



BANK OF ENGLAND

# Speech

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## The Great Divide

Speech given by

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In November last year, the Bank of England hosted a so-called *Open Forum*. This was a new departure. For the first time in its 300-plus year history, the Bank brought together all of the main stakeholders in the financial sector: not just policymakers, banks and investors, but politicians, civil society, businesses, regional representatives, religious groups and the media. This was a deliberately broad church, with an eclectic congregation comprising religious zealots, high priests, regular church-goers, agnostics and atheists.

The aim of the Open Forum was to discuss, in an unscripted way, the progress made towards fixing the financial sector. The Open Forum was an opportunity to hear a different set of views from a different set of voices: from the customers and users of finance, as well as the producers and investors; from the often-silent majority of outsiders to finance, as well as the often-vocal minority of insiders. This made for a very different dialogue.<sup>1</sup>

Since the crisis, there have been hundreds of conferences on the future of finance. Typically, these are full-to-bursting with bankers, central bankers, regulators and academics. And, typically, they are in transmit mode. These are conversations *among* the elite in the language *of* the elite. The Open Forum was a different animal, its cast much wider, its language much plainer. Attendees were in receive mode.

The most important and compelling message the Bank received at the Open Forum came in the first session. The Bank had conducted some polling of perceptions of the financial sector – for example, by asking people what one word best described the future of financial markets. Among the Bank’s usual contacts, including those in the financial sector, the most used word was “regulated”. Many of us will have heard that message from financial insiders concerned about the perils of over-zealous regulators.

For me, the more revealing responses came from the general public, from the customers, rather than the producers, of financial services. The word most used by them when describing financial markets was a rather different one: it was “corrupt”. Not far behind were words like “manipulated”, “self-serving”, “destructive” and “greedy”. I am sure many of you have heard those messages too. They are certainly ones I have encountered frequently on my visits around the country.

Chart 1 shows the “word clouds” from the two samples. For the Bank’s usual contacts, 69% of the most-used words were either positive or neutral. For the general public, by contrast, only 40% were positive or neutral. This is only one poll. And I am not, at this stage, making any value judgement on which faction is right. But if nothing else, these results suggest a yawning gap in people’s perceptions of finance. It seems very unlikely these word-clouds form part of the same nephological formation.

To borrow from the title of a recent book by Nobel Laureate economist Joe Stiglitz, these results suggest to me a *Great Divide*:<sup>2</sup> a Great Divide between the views of financial insiders and outsiders, between the

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<sup>1</sup> Videos of the Open Forum are available at [www.boeopenforum.co.uk](http://www.boeopenforum.co.uk).

<sup>2</sup> Stiglitz (2015).

perceptions of producers and consumers of financial services, between the silent majority who buy and the vocal minority who sell financial products, between the echo chamber of the elites and the voting chamber of wider society. They underscore just how far finance still has to travel to regain its social licence.<sup>3</sup>

This “Great Divide” is my jumping-off point. I want to discuss the crucial role finance plays in society and why. I want to discuss the progress made, so far, in restoring trust in finance. And I want to discuss what further progress might be needed to narrow that trust deficit. That may call for the financial sector to seek new ways to define and communicate its purpose, its contribution to wider society, to act as an antidote to the short-term demands of shareholders and executives.

Yet it would be easy, too easy, to point the finger at finance alone. For this Great Divide exists not just between the *financial* elites, but between elites generally and wider society. It is not just bankers who have suffered a loss of public trust. In varying degrees, this is also true of big business, government and, yes, politicians and central banks. These lessons for bankers may be relevant to some of us in this room too.

### **The Role of Finance in Society**

Let me start by discussing why closing the trust deficit in finance matters to the economy and to society. Whisper it quietly, but a large and well-functioning financial sector is an essential foundation for a growing and well-functioning economy. That is not an ideological assertion from the financial elite; it is an empirical fact. Most of the time and in most countries, finance is a growth-booster not a growth killer.<sup>4</sup>

The economic textbooks do not get everything right, but on this they are clear and compelling. Banks and capital markets help finance investment by companies. And that, we know, is the seed-corn of future growth.<sup>5</sup> They also help insure against risk by companies and households. And that, we know, is the seed-corn of stability.<sup>6</sup> In a nutshell that is why, over long periods of time and across wide ranges of countries, well-functioning finance has supported wealth-creation and well-being.

The other, more obvious, way of capturing why finance matters is to see what happens when it goes wrong. Then it can quickly take large chunks out of the capital our societies have, over time and at great cost, painstakingly accumulated. That crumbling of capital, in its broadest sense, is the reason financial crises have been about as costly as any event societies have ever faced historically, war and revolution excepting.

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<sup>3</sup> Carney (2015).

<sup>4</sup> For example, Levine (2005) and Beck (2012). There is also evidence finance fosters entrepreneurship (Guiso et al (2004)) and reduces poverty and inequality (Beck et al (2007). This evidence is not, however, uncontested (for example, Cecchetti and Kharroubi (2012)).

<sup>5</sup> For example, Beck et al (2000) show evidence that finance has an important impact on growth by fostering productivity growth and resource allocation rather than capital accumulation.

<sup>6</sup> For example, Froot et al (1993).

Capital, for these purposes, has more than one face. The collapse of capital during financial crises shows up, most obviously and immediately, in measures of *financial capital* (the values of bonds and shares) and *physical capital* (the accumulation of buildings, houses, plant and machinery). And because we assign monetary values to these concepts, and obsess about them in the media, these losses of capital are clear and visible.

Yet it is another form of capital that may matter every bit as much to wealth and well-being in society – *social capital*. There is neither a standard definition, nor a simple means of measuring, social capital. In general, social capital refers to the relationships, trust and co-operation forged between different groups of people over time. It is the sociological glue that binds diverse societies into a cohesive whole.<sup>7</sup>

The global financial crisis of the past few years provides a case study of how these capitals, plural, can be decimated by crisis and the toll taken by society. Consider financial capital. At their peak, the world's 100 largest banks had a market capitalisation of around \$4.9 trillion. That was around 8.5% of annual global GDP. At its trough, this had fallen to \$1.4 trillion – a destruction of financial capital of \$3.5 trillion.

Banks have subsequently recovered some of their poise. Nonetheless, the market capitalisation of the world's 20 largest banks today remains around half its value in 2007. Their market value lies well below the book value of their assets, with the ratio of so-called “price to book” currently around 0.8. Put simply, that means many banks are a value-destruction machine for investors.

Yet these losses pale by comparison with the losses felt by the wider economy as a result of the financial crisis. In the UK, eight years on, GDP is still tracking around 15 percentage points below its pre-crisis trend. Assuming this pre-crisis trend was a reasonable one<sup>8</sup>, this is a cumulative income loss of over one year's worth of pre-crisis GDP or £1.8 trillion. For advanced economies, the corresponding cumulative loss of income is also close to one year's worth of pre-crisis GDP or \$32 trillion. These are simply mind-boggling sums.

And the clock, of course, is still ticking. These losses are unlikely ever to be fully recovered. Quite how we value the net present value of this continuing stream of losses depends on how much we discount the income of future generations and how sustainable pre-crisis rates of growth were believed to be. But even on conservative estimates, it seems possible the eventual cumulative losses of income could total multiples of annual pre-crisis GDP.

