Tacitus Lecture

Recovering from a Breakdown in Trust

25th February 2010

Master, Warden, Lord Mayor, Your Excellencies, my Lords, Aldermen, Sheriffs, Chief Commoner, Ladies and Gentlemen.

What a great honour to be invited to deliver the Tacitus Lecture in front of such a distinguished audience. Thank you for the invitation.

When John Adams gave a lecture in front of a similarly distinguished audience he remarked that he had never known such an intellect gathered in one room since his friend Thomas Jefferson dined alone! He would not have said that today.

When you asked me for a title I chose some months ago Recovering from a Breakdown in Trust. After reading and thinking around this subject I concluded that I would have been wiser to entitle the lecture Breakdown in Trust?

Let me begin by reading the following:

"A shocking crime was committed on the unscrupulous initiative of few individuals, with the blessing of more, and amid the passive acquiescence of all."

These are not the words of the inestimable Gillian Tett on the recent financial crisis but of Publius Cornelius Tacitus after whom your Annual Lecture takes its name. He was referring to ancient Rome rather than modern London.

It is however a description that many would endorse as a fair description of the events now increasingly characterised as the Financial Crisis, one that gets confused – perhaps sometimes conveniently – with the consequences of the underlying economic cycle. This Crisis was indeed the largest shock to public equanimity that has occurred in a generation; we in Britain would have to go back to the Second World War and Dunkirk to find such tangible fear in society, although 1956 came uncomfortably close to revealing the ebbing of public self-confidence in

Britain as a major power as our foreign policy stumbled in Egypt and the Soviet Union's seemed to be unstoppable in Hungary.

There is a widespread belief that with such shocks goes a breakdown in trust – trust in banks, for certain, but also in the governing and professional classes in general – indeed in any authority figures.

Dislocations of the sort we have just experienced to our reasonable expectations of the future provide a breeding ground for suspicions and, by an osmotic process that is difficult to understand, evidence to support these suspicions that would have been ignored in more stable times, appears in front of us daily. Just as when you learn a new word you see it everywhere so evidence for suspicion pops up from unexpected sources.

I am nonetheless not convinced that we have a crisis of trust but first let me just reflect for a moment on what I mean by trust. The most serviceable definition that I have found - from a work by Gambetta in 1998, *The Making and Breaking of Cooperative Relations* - is that trust is the <u>subjective probability that expectations will be fulfilled</u>. It is neither person nor circumstance specific.

I should, at this point, make clear that I am neither a social scientist nor a behavioural psychologist, although according to many friends, having taken on the chairmanship of Royal Mail, I am mad. You can therefore calibrate my remarks accordingly.

There is a view, widely held, that trust is not a survivable concept in freely competitive markets in any event. For example, in a paper in the Journal of Law & Economics in 1993, Williamson wrote about how transaction cost economics casts substantial doubt on the survivability of trust using the argument that under competition firms are under pressure to utilise any opportunity for profit. In an earlier work, *Markets & Hierarchies, Analysis and Antitrust Implication*s, he concluded that reliable knowledge on trustworthiness is impossible leading to a conclusion that decisions must be based on opportunism. Perhaps, he argued, the only way to identify loyalty is to infer it from observed behaviour. This is not a trivial point and in her Reith Lecture of 2002 Professor Onora O'Neill drew a most important distinction between statements about trust and behaviour from which trust can be inferred.

In a theoretically based study, Gorobets & Nooteboon showed that trust is viable in markets and indeed I would argue that the functioning of markets depends on there being a level of trust, for without it suspicion, in the absence of data-based decisions, would grow to the point where transactions would cease. Indeed in the functioning of the wholesale money markets that is precisely what happened during the Crisis as suspicion grew to a level which caused the money markets to cease to function as mutual suspicion over the state of counterparty banks' balance sheets passed a tolerable level. You will know as World Traders how important establishing trust is to your successful functioning.

Confucius said that "three things are needed for government: weapons, food and trust. If a ruler cannot hold all three, give up weapons first" he said "food next Trust should be guarded until the end". Many military dictators have been toppled although they had weapons; populations will endure lack of food – war time rationing for example – but only if they trust their leaders.

