

London School of Economics & Political Science

## Conduct Costs Project (“CCP”)

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### **Response to**

### **The Banking Standards Review (“BSR”) Consultation Paper, February 2014**

We respectfully offer the following response to the specific questions posed in the Consultation Paper. We invite the BSR to consider this response in conjunction with the CCP’s “Initial Response” (attached), provided to the BSR and published on our project site: <http://blogs.lse.ac.uk/conductcosts/>.

#### Objective

Q.1 Do you agree with the objective to establish a new independent organisation with the aim of defining and raising standards of conduct and competence in banking?

**Yes.**

#### Collective Action

Q.2 Do you agree that there is a case for a collective approach calling for the participation of all banks doing business in the UK?

**It is essential.**

#### Role and Scope of the New Organisation

Q.3 Do you agree with the proposed role of the new organisation to set standards of behaviour and competence for banks and building societies, and to define metrics against which they could benchmark?

**Yes. The importance of any new organisation (“the Organisation”) achieving cohesion and co-operation with policy-makers, regulators, industry associations, banks, other professional bodies and civil society groups cannot be overstated.**

**This requires strategically embedding the new organisation into the fabric of the industry.**

It is essential to the long-term success of the Organisation that it develops the operational means by which to achieve its goals. This includes establishing close relationships with stakeholders. For example, and while subject to our comments in response to question 8 (and at paragraph 2 of our Initial Response), we suggest that, with regard to the regulator(s), this should take the form of a Memorandum of Understanding covering matters such as mutual assistance and exchange of information. Other examples would include the nature and extent of the binding undertakings of banks through their membership commitments. Again subject to our response to question 8 below, the Organisation might explore the benefits of obtaining “FCA Confirmation” of ‘industry guidance’ published by the Organisation.

It will also be beneficial (not least in terms of assessing conduct and benchmarking) to consider the means by which the Organisation can avoid the potential disclosure gap between the regulator and the Organisation in matters of ‘conduct’ concern that might arise by virtue of s.348 FSMA 2000. The banks, regulators and the Organisation alike should be permitted to disclose conduct costs and other conduct performance metrics that are collated and/or otherwise received without falling foul of any ‘selective’ or improper disclosure laws. In short, such information should be the subject of specific [public interest] disclosure obligations (see Paragraph 5 of our Initial Response) and be deemed non-confidential. This may, of course, require legislation or new regulations but it is important that the general bank oversight infrastructure cuts back at least some of the omnipresent “confidentiality” requirements to the extent they continue to justify unnecessary secrecy and behaviour on “transparency” that falls far short of the fine words one hears on the subject.

Governance over the strength and efficacy of the operational mechanics (such as those described above) is important. To this end, we suggest that the organisation gives consideration to the establishment of a ‘Liaison Committees’, such as a “Regulatory Liaison Committee” (“RLC”). The RLC for example would be charged with overseeing the MoU and maintaining a synergy between the Organisation's objectives and the regulatory system.

Q.4 Do you agree with the proposed scope of the new organisation to include all British banks and building societies, and foreign banks doing business in the UK?

**Yes, although the Organisation ought to adopt, as part of its objectives, the ‘professionalisation’ of the banking industry as a whole. The activities of banks are not confined to domestic deposit taking services. They are multifaceted and global. Standards applicable to a systemically important financial institution should not be limited to their UK operations. Where the bank does business in the UK, the Organisation should expect ‘the standards’ to be applied at a group level. The Organisation should set a realistic, medium to long-term objective to promote globally recognised minimum standards of conduct and competence. In the absence of similar, counterparty organisations in the U.S, Europe and Asia, the Organisation might start with informal dialogue with regulators (including MoUs), banks and other policy and interest groups.**

## Credibility

Q.5 Do these proposals go far enough to ensure the body has credibility?

**Yes. The Organisation may also give consideration to the benefits of having (non-financial) sanctioning/disciplinary powers (based on the contractual effect of its rules). If specific powers of enforcement and accountability are considered inappropriate, perhaps the Organisation could explore forms of indirect deterrence such as a standing commitment by the Organisation (confirmed within MoU and acknowledged within the Organisation’s by-laws and terms of membership) that it will disclose non-conformity to the regulator(s) and that any and all information held by the Organisation is free of any proprietary or confidentiality restrictions.**

*Please also refer to paragraph 2 of our Initial Response.*

## Membership

- Q.6 Do you agree that the new body should initially work with banks and building societies rather than individuals? What are the pros and cons of aspiring to build individual membership over time?