One reason these losses may have endured is because crises have a deep, and irreversible, scarring effect on an economy's growth potential.<sup>9</sup> That may arise because credit-starved companies are unable to invest

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<sup>7</sup> For example, Putnam (1995, 2002) and Field (2003).

<sup>8</sup> The pre-crisis trends here are calculated using the average annual growth rate between 1997 and 2007.

<sup>9</sup> IMF (2015).

or indeed start-up in the first place. Or it may be because financial crises act as a permanent drag on risk-taking and entrepreneurship, as was also evident after the Great Depression of the 1930s.<sup>10</sup> Either way, perhaps it should come as no surprise that productivity has flat-lined since the crisis.

Yet it is perhaps along the third dimension - social capital - that the losses arising from the crisis may prove most enduring. Social capital is inextricably linked to trust. And banking is quintessentially a trust business. At root, it involves swapping promises to pay. These promises rely on trust. It also involves, in John Kay's words, "other people's money".<sup>11</sup> It is a fiduciary function.

It is these two features that make any loss of trust in banking particularly damaging and worrying. And as the New City Agenda's research makes clear, there has been a significant loss of trust in banks, and hence an erosion in social capital, since the financial crisis.<sup>12</sup> Despite a modest recovery over the past few years, it remains at low levels both by historical comparison and relative to most other industries.

The latest survey by Edelman puts trust in financial services at 51% at a global level. That is well above the low-water mark of 43% in 2012.<sup>13</sup> But it means banking is still not trusted by around half the population. It leaves financial services at the bottom of the industry league table of trust. Here in the UK, the fraction of the population trusting banks is lower still, at around 41%.<sup>14</sup>

Other surveys of the public tell essentially a similar tale. An Ipsos-MORI survey in 2015 found that little more than a third of those polled believed bankers told the truth.<sup>15</sup> A far-larger fraction believed bankers did not tell the truth. That leaves banking nursing a "trust deficit" of around 20%. Only estate agents, journalists, government ministers and politicians fared worse, with trust deficits of 40-50%.

A survey by the Chartered Institute for Securities and Investment (CISI) earlier this year found that over half of respondents believed it would take over a decade for the culture of banking to be restored in the eyes of the public.<sup>16</sup> And looking at actual complaint cases taken to the Financial Ombudsman by the public, there has been a relentless rise from around 100,000 prior to the crisis to more than triple that number today<sup>17</sup>.

At least until recently many economists like me, when faced with this evidence, might have shrugged our shoulders. Social capital had no real role in our models of economic growth, unlike physical capital and

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<sup>10</sup> Friedman and Schwarz (1963).

<sup>11</sup> Kay (2015).

<sup>12</sup> New City Agenda (2014).

<sup>13</sup> 2016 Edelman Trust Barometer. For more information, see <http://www.edelman.com/insights/intellectual-property/2016-edelman-trust-barometer/global-results/>

<sup>14</sup> 2016 Edelman Trust Barometer. For more information, see <http://www.slideshare.net/EdelmanInsights/2016-edelman-trust-barometer-financial-services-results>

<sup>15</sup> For more details, see Ipsos-MORI [Veracity Index 2015](#)

<sup>16</sup> For more details, see Chartered Institute for Securities & Investment (CISI) news release '[Bankers pessimistic about culture change...](#)' (February, 2016).

<sup>17</sup> Financial Ombudsmen Service. For more information please see <http://www.financial-ombudsman.org.uk/publications/complaints-data.html>.

human capital. Trust did not butter our parsnips and nor did it enter our production functions. Recently, however, that orthodoxy has changed and the importance of trust has become clearer.

Evidence has emerged, both micro and macro, to suggest trust may play a crucial role in value creation. At the micro level, there is now ample evidence the degree of trust or social capital within a company contributes positively to its value creation capacity.<sup>18</sup> At the macro level, there is now a strong body of evidence, looking across a large range of countries and over long periods of time, that high levels of trust and co-operation are associated with higher economic growth.<sup>19</sup> Put differently, a lack of trust jeopardises one of finance's key societal functions – higher growth.

Those social capital effects appear to be particularly potent when it comes to financial decisions. Evidence suggests that a lack of trust leads people to retreat from the stock market and banks and to move towards cash holdings and informal sources of credit, such as payday lenders and loan sharks.<sup>20</sup> That jeopardises the second key benefit of finance to society – improved risk-sharing by households and companies.

So a lack of trust in finance potentially hobbles both economic growth and financial stability. That lack of trust is the mirror-image of the perception gap between the financial sector and wider society, the Great Divide. The Great Divide matters because it signals a pronounced and protracted erosion of social capital. It puts finance on notice for losing its social licence. And, unaddressed, that jeopardises future wealth and well-being.

### **The Trust Problem**

If this trust in finance problem is to be tackled, it needs first to be understood. Why trust is important, and what determines it, are issues that have occupied the world's greatest minds for centuries, perhaps millennia. The philosopher Baroness O'Neill from Cambridge University often draws an important distinction between "trust" and "trustworthiness".<sup>21</sup> Although this may sound subtle, it carries important implications.

Seeking to maximise trust may be an unrealistic and, indeed, undesirable objective for society. In a world of risks and uncertainties, including about individuals' trustworthiness, people need sometimes to mistrust if they are to avoid bad choices. If the principle of *caveat emptor* - buyer beware - is to work effectively, not just in financial services but more broadly, it requires a constructively sceptical public. Like cholesterol, there is such a thing as too much trust, as well as too little.

A plausible objective of public policy, then, is not to maximise *trust* among *consumers* of financial services, but to maximise *trustworthiness* among its *producers*. Yet the words "corrupt", "self-serving" and "greedy"

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<sup>18</sup> For example, Bloom et al (2012), Guiso et al (2015).

<sup>19</sup> For example, Knack and Keefer (1997), La Porta et al (1997) and Boulila et al (2006)

<sup>20</sup> Guiso et al (2008) and Zingales (2015).

<sup>21</sup> O'Neill (2014)

are hard to square with “trustworthiness”, as are opinion polls putting bankers at risk of relegation from the trust league table. Opinion polls of the public are not an objective truth and talk can sometimes be cheap. But it appears these concerns are not confined to financial outsiders: financial *insiders* appear to harbour serious doubts about their trustworthiness and culture too.

As survey in 2013 of financial professionals found, rather remarkably, that over half believed their competitors engaged in illegal or unethical behaviour.<sup>22</sup> A smaller, but still high, fraction of 24% believed their own company engaged in such practices. Similar percentages believed their industry did not fulfil its fiduciary function of putting clients’ interests first.

The significance of these findings is not the precise percentages, as striking as these are. More fundamentally, it is because of what they reveal about finance’s perception of *itself*, the mirror it holds to the *social identity* of finance. Psychologists and economists have, over recent years, begun to recognise the importance of social identities in explaining otherwise puzzlingly irrational behaviour.<sup>23</sup>

A now-famous study examined the academic performance of Afro-Caribbean boys in US schools, which was systemically weak almost irrespective of ability. A large part of the explanation was found to lie in social identities. Specifically, the social identity of young black boys was defined by doing poorly in class.<sup>24</sup> For reasons of self-image and social identity, these boys systematically underperformed relative to their ability, not wishing to be seen to be “acting white”.

Some of the self-same social identity problems may exist in banking. An experimental study in 2014 looked at the incidence of cheating in different groups.<sup>25</sup> It found not only that bankers were more likely to cheat, but that this cheating was more prevalent when people were reminded that they were bankers. They then “acted banker”. In other words, social identity mattered. If that social identity is defined by cheating or by failing to fulfil fiduciary functions, these behaviours will become self-reinforcing and self-fulfilling.

