EMBARGOED UNTIL 6:30PM, 1 OCTOBER 2012

*** CHECK AGAINST DELIVERY ***

Rebuilding Banking: Stephen Hester address to London School of Economics Public Lecture Series

Good evening ladies and gentleman. Thank you for that introduction and many thanks as well to the London School of Economics for the invitation to come here. Tonight I plan to speak candidly about the job of recovering a failed global bank and the on-going transformation of the banking sector more generally. Our work at RBS and the wider reform agenda in banking is far from complete. So I am here to listen as well as to speak and will leave plenty of time for your questions.

I have had both an insider and outsider view of the banking crisis and its causes. From 2004 to 2008 I was managing a company outside the industry and from there was initially asked onto the new Board of Northern Rock after its nationalisation, and then from late 2008 have served as the Chief Executive of RBS. The bank is a British poster child for what went wrong in banking and to fix it we are engaged in probably the largest and most far-reaching company restructuring ever.

On the eve of its financial collapse RBS had a balance sheet of £1.6 trillion - which is about the size of the UK economy - and was relied upon every day by 30 million customers. This vital institution was resting upon a wafer thin capital base and had effectively run out of money to fund itself and its customers. As we all know, RBS, with many other banks then and since, was rescued by the state because the consequences of its collapse were thought calamitous for the financial system and the economy at large. Global banking reform is well on the way to removing the risk of a systemic repeat. But that is not my central topic tonight.

I was recruited to recover the bank's fortunes for all who rely on us. This meant restructuring the balance sheet and risk profile, changing the culture that had created that balance sheet and, crucially, ensuring customer service was maintained and over time improved. Oh yes and there is then the small matter of that £45bn taxpayer investment. We need to make RBS worth that and more to its shareholders so taxpayers can get back that money and put it to work on other things that matter more.

Along with 140,000 colleagues, we are trying to build a really good bank. I believe the best way to do this is to create a really good company – this is a theme I will expand on throughout my remarks. I first came into banking in the 1980s and the early part of my career was as an adviser to other companies which made me think deeply about what makes companies succeed. And during the era since then it can be argued that the definition of corporate success became dangerously narrowed.

To paraphrase Milton Friedman “the social responsibility of a company was to increase its profits.” That became the prevailing view and critics would argue it remained that way for banks right up until the 2008 crash. In my view the evidence points to a different and more balanced conclusion now and I will explain why tonight.

I have also given a lot of thought to whether or not banks can be thought of in the same way as other companies. Banks have very similar issues to other companies in most respects but they are also different because of the way they are funded and in the way they are geared to the economies they serve. Financial prudence, safety and soundness are important to a bank and to society in a way that was not well calibrated prior to the crisis - by banks or by managers of our major economies. This is where the banking sector has made the most progress since 2008 and I want to talk about that.

In exploring these themes, I will talk about how we set about restoring the battered reputation of the banking industry, and in particular, the topic of the hour “how to fix the culture of banks”. I will not be offering up a 20-point plan to fix culture at RBS. I think that in business enduring cultural change, like the desire to obtain a higher share price, is rarely best achieved when it is the primary goal.

My view for debate this evening is that if you create a really good company then you will get a really good culture. The process of getting it right is the product of a slow, deliberate and sustained march through a series of small things. Many of them are basic management disciplines. It is easy to say that a bank like RBS exists to put customers at the heart of everything we do. I know because I've just said it, but it takes a long time and there are many changes and improvements to attain and sustain. I will talk about some of those things tonight.

Banking matters. And while societies have long been wary of financiers, the current level of negative feeling is, in my view, particularly unhealthy. We need to reach a new compact with society where banks are better at balancing the interests of everyone who depends upon them. Only then can we expect some acceptance of the difficult trade-offs we face in reconciling what are often competing interests.

So where we are now?

Banking has been at the forefront of economic and public policy debates since 2008: blamed for the crisis; fingered for holding back economic recovery and back in the dock today for a wide range of cultural failings.

As a result, the pendulum of regulation and public attitudes has swung dramatically. And banks are changing - substantially. Of their own volition, and under unyielding public pressure, which is focused most in those countries where economic problems have been greatest. When complete, the industry's transition will still see it playing a central role in modern economies. And every bank and those who regulate them will need to have answered some basic questions about their institution:

- is it safe and sound?
- can it recover in a future crisis without Government capital?
- are customers and society served well?
- can it satisfy the requirements of its shareholders?