**Individual membership will give access to a professional organisation to "real" people, those who have to implement, and make decisions and judgements. For this reason, it is desirable to have individuals as members as soon as possible.**

*Please also refer to paragraph 6 of our Initial Response.*

## Ethics

- Q.7 In the section titled 'Ethics', a case is made for a more pro-active approach to managing ethical issues. Do you agree with this, and if so how should it be done?

**Yes. We view ethics as being a core function within the decision-making equation. Ethical issues are not merely for discussion at lofty, philosophical levels. They can arise with surprising frequency in the course of an ordinary working day. Managing ethical issues should sit alongside managing risk, specifically legal and conduct risk. Indeed, the CCP has initiated a Conduct Risk Insights ("CRI") Programme that will include a series of consultative workshops aimed at leveraging banks' collective experience (and challenges) in conduct risk management. The CRI Programme specifically raises 'ethical' questions as part of the design and implementation of effective conduct risk management. The exceptional value in the CRI Programme, of course, comes from the comparative insights that CCP will then feedback to individual banks following the consultative workshops and on the strength of continued dialogue.**

## Professional Standards: *Behaviour*

Q.8 Do you agree with the proposal to build on best practice as set out in the regulators' guiding principles?

**We refer to what we believe ought to be the approach at paragraph 2 of our Initial Response. That is, banks should not simply “reverse engineer” what good conduct looks like. The new, more interventionist regulatory approach, focusing on forward-looking judgements and on appropriate ‘outcomes’, coupled with the product of a treating customers fairly mantra, ought to align expectation and standards in the minds of banks, customers and regulators - and this is a positive development. However, in our view the issue is with the use of the word ‘appropriate’. It is becoming increasingly routine to scope conduct risk by reference to the regulator’s outlook and priorities and what it considers ‘appropriate’ behaviour and outcomes. This, we think, largely misses the point and can in fact lead to an unconstructive preoccupation with regulatory expectation. It promotes a focus on pre-empting the next thematic review, product intervention or enforcement action. It results in management information and risk management output fit for ‘compliance-purpose’, rather than fit for ‘client-purpose’: it can lead to ‘regulatory neurosis’.**

**We see the Organisation’s role in promoting best practice that has at its core an appropriate balance of incentives for good behaviour (distinct from deterrence of bad behaviour, which ought to remain within the concern of the regulators), but that gives equal attention to the cultivation of ethical practice in banking. Banks should ‘want’ to achieve the best outcome for clients, not merely feel that they are ‘compelled’ (or ‘incentivised’) to do so – for fear of the ramifications. Furthermore, banks should ‘want’ to avoid disproportionate damage to counterparties relative to its benefit in a transaction. It ought not be right that when faced with asymmetric information, an imbalance of bargaining power, or simply because the other party is objectively experienced and well resourced, that a bank can simply rely on the principle of ‘caveat emptor’ to prevail in a transaction at any cost. Although we would resist imposing general good faith obligations as a matter of contract law, some generally accepted standard of fair, honourable conduct has now become essential to the protection and**

enhancement of market integrity and productive competition. And this starts with appropriate behaviour. The Organisation can play an important role in promoting the ‘motivation’ for good behaviour through professional standards. But first, the banks must ask the question - and do so from the right perspective.

Q.9 What would be the best way of assessing the implementation of a bank’s code of conduct?

**By using concrete indicators like conduct costs.**

**By holding (we would suggest) the Senior Independent Director responsible to the board and the Organisation for overseeing:**

- **The production of a code of conduct that is demonstrably tailored to the bank**
- **The supervision and enforcement of the Code;**
- **Regular training and awareness assessments, at all levels, on not only the content or ‘form’ of the Code but its spirit or ‘substance’. Including oversight of the appropriateness of ‘grey area’ case studies used within training and competence assessments.**
- **The bank’s responses to conduct costs;**
- **An effective whistleblower mechanism and related counselling procedure for employees at all levels who feel that something is amiss.**

**It is acknowledged that this question carries all the usual problems of "proving a negative" (i.e demonstrating that nothing needs fixing).**

### Professional Standards: *Competence*

Q.10 Do you agree with the agenda outlined in the ‘standards of competence’ section?

**Yes.**

*Please also refer to paragraph 3 of our Initial Response.*

Q.11 Would you support the proposed relationship with the existing professional bodies?

**Yes, but we stress the need for a genuinely fresh look at the effectiveness of traditional training methods.**

*Please also refer to paragraph 3 of our Initial Response.*

- Q.12 Is the proposal for assessing in-house training sensible and practical? Could the new organisation play a helpful role in the certification process?