If this evidence is right, it suggests that the culture problem in banking may be deeply ingrained, psychologically and sociologically. That still begs the question, however, of what happened to change the social identity of banking in the first place. The crisis alone is not a sufficient explanation. Complaint cases taken by the public to the Financial Ombudsman were rising *prior* to the crisis, despite bankers riding a reputational high over that period. The erosion of trust in banking appears to have been secular.

In making sense of these trends, a useful distinction is between *personalised* trust and *generalised* trust.<sup>26</sup> Personalised trust refers to mutual co-operation built up through repeated personal interactions – for

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<sup>22</sup> Labaton Sucharow (2013).

<sup>23</sup> For example, Akerlof and [Kranton](#) (2010).

<sup>24</sup> Fryer (2006).

<sup>25</sup> Cohn et al (2014).

<sup>26</sup> Sapienza and Zingales (2011).

example, like visits to the doctor or hairdresser. By contrast, generalised trust is attached to an identifiable, but anonymous, group – for example, trust in the rule of law, or government or Father Christmas.

For most of its history, banking has been a relationship-based business. Banks were local. The local branch manager was a pillar of the local community, serving as part financial counsellor, part psychological counsellor. Service was customised and personalised. Without wishing to be misty-eyed about this model, which was far from perfect, what it did deliver was repeated interactions with customers. This imbued banking with personalised trust, just like doctors and hairdressers. Meanwhile, its very mystique meant banking maintained a high degree of anonymous, or generalised, trust among the public too.

Over time, however, this business model was changed fundamentally. Local branches went into retreat. Between 1997 and 2013, their numbers in the UK fell by over 25%.<sup>27</sup> The local branch manager began to disappear from view. Service became centralised and transactional. With personal connections loosening, banking began to lose personalised trust, falling behind doctors and hairdressers. Banking came to rely for its legitimacy, to an ever-greater degree, on generalised trust.

That was the pre-crisis story. But when the crisis came, it dealt a hammer blow to generalised trust in banking too. Anonymity gave way to ignominy, blissful ignorance to blistering resentment. In the trust league table, banking plummeted from mid-table mediocrity to relegation-threatened remorse. Trust in banking had, by turns, suffered a double-whammy: first a slow puncture of personalised trust as banks retreated from the high street, then a high-speed blow-out of generalised trust as the crisis broke.

That loss of generalised trust is not confined to the financial elite. Many other entities rely on generalised trust on the part of the public, from governments to businesses to the media. They too appear to have suffered a loss of generalised trust over recent years, joining banking at the bottom of the league table. Their crises have been different - from expenses to remuneration to mis-reporting – but the result the same.

These trust-busting events have generated, as in finance, a growing perception gap between the elites and the general public. In 2016, the trust gap between the “informed public” and the “mass population” hit a new high of 12 percentage points at a global level. The UK results were even more striking. Not only was the trust gap, at 17 percentage points, higher than in any other country, bar the US. But this gap has widened progressively since 2012, when it stood at only 7 percentage points.<sup>28</sup>

The Bank of England has not been immune to this generalised loss of trust. While in general it fares pretty well relative to others, the Bank’s net trust rating currently stands at 28%.<sup>29</sup> The Bank has a positive trust

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<sup>27</sup> European Central Bank Statistical Warehouse, available at: <https://sdw.ecb.europa.eu/>

<sup>28</sup> 2016 Edelman Trust Barometer. For more information, see <http://www.edelman.com/insights/intellectual-property/2016-edelman-trust-barometer/global-results/>.

<sup>29</sup> Results from a poll conducted by Populus for the Bank of England in March 2016 of around 2,000 adults.



rating of more than 80% among some members of the public, but among others it has a trust deficit of more than 50%. As for banks, governments and the media, this too is quite a Great Divide.

It was writer Norman Douglas who said that “distrust of authority should be the first civic duty”.<sup>30</sup> And as someone sometimes described as an iconoclast, I have sympathy with that sentiment. But, again rather like cholesterol, it is possible to have too much of a good thing. Taken too far, distrust can be corrosive rather than regenerative. Sometimes bridging that Great Divide can be a bridge too far.

## Progress So Far

That begs the question of what can be done to close the gap, to restore trust in the financial sector, to alter the social identity of banking. There has been no shortage of ink spilled in crafting a response to the crisis. That includes regulatory response where there has been root-and-branch reform of both banks’ *prudential* standards – their safety and soundness – and *consumer* protection – their offering to customers and clients.

The prudential regulatory reform agenda has been covered extensively elsewhere, including in speeches and consultation documents by the Bank of England, over the past few years.<sup>31</sup> So I shall confine myself to three points. First, this regulatory reform effort has, to my mind, moved the financial system onto a materially securer footing. That was essential, of course, given the serious risk of global banks sliding into a financial black hole back in 2008.

There is no single metric that captures this improvement in banks’ resilience. One is that the equity capital of the global banking system has more than doubled to \$6.1 trillion since 2007. Another is that the five largest UK banks’ liquid assets are around £100 billion higher than they were pre-crisis, a rise of more than 50%. A third is that the proportion of financial markets participants citing bank failure as the biggest risk to the UK financial system has fallen by an order of magnitude from its peak.<sup>32</sup>

Second, are these new and higher prudential standards sufficient to prevent a repeat performance? Truth be told, we cannot know for sure. What is certain is that an academic debate still rages on this question. A couple of months ago, the Bank hosted a conference among academics and policymakers to assess progress on prudential standards. Many of the academics doubted whether sufficient progress had been made to protect against future crises.<sup>33</sup> The prudential bar, while higher, had still they felt been set too low.

Whatever the right answer, I very much welcome this academic challenge. This challenge was sadly missing ahead of the crisis when prudential regulation was a niche academic issue. In my view, this absence of

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<sup>30</sup> Douglas (1945).

<sup>31</sup> For example see Bailey (2015) on prudential regulation, Cunliffe (2015) on macroprudential policy, Carney (2015) on markets and Bank of England (2016) on buy-to-let underwriting standards.

<sup>32</sup> [Bank of England Systemic Risk Survey 2015 H2, available at: http://www.bankofengland.co.uk/publications/Pages/other/srs/srs2015h2.aspx](http://www.bankofengland.co.uk/publications/Pages/other/srs/srs2015h2.aspx).

<sup>33</sup> Armstrong and Davis (2016).

academic debate and challenge contributed, in no small measure, to international prudential standards being set at levels which were, with the benefit of 20/20 hindsight, not just too low but ridiculously too low. We must not repeat that same mistake.

So academic challenge, challenge which causes policymakers to think, and possibly rethink, their calibration of prudential standards, is an essential ingredient of a healthy financial and regulatory system. The academic debate about prudential standards for banks is not closed; it has only just opened. And one of the Bank's public policy responsibilities is to help nurture that policy challenge. Indeed, this was one of the prime motivations behind the Bank's new research agenda, launched last year.

Third, there is a clear and obvious complementarity between improved prudential standards for banks and protecting bank customers. Since January 2011, UK banks have paid out more than £23.3 billion to customers in redress for mis-sold Payments Protection Insurance (PPI) alone.<sup>34</sup> These are astonishingly large sums. On this scale, misconduct towards bank customers clearly has the potential to cause lasting damage to banks' prudential safety and soundness.

