Towards a more sustainable financial system: the regulators, the banks and civil society[1]

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This article argues that (a) although the "Global Financial Crisis" of 2007–9 may be over, the global financial system is still deeply flawed; (b) the problems that beset the system cannot be cured by laws and regulation alone; (c) the essential nature of the problems lies in a deeply engrained culture within most banks that undervalues ethics and morality; (d) the solution to the problems will have to include a change in that culture that goes some way beyond the traditional sphere of corporate governance; and (e) to bring about a genuine change in culture will require a greater engagement by civil society in the internal affairs of banks than has been the case to date, but for which there are clear precedents in other areas of banking activity.

> "We have said repeatedly that the banks understand the public mood with respect to remuneration and the banks also understand their societal responsibilities. It is not surprising therefore that we are talking with the government on these and a range of other issues."
>
> (British Bankers' Association)[2]

A. The recent eurozone problems

As is well known, the Irish government, on 21 November 2010, formally requested assistance from the International Monetary Fund (IMF) and various EU institutions in connection with the much publicised financial crisis that Ireland was experiencing. The combined rescue package was in the region of £70bn. This followed several days of intense speculation as to the state of the Irish economy and the funding requirements of Irish banks and the Irish state. In the latter part of November 2010, the Irish government and the Irish banking system had faced renewed pressure[3] from the financial markets, various foreign politicians and the European Central Bank to accept that some form of "bail-out" was needed in order to restore trust and confidence that the enormous problems brought about by excessive leverage (particularly property lending) in domestic banking markets could be solved. The various measures on which the Irish had been relying to keep their financial system afloat, notably emergency liquidity funding (around £110bn) from the European Central Bank to the Irish banks, were not thought to be appropriate (at least by the funders) as a long-term solution. Something more permanent was required if the markets were to be persuaded to continue funding the banks and indeed the government itself (even though the government continued to remind everyone that it would not be in need of further funding from financial markets until mid-2011). Many commentators (including the UK's Chancellor of the Exchequer, George Osborne) remarked that the Irish financial system had ceased to be "sustainable". This certainly appeared to be the case. As the story unfolded, questions were raised as to the sustainability of euro itself[4] (and, at the time of writing, such questions continue, much to the annoyance of eurozone politicians[5]).

It is clear that the financial system as a whole is still subject to aftershocks from the "Global Financial Crisis". The *Financial Times* lead editorial of 18 November 2010 (commenting on the Irish situation) warned us that "Europe Heads Back into the Storm" and that we should be prepared "for bank failures – and not just in Ireland". As long as it remains necessary for key financial institutions, and countries such as Ireland and Greece, to be "propped up" by bail-out measures of various kinds it can hardly be said that we have a sustainable financial system. As Sir John Vickers, the Chairman of the UK's Independent Commission on Banking (the "Vickers Commission"), said in a speech on 22 January 2011, the current financial system is "damagingly rickety". There has to be change – but, for a "system" that crosses many different sovereign (and competing) jurisdictions, how can change be effected?

The problems faced by the Irish had parallels elsewhere. The financial systems of Portugal, Greece and, possibly, Spain have been under similar pressures. The desire of EU institutions to encourage the Irish to "do something" about their problem was driven to some extent by a concern that the "contagion" of funders' lack of confidence could rapidly spread to these countries. (At the time of writing, this still appears to be a possibility.) The requirements for bail-out funding for the Irish alone were huge. How much more will be needed for other countries?

Further, the taxpayers of the more solvent EU countries, who in effect underwrite the EU funding institutions, have been growing restless. The problem is not merely financial or economic; it is political. Observers of Ireland's dire financial

straits have not been slow to point out that this one-time "Celtic Tiger" has in the past apparently reaped considerable benefits from joining the euro but, now that its (unsustainable) domestic property bubble has burst, the disadvantages of not being able to set its own currency exchange rate or domestic interest rate are all too obvious. So perhaps it should leave the euro? Or simply default? None of these "options" looks politically bearable . . . but the laws of arithmetic pay no regard to politics.

It is not open to other EU economies simply to look on, offer encouragement and wring their hands at the discomfort of the Irish and others but otherwise do nothing. It is a truism that we live in a highly interconnected world and the interconnected economies of the major world players, within the EU and elsewhere, are tied together by a global financial system – as are the economies of most of the smaller countries. Thus, if the Irish banks (or any of them) failed – or still worse if the Irish government could not honour its sovereign debt commitments[6] – this would have adverse, possibly extremely adverse, consequences for banks in other countries (including state-funded banks in the UK, such as the Royal Bank of Scotland (RBS)) that have significant exposures to them.[7] If other eurozone economies started to feature sovereign defaults, there would also be severe consequences for banks throughout the EU that have exposures to them. There is a risk of the Global Financial Crisis of 2007–9 returning, this time adding the risk of sovereign defaults as it becomes apparent that major state bail-outs of profligate, virtually bust banks only pass the debt problem up the chain to the level of the state – and not all states can afford such measures. Within the EU (and especially the eurozone) the problems experienced in the so-called "peripheral" states are bouncing back in the direction of the "core" states – especially Germany – who are, it seems, is being asked to pay for the failed economic and fiscal policies of countries who look to have been living beyond their means. Not unnaturally, the Germans do not feel that their financial support should be given without strings. There is no such thing as a free lunch – and the price of the support seems likely to cause political repercussions. It comes hard to a country which has been used to thinking of itself as "sovereign" to be told that (a) it must accept some kind of bail-out not only for its own sake but for the sake of the currency system it has joined and (b) as part of "the deal" it must (for example) make radical changes to its taxation laws or other policies that it regarded as nobody else's business. Such things, it seems, are now everyone's business . . .