In our form of democracy trust is needed between the governed and the governors and between the regulated and the regulators. For all that we may be unsure about the trustworthiness of our politicians in general our society functions only because we are, as a population, broadly willing to accept the laws and framework established by those whom we elect. Our actions speak much more clearly than what we say. This is often true of politicians too. Effectively we place trust in those who govern us or we would break the framework of our society.

But today many commentators are constantly telling us about of a crisis of a breakdown of trust. Just listen to Governor Subbarao of the Indian Reserve Bank: "What the crisis has done is to cause a massive breakdown of trust: trust in the financial system, in bankers, in business, business leaders, investment advisors, credit rating agencies, politicians, media and in globalisation". Is it true?

The Royal College of Physicians commissions each year Ipsos Mori to conduct a general public survey to discover views of trust in the professions in 2009. Unsurprisingly perhaps it found that 92% generally trust doctors to tell the truth and only 5% do not. But the survey also said that only 13% generally trust politicians to tell the truth, a proportion that has fallen, since the 2008 survey, by 8%. 82% did not. And for other authority figures the results are not encouraging: trade union officials and business leaders are down at 38% and 25% respectively; government ministers at 16% and journalists, up from recent years, at 22%.

Business leaders registered their worst net score (that is, the proportion who trust them to tell the truth minus those who do not) since the survey began 27 years ago. And yet business leaders communicate to their workforces as though they are wholly trusted. So perhaps Governor Subbarao is on to something.

But for all that this is discouraging, the survey concludes that there is little evidence that "as a society Britain has become less likely to trust others to tell the truth. Average levels of trust across all surveyed professions have been relatively stable over the decade – although net trust has fallen somewhat" And that decade took in the Financial Crisis.

But I wonder if this is an appropriate measure of trust – is truth telling a useful measure of trustworthiness? I am more attracted to looking at actions and inferring trust from those than from this sort of survey.

After all it has long been a comedian's joke that no one trusts estate agents – yet we have not abandoned using them, although the emergence of on-line property markets may begin to provide evidence to support the absence of trust hypothesis. At quite another level we are fully prepared to drive our car at 70 miles per hour alongside and just two feet away from another driver doing the same in his or her car without checking first if he or she is an estate agent!

Furthermore if trust is the subjective probability that expectations will be fulfilled, we will calibrate our own expectations when dealing with someone that we trust very little. So we will lower our expectations and only trust such people less, even less, if they still fail to live up to that recalibrated expectation. Ultimately if we must deal with them they become a necessary evil.

Loyalty to such people may carry opportunity costs but may also yield economies from learning by ongoing interaction. Neither trustworthiness nor our willingness to trust, is a constant – it is adaptive, a function of experience.

In addition the incidence of trust does not follow a symmetric pattern. Increasing trust, once given, occurs incrementally but decreases in trust may occur both incrementally and in discontinuities. As the saying goes, "trust comes on foot but leaves by express train".

Let me give an example from my own world. Despite all the noise, the Royal Mail brand is a highly trusted brand. Everyday – six days a week

– Royal Mail delivers around 72 million items to around 29 million addresses. When a customer posts a letter he or she has a high expectation that it will arrive next day and the independently verified statistics show that he or she is right to place that trust. But that trust has to be earned and re-earned every day, and for someone whose letter goes astray, that trust is rapidly damaged no matter how many good experiences he or she has had.

And this trust is not just placed in the institution but in the postman or postwoman who delivers the letter or the packet, which of course is why we take such a hard line with anyone who betrays that trust. The desire to serve the customers comes not just from corporate exhortation but also from within the individuals in the enterprise. I will come back to this theme.

As Roderick Kramer has pointed out in the Harvard Business Review recently, all this trust is natural. We enter the world "hard-wired" to trust, we are born to trust other mothers, "to be engaged and to engage others…The tendency to trust made sense in our evolutionary history."

And now the new field of neuroeconomics has found that oxytocin, a natural chemical in our bodies, can boost both trust and trustworthiness.

Kramer quotes research that shows we over estimate our ability to assess others; we underestimate the chance that bad things will happen to us and overestimate the likelihood that good things will happen to us.