Given those spillovers, what progress has been made since the crisis in better protecting consumers? Here too there have been a slew of initiatives over the past few years to re-shape standards within the financial sector, partly in response to episodes of mis-selling and market-rigging. This has been a collective effort by legislators, regulators, standard-setters and, ultimately, banks themselves.

The report by the Parliamentary Commission on Banking Standards (PCBS) in 2013, which involved a number of people here tonight, laid out a very comprehensive reform road-map. Among its recommendations was to make senior bankers personally responsible for their actions, aligning rewards with responsibilities. The good news is that this recommendation is now embedded in statute through the Senior Managers and Certification Regime in the UK. Just two weeks ago, the extension of that regime to all authorised financial services firms was given Royal Assent. I think that can be chalked up as a big win.

The PCBS also made recommendations in the area of professional standards and culture in banking. In response to that, and following a review by Sir Richard Lambert in 2014, the Banking Standards Board (BSB) was established in the UK last year. As one of its first tasks, the BSB assessed banks against their own internal standards and sent them confidential reports on their compliance. The main themes from that exercise were outlined in the BSB's first Annual Review published earlier this year.<sup>35</sup>

Following several episodes of misconduct in wholesale capital markets, the Fair and Effective Markets Review (FEMR) was launched in 2014 to assess their functioning, overseen by the Bank, HM Treasury and the FCA. It reported last year, making a number of recommendations including the establishment of a FICC

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<sup>34</sup> For further details see <http://www.fca.org.uk/consumers/financial-services-products/insurance/payment-protection-insurance/refunds>.

<sup>35</sup> See BSB (2016).

Markets Standards Board (FMSB).<sup>36</sup> The FMSB came together last year with a remit to provide guidance on appropriate standards of conduct in wholesale markets. Encouragingly, most of the major players in wholesale markets have joined the FMSB. Regulators will use these standards to inform their judgements under the expanded Senior Managers Regime.

At an international level, the Financial Stability Board (FSB) agreed in early 2015 a work-plan to reduce misconduct risk, including in the area of key market benchmarks.<sup>37</sup> Following a recommendation in FEMR, work is underway to develop a global code of conduct in the foreign exchange market. Also in 2015, the G30 issued a report on Banking Culture and Conduct.<sup>38</sup> And in the same year, the New City Agenda published its assessment of progress towards improving culture among UK banks.<sup>39</sup> This is good progress.

## The Road Ahead

These initiatives are important down-payments towards closing the trust deficit. Yet even if these initiatives are necessary steps, are they likely to be sufficient? The Bank's Open Forum suggested that would be an optimistic conclusion. So too would the evidence from various opinion polls and, indeed, from banks' own assessments of their culture. If so, what further initiatives might help in closing the Great Divide?

It may be tempting to conclude that the trust gap can be closed by simply having a better-educated public, one which better appreciates the important role finance plays in supporting the economy and wider society. On this diagnosis, closing the Great Divide would call for enhanced public understanding of finance, perhaps through a targeted public education programme.

Yet as Gillian Guy, CEO of Citizen's Advice, perceptively pointed out at the Bank's Open Forum, the perception gap may as much reflect the lack of understanding of the *public* on the part of those inside *finance* as a lack of understanding of *finance* on the part of the *public*. I think that is spot on. Closing the perception gap calls for a two-sided effort.

### (a) *Enhancing Public Education*

A great many people find financial issues difficult and boring. That is a weak foundation for making good financial choices. At least some of those problems originate in the mental block many people encounter when it comes to mathematics. Finance is a numbers game. And research by the Department for Business, Innovation and Skills suggests there are an incredible 17 million adults in the UK whose standards of mathematics are no higher than those of a primary school child.<sup>40</sup>

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<sup>36</sup> See FEMR (2015). FICC here refers to Fixed Income, Currency and Commodity markets.

<sup>37</sup> FSB (2015).

<sup>38</sup> G30 Working Group (2015).

<sup>39</sup> New City Agenda (2014).

<sup>40</sup> See BIS (2012).

The way maths is taught may be part of the problem here. For many, maths is a turn-off because it seems unrelated to their everyday lives; it lacks real-world relevance. Sad to say, payday lenders have a greater resonance to many people than Pythagoras's theorem. The abstract nature of mathematics, as taught, leads many children to tune out or switch off entirely. Others conclude that they simply do not have "a maths brain". This is an educational scar that can last a lifetime.

Part of the solution may come from making maths relevant to people's lives, to link it to real-world decisions. And what better set of real-world decisions than *financial* ones: how to draw up a monthly budget of debits and credits; how to make sense of an Annual Percentage Rate on a loan; how to decide between competing savings, pensions and mortgage products. These are big financial decisions that, if flunked, can have big social, as well as financial, consequences.

Re-orienting the school curriculum in this, more practical, direction might help in bridging the information gap. So too would making available courses which help adults, all 17 million of them, make better financial decisions. As one example of that, the Open University has recently made available on-line a set of three modules for helping adults better understand financial matters and, ultimately, make better financial choices.<sup>41</sup> Charities like Citizens Advice are also doing fantastic work in this area.

Of course, part of the reason so many members of the public find finance difficult is because it is difficult - and, sometimes at least, it is made deliberately so. There is plenty of evidence, including from the financial crisis, of financial products being made more complex than was necessary and consumers being charged a premium for buying them.<sup>42</sup> This damaging cycle persists because of the difficulties consumers understandably face when trying to compare these products.

To give a personal example, I consider myself moderately financially literate. Yet I confess to not being able to make the remotest sense of pensions. Conversations with countless experts and independent financial advisors have confirmed for me only one thing - that they have no clue either. That is a desperately poor basis for sound financial planning.

This problem is one which, if anything, is becoming more acute over time. More of the risk associated with financial decisions is these days being shouldered, not by the state or companies, but by individuals. Take pensions. Over the past twenty years, we have seen a secular shift away from defined-benefit towards defined-contribution pension schemes. That places the investment risk of pensions squarely on the shoulders of the individual, rather than companies.

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<sup>41</sup> For more details on the Open University's 'You and your money: personal finance in context' modules see <http://www.open.ac.uk/business-school-research/pufin/course-modules>.

<sup>42</sup> For example, Zingales (2015).

Whatever the merits of these shifts, they underscore the importance of simple, easily-understood financial products for the public if they are to manage these new risks. They also underscore the importance of adequate information on these products. In 2010, the Money Advice Service was set up to help provide this information. Following a review last year, this service is in the process of being replaced. A new body is also being established to provide a single point of contact for advice on pensions, replacing the existing Pensions Advisory Service and Pensions Wise.

Just yesterday, the Competition and Markets Authority (CMA) proposed that a new price comparison website be set up, funded by the banks, to better enable bank customers to pick the best deal for them.<sup>43</sup> They also suggested greater transparency around bank charges. If implemented, these measures would be good news for retail customers. Alongside the move to a Faster Payments service in 2008<sup>44</sup>, these are among the two biggest improvements to bank customer service in the past decade.

But here's the rub. Both of these improvements were the result of regulatory intervention by the competition authorities, not market-led initiatives by industry. They resulted from regulatory push, not customer pull. This suggests fiduciary concerns still may not course through the banking bloodstream as freely and easily as would be ideal. They help explain why that Great Divide remains so wide.