B. The post-Crisis reform agenda

Much has been written about the 2007–9 Crisis and its causes, and no doubt much remains to be written about the current "knock-on" sovereign debt crisis being experienced in countries such as Ireland. Moves are afoot – at various levels, national and international – to implement reforms aimed at making a repetition of the Crisis unlikely, if not impossible. Some have already taken effect and still more are in the pipeline and the subject of ongoing debate. They include "macro" questions such as requiring a separation of investment banking from deposit-taking[8] and/or splitting up the bigger banks in order to encourage more competition as well as more detailed requirements for more, better quality capital (which will take several years to come to pass[9]); curbing remuneration policies that encourage "reckless risk-taking"; requiring banks to hold a certain amount of "skin in the game" when they package up portfolios of financial assets of various kinds (eg retail mortgages) and sell them off into the wholesale markets; requiring certain kinds of derivative trades to be conducted through clearing houses; tweaking various voluntary codes related to the performance of non-executive directors, risk committees and other aspects of bank corporate governance; exhorting shareholders to be more "engaged" and accept some responsibility for "stewardship" of the companies in which they invest; and so on. Apart from substantive measures such as those listed above, there has also been a great deal of rearrangement of the "regulatory architecture", with new national and international bodies being set up, staffed largely by the same people who staffed their predecessors. In addition, regulators such as the UK's Financial Services Authority (FSA) (which is about to be dismantled by the new UK coalition government) tell us that they are taking a more "intrusive" approach to the exercise of their powers, such as the vetting of bank personnel in key areas where they may have "significant influence". Indeed, according the FSA's chief executive, "people should be very frightened of the FSA" in the post-crisis era (the unfortunate implication being of course that they were not before).

There is thus a great deal of reform activity and debate. There is also disagreement on a range of key issues, making global reform extremely difficult. At international level, the pace has slowed somewhat since the heady days of the 2009 G20 pronouncements that recorded how various political leaders had (to quote the then UK Prime Minister, Gordon Brown) "saved the World". The G20 gatherings of 2010 have been disappointing in their non-conclusions. More activity can be seen at national level, as various countries have decided to "go it alone" and implement at least some of the reforms that they see as necessary for their own jurisdictions. This leaves a number of gaps, however. Truly global regulation on anything of importance remains no more than a very distant prospect. Whilst this is the case, any kind of radical reform, even at national level, is potentially hobbled by the oft-repeated threat (from banks and their spokesmen) of regulatory arbitrage. Although many banks would now, no doubt, like to get back to "business as normal", there is an ongoing public uneasiness.[10] As the travails of Ireland have shown, there is an uncomfortable feeling that while so many financial institutions are still on "life support" (the UK's RBS still needing the large injection of taxpayer cash that saved it from insolvency with only two hours to spare,[11] for example) the financial system as a whole does indeed look too rickety and too patched up to be regarded as "safe" again. This feeling of unease is only increased as various stories about bank behaviour, past and present, continue to grab the headlines, from lawsuits and regulatory action involving the likes of Goldman Sachs and Citigroup to the apparently still-favoured unsavoury bonus and remuneration practices of banks, so embarrassing that banks are fearful of revealing even outline details to the public.[12] The sight of senior bankers calling for an end to "bank-bashing" whilst awarding themselves multi-

million-pound remuneration packages (in a supposed "age of austerity") does not help matters.

The questionable behaviour, to make matters worse, seems to be deeply embedded in the structure of the institutions themselves, with investment banks firmly attached to business models that include both advisory roles and trading for their own account (resulting in conflicts of interest, confidentiality questions and the temptation to "work both sides of the street"). The litigation brought in the US by the hedge fund, Terra Firma, against Citigroup regarding alleged statements made to Terra Firma's CEO, Guy Hands, by a Citigroup executive in connection with an auction sale of the EMI business resulted in victory for Citi and humiliating defeat for Terra Firma and Mr Hands but damaged the reputation all concerned. Much criticism has ensued of the way investment banks operate with structures that are bound to lead to conflicts of interest. Commenting on the case in the *Financial Times* (5 November 2010) Philip Augar observed:

> "Conflict of interest pervades financial services. The practice of taking two or even three bites of the cherry, advising both sides of a transaction and taking a financial turn where possible, became accepted during the late 20th century. . . . Investors, shareholders and their representatives should not tolerate this situation. They should insist that the managers of entities in which they have a financial interest take independent advice in every financial transaction and require conflicted parties to choose between one side and the other. . . .
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> While such changes would be intended primarily to benefit the pension funds and savers that are the market's end users, there would be a spin-off for the banks themselves. A cleaner structure would help them live up to their stated ethical framework and rebuild public trust in the industry. Under the currently convoluted business model, banks cannot truly walk the talk of right-minded ethical behaviour."

C. Has anything really changed?

New rules and regulations are being promulgated in a range of areas but doubts persist about how effective rule-making, by itself, can be in effecting real change. Before the Crisis, the FSA's "Handbook" of rules and guidance was, notoriously, more than 6,000 pages long. Further, in the UK, banks and other financial institutions have been subject to more broadly based "principles-based" regulation (PBR) for many years, both before and after the Crisis. Some of the FSA's principles are so broadly drawn that it is hard to imagine any kind of misbehaviour that would not be caught by at least one of them.[13] Many have posed the question: why did none of this stop the Crisis happening? Many answers have been offered. It is not the purpose of this paper to contribute to that debate; it would seem that opinions on the question will always differ as the causes of the Crisis were somewhat complex.[14] But the more important question for society now is: can we be comfortable that requirements for more capital (eventually) coupled with yet more adjustments to the rules (the FSA Handbook is updated about once a month) and the adoption of revised codes of conduct, etc, will stop it all happening again? Ultimately, there is a limit to what rules can achieve. Similar points might be made about the numerous changes to the "regulatory architecture". None of these changes involves any mechanism whereby the public may be able, from time to time, to verify that the new system is in fact working better than the old.[15] Accountability, in the sense of enabling any monitoring of how much better the new system actually is, does not seem to be on the agenda.

