# Topic 1 The banking ecosystem

## Learning objectives

In this topic we shall cover:

* a brief history of banking;
* what banks do;
* the broad organisational structure of banks;
* financial market participants;
* types of banks;
* how climate change is affecting financial services.

## 1.1 History of banking

Borrowing and lending money or its equivalent has been part of the economy of every society since ancient history. Priests in Babylon (18th century BCE) lent money to merchants, and the Code of Hammurabi (approximately 1755 BCE), considered by many scholars to be the oldest laws established, included laws governing banking operations in ancient Mesopotamia.

**Table 1.1 Selected entries from the Code of Hammurabi**

| Law | Description |
| --- | --- |
| 48 | If any one owe a debt for a loan, and a storm prostrates the grain, or the harvest fail, or the grain does not grow for lack of water; in that year he need not give his creditor any grain, he washes his debt-tablet in water and pays no rent for this year. |
| 49 | If any one take money from a merchant, and give the merchant a field tillable for corn or sesame and order him to plant corn or sesame in the field, and to harvest the crop; if the cultivator plant corn or sesame in the field, at the harvest the corn or sesame that is in the field shall belong to the owner of the field and he shall pay corn as rent, for the money he received from the merchant, and the livelihood of the cultivator shall he give to the merchant. |
| 50 | If he give a cultivated corn-field or a cultivated sesame-field, the corn or sesame in the field shall belong to the owner of the field, and he shall return the money to the merchant as rent. |
| 51 | If he have no money to repay, then he shall pay in corn or sesame in place of the money as rent for what he received from the merchant, according to the royal tariff. |
| 52 | If the cultivator do not plant corn or sesame in the field, the debtor’s contract is not weakened. |
| 119 | If any one fail to meet a claim for debt, and he sell the maid servant who has borne him children, for money, the money which the merchant has paid shall be repaid to him by the owner of the slave and she shall be freed. |
| 121 | If any one store corn in another man’s house he shall pay him storage at the rate of one gur for every five ka of corn per year. |

(King, 2004)

**Example: Hammurabi**

A farmer in ancient Mesopotamia has taken a loan to grow grain. The farmer agrees to give 20kg of grain to the creditor, ie lender, after harvest. The farmer’s expected harvest is 100kg.

Heavy rains early in the growing season damage the farmer’s crop. At harvest time the farmer manages to harvest only 20kg of grain.

Would the lender have a right to any of the harvest under the Code of Hammurabi?

Yes

No

**IN BRIEF: Barter and money**

In early history people used to barter with any goods they had or produced, such as exchanging two eggs for half a litre of milk. This had its limitations, for example when the other person already had enough eggs, or when someone only had an asset to exchange that was of significantly higher value and not divisible, such as a cow. In the latter case, buying small items would be practically impossible.

To overcome these limitations, certain commodities considered valuable by everyone, such as gold, silver, grain and shells, were used to pay for goods and services. These were eventually replaced by coins made from gold, silver and bronze whose value was established on the basis of their weight. Paper money is a relatively new concept that started as an ‘I owe you’ that could be exchanged for coins in a different city. The creation of money required a trusted intermediary, typically a bank.

### 1.1.1 Finance as a specialism

As currency developed, finance became a more specialised profession. In ancient Rome money changers would conduct their business from long benches (*banco*) in enclosed courtyards, exchanging coins from different locations into the currency of the city. Ancient Greeks started lending and investing as well as taking deposits, exchanging currency and validating coins. In addition, they developed trade finance in the form of letters of credit that could be issued in one city and honoured in another, reducing the need to travel with coins or equivalent forms of payment such as grain and precious metals. Credit-based banking spread throughout the empire.

Although banking in Western Europe declined with the fall of the Roman Empire, it gained traction again with the start of the Crusades and the expansion of European trade and commerce. The Crusades (11th to 13th century) were often financed by mortgaging land and business. Foreign exchange contracts were developed to meet the need for payments in foreign currency due to trade.

**Reflect**

Who is responsible for the issuance of coins and banknotes in your country?

