A CALL TO ETHICS

By David Lascelles

Greed, short-termism, bonuses, the hard sell. Britain's financial services industry may be booming, but it has been getting a bad press. Judging by the newspapers, the public sees people in finance as objects of dislike: wheeler dealers who cannot be trusted, who grossly overpay themselves, who will do anything for a buck, even to the point of destroying whole communities by stripping their assets and cutting jobs. This animosity is stirring politicians to set up strings of inquiries into alleged misdeeds, and regulators to pile on even more rules to keep the business in order.

A caricature, certainly, but not one that can be ignored. The fact that the UK's financial services sector now ranks among the country's most successful industries – and in many respects leads the world – does little to allay public concern that it is ethically suspect, that it lacks standards of decency and good behaviour, and that it is driven by selfishness and greed. When the authorities announce new measures to discipline financiers, they are greeted with applause rather than with a caution that these might damage an industry which employs hundreds of thousands of people and delivers billions of pounds worth of overseas earnings.

Public mistrust, it must be said, has its roots in patches of fertile ground. There have been enough scandals in recent years to justify a certain degree of cynicism in the man in the street: endowment mis-selling, raids on pension funds, overcharging, dodgy investment products, fat cat pay-offs. This mistrust has been overlaid more recently by controversy about the activities of the private equity crowd – little understood outside their hectic specialist world – whose huge influence seems to be matched only by their secretive ways. There is also a suspicion, even among those close to the business, that the financial world really doesn't care about ethical behaviour because all that matters is profit. Profits are easy to come by in an industry which appears to be cosy and uncompetitive.

In many ways, all this is highly ironic because there has never been a time when the UK's financial services industry was more conscious of the need to behave responsibly, and of the importance of instilling ethical behaviour into its practitioners. There is scarcely a bank, a fund management firm or a stockbroker in the City which has not devoted a great deal of time and resource in recent years to developing codes of conduct, setting up ethical compliance machinery, even forgoing business opportunities that might have generated a handsome profit but would have breached some self-imposed ethical ordinance. Trade organisations, professional bodies and even the financial regulator have all played their part in reinforcing this process.

This transition has not been easy for the City, coming as it does from a tradition of clubbishness and self-regulation, with a low tolerance of outside interference and moralising. In the old days its famous motto "My word is my bond" provided a guarantee of integrity, but the reality was a rather murkier world where people set their own rules, and frequently ignored them "because everyone else does". Insider trading, front-running and conflicts of interest were commonplace though also, it has to be said, perfectly legal. Although professional standards were applied to the City's affairs, these were narrowly based. The concept of ethics with its connotations of values and widely accepted standards of behaviour did not have much currency. Transparency and accountability were conspicuously lacking.

With the tradition of self-regulation so deep-rooted, it took more than ten years from the 1986 Big Bang – when the modern City can be said to have been born – to get the rules on to a statutory and more open footing. Only then did the City begin to evolve business standards that could be described as transparently created and publicly accountable, covering ethics, corporate governance, disclosure and a host of other aspects reflecting the spirit, not just the letter, of the law. And these were not merely ethical principles as the City chose to understand them, but ones which were approved by broad strata of society. The City's contemporary approach to ethical issues needs to be seen against this background which, though now largely obliterated, accounts for the resistance that is still occasionally encountered among its members to the idea that they should behave like everybody else.

But, by dint of an enormous amount of work, the City can now be said to have a well-grounded system of business ethics which is as good as any in comparable financial centres. One of the tests is what happens when people contravene it. Where previously such behaviour would have been met with nods and winks, it is now a grave disciplinary matter which can cost people their jobs. At the international level, London may have had its scandals, but it has been spared its Enrons and dotcom busts, and is widely considered to have established a more solid ethical framework than Wall Street; one where ethical codes are respected, where shareholders have a bigger say over management in areas like pay and the appointment of directors, and where governance is stronger. These are extravagant claims which could be exploded by a single major scandal tomorrow. But what can be said with certainty is that ethics has become serious business, a matter of top-level concern, and a subject of constant and evolving debate.