The Bank of England itself has an important role to play in this public education effort. Decisions made on interest rates in the economy and on credit provision by banks have an important bearing on the general public's financial decision-making. To that end, one of the Bank's strategic priorities over the next few years is to increase public awareness of the Bank's thinking and actions, using new methods such as videos, cartoons and social media, to help the general public's financial decision-making.

#### *(b) Creating "Purpose" in Banking*

Regulation and education can only take us so far. Culture cannot be regulated or educated; it has to be inculcated among financial firms themselves. As social identity theory reminds us, it is the sociology and psychology of banking and bankers that needs to change, as much as their finances. In thinking about how best to achieve that re-orientation, it is worth returning to the two dimensions of trust – personalised and generalised. In banking, both have been casualties. How best are they to be restored?

Since the crisis, it is clear that some banks have re-oriented their business model with an explicit eye to recreating *personalised* trust with their customers. For example, some banks have consciously expanded their branch network and extended opening hours to include evenings and weekends. For example, Handelsbanken has opened more than 140 branches – growing its UK network by nearly four times – since

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<sup>43</sup> For further details, please see <https://www.gov.uk/government/news/cma-wants-banks-to-work-harder-for-their-customers>.

<sup>44</sup> For further details, please see <http://www.fasterpayments.org.uk/about-us/>.

the height of the financial crisis.<sup>45</sup> Metro Bank now has over 40 ‘stores’, having arrived in the UK less than six years ago.<sup>46</sup> Other challenger banks are following hard on their heels.

The aim here is to create, or re-create, the local bank. It is a back-to-the-future model of banking, one in which “knowing your customer” is a business prerogative, not a legal imperative. Some have argued this is a valiant but ill-fated attempt to hold back the tide, as other retail businesses retreat from the high street. And perhaps that is right.

Or perhaps banking, or at least parts of it, is different. As a trust-based service, perhaps a banker is more like a high-street doctor or hairdresser than a clothes retailer. Time will tell. For what it is worth, early indications – including from the New City Agenda’s own research – offer some grounds for encouragement that some of the new entrants may be breaking the cultural mould of banking.<sup>47</sup> Some are certainly scoring highly in terms of customer satisfaction.

The alternative business model for banking is to retreat from the street, but to seek new ways to nurture generalised, or anonymous, trust on the part of the public. Technology may be a great enabler here, allowing a customised and personalised service even if it is not a person actually delivering it. Indeed, it is striking that it is often technology companies that are towards the top of the industry trust league table.

I am a long-standing supporter of alternative business models for banking, ones which connect end-savers and end-borrowers directly, peer-to-peer. Their offering to consumers is often a different one, challenging both the product and the pricing of incumbents. It is disruptive innovation. Many of these challengers are growing fast and have high levels of customer satisfaction. Innovation never occurs in a straight line, nor without bumps, but these new entrants bring welcome diversity to the banking market.

Whatever business model is adopted, success will hinge on whether the public have faith in banks pursuing a purpose aligned with their needs, that they are fulfilling their fiduciary function. There is a mountain to climb on this front, not just for banking but for business generally. If not at an all-time low, public trust in big business is plumbing the depths. And the chorus of criticism of business is not confined to the general public. It is shared by politicians, academics, investors and indeed sometimes by companies themselves.<sup>48</sup> For a growing body of opinion, the short-term, shareholder-centric model of public companies is failing to satisfy the wider needs of society.

There is at least some evidence that companies themselves may be reaching the same conclusion, seeking out alternative models of governance than the public company. It is a striking, and troubling, fact that the number of companies quoted on London’s main stock exchange has roughly halved since 2000, while IPOs

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<sup>45</sup> Handelsbanken 2016 Fact Book, available [here](#).

<sup>46</sup> Metro Bank news release, ‘Metro Bank brings the revolution to the King’s Road’, available [here](#).

<sup>47</sup> New City Agenda (2014).

<sup>48</sup> For example, Mayer (2013), Haldane (2015), Lazonick (2014).

has fallen by around 50%. In the US, many of the fastest-growing companies, such as Google, eBay and Apple, either remain in private hands or have alternative share structures, such as dual-class listings.<sup>49</sup>

Interestingly, re-examining this shareholder-centric model was one of the key recommendations of the PCBS back in 2013. I quote: “The Commission recommends that the Government consult on a proposal to amend section 172 of the Companies Act 2006 to remove shareholder primacy in respect of banks, requiring directors of banks to ensure the financial safety and soundness of the company ahead of the interests of its members.” Yet progress on that recommendation has, to date, been rather limited.

Take an issue like executive pay. This has been topical recently, with a number of high-profile cases of executives being paid amounts which do not obviously align well with their company’s performance. Some investors have expressed discontent at these pay packages and some have even gone so far as to vote against them. Investors have had their “Say on Pay”.<sup>50</sup> And, as is often the case at this time of year, as the pollen count has picked up there has been talk of a “shareholder spring”.

Ultimately, however, these investor votes are binding on neither management nor boards. They are a “Say on Pay”, but not a “Stay on Pay”. With very few exceptions, no differences were made to executive compensation packages as a result of investor action. And the cases of investors actively voting against pay packages have in any case been rather rare. The “shareholder spring” may be as ephemeral as that pollen.

Yet high executive pay-outs potentially have implications, adverse ones, for value-creation by companies and thus longer-term returns to investors. Monies paid out to executives are monies not being re-invested in the company, reducing investment in physical and human capital. They also drive a wedge between management and their employees – a wedge that has widened to over 150 times median wages in the UK and over 300 times in the US.<sup>51</sup> That, in turn, erodes social capital. A company, like a country, whose physical and social capital is being eroded is one whose wealth-creation capacity is being impaired.

What applies to pay-outs to executives applies, with equal force, to pay-outs to shareholders. Whether as dividends or buy-backs, these too have been on a steadily rising tide over recent decades: from around 10% of profits in the 1970s, to 60-70% today, as short-term shareholder demands have risen steadily.<sup>52</sup> Yet monies paid-out to shareholders are monies also failing to be re-invested in future value creation by the company. In short – too short – the shareholder-centric model may have become a recipe for depleting long-term company wealth-creation and, thus, societal well-being.<sup>53</sup> Or that, at least, is the contention.

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<sup>49</sup> Big Innovation Centre (2016).

<sup>50</sup> “Say on pay” is a term used to describe a rule in corporate law where a firm’s shareholders have the right to vote on the remuneration of executives.

<sup>51</sup> See High Pay Centre (2015) and Economic Policy Institute (2015).

<sup>52</sup> Haldane (2015).

<sup>53</sup> For example, Asker et al (2014) and Davies et al (2014) show, for the US and UK respectively, that private companies invest more than otherwise-equivalent public companies.

So what to do about it? Earlier this week, an interim report was issued on “The Purposeful Company” by the Big Innovation Centre.<sup>54</sup> I should declare an interest here, as I and others at the Bank have been involved in putting together this report. The report serves two purposes. First, it sets out the evidence base on the benefits and costs of the current shareholder-centric model of companies. Second, it makes some tentative suggestions for reform which might tackle some of these costs.

