Tomorrow's Finance

Building trust by changing behaviours in financial services

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by Professor John Kay

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This isn't the only event that has taken place over the past year on restoring trust and confidence in the financial services industry. There have been quite a lot of them. The impression that you would get from many is that remedying the erosion of trust is primarily a public relations problem and that what is needed is for the public to have its confidence in the industry restored. However, I don't think it is a public relations problem, and I was glad to see the reference to changing behaviour in the title of this event. It is behaviour, not perception, that needs to change.

You do not restore trust and confidence by delivering lectures about how honest you are. Indeed, my experience is that when someone tells me how honest they are, that is a moment at which I keep a firm grip on my wallet. People who feel the need to continually declare their trustworthiness are rarely people who naturally inspire trust. I am going to look at this issue in a rather more basic way, as if I were a doctor and the financial services industry was my patient. First of all we must acknowledge that the patient is ill and no amount of hair and make-up will convince anyone otherwise. With this in mind we need to assess the symptoms, give a diagnosis, and then we can talk about treatment.

Obviously, when considering this issue, I am influenced by the work that I did with the Department for Business, Innovation and Skills last year, reviewing the performance of UK equity markets. Over the last ten years, as far as equity markets in the UK are concerned, there are three things that are immediately noteworthy.

The first is that, as a source of capital for fresh investment in British business, equity markets are basically defunct. They are not the way that established companies, or new businesses, now raise finance for investment. In fact, if we ignore the rescue rights issues for British banks, which were mainly subscribed to by the UK government, considerably more equity has been removed from the corporate sector through acquisitions and share buy-backs than has been raised through share issues. Equity markets are no longer a source of fresh capital.

It is also interesting to note that equity markets in the last decade have provided poor returns for savers. Indices have offered disappointing returns and the returns savers have earned from them have been even worse than the index returns. And yet financial intermediation has never enjoyed a more profitable decade than the last ten years.

So this is the basic story; companies have stopped using equity markets, savers have made poor returns and financial intermediaries have done very well indeed. It is obvious when put in these terms that I am describing a situation that is, both economically and politically, unsustainable. It is also the case that given these facts, it is unsurprising that trust and confidence in the financial services industry is at an all time low.

So, trust and confidence are the issues we need to address. What has happened? My diagnosis is that the principal cause of the long-term decline in trust and confidence in the financial sector has been the systematic replacement of a culture which was based on client relationships by a culture which is based on transactions and trading.

When I learned about money and banking, many years ago, lending to business was the main activity of banks. This is no longer the case. To illustrate the scale on which the financial services industry now deals primarily with itself, let us ask the question: Of the total assets and liabilities of British banks, what proportion is represented by lending to real non-financial businesses? It is less than 3%.

The volume of trading in foreign exchange is between 70 and 80 times the volume of global trade in goods and services. Most people are aware of high-frequency trading, which is trading in which people hold equities for, literally, a matter of seconds, and in which the distance between the exchange and your computer matters a great deal to the efficiency of your trade. In the UK, high-frequency trading accounts for about 50 per cent of the total volume of dealing in equities. In New York it is closer to 70 per cent.

We have seen an explosion of trading relationships and the growth of transaction-based business. It has replaced an old culture that had many things wrong with it, but at its centre was the fundamental understanding that good business is based on trust relationships.

There are many reasons for the change we have seen in the financial services industry. Part of it is globalisation and more specifically, the Americanisation of the financial services industry. Another part of it is the formation of large financial conglomerates. When this development began in the UK in the 1980s, it was initially retail banks that bought into the wholesale financial services sector. They managed these acquisitions very badly and were largely unsuccessful. What happened over the next two decades was that the direction of managerial control was reversed in favour of investment banks. So, instead of retail bankers attempting – badly – to run investment banks, we saw investment bankers attempting – badly – to run retail banks.