But is it enough? Almost certainly not, judging by the persistence of negative perceptions. If so, what more does the financial services industry need to do to regain public esteem and trust? And how can ethical standards be firmly grounded in an industry packed with highly motivated individuals lured by glittering rewards? Is it even possible for an industry which makes its profits by using other people's money to be viewed in a wholly virtuous light?

This is challenging territory. Taking the last point first, people will always mistrust financiers as a matter of social culture. But this is no reason for the City to let up on the ethical front, though it will make the task harder. Ethical standards, if they are to reassure a sceptical public, will always have to be higher and more rigorously enforced in finance than in other businesses which have the public "on their side", so to speak. The importance of capital and the financial system to the country at large imposes a particular obligation on the finance industry to behave in a responsible way, and public expectations are high.

"Is the City worse than other sectors?" asks Lord George, the former Governor of the Bank of England. "I don't think so, but it probably needs to be more conscious of the need for ethical behaviour."

But while public suspicion may provide a powerful reason for finance to look to its ethics, it is not the only, or even leading, driver behind the quest for high ethical standards. Depending on your point of view, ethics may be a matter of principle – something that all decent folk should embrace without question – or a matter of good business practice – something that all well-managed businesses should have – or both. It is not just a matter of public relations.

The City being what it is, the business case for high ethical standards is the predominant factor.

The central component of the business case is that finance is built on trust, people trusting financiers to look after their money, to deal fairly with them, to put their interests first – often at key moments in their lives, such as buying a house. As Lord George points out: "There needs to be a real appreciation that trust matters. If you don't have it, people won't use your services. It's very simple. If you want to prosper in the long-term, you must treat your customers fairly." Trust need not be simply about inspiring confidence in customers; it can also encourage co-operative behaviour and loyalty in them, which is good for business. "You should treat others as you would like them to treat you", says Lord George.

Some measure of the value of trust to a business can be gained by looking at HSBC, the UK's largest banking group. According to independent assessments, the brand value of HSBC is in the order of $15bn, much of which rests on its reputation for honest dealing and people's willingness to entrust it with their financial affairs. Stephen Green, the bank's chairman, says that "values are central to value, they are part of a sustainable business." Poor ethical management within the group could easily erode this highly volatile and intangible asset.

Ethical management is, however, a comparatively new discipline in which new challenges are popping up all the time. As the test cases and dilemmas in this book show, the issues can be complex, technically difficult and blurred by conflicting interest. There is the additional consideration in the City that money constantly lies in temptation's way, that individuals are highly motivated and competitive and that the City's hothouse atmosphere can lead people to believe they operate in an exceptional world where common standards do not apply.

According to Mr Green it has to be done with a mixture of controls and leadership. "You need a plethora of controls. But no amount of controls is sufficient with such a large and complex business. Ultimately, there is no substitute for leadership – for the board and top management to ensure that there is a lively sense of values at the heart of the place."

But if a strong framework is needed to create the values and shape the operating environment, the behaviour of individuals who need to be keenly aware of the firm's ethical position and to have the incentive to abide by it is also vital. How do you ensure that salesmen don't use unethical sales tactics, that the corporate finance teams don't suppress conflicts of interest for the sake of a deal, that the bank doesn't take on dodgy clients to meet sales targets? These are all questions that constantly challenge management. The answer is that you cannot provide 100 per cent guarantees. You must, therefore, have the best possible values and controls. "Do we get it right all the time?" asks Mr Green. "No. Do we have rotten apples? Yes. But it is all very different from the swashbuckling days of the 1990s."

HSBC has developed policy guidelines on lending to potentially controversial industries such as forestry, chemicals, water and armaments. On arms, the answer is simple: it doesn't lend to firms which make or deal in armaments. In other areas, it seeks reassurance that the borrower is a responsible entity which meets its ethical standards: if it isn't, the bank tries to persuade them. "We would rather find a way of working with them than cut them off," says Mr Green. "The NGOs (non-governmental organisations) support this approach because the alternatives can be worse. But there have been cases where we have turned business down." Mr Green declines to put a number on forgone business, but reckons it is worth less than the reputational value earned as a result.