There are, as yet, no signs that the old "game" of "outwitting the regulator" – an ongoing exercise of cat and mouse in which the regulator/lawgiver lays down rules to stop the latest examples of market misbehaviour only to find that the market finds ingenious ways to "creatively comply" with the new rules (obeying the letter but not the spirit) and carries on pretty much as before – has come to an end.[16] There are, in reality, no "gatekeepers" with reputational capital at stake to stop a return to the old ways.[17] And "creative compliance" is so much easier when the market is global but there is no global regulator (and opportunities for regulatory arbitrage arise). Meanwhile, the regulator seems to be more concerned with devising more rules to address *manifestations* of "bad attitudes" inside financial institutions than to address the attitudes themselves.

Recent examples of the ongoing nature of the "old problems" can be found in two stories in the *Financial Times* from 17 November 2010. On page 3, it was reported that the FSA was to launch a "new crackdown on poor mortgage lending practices". Lenders were going to have to do "a better job of informing their customers and ensuring they can afford their mortgages". According to the FSA's consultation document (July 2010) many borrowers had been making "poor lending decisions" – some had deliberately over-stretched themselves, others had just misunderstood the effect of what they were doing.[18] Of course, a number of lenders had been slack in checking borrowers' ability to repay because they were going to securitise and sell off the mortgages anyway. And the solution to the problem? Make lenders responsible for carrying out more checks on borrowers. In the *FT* article, an industry spokesman raised some objections to the FSA's proposals. His chief concern was that they "would strip consumers of too much responsibility and in turn make lenders too accountable for risk." He had a point. There cannot be many people left in the UK in 2010 who do not understand that (a) loans ultimately have to be repaid and (b) giving security over your house (ie a mortgage) risks your losing the house if you default. There is a risk in borrowing on the security of a mortgage – but we generally are happy to take it because most of us need a mortgage to effect the purchase of the house in the first place. We may take an over-rosy view of our prospects in assessing our ability to repay; we might well expect the lender to be more conservative. Usually, some sensible balance is stuck. However, because the culture that used to operate inside lending institutions such as mutual building societies seems to have collapsed as they have been "de-regulated",[19] we will now find that a further set of rules is put in place that will be unnecessary for sensible borrowers and may well be circumvented by the more unscrupulous. The regulator will feel that it has at least tried to address the problem but, in reality, the problem lies at a deeper level than

the provision of advice and checking procedures. (You can almost see the boxes being ticked.) It lies in the culture of lending institutions who no longer see that lending irresponsibly to people who clearly cannot afford to repay is just plain wrong. You should not need a regulation or rule to see that this is so. If you do, you should not be in the retail financial business.

The other story in the *Financial Times* was on page 15, in an article by John Kay. The author had been studying a new retail "complex structured product" (called a "kickout bond") in some detail and described its main features as follows:

> "The typical structure . . . is something like this. If the FTSE index is higher in a year's time than it is today, you receive a 10 per cent return and your money back (no doubt with an invitation to apply for a new kickout bond). If the FTSE has fallen, the bond runs for another year. If the index has then risen above its initial level, you receive your money back with a 20 per cent return. Otherwise the bond runs for another year. And so on . . . the investment matures after five years. If the FTSE index, having been below its initial level at the end of years one, two, three and four, now lies above it, then bingo! You get a 50 per cent bonus. There is, of course, a catch. If you miss out on the five year jackpot the manager will review whether or not the FTSE index closed at more than 50 per cent below its starting level. If it hasn't, then you will get back your initial stake, without bonus or interest. If the index breached that 50 per cent barrier your capital will scaled down, perhaps substantially."

As Kay points out, even readers of the *FT* would need to read the above description several times before understanding it. And yet the product will be sold to consumers – the typical buyer being someone attracted by the "headline" return of 10 per cent and, as Kay puts it, "credulous enough to believe that he or she is not really taking on a significant level of risk in order to achieve it". The product is a straight gamble or "play" on what the FTSE index will do during the product's life of five years. No doubt it will sell well and no doubt those who lose money on it will claim they were "mis-sold" it. You can see it all coming.

Why does this happen? Again, the culture of those who devise such instruments is clearly not concerned about encouraging gambling by those who do understand the product or about the risk of poor explanations of its effect being given to those who do not. As for the buyers of the product . . . if they watch football or other sports on television regularly, they will have become accustomed to aggressive advertising (typically at half-time) for placing bets on the outcome of what they are watching. So they will have been encouraged to see regular gambling as perfectly acceptable and normal behaviour.[20] Why not have a slightly bigger flutter on the FTSE? Our social culture encourages the marketing of products like this, just as it encourages gambling. But – again, to quote John Kay,

> "In a world of complex products and equally complex production processes, consumers are protected from unsafe cars and toxic foods by a combination of regulatory action and supplier concern for reputation. Public agencies prohibit the sale of dangerous cars and food, and companies such as Ford Motor, Nestlé and Tesco do not want to sell them. But neither reputation nor regulation seems to achieve these results for retail financial services."

The two *Financial Times* stories should be compared with each other. If the moral climate in the financial markets (and perhaps in society more widely) is such as to give its blessing to products of the kind described by John Kay, what chance is there of a new set of FSA rules[21] changing the underlying behaviour and attitude that results in the mass-marketing of mortgage products to those who cannot afford them?

It is doubtful that we can draft our way out of problems like this merely with laws or rules and, even if we could, our efforts could only be jurisdiction-specific rather than global in effect. And that is a problem. If (for example) broadly based "PBR" does not work, and if (as is surely likely to happen) non-executives on bank boards continue to be outmanoeuvred (or simply cowed into submission) by aggressive executives, what can be put in place to stop the herd instinct taking over again as soon as the threats posed by the Crisis appear to have receded? If there has been any change in moral or cultural attitude on the part of the banks (who are starting to complain that the "bank-bashing" should stop) it is hard to put you finger on what it consists of.[22]

D. Questions of Culture

A number of commentators, including very experienced bankers such as Ken Costa[23] and Stephen Green,[24] have suggested that the reform agenda needs to include elements that are not easily covered by changes to laws, regulations or even voluntary codes. The issues raised go beyond regulation, even self-regulation, in the conventional sense. Their suggestion is, in effect, that the markets need to "get back" to the need for some moral and ethical content in decision-making inside financial institutions.[25] It is a suggestion that should be taken seriously. Even Lord Turner's celebrated remark (and implicit criticism) that certain financial activity is "socially useless"[26] has a moral dimension to it. In a business that, directly or indirectly, relies on taxpayer support (if only because of the lender of last resort function of central banks) it may be acceptable, even essential, for there to be a degree of risk-taking insofar as this is inevitably part of the service (essentially, maturity transformation) that banks provide to society; but if the risk-taking is little more than placing bets on contingencies (as with, say, "naked" credit default swaps) with no social benefit whatsoever, society is entitled to ask if this behaviour can be morally justified.[27] Gambling with your own money (up to a point) may be tolerable but gambling with other people's is not.