There are possible remedies on the table. Part of the solution to the shareholder short-termism problem may come from mobilising and catalysing what is at present a dispersed, and too often disinterested, long-term investor base. The falling share of institutional investors in equity ownership, together with the rise of passive investment strategies, has exacerbated the trend towards “ownerless corporations”. This is a particular problem in the UK, given its relative lack of block shareholding.<sup>55</sup>

Under the auspices of the Investment Association, an Investor Forum has been set up following the recommendations of John Kay’s review.<sup>56</sup> And, internationally, an initiative by asset managers called “Focussing Capital on the Long Term” is seeking some of the same objectives.<sup>57</sup> Ultimately, however, it is simply too soon to say whether any of these initiatives will mobilise and catalyse long-term investors sufficiently to exercise leverage over company management in ways which support long-term value creation.

A second, complementary strand would be to seek to reinforce and broaden the “purpose” of companies, to better reflect their broader societal role – their role in serving stakeholders plural (employees, customers, clients) as well as shareholders. Some companies have been able to do so voluntarily by defining clearly their societal purpose and sticking with it. The evidence is that, so purposed, companies create extra value, not just for their staff and customers, but for their shareholders too; it is win-win-win.<sup>58</sup> Indeed, it is win-win-win-win if you throw society into the mix.

Other companies, including perhaps some in banking, may need a helping hand in this journey. One option here would be to revisit the UK Companies Act. At the time it was introduced in 2006, the Companies Act envisioned an “enlightened” model of shareholder interest which weighed, albeit secondarily, the claims of a wider set of stakeholders, including employees and customers.

The experience since has been rather different. Most academics would put the UK at one end of the spectrum in the primacy it gives to shareholders. The model has, judged at least by public opinion, failed to be sufficiently “enlightened”. That begs the same question begged by the PCBS report back in 2013: would a more plural, less shareholder-centric, statutory definition of companies’ objectives, the like of which exists in a number of other countries, help in better serving investors’, customers’ and ultimately society’s needs?

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<sup>54</sup> Big Innovation Centre (2016).

<sup>55</sup> Haldane (2015), Big Innovation Centre (2016).

<sup>56</sup> See Kay (2012) and <http://www.investorforum.org.uk/>.

<sup>57</sup> See <http://www.fci.org/en/home.html>.

<sup>58</sup> Big Innovation Centre (2016).



There is no off-the-shelf corporate model that suits all seasons. But there may be value in a plurality of corporate structures. For example, so-called “Benefit Corporations” have recently begun springing up in the US.<sup>59</sup> “B-corporations” redefine the fiduciary responsibilities of a company to embrace a much wider range of stakeholders. The time may be ripe for appraising, or re-appraising, these options and others besides, especially in banking where shareholder tensions and short-termism may be particularly acute.

(c) *Communicating “Purpose” in Banking*

Actions to restore trust and purpose, in banking and elsewhere, speak louder than words. But words matter too – indeed, they may never have mattered more. Many banks these days can no longer rely on personalised interaction to generate trust. Instead, they are reliant on arms-length interaction, on generalised trust among the public. That trust is likely to be easier to restore and maintain if banking can communicate its objectives and purpose in ways which are understood by all.

It could be argued that there is no shortage of words by which to judge the actions and intentions of the banking system. Both are set out in great detail in banks’ annual reports. Indeed, the detail in these reports has never been greater. Chart 2 plots the page length of annual reports by the big four UK banks since 1990. This has risen from under 100 pages then to anywhere between 300 and 600 pages now. While all companies’ annual reports have risen in length at the same time, banking tops the tree-felling league table.

Clearly, then, there has been a rapidly rising tide of banking information. Or has there? The Godfather of information theory, Claude Shannon, defined information in terms of its ability to reduce our uncertainty.<sup>60</sup> But page length and certainty are not synonyms. As even professional investors find banks’ annual reports somewhere between undigestible and unfathomable, it seems possible more banking information, in the conventional sense, may have made for less banking information, in the Shannon sense.

One interesting diagnostic comes from looking at the *nature* of the information provided by banks’ annual reports, rather than its quantum. Linguistic analysis provides a range of metrics for determining the complexity of a language, including word and sentence length.<sup>61</sup> By taking a range of measures of linguistic complexity, and applying them to banks’ annual reports, we can get a window on Shannon’s measure of information-content.

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<sup>59</sup> Big Innovation Centre (2016).

<sup>60</sup> Shannon (1948).

<sup>61</sup> DuBay (2004).

Chart 3 plots six metrics of linguistic complexity, as applied to the annual reports of the four largest UK banks.<sup>62</sup> It compares them with a series of alternative publications, specifically a UK broadsheet newspaper, a UK tabloid newspaper, a set of recent Bank of England reports, a selection of my own speeches, and a selection of speeches by the leaders of the UK's main political parties. These comparators have no significance beyond the fact that they are examples of material written for a general audience.

What this demonstrates is that banks' annual reports rank highly on the linguistic complexity scale, well above even a broadsheet newspaper. That means they are unlikely to be accessible to the vast majority of the general public. It is communication *among* the financial elite in the language *of* the financial elite. Perhaps that is no more than confirmation of what we already knew. Nonetheless, it means these communications are, by themselves, unlikely to have helped build, or rebuild, generalised trust in banking.

It also begs the question of what more could be done to make banking more accessible to the wider public to help build trust. One option might be for the banking industry to conduct events similar in spirit to the Open Forum – events which seek to engage with, and take messages from, the general public. These might be one means of accreting personalised trust with customers – “Trust Town Halls”. To be successful, these would need to be repeated rather than one-off events, as personalised trust arises from repeat interactions.

Another idea is to consider whether there was scope for something akin to an annual report for customers, rather than investors. This might be (considerably) shorter in length, (considerably) simpler in language and (considerably) easier to digest in a 5 minute sitting. It would be part of banks' contract, social rather than legal, with their customers. A third idea might be for banks in future to begin publishing self-assessments of their culture, so that customers could have some better sense of the progress being made.

If these are important communications lessons for financial services serving society, they are no less important for public policymakers serving society. Let me take my home institution as a case study here. That is not because I believe it is an outlier – if anything, I think the Bank is at the frontier of central bank best practice on transparency and openness. It is simply the example I know best.

The Bank has made considerable efforts to improve its openness and transparency over the past few decades, including through published reports of its analysis and decisions, published minutes of those decisions, speeches and Parliamentary appearances. To bring that point home, consider a simple measure of transparency as it applies to monetary policy: the number of words used to describe a policy decision.

Back in 1989, when I first joined the Bank, monetary policy decisions were made by the Treasury. Their public communication typically took the form of a press release, usually comprising no more than a few

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<sup>62</sup> These include the Coleman-Liau, ARI, SMOG, Gunning fog, Flesch-Kincaid and Coleman correct completion measures. These measures consider not only sentence length but also the number of polysyllables (words of three syllables or more) and the average number of syllables per word.

hundred words. Ten years on, the monetary policy world had changed. Decisions were now taken by the Bank's MPC and were accompanied both by published minutes of MPC meetings and a quarterly *Inflation Report*. This pushed the word-count per decision up to around 20,000.

Fast forward to today. Monetary policy decisions are still made by the MPC and communicated through Minutes and the *Inflation Report*. But there have been additions. A Monetary Policy Statement now accompanies every policy decision. And, after a lag of eight years, transcripts of the policy meetings themselves will in future also be published. By my rough estimates, that will push the word-count per monetary policy decision up to around 30,000 to 35,000.