**Yes and Yes.**

*Please refer to paragraph 3 of our Initial Response.*

## Benchmarking

- Q.13 Do you think a benchmarking exercise, to help banks identify areas for improvement, would be of value?

**Yes.**

*Please refer to paragraph 4 of our Initial Response.*

- Q.14 Are the groups of metrics outlined in the section titled 'Benchmarking' the correct ones? Would you propose others?

**Yes, especially conduct costs (because of their "concrete" nature).**

- Q.15 Would it make sense for banks to adopt a set of standard questions to add to their existing staff surveys?

**We do accept that there is some merit in conducting surveys of employees where this facilitates inter-bank comparison and identification of conduct trends/issues. However, we have reservations regarding the usefulness of surveys compared to other indicators of 'actual' experience and certainly about standardisation of questions. The concern is that standardisation, if not properly implemented, can lead to box-ticking and semi-automaticity. Interviewing staff members may provide more qualitative results but employees would need to feel able to give honest and open answers, without fear of reprisal. Individual, but not departmental etc.**

**anonymity is fundamental to promoting candour in this respect.**

*Please also refer to paragraph 4 of our Initial Response.*

- Q.16 Is self-reporting appropriate? Might other methods deliver better results?

**Reporting of ‘conduct costs’ and other conduct benchmarks should be mandatory and verified by auditors. We would be concerned to avoid a similar practice to that adopted by banks in regard to their Sustainability (or CSR) Reports, where only so-called ‘limited assurance’ by auditors is obtained. It is very limited indeed, in terms of its basis and its scope. Moreover, it provides no substantive check on the conduct disclosure practices of the banks, despite specific indicators emphasising the materiality of these indicators.**

**We are therefore of the view that the banks should be under an obligation to record instances of [mis]conduct and to report these in a clear and transparent way. The Organisation should work to hold the banks to account in this regard.**

*We expand on the disclosure and reporting issue within paragraph 5 of our Initial Response.*

## Discipline

- Q.17 Are there non-bureaucratic alternatives to the approach outlined in the section titled ‘discipline’ that might work better? Is there a role for kite-marking?

**We consider that league tables will be more effective than kite marking, which is too "black or white" and simplistic. Kite marking will inevitably derive from a standardised code of conduct – this can be objectively useful where it positively incentivises/motivates banks to behave appropriately and where it forms both the obligation for on-going conduct review and the benchmark against which bank conduct is externally audited. League tables, on the other hand, pitch banks against each other and serve to engender a ‘race to the top’. They also catch the media's attention (and publicity (and banks' fear of the negative kind) is an important tool in making the Organisation effective)**

## Banking as a Profession

Q.18 Do you agree with the proposition that the new body should aim to become, in time, a membership organisation for bankers to join?

**Yes, but we would suggest that the Organisation needs to set out a reasonably clear vision of what "profession" means. For example, the legal profession circa 1975 was quite different to that which we have today. There are many occupations that call themselves a "profession" (not just medicine, accountancy, law) and the traditional professions operate more and more like ordinary businesses. So, we believe that the Organisation needs to spell out some "hallmarks" of profession in the context of banking. We think that mutual discussion of, and agreement on, "what an ethical banker should and should not do" is one such hallmark. This requires cross-industry consensus and a continuous programme of dialogue to achieve and maintain that consensus. One beneficial effect of this is that the industry will have its own strong motivation to discipline those who break the rules (because they are cheating those who, at a financial cost, observe them and because they bring the whole activity into disrepute).**

## Thought Leadership

Q.19 Should the new organisation aspire to a role as a thought leader in banking, sharing best practice and helping to propose solutions to challenges that arise in the future?

**Yes.**

## The Banking Standards Review Consultation Paper, February 2014

### *Initial Response*

#### **1. The status of the "new organisation" (the "organisation")**

- 1.1. We broadly agree with the Consultation Paper's ("the Paper") governance, disclosure and public reporting proposals.
- 1.2. We agree that its independence will be crucial to its credibility. It must not be (or look like) the "same old, same old" dressed in new clothes. This goes to its place in the overall social/political/industry structure and also to the composition of its governing body and relevant committees. It should be fiercely independent, sceptical of tradition and able (and feel encouraged) to ask awkward questions, not just of banks but also of regulators, politicians and others who may influence or be affected by bank conduct and behaviour.
- 1.3. This leads us to the conclusion that the organisation should not report to the FCA, the PRA or any body of politicians (such as a Parliamentary Committee). It has to report to someone, however. We would tentatively suggest it reports to the Governor of the Bank of England. Although the Governor is, of course, part of the regulatory structure, we feel that there is more public confidence in his/her independence and freedom from "regulatory capture" threat and political agendas than is the case with the alternatives.
- 1.4. We do, however, see the importance of the organisation having strong links with regulators. Subject to our comments at 2 below, we suggest that the organisation seek a Memorandum of Understanding with the regulator(s) covering matters such as mutual assistance and exchange of information. The organisation might also benefit from establishing a 'Regulatory Liaison Committee' charged with overseeing the MoU and maintaining a synergy between the organisation's objectives and the regulatory system.
- 1.5. We would like to see some representation from "challenger banks" as well as more established commercial/retail banking in the organisation.

