In Sir Robin Jacob's words, this is an example of an area of trademark law left with little certainty: »*I am sorry to say, much less than commercial men would wish – and areas of uncertain law much greater than is good for business*«, and he continues: »*if the law is predictable most people do not fight*«.[100]

At this stage of my research I can only point out that a gap exists between the way the CJEU frames the average consumer and the economic rationale behind trademark law. Today it is far from certain that the outcome of infringement decisions related to confusingly similar trademarks lower consumer search costs.

This article has shown that it is a complex task from an economic perspective to analyse the size of consumer search costs in different products markets. That being said, it may be possible to deduce principles on the role trademarks play in lowering consumer search costs in the context of different product markets in the physical and online market places, not least for trademark law to accommodate the use of trademarks in the online environment. Essentially, by way of implementing elements from economics the CJEU, mainly the Court of Justice through its preliminary rulings, could possibly give a better steer on the employment of the average consumer concept in infringement decisions related to two alleged similar trademarks by asking if consumer search costs are actually lowered as a result of the decision. This article is an example of how economic theory may nourish European trademark law.

By way of Advocates-General opinions, this article has shown that it is not farfetched to bring economic theory into EU trademark law.

9. Conclusion

Being a work in progress, this article leaves more questions than answers, though it highlights an important debate: What is more broadly the purpose of having trademarks in EU? What can be learned from economics in creating a more solid policy ground for EU trademark law in general and in relation to the use of the average consumer deciding infringement between two confusingly similar trademarks?

understood by »*efficiency*« within welfare analysis – a much researched area of law and economics.

100. Mellor, J. *et al.*, *Kerly's Law of Trade Marks and Trade Name*, 15th ed., 2011, foreword.

KAPITEL 3

What effect does regulation have on the culture of banks?

Af Dr. David McIlroy

1. Abstract

The changes in UK financial services regulation contributed to a limited extent to adverse developments in the culture in UK banks but the major reasons for movement away from a concern for the interests of customers to the generation of short term profitability at all costs came from elsewhere. The introduction of the new Senior Managers Regime by the UK regulators is unlikely to be sufficient, in itself, to see positive changes in the culture in UK banks given the importance of middle managers in large banks in determining what banks actually value and reward.

The UK has experienced two major revolutions in financial services regulation. The first, which introduced the Financial Services Act, was in 1986 when Mrs Thatcher was prime minister. The second, which introduced the Financial Services and Markets Act was in 2001 when Tony Blair was prime minister. Under the Financial Services and Markets Act, the Financial Services Authority replaced the Bank of England as the regulator. This essay explores the behaviour of banks under those two different regulatory regimes. It identifies negative developments in the culture within banks are responsible for the harmful behaviours in which the employees of the UK's major banks engaged. In 2013, the Prudential Regulation Authority and the Financial Conduct Authority replaced the Financial Services Authority. These two regulators have now introduced rules which are expressly designed to address the culture within banks. The essay concludes by considering whether those rules are likely to be sufficient to achieve their goal.

1.2. The effect of the Financial Services Act 1986 on the culture in banks

Prior to 1986, the British banking sector was divided between retail banks and investment banks. Retail banks had branches in towns and cities up and down the country, and which concentrated on what EU Directives rightly identify as the core banking activities of taking deposits and granting loans. The UK market for retail banking was highly concentrated, with Barclays, NatWest (now owned by RBS), Midland Bank (now HSBC) and Lloyds' Bank having accounted for more than 80 % of deposits since the 1920s. The British banking system was »*a club of a small number of large members*«.[1] The popular impression was that such banks made a respectable, but not outrageous, level of profit through providing essential banking services of liquidity transformation and exchange of risks for their customers.

In the City of London, a different sort of institution was to be found: the investment bank. Investment banks concentrated on the buying and selling of stocks and shares as well as advising on share issues. Because of the strict restrictions on which institutions could operate in the London Stock Exchange, investment banking in Britain was also a club with a small number of members.

That division between retail banks and investment banks meant that the two sorts of institutions had different cultures. Investment banks, whose main business was direct involvement in the financial markets, treated those they dealt with as counterparties, unless and until they had entered into an express agreement to act as their advisers. Retail banks, whose main business was taking deposits and granting loans, treated their clients as customers, to whom they gave support and advice without, however, acting as an insurer or indemnifier for the customer's actions taken in reliance on that advice.

Despite the fact that four retail banks dominated the market, the attitude of the high street banks towards those they dealt with was consensual, with the bank preferring to make its profit by lending to customers who were able to repay the loans with interest, and interested in sustaining long term relationships with them.

The world in which the investment banks operated was, by contrast, far more antagonistic. Prior to 1986, we were not yet in the world of 'casino banking' but the law of jungle definitely applied on the floor of the London Stock Exchange. Investment banks dealt with those who MiFID I would later

1. Colin Mayer »Regulatory Principles« in Ferran, Eilis, and Charles Goodhart. *Regulating Financial Services And Markets In The 21St Century*. Oxford: Hart Pub., 2001. Print.

call market counterparties, who were aware of the risks they were taking, or professional clients, who had access to their own professional advisers to advise them as to the risks they were taken.

In 1986, Mrs Thatcher's government introduced the Financial Services Act, referred to at the time as »the Big Bank in the City«. The effect of this liberalizing measure was that within two years, the UK's investment banks had all been taken over by the UK's retail banks. So, for example, Barclays now had an investment banking division, Barclays Capital (»BarCap«), run by Bob Diamond (who went on to become CEO of Barclays).[2] Universal banking, a phenomenon long established in Germany, had come to the UK.

Despite the fact that the Financial Services Act 1986 led to consolidation in the UK banking sector, the activities of retail banking and investment banking continued to be subject to very different regulatory regimes.

In 1991, retail banking was subjected to a regime of self-regulation under which the banks agreed to sign up to the voluntary Banking Code, a document written and administered by the British Bankers' Association, to whom consumers could complain about poor service. The Banking Code was a short document containing open-textured rules, such as

- We will deal quickly and sympathetically with things that go wrong and consider all cases of financial difficulty sympathetically and positively
- When you have chosen an account or service, we will give you clear information about how it works, the terms and conditions and the interest rates which apply to it.