These are big steps forward from an openness perspective. The key question, from a Shannon perspective, is how far they have helped understanding of monetary policy by the general public. The evidence here is mixed. On the upside, around 60% of the general public believe the Bank has a good understanding of the economy. On the downside, despite the raft of transparency initiatives, only around a third believe the Bank operates with openness. And, perhaps most tellingly of all, only around a quarter believe the Bank explains its actions and decisions in terms they can understand.<sup>63</sup>

What explains this mixed message? Perhaps, as with banks, some of the explanation lies in the *nature* of communications, rather than their quantity. Chart 4 puts Bank of England reports and speeches on the linguistic complexity map. They occupy a position in the top right hand corner, with levels of complexity higher-even than commercial bank annual reports. This suggests the vast majority of the Bank's publications may be inaccessible to the vast majority of the general public.

Having assessed my own speeches, including this one, the conclusion is much the same. They, too, are likely to be impenetrable to most. These linguistic issues are not merely matters of careful drafting. They are important at a substantive level when it comes to building social capital, accreting generalised trust, closing the Great Divide. Plainly, there is further still for us all to go, myself very much included, in simplifying our communications to enable us to speak clearly to those we serve.

Set-piece communications, in the form of written reports and speeches, are only one aspect. There are different methods and media which can be used to reach different audiences using different voices. Last year's Open Forum was an example of such an initiative.<sup>64</sup> The Bank's enhanced public understanding programme is another. A third would be to seek different means of engaging more directly with the general public around the country.

Along with other MPC, as well as FPC and PRA Board members, I undertake regular visits around the country organised by the Bank's network of regional agencies to better understand the economy. They

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<sup>63</sup> Results from a poll conducted by Populus for the Bank of England in March 2016 of around 2,000 adults.

<sup>64</sup> For further details, please see Bank of England Open Forum (2015).

provide an extremely important window on the world, one that data and analysis alone is rarely able to provide. Traditionally, these visits focus on the Bank's company contacts – in other words, the visits provide, first and foremost, a corporate window on the world.

But not least in the light of the Open Forum, I have recently reconfigured those visits. Now, as well as the Bank's business contacts, I speak to local schools, colleges and universities and to local voluntary organisations, charities and community groups. This has opened a completely new window on the world for me. It is different voices – from the third sector, from trade unions, from students and educators - with different perspectives.

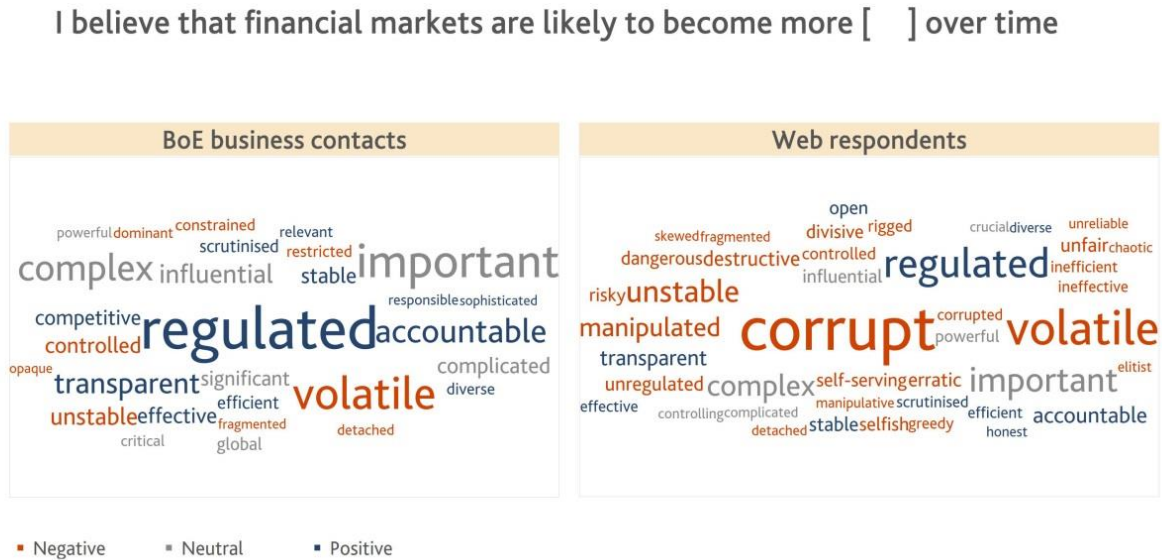
There is probably scope to expand the reach of these visits in the years ahead. I am attracted to the idea of "Trust Town Halls". These would enable me to engage more directly with as wide a spectrum of the general public as possible, in a language that is hopefully non-elitist, in a format that means I am listening as much or more as I am speaking. It is a move out of the echo chamber, an attempt to begin the process of building personalised trust, bridging that Great Divide.

## **Conclusion**

The Great Divide is a problem for banking, but not just banking. There are good steps being taken to re-build trust with the general public, both within banking and more broadly. This effort will not only take time but may require some quite different approaches to pursuing and communicating purpose – purpose in banking and indeed in central banking. Social capital is an elusive asset. But having seen it eroded, it now falls to us all to rebuild it, brick by brick, bank by bank, policy by policy, word by word.