How can changes in culture be brought about? It must surely be the case that decision-making bodies inside banks need to have someone present who is not afraid to ask the question: it may be legal, but is it right? Who could such people be? At first blush, the non-executive, independent director seems to be the person who should take on the role. However, their track record thus far, in relation to banks, has not been encouraging. Much turns on the qualities of the individual. They will need thick skins and a strong constitu-

tion as well as a degree of contrarianism in their character. They will need to be able to stand up to domineering executives. They will need to have an eye both for the big picture and the time-consuming detail. They must be prepared to ask the most awkward questions and not to settle for fobbing-off answers. They should have no interest to pursue in relation to the bank other than the protection of the shareholders' capital, consistently with earning realistic and sustainable returns. They will not be associated with firms who earn fees from other activities with the institution; they will not be capable of being "bought". From the perspective of the executive they may seem to be a nuisance. But, as ever, the important thing is the level playing-field and getting the balance right. If all banks have people of this kind on their boards, they should be able to adapt. There is no reason why an able executive of a taxpayer-funded institution should not be able, and required, to justify proposals to a sceptical independent. And if we are to be serious about this, the presence of truly independent spirits must be an absolute requirement, not a matter that is subject to the "comply or explain" concept. Banks are different from other businesses. They now have their own insolvency and "resolution" regime and they have special access to the public purse if they get into trouble. They should have their own internal governance regime as well – enforced by law.

In any event, can we really believe any more either that, when it comes to risk management, the executive will always know best or that "comply or explain" codes are going to make significant inroads into the problems that the Crisis has exposed? History suggests otherwise. The call for a moral dimension and a "keeper of the corporate conscience" is not, let us be clear, a suggestion that market-players suddenly "get religion". It is a call for a recognition of enlightened self-interest and a change in culture that recognises what that means. If banks do not change, their reputations will suffer (even more) and the public's patience with those who behave as if the Crisis had not happened will run out. Nothing hurts banks more quickly than rapid deterioration of reputation. A bank run is, in fact, the most obvious physical manifestation of what happens when reputation sinks too low. And reputation, for banks and many other businesses, is a much more fragile thing now than it has been for many years.

The misfortunes of corporate giants such as BP (with the *Deepwater Horizon* Gulf of Mexico oil spill as well as the Texas City incident before that) have shown how quickly reputation can be damaged in our modern, internet, interconnected, 24-hour rolling news media world – and how severe the financial consequences can be. (The current CEO of BP recently said that he feared whether the company could survive the firestorm that *Deepwater Horizon* unleashed; the incident ultimately resulted in BP reporting its first annual loss since 1992.) An unfortunate incident on day 1 can attract bad headlines on day 2, be subject to unwelcome political comment and, possibly, intervention on day 3, and trigger consumer backlashes, fuelled by internet-based campaigns on day 4. By day 5 the CEO has to consider his position and, if nothing is done, day 6 may see the start of a run on the shares (if that has not already happened) followed by severe profit warnings and freezes on dividends. Every innocent, but perhaps incautious remark is recorded, repeated out of context and magnified beyond reason if it can justify a headline story in the news bulletins. Every onlooker who carries a mobile phone also carries a digital camera and is able to upload images to the internet within minutes; and if they are capable of causing embarrassment they will "go viral" before the day is out. What if the "next *Deepwater Horizon*" involves a "systemically sensitive" bank? It could easily happen. The experience of the relatively minor Dutch bank, DSB,[28] shows how quickly a damaged reputation and the unwelcome interest of the modern media can bring a bank down. And then, of course there was Northern Rock . . .

Many commentators have pointed out that the BP experience holds lessons for businesses in other sectors. For example, Michael Skapinker, writing in the *Financial Times* on 1 November 2010, commented:

> "[A] Deepwater Horizon lurks in every organisation. You do not need to be in a safety critical industry, such as oil, chemicals or nuclear. Enron and Arthur Andersen were felled by fraud: Lehman Brothers by risky financial bets."

Skapinker's recommendations, as regards "lessons learned", include having "a powerful figure heading a team whose rewards depend on safety [who] is more likely to uncover risky practices than the managers who stand to benefit if those risks pay off". He also cautioned that

> "it is no use moaning about the media. . . . That is the way it is. Blogs and Twitter keep up a relentless patter. But what really hurts is round-the-clock television. Those hours need to be filled with supposed experts who are expected to say what is happening before they can possibly be sure. . . . It is not going to change. Far better to prevent the crisis happening in the first place."

The BBC's Business Editor, Robert Peston, has also made direct comparisons between BP and the banks (in this case, Lloyds Bank). In his blog of 2 November 2010[29] he comments:

> "[W]hen businesses of the scale and economic importance of Lloyds and BP run into difficulties, it is impossible to limit the costs of the clear up to the holders of risk capital, their shareholders.
>
> It's not just the potential of BP to poison the seas and its role in meeting vital energy needs –or the pivotal role of Lloyds in the payment system, credit creation and the protection of saving – that legitimise ministers and regulators systematically sticking their noses into the affairs of big companies."

The same kind of reputational issues can bring both oil companies and banks to their knees with frightening speed and, in both cases, the taxpayer may well end up picking up at least part of the tab. And perhaps the time has come for all of us to "stick our noses" into how such businesses are run, rather than leave it to the regulators alone. "Sustainable finance" should not just be about the relationship between financial institutions and the environment and society (important though that is), it should also be, in the post-Crisis era, about the running of the institutions themselves in a sustainable manner and their acceptance of responsibility for a sustainable financial system: systemic responsibility.