The British Bankers' Association established a Banking Ombudsman who would hear consumers' complaints and who could award compensation. In 2002 a Business Banking Code was introduced so that small businesses with a turnover of under £1 million could also complain to the Banking Ombudsman.

Investment banking was, however, subject to a very different regulatory approach. A number of different regulators were established by the Financial

2. Bob Diamond is a British-American banker and former CEO of Barclays. He resigned in 2012 following controversy over Libor rate manipulation by employees of the bank when the regulators made it known that it no longer regarded him as a fit and proper person to run the bank: see »Bank of England governor refuses to back Bob Diamond«, *The Guardian*, 29 June 2012, available on-line at http://www.theguardian.com/business/2012/jun/29/bank-england-bob-diamond-mervyn-king, accessed 18 March 2015.

Services Act 1986. Most of investment banks' activities fell under the jurisdiction of the Securities and Investment Board (SIB).[3] The regulation by the Securities and Investment Board was based on more detailed rules. In part, the justification for moving away from the self-policing which had previously characterized the London Stock Exchange, was that whilst such self-policing had worked well when the Stock Exchange was an exclusive club with a small number of members, it was no longer appropriate now that it had been opened up to a far wider range of participants.

What effect did the move away from self-regulation to governance through a mass of detailed rules have on the behaviour of investment banks? Even before the credit crisis, Professor Alistair Alcock of Salford University criticised the increasing emphasis on rules as meaning that whereas in the 1980s people in the financial services sector asked themselves whether what they were doing was right, in the 1990s they asked themselves whether what they were doing was within the rules.[4] The question was no longer whether something was honest and fair, but instead whether it was within the rules. In a recent independent report into Barclays, Anthony Salz said: »*Barclays was sometimes perceived as being within the letter of the law but not within its spirit*«.[5] Although the UK did not experience any scandals on the scale of WorldCom in the USA,[6] basic standards of honesty and transparency were lost within a forest of detailed rules.

1.2. The effect of the Financial Services and Markets Act 2000

In 2001, the fact that the investment banks had all been swallowed up by the retail banks was recognised when the Financial Services and Markets Act 2000 was adopted. Under the 2000 Act, the multiple regulators which had existed under the 1986 Act were abolished and all financial services were brought under the jurisdiction of the single regulator, the Financial Services Authority.

3. Regulation of investment banks was shared with the Personal Investment Authority (»PIA«), the Securities and Futures Authority (»SFA«) and the Investment Management Regulatory Organisation. Buckle, M and Thompson, J., »The UK Financial System: Theory and Practice«, *Manchester University Press*: Manchester, 1998, 384.
4. Alistair Alcock, »Are UK Financial Services Over-regulated?«, public lecture at the IALS on 31st October 2002.
5. Anthony Salz, »The Salz Review of Barclays« (April 2013), 2.18. http://online.-wsj.com/public/resources/documents/SalzReview04032013.pdf
6. Where many of the accounting manoeuvres were within the letter of American accounting rules, but their cumulative effect was to present a picture of the company's finances which was misleading to the tune of $9bn!

The Financial Services Authority was built out of the Securities and Investment Board which absorbed the other regulators and extended its remit to cover all regulated financial services activities. The effect of this was predictable: the approach to regulation by means of detailed rules which had characterised the Securities and Investment Board now became the hallmark of the Financial Services Authority's approach to regulation. As the rules became more detailed, so the trend for bankers to concern themselves *solely* with the question: is it within the rules?, became more pronounced. However, on top of this, the major banks also began to engage in patterns of widespread breaches of the detailed rules when the rules got in the way of making a profit as well as flagrant defiance of basic standards of honesty and transparency.

Each of these three major features of banking culture in the UK during the first decade of the twenty-first century will be considered in turn.

2. Exploiting the detailed rules

In the 1970s, the main activity of many banks in the UK and in the USA was the lending of money by way of mortgages. These long term, typically 25 year, loan contracts were funded out of the deposits taken by the banks. There is an obvious problem for banks who have this as their business model, the problem of liquidity shortage. A bank cannot lend more money by way of mortgage unless it increases the amount of the deposits it has taken.

Faced with this, banks found ways of increasing their business both by borrowing short-term money on the financial markets to supplement their deposit and by selling the mortgages they had entered into on to other banks. Mortgages were bundled together, the income streams divided into tranches, and then sold on as securitised products. The first Basel Capital Accord (1988) encouraged these sales, giving capital relief to the bank selling the securitised product.

The originate-and-hold model, under which the bank which enters into a mortgage is the same bank as receives the stream of repayments under the mortgage, was replaced by the originate-and-distribute model, under which the bank which enters into the mortgage now sells the mortgage on to other institutions.[7]

7. Greed was a factor among unscrupulous lenders that made bad subprime loans and then sold them off in the form of mortgage-backed securities to uninformed investors (Krugman, Paul (2010). »Looters in Loafers.« *New York Times*, April 19.) Favorable terms were given to borrowers, enticing people with very limited ability to repay

The risk weightings under Basel I facilitated this practice. But securitisation weakens the incentives on the bank which is granting the mortgage to ensure that the borrower will be able to repay the loan. In the most extreme examples, so-called »Liar loans«, bankers selling mortgages encouraged customers to over-state their income in order to obtain a larger loan. In other cases, some of the loans which were securitised were *already* in default at the time they were sold on to other institutions. The US regulators ordered Bank of America to pay a fine of $1.27 billion in respect of the on-sale of mortgages by Countrywide in a scheme known as »Hustle« in which mortgage products were moved quickly with little regard for quality.[8]

In the UK, the first major bank to fail, Northern Rock, had grown aggressively, to the point where in the first 6 months of 2007 it was responsible for 1 in 5 of all mortgages including remortgages and 1 in 10 of new mortgages. Northern Rock had built its market share by being prepared to lend in cases and on terms when other banks were not willing to do so. For example, Northern Rock would lend up to 6 times a borrower's income, when the traditional lending criteria used by banks were close to 3 times a borrower's income. Northern Rock also offered mortgages of up to 125 % of the value of the property, in essence betting that houses prices would rise by at least 25 % in order for the loan to be fully secured. Northern Rock was financing these mortgages not from its deposits but from short term borrowing on the money markets. It was then using securitisation heavily in order to satisfy the capital adequacy rules so that it could keep on lending.[9]

loans who should not have been borrowing at all. The securities associated with these loans would be of little value to investors, but investors nonetheless bought the securities because they were not aware of the quality of the underlying loans. Thus a lender could profit from both sides of the mortgage market without taking on any risk at all: Clements, Matthew T. »Self-Interest Vs. Greed And The Limitations Of The Invisible Hand«. *American Journal of Economics and Sociology* 72.4 (2011): 949-965. Web.

