements. Beyond this, a lack of access to capital makes it hard for financial mutuals to gain the capital they need to back up the products they offer, and even more difficult for them to grow and develop new services.

The Mutuals' Redeemable and Deferred Shares Bill, which received its second reading in the House of Lords on October 24 2014, would help, if passed, to create an instrument for mutual insurers and friendly societies to raise Core Equity Tier 1 capital. It would allow mutual insurers and friendly societies to take part in tactical acquisitions. The deferred character of the shares proposed would allow mutual financial services providers to raise capital externally, without losing their mutual status. Elsewhere in Europe and Canada similar instruments are used to help mutuals gain access to the capital they need, each maintaining the one member, one vote principle, excluding those who hold such equity from voting on decisions to transfer or dissolve the mutual. This bill would thus protect the character and culture of the UK's friendly societies and mutual insurers while ensuring that they have the flexibility required to raise capital and compete with PLCs.

Ideally a similar instrument should also be created for smaller building societies, if we are not to see a wave of further consolidation in the sector driven by increasing capital demands. The country's largest building society, Nationwide, have set the precedent by issuing new capital instruments including Core Capital Deferred Shares (CCDS) and Contingent Convertible bonds (CoCos).[31] However, despite wide-spread amendments to the charters of smaller building societies, no other societies have yet taken the leap to issue these instruments. This may be due to the expense involved in issuing to retail and institutional investors on open markets. It is vital that smaller building societies also have access to instruments which provide them with the ability to raise Tier 1 capital if we are to preserve what little diversity of size and region survives in the UK's financial services sector. Regulators and government alike must be open to continued innovation in capital instruments for mutuals which enable them to meet regulatory requirements while maintaining their distinctive

character. This may include instruments exclusively for sale to existing members, where the information requirements (and related expenses) may be lower than those for an open market equity sale; tools the FCA, to date, has been reluctant to approve. Member certificates fulfilling this description are already successfully used by cooperative banks in much of continental Europe.[32] While there are likely to be limitations to the volume of capital which can be raised in this way, such instruments would nonetheless provide some security for mutuals against the threat of consolidation or demutualisation if capital requirements suddenly rose.

Where the threat of demutualisation exists, there is also a question over whether legislation should be used to prohibit demutualisation, as is the case across much of Europe. Legislation of this sort, while valuable in protecting the diversity of the financial services sector, also undermines the democratic nature of mutuals. As the owners of the business, a mutual's members should be able to make the decision about whether demutualising is in their interest. Where difficulties arise, it is because current members and managers have an immediate financial stake in demutualisation, which may tip the immediate incentives towards dissolving the organisation, even if this is not in the long-term interests of members. To avoid this, legislation may be needed to encourage "disinterested demutualisation". Under this structure, used successfully by Nationwide among others, financial mutuals may demutualise, but all the proceeds are placed in a charitable trust to compensate present and future members for the loss of the benefits of mutuality, rather than being distributed. The assets associated with the mutual entity, including capital reserves, cannot be transferred to a PLC or private company, and cannot be distributed among current members.

Disinterested demutualisation

One contributing factor in the demutualisation of many building societies in the 1980s and 1990s was the trend towards "carpet-bagging". Customers purchased products or opened accounts (and thus obtained membership) with the sole aim of securing a share of the windfall expected when the building society was publicly listed. Members were also offered financial incentives to vote for demutualisation, which to consumers are likely to have been more immediately attractive than the long-term gains of mutuality. These incentives can distort rational decision making about the future of mutuals. In response to an attempt by carpet-baggers to force demutualisation, Nationwide changed its constitution to remove these financial incentives.

As explained by Alison Robb, Group Director, Nationwide:

'For the majority of people we do business with there is no financial incentive for them to try to get us to convert, which was behind a lot of the challenge in the carpet-bagging days. It's a way of getting around people trying to push us to demutualise for the wrong reasons. Ultimately, though, we are owned by our members, so if they think the right thing to do is demutualise they have the right to do that. We just don't want them to do it for a short-term financial gain.'

This type of provision, commonly used across Europe, provides protection against demutualisation, and has been copied by other building societies in the UK. Legal recognition of this principle would provide protection to mutuals against attempts to demutualise, particularly those driven by "carpet-baggers" out to make a quick windfall. By adjusting the payoffs associated with demutualisation, this should ensure that decisions are reached on the basis of the long-term benefit of the community of members, rather than a short-term cash incentive.

CHAPTER 3 - COMPETING ON CULTURE

Improvements in the culture of the UK's financial services firms will be critical to the sector's continued success and stability. However to date, efforts to change culture inside financial services firms have proved difficult. Culture is transient; rather than relying on written rules which can be easily duplicated it exists as intangible norms and relationships between individuals and groups. As such, the regulator's ability to enforce cultural change is limited. Yet cultural change is essential if businesses are to obey the spirit, not just the letter, of new regulation and if the financial services sector is to play a successful, sustainable role in the UK's economy.

Importantly, this cultural change must persist even as memories of the financial crisis recede and the economy recovers. To ensure that history is not repeated, wholesale cultural change is needed. To do this, we need to find a way of changing the incentives that financial services companies and their staff face. One way of doing this is through regulation, increasing the costs individuals face, in terms of personal liability and criminal charges if the fail to comply with regulation. However this system only works where the negative behaviour has been previously observed and specifically regulated against. A better way forward, therefore, would be to make financial services companies and the communities of staff within them commit to a broad culture of good behaviour and a set of ethical principles.

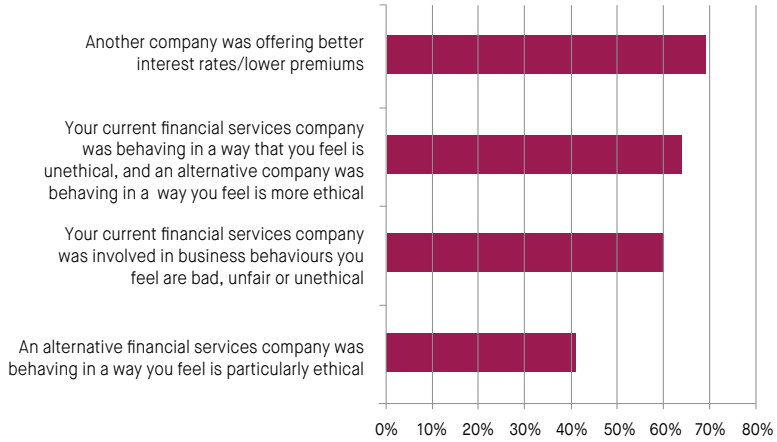
Getting a business and its employees to sign up to such a code is one thing; getting them to keep it is another. One tool which may help to increase the salience of behaviours to those inside financial services is competition. If financial services firms and their staff feel as though poor behaviour put them at a competitive disadvantage, they may have sufficient "skin in the game" to overcome incentives to play the system and develop peer-monitoring systems to ensure the company maintains its stated behavioural standards. Improving the diversity of the industry can be seen as providing consumers with choice, however for this to feed through to better behaviour across the board financial services firms

must feel that there is an element of competition influencing consumer behaviour.