But even close attention to ethical issues provides no guarantee in an organisation which operates in 76 countries. Mr Green points to a controversy that HSBC recently found itself in for lending to unsustainable Malaysian logging activities, which he puts down to a failure of controls. The revelation that HSBC lost money on lending to the sub-prime market in the US (mortgages for the underprivileged) has also raised questions about its ethical stance. But Mr Green stresses the positive: "If we didn't lend to such people, they would have to turn to the loan sharks. Big banks should not withdraw from these markets." Since HSBC runs a global brand, the risk is that taint in one country can quickly spread to another, faster than in companies which differentiate their brands from one market to another. This reinforces the need for tight ethical management.

The values themselves may be developed internally by institutions, but it has become important for the finance sector to show that these are not the product of the City club but have wider endorsement, for example from stakeholder groups, NGOs and even the regulator. This has given added impetus to internationally developed sets of standards, such as the Equator Principles for managing social and environmental risk in project finance to which most large banks now subscribe. Mr Green says: “The expectation now is that banks will be responsible in their lending. The Equator Principles have teeth. They ensure that questions systematically get asked.”

Few of the City’s financing activities have attracted as much criticism as private equity, the practice of acquiring companies for private investors in highly-leveraged deals and re-engineering them to increase their value for re-sale. The huge size of these deals – often billions of dollars – and the fact that they target household names like Boots and Sainsbury’s has set alarm bells ringing. What are the ethical principles behind these deals, which can cause tremendous disruption, job losses, but also bring fantastic rewards to shadowy operators and investors?

Lord George believes that much of the criticism that has been levelled at private equity is unfair and overlooks the good that this form of investing can do by bringing about change and modernising underperforming companies. “The private equity business feels that it can run companies much better than existing management. They’re taking a risk, and if it doesn’t work they lose money. When it works, it’s doing good for the economy as a whole, even if jobs are lost. You can’t just hang on to what you’ve got. We’ve learnt that that is a blind alley. It’s misguided. It’s why employment is higher here than in countries which haven’t seen that risk taking.”

Many of the criticisms of private equity focus on allegations of short-termism, the view that it is more about making quick bucks than turning companies round. Mr Green accepts that some of the private equity business is about asset stripping. “It happens. But not enough to condemn an entire asset class. I think it is simplistic to attack it.” Nonetheless, Mr Green is keen to ensure that negative perceptions of private equity do not taint the group as a whole. “I expect the head of private equity to think about the impact on the brand,” he says.

But even if the private equity business believes it applies high ethical standards to its business, it knows it has an image problem. Early in 2007, it set up a working group under Sir David Walker, the former banker and City regulator, to devise a voluntary code of conduct to appease its critics. This will be a challenging task for a business which prefers to keep a very low profile, yet without such a code it is possible that private equity could be severely hampered by public hostility, union opposition and, ultimately, political pressure.

Allegations of short-termism are not, however, confined to private equity. If there has been a long-standing criticism of the City, it is that much of its investment activity is geared towards short-term profit, to the detriment of business development over the long-term. While this criticism in the past focused on the economic impact, increasingly it is viewed as an ethical issue: short-termism is equated with greed, irresponsibility and obliviousness to the interests of wider stakeholders.

Mark Anson is chief executive of Hermes, one of the City's largest fund managers, and a leader on many of the ethical issues surrounding the asset management and pension fund sectors. Most people, he says, are genuinely interested in the long-term: asset owners, companies, employees. So why is there such pressure for short-term results? The usual suspects are stock market analysts, speculators, barrow boys and the media. But Mr Anson says people have been blaming each other for too long, and it is time for asset owners and public companies to "break out". One of the initiatives he points to is the Marathon Club, a group of institutional investors which encourages managers of pension funds and similar institutions to take a longer-term view by providing support and "how to" guides. "There's a growing consensus that this short-term approach has to stop," he says. Lord George also believes that it is becoming increasingly seen as a matter of commercial self-interest to take the longer view. "The best business takes the long view. Short-termism is short-sightedness."

