



## “CULTURE AND STANDARDS - PUBLIC AND PRIVATE SECTOR”

Lecture by

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Chaired by: THE RT HON DAVID DAVIS MP

### LORD GUS O'DONNELL:

You will be pleased to know there are no slides and there will be copies of this lecture available later, so do not worry about taking notes. It will all come through in the end. I want to draw on my experience, which David very kindly referred to - and white hair, come on - you win!

THE CHAIRMAN: I did say grey!

LORD O'DONNELL: --- draw on my experience of many decades in the Civil Service and my much shorter time in the private sector as an adviser to TD Bank, Toronto- Dominion, as David knows it, in Canada, and as Chairman of Frontier Economics in the UK. I want to use this experience to consider the challenges posed in changing the culture in UK banks. I have learned a lot from reading the Banking Standards Review by Richard Lambert, the Salz Review, various reports of the Parliamentary Commission on Banking Standards, but, just to be clear, all the views I express today are my own and do not necessarily reflect the views of any of the above-mentioned organisations. I put that in!

Let me start with the Civil Service. It has existed for over 170 years. Its culture has changed massively over that period. It started life as a corrupt, incompetent organisation, as highlighted by the Northcote-Trevelyan Report in 1854. It has evolved into a meritocratic institution with cross-party support for its values, as shown by the passing of the Constitutional Reform Act at the end of the last Parliament, and exemplified in a recent House of Lords debate prompted by Lord Hennessey of Nympsfield, Peter Hennessy to all of us that know him. Of course, the Civil Service is far from perfect and needs to keep adapting and improving to meet the needs of government in the 21st century.

Let me go back to when I joined the Civil Service in 1979. I do not remember receiving a Code of Conduct or of much talk about culture. I came from a very different culture, that of academia, I had been a lecturer at Glasgow University, and I was aware of very significant cultural differences. First and foremost, in government, the end product was about devising and implementing policies, not simply publishing interesting work, which was the university culture. There was little talk about values, but behaviours were drummed into you by colleagues as “This is what you do in the

Civil Service” and “That’s the way we do things”. For example, you do not publish articles critical of the Government that employs you, something I tried to do in my early days. You do not speak publicly much at all and certainly not about politically sensitive subjects. You are heard internally, not seen externally. Debate was encouraged and very non-hierarchical, but the process of advising ministers was much more controlled. Departments varied in how far their junior civil servants were let loose on ministers, and while I found this frustrating at first, over time, unsurprisingly, as I moved up the hierarchy, I appreciated the need for a certain amount of quality control from above.

The Civil Service values, let’s talk about them, are honesty, objectivity, integrity and impartiality. The Civil Service has particular ways of inculcating these into everybody. It was routinely claimed that if you cut a civil servant in half, as the occasional minister much wanted to do, you would see the values running through them like Brighton rock. You were of course obliged to sign the Official Secrets Act, and this did bring home to me very powerfully the need for confidentiality. The vetting process also brought home a feeling that your whole life was subject to a certain scrutiny, and if you got into financial trouble, sooner or later, your employer would find out. I do not know how much these devices mattered, but the end result was that I never really met fellow civil servants who ever remotely considered selling information for commercial gain. This is not to say that a barrel containing over 400,000 apples will not have the odd bad one, but the culture was such that dishonest behaviour would leave you as an outcast. In the Civil Service, reputation and standing were far more important than how much you earned or your grade or where you actually worked.

I would not go quite as far as Adam Smith, one of my great heroes. I used to work in the Adam Smith Building in the Department of Political Economy at the University of Glasgow. Adam Smith considered it to be a far greater punishment to be pilloried than to be sent to the scaffold, so getting a reputation for dishonesty was, and remains, pretty crippling, particularly in the Civil Service.

We assume honesty in our Civil Service, but this is far from the norm around the world. I once remember going out to Kabul with the Permanent Secretaries from Defence, DfID and the Foreign Office, and I met the senior ministers in the Afghan Government to talk about running a Civil Service. They had one question which dominated all of the discussion we had which was: how do you stop corruption?