Consumer willingness to switch on the basis of behaviour

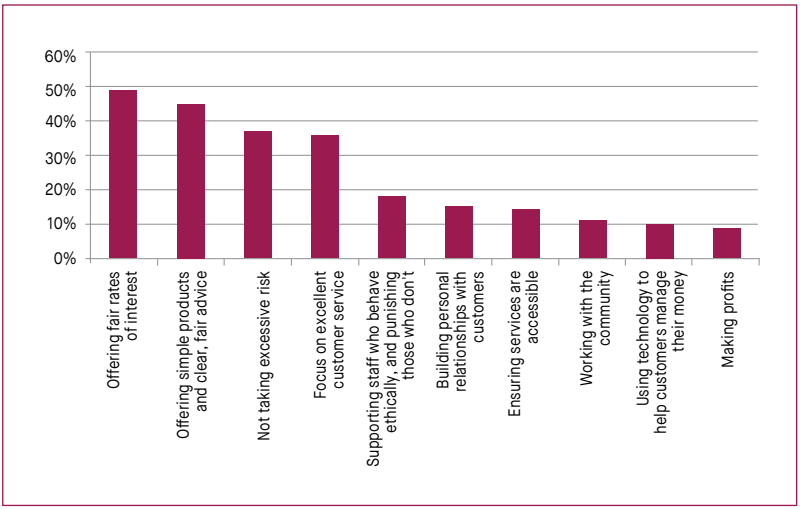
Survey evidence suggests that consumers are willing to switch financial services providers to encourage better business behaviour, as illustrated in Figure 5. Four in ten consumers (41%) would be willing to at least consider switching to an alternative financial services firm which behaved in a particularly ethical way. This would rise to 60% if the individual felt that their current provider was behaving in an unethical way and to 64% if there was a clear contrast between bad business behaviours at a current provider and ethical practices in an alternative company.

Figure 5: Consumers' reported likelihood of switching



Source: SMF/Populus, Good Culture polling, August 2014.

Figure 6: Behaviours consumers would most like to see in financial services companies



Source SMF/Populus, Good Culture polling, August 2014. Respondents were asked to pick three options from a list of 11, in response to the question "All else being equal, which of these behaviours would you most like to see in a financial services company?" If all options were equally important to consumers, each would be selected by 27.3% of respondents. Scores above this level indicate that a behaviour is a relative priority for respondents.

The British public are clear about what they want from their financial services firms – fair prices, transparency and good customer service. When asked to pick the top three from a list of options, half (49%) of consumers said they wanted financial services firms to offer fair interest rates on savings and lending products and fair premiums on insurance policies, while 45% prioritised the provision of simple, understandable products and clear, fair financial advice. Consumers are also concerned about the amount of risks financial services companies take with their cash, with over a third (37%) wanting providers to not take excessive risks with customers' money.[33]

Price, however, remains the key determinant of customer switching behaviour. Seven in 10 (69%) consumers report that they would be willing to switch financial services provider if another company was offering

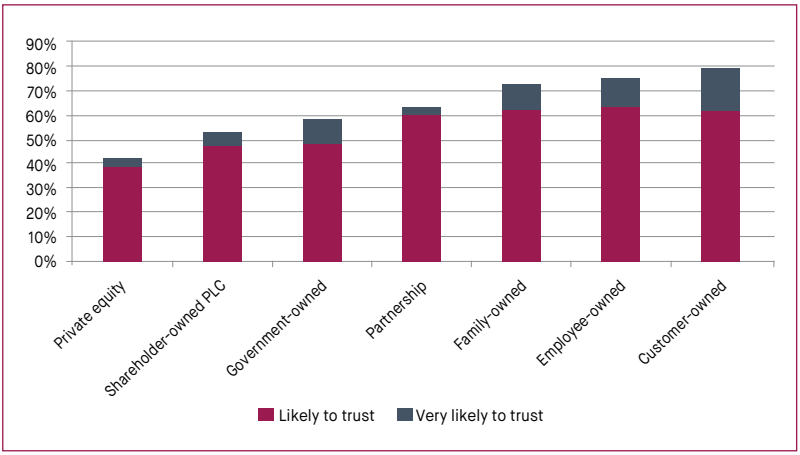
better interest rates or lower premiums. This fits with switching behaviour observed since the introduction of the Current Account Switching Service in September 2013; the biggest winners in terms of new customers have been those providers competing keenly on price.[34] While for many consumers, a higher price will be too much to pay for better business behaviour from financial services companies, nearly one in three consumers (29%) would be willing to pay more for financial services products to companies which guaranteed good business behaviours. This rises to four in ten (38%) for those who have previously changed consumption habits in response to a firm's behaviour (37% of consumers). Among those willing to pay, the average price increase that would be tolerated is 5.9%.[35]

This evidence suggests that many consumers are sufficiently concerned about business behaviour and culture in financial services firms for it to influence their consumption choices. However, the ability of customers to act on these preferences for better behaviour from financial services providers depends on their ability to recognise good culture, as well as the incentives to act on these preferences.

Choice of ownership: competition enough?