E. The rise of "civil society"

As things stand, the public in the UK is reasonably confident about the big banks. But that is because two of the biggest are partly owned by the government. That is not a sustainable position. When the government sells its shares, public confidence will have to rest on other factors. We may then find that it is not just the regulator of whom banks should be "very frightened". Other forces are also at work. Civil society, in the form of non-governmental organisations (NGOs), charities or simply *ad hoc* groups of "concerned citizens" – or other stakeholders – now have considerable weaponry at their disposal. This includes the ability to have a seriously negative impact on corporate reputation. The NGO "toolkit" involves (a) creating consensus around a given set of issues; (b) giving maximum publicity to those issues (sometimes by protest events, sometimes by litigation,[30] for example); and (c) using publicity to affect the reputation of those whose acts are complained of to such an extent that, ultimately, they change their behaviour. Occasionally, of course the actions of NGOs do lead to a formal change in law, but this is not always necessary for them to achieve their objective. The main reason they succeed (assuming their cause is a good one) is that, over time, they change perceptions of acceptable behaviour, of what is right and what is wrong. If a deeply entrenched culture is to be changed, the methodologies of the NGOs (leaving aside the more extreme ones) may be the best tools for the job, albeit coupled with regulatory changes.[31]

The activities of civil society "players" have, historically, been used to great effect in the context of environment, social and governance (ESG) issues insofar as they affect banks. Banks have had to respond and, thanks largely to the pressures that stakeholders have been able to exert (in many cases via international financial organisations such as International Finance Corporation (IFC) and European Bank for Reconstruction and Development (EBRD) as well as taxpayer-funded export credit agencies and the OECD[32]), they have been subject to a considerable "greening" process over the last decade. Initiatives such as the Equator Principles[33]in the context of project finance have had a significant impact already and the ESG agenda's impact still continues to develop in areas such as the investment policies of pension funds, hedge funds and other institutions. Many examples could be quoted but EBRD's annual Sustainability Report clearly demonstrates how seriously ESG issues are taken at a major international institution.[34] Furthermore, the "greening" of the banks is a largely global phenomenon; it is not tied to any one jurisdiction or geographical region. The various measures taken by EBRD, IFC and others are constituent parts of a growing body of soft law with a global reach. Although it is true that there is no effective global regulation for the global financial market, the ESG area represents at least a partial exception to the rule and the reason for that is the peculiar effectiveness of soft law in areas that affect the reputation of individual banks. A sense of right and wrong, coupled with enlightened self-interest, has taken root.

The influence of civil society on bank behaviour has also been felt in what is perhaps the most obvious area for it to target – the treatment by banks of their retail customers. Virtually all major banks see a need to restore their image and reputation with retail customers following the Crisis – as well as in the aftermath of reputation-damaging litigation such as the unauthorised overdraft case in the UK.[35] There will no doubt continue to be examples of ill-judged products being launched on the public (such as those referred to in the article by John Kay mentioned above) and claims of "mis-selling" seem to have become part of our way of life, but there are at least signs that banks are trying to improve. "Charters" and codes of conduct now proliferate in the retail arena. One reason for this, of course, is that the consumer experiences bad retail practices at first hand (although the complaint, if there is one, generally only arises if and when money is lost). Experience of bad behaviour in wholesale markets, on the other hand, is felt on the high street less directly and transparently (although, as the Crisis has shown, it is certainly felt). As a result, the reputational risk that comes with bad behaviour in the wholesale markets has, to date, tended to be treated rather more casually by banks. They just seem to pay the fines and "move on" as if nothing had happened (even though the fines can be huge) admitting to "mistakes" or misjudgements but rarely being held to task (or holding themselves to task) for moral culpability. One senses that they just do not *feel* moral culpability. All the members of the herd are up to broadly the same tricks, so how can it be right to single out just one of them, the one who got caught, and vilify it for being in the wrong? Surely, they were just unlucky? The point was elegantly made by Keynes as long ago as 1931 in a passage quoted in a recent speech (20 November 2010) by Andrew Haldane of the Bank of England:

> "A sound banker, alas, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional and orthodox way with his fellows, so that no one can really blame him."

Perhaps the time has now come to "really blame" them? Civil society's agenda for banks –and other corporates – has not stopped with ESG and consumer issues. Recently, the UK has experienced intensive "direct action" campaigns against companies such as Vodafone who have been perceived (rightly or wrongly) to have indulged in over-aggressive tax avoidance. (One of the themes of the protesters is that the tax that is lost as a result could have been used to offset some of the pain being experienced (or expected to be experienced) by "the cuts" – or austerity measures – being implemented by the UK government.) Such campaigns, when reported by the mainstream media, can quickly have an extremely adverse reputational effect: the company that is the target risks becoming the latest "poster boy" for corporate malpractice and its customers may start to look elsewhere.

Banks are known to have become sensitive about the amount of tax they pay, seeing it (for the most part) as part of a "positive message" that should be conveyed to the public. The reaction of one bank (Standard Chartered) to the tax-avoidance protests was that, although they were prepared to be more transparent about the taxes they pay in different countries, they wanted "a level playing-field". Their head of government relations was quoted in the *Financial Times* of 10 November 2010 as saying that they did not want to devote a lot of resources to such an exercise if their competitors did not do so and that "we need civil society to push on this". The

message? We might change our ways if everyone else does but we need to understand better how strongly the public really feel about this.