The interesting thing was I talked to them about the need to build the right culture, but that clearly was going to be very long-term, and you do not build that overnight. But it brought home to me the fact -and this is true of all too many developing countries - that they have almost set things up to guarantee corruption. If you set up a civil service with incredibly low pay and you set up your bureaucracy such that many of the transactions involve cash payments, you have all sorts of great seeking opportunities available, licences which can be handed out to various people; you will have a very corrupt system. There are lots of things you can do to change this. I have talked more about the question of ethnics in a lecture I gave, the Michael Quinlan Lecture, and if you want to go into that, I suggest you read that.

You are also taught from the start in the Civil Service objective methods of analysis. You are encouraged to be led by the evidence, not start from ideological views. Of course, objectivity is a much disputed term. Many would argue that all analysis is subjective and dependent on certain value judgments and frameworks. For example, when I joined the Treasury in 1979, it was a very Keynesian place, and it found monetarism, which was just coming in, very, very scary. The Treasury model was essentially built on Keynesian assumptions and - surprise, surprise - it gave you Keynesian answers. You were expected to provide rigorous evidence when making policy

suggestions. There is undoubtedly a bias in advice towards the prevailing consensus, which is why sometimes ministers get frustrated and look elsewhere for advice. If you look at large organisations, it is very important, both in the public and private sectors to beware of group-think or, when you are criticised externally, to fall back on that defence, "We are unique, we are somehow special, this does not apply to us." This is why good civil servants will always explain their assumptions and make ministers aware of alternative views. All this talk about the Civil Service Reform Act opening up to evidence from outside; actually that involves no change whatsoever. Basically, any good Civil Service paper should say, here are the different views, here is the evidence. The thing that the Civil Service does is look at it objectively with these values, so to give ministers the pros and cons of each individual piece but allow them obviously to look at whatever they want, so making ministers aware of alternative views, even if you believe them to be wrong, is a very important part of the deal.

That follows from the third value, integrity. For me integrity is that combination of honesty, objectivity and ethics, and it means you have to operate that way when giving advice to ministers and when dealing with the public, both sides of things.

David referred to my time as a spokesman. I started life as a spokesman for Nigel Lawson. A wonderful triumph! Within a couple of months he had resigned, falling out with Mrs Thatcher, as she then was, and I went on to be John Major's spokesman both as Chancellor and Prime Minister. It is quite a balancing act. That job requires you to present the Government's case as persuasively as possible whilst respecting Civil Service values.

Let me give you a concrete example. I remember having to argue why a Minimum Wage would increase unemployment and later, under a different administration, why a Minimum Wage would improve the welfare of the worst off.

The Civil Service must be objective and provide honest advice in private, but is required to make the case for whatever policy ministers have decided in public. Too often this subtle distinction gets lost on commentators who believe that the Civil Service believes in a particular policy simply because they explain its merits publicly. When we go before a select committee, which I did probably once a month, I remember appearing before David and John, to defend various Government policies, that was my job, and actually within Parliament that is completely understood, but outside I think it gets lost.

Those values of honesty, objectivity and integrity are shared by many organisations, but the fourth one, impartiality, is rather peculiar to the Civil Service. In the Civil Service we mean by impartiality political impartiality. There are professional groupings that have impartiality in slightly different ways, for example, the judiciary, but let me concentrate on the Civil Service.

For a senior civil servant to state their political allegiance on a public stage would be thought by all other civil servants to be bizarre and inappropriate. All civil servants have their private political beliefs. I would guess - although I do not know - they are rather more likely to vote than the average citizen, but they know they have signed up to a career of working for whoever you, the great electorate, of which I cannot count myself any more. I find myself disenfranchised, something I am very upset about. As a member of the House of Lords, I am there with the criminally insane and criminals, which is another debate we could have! But I have not got a vote in the next General Election.

Of course, there are some civil servants who discover along the way that they want to be much more politically active. They leave the Service with no ill-feeling. Indeed, it can be a great

advantage for a politician to have seen the Civil Service from the inside. There are lots of examples of that in our system.