Since I came back into the banking sector in late 2008 I've said many times that banks can only be as sound as the economies in which they operate and they can only be as successful as their customers. It is rare to find strong banks in weak economies and vice versa. Banks are geared to their economies which bestows them with an extra responsibility to be safe and sound but also means they rely a lot on policy-makers to ensure economic health and stability. Banks are a messenger of good and bad economic management as well as principals themselves.

Where we stand today, a few years after the crisis hit, still feels uncomfortable to say the least. The critics claim that our industry cannot get things right. Most worryingly of all some would have it that after years of reform and change banks have made very little progress at all.

I believe that an impression of little progress is wrong. But I can entirely understand the public sentiment. The industry is currently revealing the last vestiges of its era of over-reach, through issues such as LIBOR and PPI and those scandals are bound to dominate public perceptions. The reality is that they represent the bill for damages rendered and dealing with them openly and directly is clearly necessary to enable the industry to move forward.

The impression that banks have not made progress in restoring safety and soundness is wrong. We have to remind ourselves that four years ago senior members of the Government worried that cash machines at RBS would run dry. Through much of 2009, global financial markets were riddled with paranoia and panic as rumours about hidden troubles could send the shares of seemingly reputable institutions tumbling in the space of an hour. And the question of trust was not "will banks do the right thing?," but instead "will they keep my money safe?". Today these issues are still being confronted in some Eurozone countries. Their issue is still safety. In the UK we are increasingly able to move onto other difficult topics in banking, as safety and soundness have vastly improved.

We can look just at RBS for evidence of how far we have come.

When we set out to recover RBS, there were three priorities which have been our guide each step of the way.

1. We need to serve customers well (and better)
2. We need to be safe and sound for all who rely on us

3. From the first two goals we need to fashion a valuable bank for shareholders and notably protect the £45bn taxpayers have invested and can't afford to write off.

So during the last three years we have tried to answer the existential challenge first and restructure the bank to safety and soundness. And we have also worked to sustain customer service during that challenge whilst also laying foundations throughout the business for doing a better job and becoming a better bank. Even in our most difficult moment, we began to restore customer service to the heart of our thinking. That's why we took early decisions to lengthen the period of grace available to customers who were struggling with mortgage payments and why we guaranteed the price and availability of overdraft funding to anxious SMEs. But we knew that would count for little if we did not also put the bank on a much sounder financial footing.

At RBS we have reduced the size of our balance sheet by £700bn - more than has been achieved anywhere else to date by banks or even governments and with huge streamlining of scale and scope. But at the same time we have actually increased lending in our core UK retail and commercial businesses, protecting customers who are also our future.

We have increased capital ratios from 4% to over 10%. To my earlier remarks, we have implemented a huge reduction in the balance sheet and a huge increase in the capital it sits upon. We have dramatically reduced dependency on wholesale funding markets and achieved the gold standard of banking, by taking as much through customer deposits as we make in loans. I will come on to cultural change in a moment but it's worth mentioning here that changing our funding structure is about more than metrics. It could only be achieved by changing the mindset of our bankers and having them think about customer relationships in a more sustainable way.

And along the way there have been massive reductions in support needed from Government - all emergency liquidity support (well over £100bn) has been repaid and the £300bn credit insurance scheme, APS, is coming up to its first potential exit point with no claim having been made and no need for the insurance to continue. The UK is better off and safer for these changes happening. Of course I accept completely that none of that support should ever have been needed had RBS been a really good company in the first place.

We have about 15 months of heavy lifting still to do to essentially complete the restructuring phase at RBS and to make good on the promises made in our 5-year plan. We are out of the mire but not yet out of the woods because we still depend on the health of the economies we serve today which in turn still face significant challenge. However, we face today's challenges with a financial strength that many people would have thought inconceivable just 3 1/2 years ago when we launched our turnaround plan.

The job of leading RBS has brought home to me in a profound way that the role of any CEO involves balancing the interests of the many people who depend upon a company. When those interests are competing - whether for time or resource - a judgement call is required and, while it's not the way to win popularity contests, one hopes that this will be met with understanding in most quarters.