Nearly two thirds of consumers (60%) agree that ownership structure can make a difference to the behaviour of financial services firms. After being shown definitions of various business ownership structures, consumers reported that they were more likely to trust customer-owned financial services companies than other types of business, as illustrated in Figure 7 :

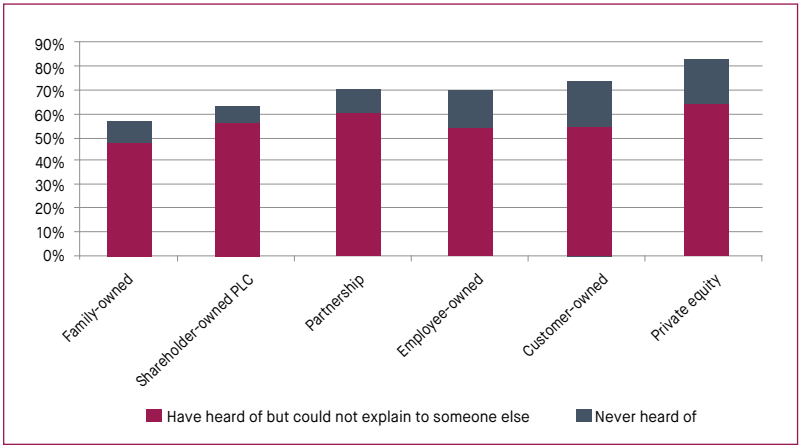
Figure 7: Public trust in financial service providers by ownership model



Source: SMF/Populus, Good Culture polling, August 2014.

This may suggest that consumers concerned about business behaviour among financial services providers should simply opt for mutual providers; indeed, their reputation for better culture should provide financial mutuals with a competitive advantage. In practice, however, customers struggle to differentiate between ownership structures of firms. As Figure 8 shows, the majority of the British public have either not heard of most business structures or have heard of them but would be unable to explain what they mean. Just a quarter of people (26%) have heard of customer-owned businesses and could explain the model to someone else. Understanding of PLC models is slightly higher, with just over a third of consumers (35%) confident that they could explain the structure to someone else. This lack of awareness of the defining features of ownership models leaves consumers unable to act upon their intuitions about the relative pros and cons of each.

Figure 8: Public awareness of business ownership structures



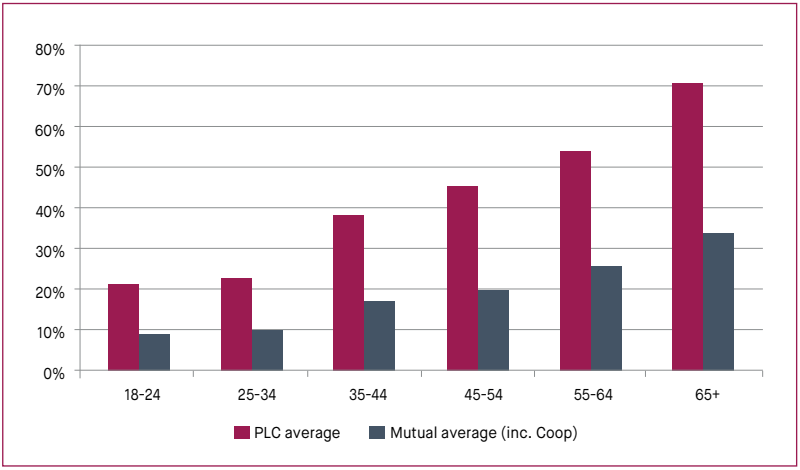
Source: SMF/Populus, Good Culture polling, August 2014.

The average member of the general public can only correctly recognise the ownership structure of two of the UK's largest 15 financial services providers. The public are better at identifying PLCs, which they spot correctly 45% of the time on average, than mutuals, which are recognised correctly on just 21% of occasions.[36] Customers are better at identifying the ownership structures of their own financial services providers, with the average member of the public correctly identifying the ownership structure of firms they use in two thirds of cases (66.7%).[37] Moreover, awareness of different types of business ownership is concentrated among older age groups, as illustrated in Figure 9 – perhaps those who remember most clearly the days before demutualisation. Given this, significant efforts would be needed to educate younger generations about the nature of mutuality and its benefits. While consumers' abilities to recognise different firms' ownership structures improved very marginally after being shown definitions in our polling, evidence suggests that even when consumers have a better idea of what mutuals are, they struggle to recognise them in practice. This suggests that consumer preferences alone are unlikely to be sufficient to create demand for mutuality and the diversity of financial services providers the economy needs to maintain stability. Instead, mutuals and other financial services providers which

pride themselves on business behaviour need a way to make their cultures obvious to consumers.

Figure 9: Recognition of financial services firms' ownership structures by age group