In our democratic system, with a permanent Civil Service, impartiality is absolutely vital. If you want to move to a non-permanent Civil Service, as they have in the United States, where all the top ranks change as the administration changes, then you would move away from the impartiality, obviously. I would not favour that, but it is certainly feasible; you could do it and some countries do. So long as we have the current permanent Civil Service, it is vital to maintain impartiality so that civil servants retain the trust of all parties. For example, that means having the capacity to work with whichever administration comes in. That is why we have seen some rather silly comments recently about permanent secretaries should only be there thinking about implementing the priorities of the minister of the day. Of course, they should do that, that is their primary concern to implement the wishes of the democratically elected politicians, but actually they do need to preserve the capacity in the department, if, for example, the Secretary of State for Work and Pensions came and said, "Let's abolish all capacity to model pensions, get rid of PENSIM, the lovely model that we all use, the permanent secretary you could expect to not say, "Yes, Minister"; you would expect the permanent secretary to come back and challenge that. I do not think that is a dispute between ministers and civil servants. I think all ministers - nearly all ministers - would accept that.

These values are mentioned in the legislation and they are in the Code of Conduct, I regard them as necessary but not sufficient. In the 21<sup>st</sup> Century the Civil Service needs to demonstrate more than ever not only that it is operating fairly by those values but that it is also operating efficiently. That is why when I did my pitch for becoming Cabinet Secretary and Head of the Civil Service to Tony Blair, I basically, knowing he likes a good sound bite, what we need are the four Ps: Pride, Passion, Pace and Professionalism. We need to add these to our traditional values. The bit about pride and passion is we should be passionate about the public sector ethos. I want to attract the best people to work in the public sector and, curiously enough, I am not going to offer them the highest pay, but I am going to offer them a very really important, responsible job implementing the policy of the democratically elected Government, designed to improve the well-being of our public. So, pride and passion are really important.

Pace and professionalism to me were really important because if we go back to that past where we started off as the incompetent Civil Service, way back, actually one of the things that we had not really picked up on was professionalism, the whole gifted amateur thing, and pace. I personally thought we could do more on those and think we still can. That is an ongoing work in progress, I would say.

How do you set about inculcating the desired values into all your staff? First, in the Civil Service you receive the Civil Service Code, but more importantly you are asked every year in the People Survey whether you are aware of the Code, what do you think of it, what would you do if it is being breached and do you have confidence in whether anyone would follow that up. The numbers: 89% of civil servants are aware of the Code. This comes from a sample size of approximately a quarter of a million, so a pretty good evidence base. 89% are aware of the Code. Two-thirds of them are aware, if they had concerns about the Code being breached, how to raise those concerns and - and this to me is the most powerful one: two-thirds of those are confident that if they raise concerns they would be investigated properly. All of those numbers have increased from the first time we did the People Survey in 2009 up to 2013, so the ongoing process which I starting of making people more aware of all these issues is getting better.

Taking the fast stream, they have a special induction programme which introduces them to the

values so they set off on the right foot. The difficult group are later entrants who come in with no knowledge of Civil Service values and their own way of operating, inherited from their previous organisation. Any large organisation needs to be able to tackle that challenge. I found that the ex private sector people coming into the Civil Service found the notion of impartiality the hardest to get to grips with. They wanted to deliver for their minister and could not quite get where to draw the line on party versus government. This was one of the reasons I set up the Top 200 Group where we got a lot of people who had come as leaders from other sectors, particularly running agencies, to take them through, to inculcate with them the values. I wanted these invaluable new entrants to give, as it were, the “lifers”, people who had been in the Civil Service all their careers, the benefit of their more diverse, more commercial experience, but at the same time to pick up the particular Civil Service values.

In this process, we often hear another cultural problem. The private sector people had an admirable approach to maximising efficiency. However, there were times when this did not work for the public sector. I discuss this in more detail in my radio series *In Praise of Bureaucracy*. The problem is many public services need to be provided fairly, which means, at times, a loss of efficiency. For example, we all expect the Post Office to deliver letters to all parts of the UK for the same price despite the wildly different costs involved in delivering to different locations. Indeed, if there are not these sorts of issues, I would be asking should the service be delivered by the public sector at all? Why do we not just privatise it? In the UK, we have gone further than other countries in finding ways to deliver key services like the utilities, like water, using private sector suppliers in a regulated framework. The contrast comparing the UK and Canada, where nearly always these utilities are provided by the public sector often with price controls, we are, I think, some way ahead and - surprise, surprise - that new model now applies to the way we deliver our mail.