So what exactly is this "civil society"? Again, EBRD's work helps to provide an answer. According to its website, EBRD recognises "the importance of local knowledge, technical expertise and innovative ideas and solutions that civil society organisations (CSOs) can contribute to our projects, policies and strategies". EBRD "engages in dialogue with a variety of CSOs, ranging from those involved in environmental and social issues to those concerned with promoting transparency and accountability, human rights and democracy". The "civil society stakeholders" include "NGOs, women's groups, faith-based organisations, think-tanks, business development organisations and academic institutions". The bank's "Civil Society Engagement Unit" was created in 2001.[36]

Is it a hopeless aspiration to expect civil society to take up more vigorously the ethical and moral challenges that the financial crisis has presented? It is certainly an ambitious notion – because for civil society to grapple effectively with the issues will require rather more than traditional protest and manifestations of "public anger" (although they would no doubt be a feature of any campaign). The move from complaining about "greedy bankers" and organising marches with banners to making constructive and positive suggestions about how financial institutions should behave and what evidence is expected of a change in culture is a big one. It would require organisation, dialogue and planning as well as engagement with the financial services sector itself. But it can be done. The first step is to decide how badly we want it to happen. And, then, to prioritise the issues. Care should be taken to avoid being seduced by the politics of envy that the Crisis has unleashed. Bankers' bonuses are a symptom of a questionable culture but they are not in themselves a priority. They can, in reality, be a distraction. The more important issues lie in how banks are now approaching governance and the inculcation of ethically based conduct and enlightened self-interest in their day-to-day activities. Are the people at the top setting an example? Is "the message" communicated effectively throughout the organisation – and in such a way that its genuineness is crystal clear? How are the independent non-executives on the board selected? Who is the Chief Risk Officer and how is his or her independence protected? How independent is the General Counsel and the legal department? How is the relevant information made available to the public?

Other questions that should be high on the agenda would relate to business models and disciplinary records. How safe is the deposit-taking function from infection by investment banking activities? How is capital structured? How much funding is from depositors and how much from wholesale markets? What are the different lines of business? How do they measure up against a "social usefulness/riskiness" test? How is the value of assets calculated and accounted for? What is the track record as regards disciplinary action by regulators? What levels of damages or fines (or sums "in settlement") have had to paid over the previous (say) ten years? How many senior executives have been dismissed or forced to resign?

There are many complex questions that require consideration, but understanding them and their importance does not necessarily turn on specialist knowledge or regulatory experience. It is not beyond the grasp of organisations who are capable of grappling with the complex issues of climate change, human rights, the relief of poverty and fighting killer diseases. Indeed, one of the attractions of involving civil society more actively in such issues is that it should result not only in greater openness but also more jargon-free communication, as straight answers to straight questions are demanded.

F. Conclusions: can "civil society" make a contribution?

Has the time of "civil society" being able to have real, concrete influence on the behaviour of banks and other commercial concerns across a wider agenda (beyond ESG, as traditionally understood) now arrived? Domestic regulators should, one would hope, see the advantages in encouraging more engagement from the public and significant investors but the prime movers may include the international financial institutions, at least as regards bank behaviour in their countries of operation. These institutions are, of course, political creatures with very particular missions that are not all shared by commercial banks but, as the gradual adoption by commercial banks of the IFC-originated Equator Principles – and the increasing sensitivity of the financial sector to ESG issues – has shown, institutions such as EBRD and IFC have the ability to change behaviour, or at least make other banks stop and think. It is, after all, difficult (especially following the Crisis) for ordinary banks to do business in certain parts of the world without the involvement of an IFC or EBRD and, if they have a policy in a particular area associated with ESG, it is almost impossible for co-financiers from the private sector to ignore it. Over time, they may simply decide to adopt it (or something like it) themselves.

So, the ability of civil society to "make a difference" to how banks behave is at least beginning to become apparent. So far, the agenda has concentrated on ESG and consumer issues but there are signs that it is beginning to spread out. It would surely be a perfectly logical, and entirely justifiable, step for that agenda now to embrace what we might call the systemic responsibility of banks. That is, the responsibility to behave in a way that is consistent with the need to create and preserve a more sustainable financial system, both domestically and internationally.

The responsibility has to be reflected in the culture. Is not part of the agenda for a "charm offensive" or a matter of "image" or "PR". It is just no use continuing to behave in a way that suggests that systemic responsibility is an issue for regulators and lawmakers alone (and if a way round their attempts to regulate behaviour can be found, it should be taken). Such an attitude, in the light of what the Crisis has shown us, is simply irresponsible and morally objectionable. It is not only shareholders who are put at risk by it. It is all of us. If the financial system collapses, all the elements of civil society will suffer even more than they have already as a result of the Crisis. The possibility of complete collapse may perhaps seem like a doomsday scenario and unlikely to happen, but that is not a justification for complacency, since the cost of bail-outs and restructurings that are needed in

order to prevent that collapse fall, in the long run, on society as a whole. We need to know how (if at all) the Crisis has brought about lasting changes and what those changes actually are.

There will be no hope of "making poverty history" if we cannot trust our banks. Poverty will only spread if nothing is done. The call for more enlightened self-interest needs to be supported by sections of civil society, and investors in financial institutions such as pension funds, making it clear that they wish to see hard evidence that the call has been heard and action taken on it. Some sense of expectation – coupled with a realistic threat of serious adverse reputational consequences if the expectation is disappointed – needs to be conveyed. We need sustainable development policies and we need respect for human rights. But we also need a sustainable financial system if any of these objectives are to be accomplished. So the time has perhaps come for an extended meaning to be given to the E and the G in ESG.[37] What could be more relevant to the environment of a bank than the financial system in which it operates (and without which it could not operate)? And what could be more relevant as regards governance for a bank than its own governance and the ethical standards that it expects of those who work for it? We are all stakeholders in this agenda. ■

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1 The original version of this article was presented as a paper at the XIX International "Tor Vergata" Conference on Money, Banking and Finance held at the University of Rome (Tor Vergata), 13–17 December 2010.

2 From a news item in the *Financial Times* (26 November 2010: "Vilified Lenders Launch Charm Offensive") reporting that the major banks were "considering" paying hundreds of millions of pounds into a new, so-called "Big Society bank" being set up by the UK government for the purpose of funding community projects. It is thought that a large amount of the money to be "pledged" by the banks will come from dormant deposits. One "senior banker" was quoted as saying, "This is more a PR exercise than something of substance."