Looking back to 2009-2010, at RBS we made faith in the basic solvency of the bank priority number one. We thought that was the best thing we could do for our customers, our regulators, our shareholders, our employees and the communities we operated in. But it was emphatically not our only priority and much has been and is being done to make progress on other fronts.

So most vitally, let me now turn to the question of whether we are serving our customers and society well?

It is possible to look at the many scandals that have hit banking in recent years and see them as individual episodes of bad judgement or wrong behaviours. In fact, I think it's more accurate to say that most of them are related to one big scandal: banks have simply not been good enough servants of their customers in the recent past.

The banking industry in the decade preceding the crisis was focused on income, it expanded too fast, prioritised sales over service and failed to properly balance the interests of its customers and shareholders with those of its managers. Hubris set in. Too much of the ethos became selfish - personally and institutionally. Of course market economies rely on self interest as a key mechanism. But it works best where “enlightened” or “sustainable” self interest is what’s pursued.

There is a basic truth about what makes a good company. Really good companies perform well for their owners, regulators, employees and communities if, above all else, they serve their customers well. You can have a number of different goals for your company, but at the core great businesses are driven by their customers’ priorities - by their customers’ values, goals and needs - and not by their own.

Let me give one example. Anyone who shops regularly in a supermarket can’t fail to have noticed the transformation in service in the last twenty years. Ask any member of staff for the most obscure item and they will stop what they are doing and take me to the item immediately. Banks have not kept the same pace in either service or product.

I should be clear that at RBS, the vast majority of our staff are focused very squarely on doing a good job for their customers. But it is also clear to me that we have to do more to nourish the very real care for customers that exists in RBS. And we have to do more to make sure everyone who works in our bank walks through the door everyday with the customer completely front of mind.

Banking needs to unambiguously recognise that its purpose is to serve customers well. And to serve them well in the context of their broader communities and the range of impacts that banks, as a huge industry, have on society - culturally and economically.

The point I am making, however, is that we must do more than treat symptoms – we cannot afford to just fix LIBOR, to just fix money laundering controls, or to just fix the way we market our products. We have to address the root cause of the industry’s failings. And that, for me, is very clearly the need for better focus on serving the customer well in our collective cultural DNA. That is the route through many of the “cultural failings” associated with banks today.

Now, I want to address those silent criticisms about words versus actions that may be swirling in the room. And I want to address my own argument that change in this area is achieved by doing many things over many years.

First, since 2009 RBS has already made progress in becoming more customer-focused. And these changes will have increasing visibility as they bed in.

- Improving support for our customers was the top goal of our strategic plan launched in 2009

- The service offerings across all of our retail and corporate divisions have been overhauled to be explicitly customer-driven.

- We are undertaking a major reform to the way we evaluate risks and strategy so that our ability to be there for our customers cannot be questioned in the future.

- We have reformed the way we pay our staff so that customer satisfaction and risk control rather than just profit determine whether or not you get a bonus and how big that bonus might be. I take to heart the sentiment that we should pay people to serve well not simply to sell well.

- Throughout our business we have instituted customer and reputational filters and controls that seek to examine what products and services we provide to customers through the lens of sustainability, transparency and fairness.

- In our investment bank we have pulled out of markets and businesses that were not connected to the priorities of the large corporate and institutional customers we serve.

- And even as we undertook the largest corporate restructuring in history with massive cuts to our balance sheet, we have grown our support for core UK Corporate and Retail customers.

The second thing I should say about the criticism of ‘ talk over actions ’, however, is that I agree. There is no question that we have to do more. And we need to make sure that what we have done translates into results. The changes I just outlined have been important, but much of it has focused on consolidating the existing cultural strengths present in our bank and taking care of what might be called ‘hygiene issues’ in areas of weakness.

If banks hope to ever be considered great companies again, the work to strengthen our customer culture has to be demanding, stretching, and continuous. At RBS that will include:

- Explicit customer charters across all our businesses, setting expectations and offering transparency and motivation on how we do against them. We began this work in our Retail Bank using “Helpful Banking” as our focus for staff and customers. We are going to extend the use of charters and make them more demanding at the same time.