Regulation, and its unintended consequences, is also part of this story. It was regulatory arbitrage that created an explosion of securitisation. Transactions were substituted because, although they had essentially the same economic effect, they were treated differently by the regulatory structure. That was behind a great deal of the rise in trading activity. In that time we have allowed a regulatory structure to develop that is focused on market participants rather than the real users of markets – businesses and savers. Virtues like transparency, price discovery and liquidity are prized above those that serve the needs of final customers.

We have in Europe what is called a Market Abuse Directive. Think about that for a moment. What regulation surely ought to be concerned with is not abuse of markets, but abuse of customers. I recently saw a video in which someone who was engaged in large retail financial services was asked how MiFID (Markets in Financial Instruments Directive) affected his customers. There was a pregnant pause, after which he said that he could not think of any way in which it affected his customers at all. The regulatory structure we now have focuses, in a self-referential manner, on the issues and concerns of market participants, rather than issues that are of concern to users.

The substitution of relationships by trading was partly a product of an ideological shift. It was an aspect of the marketisation revolution, which had many positive consequences, that followed the election of Thatcher and Reagan and became the dominant political ideology of that era. It was also promoted by a misguided set of economic theories based around the efficient market hypothesis, to which I will return later.

I have outlined some of the multiple causes which came together to create this explosion of trading and a culture within the financial services industry that was largely about transactions, and very little about the development of long-term relationships.

The rise of the trading culture has had two broad effects. One is that the quality of financial intermediation has diminished. If we ask ourselves what financial intermediation is about; it arises because individuals want to have portfolios that achieve diversification and liquidity. But the price of such diversification and liquidity is a diminution in the quality of the relationship that the saver can have with the activity in which his money is being invested.

Financial intermediation is a way of trying to solve that problem, by aggregating the process of acquiring information and monitoring the underlying investment. That is what intermediation is for, and yet that fundamental objective is often forgotten. Successful financial intermediation depends on the quality of the relationship between the intermediary and the company in which money is invested. It also depends on the level of confidence that the saver has in the intermediary who is responsible for the investment. It is intrinsic to successful financial intermediation that there are relationships of trust and confidence between the saver and the intermediary on the one hand, and the intermediary and the underlying subject of the investment on the other.

If we frame the situation in this way, it becomes self-evident that the desired outcome is unlikely to be achieved when there is a very long chain of intermediaries. One of the things that shocked me at the beginning of the Equity Markets Review was the sheer number of intermediaries that are now involved in the equity investment process.

To name a few – there are custodians, registrars, nominees, fund managers, fund of fund managers, investment consultants, pension fund trustees, people who provide wrappers, issuance companies, platforms, independent financial advisers and so on. As these people continue to trade with each other, in what are often anonymous relationships, they reduce the possibility of generating the kind financial intermediation that we really need.

Underpinning all this, we have economic models that are unhelpful at best. Widely used models of trading are based on arbitrage conditions and equilibrium in markets, to account for volumes of trading that would be entirely inconceivable if the assumptions held. The largest paradox though relates to the efficient market hypothesis, under which information is managed so efficiently there could be no incentives to obtain the information in the first place. The contradictions in these models have borne themselves out time and time again, sometimes with devastating consequences.

We are now at a point where acquiring and providing relevant idiosyncratic information has been replaced by a process where all companies produce accounts based on the same standard template. Where there used to be loan and business assessment by individuals using their judgement, there is now computerised scoring. Computers can help, as can good transparent information provision, but the notion that it can replace qualitative knowledge is a gross misconception.

So we have a situation in financial markets in which the quantity of information has exploded, while the quality of information has declined. We have also seen another paradox in which regulation has become both extensive and intrusive and yet it still does not serve the needs of users of markets adequately. The overarching theme has been huge increases in the quantity of financial intermediation alongside ever diminishing levels of quality.

So what can we do? Firstly, we need to look at the issue of fiduciary standards and fiduciary behaviour. To properly understand these terms we need to look back at the old English legal concept of a fiduciary relationship. What it means is that people who manage other people’s money, or advise others about how they should manage their own money, have an obligation to put their clients’ interests ahead of their own. Also, if there is a conflict of interest, it should be either avoided or disclosed and they may not profit from it.