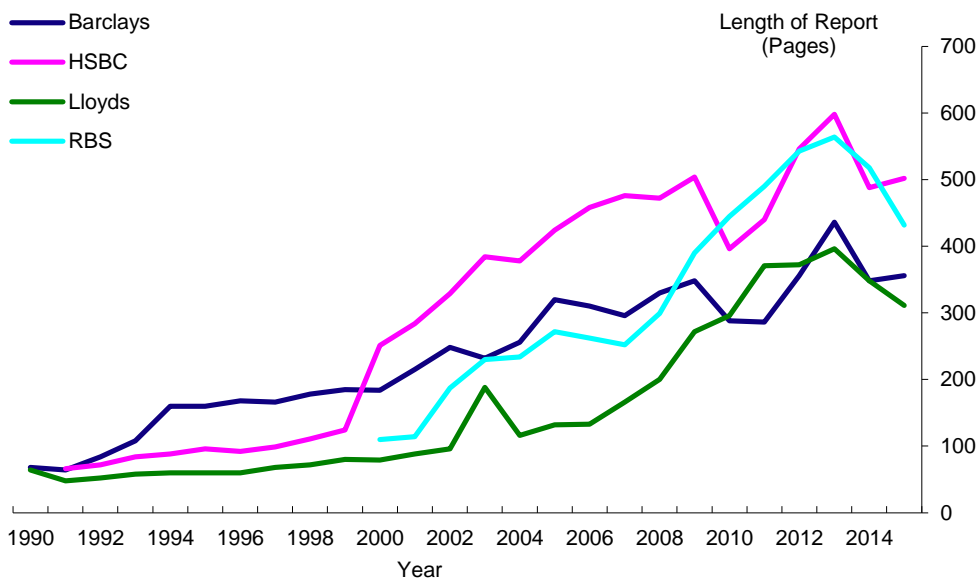
## Appendix

**Chart 1:** Word clouds from the Open Forum



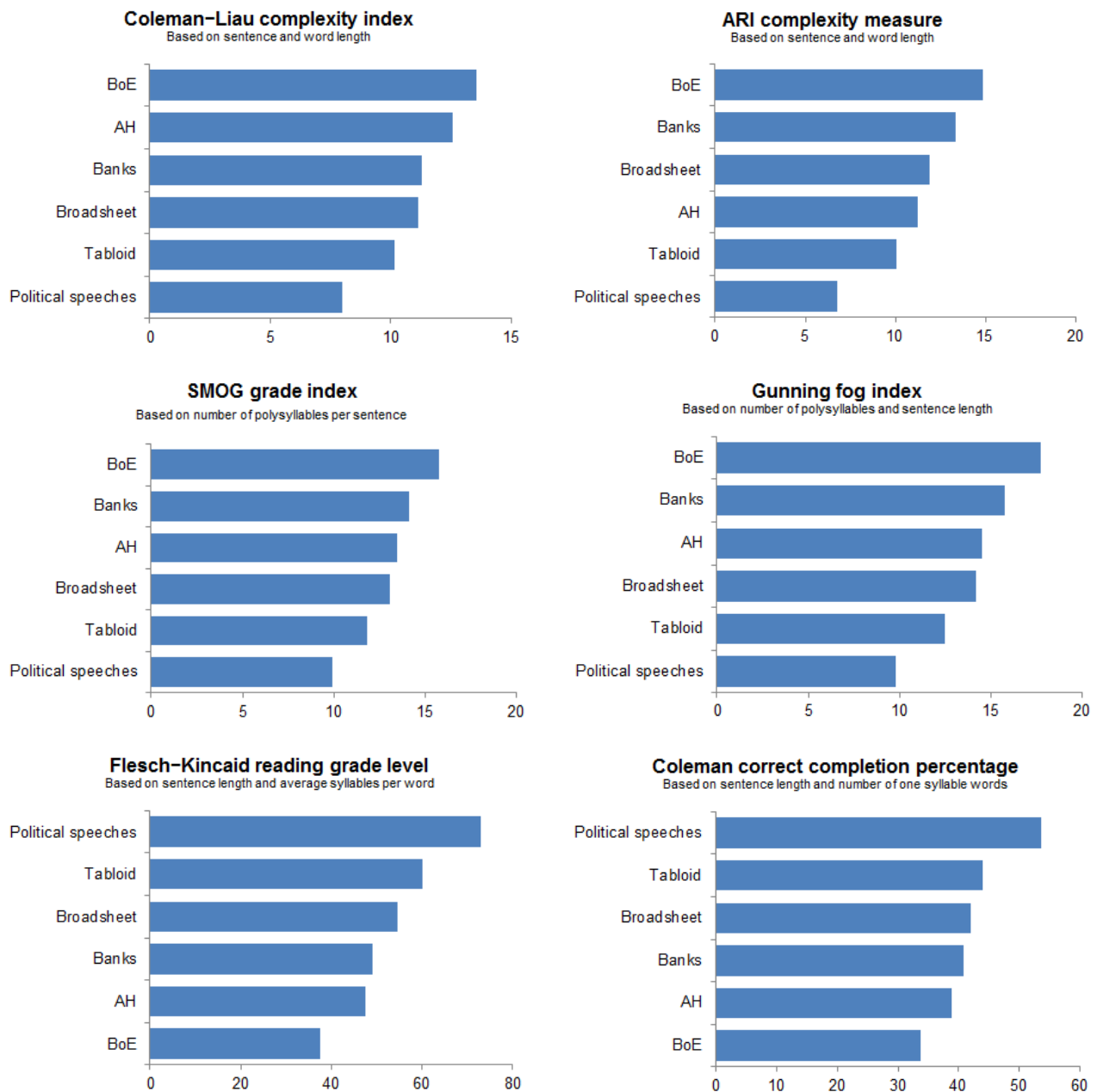
Source: Bank of England Open Forum (2015). Notes: The size of the text in each word cloud indicates the number of times each word was reported back. The poll was conducted online in 2015 Q3 and via the Bank of England Agency network. It included over 2000 people, and included those from all regions of the UK, all age groups (from school children to retirees) and employment sectors (including those not employed).

**Chart 2:** Annual Report Lengths



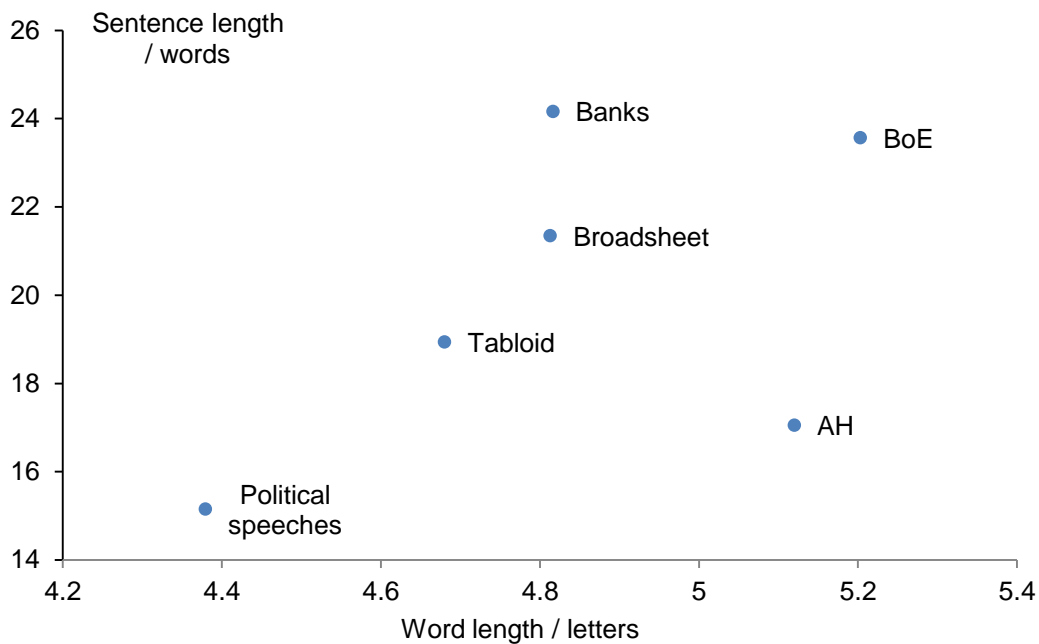
Source: Bank calculations based on published Annual Reports by Barclays, HSBC, Lloyds, RBS.

**Chart 3: Linguistic complexity measures for a set of publications**



Source: Bank calculations. Notes: A dataset of around 600 paragraphs from each of the following sources was used. Banks - a mixture of terms and conditions and various reports from Barclays, RBS, HSBC and Lloyds. BoE – a mixture of Bank of England speeches, reports and news content. AH – a selection of my recent speeches. Political speeches - the Leaders' speeches from Conservative, Labour and Liberal Democrat party conferences in 2012 and 2014. One Tabloid and one Broadsheet newspaper were also included. These measures consider not only sentence length but also the number of polysyllables (words of three syllables or more) and the average number of syllables per word. In general a lower number signifies lower complexity, apart from the Flesch-Kincaid reading grade level and Coleman correct completion measures where a higher number implies lower complexity. For further details please see DuBay (2004).

**Chart 4:** Average sentence and word length across publications



Source: Bank calculations. Notes: A dataset of around 600 paragraphs from each of the following sources was used. Banks - a mixture of terms and conditions and various reports from Barclays, RBS, HSBC and Lloyds. BoE – a mixture of Bank of England speeches, reports and news content. AH – a selection of my recent speeches. Political speeches - the Leaders' speeches from Conservative, Labour and Liberal Democrat party conferences in 2012 and 2014. One Tabloid and one Broadsheet newspaper were also included. The chart shows simple sentence length and word length figures.

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