What are the weaknesses of this culture? I have talked about the strengths. The priority for fairness is at times difficult to reconcile with innovation. There are great examples of innovation in the public sector. David and I were talking about nudging. Some of the behaviour advances that we implementing in government are cutting edge, so we now have a model of the UK Nudge Unit being set up in the White House. I have just come back from Helsinki where they are thinking about setting one up in Finland. When I released my work on well-being and policy related to behaviour change, we launched that report in Berlin because Angela Merkel was really interested in the whole well-being and behaviour change agenda. We are doing innovative things in the public sector. Using crowdsourcing to find out where to reduce the regulatory burden was something that was going on quite strongly as I was leaving as Cabinet Secretary.

In general, the high cost of failure, as witnessed by various PAC hearings, and I have to say, David, that they have not got much better, in your time we would at least at times learn not just from failure but from success. We seem to have forgotten how to celebrate and learn from successes as opposed to pillorying failures. Innovation often means giving different services to similar people. Many regard this as a two-tier public service and therefore wrong. If we are to deliver meaningful decentralisation and innovation, which I strongly support, we need to be prepared for different levels of provision in different parts of the country. These of course are highly political issues and should be decided by ministers, but there are also inevitable difficulties for the Civil Service, for example, when we come across areas where the private sector people are used to having a leader in place for quite a long time. I remember, going back to the example of pensions, this is a multi-billion pound industry - pensions. You talk about pensions. You imagine if in the private sector the chief executive changed nine times in five years. I suggest that company would have gone bankrupt. We had nine Ministers for Pensions in five years. This is no way to run pensions.

I will come back to the lessons and I will try and bring it together when I have contrasted what I say about the Civil Service with banking. Let me turn to banking. There is little dispute that the UK banking industry has enormous reputation problems. Three-quarters of people believe banking has a bad reputation, only one in five trust bankers to tell the true and politicians in general know that attacking bankers is popular. This is hardly surprising given the scale of the financial crisis. UK banks were seen as being involved in casino banking with the risks underwritten by UK taxpayers. Yet, paradoxically, people say they trust their bank, and when it comes to where they put their money, they put their money with their bank. Trust is interesting in terms of what people say. As an economist, I am much more interested in what people do. What they do is they leave their money in. Question mark - what are the alternatives? I am now advising TD Bank, Toronto-Dominion, the second largest Canadian bank, and I was attracted to it by its values and culture. Its business model - and here I will quote the CEO Ed Clark's words: "Old-fashioned banking focusing on the customer's wants and needs; building long-term relationships; earning their trust and then their business. At the end of the day it is about creating value in the real economy." I have not heard that kind of quote in the UK.

How could such a bank survive through the global financial crisis and the competitive era of global banking? First they decided long before the crisis to get out of the structured credit derivatives business. They were the only bank in Canada not to sell structured asset-backed commercial paper. They refused to do sub-prime mortgage lending when they entered the US. They turned their securities dealer into what we would now call a 'Volker dealer', focusing on adding value to their clients, not treating them as counter-parties to proprietary trade. This demonstrates one important lesson. Just because "everybody else is doing it", does not mean it is right. You need some basic rules like - and this is a classic of Ed Clark's: would I recommend this product to a member of my family? You need leaders who have the right values and will apply their values to assessing everything that is going on in their area of business. As Adam Smith put it, it is a quote from the *Theory of Moral Sentiments*, my favourite book by him:

"Every faculty in one man is the measure by which he judges the like of another. I judge of your sight by my sight, of your ear by my ear, of your reason by my reason, of your resentment by my resentment, of your love by my love. I neither have, nor can have, any other way of judging about them."

The point of that quote is that we judge people by our own standards. If our leaders are judging their organisations and their staff by their own standards and their own standards are very low, then you are never going to get anywhere.