Proportion of age group correctly recognising ownership structure on average

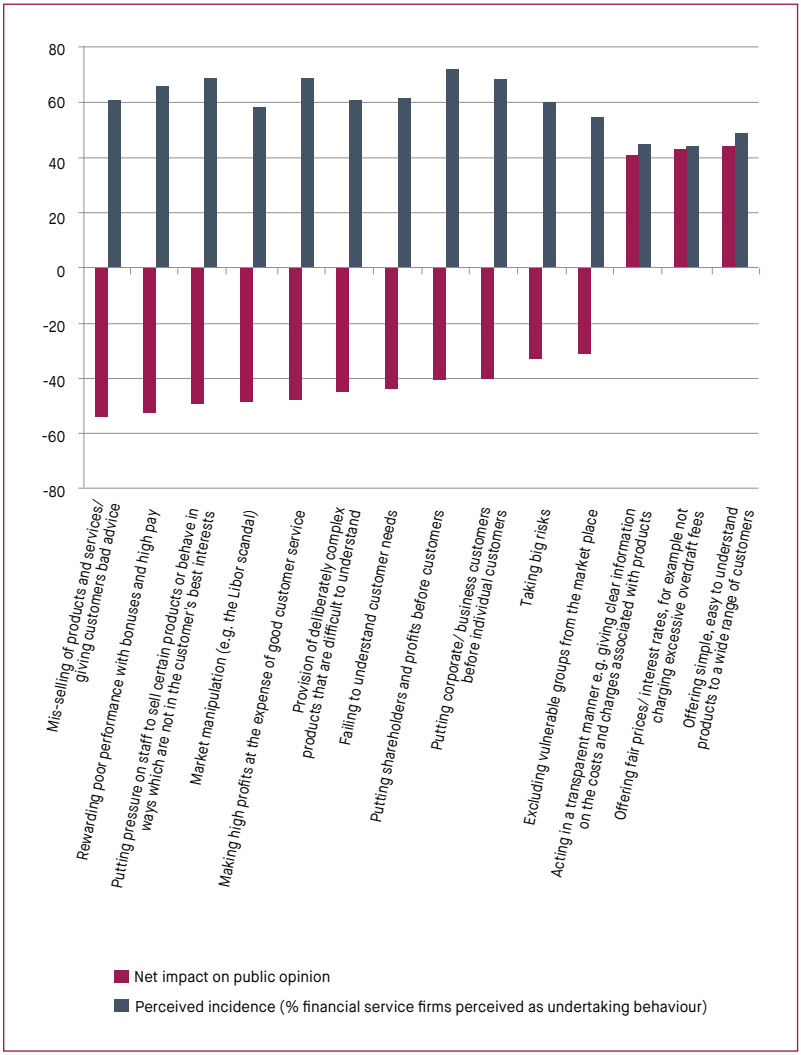


Source; SMF/Populus, Good Culture polling, August 2014. SMF analysis

Recognising good behaviour in financial services

Many of the behaviours that financial services firms have indulged in over recent years have contributed to the negative view the public holds of them, as illustrated in Figure 10. Seven in ten consumers (69%) report that involvement in mis-selling of products or provision of poor advice worsens their opinion of a financial services provider. Two thirds also said that their view of a financial services company was damaged by firms making high profits at the expense of good customer services (66%) or pressuring staff to behave in ways that are not in the customer's best interests (67%). Customers are also disillusioned with the persistence of bonuses at times of poor performance, with 67% reporting that this worsens their view of a financial institution.

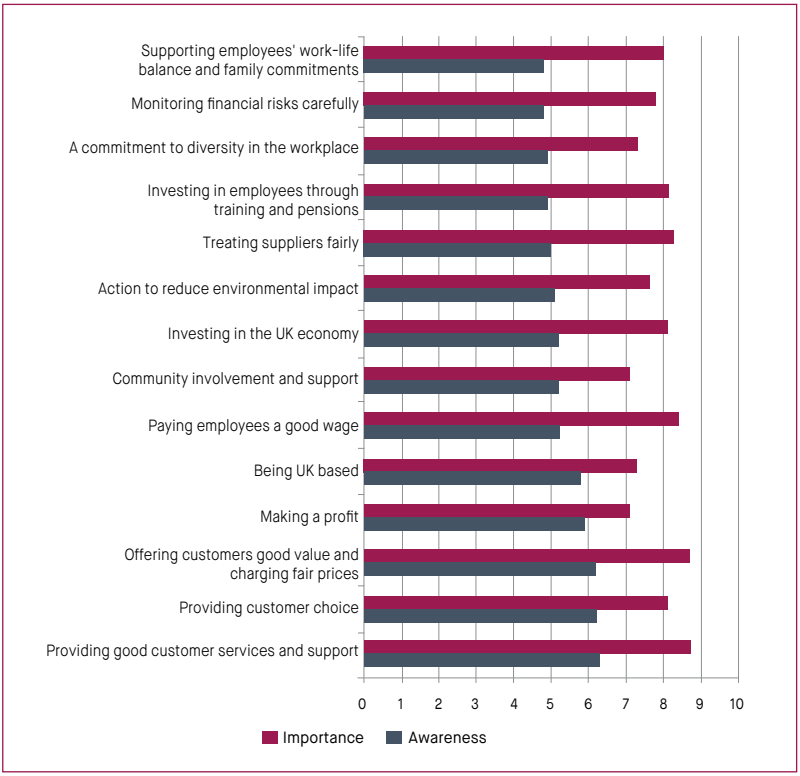
Figure 10: Net impact of financial services firm behaviours on public opinion



Source: Populus survey data for the SMF, SMF calculations. Net opinion impact scores are calculated by weighting responses and summing across the population to provide an indication of the net impact behaviours have on public opinion. The maximum positive score, if a behaviour significantly improves the opinion of each member of the public, is 100, and the maximum negative score, if a behaviour significantly worsens the opinion of every member of the public, is -100.

Customers struggle, however, to access information on the business behaviour of firms which would help them to make informed purchasing decisions, considering the sort of business behaviours that they wish to encourage in firms. Customers report that they are relatively well aware of business behaviour in areas where it affects them directly – for example, customer service, choice and value – but struggle to assess firm behaviour on other important dimensions, such as the treatment of employees, monitoring of financial risks and treatment of suppliers. Across the board, consumers' knowledge of firm behaviour fails to match the importance they attribute to it, as illustrated in Figure 11.

Figure 11: Consumers' awareness of and importance placed on dimensions of business behaviour



Source: SMF/Populus, Good Culture polling, August 2014.

Given the difficulties consumers face accessing information which could allow them to differentiate between financial services providers on the basis of behaviours, this dimension of diversity is not, at present, a full-strength axis of competition between financial services providers.

Boosting cultural competition

The survey evidence summarised above suggests that customers care about the behaviour of financial services providers and are willing to consider this when making purchasing decisions. However, they struggle to differentiate between firms on the basis of behaviour. Providing conditions conducive to diversity of ownership structures alone is unlikely to be sufficient to improve culture across the UK's financial services sector, as the majority of consumers are unable to recognise differences in ownership. On the basis of this evidence, it appears that a lack of pertinent, readily-accessible information on company behaviour is currently acting as a barrier to active consumer choice on the basis of firm behaviour in financial services. If this is the case, the provision of a suitable resource to inform customer decision making, could help to make business behaviour and culture a dimension of competition between financial services providers. This would have the important advantage over other methods of encouraging good culture of providing firms of all types with a business case for investing in good behaviour which should help to ensure that changes in culture are persistent and self-regulated.

Good Culture Kitemark

A tool to improve customer knowledge of financial services firms' behaviour would need to be simple and immediately visible, not relying on the consumer to do any further research. One potential mechanism would be the use of a Good Culture Kitemark. This would act as a signalling mechanism, providing consumers with a way of immediately knowing whether a given organisation lives up to a set of standards. This could be displayed on a company's advertising materials, their website and social media providing a form of instant information about the business' behaviour.

