Capital Failure: Rebuilding Trust in Financial Services

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Until six years ago we lived in the `Great Moderation'. Macroeconomic outcomes were unusually good. Light-touch regulation of the financial sector seemed to be just fine. But then things fell apart. A loss of trustworthiness was central to what caused the Global Financial Crisis. Repairing this trustworthiness is an urgent task, a task we address in this book.

The arguments of *Capital Failure* are very clear. The Great Moderation was underpinned by deregulation of financial markets, based on economists' belief that the self-interest of individuals would produce good outcomes and that markets are efficient. In principle, Adam Smith's 'invisible hand' was supposed to ensure this outcome. But, instead, the pursuit of self interest during the Great Moderation led those in the financial sector to behave in untrustworthy ways. Financial institutions neglected the interests of those who borrowed from them. Encouraged by inappropriate compensation schemes, they would only invest in projects which had high short-term payoff, or in speculative activities designed to achieve short-term returns. They sold unsuitable products, loaded those who borrowed with unacceptable risk and with unsustainable debt, extracted excessive fees, rigged markets, and defrauded clients. What happened in a largely selfish system, without an adequate regard for the interests of clients, produced very bad outcomes. The economy does not work well if the financial system cannot be trusted.

The authors of *Capital Failure* believe that - although individuals are usually self-interested - they also have 'other-regarding' motivations - desires for esteem, for the approbation of others, and for the genuine well being of others. This is an argument which was put forward many years ago, also by Adam Smith, and has been developed since by many others. Our book argues that the trust-intensive nature of financial services makes it essential to cultivate such motivations.

There is a pressing need for the financial services industry to become more professionalized, in a way which enables trustworthiness to return. How might those who work within the industry become more strongly bound by professional standards of behaviour - as is true of lawyers, and of doctors (who sign a Hippocratic Oath)? A culture needs to be established in the Financial Services Industry so that those who work within it act in the interests of their clients, and of society at large, rather than only in their own interests. It provides proposals for how this might be done.

Capital Failure has been produced by a group of authors who wanted to understand the problem and what to do about it. They sought to understand the way in which the financial system depends on trust, and on the ethical principles which underpin that trust. It became clear to us that the standard tools of economic analysis – based on an assumption that all behaviour is selfish – was insufficient to evaluate these crucial questions. What we needed was an interdisciplinary approach, providing insights from philosophy, law and history, as well as inputs from practitioners in the industry. All of these these insights are necessary if the reforms in finance are to succeed. Otherwise selfish individuals are likely to arbitrage away any reforms which are introduced.

Our wish for such an interdisciplinary approach coincided with the early development of the Balliol Interdisciplinary Institute (BII), the brainchild of Andrew Graham, then Master of Balliol. We are glad to acknowledge both the support of Andrew and of the BII itself.

Over a period of three years, a group of philosophers, lawyers, historians, economists, former civil servants and financial services practitioners met in Oxford to examine this question in detail. We considered the extent to which the attitudes and behaviour of managers and employees in the financial services industry actually contributed to the financial crisis, and how changes in such attitudes and behaviour might be achieved, in parallel to any regulatory changes. Our work included a series of seminars, held both at Balliol College under the auspices of the Balliol Interdisciplinary Institute, and in the Economics Department, and also with the support of the Oxford Martin School and Institue of New Economic Thinking. The participants examined philosophical, legal, historical, economic and regulatory aspects of the question. These chapters have been brought together in *Capital Failure*. Richard Lambert has written a Forward for the book which endorses its objectives; in May Lambert published a report recommending that a Banking Standards Review Council be established.

Capital Failure suggests a number of reforms of governance, and of legal and regulatory arrangements, to address the question of trust. These would seek to change the ethical culture in finance to one that reinforces other-regarding behaviour. Such proposals would encourage firms and individuals in the financial services sector to act in a more trustworthy manner by focusing on four key requirements: the appropriate definition of obligations, the identification of corresponding responsibilities, the creation of mechanisms which encourage trustworthiness, and the holding to account of those involved in an appropriate manner. Financial reforms at present lack sufficient focus on these requirements. The book explores how these requirements can be better met in specific parts of the financial services industry in order to bring about better outcomes.

We would like to express our gratitude to those who talked at the BII seminars in Balliol, and those who attended them and provided important insights. In addition to the authors of the book we would particularly like to thank Xuehua Bai, Wilfred Beckerman, Paul Davies, John Franks, Les Hannah, Bob May, Nick Monck, Jon Moynihan, Jaya Patten, and John Vickers.

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