We would be sceptical about the need for many City Establishment figures.

## 2. **The conduct principles being developed by regulators**

- 2.1. The Paper attaches some understandable importance to these (see, for example, the foot of page 13). Whilst any standards adopted by a bank must of course be in conformity with what regulators require, we feel that the organisation should see such regulatory requirements as a minimum and steer away from an approach that relies too heavily on "reverse engineering" what regulators have laid down into a bank's own organisational structure and deeming that to be sufficient.
- 2.2. Banks should be encouraged to start afresh, notionally, with a "tabla rasa" when devising "ethical" rules for how they wish their staff to behave in the light of the experiences they have had. They should then, when they have developed some substance to such rules, check back against what is required by regulation and ensure that no regulatory requirements have been omitted. The difference in approach is important. One approach involves a mindset that poses, as a first question: what are the regulators making us do? The other poses the first question: what do we think is right? The banks' "restore trust agenda" (which should be more about deserving trust than simply regaining it) is not about an ongoing struggle to get the compliance function to work effectively. It is about re-thinking, for each person in the bank, why he/she goes to work every day and what makes him/her proud of a job well done.
- 2.3. It follows from the above that we would encourage banks to surpass the standards of regulators not merely to "meet or surpass" them. We agree that the organisation should benchmark the banks' efforts in this area against good practice. We see the organisation's role in the cross-pollination of ideas that lead to good practice as crucial.

## 3. **Training**

- 3.1. Whilst training in conduct matters is, undeniably, a "good thing", staff should not need to be trained in order to understand the importance of

- honesty - if they do, the bank really does have a problem. Sadly, however, it is want of honesty that seems to have given rise to some of the most prominent scandals of recent times.
- 3.2. Notwithstanding 3.1 above, we do think that all concerned in the industry (including regulators) need to develop a better common understanding (which they should share with the organisation and the public) of where some of the boundaries lie in relation to, for example, "manipulation" and taking advantage of another's ignorance or error (leaving aside consumers, who are a special case). To use a celebrated example of language from a recent scandal, is it ever appropriate to regard a counterparty as a "muppet" and milk him for what you can get? There is a danger that we set up training programmes for the sake of appearance and overlook some of the fundamental right vs. wrong judgement issues, which still require a more substantive debate in the industry – a debate that might include the continued efficacy and modifying the application of parts of COBS in regard to eligible counterparties.
  - 3.3. The extent of the need for training in banks should, one would think, depend on how well the staff of any given bank understand (a) what honesty means and how it affects decisions and behaviour in their work and (b) how decisions should be taken in the inevitable "grey areas". A "programme" of training designed for all banks may, by its nature, be somewhat crude (looking as though it has been devised in a "one size fits all" workshop) and, as a result, not taken very seriously. We do not believe it is being suggested that all banks have the same training programme but we would caution that the idea of assessment of training by the organisation should not lead to this result.
  - 3.4. Training needs to address the potential confusion for staff that can arise when there is a sharp change in values and the bank's judgement on right and wrong behaviour. What was OK yesterday, even encouraged, may not be today. And vice versa. No one criticised generous bonuses in years leading up to the Crisis and much of the now-condemned "excessive" and aggressive behaviour was well known and not regarded

as a sign of serious moral decay or reputationally problematic for banks (or something to which regulators should respond). Now things are different. And the changes in culture that post-Crisis scrutiny of banks will require is not yet a closed list. The implications for conduct are fundamental.

- 3.5. We believe that on-line training should be discouraged (because it is unlikely to be effective) and face-to-face training encouraged.
- 3.6. We would suggest that training initiatives should include off-site "schools" where staff from different banks can compare experiences and seminars and workshops are arranged at which examples of best practice, "lessons learned" etc. can be openly discussed. Confidentiality of a bank's sensitive information needs to be respected but it is a characteristic of a "profession" (if that is what we are trying to set up) that fellow-professionals meet each other and talk about matters of shared professional interest (especially questions of professional ethics) reasonably regularly. (NB These occasions should not be arranged so as to be marketing opportunities for outside advisers).