The standard of assessment for the kitemark should be above and beyond the obligations of regulation, to ensure that the scheme adds value, and encourages a dedication to good business behaviours beyond those affected by legislation. The scheme should encourage adherence to minimum standards on a wide range of issues, including standards of corporate governance, board membership and qualifications, protection for whistle-blowers, engagement with and training of staff, standards of customer service, long-term planning, engagement with broader stakeholders and risk-reporting. These criteria would address many of the concerns over the cultures of financial services firms exposed during the crisis. Over time, new issues are likely to emerge and so the standards should be regularly reviewed to ensure that they remain relevant. Most importantly, the right to display the kitemark should not be a given, but something firms have to go above and beyond to achieve, with serious effort put into amassing evidence before the award is given. An equivalent standard in other industries would be the Living Wage or Fairtrade standard – something a firm can work towards if they feel it would provide a competitive advantage to them. While worthwhile initiatives such as Fairer Finance and the Simple Products scheme already go some way towards this objective, the proposed Good Culture Kitemark would go further, looking beyond elements of customer service and experience to the internal workings of the firm which our survey suggests consumers are concerned about but otherwise feel unable to observe. Unlike other schemes, firms should be unable to purchase participation. Financial services providers should be able to apply for the kitemark on an annual basis through submission of data on a set of pre-determined metrics, and should have to reapply each year to continue using the mark on their advertising and publicity materials.

Ideally these standards should be implemented by a new umbrella body containing representatives of various industry bodies and those affected by financial services decisions. This could include, for example:

- Representatives of consumer bodies such as Which? or Fairer Finance;
- Industry representatives from the British Banking Association, Association of British Insurers, Building Societies Association and Association of Financial Mutuals;

- Academics with specialist knowledge of corporate governance in financial services;
- Representatives of relevant regulators and statutory bodies including the PRA, FCA and Financial Services Consumer Panel

The aim should be to bring together a broad range of perspectives on the necessary features of good culture in financial services. Different bodies will bring different views, each contributing to a debate over what should be considered "good culture" and ensuring that the final set of standards is robust and reflects the systemic importance of financial services in the economy. It will, however, be vital that the awarding panel contains non-industry representatives, particularly a consumer group, to maintain objectivity and minimise risk of capture by industry insiders. A substantial role for consumer groups should also help to ensure the kitemark remains relevant to customers and attains a certain level of public awareness.

In as much as the scheme aims to set voluntary standards for business behaviour in financial services and report on these, it resembles the Banking Standards Review Council proposed by Sir Richard Lambert in his Banking Standards Review (2014).[38] The plan proposed here goes beyond this, however, in two ways. Firstly, a broader range of organisations should be involved in setting standards of good practice, given the systemic importance of the financial services sector. Secondly, information on financial services firms' performance against these criteria should be made easily accessible to consumers in the form of a kitemark, rather than being published in an annual report. We hope this will enable the standards to become a short-cut for customers, condensing the accumulated knowledge of the expert awarding panel and the information provided by firms into a single, easily-observed and understood indicator.

With information on firm behaviour provided in this simple format, it would be easier for consumers to add business behaviour as an element in their decision-making process. While other factors would remain important in consumption decisions, including brand loyalty, familiarity and price, increasing the visibility of behaviour of financial services providers should help consumers to act on their preferences, increasing

the salience of behaviour as a dimension of competition between firms. This, in turn, should flip the incentives within financial services firms to push the boundaries of good behaviour, either for corporate profit or personal gain. Instead, with the threat of losing the kitemark and business as a result of bad behaviour, the organisation's employees should be incentivised to monitor each other's behaviour, reinforcing norms of good culture. In some ways an extension of the Lambert proposals, our recommendation aims to unlock competition and the power of consumers to vote with their feet to ensure that reporting on business behaviour has bite on corporate cultures.

There is a risk that, over time, a kitemark style device could be captured by financial services firms leading to an erosion of standards. This would prevent the kitemark from performing effectively as a signal of the quality of corporate culture. While we would hope the independence and broad nature of the supervisory organisation would go some way to preventing this, the introduction of a simple score system could also help to keep standards high and ensure that consumers are always able to distinguish firms with strong corporate culture. These scores, which should have a clear visibility on product literature at the point of sale, similar to energy efficiency ratings on household electrical appliances, would help consumers to make decisions on the basis of business behaviour as well as price and quality.

Recognising risk

The reason energy efficiency ratings attract consumers attention is that the consumer feels the effects through their energy bill. For a financial services culture rating to have a similar impact, it would need to have a similar salience to consumers; they would need to feel that the corporate culture of financial services firms was something that could affect them personally. At present, however, customers are relatively isolated from the business behaviours of financial services firms and a significant majority of consumers (71%) believe that it is the government's job to set rules and make sure financial services companies behave well. Consumers are, to an extent, uninterested in monitoring the behaviour of financial services

providers; especially the elements that do not affect them directly on a regular basis like risk management and oversight. While customers are happy to be involved in discussions about customer service, they seem to believe that oversight of the financial services sector is too complex and opaque for consumer monitoring to be worthwhile. This trend is also visible in the fact that financial services providers compete on upside risk - that is, the returns they can offer to investors and savers, and the rates of interest they can offer to borrowers – but not on downside risk, the extent to which they would be safe in a crisis.

This is likely to be a result of the UK's comprehensive system of deposit insurance. Deposits of up to £85,000 in each bank are insured, meaning that if the bank goes bust individuals with less than that in an account will not lose a penny. This system of government insurance, extended to shore up the system in the heat of the financial crisis, has now become a form of moral hazard. With £85,000 covering most people's savings, there is little incentive for consumers to assess the safety and resilience of the financial services providers they choose. Although consumers report that they are concerned about the amount of risks financial services firms take, and on average believe that nearly two-thirds of financial services firms are taking big risks, consumers are not acting on these concerns. The reassurance provided by deposit insurance that they will not be personally affected has removed the incentive for deposit holders to actively oversee financial services providers. If financial services firms are to be universally convinced that it is not worth taking excessive risks, chasing profits and engaging in unsustainable behaviours, they need to believe that there will be large-scale competitive consequences to failing to develop a suitable corporate culture. Ultimately, the strongest form of discipline for financial services firms will be the threat of consumer exit in the face of bad behaviour; a direct impact on the business' bottom line which forces them to confront the issue. In this situation, the provision of information about the corporate cultures of financial services firms alone is unlikely to be sufficient to drive changes in consumer behaviour.