Italian merchants in the 14th to 17th century invested their surplus funds in other ventures, including the financing of individual and government consumption. Those who were successful were approached by others to invest on their behalf, leading to the development of merchant banking. The legalisation of interest in Florence in 1403 permitted the Florentine bankers to offer loans and deposits on an interest basis across all their branches in Europe.

Major financial centres across the world developed in tandem with trade. In the 16th century, London was the main centre of trade and became a major financial centre. In the early part of the 17th century, Amsterdam overtook London as the main centre for global trade. During the Industrial Revolution, the primary centres for finance shifted to the United States of America (New York) and the United Kingdom (London). They were later joined by Hong Kong, Tokyo and Singapore. For a long time, Lebanon was the main financial hub in the Middle East, until 1982 when banks moved to Bahrain and subsequently to Dubai.

**First economic bubble**

The first recorded economic bubble, Tulip Mania, developed in Holland in the early 17th century. Tulips had become so popular that in 1623 a single bulb would be traded for almost 7 times the average annual income. By 1636, prices had risen even further and the bubble eventually burst in 1637 when supply by far outstripped demand.

## 1.2 What is a bank?

A bank is a financial services provider that uses money deposited by customers for safekeeping and investment. It pays out the deposited funds when required, makes loans at interest and exchanges currency.

Traditionally, the role of banks is to act as an intermediary between depositors and borrowers, keeping customers’ money for safekeeping. Deposits are typically short term and can either be paid back on demand or after a notice period. As such, banks manage liabilities – ie debts – and in the process lend out money that creates bank assets. This process creates liquidity in the market and allows for economic development by directing the flow of funds to where it can be used most effectively.

**Liquidity**

Availability of assets (eg cash) that can quickly be made available to meet an institution’s liabilities, without affecting the market price of those assets.

As peer-to-peer (P2P) lending initiatives show, it is possible for borrowers and lenders to transact directly with each other without a bank. However, there are reasons why using a bank is beneficial:

* **Cost**: the costs related to searching and vetting the other party, drawing up legal contracts, and enforcement are high, but banks can reduce them on the basis of economies of scale.
* **Diversification**: banks pool borrowers and can achieve diversification, which reduces their risk of non-repayment.
* **Mismatch in liquidity preferences**: loans are generally issued for a long term with repayment profiles to match business expectations, whereas deposits are generally short term, repayable on demand or with a short notice. This gives rise to one of the key risks in banking: liquidity risk. As covered in a later topic, this is the risk that depositors withdraw more funds than the bank receives in payback of loans.

The banks’ intermediation function forms the basis for another significant function in the economy: provision of national and international payment services for the exchange of goods and services. Banks use payment systems to provide these services to customers.

Modern banks still undertake the intermediary role and payment services but also provide other services such as:

* investment advice;
* wealth management;
* foreign exchange;
* mergers and acquisitions; and
* brokerage.

### Profit and purpose

Similar to other businesses, banks aim for profitability. They make profits in the following two main ways:

* **interest margin**: charging a higher interest on loans than the interest they pay to depositors;
* **fee income**: charging fees for professional services such as account maintenance, payment services, loan arrangement, brokerage, debt and equity issuance, mergers and acquisitions, investment advisory, etc.

Although some banks provide a variety of products and services to a broad customer base, others focus on a specific market segment, customer group or geography. To find out more about a bank’s focus, the purpose or mission statement typically provides a good starting point.

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| **Example: purpose statements***Lloyds Banking Group*Our purpose is to Help Britain Prosper. We have served Britain through our products and services for more than 320 years, across every community, and millions of households (Lloyds Banking Group, no date).*HSBC*Our purpose – Opening up a world of opportunity – explains why we exist. We’re here to use our unique expertise, capabilities, breadth and perspectives to open up new kinds of opportunity for our customers. We’re bringing together the people, ideas and capital that nurture progress and growth, helping to create a better world – for our customers, our people, our investors, our communities and the planet we all share (HSBC, 2021).**Reflect**What does the difference between these purpose statements tell you? |

## 1.3 Bank organisational structure

Banks typically either specialise in a narrow range of products and services or offer a wide range of financial services.