3 Concerns about the Irish financial system surfaced early on in the Global Financial Crisis as the state felt obliged to guarantee all domestic bank deposits (the first to take such action in the Crisis) in 2007; worries about the state's own creditworthiness started to surface in the first half of 2010.

4 See, for example, *The Times* of 23 November at p 24 "This Bail-out is Not Enough to Save the Euro" (Ruth Lea), the *Sunday Times* of 21 November, at p 24, "The Death of the Euro" (Smith and Woods) and the *Financial Times* of 5 November 2010 "The Futile Attempt to Save the Eurozone" (Samuel Brittan) in which the author comments: "Euro-federalists will fight tooth and nail to prevent a disintegration of the eurozone. They are powerfully reinforced by banks with investments in the peripheral countries. But if something is unsustainable it will not be sustained." On 23 November, Germany's Finance Minister also admitted that the euro was threatened.

5 In the time-honoured tradition of football club chairmen expressing undying confidence in the (about to be sacked) head coach, senior eurozone politicians continue to protest (eg at the Davos WEF conference in January 2011) that the euro is here to stay.

6 Some politicians have been musing in public about the possibility of holders of sovereign debt from EU nations being due for a "haircut" – ie not being paid off their debts in full.

7 According to the *Financial Times* of 23 November 2010 (p 2) the total European bank exposure to Ireland is $509bn; UK bank exposures are $149 bn., German bank exposures are $139bn and US bank exposures are $69bn. French and Belgian bank exposures are $50bn and $54bn, respectively.

8 This approach seems to have found favour in the UK regulatory establishment, judging from various general remarks made by members of the Vickers Commission and others, but it is (of course) being strongly opposed by banks, whose lobbying campaign is now gaining more momentum (and the UK view is not widely shared in other jurisdictions).

9 Already, significant doubts are being expressed (more robustly in private than in public) as to whether Basel III goes anywhere near far enough, but certain major jurisdictions (eg France) are thought to be rigidly opposed to any further strengthening of capital requirements. As an example of the former viewpoint, see the Bank of England Discussion Paper No 31 (January 2011) entitled "Optimal Bank Capital", by D Miles, J Yang and G Marchegannio, where the authors conclude that "the amount of equity funding that is likely to be desirable for banks to use is *very* much larger than banks have had in recent years and higher than targets agreed under the Basel III framework". Also, the Vickers Commission has told us (in a publication on its website dated 26 January, 2011) that a majority of those who responded to its September 2010 "Issues Paper" regarded the Basel III capital requirements as "insufficient".

10 This was, for example, reflected in the *Financial Times*' lead editorial of 1 February 2011, which, after weighing up the dilemma of choosing between "draconian" capital ratios or tighter restrictions on the activities of investment banks and retail banks (in the absence of some form of "separate capitalisation" solution to the "too-big-to-fail" systemic problem) reflected that: "What remains clear is that the status quo is unacceptable."

11 The former UK Chancellor of the Exchequer, Alistair Darling, revealed in a BBC interview in the summer of 2010 that he had only been given two hours to come up with a solution to the bank's liquidity crisis before it would have to close its doors.

12 On 22 November 2010, in an article in the *Financial Times*, Sir David Walker suggested that the UK's modest proposals requiring disclosure of "high-end" bank remuneration (which he had put forward himself as part of the Walker Review) should be watered down in view of the fact that other competing jurisdictions were not introducing similar rules. Megan Murphy wrote a critical article in the *Financial Times* the following day ("High-fliers score big win on pay disclosure"): "Senior executives know that forcing banks to disclose the number of executives paid vast sums threatens to reverse much of the progress they have made in rebuilding reputations with politicians and the public. This is because it would reveal just how richly remunerated are thousands of relatively middle-ranking bankers and traders. . . . Senior bankers . . . have warned that the

proposals threatened to provoke a lynch mob response from the public, even without naming every executive."

[13] They include, for example, requirements to conduct business "with integrity", to conduct business "with due skill, care and diligence", "to take reasonable care to organize and control . . . affairs responsibly and effectively, with adequate risk management resources", to "maintain adequate financial resources" to "observe proper standards of market conduct" and to "pay due regard to the interests of . . . customers and treat them fairly."

[14] The author expresses his own views in R McComick, *Legal Risk in the Financial Markets* (Oxford University Press, 2nd edn, 2010), ch 6.

[15] In December 2010, when the FSA (at first) refused to divulge any of the contents of its investigation into RBS's failure, having concluded (it said) that there were no crimes or failure of corporate governance involved, the public reaction was extreme – and the FSA eventually had to concede that some material would be published. It seemed that the strength of the reaction took the FSA completely by surprise. The Crisis has fundamentally changed the relationship between banks and society – and therefore between the regulator and society. The public has become much more sceptical, inquisitive and information-hungry – and will not settle for bland assurances that "all is well" and that the regulator "knows best". It is not clear that those designing the new reforms have fully taken this into account.

[16] For a compelling critique of this behaviour, see D McBarnet, "Legal Work, Legal Integrity and the Banking Crisis" in IG MacNeil and J O'Brien (eds), *The Future of Financial Regulation* (Oxford, Hart Publishing, 2010), 67. As regards the current attempts to find ways round reforms in the US designed to restrict proprietary trading (part of the so-called "Volcker rule"), see, for example, F Guerrera and J Baer, "Wall Street to Sidestep Volcker rule", *Financial Times* 10 November 2010 and T Braithwaite, "Republicans Take Aim at Ban on Proprietary Trading" in the same issue. The latter article contained the comment that "banks and their lawyers have been poring over the rules for loopholes. One is to disguise trading as customer-related activity, which is allowed under the law. . . . The line with proprietary trading may not be clear cut."

[17] See J Coffee, *Gatekeepers* (Oxford University Press, 2006), *passim*.

[18] See para 1.33 of the document.

[19] According to recent comments (to the Treasury Select Committee, on 23 November 2010), Lord Turner, the Chairman of the FSA, now regrets much of this de-regulation and would like it to be reversed.