Consumers need some protection against the vagaries of the financial system. They cannot be expected to fully understand its complexities

or anticipate failures. But there should be a "smell test", a sense that if something sounds too good to be true there may be risks involved. The government must toe a difficult line between encouraging consumer trust financial services, crucial for the maintenance of the monetary system, and creating a system where customers have no incentive to look closely at the institutions they are trusting with their money. We would suggest that deposit insurance could be gradually lowered to around £30,000. This is higher than the median household's annual disposable income in the UK, [39] so should successfully protect most precautionary savings that households may wish to hold in cash and access quickly in an emergency. It is also significantly higher than the amount of cash required to place a 10% deposit on a house of median value (£177,299 in September 2014),[40] and higher than the total financial wealth of the median household.[41] This level of deposit insurance would thus protect the majority of the UK's cash savers, while acting as a signal and encouraging consumers to be aware of the risks inherent in financial services provision. Reducing deposit insurance and thinking about ways to put some skin in the game for customers as well as producers, could increase the salience of business behaviour of financial services firms for consumers, and help to promote good culture across the sector.

CHAPTER 4 - PROMOTING GOOD CORPORATE GOVERNANCE

Competition and diversity of ownership structures are two ways of encouraging better behaviour and culture among financial services firms. But, strong corporate governance remains inherently important. Mutual business models will only provide benefits when they are properly overseen, and competition over culture cannot eliminate the incentives for rogue individuals to engage in bad business behaviours for personal gain. As one representative of a building society put it in an interview: "You can't just say that because you are a mutual you are operating properly."[42]

Corporate governance is the process of monitoring and controlling the behaviour of a business. It includes managing risk, complying with relevant regulation, addressing problems of information asymmetry and working to ensure that the success of the business is sustainable. These functions are critically important in financial services, where information asymmetries, complex processes and opportunities to behave in harmful ways are plentiful. Over the past decade, financial services firms of all colours have struggled with elements of corporate governance. While regulation can, and has, gone some way to addressing these problems, in many ways good corporate governance is linked to the culture of a business; rules must be obeyed in spirit, not just to the letter. After several damaging scandals over the last decade, changes are needed across the financial services sector to strengthen oversight and embed good culture throughout the industry.

Diversity of ownership may help to induce long-termism and improve the resilience of the UK's financial services sector, but all forms of financial services firms are vulnerable to problems of corporate governance,[43] as the crisis at the Co-Operative Bank in 2013 demonstrated. Although the Co-Operative Bank was not strictly a financial mutual,[44] it had always tried to distinguish itself by its commitment to ethical behaviour. Its failure is a lesson that all firms dealing in the complex markets for financial services must uphold rigorous corporate governance.

Oversight, overlooked?

A crucial element of corporate governance is oversight of the business. Owners should keep a close eye on managers to ensure that management act in the interests of the firm and are not able to capture the business in a way that allows them to benefit at the expense of other stakeholders. In the complex world of financial services, this oversight can be particularly difficult. One important aspect, which has been the subject of new regulations in recent years, is the qualifications and knowledge required by non-executive directors. These directors are meant to oversee the business, representing the owners (be they shareholders or members) at board level. In recent regulation the FCA has suggested that in future regulatory approval of non-executive directors may depend on the uptake of training where necessary. These directors must also have the time necessary to consider the information they are given and the decisions they are called upon to make.

The potential for the boards of companies to be captured and work in the interest of management, rather than shareholders has long been a concern, with regulation developed to provide shareholders with means of recourse. However representing shareholders is not the only duty of the board: they also have a duty of stewardship to the company and its long-term success. The tension between these duties needs to be carefully navigated within PLCs. Board members are responsible for determining the strategic aims of an organisation, and should thus be the ultimate check against short-termism and isolationism in business, as recommended in the Kay Review.[45]

Beyond the board, shareholders need to execute their fiduciary duty to watch over the company and check it is being run in an appropriate manner. In practice, however, owners, both of PLCs and mutuals, are increasingly detached from the process of corporate governance. PLCs struggle to engage with the large asset management firms which are now their largest stakeholders who may have only a passing interest in the firm. Short-term shareholders have little reason to invest time and effort in corporate governance. Large equity holders with rights to cash flows can also encourage excessive risk taking in the hope of boosting short-

term profits, against the interest of other stakeholders in the business, especially customers. As such, concentrated shareholdings, associated with institutional investors, can cause particular problems.[46]

Customer-ownership does not necessarily mean that mutuals avoid these problems. Indeed, these firms run into the opposite problem of concentrated shareholdings increasing risk; the dispersed power associated with mutual ownership structure means that these firms can run into free rider problems. The costs to each individual of participating are high relative to the size of influence they can possibly have on decisions, meaning they may rationally decide it is not worth taking the time to get involved.[47] The non-tradable nature of mutual ownership also means that these firms are not subject to stock market pressures, so it is especially important that members provide feedback and monitor the firm. Many financial mutuals struggle to engage members in formal democratic processes such as Annual General Meetings (AGMs). However these businesses are increasingly looking for other ways to engage with members, to ensure the business continues to reflect their needs.

Mutuals adopt a range of engagement exercises to strengthen member oversight and input. For instance, Penrith Building Society is attempting to raise its visibility in the community by sponsoring the Penrith Show, and inviting members to informal drinks evenings and coffee mornings. Senior members of staff and board members are available, providing members with an opportunity to make their views held outside the firm's formal AGM process. At the other end of the size spectrum of the UK's building societies, Nationwide is developing innovative ways to interact with its very large membership base. These include the formation of a members' panel, whose views are sought regularly, and the development of local community volunteer opportunities organised through branches, providing a link between members and the broader community, establishing the branch as a point of contact.

The make-up of boards in the UK is heavily weighted towards the interests of shareholders, and often lacks representation of other groups, like employees, customers and local communities, who could help to bring a

long-term perspective. Particularly in the financial services sector, given its systemic importance to the economy, a lack of external voices can lead to dubious decision-making and risk-taking.

Widespread perverse incentives

A further set of oversight problems, common across all models, emerge due to the level of information needed to adequately assess the position of a financial services firm. At the individual level, staff may face incentives to behave in ways that are not in the customer's or the wider firm's best interests to meet targets, particularly in an industry where performance-driven compensation plays a substantial role. Yet monitoring behaviour in giant companies where individuals perform highly specialised and technical tasks is extraordinarily difficult.