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| **Example: bank types***Morgan Stanley*Morgan Stanley is a multinational investment bank headquartered in New York. Its main business is in the areas of investment banking, capital markets and investment management. *Citigroup*Citigroup is an investment bank and financial services corporation headquartered in New York. Its business spans all types of financial services including retail, wealth management and investment banking. *Lloyds Bank*Lloyds Bank is a British retail and commercial bank with branches across England and Wales. **FACTFIND**Look up these banks and identify the similarities and differences in their product and service offerings. |

Similar to any organisation, banks structure their business to enable them to offer their services efficiently and profitably.

* The day-to-day operations of a bank are overseen by a chief executive officer (CEO), whose executive committee (ExCo) usually consists of a chief financial officer (CFO), chief risk officer (CRO) and other directors.
* The ExCo reports to the board of directors, who represent the interest of shareholders. The board of directors determines the bank’s strategy and risk appetite, and provides oversight and control. It is responsible for appointing the executives.

### 1.3.1 Bank functions

There are a number of functions that every bank has, such as:

* risk management;
* compliance;
* audit;
* finance;
* operations;
* information technology (IT);
* human resources (HR).

In addition, there are functions that differ depending on the services offered, such as tellers in retail banks and traders in investment banks. The structure of a bank depends on whether it is a global diverse bank or a local bank with a narrow service offering. However, three broad functional areas can be identified: front, middle and back office.

* **Front office**: the client-facing, revenue-generating part of the bank. It includes the traders on the trading floor, sales staff, advisers, fund managers and also tellers at the counter. The key test to distinguish front-office staff from others is that front-office roles directly contribute to generating revenue.
* **Middle office**: provides support to the front office, situated between the front and back office, and is not revenue producing. Its role is to ensure transactions are complete, track profits and losses, manage risk, and ensure compliance documentation such as ‘know your customer’ has been completed.
* **Back office**: ensures the smooth processing of transactions, settlement, reconciliation and reporting. It maintains relationships and interacts with clearing houses and exchanges.

**KEY TERMS**

**Know your customer**

Process by which banks obtain information about the identity and address of customers when opening accounts and for the duration of the relationship to ensure that services are not misused.

**Reconciliation**

Accounting process that checks figures are correct by comparing sets of financial records.

**Settlement**

The payment of an outstanding account, invoice, charge, etc.

The distinction between front, middle and back office is sometimes blurred, and some banks may only identify front- and back-office functions.

## 1.4 Financial market participants

Banks do not operate in a vacuum but are part of the larger financial markets infrastructure, which includes other types of financial institution, such as insurance providers, asset managers, clearing and payment services providers, and non-bank financial institutions, as well as regulators and self-regulatory organisations.

### 1.4.1 Regulators

Trust is the cornerstone of effective financial markets. This is generally achieved by a combination of laws, regulations and rules of conduct.

* **Law**: a system of rules regulating the actions of the members of society and enforced by imposition of penalties.
* **Regulation**: a rule or directive made and maintained by an authority.
* **Conduct**: the manner in which an organisation or activity is managed or directed.

Laws can take the form of legislation, custom and policies, and are recognised and enforced by judicial decisions. Breaking a law typically results in a reprimand, penalty and/or prison sentence. Financial laws provide the legal framework for the financial sector. In the UK, for example, a key financial law is the Financial Services and Markets Act 2000.

Due to the nature of their services and to ensure stability of the financial system, banks must be licensed and supervised to be able to accept deposits, make loans and offer other financial services. Banks are typically regulated by national governments, central banks and/or a financial services authority (ie a regulator).

Financial regulations form the framework guiding practical implementation of financial laws. They are typically developed and maintained by financial regulators, such as central banks or financial supervisory authorities. Regulations are important to protect consumers from financial fraud, to prevent excessive risk taking and to promote stability of the financial system. In the UK, for example, financial market institutions are regulated and supervised by the Prudential Regulation Authority (PRA).

**Central bank**

An organisation that acts as a banker to the government, supervises the economy and regulates the supply of money.

Conduct rules can be issued by official authorities, such as the Financial Conduct Authority (FCA) in the UK, or be adhered to as part of self-regulation, such as the Standards of Lending Practice that UK lenders can voluntarily sign up to.