[20] Somewhat, ironically, it was reported on 25 November 2010 that the market capitalisation of Ireland's largest bookmaker, Paddy Power, had overtaken that of its largest bank, Bank of Ireland.

[21] It is acknowledged that, at last, the FSA seems to have come to the conclusion (subject to consultation) that certain kinds of financial products should simply be "banned" and certainly subject to more rigorous requirements prior to launch (January 2011 Consultation Paper DP 11/1). Comparable reforms seem to be in contemplation at EU level (see MifID Consultation document of 8 December 2010: s 7.3.3).

[22] In an article, P Hosking, "Banker-bashing Over? Not Likely", *The Times* 29 January 2011, Hosking asserted that: "Nothing much has changed in banks. Their attitude to capital and leverage is still too reckless. Their attitude to customers is still to treat them as mugs to be fleeced, whether they are small customers wanting advice on nest eggs or big companies seeking capital. Their contempt for public opinion on remuneration is as marked as ever."

[23] K Costa, "Tame the Markets to Make Capitalism Ethical", *Financial Times* 3 November 2009 where he asserts that "we seem to have lost the grammar of ethical discourse" in business dealings and that (amongst other things) there needs to be greater "engagement", ie "forging links with all other social partners who make business possible, increasing charitable giving and tackling environmental degradation and poverty." Such measures can help reattach capitalism to "its moral moorings". He also observes that "regulation, though necessary, is not enough".

[24] See, for example, S Green, *Good Value; Reflections on Money, Morality and an Uncertain World* (London, Penguin, 2010), 131: "It is clear . . . that capitalism for the twentieth century needs to rediscover a fundamentally renewed morality to underpin it. It needs to start with a question: What is progress? Is it the accumulation of wealth, or should it involve a broader definition of the quality of life which takes into account a more integrated understanding of well-being?" These ideas are entering the mainstream: for example, on 25 November 2010, the UK's Office of National Statistics announced that it would be developing new measures of national well-being. The aim is that these new measures will cover the quality of life of people in the UK, environmental and sustainability issues, as well as the economic performance of the country". (Stephen Green joined the UK government as a trade minister in January 2011.)

[25] As Green puts it (*ibid*, 132), "The truth is that the value of our business is dependent on the values with which we do our business. Capitalism needs to integrate values with value. We have to recognize – boards, managements and owners alike – that values go beyond 'what you can get away with', and that values are in the end critical to value – to sustainable value, that is. Better risk management, enhanced regulation, codification of directors' responsibilities in company law – all these things are necessary. But they are not, and cannot be, sufficient without a culture of values."

[26] This was a remark made in an interview with *Prospect* magazine in August 2009.

[27] Society may not demand that bankers "do God's work" but, given the extremely high remuneration that bankers earn, it would be foolish for them to feel impervious to the need to explain what value is delivered that could be regarded as commensurate with that remuneration. Reference simply to "the market" will not be enough, now that it can be seen how much the "market" needs the support of the state and "taxpayers' money".

For a recent exposition of the place of morality and trust in banking, see the historian, Niall Ferguson's lecture of 6 July 2010 at St Paul's Cathedral (available on the St Paul's Institute website) where, commenting on the moral principles that guided the career of Sigmund Warburg, he observes: "Better education, then, not over-regulation, is what is needed to repair the damage done to our financial system by years of cynical and reckless 'transactions banking'. The traders ended up driving the financial system to the edge of chaos. . . . It is time that we reminded ourselves that, without trust, finance cannot function, and that trust cannot be won and retained without consistent ethical behaviour."

[28] This bank went into insolvency in 2009 following adverse comment in the Dutch media which appeared to trigger a bank run.

[29] Available on the BBC News website.

[30] For a recent example, see "Greenpeace Sues UK to Stop Deep Drilling", *Daily Telegraph* 13 November 2010: "The campaign group said it had filed a claim . . . seeking a ban on new activity until the causes of BP's *Deepwater Horizon* accident are fully understood."

[31] Michael Skapinker, "Companies Play Catch-up with Campaigners", *Financial Times* 1 February 2011 comments (in relation to how companies should respond to the growing influence of NGOs): "[Companies] should certainly put far more strongly the benefits that they bring to society, but they need to recognise, as many company leaders do, that, following the financial collapse and the controversy over high executive pay, their moral position is weak. And, while they are trying to recover from that, they should survey the world of social networking and online video and ask why so many NGOs are so much better at it than they are."

[32] See, for example, the OECD's "Declaration on Green Growth" adopted at a Ministers' meeting in June 2009.

[33] See website at www.equator-principles.com . See also PQ Watchman, A Delfino and J Addison, "EP2: The Revised Equator Principles: Why Hard-nosed Bankers are Embracing Soft Law Principles" (2007) 1(2) *Law and Financial Markets Review* 85. The principles are currently the subject of a "strategic review" being carried out on behalf of the Equator Principles Association (which comprises, essentially, the banks that have adopted the principles) in order to "ensure" that they "continue to be viewed as the "gold standard" in environmental and social risk management for project finance within the financial sector" (see the website referred to above).

[34] The latest such report, for 2009, is available on EBRD's website. The first paragraph of the Bank's President's introduction to the report states: "Environmental and social considerations inform the Bank's country strategies and operations, particularly in sectors that are key to sustainable development, such as infrastructure, transport, energy, agribusiness and financial markets. The Bank consults widely with civil society organisations at both local and international levels"

[35] See *Office of Fair Trading v Lloyds TSB Bank and others* [2007] UKHL 48.

[36] Following the arrival of the Coalition government in the UK, we now have a Minister for Civil Society, concerned mainly with charities, "social enterprise" and voluntary organisations.

[37] The "London Principles" on sustainable development (sponsored by the Corporation of London and Forum for the Future) do in fact support this "extended" interpretation of ESG. Principle 2 states that signatories should "promote transparency and high standards of corporate governance *in themselves* and in the activities being financed" (emphasis added).