8. Rexrode, Christina, and Julie Steinberg, »Judge Orders Bank Of America To Pay $1.27 Billion In »Hustle« Case«, *The Wall Street Journal*, 2014. Web. 30 July 2014, http://www.wsj.com/articles/judge-orders-bank-of-america-to-pay-1-27-billion-in-hustle-case-1406744359

9. House of Commons Treasury Committee, »The Run on the Rock«. London, House of Commons, 2008, 56-II, 59, available on-line at http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56ii.pdf. Volume I available on-line at http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf. Accessed 18 March 2015.

2.1. Interest rate swap mis-selling: ignoring the detailed rules

In the UK, the take-overs of investment banks by retail banks contributed to a reverse take-over of retail banking culture by investment banking culture with the result that retail banking customers were treated as counterparties by banks in more and more respects. The arms-length approach which investment bankers used when dealing with counterparties was the default approach of the banks' salespeople when dealing with the banks' retail clients.

This trend is illustrated by the interest rate swaps mis-selling scandal. In the first decade of the twenty-first century, small businesses which borrowed £1 million or more were routinely introduced by their bank manager to a salesperson from the bank's investment banking division. That salesperson would then proceed to sell the business an interest rate hedging product such as a cap, a collar or a swap.[10] Interest rate hedging products are derivatives, financial products derived from interest rates. The interest rate hedging product would usually be for a minimum term of 5 years, but could be for as long as 25 years. Often the interest rate hedging product was for longer than the period for which the bank had agreed to lend money to the business and if the company was worried about the rates under the interest rate hedging product, the bank would reduce the headline rate by giving itself the option to cancel the interest rate hedging product on one or more occasions in the future, with the result that the hedge became more and more of a one-way bet against the business. The sale of such interest rate hedging products was profitable for the banks, even in normal market conditions, and earned their investment banking salespeople large amounts of commission. What the banks did not predict, however, was that because of the fall in base rates, interest rate hedg-

10. FSA/ FCA Redress Scheme for definitions – »A cap is a separate contract to the underlying loan agreement that can have the effect of limiting increases in a customer's loan repayments if the interest rates rise. A customer typically pays an upfront fee and/or an ongoing premium for a cap. The lower the agreed interest rate, the higher the premium. As interest rates fluctuate, a customer's loan repayments will fluctuate. If base rates are above the agreed interest rate, the customer receives a payment from the bank that can be set against the increased loan repayments. If interest rates are below the cap, then no payment is made. A collar is a separate agreement with the bank that limits fluctuations in interest rates within certain pre-agreed levels. There are two types, simple collar and structured collar. An interest rate swap is a separate contract to the underlying loan agreement. It is an agreement between two parties whereby one type of interest payment is swapped for another; such as exchanging a fixed interest rate payment for a floating payment«. FCA, »Interest Rate Hedging Product Review – FAQs«, available on-line at http://www.fca.org.uk/consumers/financial-services-products/banking/interest-rate-hedging-products/questions. Accessed 18 March 2015.

ing products have proved to be fabulously and scandalously profitable. The banks never explained to their customers that interest rate hedging products carried break costs, or if they did, they never explained that those break costs depended on market expectations regarding future interest rates over the remaining term of the hedge. Customers were not told at the time of the sale: that the longer the term of the hedge, the larger the break costs could be; the lower interest rates were, the higher the break costs would be; or that the hedges could prove to be ruinously expensive in certain circumstances.

In 2012, the UK regulator concluded that the banks had failed to meet the regulatory standards applicable to the sale of interest rate hedging products in over 90 % of cases.[11] A Redress Scheme had to be established which has so far processed 17,000 claims and provided some degree of compensation in 14,000 cases.[12]

How did the interest rate swap mis-selling scandal happen?

The first answer is that the scandal occurred because financial products which had been sold on the wholesale markets to counterparties who understood them and who were prepared to exchange some known risks for other known risks were now being sold by the banks to retail customers who had no idea of risks involved.

What occurred was analogous to a scandal which occurred in the fifteenth century and which has left its mark on the languages all across Europe. At that time, there was a shortage of pork. As a result, the price of pork, the staple meat on which the poor depended, rocketed. The bubble in the price of pork created an opportunity for fraudsters. An unscrupulous salesman would sell a customer a bag full of what they said was pork. If the customer was foolish enough not to open the bag before purchasing it, they would be sold cat meat. This has left its mark in the English language in the expression »*to buy a pig in a poke*«. Someone who insisted on the bag being opened before purchasing, »*let the cat out of the bag*«, another English expression.

The imprudent consumer in the Middle Ages who bought cat meat without opening the bag only had themselves to blame. The same is not true of the consumer of financial services today. The scandal of selling cat meat as pork is one to which financial markets are particularly vulnerable, given the inherent issues of information asymmetry and the ease with which financial prod-

11. Financial Services Authority »Interest Rate Hedging Products: Pilot Findings«, (March 2013), 5. http://www.fsa.gov.uk/pubs/other/interest-rate-swaps-2013.pdf
12. Financial Conduct Authority »Interest rate hedging products«, http://www.fca.-org.uk/consumers/financial-services-products/banking/interest-rate-hedging-products

ucts can be designed so that they perform reasonably well in some circumstances but disastrously in others.