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| **Reflect**Which key financial laws, regulations and conduct rules apply in your country to your institution? |

### 1.4.2 Standard setters

Standards establish and harmonise rules and regulations, creating consistency to improve efficiency and stability while reducing risk. Many organisations set different types of standards globally.

Among the most important global standard setters are as follows.

* **Bank for International Settlements** **(BIS)**: supports central banks’ pursuit of monetary and financial stability through international co-operation, and acts as a bank for central banks. The BIS is based in Basel, Switzerland, and is the originator of the capital adequacy rules commonly known as the Basel Accords (through the Basel Committee on Banking Supervision).
* **Financial Action Task Force (FATF)**: an intergovernmental body setting international standards that aim to prevent money laundering and terrorist financing.
* **International Accounting Standards Board (IASB)**: the independent, private-sector body that develops, approves and promotes the use of International Financial Reporting Standards.
* **International Organization of Securities Commissions (IOSCO)**: the international body and global standard setter for the securities sector. IOSCO develops, implements and promotes adherence to internationally recognised standards for securities regulation.

The standards set by these institutions are typically incorporated, in part or in full, in the financial laws and regulations of most countries.

**Money laundering**

Processing the proceeds of criminal activity to make the funds’ source appear legitimate.

### 1.4.3 Other supporting institutions

Many institutions support the efficient working of the market by increasing transparency and reducing risk. These include the following.

* **Clearing houses**: financial institutions providing clearing and settlement between banks for cash, derivatives, equities and other financial instruments. They reduce settlement risk by netting transactions between financial institutions and paying/receiving the balance at the end of the day only. Examples of international clearing houses are LCH, Shanghai Clearing House and the Continuous Net Settlement System. National clearing systems provide the same services, but their members are all based in the same jurisdiction.
* **Exchanges:** marketplaces for the trading of securities, commodities, derivatives and other financial instruments in a regulated virtual and/or physical space. Exchanges ensure fair and orderly trading, and efficient dissemination of prices. Examples include the London Stock Exchange (LSE), New York Stock Exchange (NYSE), London Metal Exchange (LME), Chicago Board of Trade (CBOT) and Hong Kong Stock Exchange. Exchanges are highly regulated and are dominated by electronic trading**.**
* **Trade repositories**: centrally collect and maintain records of derivatives and securities financing transactions.
* **Society for Worldwide Interbank Financial Telecommunication (SWIFT)**: a global, member-owned co-operative providing financial messaging services to securely move value. SWIFT is a global system for interbank transactions.

**KEY TERMS**

**Clearing**

All activities from the time a commitment is made for a transaction until it is actually paid. A clearing cycle is the time it takes to process a payment or security through a given clearing system.

**Derivatives**

Financial instruments whose value is derived by referencing another underlying asset or liability, that settle at a future point in time, and that generally have little or no value upfront.

**Net settlement**

The process to settle the positions between participants typically applied by clearing houses. The positions are netted, ie offset, between participants and each participant pays the net amount that it owes to each other participant prior to the close of the clearing system.

**Securities**

Financial assets that can be traded. They can be divided into two broad classes: those that represent ownership (equities) and those that represent debt (such as government or corporate bonds).

**Settlement risk**

Occurs in relation to payments when an opportunity exists for one party to fail to pay another party. This could happen when making a payment through a net settlement clearing system or when delivering foreign exchange in a different time zone.

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| **Activity: clearing houses**

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| ***Paying bank*** | ***Receiving bank*** | ***Amount*** |
| AAA | BBB | $2,000,012 |
| AAA | CCC | $1,003,465 |
| AAA | BBB | $257,931 |
| BBB | AAA | $3,408,628 |
| BBB | CCC | $734,589 |
| CCC | BBB | $1,945,290 |

Banks AAA, BBB, and CCC have conducted the transactions in the table using a clearing house. At the end of each day, only the net amount will be settled. What is the amount each of them will pay or receive based on the transactions showing?Type the correct numbers:Bank AAA – net receiving:Bank BBB – net receiving:Bank CCC – net paying: |

**KEY TERMS**

**Commodities**

Natural resources or goods that are similar to other examples of their type and can be traded.