What did TD's decisions mean? It meant foregoing short-term profit to avoid future risks and to protect clients and customers, and they did indeed adversely affect their share price in the short-term. Instead they concentrated on being seen as the most convenient bank with the best service, and to deliver this they focused on culture, having highly motivated employees who believe in this vision. They worked hard at diversity. Over a third of their leadership positions are held by women. They found ways to support local communities and to celebrate, most of all, the awards they got for customer service, the JD Power awards, which ever since the beginning they have won. When I go to other businesses they celebrate their profits.

I can verify that they really live this culture. I have been there many times, but you might be wondering so how much does this cost them? Since 2002, they have delivered total shareholder return of over 15% per annum, well above their Canadian peers and more than five times higher than their US peers, so it is perfectly possible to be a customer-focused bank with strong values and be highly successful. I will let you in the audience work out what the shareholder return on holding

UK banks' shares would be. Slightly depressing!

All banks are facing a new challenge of how to ensure, as they move into the new technological era, that these benefits can accrue to customers, but they do not dehumanise relationships. As more and more customers bank primarily on-line and cease to visit their branches, the challenge is to maintain personal contact. It can be done. The UK bank with the highest reported satisfaction with service is First Direct, which has no branches at all.

The good news is that UK banks recognise the problems and are determined to tackle them. Douglas Flint, the Chairman of HSBC, recently explained:

“The greatest opportunity for improvement will come from defining, teaching, rewarding and enforcing values in terms of behaviours. This process will be underpinned by regulation, but the hope is that it will be achieved by self-regulation.”

Lord Sharkey and I were talking about this beforehand. Excellent words - we need to see the actions back up the words.

This brings me to the proposed Banking Standards Review Body. This will be an independent body, financed by the industry, which will have the job of promoting high standards of behaviour and competence. “Independent financed by the industry”. That reminds me of, going back to my press days, the Press Complaints Commission. The Banking Standards Review Board has a tough job. “Self-regulation financed by the industry” has for various reasons got a bad name.

The proposed composition of the new body, the BSRB, is a big step in the right direction. Indeed, Richard Lambert's report is commendable in terms of its aspirations. The question is can his exciting vision, as he sets it out, be achieved? The steps taken by Barclays under Sir David Walker's wise leadership are also big steps in the right direction. Commissioning the Salz Review was a brave step and will allow everybody to see if its recommendations are implemented. They are also adopting some of the devices I listed above and are trying, with others, to establish professional standards in banking. Similarly, Lloyds and Santander, as well as many of the new challenger banks, are emphasising customer service as the key to success in retail banking. If you want to know what a TD branch looks like in Canada, without going to Canada, go into a Metro branch. They have stolen a lot of TD's ideas - penny arcades and all the rest of it. However, one could argue that TD stole some of its idea from a bank called Commerce Bank in the United States which was set up by someone who is now setting up Metro Bank. So the best things come through whatever.

One of the difficult issues for the banks and the FCA is getting the balance right between encouraging competition without establishing a world where competitive pressures lead to mis-selling. This is made more complex by the nature of the banking business. The truth is that we, the Great British public, are not very good at making financial decisions. For example, people buy annuities that are not best for themselves. In the days when they were forced to, which will soon be behind us, people did not look around and they ended up buying ones that were a bad buy, staying too much with the incumbent. I applaud the Chancellor's move to free up the decision of how to spend your pension savings, but consumers will need help to make the right choices. More generally, a deep understanding of the way that consumers make financial decisions and the possible behavioural biases is crucial for banks and their regulators. The FCA is clearly aware of this and looks to me to be slightly ahead of other regulators around the world in engaging with banks to come up with solutions that benefit customers. But the regulator has a very difficult job in a world where customers may not know what is in their best interests. Rightly, customers might

not wish to spend a lot valuable time thinking through complex options. If you think about where should I put my ISA, and you are determined to have a cash ISA, you are not going to spend an enormous amount of time on 1% versus 1.5%. These are small numbers. When you look at it behaviorally, people are used to very large numbers. They are used to 50% off. When you look at 1% versus 1.5%, it looks like very small numbers. You do need to understand the behavioural stuff. I think that hugely important for the whole of public services and hugely important in banking.

There are some difficult ethical issues there. I wrote a piece in the *Sunday Times* on 27 April on the ethnics of nudging. I will not repeat that here, because I am running out of time, but anyone who is interested in that can go to that.