At first glance, however, it might appear that the banks were not as bad as the mediaeval cat-meat salesmen. Hedging of interest rates, usually over short periods of, say 1 to 2 years, can be a reasonable strategy for some businesses to adopt. The UK regulator has rightly refused to condemn or to outlaw interest rate hedging products as a class.

However, the interest rate hedging products which were sold were only rarely the ones which were optimal for the customer's needs. The long term profile, or other features, of the interest rate hedging products which were sold was such that they were, in almost all cases, unsuitable for the customers to whom they were sold. They were products which the banks could not, in good conscience, have advised their business customers to enter into. Put bluntly, they were products which it was in the banks' interest to sell but it was not in their customer's interests to buy. In selling interest rate hedging products to their clients, banks were not treating their clients as customers to be served but as unsuspecting counterparties to be taken advantage of.

2.2. The LIBOR Scandal: disregard for the rules

The third issue which illustrates the culture of the banks is the LIBOR scandal. The banks' actions in manipulating LIBOR demonstrated how the banks continued to act like a club against the interests of their clients. Up until its recent reform,[13] LIBOR is a series of benchmarks for different currencies, for the rate at which banks were supposed to be lending to each other over various short term periods.

Banks' submissions to the British Bankers Association (»BBA«) which set LIBOR were routinely influenced by requests made by traders:

- on 5 February 2008, Trader B (a US dollar Derivatives Trader) stated in a telephone conversation with Manager B that Barclays' Submitter was submitting »*the highest LIBOR of anybody [...] He's like, I think this is where it should be. I'm like, dude, you're killing us*«. Manager B instruct-

13. In December 2013, the British Bankers Association announced the transfer of the responsibility for the administration of Libor to the NYSE Euronext. NYSE Euronext, the new administrator, is a London-based company regulated by the FCA. This change was a key recommendation of the Wheatley Review, which was set up in the wake of the scandal to restore the credibility to the index. Browne, Anthony. »Libor Now Has A New Administrator – But Our Reforms Have Gone Much Further«. *British Bankers Association* 2013. Web. 12 Mar. 2015.

ed Trader B to: »*just tell him to keep it, to put it low*«. Trader B said that he had »*begged*« the Submitter to put in a low LIBOR submission and the Submitter had said he would »*see what I can do*«;[14]

- Barclays' Derivative Traders would request high or low submissions regularly in emails, for example on 7 February 2006, Trader C (a US dollar Derivatives Trader) requested a »*High 1m and high 3m if poss please. Have v. large 3m coming up for the next 10 days or so*«.[15]
- On Friday, 10 March 2006, two US dollar Derivatives Traders made email requests for a low three month US dollar LIBOR submission for the coming Monday. One said »*We have an unbelievably large set on Monday (the IMM). We need a really low 3m fix, it could potentially cost a fortune. Would really appreciate any help*«;[16]
- One trader, Trader D set calendar entries on at least 4 occasions in 2006 to remind him to make requests for EURIBOR submissions: »*Ask for Low Reset Rate*« and »*Ask for High 6M Fix*«.[17]

But the nature of the LIBOR Panel Banks as a club, acting in their own interests against those of the rest of the market, and against their customers, is revealed by the extent of the evidence that the banks manipulated LIBOR for the benefit of traders at other banks.

- At least 12 of the US dollar LIBOR requests made to Barclays' Submitters were made on behalf of external traders that had previously worked at Barclays and were now working at other banks (although those banks did not contribute US dollar LIBOR submissions).[18]
- For example, on 26 October 2006, an external trader made a request for a lower three month US dollar LIBOR submission. The external trader stated in an email to Trader G at Barclays »*If it comes in unchanged I'm a dead man*«. Trader G responded that he would »*have a chat*«. Barclays' submission on that day for three month US dollar LIBOR was half a basis point lower than the day before, rather than being unchanged. The external trader thanked Trader G for Barclays' LIBOR submission later that day:

14. »FSA Final Notice to Barclays Bank plc« 27 June 2012, para. 57 ii. Available on-line at http://www.fsa.gov.uk/static/pubs/final/barclays-jun12.pdf. Accessed 18 March 2015.
15. *ibid.* para. 58.
16. *ibid.* para. 59.
17. *ibid.* para. 61.
18. *ibid.* para. 82.

»*Dude. I owe you big time! Come over one day after work and I'm opening a bottle of Bollinger*«.[19]

- Lloyds Bank was found to have engaged in at least three schemes of »*forcing LIBOR*« to influence the GBP LIBOR submissions of other LIBOR Panel Banks to benefit trading positions.
- Bank of Scotland engaged in at least one scheme in November 2006 and December 2006.
- RBS sought to manipulate LIBOR in connection with its own submission of rates that formed part of the calculation of Japanese yen (»JPY«) and Swiss franc (»CHF«) LIBOR and also sought to influence other banks' JPY LIBOR submissions. RBS also inappropriately considered the impact of LIBOR and RBS's LIBOR submissions on the profitability of transactions in its money market trading books as a factor when making (or directing others to make) JPY, CHF and USD LIBOR submissions. RBS's misconduct undermined the integrity of LIBOR.

Requests within banks, and between banks, to manipulate the LIBOR rate became routine. As Paul Downes QC puts it: »*It is clear that from at least 2005, there was a cultural acceptance that LIBOR was simply a variable, to be managed just like any other variable, to maximise the returns being generated by individual traders, for their own personal financial benefit, and to bolster the banks' trading revenue*«.[20]

2.2.1. *Other factors*

This paper has focussed so far exclusively on the contribution of regulation to the development of a culture of exploiting clients which profoundly changed the approach of banks in the UK in the last thirty years. It would be wrong, however, to suggest that regulation was the sole, or the primary, driver for such a disturbing and costly cultural shift. After all, Germany has had universal banking for a long time without, at least to my knowledge, experiencing the systematic abuses and scandals which have occurred in the UK.

The abuses show how the banks have:

1. obeyed the detailed rules without regard to whether the picture being created was honest and transparent;

19. *ibid.* para. 83.
20. Paul Downes QC, »LIBOR: more to LIBOR than *Graiseley*?«, (2014) *Butterworth's Journal of International Banking and Financial Law* 83-85.