- In our business bank we have piloted a retraining and accreditation programme for all of our front-line bankers to ensure they are better equipped to serve our customers. Banking is a profession and we need to take the professional training of our people seriously. The work in the business bank is encouraging and a similar programme is now running in our Wealth business, Coutts. We will do much more in this area.

There are many other things we are doing that I could highlight here. And we will still need to strike a balance between all the relevant interests in the company. We know that difficult and ambiguous challenges require actions which can never please all interests at the same time. Serving customers and society well at the same time sometimes means saying no to things our customers want. All businesses have complex service and pricing trade-offs between customers and across products. And our ability to fulfil customer needs and our role in society requires us to have good people. But I am saying that I see no way in which a bank can become a really good company without having the customers’ interest at the heart of its values.

Mention of values brings me back to the current public focus on the culture of banking. It ill-behoves me to talk about what we must do now to “fix culture” given my previous remarks. To summarise my position so far, I think that a really good bank must be safe and sound and it must put serving customers well at the heart of its thinking. All the things needed to make that a reality will in their own way build towards a culture that sees everyone in the bank striving to do the right thing, at the right time and for the right reasons. We should accept that there is something oblique about cultural change.

That said it is very important that included in the list of things to do are measures which clarify what doing the right thing means and ensure that in areas as important as conduct and ethics employees have something akin to a regular fitness programme. It is not enough to draft a code of conduct and stick it on an intranet site. So the Board of RBS are reviewing our code to make sure it reflects the ethos I have outlined tonight but most importantly that we can bring it to life with our people in the years ahead.

We have spent a lot of time since 2009 reforming the way we pay and incentivise our staff. It is perhaps fair to say that our focus initially was on reforming pay so that it better balanced the employee and the shareholder interest by, for example, paying bonuses in shares not cash and making awards subject to deferral and claw-back so that performance could be evaluated over years not months. Now our reform agenda has to go further so that pay also takes proper account of the customer interest. That means pay awards must be reflective of improvements in customer service and satisfaction and not just sales.

We will make governance changes too to reinforce active and transparent board oversight of customer, community and employee issues in our company.

If we get the next phase of our recovery plan right and succeed in balancing the interests of customers with others in a fair way then I think we will be well advanced in our new compact with society.

Conclusion

One of the things I've had to adjust to in the last 4 years is the huge amount of public interest in what we do and how we do it. A CEO expects to be in dialogue with their customers and investors. What's now clear in my job is that I as a CEO and RBS as a bank also need to be in dialogue with broader society. The public have higher demands of us in the reform agenda than other banks. It's taken a while to get used to that but we have come to realise that the almost unique accountability it brings is borne of a public desire for a different RBS to emerge.

We have tried to lead the way by being more open in our public disclosures and more accessible in our communication style. In the early years of our recovery plan we have focused on restoring safety and soundness to RBS. We probably saw this as the best thing we could do for the country. But the dialogue with the public is as intense as ever. And the relief that we are out of intensive care has given way quickly to a conversation about what sort of bank we will become. Are we on the side of our customers? And are we going to keep changing and reforming until people believe we can make a positive difference to their lives and the prosperity of the country? The answer to all of those questions is yes. We will try to.

Banks took Friedman's instruction to make money more literally than I'm sure he would ever have intended. The consequences were bad all round. The role of good companies and good banks extends beyond the narrow pursuit of profit. What I want to achieve with RBS accords more closely with an economist who is still around and entertaining us with his FT column. In a lecture like this given in 1998 John Kay described successful companies as:

"Organisations which serve the needs of their customers, provide a rewarding environment for those who work for them, which satisfy the requirements of those who finance them, and support the development of the communities in which they operate".

In the last 4 years I have come to understand the wisdom of Kay's description. There are 140,000 people at RBS trying to make this the reality of our recovery plan. To do it well we must every day seek to understand the interests of all of those who depend on our company, to understand the trade-offs we must make and to try and get the judgement calls right if we are to be a successful business again. When a company is recovering from the edge of insolvency those trade-offs can be acute. But that is why we have companies in our society. That is what they are expected to do.

I am confident we can build on our progress to this point. A strong, safe balance sheet combined with a culture that puts customer service at the centre of our thinking makes for a really good bank. It is also what will help us win back the thing that our industry rests on and cannot succeed without - trust.