So to return to Tacitus' words: "A shocking crime was committed on the unscrupulous initiative of few individuals". Perhaps we could just as easily have been speaking of MPs' expenses as of the Financial Crisis. Many feel betrayed in both areas because they placed trust (misjudging expectations of fulfilment) in both our financial and political systems. Is the resulting anger just the boiling over of temporary frustration? Or is there indeed the beginning of a breakdown in trust so fundamental that it needs us to reappraise our whole approach?

I think we have to separate out the crooked from what I call, the collectively misguided. Let me explain.

Bernard Madoff set out to betray trust somewhere along the way – indeed to use and encourage misplaced trust as a business strategy. Our correct response to this is to be more alert to such criminal intent when placing trust and public censure and punishment for those who abuse trust in this way. The same principle applies to Members of Parliament who made false expenses claims when they had not incurred the expenditure.

The collectively misguided, on the other hand, is born in an environment of trust in an entire system. It is the result of circumstances where no individuals or few individuals deliberately set out to betray trust but the results of mass collective action are different, wholly different, from the expectations of all society, including those now identified as culprits. Nonetheless the consequence is at best divisive for society and at worst deeply damaging.

Tacitus describes in one paragraph in his Annals, Book Four, both types of betrayal of trust. He records that Pedius Blaesus was expelled from the Senate for violating the Treasury of Aesculapius and had tampered with a military levy by bribery and corruption. Nothing new there. He also records that the people of Cyrene felt betrayed when land bequeathed to them by King Apion was adjudicated to have been justifiably seized from them. The system in which they had placed their trust, after proper process, had proved not to justify their trust.

If you accept this distinction then finding someone (or a class of people) to blame for the Financial Crisis in general (or MPs expenses in general) is much more difficult. There was no overall architect or evil genius behind either. Indeed in many respects we were all involved.

I vividly recall one industrialist who was railing against the bankers for causing the crisis. I asked him what he was doing now. He explained that he had sold his business, at the top of the market, and was looking at new opportunities. He did not like when I said he was a beneficiary and willing participant in the bubble too and had been very happy to take advantage of the misvaluation of assets and risks that accompanied that period and for whom in his view only the bankers were to blame. We all enjoyed the boom. Just as we all acquiesced in underpaying our Members of Parliament.

So Tacitus' words "shocking crime" may not be appropriate after all but his other words "amid the passive acquiescence of us all" has an uncomfortable ring of truth about it.

It is difficult to argue that there has been a total breakdown in trust. Whatever they say about who they trust people still deposit their money in banks, relying, if not on trust in the bankers themselves, then certainly in a belief that in the end politicians can be trusted not to let their banks fail. Indeed at some point we just have to trust someone.

I think, although recent events suggest some growth in untrustworthiness, what we are witnessing is a growth in suspicion. In the information age through which we are now all living the spread of suspicion is more efficient and rapid than ever before and, given that in the transmission of information by citizens there is no obligation not to deceive, there is also no check on its veracity. Indeed Professor O'Neill asserted the drive for transparency has marginalised the obligation not to deceive.

Does all this matter? I think it does. Our freedoms are hard won and should be vigilantly guarded. Free markets have brought prosperity to millions, open trade improves total wealth and an innovation culture has revolutionised the world with communications and transport opportunities few could have dreamed of a century ago.

But as Alexis de Tocqueville argued the French Revolution happened long before it happened. The moralist, Parker Palmer, has further argued that the eruption that was the Reign of Terror in France was the direct result of "small seismic shifts" that had been accumulating deep underground in French society for decades. If people had paid attention to the tectonic instabilities caused by greed and injustice and had responded wisely to these warning signs, the explosion may have been avoided.

There are some little warning signs around today, insufficient to be wrapped under the clichéd banner of a Crisis of Trust, but there nonetheless. The ratio between top and bottom pay is becoming dangerously large – this is not a question of jealousy, rather it is a question of inherent fairness. How do you trust someone whom you regard as unfairly rewarded?