While it is clear that City institutions have been responding to ethical pressure by developing and implementing much stricter standards, there have also been market and structural developments which sometimes make these issues harder to handle. One is the distance between lender and borrower that has been created by innovations in the financial markets. Instead of lending directly to borrowers, banks can now do so through intermediaries, for example by trading in credit derivatives, by securitising loans or by lending to private equity and hedge funds, who use the money to finance their own deals. This means that banks may not be able to enforce their ethical principles. According to Mr Anson, "We are moving from relationship to transaction-based banking. There is more money to be made that way. But it creates an environment where standards can decline."

The application of ethical standards is also a big issue for the fund management industry, though individual funds are usually only deployers of capital belonging to other people, such as pension funds, to whom the decision about how the money should be used really belongs. Some asset managers use this to duck responsibility for applying ethical standards to investment. Mr Anson thinks firms can be more proactive by drawing issues to asset owners' attention, by designing filters to avoid unethical investments, or by being more open about how they select stocks for investment. "You can't turn a blind eye. There should be some ethical obligation on the asset manager," he says. Like the banks with their Equator Principles, the asset management business has been implementing industry-wide principles under external auspices, for example the UN's Principles for Responsible Investment which encourage asset managers to build environmental, social, and corporate governance issues into their investment decisions.

But even here, complications emerge. How, for example, do you treat an investment in tobacco? For many people this is an ethical issue: tobacco is harmful, so it should not receive investment. Yet tobacco companies are very profitable and enjoy strong cash flows through all phases of the business cycle. This can be very convenient for institutions like pension funds which need to make regular payments to their members. Another question for fund managers is how much they should engage with the companies in which they invest. Mr Anson believes that funds should encourage companies to outperform the market, but not to change their business model. "We don't want to shut companies down. Who is to say what is a despicable company?" Furthermore, by excluding sectors or individual companies from the investment portfolio, investors could be damaging their interests, according to modern portfolio theory, which says that the more diversified a fund is, the better it is because it spreads risk.

However, one of the most difficult challenges currently facing the finance sector — as it enjoys the biggest boom in its history — is how to handle the controversy over soaring bonuses. Few issues have triggered as much public ire or raised such pointed questions about the ethics of the City. For people in finance, bonuses are not a question of ethics, so much as deserved reward. There has, therefore, been some astonishment about the strength of public feeling on the issue and a sense that it has been created by the tabloid press and will eventually go away. Certainly, there has been surprisingly little comment from the authorities and not much from political quarters. The City's Lord Mayor even wrote an article for the *Financial Times*, defending the bonus system as ensuring that London remains at the forefront of the international finance business and continues to attract top talent.

Nonetheless, there is considerable unease within City management because of the size of the sums involved and the ever-present danger that these could trigger some kind of regulatory or political backlash.

Lord George says that the problem lies mainly with short-term cash rewards, which the City needs to manage very carefully. "I have no problem with the principle of paying bonuses. But if you really want to have a long-term, trust-generating approach, the reward to individuals for their contribution should be structured in a long-term way."

It has long been recognised that fear and greed are what get financial markets going, and Mr Anson at Hermes points out that "a little bit of greed is good" because it incentivises people to outperform. "The problem," he says, "is a lot of greed, and a focus on your own wealth rather than the client's." Mr Anson, who is from the US, recalls visiting a company chief executive and noticed that the screen on his desk was tuned in not to the company's share price or even business news, but the value of his own stock options. "That man was simply not concerned with the long-term value of his company."

Dealing with the bonus issue presents City management with a particularly sharp dilemma. Mr Green at HSBC says that individual institutions are "prisoners of the market" because they have all got to pay fair compensation to attract and retain good people. "I find it impossible to defend it. But we could not possibly say that we are not going to pay the market rate," he says. One way forward might be to encourage people who receive large bonuses to handle them in a responsible way, spend wisely, donate to charity, and aid those less fortunate than themselves. Mr Green comments: "I think there's scope for the City to improve its image, and for others to point out the social responsibilities of those to whom much is given." Ultimately, however, this is more a matter of individual responsibility than of company policy or official pressure. Nonetheless, the bonus issue, and the manner in which it handles it, do give the City an opportunity to demonstrate to the country at large the level of its ethical awareness.