#### 4. **Benchmarking**

- 4.1. We believe that the organisation should place banks under a good practice obligation to record instances of conduct failure within a database accessible by the Board, Board Committees, Legal, Risk & Compliance and Sustainability & CSR. The organisation should work to promulgate a minimum level of detail (metrics) to be recorded in relation to a particular conduct failure.
- 4.2. Devising a system of regular reporting by banks on matters that relate to their conduct (such as the level of conduct costs experienced) and requiring the reporting to be done in a manner that enables comparisons to be made (even a "league table" to be drawn up) is of key importance.
- 4.3. We would like to suggest the following guiding principles in this area:
  - "Concrete" indicators are always preferable;

- Behaviour counts for more than words;
  - Facts count for more than opinions;
  - Hard evidence of actual experience counts for more than surveys; and
  - "Anecdotal" evidence is unreliable.
- 4.4. It follows from the above that we would not place as much reliance on surveys, interviews, codes of conduct and internal reports (or reports commissioned by bank management) as the Paper appears to be suggesting. As will be apparent, we place rather more emphasis on the "story" told by conduct cost history for each bank and are pleased to see that such costs would be part of the benchmarking exercise.
- 4.5. A definition of conduct costs will be essential. We have proposed one in the LSE Conduct Costs Blog.
- 4.6. We do not understand the reference to "relationships with, and interventions by, the regulators" at the top of p.18 of the Paper. What is this expression intended to cover other than conduct costs?

## 5. Disclosure and Reporting

- 5.1. We suggest that the organisation looks to hold banks to account on the adequacy of their conduct costs reporting.
- 5.2. We would like to see the organisation encourage a much greater degree of transparency, from regulators and banks themselves, about how and why conduct costs are incurred and what measures banks are taking in order to avoid recurrence of the problems that lead to them. It is, in our view, unacceptable for a major UK bank (for example) to announce that it has incurred several hundred million pounds worth of new "legal costs" but "decline to comment" on what they are for. We accept that where a bank makes provision for an as yet unsettled, but nevertheless anticipated, conduct cost, there is a sound commercial necessity for the particulars of that provision to remain confidential. However, as soon as the cost crystallises (the bank settles), the bank should disclose and report on the settlement – irrespective of its balance sheet 'materiality'.

We do not consider the ‘flood gates’ argument to be a sound basis for the opacity in Bank conduct cost disclosure.

- 5.3. In connection with transparency, we would make the technical point that traditional accounting requirements as to materiality as a test for disclosure should be disregarded in relation to the disclosure requirements to be imposed by the organisation. Because the major banks are so big, many important costs (even, in theory, a record FCA fine) tend to be, or could be, aggregated into larger, more opaque disclosures than is in the public interest – because they are not considered ‘material’ enough to the balance sheet to warrant specific disclosure. All instances of misconduct should be recorded and reported to the organisation and within the banks’ public disclosures.
- 5.4. We would suggest that the organisation should review the adequacy of bank reporting of conduct-related matters within their sustainability reports. We have observed that despite purportedly reporting pursuant to the Global Reporting Initiative Index, banks, in relation to the ‘core conduct indicators’ of EN28, SO8 and PR9, either i) do not report or ii) simply cross-refer to the annual report and accounts. Our various interviews with banks have not produced any credible defence of the excessive secrecy in this area and the lack of frankness on this topic in a document such as a Sustainability Report seems to us to work against the very image (of being a responsible corporate citizen) that banks are trying to project in that document.
- 5.5. We would suggest a code of practice for conduct costs disclosure and reporting, at least similar to that previously provided to the organisation.
- 5.6. Our experience suggests that much of the information on conduct costs is not currently easily found in the public domain and that banks will have to be required, in clear terms, to produce that information (which they are currently reluctant to do) if a comprehensive picture is to be produced for any one bank or the industry as a whole.

## 6. **Membership of the organisation**

- 6.1. We broadly agree with the approach suggested in the Paper, i.e.

membership at bank level, at least initially. We do think, however, that a consequence of this is that the organisation must take positive steps to be accessible to the many communities that make up large banks and not channel all communication through "senior management". These communities could include (a) those who work on the sustainability and CSR sections of the bank (b) the younger employees (c) those who work in retail branches (d) those who have recently joined the bank and (d) those who work overseas.

## 7. **Other**

- 7.1. We would like to know what is proposed as a sanction for banks who do not meet the expectations of the organisation. Could this tie in, in some manner, with the rules regime of the regulators? Or does that make the organisation little more than a "meta-regulator"?
- 7.2. Consideration should be given to the organisation being given immunity from suit.