The debate over bankers' bonuses is caught in so much hysteria that it is difficult to disaggregate. Bankers' bonuses did not cause the Financial Crisis; it was the objectives they were trying to achieve that contributed, in part, to the outcome. Nevertheless if the rest of society is to underwrite their risks then it has the right to ask in return for fairness in their rewards. Again how do you trust someone you regard as unfairly rewarded at your expense?

It is too easy to fall back on the arguments about the marketplace for talent. The same arguments were used about the marketplace for slaves.

It needs leadership and moral courage to help allay the growing atmosphere of suspicion.
Is the MPs' expenses scandal another manifestation of the same problem? How do you trust your law makers if they are less than honest about their expenses? And how do you trust business leaders or bankers or politicians to tell the truth?

Are these the same little warning signs that with the benefit of hindsight some decades from now we will be seen to have ignored?

Our normal reaction to such concerns has been to call for greater respect for individual rights, demand higher standards and levels of accountability and greater transparency. Accountability has been growing steadily with more and more detailed interference from target setting and yet so is suspicion – have we got the concept of accountability wrong?

Let me consider one example. There has been a great call for more accountability for ratings agencies. Their ratings in the meanwhile have become more and more embedded in capital adequacy rules and in covenants for capital issues. Investment managers are circumscribed in attempts to protect their clients by rules about the types of securities in which they can invest defined by using their ratings.

This removes responsibility from the professional and places it in the hands of administrators of rules.

And what has happened? - There are more and more calls to regulate the ratings agencies, to set rules for their internal conflicts and no doubt standards for their ratings' processes. Conforming to rules, meeting targets, responding to that chimera "best practice" become more and more important than professional service and judgement.

Much of the activity that increased risk in the financial system was carried out in regulated firms and without breach of the rules. Investment managers lazily, but not breaching regulations, relied on credit ratings instead of doing their own research and forming their own judgements, upon which they in turn could be judged. Their clients may even have thought that is what they were paying for. This atmosphere of accountability at a micro level is undermining the personal responsibility needed to underpin necessary trust.

I agree that governance must play a role in creating and shaping desirable behaviour. As Mark Goodridge of ER has written in its journal this month “behaviour cannot be regulated; it all boils down to personal choice”. Jus so but I disagree with Sir David Walker when he says in his recent report that behavioural improvements can be achieved “through clearer identification of best practice …” I am tempted to say – there we go again, it will be alright as long as we can show we are following so-called best practice whether we think it right or not.

Best practice is an odd concept. It implies that there is one superior way of carrying out an activity. In any system populated by the interactions of thousands of human beings there will be an enormous number of ways of carrying out an activity or achieving a goal. Who is going to decide which is best? Best practice should be what is right for me at this moment in these circumstances with these resources, Imagine what best practice would look like for a football team.

The result is that best practice becomes a tool used by those with particular concepts of how activities should be conducted. It stifles change.

To illustrate my point another way boards are now encouraged under the FRC code to have a remuneration committee, a nomination committee and an audit committee of non-executive directors. This can work perfectly well but it can also have the perverse effect of creating information imbalances between non-executive directors. Indeed it almost encourages some directors on some issues to take a view that they need not fully understand a particular issue in depth because a particular committee is looking at it.

How can you know what is going on if you do not participate in the discussion with the auditors (that you have appointed) at the audit committee and rely on an abridged description of the proceedings at a subsequent board meeting?

I do not make a major case for or against the existence of such committees but I do resent the concept that having them constitutes best practice and that is it necessary to climb over a mountain of suspicion in consequence to justify not having them.

We should not outsource our own responsibility to earn trust to codes of best practice behind which lazy owners can hide and avoid engaging in thoughtful analysis and judgement about the stewards of their investments.

It does however seem to me to be wholly legitimate to ask, as Paul Volker and President Obama have, whether it is possible in a financial system designed to intermediate and provide services to customers, at the same time to transact for oneself as well as for one's customer. I see nothing wrong with proprietary trading for its own sake but I have always struggled to understand, on the scale practiced in recent years, how the inherent conflicts between trading for yourself and for your client can be fairly reconciled so that you can be trusted.

This is a different point from the casino bank and moral hazard point.