2. ignored the detailed rules when those rules got in the way of making a profit;
3. disregarded the rules entirely and behaving like a club.

What those three behaviours have in common is a cultural attitude which says: let's make a profit at all costs. Whilst the heavy use of detailed rules by regulators contributed to the first abuse and the change in regulation to allow the takeover of investment banks by retail banks led, paradoxically, to the infection of retail banking with the approach of a certain type of predatory investment banking, the third abuse shows that it was a particular approach to profit-making which was the key driver, and that that approach to profit-making had become culturally embedded.

This change to a culture where sales were the overriding imperative and it did not matter whether or not the products sold were in the customers' interests has been widely observed in other studies. McCabe (2009)[21] identified how the branches of a UK high street bank had become seen internally as selling spaces rather than bases from which financial services were provided. Kerr and Robinson (2012)[22] studied the changes in Scottish banking and found that: a business culture imported from the USA had a big impact in changing Scottish banking; branches came to be seen as sales outlets and staff were transformed from professional advisors embedded in the community into salespeople with targets to meet. Knights and Tullberg (2011)[23] studied financial services in the UK and Sweden and found that: the banking crisis arose partly because of a narrative of the »*masculine autonomous self*« – notion of the self-interested, self-sustaining individual; which led to »*poor ethical standards stemmed from the conditioning of individuals to not recognize their social interdependence*«. In his independent review of Barclays business practices, Anthony Salz lays many of the central failings of Barclays bank in the run-up to the LIBOR scandal on its internal culture: »*despite some attempts to establish Group-wide values, the culture that emerged tended to favour transactions over relationships, the short term over sustainability, and*

21. McCabe, D. (2009). »Enterprise contested: Betwixt and between the discourses of career and enterprise in a UK bank«. *Human Relations*, 62(10), 1551-1579.
22. Kerr, R., & Robinson, S. (2012). »From symbolic violence to economic violence: The globalizing of the Scottish banking elite«. *Organization Studies*. 33(2), 247-266.
23. Knights, D., & Tullberg, M. (2012) »Managing masculinity/mismanaging the corporation«. *Organization*, 19(4), 385-404

financial over other business purposes«.[24] New City Agenda and Cass Business School's »A Report on the Culture of British Retail Banking«[25] summarises the research as showing that a widespread and aggressive sale culture was one of the central reasons for the numerous failures of banking in the UK over the last 8 years – problems that were particularly prevalent in the biggest banks.

The approach which says »*let's make a profit at all costs, and by all means*« had become culturally embedded in the City of London because of the way in which the banks interpreted the ideas of two men: Adam Smith and Eugene Fama. From Adam Smith, they took the idea that markets are a-moral and from Eugene Fama the idea that the a-moral market was the optimal way to allocate social goods.

2.3. Markets as a-moral

In *The Wealth of Nations* Adam Smith suggests that we don't need to rely on the fact that the butcher loves us or wishes to serve us in order for society to flourish. It is sufficient, he says, if the butcher is looking out for his own, rather than our, self-interest. If the butcher is looking out for his own self-interest he will want us to be his customer again tomorrow and so he will try to give us a good service and provide us with quality meat at a reasonable price. Provided the butcher is acting with enlightened self-interest, and thinking about the long-term rather than the short-term, our interests will be adequately met even if they are only treated by the butcher as means to his self-interested ends. Whilst that may be true in some contexts, the assumption is problematic in relation to one-off transactions where there is a high degree of information asymmetry.[26]

Smith says that if everyone acts out of self-interest, the invisible hand of the market will transform our individual, self-regarding actions, so that the outcome is the best for all. The way Smith has been interpreted is as if he was saying: it does not matter whether you are acting benevolently, seeking an outcome to a transaction that will benefit both you and your counterparty, or whether you are acting self-interestedly, without regard for the interests of

24. Antony Salz, »The Salz Review of Barclays« (April 2013) 2.13 http://online.-wsj.com/public/resources/documents/SalzReview04032013.pdf
25. http://newcityagenda.co.uk/wp-content/uploads/2014/11/Online-version.pdf
26. A second hand car salesman or an estate agent may sell us something which we will not need to replace for many years. His incentive to give us a good service at a reasonable price is therefore far weaker than that of the butcher who wants us to return to his shop the following day.

your counterparty, or whether you are acting selfishly, pursuing your own interests at the expense of those with whom you are dealing, the invisible hand of the market will ensure that, overall, the outcomes in the market will be optimal, at least for the greatest number.[27] Because of the magic of the invisible hand, markets are a morality-free zone.

However, if you believe in the doctrine of the invisible hand of the market then the focus of your legislation will be on laws which seek to ensure that the hand of the market can keep operating. You will want, therefore, to outlaw or regulate monopolies, where the butcher knows that he need not provide good service at a reasonable price because he knows that he has a monopoly.

In the UK banking sector, there was a toxic combination of an oligopoly of just 4 major banks and customer relations which were very »*sticky*« where, because customers were dependent on their banks for credit, customers would not leave a bank despite poor customer service. This created ample potential for conflicts of interest, which actually the banks resolved simply by preferring their own interests over those of their customers.

The currency speculator, George Soros, is perhaps a surprising critic of the idea that markets are a-moral, but this is what he said with regard to conflicts of interest:

»It has been extensively analyzed by economists, but they look at it exclusively in terms of contracts and incentives and they largely disregard questions of ethics and values. Yet if you leave out ethical considerations the problem becomes pretty well intractable. Values like honesty and integrity lose their grip on people's behaviour and people become increasingly motivated by economic incentives. By claiming to be value free, market fundamentalism has actually undermined moral values«.[28]

3. The efficient market hypothesis

Up until the global financial crisis, the doctrine of the invisible hand was reinforced by the efficient market hypothesis, popularised by Eugene Fama of Chicago University in the 1960s. The efficient market hypothesis comes in a

27. Whether this is a correct interpretation of Adam Smith is controversial, and depends on how one understands the relationship between *The Wealth of Nations* and his other work *The Theory of Moral Sentiments*.
28. Soros, George. »Soros: Capitalism Versus Open Society«. *Financial Times* 2009. Available on-line at http://www.ft.com/cms/s/2/d55926e8-bfea-11de-aed2-00144-feab49a.html#axzz3UBk5QiFw

number of different forms but its essence is captured by the slogan »*You can't beat the market*«. The efficient market hypothesis is the belief that the markets always know what they are doing, even if individual investors within them don't, and therefore the market price for assets is an accurate reflection of their real value.