**Financial instruments**

Assets or packages of capital that can be traded.

## 1.5 Types of banks

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Banks are commonly defined based on the type of service they provide or the customers they serve.

### Retail banks

Retail banks provide financial services to individuals to meet day-to-day banking and financial needs. Products offered are highly standardised and include:

* current accounts;
* savings accounts;
* credit cards;
* personal loans;
* mortgages; and
* currency exchange.

The target customer base of a retail bank comprises individuals at any stage of their life so they can receive funds, make payments, save money and take out loans. Generally speaking, retail banks directly target customers at most income levels up to income and wealth commonly defined as mass affluent. They may, however, also service high-net-worth individuals with current accounts and credit cards, either directly or indirectly via an agreement with a private bank. Account relationships can be segmented by level of income or level of deposit.

**KEY TERMS**

**Mass affluent customers**

People with above-average incomes and above-average liquid assets.

**High-net-worth individuals**

Individuals with a relatively high amount of liquid assets – amounts vary by country.

**Segmentation**

Categorising customer types, for example to serve the needs of particular groups and define the form of interaction between the bank and its various customers.

Historically, retail banks have operated out of bank branches in easily accessible locations. In many markets, however, banks are reducing their branch networks in favour of providing more extensive online and telephone banking.

### Private banks

Private banks provide a full range of financial products and services to wealthy individuals and families. Most private banks require a minimum level of wealth or investable assets, such as between US$500,000 and $1m of investable assets, although entry criteria vary by institution.

The services offered are more personal than in retail banking, with a high level of discretion. Private banking services include tailored investment advisory services, such as portfolio management and asset allocation across a wide range of opportunities including property, securities, funds and collectibles. Private banks may:

* offer their own current accounts and credit cards; or
* have an arrangement in place with a retail bank to offer these services for their customers.

**KEY TERMS**

**Asset allocation**

Balancing risk and reward based on an investor’s circumstances (eg goals and attitude to risk) by adjusting the percentage of each asset in an investment portfolio.

**Portfolio management**

Building and overseeing a selection of investments over time to meet defined financial goals.

### Corporate banks

The target client base of corporate banks ranges from relatively small companies to large multinationals. Corporate banks typically segment clients by size, offering appropriate products and services accordingly. Corporate banks typically recognise three main segments:

* **Small and** **medium-sized** corporates with fewer than 250 employees and an annual turnover up to US$50m. This segment is often referred to as business banking.
* **Mid-large** corporates with a turnover between $50m and $500m. This segment is often referred to as commercial banking.
* **Large** corporates with an annual turnover exceeding $500m. This segment is often known as wholesale banking.

Products and services cover credit management, asset management, cash management and underwriting services, including working capital financing, overdrafts and revolving facilities, leasing, hedging, foreign exchange and payment facilitation.

The larger the company, the more sophisticated and tailored the products and services offered.

### Investment banks

Investment banks work mainly with larger corporate clients, governments and other institutions to create capital. They are involved with bond issuance, structured and syndicated financing, initial public offerings (IPOs) and subsequent fundraising, mergers and acquisitions, large project finance and brokerage. In addition to issuing debt and equity, investment banks often also act as underwriters. Transactions are typically complex and highly tailored to the client and their requirement; this may include estimating the price at which debt or equity can be brought to market.

**KEY TERMS**

**Bond**

A debt security whereby the bond issuer owes the bond holder a debt and may pay interest and/or pay the original amount at a later date.

**Equity capital**

Funds invested in a business in exchange for stock/shares. Private equity is direct and so not listed on a public exchange, whereas public equity is listed on an exchange.

**Overdraft**

A line of credit provided to a customer by a bank.

**Revolving credit**

Form of borrowing without a specific term; the credit is ‘revolving’ when a customer pays off an amount but can withdraw more to fund new purchases up to the agreed limit.

**Syndicated finance**

Financing offered by a group of lenders, ie a syndicate, for a single borrower.

**Working capital**

The capital a business uses in its day-to-day operations, or the measurement of the liquid assets that a business can use for that purpose.