Indeed the growth of boutique advisory businesses in the last decade suggest that the growth of suspicion amongst clients of integrated investment banks had reached a level where, for some activities, some clients were no longer prepared to place their trust in the way they had hitherto.

I am sure if trust is to be restored, the long and difficult task of attempting to define the boundaries of proprietary trading and client facilitation needs to be undertaken with, in the end, a different ownership structure for the different activities. And to those who say that this may increase the cost of government funding I would like to ask that the cost be balanced by the cost of a continuing growth in suspicion hanging over our Western intermediating institutions.

I commented earlier that trust in the Royal Mail comes from trust in its individual postmen and postwomen. The same needs to be true of the banks. The role of the board in governance needs to be less about meeting rules and more about ensuring the employees have the right objectives and values to meet their clients' needs. The objectives that run counter to the interests of the clients – loosely characterised sometimes as some aspects of transactional banking rather than relationship banking – need to be curtailed by the boards. Tescos did not build their success on hedging food prices but by satisfying customers. I know that there are important differences but at the end of the day unless bankers expect to get rewarded from moral hazard, they must reorient their objectives to satisfying clients. Justifiable bonuses will then be the result.

In our world today transparency is here to stay and so the information on which suspicion breeds will also affect us all. Inevitably all institutions will have to learn new ways to build trust to avoid having information asymmetry about failings drowning out the vast majority of good outcomes experienced by customers and stakeholders. Learning to communicate quality in new ways (and other measures of success) in a balanced way may become just as important in gaining trust as satisfying regulators.

So also will innovation be with us – whatever our financial regulator may think. Economists will argue that under innovation, uncertainty is greater, contracts are more problematic and the need for trust increases .

If we are to recover or improve trust we also each need to take our own actions. We do not just have rights we also have obligations. Immanuel Kant defined this rather well seeing duty as the basis of rights and of justice, a view of which our entitlement society seems to have lost sight.

So, for example, users of financial services cannot claim to be victims if they have exercised no common sense or judgement in seeking a product. Of course, there is an information imbalance but that does not absolve consumers of any responsibility for their actions. The producers have rights too balanced by duties of customers just as the other way about.

As Professor O'Neill puts it in her lecture on the *Philosophy of Trust* "well placed trust grows out of active enquiry rather than blind acceptance".

I have said that much rests on personal responsibility and Roderick Kramer's timely paper *Rethinking Trust* suggests some ways in which each of us can improve our ability to trust wisely. Amongst other things he proposes that we should make an effort to know ourselves – after all our calibration of others' trustworthiness starts with our calibration of our own. We should not place immediate, full trust but learn as we go. We should understand how we can disengage early from a relationship before placing too much trust. We should send strong signals of what we value and our willingness to support these values. We should understand others' pressures and perspectives and, perhaps most importantly, we should always be questioning and vigilant. I would add that we should also do the right thing and this will affect those around us.

We all need to trust and to be trusted because all guarantees are incomplete.

We also need to think less about transparency and more about avoiding deception.

In conclusion, I do not believe that there has been a crisis and breakdown of trust but unless we all take care the consequences of rising suspicion hold dangers for all of us, for our liberty and for our prosperity. As individuals we can do something about this – whether boards or individuals, we are not powerless.

When preparing these remarks I spoke to one friend who told me his brother when seeking to obtain planning permission in a European Union country for a property, refused, when asked, to pay a bribe to the relevant official, saying it was wrong to ask for one. He was not prepared for the official's response "but, sir, how can you trust anyone who does not accept a bribe?" It was then that I learned that concepts of trust that I have attempted to discuss this evening are much more complex than I thought when I began and that phrases like "catastrophic breakdown of trust" are careless and inappropriate for our circumstances today.

On a positive note with which to end, the 2010 Edelman Trust Barometer has reported a modest global rise in trust in business and government – surely an important factor in underpinning world trade.

It has been said of Tacitus that he was more interested in promoting a "rhetorical flourish-filled moral agenda as recording facts". I hope I have not fallen into the same trap but instead have wisely placed my trust in you in the hope that you will have found some food for thought in my remarks.