These seem to be principles that most normal people would regard as self-evident obligations for anyone who was employed in an advisory or management role. The fact that they are resisted in parts of the financial sector tells us a great deal about how the sector has come to operate and some of the values that underpin it. In trying to impose these obligations, we would be striking at the heart of the business models of some of the best-known financial institutions.

A second issue that we have to address is rethinking regulatory philosophy. I have described the ways in which regulation has gone wrong, and over the last two decades has done more harm than good in a whole variety of ways. The complexity of the regulatory system and the structure we have makes that almost inevitable.

It is likely that complex regulation will have many unintended consequences, as it has done. It has also, because of its complexity, required the creation of an industry of people who are effectively the only people who understand the activity of regulation. These people have a vested interest in the expansion of regulatory activity, which they exercise. Also, and more importantly perhaps, they see the industry through the eyes of market participants because there are no other eyes through which it is possible to see it and still have the detailed knowledge necessary to be an effective regulator. The ways in which we have regulated have lent themselves to a self-referential structure in which regulatory activity and the priorities of regulators are determined by the values and activities of the industry itself. We need to move towards a regulatory philosophy which is more concerned with the interests of consumers, and less with the efficient functioning of markets.

So we need to consider what ought to be the focus of regulatory and political activity, in reviewing the structure of the financial services industry. In part, the changes that I have described – in which transactions have replaced relationships – are the product of changes in the structure of the industry as a whole. With the benefit of hindsight, we can see that many of these changes in structure, that assembled financial conglomerates with conflicts of interest, were actually unsustainable.

What I would like to see is more separation of financial services activities. We are moving, at least in the UK and perhaps in Europe, towards taking first steps in that direction by the ring fencing of retail banking from investment banking. Whilst this is a positive move it needs to go quite a lot further. Although the Vickers report, in which this solution was proposed, did address some of the issues around conglomeration – those of cross subsidy in particular – it failed to raise concerns about culture, which is essential if we are to begin rebuilding trust and confidence in the industry. These cultural issues probably require full functional separation rather than just ring fencing.

Equally, we have to look at the conglomeration that takes place in the investment banking sector. If we were to ask what it is that a modern investment bank does, its activities include asset management, corporate advisory business, securities issuance, market making and trading on its own account. I just have to list these functions for it to become apparent that every one of them fundamentally conflicts with every other.

I have given what I think are the beginnings of an agenda: identify symptoms, make a diagnosis and start to prescribe elements of treatment. We are still quite a long way from having gone through that process publically and generally. I welcome the fact that people within the financial services industry are giving their attention to the issues of restoring trust and confidence. But if the outcome of that is just a stream of announcements reassuring us that everything has changed whilst in reality it is business as usual, public trust and confidence will continue to decline.

About Miton

Miton is a leading multi-asset and equity fund management specialist. The group manages £1.8bn of assets including nine OEICs, three investment trusts and segregated client accounts. Members of the fund management team invest in their own funds and are significant shareholders in the company. Miton has offices in Reading, Liverpool and London.

www.mitongroup.com

About Tomorrow's Company

Tomorrow's Company is the agenda setting 'think and do' tank which looks at the role of business and how to achieve enduring business success. We focus on strong relationships, clear purpose and values as the foundation of effective leadership and governance. In our programmes we challenge business leaders around the world to work in dialogue with others to tackle the toughest issues. We promote systemic solutions, working across boundaries between business, investors, government and society. We believe that business can and must be a 'force for good'. This in turn requires a strengthening of stewardship by shareholders in partnership with boards of companies. We argue that the Age of Sustainability has begun, and that in the future success and value creation will come from recognising the 'triple context' – the links between the economic, social and environmental sub-systems on which we all depend, and the opportunities this brings.

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About Slow Finance

Slow Finance by Gervais Williams focusses on the types of businesses that banks and other financial institutions should finance, the criteria they should adopt and above all the nature of the relationships which can best secure long-term returns – such as exploring in depth financing for food production and other areas vital for economic prosperity and future wellbeing.

To order the book and use the app: **www.slowfinance.com**

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