Incentive problems are also pervasive at the firm level. With products such as loans and insurance policies, the valuation of assets and liabilities is highly contingent upon assumptions about the value of certain variables – economic growth, inflation etc. - in the future. Understanding these complex products and the outlook for a financial services firm thus requires a great deal of specialist knowledge. This sets up information asymmetries between owners – be they customers or shareholders – and employees of the firm. This information gap can make it hard for members of mutuals, customers, shareholders and even managers to monitor financial services firms effectively. Independent checks on these valuations may help, but only if they are sufficiently robust.

Changing culture in financial services

The question faced by those attempting to design corporate governance systems for financial services firms is how to encourage the development of good culture when the incentives faced by individual employees or owners often generate a pay-off for bad behaviour. The behaviours that are optimal for the company as a whole, and for the rest of society, are not always those that ensure the best returns for the individuals in privileged positions in the heart of our financial services sector. Designing structures

of oversight for such complex and potentially fragmented activities is a further challenge, particularly in larger companies.

There are three possible ways to address these pervasive corporate governance problems faced by financial services firms: transparency, compensation and role design, and the development of holistic corporate cultures. Of these, long- term compensation packages and the corporate cultures that are likely to accompany them may be the most successful.

One way to overcome pervasive information asymmetries is to increase transparency, reducing the advantage one party holds over the other. Boards, shareholders and members should be given access to information about pay, incentive structures and decision-making criteria. The benefits of this approach, however, are likely to be limited: the provision of more information to overcome problems of information asymmetry can just introduce "noise" to the situation. This is particularly problematic where stakeholders lack sufficient knowledge or skills to interpret it correctly; further hindering the chances that reasonable decisions will be reached. If board members, shareholders or members lack the ability to interpret the data provided or the company is so large that the volume of data produced would be unmanageable, this alone is unlikely to help improve corporate governance, and indeed reporting can become a way of hiding problems behind reams of data.

Another way to encourage employees to act in a way that is compatible with the long-term interest of the firm is to tie their compensation to long-term performance, rather than short-term targets or profits. The formation of employee pay and responsibilities is likely to play a critical role in the development of good culture in financial services. The sector's staff must be given both the tools and opportunities to develop better behaviours. The case study below, of Handelsbanken, provides one example of how this can be achieved:

Handelsbanken: developing corporate culture

Handelsbanken, the Swedish bank with over 180 branches in the UK, operates in a very different way to most other publicly-owned financial services firms. Firstly, rather than relying on top-down structures of rules, day-to-day operational decisions are delegated to branch managers. The business works on the basis that providing employees with responsibility provides them with the opportunity to rise to the challenge. In complete contrast to a system of command and control regulation, this decentralisation places great faith in human nature, that staff will do the right thing for the business, rather than purely furthering their own interests.

This structure is complemented by the unique reward structure Handelsbanken staff face. Unlike the vast majority of other financial services firms, Handelsbanken do not pay bonuses to staff. Staff are rewarded in years in which the group's single corporate goal is met: bank's return on equity out performs the average of its peers. The reward is collective, rather than individual; rather than each member of staff being assessed individually, the performance of the company is considered, and if the bank has outperformed its peers then an additional allocation of the profit is placed in the company's group profit share scheme, the Oktogonen. The Oktogonen Foundation invests almost entirely in Handelsbanken shares, meaning staff are one of the largest shareholders in the bank. Each member of staff, from the Chief Executive down, is allocated an equal monetary amount in the Foundation, in each year that the corporate goal is achieved. However, the cash cannot be accessed until retirement.

The long-term nature of this reward engenders a sense of collective responsibility, encouraging communication and cooperation rather than internal competition.

Source: Interview with Handelsbanken, Kroner, N. (2011), A Blueprint for Better Banking, Harriman House, Hampshire, GB.

Overcoming the difficulties of asymmetric information and effective oversight through incentive structures and information provision is a tricky task, which pay structures alone are unlikely to achieve. And thus the crucial role of culture becomes clear. Norms of behaviour play an important role in determining the extent to which it is seen as being socially acceptable (within a company or externally) to exploit asymmetries of information or perverse incentives structures. Integrity, and a concern for the customer and society needs to be at the heart of financial services provision. The concept of collective accountability for corporate success introduced in the Handelsbanken case study could provide one way of overriding individual incentives to take excessive risks. This could form a counter-balance to the idea of personal liability for improper activity, providing an incentive for the staff of financial services to monitor each other and avoiding the collusion which characterised, for example, the worst of the Libor-rigging scandal.

Collective pay incentives like those used at Handelsbanken could be introduced throughout the financial services sector to encourage peer monitoring of behaviour. While these incentives schemes are relatively rare in the UK at present, studies suggest they work well in situations where there are opportunities for individuals to monitor each other so employees do not have chance to free-ride on the incentives of others.[48] In this case, the use of a collective incentive system should induce peer pressure for better behaviour at all levels of the business.[49] Such a system is likely to work well within the teams which make up financial services firms, bypassing the incentives to manipulate sales or other performance figures which are inherent in individual targets.[50] Although individual businesses may suggest they risk talent flight by introducing these regimes, a gradual, mandated redesign of incentives schemes across the industry to introduce collective rewards alongside individual performance incentives would limit the likelihood of this and could help to reduce the vulnerability of the financial services sector to bad behaviour by miscreant individuals.

These mechanisms can encourage greater diligence on the part of individuals within the financial services sector, and could also, over time,

help to create a persistent, self-reinforcing culture of good business behaviours. Competition can help firms to recognise the importance of behaviour to their business success. But the culture that firms use to compete will be determined by the corporate governance structures they have in place. The most robust corporate cultures will be those developed in close consultation with staff from every level of the organisation, to ensure individuals feel happy with the values and behaviours they are expected to adhere to. The code must also be a living document, open to consistent internal challenge and debate, if a healthy system of internal peer-enforcement is to emerge. Ultimately, this will be critical to the success of culture-based financial services reform.