Why does the efficient market hypothesis matter? According to the efficient market hypothesis the market always knows best and therefore the best thing governments can do is to de-regulate the market as much as possible. The invisible hand of the market will do the rest. The efficient market hypothesis regarded free markets as almost magical devices for adjusting supply and demand, and hence prices, to reach a state of stable equilibrium that could not be bettered by human intervention. In other words, while market forces were in one sense blind and dumb, in another sense they were all-seeing and all-knowing. They could safely be left to produce the most efficient outcome.[29]

Whereas before the credit crisis, the efficient market hypothesis and the belief that the financial markets were a-moral was taken for granted, there is now a widespread acceptance that both theses were unsound.

Lord Adair Turner, appointed in the wake of the crisis to head the UK's Financial Services Authority, has described how »bad« – or rather over-simplistic and over-confident economics – helped create the crisis. There was a dominant conventional wisdom that markets were always rational and self-equilibrating, that market competition by itself would ensure economic efficiency and stability, and that financial innovation and increased trading activity was therefore axiomatically beneficial.[30]

Jeffrey Sachs wrote in the *Financial Times* on 18 January 2012, a column entitled »*Self-interest, without morals, leads to capitalism's self-destruction*«. In it he argued that »*Self-interest promotes competition, the division of labor, and innovation, but ... it fails when market competition breaks down, whether because of natural monopolies (in infrastructure), externalities (often related to the environment), public goods (such as basic scientific knowledge), or asymmetric information (in financial fraud, for example)*«.

29. Longley, Clifford. »Just Money: How Catholic Social Teaching Can Redeem Capitalism«. London: *Theos*, 2014, 25.
30. Adair Turner, »Economics, conventional wisdom and public policy«, Institute for New Economic Thinking, Inaugural Conference, Cambridge, April 2010; http://ineteconomics.org/sites/inet.civicactions.net/fles/INET%20Turner%20%20Cambridge%2020100409.pdf

Will Hutton, a British economic and political commentator, declared that »*the dominant intellectual ideology of the last 20 years, free market fundamentalism, and the way it was applied in the financial markets, the efficient market hypothesis, was the biggest intellectual mistake this generation has ever witnessed, arguably the world has ever witnessed*«.[31]

Following the global financial crisis, even the doyen of the Law and Economics movement, American judge Richard Posner, said that »*the movement to deregulate the financial industry went too far by exaggerating the resilience—the self healing powers—of laissez-faire capitalism*«.[32]

3.1. Remedies

3.1.1. Regulating the behaviour of banks and bankers

The major way in which the UK regulators have responded to the uncovering of the anti-social nature of the culture within banks has been to replace the old approved persons regime with a new senior managers regime.

3.1.1.1. The approved persons regime

The UK regulators have now woken up to the importance of a bank's culture and this has led to major changes in the way in which banks are regulated being proposed.

When the Financial Services and Markets Act 2000 was first introduced, the UK's regulator required large numbers of employees within the banks to be »*approved*«. A bank had to obtain approval for any person carrying one of five different categories of »*controlled function*«: governing functions, required functions, systems and controls functions, significant management functions, and customer functions (SUP 10.4.5R). »*Governing functions*« were performed by all a bank's directors, whether executive or non-executive. »*Required functions*« included compliance oversight, money laundering and general oversight functions. »*Systems and controls functions*« included finance, risk assessment, internal audit. »*Significant management functions*« were those management functions performed below the level of the board of directors by, for example, the head of a business unit who has significant influence, i.e. significant powers and autonomy. Finally, »customer functions« include the investment adviser and investment management functions but not simply accepting deposits (SUP 10.10.3G).

On the face of it, the approved persons regime meant that the regulator had an extensive power of veto, and therefore powerful regulatory tool, over the careers of individuals working for the banks. The regulator's power to grant or to withdraw approval was based on whether the regulator was satisfied that the individual in question is a »*fit and proper person*« to perform the relevant functions: s.61(1), (2) FISMA 2000. This was supposed to be assessed by reference to 3 key factors:

1) honesty, integrity and reputation – no individual can be approved unless the FSA is satisfied that he intends to be open and honest in his dealings ... and that he is willing to comply with the requirements imposed on him and his firm by or under FISMA 2000;
2) competence and capability – the FSA expects the individual to have the necessary skills to carry out the function which he is performing or will be performing, and;
3) financial soundness – on the basis that if an individual is in financial difficulty, he may be tempted to put his interests above those of his customers in order to boost his own earnings.

In practice, the approved persons regime is widely acknowledged to have been a failure. It was a failure for three reasons. First, the sheer number of individuals for whom approval was sought was such that approvals were granted on the nod, rather than being considered properly. Second, the tests for competence and capability were not applied rigorously enough by the regulator. The first UK bank to experience a bank run for over 100 years, Northern Rock, was run by a chief executive, Adam Applegarth, and a chairman, Matt Ridley, neither of whom had any qualifications in banking.[33] Third, the focus of the approved persons regime was on individual behaviour. The Approved Persons Regime created the illusion of regulatory control over persons, however in practice meant that meaningful responsibilities could not be attributed to any single individual. By failing to define individual responsibilities adequately, it restricted the regulators' ability to take enforcement action, and prevented the FSA from holding individuals to account. Senior bankers could avoid liability for failings in the bank as a whole either by saying that they were personally ignorant of what was happening at lower levels in the bank