Let me come to conclusions regarding banking culture and bringing together the private and public sectors. First of all, recent developments have highlighted a need for a change in the culture of UK banking. I think we can learn a lot from looking at banks around the world, particularly banks like TD.

Secondly, banks can operate with strong consumer-focused values and be commercially successful.

Thirdly, banking is very unusual in many respects, particularly because customers can make decisions that are not in their own long-run interests. This requires banks and the regulators to understand what is driving consumers' decision-making.

Fourthly, try our codes, search for Official Secrets Act equivalents to remind bankers of professional obligations.

Fifthly, find ways to inculcate values into outsiders brought in from elsewhere, eg if you bring in US investment bankers.

Sixthly, having strong values creates a virtuous circle. The thing about TD is they make a big thing of their values. When you are hiring people, people think "I quite like those values", so then you have got this virtuous circle, where it is not hard to get the staff to have the values because that is what attracted them in the first place. This is the whole Civil Service thing. When we advertise the fast stream, we talk about values, and thereby you get the right people in so they have got them in the first place or they are very keen to have them. It is a virtuous circle, and I think that is hugely demonstrated, for example, in the private sector as well. My work at Frontier Economics, we sell to economics graduates the fact that we are an organisation that ploughs all of its profits back into the staff, and we have a very low profit line as a result, but we are very commercially successful and have been growing at 15% for 15 years. The reason we do that is that we advertise these facts and we advertise the fact that as an institution we put money aside for charity and we get staff to vote on which charities they would like to put it to. There are lots of things on remuneration that the banks could learn from that sort of area.

I remember talking to a very good friend who worked for a very big and successful investment bank, and I said, "Why do you guys always want these big bonuses?" He said, "That is our measure of success. That is how we tell whether we are doing well, whether we are valued and loved by the bank is the size of our bonus". When you think about it - and my well-being work shows this - being poor, yes, is pretty miserable but once you get to a certain level, those extra pounds do not add that much. There is a thing called the Law of Diminishing Margins in terms of income and, believe it or not, all the evidence backs it up. So why have we got into this world of ever-growing problems with bonuses? I would say let us think creatively how we could work. A lot of people take this money and then give it to charity. We can think creatively about that. It of course a



global issue but, fortunately, we have in Mark Carney a governor who is well-placed to manage trying to influential global regulations here and also understands the banking sector in Canada very, very well, obviously, and can bring those lessons to bear for the UK.

Remuneration as well - think about ways of remunerating people that are not money. When I was in the Civil Service I basically had no money. If we paid anyone a bonus of £10 the *Daily Mail* runs "A complete scandal!" because they multiply the £10 by however people who had got it and shock, horror! We had tiny amounts to give out when I look back on it. So what we did was non-financial awards. I am eternally grateful to the Queen and Prince Phillip, who basically hosted for us an event in Buckingham Palace for the Civil Service Awards, which were there to mark those civil servants who had gone the extra mile, who had been innovative, who had created new and efficient ways of doing things. Rewarding the people who live the values - it is hugely important that you do that.

Banking is of course very different. I am not talking today very much about the whole business of 'too big to fail'. Suffice to say I support the moves underway to separate out retail and other banking, and of course we need to find ways for UK regulators to get all of these things right without damaging London as a global financial centre. Let me stress the solution to all of the problems I have talked about goes further than getting the culture right. It is necessary but alas not sufficient for a healthy industry and we need a healthy banking industry to support the UK economy as it recovers from the financial crisis. Thank you.

THE CHAIRMAN: What a good note to finish on! Gus, I would just say a couple of words myself at the end here. Firstly, that was a most interesting lecture for me, it was fascinating, but part of our culture in Britain is that we do not take our own great institutions seriously and respectfully enough. As a Public Accounts Committee Chairman, I used to joke after five years of doing that job you think *Yes, Minister* is a comedy; I know it is a training film! But the truth of the matter is, as you said, when the National Audit Office produces reports on failures in public service, they always produce five parallels where possible. Some of those parallels are successes and we have some to be proud of, so it was a fascinating comparison, and I think one full of illustrations that the private sector would do well to take seriously. If you would join me please in thanking Lord O'Donnell. (Applause)