### Universal banks

Universal banks are financial services conglomerates combining retail, corporate and investment banking services under one roof, and take advantage of synergies between them, allowing the bank to broadly cross-sell its services to capture a greater share of revenue from each customer. They often also offer services such as asset management and wealth management, and have a global reach. Universal banks benefit from economies of scale in information technology and access to capital to serve their customers.

### Community banks

Community banks primarily serve businesses and individuals in a limited geographical area. They are relatively small institutions with an emphasis on personal relationships. Due to their size, they tend to have a small product range and few branches. Their focus is on providing loans to local businesses and individuals closely working with them to meet their requirements.

### Ethical banks

Ethical banks provide financial services similarly to other banks, but they abide by a set of environmental, social and governance (ESG) criteria.

* **Environmental** or green criteria identify how the organisation deals with environmental issues such as sustainability and climate change.
* **Social** criteria identify how the organisation manages its relationships with employees, suppliers, customers, governments and the society in which it operates.
* **Governance** criteria identify how the organisation is managed, its internal controls, shareholder rights and corporate culture.

Each institution has its own definition of what these criteria mean to the organisation, for example reflected in the industries it avoids for investment purposes.

### Multilateral development banks (MDBs)

MDBs are international financial institutions supported by two or more countries to encourage economic development in poorer countries. MDBs have member nations of both developed and developing countries. They provide loans and grants to member countries to fund projects aimed at improving social and economic development.

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| **FACTFIND**Look up the following banks and identify which types of institution they are:* World Bank;
* J.P. Morgan;
* ING Bank;
* Lloyds Bank;
* Citigroup;
* Valley National Bank.
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### Fund management

Fund or asset management refers to the management of pools of money collected from a range of investors to invest in securities such as stocks, bonds, money market instruments and other assets. Fund management companies typically manage a range of funds with different investment mandates and risk and return characteristics. Clients buy units in a fund that meets their requirements; they share in the profits of the fund.

## 1.6 Climate change and financial services

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Financial services are not static; they adapt to new technologies and the requirements of society. One of the main current social and economic issues is climate change. With its impact on society, the economy and the financial system, climate change must be considered as part of banks’ strategy. Examples of organisational changes include:

* reducing carbon emissions in bank buildings;
* enhancing energy efficiency;
* reducing the amount of paper used;
* reducing business travel.

In addition, banks are actively seeking investment opportunities away from fossil fuels and towards sustainable and renewable energy. Due to the role of banks in society, they are in a position to request sustainability and climate change action as part of their financing.

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| **Example: Bank of England and climate change**“The risks from the physical effects of climate change and the transition to a net-zero economy are relevant to our mission to maintain monetary and financial stability. In particular, these risks pose a threat to the stability of the wider financial system, and the safety and soundness of firms we regulate. As such, climate change is a strategic priority for us.“Our objective is to: **play a leading role, through our policies and operations, in ensuring the financial system, the macro-economy, and the Bank of England are resilient to the risks from climate change and supportive of the transition to a net-zero economy.**“We aim to build this resilience and support the transition by ensuring that climate-related financial risks are proactively managed and pre-emptively mitigated through our policy functions (eg our supervision of banks and insurers) and the management of our own operations (eg the carbon footprint of our buildings and corporate bond holdings).”(Bank of England, 2021) |

Climate change and sustainability are not new areas of financial services. However, they have moved from being the focus of small, highly specialised institutions to become mainstream.

## Test your knowledge

1. In the 16th century, which city was the main centre of trade and became a major financial centre?
	1. New York.
	2. Amsterdam.
	3. London.
2. The client-facing, revenue-generating part of a bank is generally known as the:
	1. front office.
	2. middle office.
	3. back office.
3. Which supporting institutions reduce settlement risk by netting transactions between financial institutions and paying/receiving the balance at the end of the day only?
	1. Exchanges.
	2. Clearing houses.
	3. Trade repositories.
4. The target client base of which bank type ranges from relatively small companies to large multinationals?
	1. Corporate banks.
	2. Investment banks.
	3. Private banks.
5. In an ethical bank, which criteria identify how the organisation is managed, its internal controls, shareholder rights and corporate culture?
	1. Environmental.
	2. Social.
	3. Governance.

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