31. Will Hutton, »Thanks to the credit crunch all bets are of«« *The Guardian*, 27 February 2009 http://www.theguardian.com/commentisfree/video/2009/feb/27/will-hutton-capitalismcrisis.
32. Posner, Richard A. »A Failure Of Capitalism«, Cambridge, Mass.: *Harvard University Press*, 2009. Print.
33. Treasury Committee, »The Run on the Rock« (HC 2007-08, 56) 33.

or alternatively that the decision was taken collectively and therefore they are not personally culpable for its consequences. The result was, that as the UK's Parliamentary Commission on Banking Standards put it, »*a buck that does not stop with an individual stops nowhere*«.[34]

The Parliamentary Commission on Banking Standards emphasised that:

»Too many bankers, especially at the most senior levels, have operated in an environment with insufficient personal responsibilities. Top bankers dodged accountability for failings on their watch by claiming ignorance or hiding behind collective decision-making. They then faced little realistic prospect of financial penalties or more serious sanctions commensurate with the severity of the failures with which they were associated. Individual incentives have not been consistent with high collective standards, often the opposite«.[35]

This third problem has meant that there have been comparatively few punishments imposed for breaches of the regulatory rules prior to the financial crisis. However, in January 2015, two former senior executives of Martin Brokers were fined and banned for compliance failings related to LIBOR. David Caplin (former chief executive) was fined £210,000 and Jeremy Kraft (former compliance officer) was fined £105,000.[36] Both are also banned from performing significant influence functions at financial services firms. The regulator found that Mr Caplin and Mr Kraft's failings contributed to a culture at Martins that permitted LIBOR manipulation to take place and enabled the misconduct to continue undetected over a prolonged period. The two directors failed to recognise the risk of this culture developing and failed to take reasonable steps to prevent it.

Announcing the fines, Georgina Philippou, acting director of enforcement and market oversight at the FCA, said:

»Mr Kraft and Mr Caplin were responsible for setting the right culture at Martins and ensuring that the firm's risk management systems and controls were adequate to oversee its broking activities. They failed to do this. Proper systems and controls were non-existent and there was a culture at Martins where revenue came first and compliance was seen as unimportant rather than as an integral part of the running of the firm«.

34. Martin, Arnold. »Two HSBC Directors Quit In Protest Over New Conduct Rules«. *Financial Times* 2014. Web. http://www.ft.com/cms/s/0/a237eb26-4e12-11e4-bfda-00144feab7de.html#axzz3UBk5QiFw
35. Parliamentary Commission on Banking Standards, *Changing Banking For Good*. Web. http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/2703.htm
36. Caplin and Kraft agreed to settle at an early stage of the investigation and therefore qualified for a 30 % discount under the FCA's settlement discount scheme. Without the discount, the fines would have been £300,000 and £150,000 respectively.

The regulator has explicitly stated that this case »*should serve as a warning to everyone that holds a significant influence function that if a firm's misconduct can be attributed to cultural failings, then we expect senior management to answer for this*«. Despite the regulator's rhetoric, David Caplin and Jeremy Kraft are the first individuals holding Significant Influence Functions to be fined for failings that contributed to LIBOR misconduct and they were from a relatively small broker rather than one of the LIBOR Panel Banks.

3.2. The Senior Managers Regime

The failures by the Financial Services Authority led to its abolition in April 2013 and its replacement by two new bodies: the Prudential Regulation Authority (»PRA«) which only regulates banks, primarily with regard to their financial soundness, and the Financial Conduct Authority (»FCA«) which applies conduct of business rules across the whole of the financial services sector, including to banks regulated by the PRA. Whilst the UK has changed the regulator every time there has been a major crisis, scandal or failure in the last 20 years, such changes in the identity of the regulator have not led, in and of themselves, to a sustained improvement in the quality of banking regulation in the UK.

Of greater significance than the change in the structure of the regulators is the replacement of the Approved Persons Regime by the Senior Managers Regime and a Certification Regime.[37] These two measures are intended, in combination with a new Remuneration Code and Conduct Rules, to re-shape the corporate culture in banks.

The Senior Managers Regime is specifically designed to ensure there is an individual Senior Manager who becomes personally accountable for every aspect of a firm's regulated activity.[38] Banks now have to provide the PRA and the FCA with a Management Responsibility Map accompanied by a Statement of Responsibilities for each Senior Manager so that the regulators know exactly whose door to knock down in the event of regulatory breach.

37. The UK Treasury has announced that the Senior Managers and Certification Regime will be brought into force on 7 March 2016: https://www.gov.uk/government/-news/bankers-in-britain-will-be-held-to-tougher-standards-from-march-2016
38. The PRA lists 20 »Prescribed Responsibilities« and the FCA 27 »Key Functions« which need to be allocated to a Senior Manager who will be required to perform one or more of 18 Senior Management Functions. Significantly there will be a need to appoint a Senior Manager with personal responsibility for implementing the new Regime – to ensure the firm is fully compliant with it and personally accountable to the regulators if it is not.

Senior Managers must then assess and certify to the regulator on an annual basis (and any time a role changes) that those conducting functions that might involve a risk of significant harm to the firm or its customers, (including material risk-takers,[39] those currently performing customer-facing roles with a qualification requirement, and anyone who manages or supervises a Certified Person), are »fit and proper« to be »Certified Persons«. Under the new regime, Senior Managers are expressly responsible not only for their own behaviour but also for a specific part of the business' operation and for the integrity and competence of key members of the team in that area of the bank's operation.

What is more, under the Senior Managers Regime, the regulator no longer has to prove that a holder of a Significant Influence Function was »*knowingly concerned*« in a contravention or behaved in a way contrary to the principles for an approved person. This relatively high hurdle meant that there were very few bankers who were punished following the financial crisis, and each investigation was expensive and took a long time. Under the Senior Managers Regime, the burden of proof is reversed and therefore the Senior Manager has to show that he had taken such steps as a person in his position could reasonably be expected to take to avoid the contravention occurring or continuing – or otherwise face sanction.

The Senior Managers Regime is a clear illustration of how the financial services regulators in the UK are now trying to influence culture within banks. Senior Managers are seen as responsible for setting a bank's culture and are therefore placed under express duties both to ensure that all staff are fully aware of what is and what is not acceptable conduct for their specific function and to monitor and gather evidence that staff actually comply with these standards in their everyday interaction with customers, markets, colleagues and regulators.