Developing corporate culture in financial services

Development of a successful corporate culture depends on both strong leadership from above and engagement right through the ranks of staff. Participants in interviews for this study reflected on their efforts to develop good corporate culture:

"Staff from all departments are involved in management and board committees, so they're aware of the strategic direction as well as the operational direction of the firm. There is regular post-board communication to the rest of the staff. It's the idea that staff have to be on board to make the business successful." **Louise Watt, Operations Manager, Penrith Building Society**

When implementing change programmes, successful organisations often ensure that they consider the views of employees, to ensure that staff are comfortable with what is being asked of them:

"People on the ground deliver the culture and it's important that they are fully involved in its evolution and development, rather than managers just dictating." **Roy Badcock, Head of Corporate Affairs, Cambridge Building Society**

"The annual employee evaluation engagement survey is not just a tick box exercise. Good results and action on areas of focus are included in all senior management performance plans every year. Our strong belief is that happy, engaged employees will result in a good service to our customers and this philosophy is core to our business model." **Mark Austen, Chairman, LV=**

Board-level oversight will be critical to the success of culture change programmes, which will require significant investment of time and resources to successfully implement. These programmes will not go ahead unless non-executive directors are able to ask difficult questions, to challenge received wisdom and implement true change. There is thus

an argument for taking steps to widen the pool of non-executive directors in the financial services sector. Given the complexity of the companies these directors are overseeing, it is not surprising that candidates are in relatively short supply. However, at present the industry is drawing on a relatively limited pool of people.[51] Where this is the case, it becomes possible for an individual to take several non-executive directorships, and this can reduce the incentives for non-executives to ask difficult questions; companies are less likely to appoint directors with a reputation for making life difficult, and so presenting a challenge may reduce future opportunities for further non-executive positions within the industry. This problem could be diminished by a direct limit in the Financial Reporting Council's Corporate Governance Code on the number of non-executive directorships an individual can hold. Some industry outsiders are also needed to ask questions that those close to the sector may think of as obvious, but which could hide important issues, so providing training to those without specialist knowledge may in some cases be preferable to recruiting industry insiders. Leadership from board level and senior management will be crucial to the development and persistence of good culture across the financial services sector.

The combination of competition along an axis of corporate culture, facilitated by the provision of simplified information, diversity of providers and strong corporate governance should create strong norms of good behaviour across the financial services sector, with multiple points at which behaviour is observed and potentially corrected – both within and outside the firm. By tackling these issues together, rather than each one in isolation, the UK's financial services sector should be able to build resilience, better meet the needs of its customers and secure its long-term success.

CHAPTER 5 - CONCLUSIONS

Corporate culture plays a vital role in determining behaviour in financial services firms, where complexity means regulators and managers cannot anticipate every opportunity for transgression. By creating norms of good behaviour, financial services firms can improve the likelihood of their long-term stability and success. And given the sector's crucial role in the economy, this will also benefit both consumers and businesses alike.

Customer-owned mutuals are predisposed to good corporate culture, thanks to the coincident interests of owners and customers, Member ownership reduces the pressure on firms to make profits, which can lead to excessive risk taking, and instead provides a basis for the sustainable provision of financial services. Making life easier for financial mutuals in the UK would help to boost diversity in the financial services sector, improving both the industry's resilience and that of the economy as a whole. Providing an explicit remit to support diversity as well as competition in regulators' mandates, wider access to appropriate capital instruments and a commitment to disinterested demutualisation could help to protect the UK's remaining financial mutuals and help them to thrive.

The financial crisis and scandals since have damaged consumer confidence in financial services firms. But by highlighting instances of good corporate culture, this could provide an opportunity to instil competition along the axis of business behaviour. Although consumers currently struggle to identify good business behaviours among financial services firms, the provision of simple, easy to navigate information through a Good Culture Kitemark and scoring system could help consumers make their preference felt by financial services firms. While customers should be protected against the worst behaviours of financial services providers, giving them an incentive to care about culture by reducing deposit insurance could also provide a significant incentive for better behaviour across the sector.

These reforms could help improve the visibility of corporate culture, but they will also require a renewed commitment to strong corporate governance. Effective oversight, accountability, compliance and risk

management will remain crucial to the stability of a sector where perverse incentives and information asymmetries mean temptation is ever-present. Incentive schemes which provide collective responsibility for corporate behaviours should help to ensure that it is always in the interests of individual employees to behave well. We cannot completely remove opportunities for bad behaviour in the financial services sector, so we must ensure that good behaviour has its own reward.

Developing good culture in financial services will require more than a statement of intent, an advertising campaign or a quick mention in employee training. To create new norms of better business behaviour will require constant vigilance and oversight. We hope to make this task easier by encouraging consumers to play a role, providing financial services firms with an immediate and impelling reason to commit to improving behaviour. Over time, this, together with the other recommendations made in this report, could help to create a stronger, more diverse and competitive financial services sector, and ultimately a more resilient economy to the benefit of us all.

APPENDIX A: METHODOLOGIES

Public Polling

Survey data reported in this report was collected by Populus for the SMF. Populus interviewed 2065 GB adults online between 20 and 21 August 2014. Results have been weighted to be representative of all GB adults. Populus is a member of the British Polling Council and abides by its rules. For more information see www.populus.co.uk.

The survey examined consumer views of "good" business behaviour, views of business behaviour within financial services, awareness of different forms of business ownership, the impact of ownership on behaviour and consumer willingness to change behaviour to encourage good business behaviours.

Interviews

The SMF also carried out a set of semi-structured interviews with representatives of a variety of financial services providers. We attempted to interview representatives of organisations of varying size, ownership structure and geographical scope. We also attempted to capture organisations involved in different types of business activities, from transactions focused organisations to those involved in asset management or money market activities. Where possible we spoke to several representatives of the organisation to ensure that participants felt confident in their ability to engage in a technical discussion.

Interviews followed a semi-structured format, in which the interviewed began with questions drawn from a formal interview guide, and then allowed the conversation to develop more naturally, spending more time on emerging topics of interest. This ensured that the interview dialogue was two-way, and participants had the opportunity to reflect on the issues they felt were most important.

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Good Culture
Does the Model Matter in Financial Services?

Short-termism, poor risk management and a lack of strong corporate governance have all been identified as sources of the financial crisis. Yet more than five years after the crash these issues continue to cause concern about the stability of the UK's economic recovery. The financial sector's scandals are not isolated incidents but examples of a systemic problem. Regulation can only go so far to stamp out bad behaviours and a change of corporate culture is sorely needed if the financial services sector is to become a blessing not a burden for the UK economy.

Based on a specially-commissioned consumer survey and interviews with financial services firms, Good Culture considers the mechanisms which could be used to improve business behaviour in the UK's financial services sector. This report examines how competition, stronger corporate governance and more diverse ownership structures could help develop a better business culture, providing the financial services industry with the resilience and security needed to support the rest of the economy.

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