Senior managers are to become »*mini regulators*«, assuming primary responsibility for the appropriateness of all the regulated staff at a bank. Effective management information, guidance and training to support a more robust approach to fitness and propriety will be key. Cultural change does not happen overnight but the shift in emphasis to personal responsibility and accountability is a huge step in that direction.

Although it is undoubtedly right that those who head a bank should bear significant, and primary, responsibility for setting a bank's culture, chief executives are usually in place for between 3 and 5 years, and changing the culture of the largest banks is like trying to turn around a super-tanker.

In practice, it is the middle tier of management which is the carrier of the corporate values in a bank. It is the decisions which middle management make about who to promote and who to reward which are likely to have the most important effect in terms of determining what a bank actually values and how it expects its people to behave in reality.

Moreover, attempts to change the culture in banks will only succeed if banks incentivise, reward and promote not those who make the most sales by disregarding the interests of the customer but rather those who serve their customers best.[40]

4. The cultural question

One of the most successful toys in the world, Lego, produced one of the most successful animated movies: *the Lego movie*. The villain in the Lego movie is Lord Business. Is this supposed to be post-modern irony, in which adults see the joke in being told by a major corporation that major corporations are the enemy? Or is the message actually more profound. What has made Lego such an enduring success? Lego bricks are fun to play with. Lego is a successful business because it produces goods which serve the essential human good of play. Lego succeeds as a business because it is effective at enhancing human flourishing by enabling children to enjoy playing.

Lord Business is the villain in the Lego movie because, unlike the company which makes Lego, he does not exist for any higher purpose other than business. He is the embodiment of the idea that the business of business is business. It is this question which lies at the heart of the current concern about the culture within banks. There are two very different conceptions of a bank: one sees banks as providers of financial services and the other sees banks simply as financial businesses. In the conception of banking as a finan-

39. Described by the PRA as »material risk takers« as defined for remuneration purposes under Articles 3 and 4 of the Commission Delegated Reputation (EU) No. 604/2014.

40. The Parliamentary Commission on Banking Standards, *Changing banking for good*: »There is little point in senior executives talking about the importance of the customer and then putting in place incentive and performance management schemes which focus on sales which are not in the interests of the customer. As long as the incentives to break codes of conduct exceed those to comply, codes are likely to be broken« (para .139). Available on-line at http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/news/changing-banking-for-good-report/. Accessed 18 March 2015.

cial service, the purpose of banking is to serve the common good indirectly by serving their customers directly, providing opportunities for liquidity and risk transfer which benefit their customers in ways which are sustainable because the bank charges a reasonable profit for its services. In the conception of banking as merely a financial business, there is no deeper purpose to banking: it exists purely for the sake of making money.

Yet, conceived of as nothing other than money making institutions, banks are problematic for two reasons: on the one hand, they benefit from an implicit or explicit government guarantee which means that the full rigours of capitalism do not apply to these most capitalist of institutions and, on the other hand, they have the capacity to generate enormous external costs for everyone else in the economy.

As we have seen, the shape of regulation can have an effect on the culture in banks, but the most powerful drivers come from elsewhere. Banks need to re-discover, for themselves, the importance of serving their customers and the intentional pursuit of the common good. Stephen Green, formerly Chairman of HSBC, has rightly pointed out that »regulation and legislation »are not and cannot be, sufficient without a culture of values«, not only for individuals but also for the »institutions of capitalism – businesses, banks and other institutions of the financial markets«.[41]

5. Conclusions

The takeover by the UK retail banks of investment banks in the late 1980s led to the development of a culture of aggressive sales, with an emphasis of short term profit-making regardless, or to the detriment, of the interests of the customer. Banks exploited the detailed rules where doing so was profitable, they ignored the detailed rules where the rules inhibited profit-making, and there was in a number of areas, a complete disregard of the rules which led to unethical and dishonest conduct becoming normalised.

The forgotten truth that markets are not purely natural phenomena has been revealed by the financial crisis. Markets are dependent on, sustained by and shaped by, the existence of social attitudes, accepted standards of behaviour by market participants, and the enforcement of laws which reinforce those attitudes and behaviours. The efficient markets hypothesis has proved

41. Green, S. (2011) »Good Value: Reflections on Money, Morality and an Uncertain World«, *Penguin Group*: London. p. 132

to be unsound, at least in relation to the financial markets which exist today.[42] As the last half century has taught us, financial markets are necessary to sustain economic growth, but financial markets are not self-righting,[43] at least not without unacceptably high economic and social costs.

The disastrous decline in the cultural standards in the UK banking community has been well-documented. It resulted from self-serving interpretations of the doctrine of the invisible hand and the efficient market hypothesis which allowed those exploiting their customers to see their own actions as amoral rather than recognising that they were immoral.

The approved persons regime which the UK regulators were supposed to use to ensure that bankers were honest, competent and would act with integrity has been widely acknowledged to have been an abject failure. It is to be replaced by a new UK Senior Managers Regime which is expressly intended to change the culture of banks. Doubts have, however, already been raised about whether it will do so.

42. Frydman and Goldberg, »Flawed theories that have brought disastrous results«, *The Times*, 9 November 2009, available on-line at http://www.thetimes.co.uk/tto/-business/economics/article2151296.ece; Soros, »One Way to Stop Bear Raids«, *Wall Street Journal*, March 23, 2009, http://online.wsj.com/article/SB123785310594-719693.html; Ferguson, »The Ascent of Money: A Financial History of the World«. London: *Penguin*, 2009, 347-48; Green, »Good Value«, 1; Aglietta and Rigot, »Crise et rénovation de la finance«. Paris : *Odile Jacob*, 2009, 49.
43. Turner, »Responding to the financial crisis: challenging past assumptions«, Speech at the British Embassy in Paris on 30 November 2009, http://www.fsa.gov.uk/-pages/Library/Communication/Speeches/2009/1130_at.shtml, 1.